A cut to company tax will boost production but reduce incomes

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A cut in the company tax rate would boost production but reduce Australian incomes. Since national income, not production, is a measure of material living standards, cutting the company tax rate is not in the national interest. These are the conclusions of modelling conducted for today's Melbourne Economic Forum by Victoria University's Centre of Policy Studies.

Our modelling results for production – as measured by Gross Domestic Product (GDP) – are similar to those of the federal Treasury. But as an indicator of national benefit, the estimated effect on GDP is not suitable. The right indicator is the impact on national income.

Australia's company tax rate has been 30 per cent since the early 2000s. The 2010 Henry review recommended that it be gradually reduced to 25 per cent, with the timing subject to economic and fiscal circumstances. Coupled with the company tax rate cut, the Henry review further recommended improved arrangements for charging for the use of non-renewable resources. In the years since the Henry review, the Minerals Resource Rent Tax has come and gone, but the proposed cut to company tax remains a live issue. The Business Council of Australia continues to advocate it, based on arguments that Australia's rate of company tax is high relative to that of similar countries, and that foreign investment would respond positively to a cut in company tax.

In our modelling, the cut in company tax stimulates GDP by increasing the post-tax return to investment, which leads to a long-term increase in the capital stock. With more capital stock in place, there is an increase in both output and, in the long run, real wages. So far, a cut in the company tax looks like a winner. We have three concerns. The first is that foregone taxation revenue will add to government deficits, creating pressure for spending to be cut or other taxes to be raised. The second is that the additional capital stock should not be treated as manna from heaven. Unless domestic consumption is curtailed, the cost of creating it will add to current account deficits. This leads to our final concern, which is our finding that despite the expected increase in GDP, real national income falls under a cut to company tax.

A large proportion of the $70 billion or so of company tax revenue is collected from domestic investors, and offset against personal income tax through Australia's imputation system. Their investment income is effectively taxed at the marginal rate of personal tax, and the rate of company tax does not directly affect their incentive to invest. Nor does it change the bottom line for government, since any reduction in company tax will be offset by an increase in personal tax.

If the company tax rate is cut, it will be an increase in the post-tax rate of return to non-resident investors that will underpin the increase in foreign investment that will boost GDP. The tax office estimates that $12 billion in franking credits were issued to non-resident investors in 2013-14. Unlike franking credits issued to domestic investors, this is revenue to the government that is not offset against anything else. The government budget will suffer a loss in tax revenue on the large amount of foreign-owned capital that was willingly installed by non-resident investors when the rate of company tax was 30 per cent. Furthermore, post-tax income generated by the new capital will accrue to its non-resident owners, adding to GDP but not to domestic income.

Proponents of a company tax cut argue that in the long run, the benefit of a cut to company tax will flow to workers through an increase in the real wage. Our modelling concurs with this finding. However, while the Henry review's recommendation on company tax went hand-in-hand with a mechanism to replace lost revenue – the Minerals Resource Rent Tax – the government may now decide to cover lost revenue with an increase in income tax through, for example, bracket creep. This means that not all of the wage increase will necessarily find its way to workers.

We also note that an increase in wages is not good for everybody. Domestic investors, including shareholders in listed companies as well as many small and medium business owners, will face higher wage costs and consequently lower returns to investment, while receiving no direct gain from the cut to company tax.

Overall we conclude that while a cut to company tax will boost domestic production, it will lead to a fall in real incomes in the range of $800 to $2000 per person in present value terms.

Rather than using company tax cuts to bolster foreign investment, let's not forget that Australia offers many other qualities to investors: an educated, English-speaking workforce, proximity to the Asia-Pacific region, and stable democracy. If we can retain on this list good infrastructure and public service delivery and a strong social safety net thanks to well-considered government policy, we may continue to enjoy the benefits of foreign capital inflows without sacrificing a valuable source of government revenue.

Dr Janine Dixon is a Senior Research Fellow at Victoria University's Centre of Policy Studies and is presenting these modelling results at today's Melbourne Economic Forum.

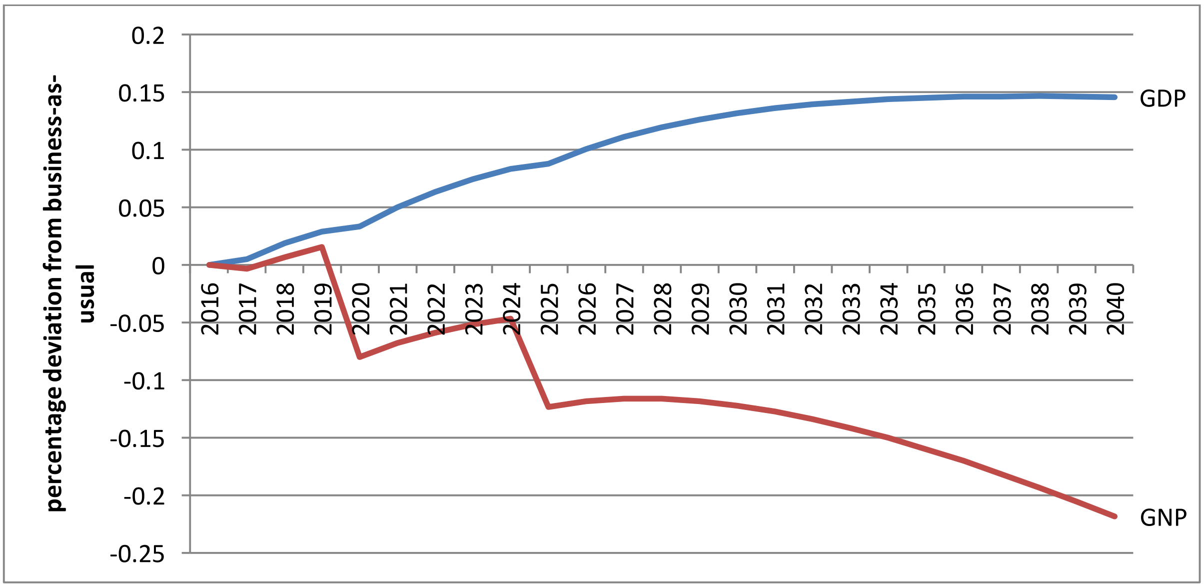

Figure 1: The impact on GDP (domestic production) and GNP (domestic income) of cuts to company tax, to 28.5% in 2017, to 25% in 2020, and to 22% in 2025, as recommended by BCA. Source: Vic-Uni Model.