

# *WORKING TITLE:* Lipstick on an economic model

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Economic models are like skin care products - the magic is all in the marketing. Just as honest dermatologists regularly remind consumers that expensive face creams are just 'hope in a jar', honest economists regularly remind politicians and journalists that the 'results' of macroeconomic modelling are no more reliable than the assumptions they rely on. And like dermatologists, those economists not selling a product are typically ignored.

Take the Financial Services Council’s claim last week that the results of modelling the council commissioned from KPMG shows a deep company tax cut is “essential to increase growth, investment and employment". In fact, the modelling showed no such thing. Like the 'clinical tests' that back up the cosmetic industry's claims, the FSC was relying in the fact that few journalists would carefully examine KPMG’s 'evidence' behind their claims about what is economically 'essential'.

The dictionary defines essential as 'absolutely necessary' or 'indispensable'. For an economic modelling exercise to conclude that cutting corporate tax was 'essential' to boost GDP growth, you might think that the modellers had first considered a range of policy options before concluding which of them were essential. You might think they had modelled increased investment in education, R&D or child care and concluded that cutting company taxes drove faster growth. But you'd be wrong.

The only policies modelled in the KPMG report were those requested by the FSC. And the only policies the FSC wanted modelled to prove that company tax cuts were 'essential' were--you guessed it--tax cuts. Few, if any, academic economists would dispute that investing in education or boosting women's participation in the workforce via better funded child care would increase GDP. But such effective options were't considered by those claiming tax cuts were 'essential'.

It gets worse. Not only did the report fail to model a range of policies before *concluding*that cutting company taxes was 'essential' to boost growth, they failed to highlight that their model is actually based on the *assumption* that cutting the corporate tax rate will stimulate the economy.

As those banks who assumed US house prices could never fall discovered, assumptions matter.

The fact that KPMG's model assumes that cutting corporate taxes boosts investment and GDP makes its 'prediction' that cutting company taxes will boost investment and GDP precisely meaningless. In any other field it would be called circular logic.

If you were really thinking of betting tens of billions of dollars on the belief that cutting the corporate tax rate would boost GDP you should inquire deeply into the quality of the data and analysis on which KPMG’s assumptions were made. Put simply, users, including journalists and policy makers, should always look at the data and assumptions *before* they look at the modelling results. Garbage in, garbage out.

What does the data about the historical relationship between the corporate tax rate and GDP tell us? What happened in other countries? And do we think that old relationships will remain stable in a rapidly changing economy?

KPMG tells us that cutting the corporate tax rate will 'lower the cost of capital' and in turn stimulate investment. But dividend imputation means that lower Australian corporate tax payments by companies translates to higher tax payments by the domestic dividend recipients. Similarly, bi-lateral tax treaties (such as with the US) mean that lower tax payments to the Australian Treasury by US companies will simply result in higher tax payments to the US Treasury. The data tells us that some countries that have cut taxes that failed to boost GDP. We know that some high tax countries have rapidly growing economies. And finally, the data from the Foreign Investment Review Board shows that Australia has no trouble attracting investment, or migration, from Asian countries with much lower taxes than our own.

The link between taxes and GDP growth is more complicated, ambiguous and unstable than those pushing for such tax cuts, and the owners of the expensive economic models, like to admit.

We shouldn't be surprised that those who stand to benefit from cutting taxes would pay for economic modelling to dress up their self-interest as national interest. But after Enron and the collapse of the US banking system we should be surprised that big accounting firms like KPMG are willing to conceal the significance of the assumptions that lay behind their opinions.

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