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Trump's tax plan
Australian perspective

Discussion paper

David Richardson
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Summary

This paper reviews the implications of the latest Trump tax plan for Australia; in particular that part of the plan that involves changes to the company tax arrangements. The present plan would bring the tax rate down to 20 per cent at the national level. With state taxes, that means that the total American rate would be around 25 per cent.

Treasurer Scott Morrison and head of the Business Council, Jennifer Westacott have said this is a challenge for Australia and if we do not meet Trump's plan jobs will go from Australia. However, calls for Australia to cut its rate on the basis of Trump proposed cuts have failed to acknowledge:

- analysis from top US economists arguing that the Trump plan will not work to increase either jobs or economic growth,
- details of reforms in the Trump bill, beyond the headline figure, that could adversely harm Australia
- IMF warnings about the dangers of a company tax 'race to the bottom'.

Within the Trump tax plan is a move to territorial taxation and protectionist US import duties or border adjustment plans. These policies would likely adversely affect Australia. The plan also cuts tax concessions and denies some interest expenses which also changes the larger picture of incentives and further demonstrates the futility of a simplistic base-rate 'competitiveness' argument.

The present paper builds on the earlier papers that cutting company tax rates has not worked in the past but represents a large gift to big companies and to foreign corporations. The Treasury has since added a new argument that an investment boom in the US following the Trump plan would take capital from Australia. That did not happen with the Chinese investment boom and we present the theory that debunks that view.

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Introduction

Donald Trump went to the election promising 15 per cent company tax and is now asking for 20. With company tax also applicable at the state level most companies will pay a theoretical 25 per cent or more. So that is not really a lot different from Australia's 30 per cent for bigger companies. Nevertheless the current Trump plan is now the new reason for creating anxiety about Australia's allegedly high tax rate. However there is a lot more behind the Trump plan than just the headline rates that have been mentioned. Here we outline the Trump plan in so far it affects companies, we look at the criticisms within the US itself, some of the criticisms from outside the US and finally the implications for Australia.

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Morrison and Westacott start the attack

The Treasurer Scott Morrison said 'Donald Trump has laid down the challenge. The world is moving to lower taxes on corporate investment and if you get out of step with that, the money will go elsewhere and so will the jobs'.[1] Elsewhere in a speech to the Business Council of Australia (BCA) Morrison said:

> And now we have Donald Trump confirming his plan to lower US company tax to 20 per cent, laying down the challenge to the rest of the world to keep up, or risk your economy losing its competitiveness. In his own words, such a move was "pro-growth, pro-jobs, pro-worker, and pro-family", designed to rebuild the nation. The "biggest winners", President Trump said, "will be the everyday American workers as jobs start pouring into our country".[2]

The Executive Director of the BCA, Jennifer Westacott, insists company tax rates do matter and that a lower company tax rate is needed to induce foreign investment. She said 'the tax rate did matter because it influenced the marginal investor'.[3] This is curious since we know the marginal investor is going to add virtually nothing to Australia. By definition the marginal benefits of a marginal investment will only just cover the marginal costs of that investment. In general there is very little to be gained at the margin. Even then you would have to hope that there are no negative indirect effects. In any event the views of Westacott were demolished by Luci Ellis from the Reserve Bank of Australia who pointed out that there are a host of other factors that influence foreign investment decisions; we could name access to resources, proximity to customers and suppliers, political stability and the like.

In the context of Labor's opposition to the corporate tax cuts Morrison continued:

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[1] Coorey P (2017) Trump tax cut exposes local business', *The Australian Financial Review*, 29 September.

[2] Morrison S (2017) 'More and better paid jobs', *Address to the Business Council of Australia*, Sydney, 29 September.

[3] Shapiro J (2017) 'BCA, RBA split on corporate tax cut benefit', *The Australian Financial Review*, 17 October.

> The Labor party seem hell-bent on leaving Australian businesses stranded on a tax island, uncompetitive with the US, uncompetitive with the UK, uncompetitive with our biggest trading partner, China.[4]

We note that Morrison and Jennifer Westacott jumped the gun after the US Presidential election assuring us that the US rates were going down to 15 per cent. This time they are again confident that the Trump plan will in fact be put into action. Even so they mislead us by talking only about the headline aspects of the plan rather than examine the implications of the plan as a whole.

Given a history of other failed Presidential proposals others are more sceptical about the Trump plan ever making it into legislation. Alan Kohler says 'it seems inconceivable that this plan would get through congress'.[5]

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[4] Morrison S (2017) 'More and better paid jobs', *Address to the Business Council of Australia*, Sydney, 29 September.

[5] Kohler A (2017) "Donald Trump's tax plan is doomed from the start', *The Australian Business Review*, 7 October.

So what is the Trump plan?

The complete plan is included in a link at the end of this paper. Here we concentrate on the company tax.

The headline from the Trump plan is the proposal to reduce the **company tax rate** from 35 to 20 per cent. This is the rate for 'normal' companies with widely-spread ownership and most big business. Note that the company taxes collected at the state level are unaffected and would act to keep taxes at around 25 per cent.

For **small businesses** (sole proprietorships, partnerships and S corporations) the rate would be 25 per cent but that would be the final tax on that income. At the moment these 'pass-through' entities pay zero tax but the income is then taxed in the hands of the recipient of the income.[6]

The Trump plan would also eliminate the alternative minimum tax (AMT) applying to companies as well as individuals.

In addition companies would benefit from allowing businesses to 'immediately **write off** (or "expense") the cost of new investments in depreciable assets other than structures made after September 27, 2017, for at least five years'. While this sort of measure is welcomed by business it does not increase the amount they can claim but changes the *timing* of depreciation expenses.

The Trump plan says 'The deduction for net interest expense incurred by C corporations [larger widely-held companies] will be partially limited. The committees will consider the appropriate treatment of interest paid by non-corporate taxpayers'. Those are the only details. But of course interest is normally a large expense for companies and this is the sort of measure that may well mean a loss-making corporation would pay tax. That is something company taxes cannot do since they only tax the profit companies actually make.

In addition the plan says 'the current-law domestic production ("section 199") deduction will no longer be necessary'. This deduction usually implies a significant

[6] 'Pass-through' entities are so called because 'These entities are called pass-throughs, because the profits of these firms are passed directly through the business to the owners and are taxed on the owners' individual income tax returns. This is in contrast with traditional C corporations, which pay tax at the entity level through the corporate income tax'. See Pomerleau K (2015) 'An overview of pass-through businesses in the United States', *Tax Foundation*, 21 January.

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reduction in the tax paid in relation to production activities carried out in the US.[7] In addition there is a vague statement saying 'in addition, numerous other special exclusions and deductions will be repealed or restricted'. No other detail is provided.

The plan says: 'Special tax regimes exist to govern the tax treatment of certain industries and sectors. The framework will modernize these rules to ensure that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance'. Again, that is the extent of the detail we get.

There are some complicated arrangements applying to US companies with overseas taxable income. At the moment the US takes a global approach to taxation. Companies are taxed on their world-wide income with deductions for any tax paid overseas. The Plan proposes to exempt dividends paid to US companies by overseas subsidiaries. The US company tax system would then move to a territorial system like Australia's. It says the plan 'will replace the existing, outdated worldwide tax system with a 100% exemption for dividends from foreign subsidiaries (in which the U.S. parent owns at least a 10% stake)'. Hence subsidiary income is exempt when paid as a dividend to the US parent. That incidentally removes the incentive to keep profits offshore since at the moment overseas income is only taxed when it is eventually paid to the parent.

However combined with the end of the worldwide tax system are new provisions 'To prevent companies from shifting profits to tax havens' there will be rules by taxing the foreign profits of US companies 'at a reduced rate and on a global basis'. This provision seems to contradict the measures that would move the US tax to a territorial system unless it is interpreted as an anti-avoidance/evasion mechanism.

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[7] Schurrer PJ (2010) 'Sec 199: Domestic production activities deduction', *The Tax Adviser*, 1 May

Implications for the US: American commentators

In this section we examine some of the criticisms of the Trump plan especially as they relate to company tax. One prominent commentator even disputes the use of the word 'plan'. Summers says: 'The Trump administration's tax plan is not a plan. It is a melange of ideas put forth without precision or arithmetic'.[8] But what we do know is that as a plan it is likely to be substantially modified by the time it ever makes it into legislation.

Small businesses would be the big winners; small companies (subject to conditions), sole proprietorships and partnerships at treated as pass-through entities. They are not taxed as such but their owners are taxed at the owners' normal tax scales. Trump wants to tax them at just 25 per cent. Apparently Trump's own businesses are pass-through corporations.[9]

In looking at Trump's company tax proposals Nobel Prize winner Joe Stiglitz repeats a point he has made before; lower company tax rates both increase after-tax profit and increase the alternative opportunity costs but reduce the after-tax value of interest deductions.[10] If all expenses and revenues were treated symmetrically and equally then changes in the tax rate would have no effect on the relative yields of different investment opportunities. However, not everything is symmetrical. There are many concessions in the company tax system throughout the world that favour research and development as well as investment through accelerated depreciation and various other measures. The strength of those favourable tax treatments are weakened when the company tax rate is reduced. Hence investment and therefore growth may fall.

Summers also makes the point that capital costs are already very low in the US. He says:

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[8] Summers LH (2017) 'The Trump administration's tax plan is an atrocity', *The Washington Post*, 8 October.

[9] Radford P (2017) 'Tax fog', *Real-World Economic Review Blog*, 2 October.

[10] Stiglitz J (2017) 'Why corporate tax cuts don't work', *World Finance*, 14 October. His views are further explained in Richardson D (2013) 'The taxation of capital in Australia: Should it be lower?', in Schroeder SK and Chester L (eds) *Challenging the Orthodoxy: Reflections on Frank Stilwell's Contiribution to Political Economy*, Heidelberg: Springer, pp 181-99.

> a big spur to investment seems unlikely. With after-tax long-term interest rates well below 2 percent, the stock market sky-high and businesses able to write off investments immediately, capital costs have never been lower…[but] The first-order effect of a Trump administration "territorial system" that renounced a U.S. tax claim to overseas corporate income would be to encourage relocation of productive activity to tax-haven jurisdictions, slowing U.S. growth.[11]

The reason the new territorial tax system would further encourage investment in tax havens is because, unlike the present arrangement whereby profit is taxed when repatriated to the US, the new system would mean income reported in tax havens would never be taxed in the US, whether it is repatriated or not. Dean Baker believes 'that in Donald Trump's America, the rich and corporations will have little trouble gaming the tax code'.[12]

Many people have made the obvious point that the Trump plan will worsen income inequality in the US. 'Trump and the GOP have made it clear (for decades) that "reform" really means cuts for the wealthy. When it comes to making the super-rich super-richer, there is no negotiation'.[13] Trump's corporate tax cut is part of that plan and to the extent that the company component contributes to inequality it takes income from the middle classes and gives it to the corporate sector. As Summers puts it: 'the immediate impact of corporate tax cuts is to help corporations and that the vast majority of corporate shareholding is concentrated among those at the top of the income and wealth distribution'.[14] Neither the corporate sector which is sitting on mountains of cash nor their shareholders are going to spend new income to the same extent as the people who lose out. Hence 'the money has little impact on helping the economy and will not trickle down to anyone other than billionaire heirs…'[15]

Dean Baker argues that the small business tax proposals are anti-growth. It would:

> create a special lower tax rate for income received from a business as opposed to income from working. Not only is this unfair, it is also an invitation for tax gaming. Higher earning people who would be subject to a 35 percent tax on their other income will find ways to have their income appear as business income… This should create plenty of jobs in the tax gaming industry, but it will

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[11] Summers LH (2017) 'The Trump administration's tax plan is an atrocity', *The Washington Post*, 8 October.

[12] Baker D (2017) 'The republican's tax plan will impede growth', Truthout, 2 October 2017.

[13] Morris K (2017) 'Trump's tax plan is indefensible', *Truthout*, 17 September.

[14] Summers LH (2017) 'The Trump administration's tax plan is an atrocity', *The Washington Post*, 8 October.

[15] Morris K (2017) 'Trump's tax plan is indefensible', *Truthout*, 17 September

> pull resources away from the productive economy. In short, it's great policy if the point is to slow growth.[16]

Other commentators have pointed to the likely failure of the Trump plan to produce growth. Economist Jane Gravelle of the Congressional Research Service has found that there is no relationship between tax rates and economic growth.[17] The US had an experiment with cutting company taxes dramatically in 1986 from 46 to 34 per cent but the evidence does not show an increase in economic growth. The opposite obtained although we would not want to claim that higher taxes would induce higher economic growth.[18]

We mentioned that one of the tax concessions to be changed relates to the deductions for interest expenses which will be 'partially limited' for C companies and 'consider the appropriate treatment' for other entities. Peter Radford is concerned that 'would dramatically reduce corporate appetite for debt-based investment'.[19]

While investment spending in the US has been low the real problem seems to be the lack of profitable investment opportunities. Hence

> The real problem appears to be that many firms can't see enough profitable investment projects, or sufficient demand for their products, to justify expanding capacity and upgrading their equipment. Rather than taking this risk, corporations are using their profits to buy back their own stock, a tactic that also just happens to benefit senior executives who own a lot of that stock. The Trump tax plan wouldn't do much to address this problem.[20]

The Trump plan complains the US company tax rate is below other industrialised countries. That which has fallen more than others recently is the UK rate so one commentator writing in the New Yorker cites the UK experience and the corporate tax cut from 30 to 19 per cent over the last decade. According to the company-tax-cutters that should have given the UK a substantial boost. Instead he cites Mark Carney, the governor of the Bank of England, who said that the UK was going through "the first lost decade since the 1860s".[21] OECD figures show that the UK investment to GDP ratio has averaged 16.5 per cent in the years 2014 to 2016 inclusive. However, on the eve of the GFC that ratio was 17.7 per cent (2007) and averaged 18.8 per cent in the decade

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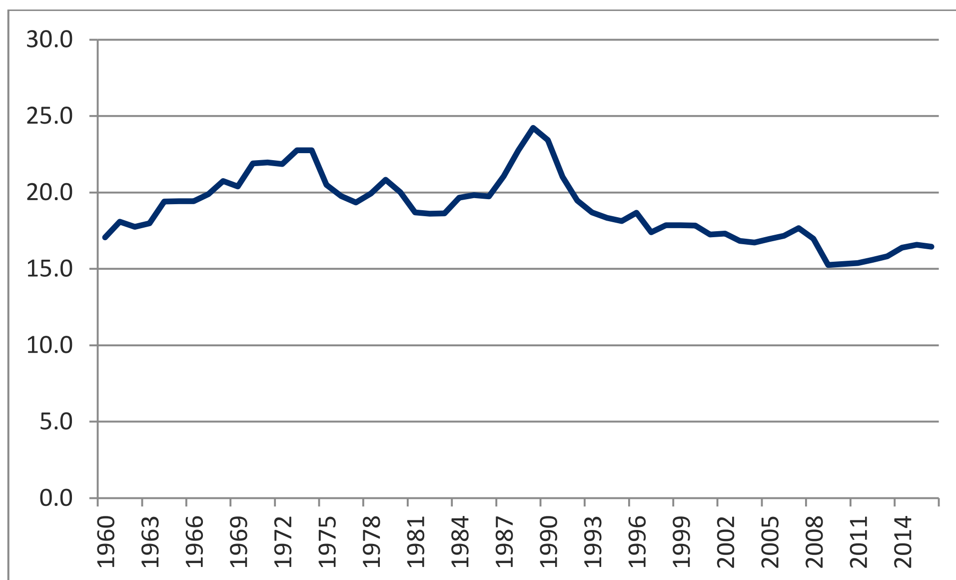
[16] Baker D (2017) 'The republican's tax plan will impede growth', Truthout, 2 October 2017.
[17] Gravelle JG (2017) 'Corporate tax reform: Issues for Congress', *CRS Report*, 22 September
[18] Bivens J (2017) 'Cutting corporate taxes will not boost American wages', *Economic Policy Institute Blog*, 25 October.
[19] Radford P (2017) 'Tax fog', *Real-World Economic Review Blog*, 2 October.
[20] Cassidy J (2017) 'A White House fairy tale about the Trump tax plan', *The New Yorker*, 20 October.
[21] Cassidy J (2017) 'A White House fairy tale about the Trump tax plan', The New Yorker, 20 October.

ending in 2007.[22] Going back even further the UK company tax rate was 52 per cent in 1981 and has been reduced in successive moves from time to time since then. Figure 1 plots the UK investment experience going back to 1960 to provide further perspective on the relationship between the company tax rates and investment.

Figure 1: UK investment as share of GDP %



Source: OECD (2017) *Economic Surveys: United Kingdom 2017*.

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Figure 1 makes it very clear that the period of company tax reductions beginning in 1981 has not been associated with an increase in investment as a share of GDP. There is nothing in Figure 1 that suggests a link between lower company tax rates and higher investment.

The Trump plan has huge implications for the size of the budget deficit. The Committee for Responsible Budget estimates the Trump plan would add $2.2 trillion to the deficit over the next decade.[23] The more usual figure and one cited by 'lawmakers' is $1.5 trillion over a decade.[24] One observer notes that the deficit hawks were shrill about Obama and his deficits but have been silent on the Trump deficits and the implications of the Trump tax plan.[25] Our point is not that higher budget deficits are

[22] OECD (2017) *OECD Economic Surveys: United Kingdom*, October.

[23] Miller R and Yoo K (2017) 'Most economists agree: Trump tax plan will widen budget deficit', *Bloomberg*, 29 September at https://www.bloomberg.com/news/articles/2017-09-28/most-economists-agree-trump-tax-plan-will-widen-budget-deficit

[24] Jackson D (2017) 'Trump sees 'great spirit' for tax reform plan, targets passage by end of the year', *USA Today*, 22 October.

[25] Radford P (2017) 'Tax fog', *Real-World Economic Review Blog*, 2 October.

necessarily a problem, rather those who might be described as 'deficit hawks' should be concerned with the Trump plan.

Overall we should always keep in mind that a company tax is a tax on companies that make a profit. In principle a company with no profit means no tax. That is not the case with some of the detail in Trump's plan. Abolishing some tax deductions like those on interest expenses means that some companies may well make a loss yet have to pay tax. That would appear to impose a huge distortion in the corporate tax system.

An important claim in the Trump plan is that wages will increase as a result of the company tax cuts. Two main mechanisms seem to be invoked. First, a lower company tax cut and higher after-tax return will encourage more investment which will increase the capital labour ratio and that in turn will increase the demand for labour and so raise the real wage. We have already addressed the tax cut-more investment/growth link. The second mechanism, suggests that with lower company taxes investors will require lower after-tax rates of return which will see a reduction in the price level which implies an increase in the value of the real wage.

Linda Qiu points out that the latest estimate from the Congressional Budget Office suggests that only 25 per cent of the cut would flow through to labour incomes while the US Treasury suggested a smaller 19 per cent would go to workers.[26] Bevins suggests:

> there is no obvious correlation between corporate rate changes and wages; again the beneficial effect of cutting corporate taxes on wages is absolutely not "highly visible in the data." In fact, the simple slope of the line through the scatterplot is positive, indicating that steeper cuts in corporate rates (the farther to the left of zero) were associated with slower wage growth (slightly and insignificantly, to be sure, as rate cuts just don't affect wages much).[27]

Bevins concludes

> Corporate tax rate cuts absolutely belong on the list of fake solutions to the slow wage growth bedeviling typical American workers…the real-world data couldn't be clearer: a strategy to boost wages based on cutting the taxes paid by corporations is ridiculous policy.[28]

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[26] Qiu L (2017) 'Trump misleads on who benefits from tax plan', *New York Times*, 27 September.

[27] Bivens J (2017) 'Cutting corporate taxes will not boost American wages', *Economic Policy Institute Blog*, 25 October

[28] Bivens J (2017) 'Cutting corporate taxes will not boost American wages', *Economic Policy Institute Blog*, 25 October

Of course there have been arguments put in support of the Trump plan. Trump's Council of Economic Advisors quote an academic paper by Auerbach, Kotlikoff, and Koehler claiming it shows large economic gains. However, Bivens from the Economic Policy Institute examined the paper and found the results were due to the inclusion of the 'destination-based cash-flow tax' as a replacement for the current corporate income tax—something from an earlier Congressional Republican plan.[29] One of the features of the destination-based cash-flow tax is that it would ignore exports for company tax purposes and not allow imported goods and services as expenses.

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[29] Bivens J (2017) 'Cutting corporate taxes will not boost American wages', *Economic Policy Institute Blog*, 25 October.

Other commentary on the Trump plan

Outside the US there has been concern about the Trump plan and its implications for the rest of the world. According to Oxfam, the taxing of the profits of companies, particularly large, successful corporations, is one of the most progressive forms of taxation.[30] It raises more income for national budgets, and when this revenue is invested in public services, it reduces inequality because it redistributes the income by putting 'virtual income' in the pockets of poor people. This equips people with the essential tools and skills to escape poverty, such as good health care and education.

Oxfam points out that the Global Competitiveness Report does not include company taxes. However, that report does include the types of things government revenue is spent on such as infrastructure, health and education, training, and innovation (which includes both the public and private sectors).[31] There are 12 items the Global Competitiveness Report mentions which are implicitly ranked higher than corporate tax. It is also worth mentioning that to date the US has avoided being caught up in the race to the bottom.

The IMF has also long opposed the trend towards international tax competition and IMF director Christine Lagarde stated in 2014 that 'there would be more revenue for all if countries resisted the temptation to compete with each other on taxes to attract business. By definition, a race to the bottom leaves everybody at the bottom'.[32] Following Trump's victory and his already announced tax plans Christine Lagarde said that 'one of the biggest risks to the global economy in 2017 was "a race to the bottom"

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[30] Oxfam (2016) 'Tax Battles: The dangerous global race to the bottom on corporate tax' *Oxfam Policy Paper*, 12 December. https://www.oxfam.org/sites/www.oxfam.org/files/bp-race-to-bottom-corporate-tax-121216-en.pdf

[31] Schwab K et al (2017) The Global Competitiveness Report 2016–2017, World Economic Forum http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf

[32] Lagarde C (2014) 'The Caribbean and the IMF—Building a Partnership for the Future', *Speech to University of the West Indies at Mona, Jamaica*, 27 June.

on taxes, regulations and trade, in an indirect reference to the policy plans of the incoming U.S. administration'.[33] She added:

> If the disruptions we are expecting for 2017 as a result of what has happened in 2016 prove to be all negative and we are to end up in a race to the bottom on the tax front, on the trade front and on the financial regulation front, then that for me would be a really big black swan that would have devastating effects for countries other than those that are likely to cause it.[34]

Many countries have pursued a race to the bottom in recent years but global investment and the global economy never responded. The IMF said that had particular implications for developing countries:

> The trouble is that by competing with one another and eroding each other's revenues, countries end up having to rely on other—typically more distortive—sources of financing or reduce much-needed public spending, or both.
>
> All this has serious implications for developing countries because they are especially reliant on the corporate income tax for revenues. The risk that tax competition will pressure them into tax policies that endanger this key revenue source is therefore particularly worrisome.[35]

It is disturbing that some Australian leaders are only too willing to join the race to the bottom.

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[33] Reuters Staff (2017) 'Lagarde warns of "race to bottom" on trade, regulation, taxes', *Reuters*, 20 January. https://www.reuters.com/article/davos-meeting-outlook/lagarde-warns-of-race-to-bottom-on-trade-regulation-taxes-idUSL5N1FA2BZ

[34] Cox J (2017) 'Davos: IMF Chief warns against cutting taxes and regulation 'to the bottom' referencing Donald Trump's policies', *Independent*, 20 January.

[35] Keen M and Brumby J (2017) 'Peer pressure: Tax competition and developing economies', *IMF Blog*, 11 July.

The US will take our capital!

The Australian Treasury has just published a paper that brings a new argument in favour of the government's company-tax-cut plan.[36] Treasury accepts the proposition that the Trump tax cuts insofar as they lower the headline company tax rates would in fact work and that the other changes in the Trump package are inconsequential. As we saw above there is a host of opinion in the US to the effect that the tax cuts would not work. Nevertheless we provisionally accept this thesis to see where the Treasury analysis will take us.

We can take as our starting point the proposition;

> *if a substantial cut in the US corporate income tax rate does result in an investment boom in the US, the rest of the world is likely to experience reduced foreign investment and, as a consequence, lower GDP and real wages than might otherwise be the case (p 7).*

Of course an investment boom in the US would boost world trade generating benefits throughout the world just as the investment phase in China resulted in additional Australian exports of goods and services. The Treasury paper even cites the IMF to the effect that it would welcome an American fiscal stimulus. But rather than boosting world economic activity through economic growth in America the paper asserts:

> *This negative impact [of a US investment boom] should more than offset any boost the rest of the world receives from increased demand for goods from the US (p 7).*

There is absolutely no empirical evidence or theoretical argument given to support the proposition that the negative effects would outweigh the positive effects.

The mechanism between higher investment in the US and lower investment in Australia is based on the view that 'a US investment boom would increase the demand for funds, causing interest rates to rise'. This is the argument that there is a limited global supply of funds and if more of those are invested in the US then the US will drain capital from the rest of the world with a rise in interest rates. Treasury says:

> *To the extent that the boom is not financed by US domestic saving, it would initially need to be funded from the existing global supply of funds, meaning the rest of the world gets less (p 9).*

The result is the rest of the world 'will experience higher capital outflows' (p 9). It is that effect that reduces investment in Australia and so contributes to a lower GDP, lower wages and so forth.

[36] Henty P, Cai YY and Davis G (2017) 'US Corporate Tax Reform: Implications for the rest of the world', Working/Technical Paper, 7 November.

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Countries will lose investment to the US;

> *if other countries do not respond by cutting their own corporate taxes or by introducing other competitiveness enhancing policies (pp 9 - 10).*

The idea that a US investment boom will harm Australia certainly seems counterintuitive. We have a recent example to compare with that scenario. It has now been many years since Australia has received the benefit of the Chinese investment boom and there is still no sign of the Chinese economy inducing a massive capital inflow from Australia to China. Indeed, in the case of China over the last decade Australian investment in China increased from $1.1 billion to $68.7 billion while Chinese investment in Australia increased from $3.0 billion to $87.9 billion.[37] The net effect was an increase in Chinese investment in Australia from $1.9 billion to $19.2 billion. So far from the Chinese investment boom draining capital from Australia the opposite happened. If the effect posited by Treasury does exist it is not large enough to nullify the benefits to Australia of the Chinese investment boom.

The Chinese example may does support the thesis that US investment boom will be at the expense of Australia’s economy. Apart from the empirical evidence we have theoretical reasons for doubting the proposition that higher US investment reduces Australian investment which is really a variant of the ‘crowding out’ thesis.[38]

The essence of the crowding out thesis is the proposition quoted above to the effect that there is a fixed global supply of funds[39] and if the US takes more the rest get less. However, this proposition is what economists call ‘stock-flow inconsistent’.[40] When someone invests they may draw down their own liquid assets or borrow from someone. When that money is spent on investment it is simultaneously received as income on the part of the suppliers of the investment goods. The consequence of spending by the investor is to reduce the investor’s net financial assets while the recipient, the supplier, builds up financial assets. If the suppliers merely pocket the extra income that is the end of the story; investment has increased and the recipients of the additional income have saved the additional spending. Savings have *expanded* to match the increased investment. Of course increased income on the part of investment goods suppliers may well be spent in turn. If it is, then the new spending is received as new money by the recipients who may save it or spend it or a bit of both. The important thing is that new investment spending creates the extra savings without any need to draw on some fixed supply as Treasury assume. After the investment the investor will have a net reduction in financial assets balanced by an increase in capital assets. The recipients of the spending will

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[37] ABS (2017) *International Investment Position, Australia: Supplementary Statistics, 2016*, Cat no 5352.0, 10 May.

[38] See Smith M (2014) ‘”Crowding out” and the fallacy of fiscal austerity’, *The Conversation*, 11 March.

[39] By ‘fixed’ here we mean not necessarily a fixed quantum but a fixed relationship between the quantity of funds and the interest rate.

[40] The following argument is put more formally in Richardson D (2015) ‘What does “too much government debt” mean in a stock-flow consistent model?’ *Real-World Economics Review*, issue no. 73, pp 2-15.

experience an increase in their financial assets. And without the need to draw on some fixed supply of assets, 'the existing supply of global funds', there need be no implications for the rate of interest or any other strain on third parties.

This is just the ordinary workings of the Keynesian multiplier but with the added acknowledgement that any additional income received is received as additional financial assets. The flow of investment has to be matched by a reduction in financial assets on the part of the investor and an accumulation of financial assets on the part of the supplier. New flows of income have to be and will be reflected in the addition of new financial assets on the part of the recipients of the income. The new financial assets may just be new debt issued by the investor, or equity in the investor's company. In the normal course of events the new income is received simply as an increase in the balance in some account with a financial institution.

Interest rates may well rise if there is an investment boom in the US. However, the interest rate increase will not be through the mechanisms mentioned by the Treasury paper but will reflect the actions of the US central bank – the Federal Reserve System. Central banks throughout the world may then react to neutralise the impact of the US action.

If the investment boom does not itself induce an increase in interest rates then there cannot be a consequential induced flow of capital out of Australia to the US through this mechanism. But even if we did believe that it would surely be in Australia's interests to argue to the Americans and others that they should not be reducing corporate taxes to take capital from Australia and other countries. Indeed, as suggested above we should be joining the IMF's call for countries to stop the race to the bottom.

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Conclusion: Implications for Australia

It is useful to ask how the Australian shareholder would fare relative to the corresponding shareholder in an American C company (the type that corresponds to the Australian company). Australian company owners are taxed at a top rate of 47 per cent on the underlying profit of the company concerned as a result of dividend imputation. If this package goes ahead the US shareholder in a US company (C-corporation) will pay 51.25 per cent. This is because the company will pay 20 per cent plus around 5 per cent or more in state tax. The remaining 75 per cent is to be taxed at the new top personal income tax rate of 35 per cent for a tax of 26.25 per cent (= 75 times 35 per cent). Adding the two means the original $100 of profit is taxed at 51.25 per cent. The Australian shareholder still does better under the present dividend imputation arrangements than the comparable shareholder in the US would under the Trump plan.

Even if one believed that the incentives facing the ultimate owners of capital were important then it would have to be conceded that that there is nothing to fear from the Trump plan in so far as C companies are concerned. The other entities will have a new 25 per cent tax rather than zero and their owners would benefit as we saw earlier. However, these tend to be small businesses that take advantage of the easier reporting and other requirements. It is hard to imagine the likes of BHP and the Commonwealth Bank fearing competition from US-based partnerships and S companies.

The Trump plan's new territorial company tax system which taxes companies only on the income they receive in the US could have implications for Australia. It is suggested that the US Inland Revenue Service (IRS) has insufficient resources to properly address the additional avoidance/evasion likely under that plan. The upshot is that more corporate activity will be channelled through tax havens. Where the US parent engages in such a strategy it is even more likely that they will encourage the Australian affiliate to take advantage of tax havens.

To the extent that the Trump plan would encourage companies to switch resources from more productive activities that could mean less investment overall and it may also mean a bit less investment in Australian operations owned by American corporations.

The main implication for Australia is likely to remain the propensity for the local leaders to want to emulate the Trump plan; or at least the headline tax rates in the Trump plan. Prior to the Trump plan we had written extensively on why there is no need for company tax

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cuts in Australia.[41] Overall there is no reason to change our minds on the uselessness of joining the race to the bottom.

There may well be other developments that could harm Australia's interests. For example, the earlier Trump and Republican plans had proposed a border adjustment tax would penalise US companies importing goods and services. Those would no longer be a legitimate tax expense while exports would not add to taxable revenue.[42] Something similar, a 20 per cent excise on multinationals' cross-border transactions between related business units, has been included in the Republicans' latest tax plan.[43] The 20 per cent excise is equivalent to denying a tax expense for imported inputs which was part of the border adjustment tax.

If implemented the 20 per cent excise would hurt the Australian operations of US multinationals such as Amgen, Boeing, Cisco and GM (design and engineering). This measure could extend to other non-US multinationals with operations in both Australia and the US.

Australia's Treasurer would be better advised to concentrate on the specific bits of the American proposals that would hurt Australia's interests and join with the IMF to condemn any 'race to the bottom'.

[See the Trump tax plan here: https://www.whitehouse.gov/the-press-office/2017/09/27/unified-framework-fixing-our-broken-tax-code]

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[41] A lot of that research is summarised in The Australia Institute (2016) *Cutting through the Company Tax Cuts Guff*, 9 June.

[42] OHlemacher S and The Associated Press (2017) 'A key part of Republicans' corporate tax plan is in trouble', *Fortune*, 17 June.

[43] Becker A and Bergin T (2017) Multinationals grapple with republican excise tax surprise', *Reuters Business News*, 6 November.