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Response to 'How company tax cuts got killed' in The Australian Financial Review.

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Introduction

On Friday 16 February the Australian Financial Review published an opinion piece on company tax and argued that The Australia Institute 'undermined a policy that woud have created jobs, profits and a bigger economy'.

Generally this is a good article which sets out how The Australia Institute undermined the Government's plan to cut company taxes, even if it may be too early to declare victory. However, the article suggests that logic is on the side of the company-tax-cutters and not the critics. We take strong issue with that view.

The article assumes that cutting taxes produce economic benefits as a matter of economic logic. For example he says 'most economists believe cutting corporate taxes will expand the economy and create jobs'. Let us contrast that with the views of Christine Lagarde, CEO of the International Monetary Fund, who warned at Davos of a 'race to the bottom'[1] and said that cuts in company taxes, regulation and trade would have 'devastating effects'.

Stiglitz v Freebairn

If you believe most economists agree on this you face some stiff opposition such as Nobel Prize winning economist, Joseph Stiglitz, who demonstrates conclusively why a cut in company taxes will have zero impact. The Australia Institute has set out Stiglitz's views and how they apply to the Australian debate. He makes the point that no matter what the rate of company tax, it is only paid when the business has covered expenses and that has important implications. As Stiglitz puts it 'if it were profitable to hire a worker or buy a new machine before the [company] tax, it would still be profitable to do so after the tax…what is so striking about claims to the contrary is that they fly in the face of elementary economics: no investment, no job that was profitable before the tax increase, will be unprofitable afterward'.[2] That of course is fundamentally different from, say, an increase in the rate of interest which will increase the cost of borrowing as well as increasing the opportunity cost of capital. Likewise many other taxes and government charges are payable whether or not the company makes a profit. For example, the iron ore royalty rate in WA is 7.5 per cent of the value of the iron ore mined.[3] If the mining company receives $100 a tonne, pays $7.50 in royalties

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

[2] Stiglitz JE (1973) 'Taxation, corporate financial policy, and the cost of capital' Journal of Public Economics, vol 2.

[3] Western Australia Government (2015) *Mining Regulations 1981*.

and has expenses of $95/tonne it will run at a loss as a result of the royalty. There is no way a profit-related tax can do that.

Despite mentioning that 'most economists' support cutting company tax, John Freebairn is the only individual cited as supporting a company tax cut. He mentions that lower corporate taxes would result in higher wages and employment. That would be the same John Freebairn who said 'There is much debate in the literature about the final or economic incidence of corporate income tax, with no general consensus'.[4] Freebairn may be a proponent of cutting company taxes but at least he admits that there is a genuine debate among economists.

Freebairn using mining as his example put an argument similar to that of Treasury but perhaps more explicit when he said 'No doubt there are some mines that have an investment that wouldn't work at 30 per cent but will work at 28.5 per cent'.[5] It was useful to see the argument put clearly so we can more readily assess it.

Freebairn treats company tax as equivalent to any other cost. But if a company does not make a profit it is not liable to pay any tax and in that respect the company tax is fundamentally different to other costs and indeed other taxes and levies such as payroll taxes and mineral royalties as mentioned earlier. If an investment is viable before the company tax it will be viable after the tax. The obvious point to make about company tax is that it is levied on profits. Before being liable for any tax the company has to have covered all expenses including notional expenses such as the allowance for depreciation and amortisation as well as any capital write downs. This gets us straight back to Stiglitz's argument.

Dividend imputation

Note at this point we have not mentioned dividend imputation and neither does the article. Even if you do believe in the benefits of a tax change that gives a higher rate of return to investors you still have to admit that the fact of dividend imputation will severely damage your argument. Australian resident investors will receive no benefit.

The article cites Treasury estimates and says they 'support lower business taxes'. It is true that Treasury papers suggest such benefits. However, these are not evidence but are mere modelling exercises. The Treasury papers presenting such 'evidence' all assume that the demand for investment is inversely related to the after-tax cost of

[4] Freebairn J (2015) 'Who pays the Australian corporate income tax?', *The Australian Economic Review*, vol 48(4), p 357.

[5] Mather J (2016) 'Benefits of company tax cut would flow to foreigners, then workers', *The Australian Financial Review*, 22March.

capital. Modelling in this way is effectively assuming what you want to prove. The initial mechanism is investment up following tax cuts, you plug that into your model of the economy with dozens of equations and dozens of variables. Given the way things work the only uncertainty is the size of the other beneficial outcomes. In earlier such modelling dividend imputation was not properly modelled as affecting the after-tax return on capital. When it was properly modelled it became apparent that only foreign investors would benefit and domestic investors may have to be satisfied with lower returns.

Foreign investment

The article expresses the view that 'to remain attractive to foreign investment, the lifeblood of the economy, experts say Australia needs to at least be in the ballpark of what might be considered competitive'. The Australia Institute refuted these arguments and pointed to the massive foreign investment in Australia coming from economies with tax rates lower than Australia's.[6] In passing though we may well ask whether most Australians do want more foreign investment. Do people realise that the companies listed on the Australian stock exchange are already 57 per cent foreign owned?

As mentioned the concentration now has been on the incentives facing foreign investors. Without the complications due to dividend imputation a company tax cut in Australia will affect the incomes received by foreigners alone.

Recently in Australia there has been interest in on the second-hand accounts of a study of German company taxes (or more correctly business taxes) and their impact on wages at the municipal level since each municipality levies its own business tax. That study was undertaken by Clemens Fuest et al [7] from German universities; the University of Munich and University of Mannheim. However, the interest in Australia is based on interpretations by Richard Holden as reported in the *Australian Financial Review*.[8] That concentrated on the wages impact of company tax cuts. However, the paper has some interesting observations that are relevant at for foreign investment. The study involved some 15,000 employers yet the authors note that despite large differences and large changes in business tax rates 'very few firms move between

[6] Richardson D (2017) *Company tax and foreign investment in Australia*, Discussion Paper, January

[7] Fuest C, Peichl A and Siegloch S (2018) "Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany." *American Economic Review*, 108(2): 393-418.

[8] Greber J (2018) 'Company tax cuts 'redress economic inequality': Richard Holden', *Australian Financial Review*, 30 January. The Treasurer Scott Morrison has also cited this work favourably. See Murphy K (2018) 'Scott Morrison on wage growth, tax cuts and playing politics – the full interview', *The Guardian*, 8 February.

municipalities in the data'. German businesses do not change municipalities in response to tax differentials and changing tax differentials between municipalities. One would have to suggest it would be even harder to get them to shift in response to changes in international business taxes. Hence this study could well be cited in order to criticise the views of the Business Council and the Treasurer insofar as they suggest Australia needs lower company taxes to attract foreign investment.

Other

Just reading our work and the sources it cites show that the article is wrong when it suggests there was a 'conventional economic wisdom on business taxes, which had been built up over decades of careful theoretical and empirical research'. For example the Congressional Research Service has been debunking such ideas for years.

The article suggests we have revised economic history in reference to the 1960s and 1970s. He might have included the 1950s. However, all we did was refer to ABS and Reserve Bank data that described those periods and compared them with the present.

The article refers to the decade long cost of the tax cut at $65 billion and the Treasury 'benefits' estimate of $200 billion over a decade. It says the benefits vastly outweigh the costs but these are apples and pears. Only in the last year of the $65 billion decade is the full tax cut implemented at which point it should be costing something of the order of $20 billion per annum and, on Treasury's estimates, it might be generating benefits of $20 billion sometime after that. Treasury modelling points to very long lags during which there may be no benefits at all and indeed, the costs may outweigh the benefits.

The Australia Institute has presented the logic, arguments and evidence in an accessible manner for everyone to examine. The article has nowhere suggested which bits of the evidence are wrong or which bits of the logic are in error. To the best of our knowledge, no one else has either. However, events can change things. The Trump tax package changed the US global company tax system to a territorial one so that company tax will now reflect just the earnings derived in the US. Our earlier paper[9] on how a cut in Australia's company tax rate would benefit the Internal Revenue Service based on IRS data is no longer applicable following Trump's changes.

[9] Richardson D (2015) *Company tax cuts: An Australian gift to the US Internal Revenue Service*, Briefing Paper, May

What else you might do for investment, jobs and wages

Even if a reader is not convinced after all this discussion there remains another telling point. No one suggests cutting taxes is good just because we want to lift the incomes of those who depend on corporate profits. Even the direct beneficiaries at the Business Council of Australia have had to point to 'benefits' to third parties. In particular they mention additional investment and wages/employment. Suppose they were right and Australia could well benefit from additional investment, employment and wages. We would still want to consider whether cutting company taxes would be the best way of achieving that. The alternatives would be incentives or direct spending that specifically targets investment, employment and wage increases. For example, if we are interested in long term productivity and living standards the evidence strongly suggests that the resources would be better spent on education and training.[10]

Perhaps a more pertinent example is the supposed increase in wages consequent on a cut in company tax rates. This is a good example of 'trickle down economics' because the mechanism is long and convoluted. It is assumed that the cut in company taxes will increase investment and so increase the stock of capital. An increase in the stock of capital will increase the capital/labour ratio and the higher capital output ratio may produce an increase in wages relative to returns on capital depending on the nature of the technology. Each step is problematic and controversial and may not work. Certainly the evidence suggests a breakdown in one or more of those elements.

If the processes worked as suggested then there are arguments about whether it would go 15 per cent or up to 60 per cent to labour. What we do know is that if you designed a personal income tax for those up to about average weekly earnings the benefit would go almost 100 per cent to labour.

Conclusion

We cannot remember a time when company tax was not a controversial issue and doubt there will ever be a time when we can truly declare victory as the Australian Financial Review suggests. The Australia Institute aims to be a part of those debates as it is on many of the social and economic issues of our time.

[10] Richardson D (2016) *Taking an 'educated guess': The relationship between living standards and cuts in company tax rates and the provision of better education services*, Briefing Note, June.