



## SUBMISSION IN RESPONSE TO THE BUSINESS TAX WORKING GROUP DISCUSSION PAPER

### About this submission

The Business Council of Australia (BCA) brings together the chief executives of 100 of Australia's leading companies. For almost 30 years, the BCA has provided a unique forum for some of Australia's most experienced corporate leaders to contribute to public policy reform that affects business and the community as a whole. Our vision is for Australia to be the best place in the world in which to live, learn, work and do business.

The Business Tax Working Group (BTWG) was established following the tax forum in October 2011 to consider what kind of business tax system would best support Australia's future growth prospects in an affordable way. The BCA welcomed the opportunity to participate in the tax forum and to contribute constructively to this process.

This submission responds to the discussion paper issued by the BTWG on 13 August 2012. It incorporates a paper commissioned by the BCA from Deloitte Access Economics titled 'Options for Company Tax Reform'.

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## 1. Overview

### BCA position

The Business Council of Australia has been a member of the Business Tax Working Group (BTWG) and worked constructively in accordance with the group's terms of reference to try to find a way of funding a reduction in the company tax rate through the business tax system.

We strongly support the BTWG ambition that Australia needs to set a course for achieving a lower corporate tax burden through a 25% corporate tax rate, to help us keep up with our competitors and trading partners. The BTWG found our headline rate to be uncompetitive internationally and established there was a significant national economic benefit to be gained by reducing it. This would need to be done as part of a comprehensive process, implemented over a decade with broad and open community engagement.

The most important job is to take the long-term national interest as our starting point, and consider the macro effects and the sectoral impacts that would flow on to the broader economy. The Business Council of Australia would support government efforts to address tax reform in this way and would want to contribute constructively to such a process. This needs to be done in a strategic rather than a piecemeal way.

Our overarching task, as part of the BTWG, was to determine whether a reduction in the corporate tax rate, funded by scaling back other business tax arrangements, would lower the tax burden on business and provide a net benefit to the economy by improving Australia's competitiveness.

Despite our best endeavours, and after extensive consultation with member companies operating across the Australian economy, we do not believe that this can be achieved within the scope of options that the Working Group could consider and presented in the BTWG discussion paper. In short, removing the provisions nominated would be more likely to harm than support the Australian economy at this stage of the investment cycle, and would be particularly harsh on some sectors.

The reasons we have reached this conclusion are set out in detail in this submission.

In summary, **thin capitalisation** arrangements are very significant provisions in the tax law but have not been costed in the discussion paper. Proposals that cannot be costed should not be seriously considered by government – given how poorly understood these options appear to be, the risks both to government budget estimates and to company bottom lines are high. Foreign investment has underpinned Australia's economic development, and to impair it without a thorough and convincing analysis of costs and benefits makes no sense. In addition, the options to change the thin capitalisation arrangements only avoid damaging business activity to the extent that firms are able to shift their debt to an appropriate overseas location.

The tax treatment of **depreciating assets** has become less generous over the past 15 years. There is limited scope for more change without significantly raising effective tax rates, especially in oil and gas, and for the resources and mining sectors on which the Australian economy is heavily reliant. In aviation, which is struggling to maintain international competitiveness, the impact would be hugely damaging. With almost 30 per cent of economic activity in Australia currently generated by the capital investment pipeline, members of the Business Council of Australia have advised that this savings measure would place a significant proportion of that pipeline at risk.

Changes to **exploration and prospecting** arrangements would treat normal business costs of companies undertaking these activities less favourably than the normal business costs of companies operating in other sectors. Changes would add to the problems of high capital and operating costs in Australia.

**Research and development** tax credit provisions are just one year into the government's 10-year innovation program, *Powering Ideas: An Innovation Agenda for the 21st Century*. R&D concessions encourage innovation and recognise its broader societal benefits. Our poor productivity performance is driven at least in part by a failure to innovate at the firm level. This is not the time to discourage investment in innovation at the firm level.

The more concessional tax arrangements have been removed in the past 15 years, and the consensus is that the company income tax base is now a broad one. For this reason, it has been difficult to identify possible savings options to fund a company tax rate cut. As well as having made significant concessions in the past, business is now bearing the full impact of the carbon and mining taxes.

The primary purpose of corporate tax reform must surely be to lower the overall taxation burden and ensure our key trade exposed sectors stay competitive. We are willing to let go of concessions if we are able to look across the whole system and see that the net effect of tax reform is to be a positive one for the Australian economy, if the benefit would clearly counter potential harm to sectors on which our national prosperity is heavily reliant over the foreseeable future.

Having looked at the potential benefits and risks associated with offsets put forward to fund a corporate rate reduction, we cannot find a positive net benefit for the economy. In terms of business confidence and investment patterns, we find far greater risks than there are benefits in the short to medium term.

In our 2012-13 budget submission, the Business Council of Australia supported the government's plan to return the budget to surplus but we noted that there was scope to defer should global conditions deteriorate further.

We maintain that position but emphasise that it would be a significant concern if the government decided to pursue the savings measures presented in the BTWG discussion paper, or other concessions such as the diesel fuel rebate, for the purposes of shoring up the budgetary position in the short term.

What we need is for the government to act now to create and maintain a more stable, predictable business environment. Ad hoc changes are harming Australia's investment credentials.

### **Background to Business Tax Working Group**

The BTWG was established following the tax forum in October 2011 to consider what kind of business tax system would best support Australia's future growth prospects in an affordable way.

The Business Council of Australia has welcomed the opportunity to contribute constructively to this process.

The longer-term intention of the government, since the release of the Henry review in 2010, has been a company tax rate of 25 per cent. In the 2010–11 Budget, the government announced a phased cut in the company tax rate to 28 per cent, and an intention to cut the rate further, as revenue allowed. The 2011–12 Budget included a reduction in the company tax rate to 29 per cent for the 2013–14 income year and to 28 per cent for the 2014–15 income year, with a faster transition for small business.

This cut in the company tax rate to 28 per cent was identified by the government as helping to make Australia's corporate tax environment more competitive relative to other similar-sized OECD countries, and to make Australia a more attractive destination for foreign investment. It was also described as encouraging the establishment of new industries and businesses, and the creation of new jobs, leading to higher economic growth and higher incomes for Australians.

The cut in the corporate tax rate was to be funded by the introduction of the Resource Super Profits Tax (RSPT).

As part of the statement in July 2010 that changed the RSPT to the Minerals Resource Rent Tax, the government announced the reduction in the company tax rate would be to 29 per cent rather than the previously planned 28 per cent. Small companies were to benefit from the rate reduction from 2012–13.

However, the 2012–13 Budget scrapped the company tax rate cut entirely. Associated savings were primarily directed to family payments and income support.

### **Terms of reference**

This reversal by the government mid-way through the deliberations of the BTWG has fundamentally changed its task.

Until the Budget, the BTWG's task was to seek to build on the one percentage point rate cut to create a material cut of two percentage points, or even a little more. It was to do so by identifying concessions or provisions that could be removed or reduced without damaging the economy and where it could be established that there would be a net gain.

As successive governments have scaled back concessions over the past 15 years, the scope to go further was always going to be limited. The subsequent removal of the platform provided by a one percentage point cut in the company tax rate left the entire task of funding a material rate reduction to the suite of base broadening measures.

The test for any individual measure and for any package of measures is demonstrable net benefit to the economy.

The Business Council of Australia has engaged constructively as a member of the BTWG and with an open mind, to assess whether such a trade-off could be achieved in the context of a reduction in the overall tax burden on business.

### **Australia's economic challenge**

An important backdrop to the consideration of the BTWG discussion paper is the challenging economic circumstances which currently prevail and point we are at in the investment cycle. The overarching consideration is an Australian economy with relatively strong fundamentals that is going through significant structural change and transition likely to continue for some time.

A central feature of our economy is an unprecedented pipeline of capital investment projects. Australia has become, and will remain for some time, an economy highly dependent on capital investment for its GDP growth. Business investment in particular is expected to contribute around half to two thirds of the increase in GDP.

If realised, the investment pipeline will underpin a highly productive economy of the future and will materially raise the living standards of future generations. However, successful delivery of the whole of the prospective project pipeline is not assured, with the downturn in commodity prices and Australia's relatively high costs potentially placing uncommitted projects at risk. The value at risk is very high; of the \$470 billion of prospective investments in the pipeline, some 15% are in oil and gas.

As commodity prices have retreated, Australia's terms of trade have come off and are down by some 7 per cent over the past year. At the same time, the global economic outlook continues to be highly uncertain. At a time of significant economic insecurity, the certainty of macroeconomic policies plays a central role in underpinning efforts to lift productivity. It also helps create an environment conducive to investment and innovation.

The Business Council has supported the government's efforts to achieve a budget surplus in 2012-13 as an important demonstration of Australia's fiscal credentials and its commitment to fiscal discipline. However, we have at all times noted that the government should have the flexibility and discretion to alter the timing of achieving a surplus if prevailing global economic conditions and their impact on Australia were to change.

## **Comprehensive tax reform**

In a vastly more competitive global environment, Australia's tax system is becoming less equipped to support our international competitiveness, particularly given the increasingly mobile nature of global capital. Also putting strain on the system is our demographic ageing allied with community expectations of rising material living standards.

A good tax system needs to reflect important principles around equity and efficiency, simplicity and policy consistency while achieving the fundamental objectives of what a tax system is intended to do. A key finding of the Henry review was that Australia should reduce its reliance on more mobile bases – personal income and business income – and increase its reliance on less mobile bases – consumption and economic rents.

A company tax system is competitive to the extent that the overall tax burden on business does not create a undue barrier relative to competitor countries. Member companies make the point that the statutory tax rate is far from their only consideration. They are concerned with the overall tax burden, with the effective rate taking account of the statutory rate, the breadth or narrowness of the tax base, and the impact of other taxes such as excises, resources taxes and state taxes such as stamp duty and payroll tax.

If Australia is to have a fair tax system, future policies must meet the following fundamentals:

- the tax system must support and complement overall fiscal policy;
- revenue adequacy must be the highest priority – however, governments at all levels must be efficient in their expenditure of public monies, recognising that the tax system alone won't be able to meet current projected expenditures;
  - hence the BCA's call for an audit on the size and scope of government.
- the tax system must be configured to promote productivity which will promote our overall economic growth;
- the tax system must be competitive to attract investment in global capital markets;
- the tax system must continue to be based on progression and the capacity to pay;
- efforts must be made to improve the simplicity, certainty and transparency of the system;
- those taxes directed at addressing social and environmental issues should actually bring about changes in behaviour, rather than having revenue raising or income redistribution as their main objective.

It is clear that consideration of long-term tax reform must encompass all taxes at the Commonwealth, state and local levels.

The reason that the Business Council of Australia argues the case for reduced company income tax rates is not narrowly motivated by the benefits this would bring to member companies. We are more fundamentally motivated by the important, longer-term economic efficiency benefits.

While the advantages would accrue to member companies, they would also benefit the community at large. The consensus in Australia is that, in the long run, the benefits of a reduction in company tax would fall significantly to labour. In other words, it is likely to lead to capital deepening and an increase in real wages as productivity increases.

The Business Council of Australia also considers there to be insufficient evidence to warrant further resources being expended on examination of the allowance for corporate equity (ACE) at this time. While significant parts of the economy are experiencing difficult trading conditions, presaging radical and untested tax changes does little to support business confidence.

## **The importance of a company tax cut**

The tax burden on companies in Australia is already around the mid range of OECD countries and high compared to our Asian competitors and trading partners. This is a problem given the increasing mobility of international investment and the international trend to lower company tax.

The heavy and growing reliance of government revenues on company taxes also undermines Australia's competitive position. Credible estimates suggest that a five percentage point reduction in Australia's company tax rate would lead to an 18.6 per cent increase in foreign direct investment in this country.

In the context of the high relative costs of doing business in Australia, a reduction in the statutory tax rate is a simple mechanism for government to reduce the overall tax burden on business without causing unintended consequences. Such a move would also do much to boost business confidence and improve wage outcomes, and was a key recommendation of the Henry Tax Review

### **Funding a corporate tax cut**

The Business Council of Australia does not advocate a company tax rate reduction without careful consideration of the full impacts and whether it delivers a net benefit to the economy.

There are economic benefits that flow simply from the improved business environment brought about by a rate cut through its role in lowering the overall company tax burden. As well as improving international competitiveness, the benefits include greater scope for companies to bring more marginal projects to fruition, and better business confidence.

Mechanisms to fund a rate cut exist within the taxing and spending choices of governments. While the BTWG's terms of reference require the funding to come from other aspects of the company tax system, this approach is excessively limiting. The revenue increase needed to fund a material reduction in the company tax rate cannot be met by altering other parts of the company tax system without very deep impacts on particular companies and sectors.

It is effective tax rates rather than statutory rates that matter for investment. While a reduction in the company tax rate would lower effective tax rates and improve competitiveness, altering other parts of the system may increase effective rates and reduce competitiveness. It could easily turn out to be the case the costs in terms of international competitiveness outweigh the benefits.

The impacts on companies' ability to do business and fund projects would in some cases be very damaging. The BTWG was established to give proper consideration to this.

The Business Council of Australia is concerned by the recent experience with the MRRT. The government introduced a tax increase in order to fund a rate reduction elsewhere in the system that has not eventuated.

### **The impact of potential offsets**

Based on detailed consultation with member companies of the Business Council of Australia, spanning different sectors of the economy and different types of business, this submission details the potential impact of funding proposals presented in the BTWG discussion paper.

Our consultation uncovered widespread concern around each proposal.

Many member companies noted the flexibility they have to locate projects and activities in other countries with comparable or more favourable tax settings than those currently operating in Australia.

Companies in a number of sectors, particularly oil and gas, highlighted the long lead times on projects and their concern that short term revenue gains to government might be sought at the expense of longer-term wealth-creating activities among the broader community. Members also highlighted that, while the savings options could take years in some cases to fully accrue to the government's budget bottom line, the impact on investment decisions would be immediate.

The costs of complexity and change are also a major concern without a clear material benefit to be gained. Predictability and consistency in tax policy are cornerstones of long-term investment. Members also see a need for deeper consideration of the very significant transition arrangements that would apply.

## Findings

The Business Council of Australia has engaged as a member of the Business Tax Working Group in an open and constructive manner. It has considered whether there are revenue-neutral reforms that can raise productivity while delivering tax relief to struggling businesses and a net benefit to the Australian economy.

We have considered the business tax system through a broad lens, taking account of the challenging economic circumstances and the requirements of the economy to raise revenue and grow income in support of a high standard of living for all Australians.

The Council has examined the options proposed in the BTWG discussion paper in this context and considered whether they are in keeping with a future-oriented tax system. We have assessed the extent to which specific sectoral and company impacts would, on balance, be positive or negative.

We find that the task of funding a material cut in the company tax rate purely from reduction or removal of other company tax provisions is not achievable without risk of significant damage to investment and growth in this country.

## Recommendations

1. That the government commit to a 25 per cent company tax rate as a long-term direction for lowering the corporate tax burden.
2. That the government jettison the options laid out in the BTWG discussion paper as the basis for changing the company tax system or for any other short-term purpose.
3. That the government commit to a comprehensive tax reform process, staged over a decade, including all taxes, and focused on the principles for tax reform described in this submission.

## 2. The economic context for considering business tax reform

An important backdrop to the BTWG's discussion paper is the challenge of current economic circumstances. The overarching consideration is an Australian economy with sound fundamentals that is going through a significant transition. This period of transition and structural change is likely to continue for some time to come.

The reason to focus on the economic environment when considering tax settings is business confidence. Business requires predictability and time to adapt to changes. It needs to be able to plan for projects that can have very long timeframes. It needs to know that tax provisions that underpin projects' viability will continue both for projects already underway and also those coming on-stream. It needs government settings that recognise the sensitivity of the economy to investment, and are equipped to respond to global conditions as they arise.

Headline economic growth, as measured by the increase in real GDP, is recorded at 3.7 per cent in the year to the June quarter 2012. This outcome has been underpinned by growth in construction spending and from household consumption. In the most recent quarter, public sector expenditure made a material contribution to growth.

A central feature of the domestic economy in recent times has been the construction of a substantial pipeline of predominantly resource-related major investment projects.

Over the past eighteen months business investment has contributed more than half of the growth in domestic demand in Australia and almost three quarters of this is accounted for by engineering construction.

Mining-related investment grew by more than 70 per cent over the past year and the latest capital expenditure survey projects further growth for that sector. However, investment decisions are being affected by falling commodity prices and the uncertain international economic environment. With almost 30 per cent of economic activity in Australia currently generated by the capital investment pipeline, members of the Business Council of Australia have advised that extracting savings from this sphere would place a significant proportion of that pipeline at risk.

While there remains a substantial volume of investment coming through the investment pipeline, especially in relation to LNG projects, the BCA's recent work has pointed out that it is by no means assured that all of the investment pipeline will come on stream or be delivered on time or budget.

The outlook for non-resources related investment has been subdued and is expected to remain that way in 2012–13. Information reported by from the RBA's business liaison suggests that non-resource firms are slowing their investment spending in line with weaker cash flows and are becoming more selective about which projects to pursue.

Notwithstanding the recent headline growth numbers for the economy as a whole, many BCA members are reporting that business conditions remain challenging and hiring expectations are quite subdued and some members are reporting layoffs. Business and consumer confidence levels have also been weaker than might be expected given the broader economic fundamentals.

The National Australia Bank's index of business sentiment has been below its long run average for over a year now.

While Australia's unemployment rate has remained stable at around 5 per cent, a pronounced fall in the participation rate (which has declined by a full percentage point since November 2010) has helped hold the unemployment rate down. The ABS measure of aggregate hours worked in the economy has also weakened considerably in recent months.

As commodity prices have retreated, Australia's terms of trade have come off and are down by some 7 per cent over the past year. As well as having consequences for the investment outlook, this is having significant implications for national incomes and for growth in the nominal economy.

Looking through the headline real GDP figures, growth in nominal GDP has slowed abruptly in recent quarters. Current growth of Australia's nominal GDP of 3.2 per cent is well below the average annual growth of 7 per cent recorded over the past 10 years. The recent weakness in



nominal GDP is an important development as it has significant implications for company profits and tax collections.

At the same time, the global economic outlook continues to be highly uncertain as characterised by two overwhelming trends: a flight from risk, and a new low-growth environment across both developed and developing countries.

Europe continues to grapple with the Eurozone debt crisis, and despite some decisive actions from the European Central Bank, it is likely to be many years before stability is returned. The Eurozone economic problems have a direct impact on other economic zones such as the US and China, for whom Europe is a significant destination for exports. The United States economy is also struggling to return to trend-like rates of growth. China's growth rate has slowed and its outlook is less assured, though it appears likely at this stage that a soft landing will occur rather than a sharp and sudden slowdown.

At a time of significant economic insecurity, the certainty and credibility of macroeconomic policies can play a central role in underpinning efforts to lift productivity and workforce participation. Credibility in policy making also helps create an environment conducive to investment and innovation.

The parlous economic and fiscal circumstances of many European countries and the reactions of markets have driven home the importance of fiscal consolidation and the critical importance of placing government finances on a sustainable footing.

The BCA has previously argued that returning the budget to surplus would provide a strong demonstration of the government's fiscal credentials and its commitment to fiscal discipline. We therefore supported the government's intention to achieve a budget surplus in 2012–13. However, we have at all times noted that the government should have some flexibility and discretion to alter this path in response to prevailing global economic conditions and their impact on Australia.

The International Monetary Fund's recent preliminary concluding statement on its Article IV consultation with Australia noted that the government's fiscal consolidation path strikes a balance between the need to limit both public and external debt increases while containing any adverse impacts on growth. The IMF noted, however, that "Australia's modest public debt gives the authorities scope to delay their planned return to surplus and let the automatic stabilisers operate in the event of a sharp deterioration in the economic outlook."<sup>1</sup>

As conditions in the global economy and in China have softened, the recent falls in the terms of trade are now having clear effects on the economy. As noted above, this has manifested in the soft growth recorded in nominal GDP, which is now quite weak by historical standards. Financial markets are also pricing in material reductions in the official cash rate.

The purpose of having fiscal rules should not be to restrict flexibility at all costs but to enhance the role of fiscal policy as a contributor to medium term fiscal stability. The rules are not designed to limit the flexibility of government budget settings in any particular year, but to provide a medium term anchor for fiscal policy.

Reflecting the materially lower terms and trade and the prospects for this trend to continue, and the implications of this for a softer overall economy, the BCA believes the practical achievement of a surplus in 2012-13 may need to be revisited. This will be particularly important if key indicators continue to point to weakness in the economic environment. Any deferral of the timing of a return to surplus should, however, be done on the proviso that the government outline a clear and credible path to fiscal discipline over the medium term. A focus needs to be on major structural changes to spending programs and more efficient delivery of government services overall.

In the event that the economy does grow at or above trend over the coming year as Treasury and the IMF have suggested, then it would remain prudent to aim for a budget surplus in 2012-13. This should, however, be achieved through expenditure restraint and not tax increases.

### 3. The need for and characteristics of comprehensive tax reform

The BCA is a strong advocate for comprehensive, planned and phased tax reform. In a changing environment, the tax system as it stands is becoming less equipped to support our international competitiveness, particularly given the increasingly mobile nature of global capital. Also putting strain on the system is demographic ageing allied with community expectations of rising material living standards, in the broader context of a shifting focus of world economic activity.

A tax system that equips Australia for the future needs to work in concert with other public policy settings, including well-designed and administered regulation and a degree of predictability in major policy settings.

#### Propositions to guide comprehensive tax reform

The BCA's submission to the 2011 tax forum laid out its propositions to guide tax reform. It argued then that any long-term changes to the tax system should be underpinned by good public policy principles. If changes to the tax system are guided by such principles, then the opportunity for short term, short sighted, poorly designed policies would be reduced.

The BCA believes that a good tax system needs to reflect both important principles about equity and efficiency, simplicity and policy consistency and some fundamental elements about what a tax system is intended to do.

In any reform of this nature, there are obvious trade-offs and it is important that these trade-offs are transparent. However, the BCA believes that if Australia is to have a fair tax system, future policies must meet the following fundamentals:

- the tax system must support and complement overall fiscal policy;
- revenue adequacy must be the highest priority – however, governments at all levels must be efficient in their expenditure of public monies, recognising that the tax system alone won't be able to meet current projected expenditures;
- the tax system must be configured to promote productivity which will in turn promote our competitiveness and overall economic growth;
- the tax system must continue to be progressive and based the capacity to pay;
- efforts must be made to improve the simplicity, certainty and transparency of the system;
- those taxes directed at addressing social and environmental issues should actually bring about changes in behaviour, rather than having revenue raising or income redistribution as their main objective.

It is clear that consideration of long-term tax reform must encompass all taxes.

#### Four broad bases

A key and overarching finding of the Henry review was that Australia should reduce its reliance on more mobile bases – personal income and business income – and increase its reliance on less mobile bases – consumption and economic rents. The BCA supports this as a framework for reform.

This framework is well supported within Australia by a wide range of experts, and is consistent with international studies on the most effective type of tax system to yield economic benefits.

For instance, the Grattan Institute in June 2012 found that, if Australian governments are serious about raising rates of economic growth, one of the three reforms they should undertake is to improve the tax mix. Along with two other big reforms of raising the workforce participation rates of women and older people, this could contribute over \$70 billion per year to economic growth in the next decade. As the Grattan Institute puts it, "There's nothing else big enough to change the game."<sup>2</sup>

The reason for the BCA to argue the case for reduced company income tax rates is not therefore narrowly motivated by the benefits for its member companies, but more fundamentally motivated by

the longer-term and important economic efficiency benefits of such a change. These benefits would clearly accrue to member companies, and they would also be enjoyed by the community at large. While, in the short term, companies would be the beneficiaries of a reduction in company tax, the BCA notes that the consensus in Australia is that, in the long run, the incidence of such a change would fall significantly to labour. In other words, in the long run, a reduction in company tax rates is likely to lead to capital deepening and an increase in real wages. More detail on this issue is laid out in the attachment to this submission.<sup>3</sup>

### **The place of company income tax in the tax mix**

As previously discussed, the relative importance of company income tax in the tax mix should take account of efficient allocation of resources to the most productive uses. The tax mix also needs to take account of our competitors, since competition for highly mobile capital also means that the global competitive pressure is more likely to be towards reductions in the corporate tax rates.

As noted in the Henry review and by others, the current system may bias investment and other business choices.

Company income tax can reduce productivity in a number of ways:

- where effective tax rates vary across assets, investment can be directed towards less productive uses;
- through its effect in discouraging direct foreign investment, taxes on investment can adversely affect technology transfers and knowledge spillovers;
- taxes on investment may also reduce investment in innovative activities, by reducing the after-tax return;
- complexity of the tax system can also reduce productivity by absorbing resources that could be reallocated to more productive uses. In addition, tax system complexity may also deter foreign direct investment;
- company income tax can also distort financing decisions. This can affect productivity by distorting the allocation of investment across industries, favouring those sectors that can more easily access debt, relative to those that have to rely more on equity, such as those that invest more in intangibles.

To assist in considering the issues associated with a company tax reduction, the BCA commissioned Deloitte Access Economics to prepare a high-level paper on the subject. This paper is included in the attachment to this submission. It notes the extensive literature on the impacts of taxation on decisions, including the impacts of corporate tax on companies' decisions. The sensitivity of foreign capital movements to differences in company tax rates between countries is a key determinant of the inefficiency costs of company taxation.

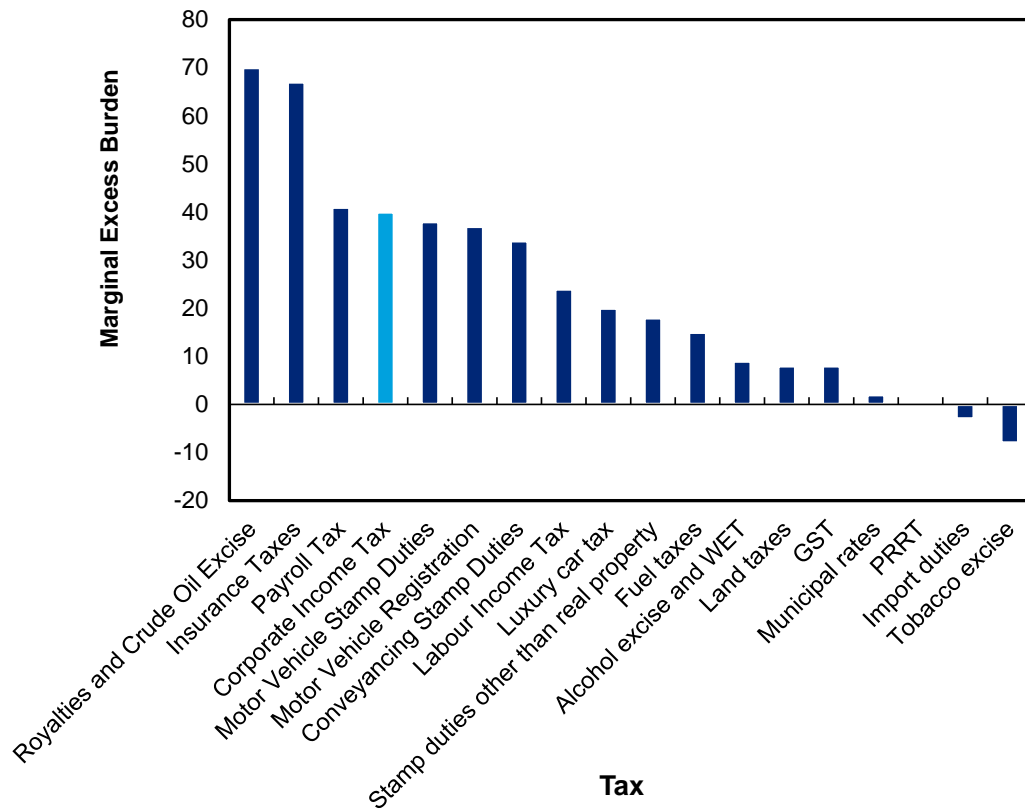
International capital is highly sensitive to company tax rates. De Mooij and Ederveen<sup>4</sup> undertook a meta-analysis (a quantitative literature survey) of 31 existing studies of the responsiveness of foreign direct investment (FDI) to company tax rates, and established that most studies find a negative relationship between taxation and FDI.

The size of this negative relationship is substantial. Overall, de Mooij and Ederveen found a semi-elasticity of  $-3.72$ , which means that a one percentage point reduction in company tax rates leads to a 3.72 per cent increase in foreign direct investment. This was a key piece of evidence that was noted in the Henry Tax Review.<sup>5</sup> Using this estimate, a 5 percentage point reduction in Australia's company tax rate would lead to an 18.6 per cent increase in foreign direct investment in Australia. This evidence is discussed in more detail in the Deloitte Access Economics paper.

The high sensitivity of foreign investment to company tax rates means that company taxes are relatively costly. As a general rule, the direct burden of taxation – the reduction in consumer and producer welfare – is larger than the revenue that is raised by the tax. The deadweight costs (or costs to society through market inefficiency) of company taxation have been examined at length in

the literature, but there are relatively few estimates for Australia. The Henry Tax Review found that company taxes were relatively inefficient, with a marginal excess burden (or change in deadweight loss for an extra dollar of tax revenue) of 0.4 (see Figure 1). In other words, a marginal reduction in the company tax rate which reduced revenue by 1 dollar would only increase net economic welfare by \$0.40.

**Figure 1: Estimated Inefficiency of Australian Taxes**



Source: *AFTS Review Final Report, Part One Overview*, p. 13, 2009 and KPMG Econtech, *CGE Analysis of the Current Australian Tax System*, 2010, p. 5.

In the 2010–11 Budget, the government estimated that a 1 percentage point reduction in the company tax rate would reduce government revenue by \$2 billion. Using the Henry Tax Review’s estimate of the marginal excess burden of the company tax, this would mean that consumer welfare would be \$2.8 billion higher, which is roughly equivalent to 0.2 per cent of GDP.

Given the estimates of the sensitivity of foreign investment to changes in the statutory company tax rate explored above, it is possible to derive some rough estimates of the effect of reductions in the statutory company tax rate on GDP. Using the framework detailed in the attachment, a one per cent increase in the capital stock increases GDP by 1/3 of 1 per cent. If the mean semi-elasticity of FDI with respect to changes in the company tax rate is –3.72, then a reduction in the statutory corporate tax rate leads to an increase in the flow of investment, which means the capital stock is higher than it otherwise would be. Using the simple rule that annual net investment is approximately equal to 3.5 per cent of the total capital stock, we can derive estimates of the effect on GDP in the long run. The estimates are shown in Table 1.

**Table 1: Estimates of the Effect of Reductions in the Statutory Company Tax Rate on GDP**

| Reduction in Statutory Company Tax Rate | Estimate of Increase in the Long-Run Level of GDP |
|---|---|
| 1%                                      | 0.36 per cent                                     |
| 2%                                      | 0.72 per cent                                     |
| 3%                                      | 1.08 per cent                                     |
| 4%                                      | 1.44 per cent                                     |
| 5%                                      | 1.80 per cent                                     |

Source: Deloitte Access Economics.

While these estimates are only indicative, they are not dissimilar to official government estimates and other estimates derived in the literature. For example, in the 2010–11 Budget the government cited modelling which estimated that the reduction in the statutory company tax rate by two percentage points, from 30 per cent to 28 per cent, would result in an increase in GDP in the long run of 0.7 per cent. This is consistent with most of the empirical literature, which finds that of all taxes, company income tax tends to have among the largest negative effects on economic activity.

In summary, international capital is important to a small open economy like Australia’s, and the evidence suggests that international capital is highly sensitive to company tax rates. Further, company tax rates overall are relatively inefficient. While estimates are only indicative, the available evidence (including the government’s own estimates) support the conclusion that company income tax has among the largest negative effects on economic activity.

## 4. The importance of a company tax cut

A company tax system is competitive to the extent that the overall tax burden on business does not create an undue barrier relative to competitor countries. Member companies make the point that the statutory tax rate is far from their only consideration. They are concerned in making investment decisions with the overall tax burden, with the effective rate taking account of the statutory rate, the breadth or narrowness of the tax base, and the impact of other taxes such as excises or resources taxes.

### The tax burden on business

Lowering the statutory company tax rate lowers the tax burden and improves investment incentives, while reducing allowances has the opposite effect. The balance of these two effects yields the outcome experienced by companies.

In more technical terms, the tax burden on business is captured in the concept of the effective tax rate. There are two relevant effective rate concepts that are discussed in the literature:<sup>6</sup>

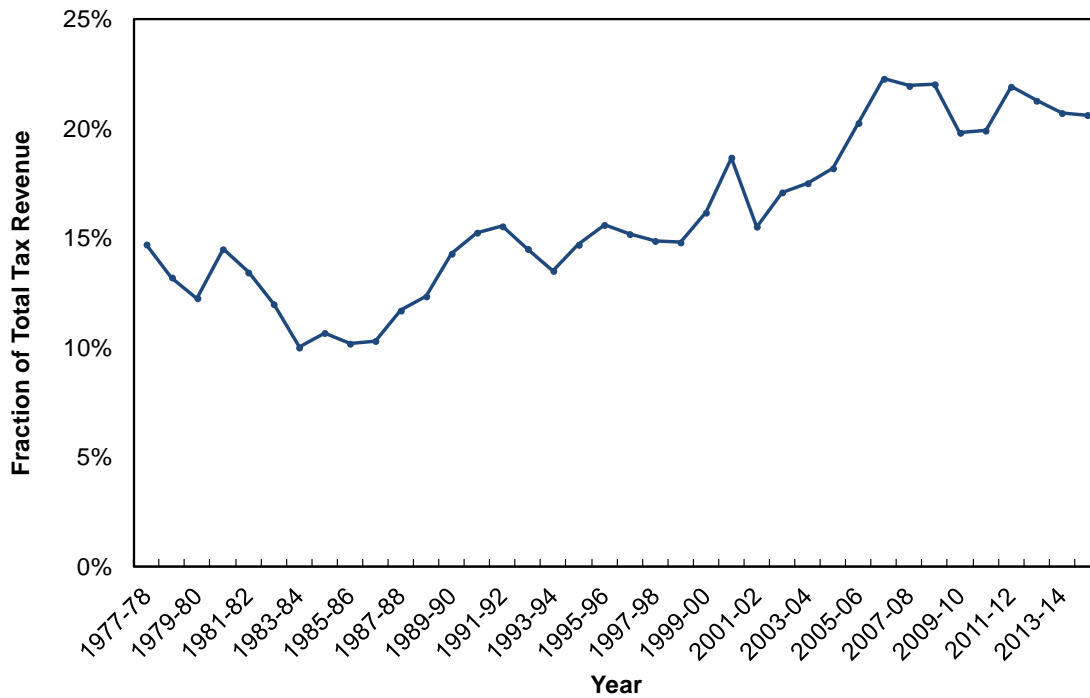
- The effective marginal tax rate (EMTR): this is the rate that applies to marginal investment projects, where the last dollar invested provides a sufficiently high pre-tax return so that the investment project just breaks even after taxes (taking into account a normal cost of capital).
- The effective average tax rate (EATR): this is a measure of the effect of taxation on non-marginal investments. It is a measure of the proportion of pre-tax economic profit that the investor gets to keep after paying company tax.

The EATR tends to be a better indicator of the tax incentives facing multinational companies investing in large, discrete projects, whereas the EMTR is an indicator of the extent to which taxation affects the scale of these projects. Company tax revenues as a whole also go beyond simple considerations of the statutory rate to illustrate the total impact of the company tax system.

### Recent trends

Revenue from company tax is expected to total \$73.4 billion in 2012–13, which is 21.4 per cent of total Australian Government tax revenue. As Figure 2 shows, over the last 30 years, reliance on company tax as a source of federal government revenue has increased markedly, with company tax revenue as a share of total tax revenues more than doubling since 1983.

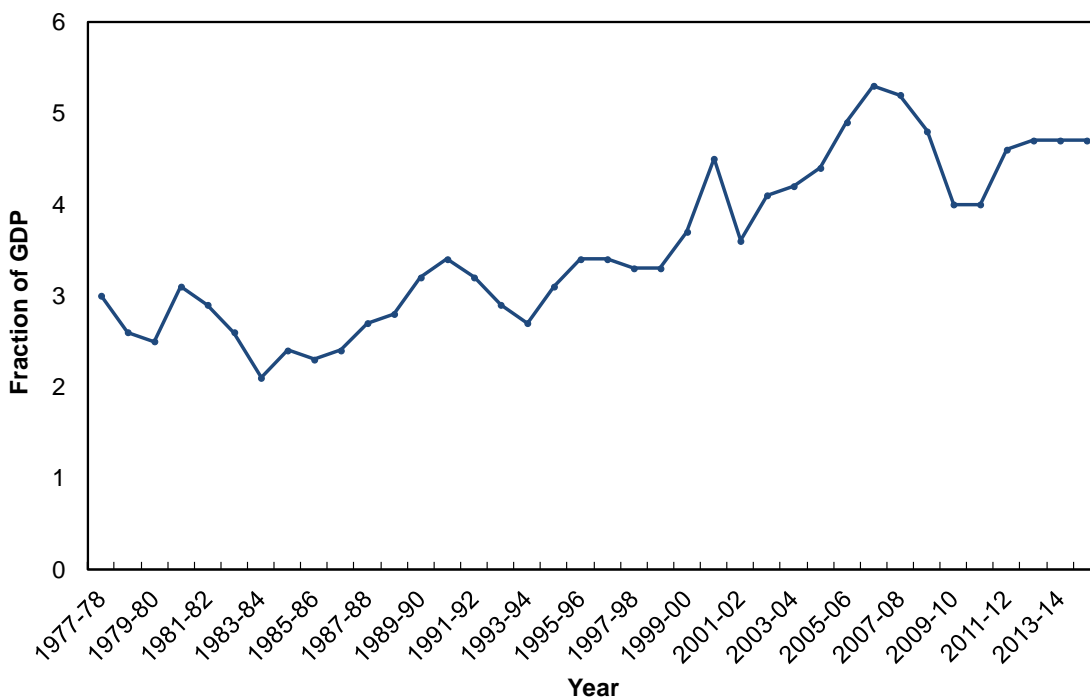
**Figure 2: Company Tax Revenue as a Fraction of Total Tax Revenue**



Source: 2012–13 Budget Paper Number 1, Statement 5, Table C2, p. 5-37; Deloitte Access Economics analysis.

In addition, the share of company tax revenue as a fraction of GDP has more than doubled over the same period (Figure 3).

**Figure 3: Company Tax Revenue as a Fraction of GDP**



Source: 2012–13 Budget Paper Number 1, Statement 5, Table C2, page 5-37; Deloitte Access Economics analysis.

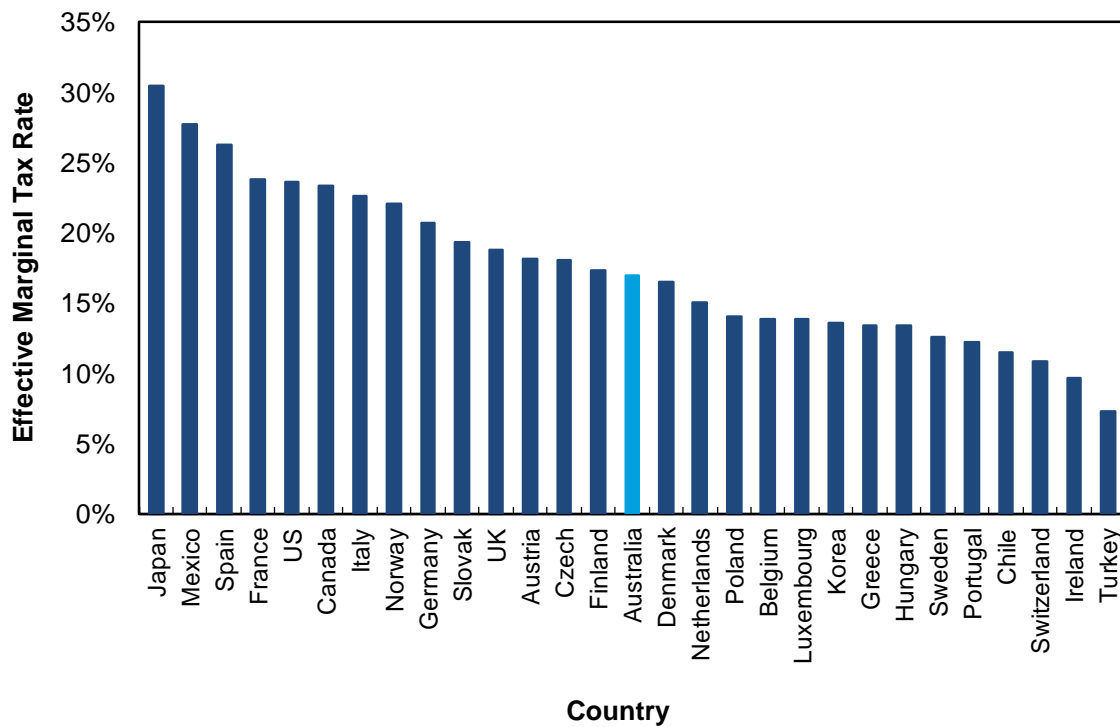
By international standards, Australia remains heavily reliant on company tax as a source of revenue. Indeed, OECD data suggest that of the OECD economies, only two countries have higher ratios than Australia of company tax receipts to GDP.

Over the same period there have been a number of important changes to Australia’s company tax arrangements. While company tax revenue has doubled in relative terms, the statutory tax rate has fallen considerably, from 46 per cent in the early 1980s to the current rate of 30 per cent. This indicates the extent of the base broadening that has already occurred in the company tax system.

**International comparisons**

Australia’s effective tax rate is around the middle of the distribution of effective tax rates for OECD economies. This information is derived from Hassett and Mathur, who apply the methodology of Devereux et al.,<sup>7</sup> to estimate EMTRs and EATRs for OECD economies, including Australia. The methodology involves calculating the net present value of depreciation allowances and adjusting post-tax returns for those allowances, in order to derive an estimate of the effective tax rate. Hassett’s results for effective marginal and effective average tax rates across the OECD are summarised in the two figures below.

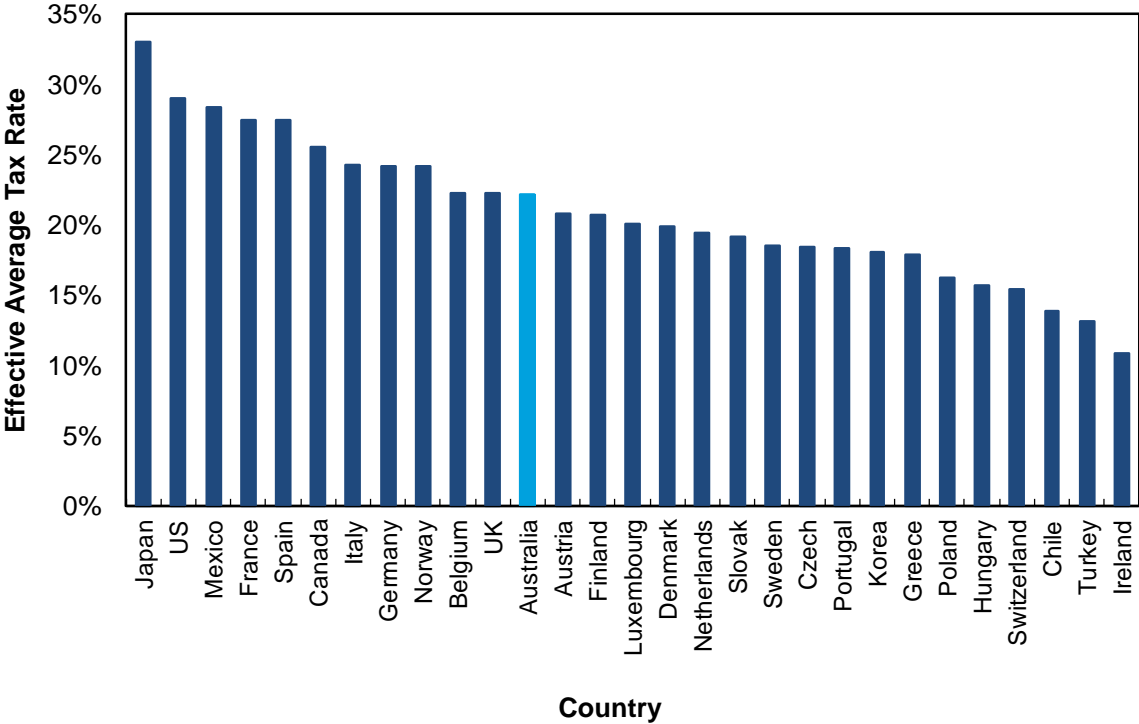
**Figure 4: Estimates of Effective Marginal Corporate Tax Rates, OECD, 2011**



Source: Hassett and Mathur, 2011.



Figure 5: Estimates of Effective Average Corporate Tax Rates, OECD, 2011



Source: Hassett and Mathur, 2011.

While OECD comparisons compare Australia with similar countries, equally if not more important is the comparison with non-OECD countries who are our competitors in the region. For Australia to remain an attractive investment destination for foreign investors over the medium to longer term, our corporate tax regime will need to be internationally competitive against a much broader set of countries. Chen and Mintz derive estimates for Australia and selected non-OECD Asian economies (Table 2).<sup>8</sup> Their methodology is different to Hassett’s (hence the difference in Australia’s estimated EMTR). The relative ranking they show for Australia suggests that our effective rate is high in comparative terms.

**Table 2: Estimates of EMTRs for Australia and Selected non-OECD Asian Economies**

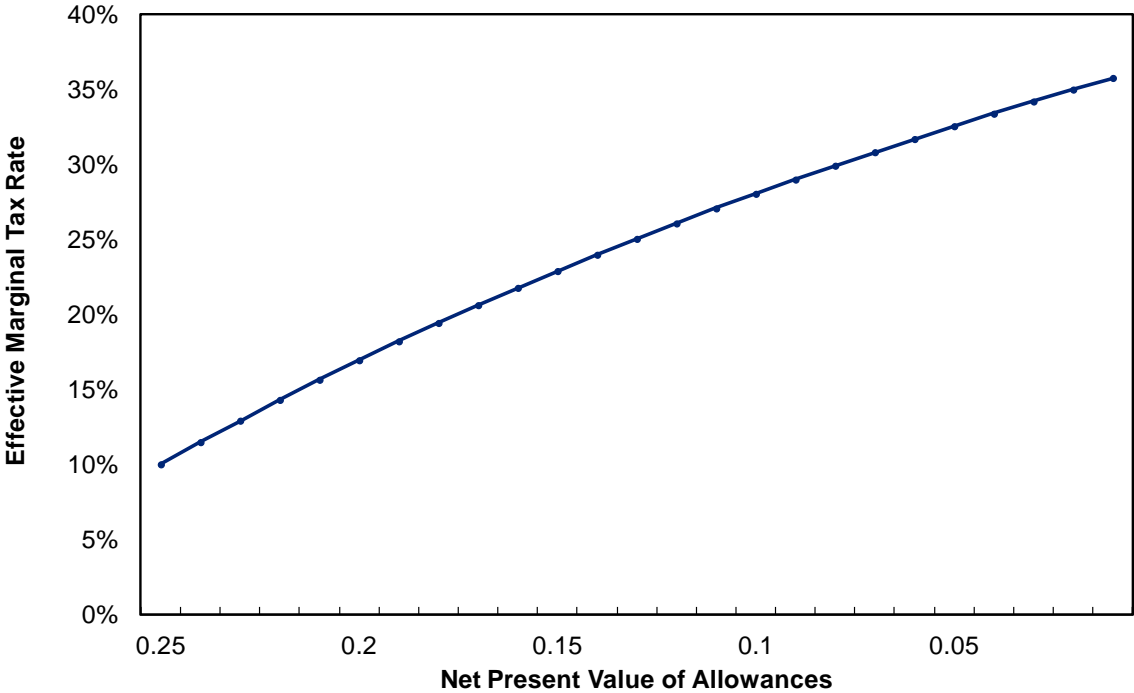
| Country   | Effective Marginal Tax Rate |
|-----------|-----------------------------|
| India     | 33.6 per cent               |
| Australia | 26.0 per cent               |
| Indonesia | 20.5 per cent               |
| Malaysia  | 18.0 per cent               |
| China     | 16.6 per cent               |
| Vietnam   | 11.7 per cent               |
| Taiwan    | 10.9 per cent               |
| Singapore | 8.5 per cent                |
| Hong Kong | 4.0 per cent                |

Source: Chen and Mintz, 2011.

The BCA appreciates that countries represented in Table 2 have very different systems of social support and government operations to Australia's, meaning they have much lower revenue demands. It is in recognition of this important difference that the BCA advocates a company tax rate of 25 per cent rather than dropping to the significantly lower levels that some Asian nations have chosen.

Reducing allowances and other tax provisions increases the required rate of return on a project (the cost of capital) and increases effective marginal tax rates. To get some idea of the sensitivity of EMTRs to changes in allowances, Figure 6 simulates a series of hypothetical examples based on the formulas derived in Devereux et al., in which allowances are progressively lowered. In this example, which is based on reasonable parameter values, EMTRs can be highly sensitive to changes in allowances: for high values of allowances, halving the value of allowances more than doubles the EMTR.

Figure 6: Lower Allowances Increase the Effective Marginal Corporate Tax Rate



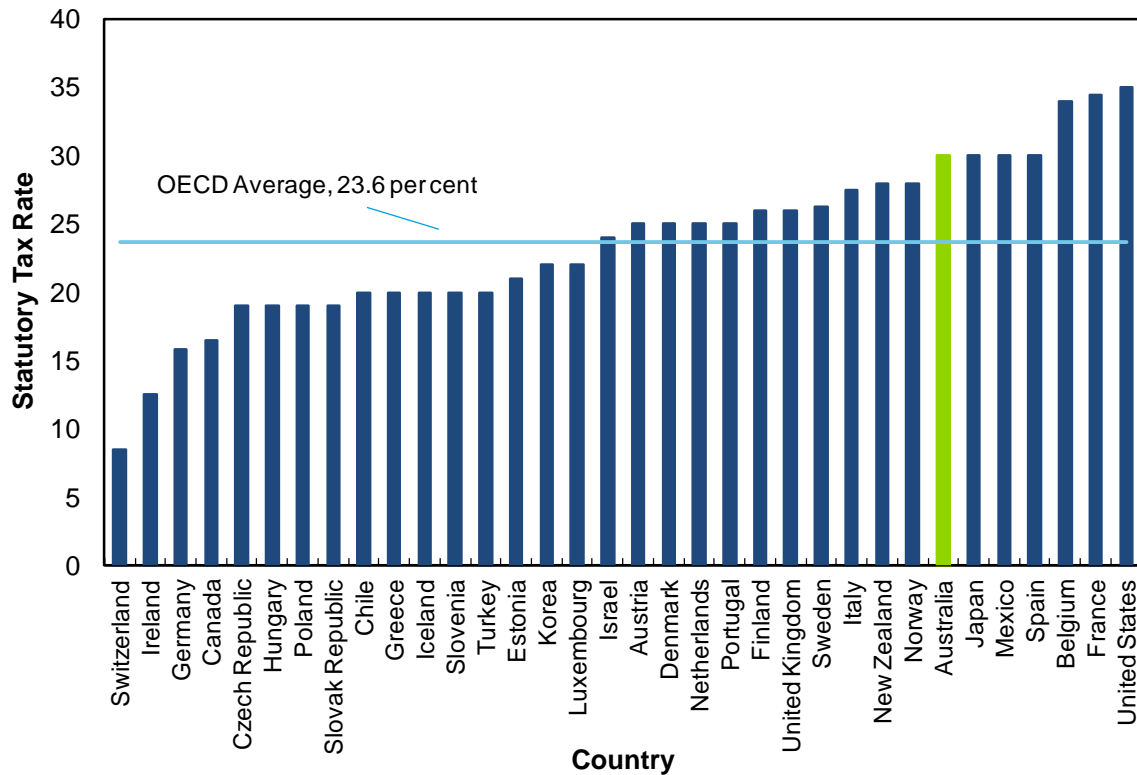
Source: Deloitte Access Economics analysis, based on the expression for EMTRs for a one-period investment, derived from p. 461 of Devereux et al (2002). The example ignores inflation and assumes a discount rate of 10 per cent, depreciation of 3 per cent, and a statutory corporate tax rate of 30 per cent.

**Role of the statutory rate**

The statutory rate is only one element of a company’s tax burden; its importance lies in its simplicity as a lever for changing the overall tax burden.

While Australia’s statutory company tax rate has fallen over the last two decades, the rest of the world has not stood still. Between 2000 and 2011 the statutory corporate income tax rates in OECD member countries dropped by an average 7.2 percentage points. As a result, Australia’s statutory rate is today relatively high by international standards. Indeed as Figure 7 shows, Australia now has the seventh highest statutory rate in the OECD, and the rate of 30 per cent is well above the unweighted OECD average of 23.4 per cent.

Figure 7: Statutory Company Tax Rates, OECD, 2011



Source: OECD Economic Surveys, 2012.

At a general level, the international evidence indicates that governments in small open economies like Australia’s rely less on personal and corporate income taxes and more on expenditure and trade taxes than do other countries. This finding, made by Hines and Summers, is an important one, and they also make the comment that “small countries are believed to face the most elastic corporate tax bases and therefore to have the strongest incentives to offer low corporate tax rates.”<sup>9</sup>

In summary, companies’ decisions are influenced not solely by the corporate tax rate but by their full tax position, including the tax rate, the tax base and the impacts of any other taxes for which they are liable. While Australia’s effective tax rates (encompassing the tax rate and base) are around the middle of the OECD pack, they are high compared to Asian competitors’ rates. A small open economy like ours has a strong incentive to keep the company tax burden relatively low so that we can compete effectively. Our relatively heavy reliance on company tax revenues indicate that there is scope to improve our competitive position.

## 5. The options to fund a tax cut

The BCA recommends a cut in the company tax rate, noting that existing government studies suggest there would be sizeable economic gains from reductions in the company tax rate.

The funding of a tax cut needs careful consideration to ensure that it brings a net benefit to the economy. The BCA does not advocate a rate reduction if the reduction is not big enough to offset the short to medium term impacts on the economy.

One consideration that has yet to be quantified is the economic benefits that flow simply from the improved business environment brought about by a rate cut. These benefits include improved international competitiveness, greater scope for companies to bring more marginal projects to fruition, and better business confidence. Other mechanisms to fund a rate cut exist within the taxing and spending choices of governments.

### **Reducing company tax rates, funded by other aspects of the company tax system**

This is the approach required by the BTWG's terms of reference, and this submission argues that it is an excessively limiting approach.

First, it is clear that the revenue increase which would be needed to fund a material reduction in the company tax rate could not be met by altering other parts of the company tax system without very deep impacts on particular companies and sectors.

Second, since it is effective tax rates rather than statutory rates which matter for investment, and since the former are affected by a range of provisions in the company tax regime, it is not clear that the overall international competitiveness of Australia's company tax system would be improved by undertaking such a change. On the one hand, a reduction in the company tax rate would lower effective tax rates and improve competitiveness; but altering other parts of the system may increase effective rates and reduce competitiveness. It could easily turn out to be the case that the costs in terms of international competitiveness outweigh the benefits.

Third, there are good economic reasons for allowing firms to claim deductions and allowances. Reducing or eliminating them could exacerbate, rather than improve, the economic distortions that are associated with the current system. The increase in distortions may more than offset any efficiency gains from reducing the statutory company tax rate. The impacts on companies' ability to carry out their business and fund projects would in some cases be very damaging. It is to give proper consideration to this issue that the BTWG has been created.

For these reasons, the BCA sees no reason why any potential revenue gains from changes to the structure of the company tax system should necessarily be required to fund reductions in the company tax rate. Similarly, it is not clear why a reduction in the company tax rate needs to be funded by changes in other parts of the company tax system. If the existing system is causing distortions, then these should be remedied in any case.

The BCA is concerned by the recent experience with the MRRT, where the government introduced a tax increase in order to fund a reduction in rates somewhere else – a rate reduction that has not eventuated. There can be a temptation for governments to implement the tax increases, take the revenue, but not deliver the offsetting tax cut. Such temptations are likely to become all the greater as fiscal pressures increase over the next few years.

### **Reducing company tax rates, funded by increases in other taxes**

The consensus of expert opinion in Australia and overseas is that a more sensible reform option would be to fund reductions in company tax rates through a change in the tax mix. This is less restrictive than the option of achieving revenue neutrality through finding offsets solely within the business tax system.

From an economic point of view, even if other taxes were increased, if those taxes had a lower deadweight loss, or less cost to society through market inefficiency, than the company tax rate, then there would be an efficiency improvement. However the risks identified earlier would still

apply: the political temptation to take the revenue from the tax increase and abandon the offsetting tax reduction may simply be too great.

Moreover, reducing Australian rates of taxation on business incomes may not improve Australia's attractiveness as an investment location if it is offset by increases in other taxes.

### **Reducing company tax rates, funded by spending reductions**

A final broad option would be to reduce company tax rates and fund these with reductions in spending. In general, the BCA considers the purpose of generating wealth for Australia to be a high and sustainable standard of living for all Australians, and therefore believes cuts to spending – like tax increases – need to be applied judiciously.

There are two broad categories of spending that are relevant: spending that targets social benefits less effectively, which creates its own distortions and welfare costs, and more effectively beneficial spending, such as that which enhances productivity.

- If less usefully targeted spending is cut, then there is an efficiency gain from such a reduction, in addition to a revenue gain. Reducing such spending in order to fund company tax cuts would result in an unambiguous welfare gain.
- If more beneficial spending is cut, any revenue gain is accompanied by a loss. Reducing such spending to fund company tax cuts would not necessarily result in an unambiguous gain.

Spending cuts need to be identified with care, and focused on those areas where the benefit to society is low.

### **The impact of doing nothing**

While tax increases and spending cuts are hard decisions for governments to make, it is important to note that doing nothing is a choice with its own costs.

If Australia retains the status quo in its company tax arrangements, it will do so in a world where other countries are changing and where capital is becoming increasingly mobile. If the trend of the last decade continues, this will mean that statutory rates around the world will continue to decline. This will affect Australia's international competitiveness, even if no changes are made to our own company tax regime. There will be costs associated with abandoning the reform agenda and not making any policy changes to company tax arrangements in Australia.

US economists Larry Summers and James Hines have written in detail about the impact of globalisation on tax system design. They observe that small open economies like Australia's rely much less on income taxes than expenditure taxes. In general, they find that countries with smaller populations and open economies have lower ratios of corporate and personal income taxes to total tax revenue. Australia is an exception in that regard. Greater international mobility of economic activity and associated responsiveness of the tax base to tax rates are two effects that increase the economic distortions created by taxation, and these effects are likely to grow over time.

## 6. Assessing the impact of each of the potential offsets

The proposals put forward in the discussion paper have been identified because the Business Tax Working Group's terms of reference required it to "identify a range of off-setting budget measures from existing Commonwealth business taxation (or spending) measures." Changes to the GST were specifically ruled out. The BTWG was required to "have regard to the report of the Australia's Future Tax System Review and relevant international experience and expertise."

In discussions with BCA members, the range of concerns expressed has been very widespread in relation to the proposals under consideration.

For all of the proposals in the BTWG discussion paper, members are concerned about the impact on international competitiveness, the consideration of timing, and the costs of complexity and change.

On international competitiveness, members cited a range of concerns. When identifying tax settings in other countries comparable or more favourable than those currently operating in Australia, a number of members noted the flexibility they have to locate projects and activities elsewhere.

Timing considerations apply to many of the proposals under consideration. Companies in many sectors face much longer lead times on projects than a government's term of office or the budget forward estimates period. This difference in time horizon for companies relative to governments concerns business representatives as it can result in undue emphasis on short term revenue gains to government at the expense of longer-term wealth-creating activities for the broader society.

While members could appreciate the purpose of individual costings, they were also concerned about the limitations of the approach required by the terms of reference. They favoured a costing approach that took a whole-of-economy perspective, accounted for behavioural and interaction effects, and which ensured that the full economic impacts of any changes would be recognised and reflected. The costs of complexity and change are a major concern for business. These costs lead business to be wary of change unless the materiality of the benefit is very clear. Given the time it takes companies to adjust, and the value of established precedents for companies in creating certainty, the impact of change on business costs should not be underestimated. Members felt that the significant transitional issues had yet to be fully considered in development of the options.

The remainder of this section outlines in more detail the potential impact of particular proposal types on business.

### Interest deductibility and thin capitalisation

#### *Current arrangements*

With the growth in cross-border investments in recent decades, Australia has adopted certain tax rules to manage the associated risks. Thin capitalisation rules prescribe the maximum amount of debt an entity can use to fund assets used in its Australian operations, and are designed to prevent excessive allocation of debt to Australian operations. This is an important integrity provision resulting from the fact that Australia's system permits deductions for interest expenses in relation to most foreign income. In the absence of thin capitalisation provisions, companies could load up their Australian operations with tax deductible debt, while deriving the profits in other jurisdictions.

But there is a fundamental tension between this integrity function and the legitimate need for companies to fund their activities with a degree of flexibility and taking account of their own particular circumstances. Companies also point out that the compliance costs associated with thin capitalisation rules are high.

There are several thresholds that Australian operations can apply: the safe harbour limit, the arm's length debt limit and (for outward investors) a worldwide gearing ratio limit. Different safe harbours apply to general entities, non-bank financial entities and banks. Thin capitalisation affects companies that operate both in Australia and overseas. Banks have indicated that the prudential rules governing their operations generally affect them before thin capitalisation rules.

### *Options in the discussion paper*

As well as three thin capitalisation options, the BTWG has put forward two further options on interest deductibility that represent a more marked deviation from established practice. These two options would cap interest deductions to a proportion of EBITDA.

The proposals are to:

- Remove arm's length tests and reduce safe harbour gearing levels for general entities. The safe harbour maximum debt level would drop from 75 per cent to 60 per cent on a debt-to-total-assets basis or from 3:1 to 1.5:1 debt-to-equity. It would also reduce the worldwide gearing ratio for general entities and non-bank financial entities from 120 per cent to 100 per cent (Option A1).
- Reduce safe harbour gearing levels for general entities, from 75 to 60 per cent and worldwide gearing ratios from 120 to 100 per cent but retain the arm's length test (Option A2).
- Reduce safe harbours for financial institutions (Option A3):
  - for banks, this would entail increasing the safe harbour for the minimum equity requirement from 4 to 6 per cent of the risk weighted assets of the Australian operations and increasing the worldwide capital ratio from 80 to 100 per cent
  - for non-bank financial entities, this would entail reducing safe harbour gearing limits for general activities from 75 to 60 per cent or from 3:1 to 1.5:1 and reducing the safe harbour overall maximum debt limit from 95.24 to 93.75 per cent on a debt-to-total-assets basis or from 20:1 to 15:1 on a debt-to-equity basis.
- Cap interest deductions for all business taxpayers excluding banks (Option A4)
  - this would entail removing thin capitalisation rules
  - instead limiting the net interest expense to a set percentage of EBITDA.
- Cap interest deductions for all business taxpayers including banks (Option A5).

### *BCA position*

None of the options has been costed at this point. The BCA is extremely concerned that the BTWG would give serious consideration to any options that are at a stage of development such that they cannot be costed. Given the size and importance of thin capitalisation in the tax system, any change will have major ramifications for business.

The risks of proceeding with options that have not been costed are high. If the government is unable to assess the revenue implications of major proposals, it is equally true that it cannot fully appreciate the impact on business and on the economy of the proposals. If the revenue impacts to the budget from changes to thin capitalisation and interest deductibility were to prove to have been overstated, the risks to the Australian Government Budget are obvious. On the other hand, if the revenue impacts to government were to prove to have been understated, any associated company tax cut would be unlikely to be of appropriate magnitude.

BCA member companies report a wide variety of ways in which thin capitalisation can affect their business decisions. For instance, Virgin Australia, while listed on the ASX, is currently majority held by overseas companies. Importantly, these companies provide no financial support to Virgin Australia, instead maintaining a passive interest. As Virgin Australia in practice operates as an isolated company for financing purposes, the integrity based thin capitalisation rules act to constrain its operations in relation to a potential advantage that the company does not actually experience.

Given this arrangement, removing the arm's length test (proposal A1) would mean that Virgin Australia could have to modify its business structures substantially to deal with very significant loss of interest deductions on commercial third-party financing for the acquisition of aircraft. Selling aircraft and leasing them back would be an alternative way for the company to fully deduct lease costs and improve its after-tax position. However, it should be noted that such an approach could negatively affect the company's overall risk profile, and is entirely subject to the prevailing global lease/finance market at any given time.



A number of companies note that the impacts of any proposed changes to thin capitalisation cannot be adequately represented by a budgeting convention with a timeframe that is well short of the decision horizons of affected companies. For instance, a number of oil and gas companies are increasing their investment at present, and report that the point at which their debt will peak is outside the forward estimates period.

The costs of change are substantial for companies, although often underestimated by government. For example, compliance with existing thin capitalisation provisions and transfer pricing already costs one multinational infrastructure and finance company over \$3 million per annum. These costs cover the development of its models, their periodic review by PwC Australia and their sign-off by the Australian Taxation Office.

The two options in the discussion paper that consider capping interest deductions to a proportion of EBITDA are potentially problematic as they present substantial practical challenges in their implementation due to the volatility of EBITDA. For instance, BCA notes that a number of its members' liabilities, such as foreign borrowings, are subject to a range of external influences on their value that are beyond the control of the company, such as foreign exchange fluctuations and commodity prices. Because these fluctuations are reflected in EBITDA, this volatility in value in turn leads to volatility in EBITDA.

Similarly, some amounts are reflected in EBITDA that are not "P&L" items in their nature. An example of this is the approximate \$250 million of transaction costs paid by Origin Energy to acquire assets that are reflected in EBITDA rather than as part of the assets, consistent with accounting rules. The one-off nature of such a large item of this kind results in a downward spike in EBITDA for that year.

Companies also noted that EBITDA can have a disproportionate impact relative to the thin capitalisation assessment of debt. If a company has a large asset base, it may be well within safe harbour limits but could be affected by the EBITDA cap. Because of this, any proposals of this kind could only be considered as alternative to thin capitalisation at companies' election, rather than introduced with the removal of thin capitalisation. This would be to ensure that those companies that experience volatile EBITDA figures retained predictability and control over their financial structure.

The EBITDA proposals would, if implemented, have an adverse impact on key industries that have cyclical revenue streams typically coupled with long-term debt to fund long life projects. These would have the perverse outcome of yielding higher tax payments in downturns (with lower EBITDA) and lower tax payments in boom times (with higher EBITDA coupled with prior year denied interest expenses).

The compliance costs associated with change were another cause for concern for member companies in relation to the options to cap interest deductions to a proportion of EBITDA. For instance, one BCA member company specified that it would need to set up entirely new models, seek their independent review and gain formal ATO sign-off of the methodology. In addition, the benefit of precedent and established rules would no longer apply. Whether detailed legislation or accounting rules were the basis for an EBITDA cap, the role for interpretation would be wider, and the impact on the company would be a loss of certainty. If the EBITDA cap were to be introduced instead of thin capitalisation, this company anticipates an additional compliance cost of at least \$250,000 in the first year, with sustained additional costs in subsequent years.

In summary, the BCA sees as the major cause for concern the poorly understood nature of this set of options, and notes the very significant but as yet unquantified impact on companies.

### **Depreciating assets and capital expenditure**

As assets that generate capital income decline in value and are used up, the tax system permits this depreciation to be written off against income over time. In a textbook situation, the basis for this depreciation would be the economic life of the asset. However, as this is often unknowable and would be very hard and expensive to administer, for both companies and the Australian Taxation Office, a series of simplifying approximations are used for depreciation periods. Some of these

depreciation arrangements have a concessional nature, in allowing a shorter depreciation period than the economic life of the asset.

Changes over the past 15 years have been in the direction of reducing concessionalism of depreciation allowances and bringing them closer to the economic life benchmark. The 200 per cent rate for the diminishing value method was introduced in 2006, while statutory effective life caps were introduced after the Ralph report reforms, in response to concerns that the removal of accelerated depreciation would adversely affect investment in certain sectors. Exploration and prospecting provisions recognise spillovers in the form of useful information from one exploration exercise to other businesses who might be considering exploration nearby.

These changes have broadened the company tax base, and have removed provisions that were excessively concessional. With a reduced set of depreciation arrangements, the scope for further scaling back is now in tension with the simplicity of administration and the stability and certainty of the arrangements for both business and government.

In addition, the impact of changes to depreciating assets and capital expenditure have the potential to have deep impacts on sectors and companies heavily reliant on the use of assets to carry out their business. The impacts are particularly notable for mining and resources and for aviation. For some companies, this year has already seen massive tax changes: the introduction of the Minerals Resource Rent Tax, the extension of the Petroleum Resource Rent Tax to oil and gas projects, the introduction of the carbon tax, and the associated cut in the diesel fuel tax credit by 6 cents per litre, all of which came into effect on 1 July 2012.

Deep cuts in some sectors necessarily mean that affected companies will be substantially worse off after a general cut in the company tax rate. The goal of a more neutral tax system should not come at the cost of compromising major projects or elements of business that are viable, productive and in the national interest. Given the starting point of the tax system as it currently stands, deep cuts in some sectors would in effect trade off some sectors against others.

Those worst affected are in many cases the same industries that are providing substantial revenue to government through tax receipts. Creating less favourable tax conditions would compound other weakening in the economy, and its effects should not be considered in isolation. BCA member companies report that changes to this suite of provisions would significantly affect the business decisions they are making.

As well as more marginal projects becoming unviable, this suite of proposals creates risks for viable projects, including strong proposals, to become marginal. For instance, one BCA member company has modelled the combination of the diminishing value option (Option B1) and reducing first use exploration to five years (Option B7) and found that it would reduce the value of a previously strongly viable project proposal by around 20 to 30 per cent.

### ***Reduce the diminishing value rate for depreciation***

#### *Current arrangements*

The diminishing value method assumes that the decline in value each year is a constant proportion of the remaining value and produces a progressively smaller decline over time.

#### *Option in the discussion paper*

The option to change diminishing value is to reduce the rate from 200 per cent to 150 per cent, thereby reversing the 2006–07 budget measure that brought the rate to 200 per cent.

The announcement at that time stated that the rationale for moving to 200 per cent was to “more accurately align depreciation deductions for tax purposes with the actual decline in the economic value of assets... [and] increase the incentives for Australian business to undertake the investment in new plant and equipment that is necessary for them to keep pace with new technology and to remain competitive.”<sup>10</sup>

Budget Paper 2 further noted that “The current 150 per cent diminishing value rate does not fully reflect the true change in value of many depreciating assets. This results in depreciation rates that

are generally too low for most plant and equipment. By increasing the diminishing value rate to 200 per cent, this measure will ensure that tax depreciation rates more closely align with economic depreciation.”

#### *BCA position*

Reducing the diminishing value rate for depreciation from 200 to 150 per cent would have a major impact on many companies, particularly in the mining and resource sectors. The diminishing value arrangements were introduced after a considered policy process, and most strongly affect companies with large asset holdings. For example, Rio Tinto has found that the net present value impact of reducing the diminishing value rate as outlined in Option B1 would require a 0.8 percentage point company tax rate cut over the life of the project if value is to be maintained. Companies noted that there would need to be a significant lead time to enable them to adjust to a change of this magnitude.

### **Statutory effective life caps**

#### *Current arrangements*

Statutory effective life caps provide simple, stable and well-understood arrangements that underpin many projects, including some extremely large projects. They are used across a number of industries to facilitate and encourage business to invest in new capital-intensive products, and are an important plank of Australia’s international competitiveness.

#### *Options in the discussion paper*

The proposals are to remove the capped effective life provided to:

- certain depreciating assets such as aeroplanes, helicopters, buses and other assets laid out in 40-102(4) and (5) and on water facilities as laid out in 40-515 to 40-575 of the *Income Tax Assessment Act 1997* (Option B2)
- depreciating assets used in oil and gas extraction and petroleum, as in 40-102(5) (Option B3)
- depreciating assets used in primary production, such as harvesters, tractors, aeroplanes and helicopters (Option B4)
- water facilities used by irrigators and primary producers (Option B5)
- other assets used in non-specified industries, for aeroplanes and helicopters, buses, light commercial vehicles, certain shipping vessels and the like (Option B6).

#### *BCA position*

Companies pointed out major implications of changes to depreciation and capital allowances. A key consideration is the complexity and opening of disputes about appropriate depreciation rates that would follow from the removal of simple predictable rules. Companies also noted their importance for international competitiveness – which was the main policy objective identified when they were introduced. A further consideration is that tax changes would not occur in isolation, but alongside falling terms of trade, worsening business confidence and a dollar that currently looks to remain high.

As an example, the LNG industry has very significant lead times on projects, with a typical 5 to 7 year construction period in which there is no opportunity to deduct costs. Statutory effective life caps are an important provision to balance that period without deductions before projects begin to generate. The very long lead times in the LNG and other resource areas suggest that the savings would take a significant period to affect government revenues, even while putting at risk future project decisions.

Changes to statutory effective life caps would have major ramifications for the aviation industry. The purchase of newer aircraft is heavily dependent on accelerated depreciation provisions, given the inherent riskiness of the airline industry and strong competitors in overseas countries. Newer aircraft bring a range of benefits, including better environmental outcomes in the form of lower

carbon emissions, and better noise reduction. But the renewal of the fleet to purchase more fuel-efficient aircraft is heavily reliant on the depreciation arrangements. The following table compares one BCA member, Qantas, with international competitors.

**Table 3: Relationship between depreciation arrangements and fleet age (selected airlines)**

| Country     | Carrier  | Effective Life   | Fleet Age                                    | Comment   |
|-------------|--|--|--|---|
| Australia   | Qantas   | 10   | 8.3  | 20-year effective life which has been statutory capped to 10 years  |
| UAE         | Emirates<br>Etihad   | N/A  | 6.6<br>4.2                                   | No corporate tax regime   |
| Singapore   | Singapore Airlines   | 3 + additional aircraft investment allowance of 20% to 50%         | 6.9  | Accelerated tax depreciation regime                                 |
| Hong Kong   | Cathay Pacific   | 6.67 + initial depreciation allowance of 60%                       | 11.2   | Accelerated tax depreciation regime                                 |
| Thailand    | Thai Airways   | 5  | 12.6   |   |
| Malaysia    | Malaysian Airlines   | 5 + additional aircraft investment allowance of 60% (over 5 years) | 13.0   | Accelerated tax depreciation regime                                 |
| Qatar       | Qatar Airways  | N/A  |  | No corporate tax regime   |
| China       | Air China<br>China Southern<br>China Airlines  | 5  | 7.6<br>7.2<br>8.7                            |   |
| Japan       | JAL<br>ANA   | 8 to 10  | 10.6<br>11.9                                 | A lower effective life applies for aircraft <5.7 tonnes             |
| New Zealand | Air New Zealand  | 10   | 9.8  |   |
| USA         | American Airlines<br>United Airlines<br>Continental<br>Hawaiian<br>US Airways<br>Delta | 5.2*<br>12**   | 14.1<br>13.7<br>10.1<br>11.6<br>12.6<br>14.7 | *Used in US trade or business<br>**Not used in US trade or business |
| UK          | British Airways<br>Virgin Atlantic   | 12.9   | 12.2<br>9.3                                  |   |
| Korea       | Korean Air<br>Asiana   | 10   | 10.6<br>8.5                                  |   |

Source: Qantas Airways Limited.

Under a less favourable depreciation arrangement, Qantas indicates that there would be a material impact on its current fleet orders, with phasing likely to be over a much longer timeframe than is currently planned. As well as resulting in an increasing average age of its fleet, this would flow through to emissions and noise levels.

Removing statutory effective life caps for aircraft (Option B6) would also have a very substantial impact on Virgin Australia. As the true effective life of an aircraft is around 20 to 25 years, a conservative estimate is that removing these caps would halve tax depreciation deductions for Virgin Australia.

Virgin Australia is expecting to take delivery of 105 brand new 737-Max aircraft, currently on order from Boeing. The removal of these caps would result in the need to revisit financial modelling regarding the pending future deliveries, in order to ensure appropriate after tax positions are maintained. The proposed reduction in corporate tax rate, even if it was as much as a 5% reduction, would by no means adequately cover the lost depreciation.

Delays and deferrals of the purchase of major assets have impacts that can ripple through the supply chain. An example of broader impacts of a positive nature, and as an indication of value that could be put at risk by changes to these arrangements, the Victorian Premier announced on 14 September this year that Boeing's Port Melbourne aircraft component plant was creating 50 new jobs building components for the 787 aircraft.

### ***Exploration and prospecting***

#### *Current arrangements*

Exploration and prospecting provisions include depreciating assets "first used" in exploration or prospecting, and expenditure on actual exploration or prospecting. These provisions recognise that exploration and prospecting often yields no viable project, and permits the write-off of such business expenses on a comparable footing to the business expenses incurred in other industries.

These provisions also recognise the spillover benefits for other companies when one company conducts exploration and discovers information useful not only to its own business but also to others who may be contemplating exploration nearby.

#### *Options in the discussion paper*

The options in the discussion paper are to:

- remove or reduce the immediate "first use" exploration deduction and replace it with deduction of the asset over five years or its effective life (Option B7)
- remove or reduce the immediate deduction for intangibles (interests in deduction "tenements") (Option B8)
- deduct capital expenditure on exploration or prospecting that is not for depreciating assets to be written down over five years or the effective life of the project. This deduction relates to expenditure on non-depreciating assets used in exploration and prospecting, such as transport, materials, labour and administrative costs (Option B9)
- remove the immediate deduction for exploration expenditure by large companies, with the capital expenditure to be written off over five years if the company or entity had a turnover over \$500 million (Option B10)
- exclude feasibility studies from exploration expenditures, with the effect that they would be deductible over five years instead of immediately (Option B11).

The BCA notes that the costing assumptions indicate that none of the expenditure reported as having been deductible under these provisions would be able to be deducted under the general provisions of the income tax law.

*BCA position*

Immediate deductions on exploration and prospecting are considered by member companies of the BCA to be perfectly reasonable on the grounds that they are normal business expenses. Where exploration costs are necessarily incurred in carrying on their income-generating business, they are already immediately deductible to companies under general income tax deduction provisions, but it appears that in the absence of the specific concession provisions in the income tax law, the general income tax provisions would not be permitted either. Such a restriction is a break from normal tax principles, which permit the deduction of costs necessarily incurred in carrying on their income-generating business. Companies that are engaged in prospecting note that the normal course of business is to engage in continual exploration for economically viable reserves, understanding that on average less than one in 10 exploration wells generates a discovery that leads to production.

The BCA sees no reason not to permit deduction of such costs, in a manner equivalent to normal business costs in other sectors.

Companies also noted that these deductions have recently been examined in the context of the Resource Super Profits Tax and the new Minerals Resource Rent Tax. Further changes to provisions that have recently been reviewed is damaging for business confidence.

**Building depreciation***Current arrangements*

Buildings and structural improvements can be claimed as a deduction with a 40-year depreciation period generally applying.

*Options in the discussion paper*

The options put forward are to:

- depreciate buildings over their effective lives (Option B12)
- remove building depreciation deductions for capital works (although the cost of repairs would continue to be immediately deductible) (Option B13)
- allow a uniform rate of depreciation of 2.5 per cent per annum (Option B14).

*BCA position*

Comments applying to statutory effective life caps also apply to building depreciation in terms of the simplicity and predictability of arrangements.

**Research and development***Current arrangements*

Research and development activity is widely acknowledged as an area where a tax concession corrects for a market failure. To the extent that a firm's R&D generates spillover benefits for other firms, the benefits to society are likely to be larger than the returns to the company. For this reason, supporting and encouraging these spillover benefits enhances productivity.

On 12 May 2009, the Australian Government outlined its innovation agenda for Australia over the next decade in *Powering Ideas: An Innovation Agenda for the 21st Century*.<sup>11</sup> A key strand of this agenda is for businesses of all sizes and in all sectors embrace innovation as the pathway to greater competitiveness, supported by government policies that minimise barriers and maximise opportunities for the commercialisation of new ideas and new technologies. *Powering Ideas* also advocates that researchers, businesses and governments work collaboratively to secure value from commercial innovation and to address national and global challenges.

The R&D tax credit was introduced as part of this innovation agenda for the next decade, replacing the R&D tax concession in order to boost business research and deliver better outcomes for the nation. The BCA notes that these arrangements were introduced after serious consideration,

including a Review of the National Innovation System<sup>12</sup> conducted in 2008 by an expert group chaired by Dr Terry Cutler, and also addressing the outcomes of a range of other reviews, including Professor Mary O'Kane's review of the Cooperative Research Centres Program.<sup>13</sup>

Since 2011, the R&D tax initiative has provided an offset for eligible activities, with a focus on activities benefiting Australia. It has two elements: a refundable offset for smaller eligible entities (whose aggregated turnover is less than \$20 million), and a non-refundable tax offset for larger entities (whose aggregated turnover is \$20 million or more).

*Options in the discussion paper*

The options put forward in the discussion paper are to:

- abolish the 40 per cent non-refundable tax offset for larger entities, instead permitting R&D deductions under general deduction provisions in the tax law (Option C1)
- impose a new turnover threshold above which the 40 per cent non-refundable tax offset could not be claimed. The turnover level would be set at a high level such as \$10 or \$20 billion per annum (Option C2)
- impose a cap in the amount that can be claimed annually under the 40 per cent non-refundable tax offset (i.e. applying to larger companies). This would retain the offset for companies with a turnover of more than \$20 million but cap the amount claimable under the R&D tax concession, with additional expenditure claimable under the normal deduction provisions of the tax law (Option C3)
- cut the rate of the non-refundable tax offset to 37.5 per cent for larger companies (Option C4).

*BCA position*

The BCA does not support changing R&D tax concessions at the beginning of a decade-long innovation agenda.

The impacts would be to reduce innovation in this country. For instance, Chevron Australia made a decision several years ago to locate an R&D facility in Australia rather than overseas. This Global Technology Centre in Perth now employs more than 100 people and supports the company's Asia-Pacific operations. One of the factors in the decision to locate the centre in Australia was the R&D tax concession.



## 7. Findings and recommendations

### Findings

The BCA has engaged as a member of the Business Tax Working Group in an open and constructive manner to see how the Australian business tax system could be improved to make the most of the challenges and opportunities arising from transformations in the broader economic environment, including the patchwork economy. It has considered whether there are revenue-neutral reforms that can raise productivity while delivering tax relief to struggling businesses.

The BCA has considered the business tax system through a broad lens, taking account of the challenging economic circumstances that prevail now and are likely to continue for some time. It has also taken account of the broad requirements of the economy for revenue adequacy and income growth, to support a high standard of living for all Australians.

It is in this context that the BCA has examined the options proposed in the BTWG discussion paper. The BCA has considered whether these options are in keeping with a future-oriented tax system, and the extent to which the specific sectoral and company impacts would, on balance, be positive or negative.

The BCA finds that the task of funding a material cut in the company tax rate purely from reduction or removal of other company tax provisions is simply unachievable without significant damage to investment and growth in this country. It also notes the impact on business confidence of constant and unforeseen changes to the tax system, and advocates instead a comprehensive, well-considered and predictable reform path that is oriented to meeting longer term societal challenges.

### Recommendations

- 1 That the government commit to a 25 per cent company tax rate as a long-term direction for lowering the corporate tax burden.
2. That the government jettison the options laid out in the BTWG discussion paper as the basis for changing the company tax system or for any other short-term purpose.
3. That the government commit to a comprehensive tax reform process, staged over a decade, including all taxes, and focused on the principles for tax reform described in this submission.

## Glossary and notes

### Glossary

ABS – Australian Bureau of Statistics

BTWG – Business Tax Working Group

EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortisation

EATR – Effective Average Tax Rate

EMTRs – Effective Marginal Tax Rates

MRRT – Minerals Resource Rent Tax

NPV – Net Present Value

OECD – Organisation for Economic Co-operation and Development

RSPT – Resource Super Profits Tax

### Notes

- <sup>1</sup> International Monetary Fund, '2012 Article IV Consultation with Australia Preliminary Concluding Statement', Sydney 2012.
- <sup>2</sup> Grattan Institute, *Game-Changers: Economic Reform Priorities for Australia*, Melbourne, June 2012.
- <sup>3</sup> See also the AFTS final report for three studies that find strong associations between an increase in the corporate tax rate and falls in real wages (Treasury, *Australia's future tax system, Final Report*, volume 1, page 153, Canberra, 2009).
- <sup>4</sup> de Mooij, R. and S. Ederveen, *Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Direct Investment*, Tinbergen Institute Discussion Papers 05-108/3, Tinbergen Institute, Rotterdam, 2005.
- <sup>5</sup> Treasury, *Australia's Future Tax System, Final Report*, volume 1, page 153, Canberra, 2009.
- <sup>6</sup> K. Hassett and A. Mathur, *Report Card on Effective Corporate Tax Rates: United States Gets an F*, Tax Policy Outlook No.1, American Enterprise Institute, Washington DC; February 2011.
- <sup>7</sup> M. Devereux et al., 'Corporate Income Tax Reforms and International Tax Competition', *Economic Policy*, 17(35), pp. 449–495, 2002.
- <sup>8</sup> The methodologies of Hasset and Mathur (2011) and Chen and Mintz (2011) differ in a number of important respects. For example, the studies use different datasets, apply different discount rates to work the present value of depreciation allowances, and use different assumptions about the impact of alternative forms of financing (debt versus equity).
- <sup>9</sup> Hines, J. R. Jr and L.H. Summers, 'How Globalization Affects Tax Design' in *Tax Policy and the Economy*, Volume 23, National Bureau of Economic Research, Chicago, 2009.
- <sup>10</sup> Commonwealth of Australia, 2006–07 Budget Paper 2, Canberra, May 2006.
- <sup>11</sup> Commonwealth of Australia, *Powering Ideas: An Innovation Agenda for the 21st Century*, Canberra, 2009.
- <sup>12</sup> Commonwealth of Australia, *Venturous Australia: Building Strength in Innovation*, Canberra, 2008.
- <sup>13</sup> Commonwealth of Australia, *Review of the Cooperative Research Centres Program*, Canberra, July 2008.

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# At a Crossroads: Options for Company Tax Reform

Report commissioned by  
the Business Council of  
Australia

September 2012

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# Executive Summary

The Australian company tax system is at a crossroads. In May 2010 the Australia's Future Tax System (AFTS) Review made several recommendations regarding company tax arrangements in Australia. One of the most important recommendations was to gradually reduce the company tax rate from 30 per cent to 25 per cent in order to boost the level of economic activity. The first tranche of rate reductions (from 30 to 29 per cent) was due to commence in 2013-14. However, in its recent 2012-13 Budget, the Australian Government decided not to proceed with this change.

This report, commissioned by the Business Council of Australia, re-examines the case for company tax reform and rate reductions. The evidence reviewed in the report suggests that there would be significant economic gains from company tax reform. However, those gains depend on exactly which reforms are pursued.

As a result, the question of how to fund such reductions needs to be considered very carefully. For example, it is possible that altering certain features of the tax base (such as allowances and deductions) can increase effective marginal corporate tax rates. Hence, although reductions in corporate tax rates can, when viewed in isolation, create economic gains, it is far from clear that a revenue neutral reduction in the statutory corporate rate – which is funded by broadening the company tax base - would reduce effective marginal tax rates and improve the overall efficiency of investment decisions.

The recent discussion paper issued by the Business Tax Working Group (BTWG)<sup>1</sup> is a positive step along the path to further company tax reform, outlining a number of possible base-broadening options and estimating the revenue effects of these options. However, the discussion paper does not address the efficiency consequences of each option, taken either in isolation or as a package of policies. Whilst estimating the revenue effects of changes to the company tax regime is important, it is even more vital to undertake a full cost-benefit analysis of various options, which would include the effects on the quantity and quality of investment and overall economic wellbeing. It may turn out, for example, that funding rate reductions by altering other features of the company tax system (or, more generally, by raising existing taxes) could lead to unintended consequences whose costs could exceed the benefits. The most economically responsible way forward is therefore to carefully and methodically assess the full economic costs and benefits of all possible reform options, and to choose the option(s) with the greatest net economic benefit for Australia.

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<sup>1</sup> Business Tax Working Group Discussion Paper, 13 August 2012. [http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Business%20tax%20ref orm/Downloads/PDF/BTWG\\_discussion\\_paper\\_2012.ashx](http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Business%20tax%20reform/Downloads/PDF/BTWG_discussion_paper_2012.ashx)

# 1 Introduction

An economy's company tax regime can play a significant role in determining overall international competitiveness and economic growth. Although capital may not be perfectly mobile across international borders, as global capital markets become ever more integrated, international capital movements are likely to become increasingly sensitive to required rates of return. Increased capital inflow from abroad provides significant net benefits to Australia.<sup>2</sup> Hence Australia's company tax system, which affects required rates of return on investments in Australia and is an important of our ability to continue to attract foreign investment, is likely to play a key role in shaping our future economic prosperity.

The structure of our company tax system will have important consequences for productivity, economic growth, wages, and overall living standards for all Australians. Company tax revenue is also playing an increasingly important part in overall fiscal policy settings, and is likely to continue to do so. By international standards, company tax revenue in Australia accounts for a relatively high proportion of overall tax revenue, and our statutory company tax rate is also relatively high by international standards. In addition, Australian companies are subject to a very large number of taxes, some of which raise little revenue but are costly to administer.<sup>3</sup> All of these factors underscore Australia's dependence on company tax, which is potentially inefficient and vulnerable to erosion through international tax competition.

In May 2010 the Australia's Future Tax System (AFTS) Review noted many of these (and other) features of our company tax system, and made several recommendations regarding company tax arrangements in Australia. One of the most important recommendations was to gradually reduce the company tax rate from 30 per cent to 25 per cent in order to boost the level of economic activity. The first tranche of rate reductions (from 30 to 29 per cent) was due to commence in 2013-14. However, in its recent 2012-13 Budget, the Australian Government decided not to proceed with this change.

The Australian company tax system is therefore at a crossroads. The risk is that in the aftermath of the 2012-13 Budget, the impetus for further reductions in company tax will be lost, and the path to reform will be abandoned. And yet the economic case which the Government has made over the last couple of years for reductions in the company tax rate has not changed.

Given this background, there is an urgent need to revisit the case for company tax reform. This report therefore re-examines the case for company tax reform and rate reductions. The report is structured as follows. Section 2 provides a brief overview of some of the main features of Australia's company tax system. Section 3 examines the effects of company taxation, the incidence of company tax, and its deadweight costs. Section 4 briefly describes the main recommendations of the two most recent Government reviews of company taxation: the Ralph Review and the Australia's Future Tax System (AFTS) Review. Section 5 sets out, at a high level, some broad options for future company tax reform. Section 6 concludes.

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<sup>2</sup> See, for example, Layton and Makin (1993), who find that higher levels of foreign investment in Australia in the 1980s created cumulative net benefits to each Australian of \$740 on average (in 1984/85 dollars). They also find that the growth rate of Gross National Product (GNP) per capita was about 15 per cent higher than would have been the case in the absence of foreign capital inflow.

<sup>3</sup> The Business Council of Australia (2007), for example, found that there were potentially 182 separate "taxing points" for Australian businesses that operate across States or Territories.

## 2 Company Taxation in Australia

### 2.1 Why Tax Companies at All?

Broadly speaking, there are three types of income that can be subject to company tax:<sup>4</sup>

- The full return to all capital (equity and debt);
- The full return to equity; and
- Economic rents (that is, returns in excess of those needed to attract investment)

Australia's company income tax system taxes the full nominal return to equity.

There are a number of sound economic reasons why company income should be taxed.

First, as discussed below, company tax can be an important source of revenue for governments. In addition to playing this pure revenue-raising role, company tax can act as an important "backstop" for the integrity of the personal income tax system, discouraging individuals from seeking to defer personal income tax by retaining earnings within a company structure. As a result, it has long been recognised that it is important to align the company tax rate as closely as possible with the top marginal rate to ensure that there is no tax advantage in retaining earnings within a company.

Second, company taxes can also, in principle, capture location-specific economic rents (whether from natural resource endowments or from locational public goods). To the extent that company taxation actually taxes these kinds of economic rents and leaves normal economic profits untaxed, it is likely to be a relatively efficient form of taxation. Taxes on pure rents are largely non-distorting<sup>5</sup>, though they may still distort investment location decisions with respect to those sources of economic rents that are not locational specific.

The problem is that economic rents are notoriously difficult to measure and even more difficult to tax without creating distortions, complexity and compliance and administration costs. Not all economic rents are the same. Other sources of rents include market power, firm-specific competitive assets (such as unique brands) and agglomeration economies. Of these, only agglomeration economies are location-specific, and hence are not vulnerable to international tax competition. Hence the mere fact that a tax is targeted at economic rents does not mean that it will not be distortionary or reduce international competitiveness.

Third, company tax can also be used to tax foreign investment, by withholding tax payments from non-resident owners of equity. Finally, company tax can be used as a way of shifting income to Australia from countries which combine residence-based taxes with foreign tax credits.

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<sup>4</sup> See the AFTS Review, page 164.

<sup>5</sup> By definition, the marginal investment is that which just earns its opportunity cost, i.e. whose expected return is equal to the opportunity cost of capital. As a result, such an investment will earn no rents, and hence, the decision to proceed with it will not be affected by a tax on rents.



## 2.2 Features of Australia's Company Tax System

### 2.2.1 Effective Tax Rates and their Determinants

This section summarises some of the key features of Australia's company tax system. Before doing so, however, it is important to note that statutory tax rates are unlikely to be the best indicator of the international competitiveness of a country's company tax regime. In addition, when comparing statutory company tax rates across countries, the unique features of Australia's current company tax regime must be kept in mind.

Basic economic principles suggest that firms respond to the effective company tax rate, rather than the statutory rate. Broadly speaking, the effective tax rate is the percentage increase in the rate of pre-tax return to capital that is necessitated by taxation. It is this effective rate, rather than the statutory rate, that is the key driver of incentives and the economic costs of company taxation. In discussing the case for future reform of the company tax system, it is important to remember that the effective rate is influenced by a range of features of the company tax system, including the statutory rate, depreciation schedules, expense provisions, transfer pricing rules, and a range of other factors.

Imputation is a perfect example of how the statutory rate can be a misleading indicator. Up until 1987, Australia broadly had what is known as a "classical" company tax system. In a classical system, company profits are taxed at the company rate, and then shareholder dividend income is taxed a second time, at personal marginal rates. In such a system the statutory or headline tax rate is an important determinant of the economic effects and distortions. The double taxation of dividends can act as a deterrent to investment if company and personal tax rates are high, and reductions in the statutory company tax rate will reduce these distortions.

In 1987 Australia moved to a dividend imputation system. Under this system, companies pay company tax on their profits, but the tax that is paid is imputed or credited to shareholders. Shareholders who receive dividends may then credit the tax against their final tax bill. Thus, under Australia's imputation system for domestic shareholders, the company tax acts as purely a withholding tax on the income of domestic shareholders and is netted out from each individual shareholder's personal tax liability. To the extent that these franking credits are actually utilised by domestic investors, the statutory rate is of relatively little importance – since whatever its rate, it is always netted off from the personal taxes of domestic investors. Hence, changing the company tax rate would, in this respect, have little overall economic effect.

On the other hand, dividend imputation does not apply to non-residents undertaking investment in Australia. Hence a reduction in the statutory company tax rate will affect the incentives of foreign investors. The issue in this case is the incidence of the company tax: is the ultimate burden of the costs of company taxation borne by foreign investors, or Australians, or a combination of both? If the burden of company taxation is not borne by Australians, then the case for reducing the statutory company tax rates would be weakened. This is therefore a key issue and is discussed further below.

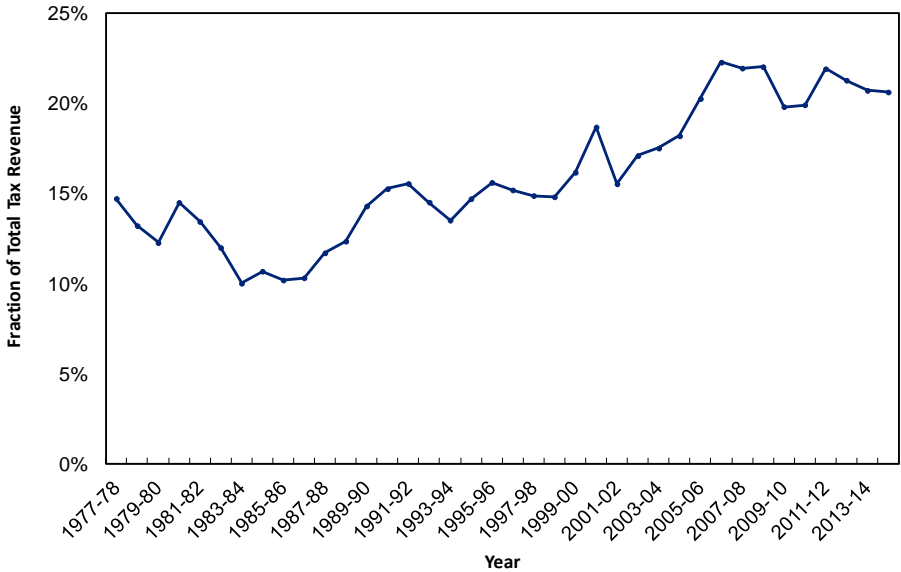
### 2.2.2 Recent Trends and International Comparisons

Australia's statutory company tax rate is currently 30 per cent. Revenue from company tax is expected to total \$73.4 billion in 2012-13, which is 21.4 per cent of total Federal Government tax revenue.<sup>6</sup> As Figure 1 below shows, over the last 30 years, reliance on company tax as a source of Federal government revenue has increased markedly, with

<sup>6</sup> This revenue is in cash terms. See 2012-13 Budget Paper Number 1, page 5-35.

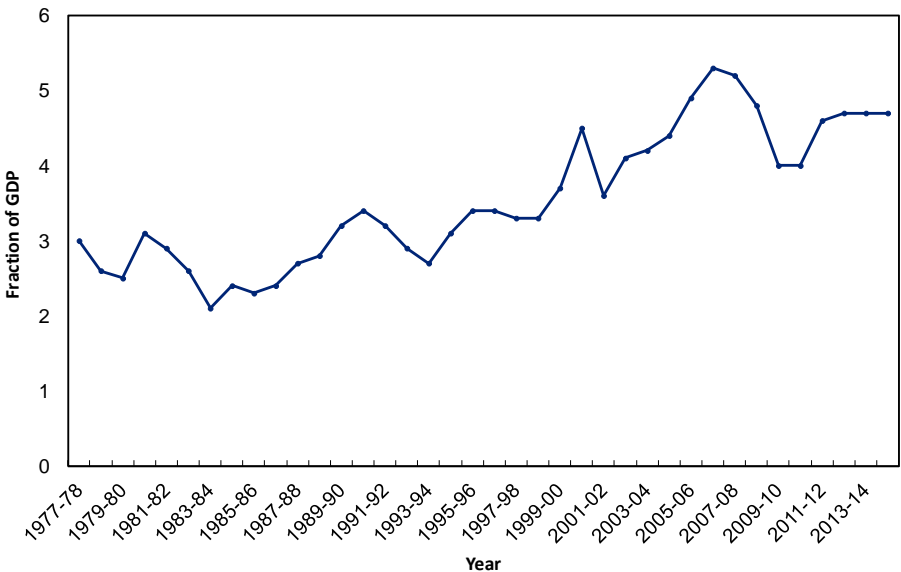
company tax revenue as a share of total tax revenues more than doubling since 1983. In addition, the share of company tax revenue as a fraction of GDP has more than doubled over the same period (Figure 2).

**Figure 1: Company Tax Revenue as a Fraction of Total Tax Revenue**



Source: Table C2, 2012-13 Budget Paper Number 1, Statement 5, page 5-37; Deloitte analysis

**Figure 2: Company Tax Revenue as a Fraction of GDP**

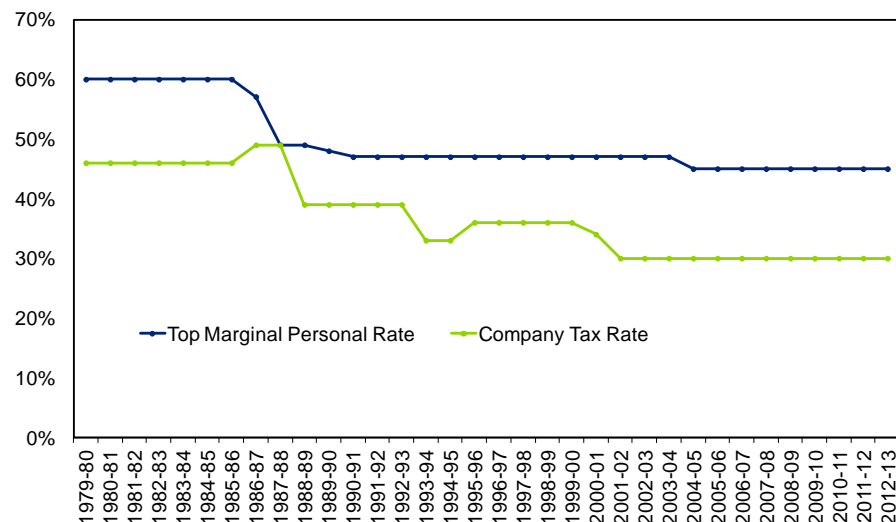


Source: Table C2, 2012-13 Budget Paper Number 1, Statement 5, page 5-37

These trends mean that by international standards, Australia continues to remain heavily reliant on company tax as a source of revenue. Indeed, OECD data suggest that of the OECD economies, only Norway and Luxembourg have higher ratios than Australia of company tax receipts to GDP.<sup>7</sup>

Over the same period there have been a number of important changes to Australia's company tax arrangements. Whilst company tax revenue has doubled in relative terms, the statutory tax rate has fallen considerably, from 46 per cent in the early 1980s to the current rate of 30 per cent. Figure 3 also shows that the gap between the top marginal personal rate (excluding the Medicare levy) and the statutory company tax rate has widened considerably since 1987-88, when the two rates were aligned.

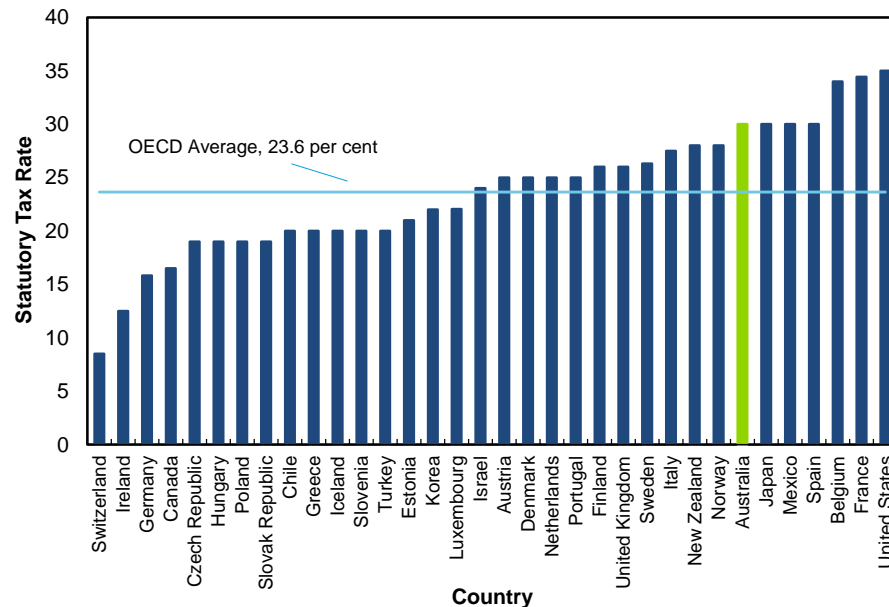
**Figure 3: Statutory Company Tax Rate and Top Marginal Personal Tax Rate, 1979-80 to 2012-13**



Source: Australian Tax Office, *Australian Taxation Statistics, 2009-10*

Nevertheless, whilst Australia's statutory company tax rate has fallen over the last two decades, the rest of the world has not stood still. Between 2000 and 2011 the statutory corporate income tax rates in OECD member countries dropped by an average 7.2 percentage points. As a result, Australia's statutory rate is today relatively high by international standards. Indeed as Figure 4 below shows, Australia now has the seventh highest statutory rate in the OECD, and the rate of 30 per cent is well above the unweighted OECD average of 23.6 per cent.

<sup>7</sup> See OECD Revenue Statistics, 2012.

**Figure 4: Statutory Company Tax Rates, OECD 2011**

Source: OECD Economic Surveys, 2012.

### Box 1: Recent Trends in Overseas Corporate Tax Rates: Some Examples

Over the last five years, there has been a trend towards lower statutory company tax rates around the world.

For example, since 2007, Korea (which has a progressive company tax system) has reduced its top company rate from 27.5 per cent to 24.2 per cent.

Over the same period, New Zealand (which has an imputation system that is similar to Australia's) has also reduced its statutory rate, from 33 per cent to 28 per cent.

Since 2007 the UK government has reduced the statutory company tax rate, from 30 per cent to 26 per cent. The UK Government also announced its intention to continue to reduce the rate 1 percentage point per annum, down to 23 per cent by 1 April 2014.

This announcement was recently revised and further reductions were announced: the UK government now expects the rate to be reduced to 22 per cent by 1 April 2014.

**Source:** Deloitte International Tax Source, <http://www.dits.deloitte.com/DomesticRates/domesticRatesLocator.aspx>. The Deloitte website provides a comprehensive list of company tax rates around the world, as well as other international tax information.

As discussed above, the concept of the effective tax rate takes into account other features of the tax system which affect the tax base, such as offsets, depreciation allowances, and other deductions.

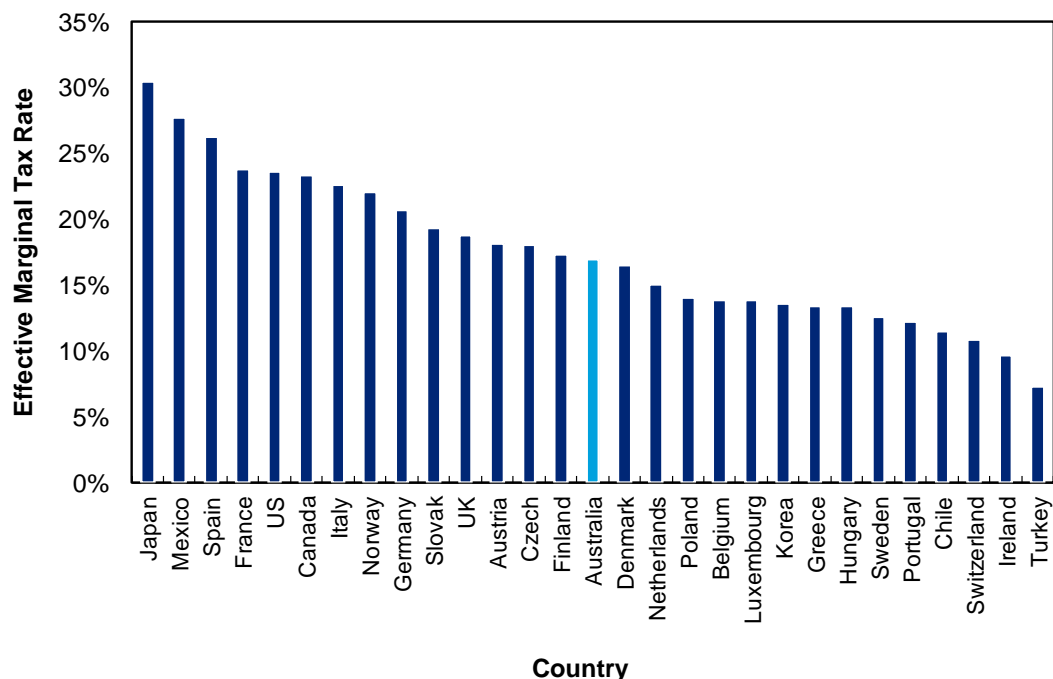
There are two relevant effective rate concepts that are discussed in the literature.<sup>8</sup>

- The **effective marginal tax rate (EMTR)**: this is the rate that applies to marginal investment projects, where the last dollar invested provides a sufficiently high pre-tax return so that the investment project just breaks even after taxes (taking into account a normal cost of capital);
- The **effective average tax rate (EATR)**: this is a measure of the effect of taxation on non-marginal investments. It is a measure of the proportion of pre-tax economic profit that the investor gets to keep after paying company tax.

The EATR tends to be a better indicator of the tax incentives facing multinational companies investing in large, discrete projects, whereas the EMTR is an indicator of the extent to which taxation affects the scale of these projects.

Hassett (2011) applies the methodology of Devereux et al (2002) to estimate EMTRs and EATR for OECD economies, including Australia. The methodology, involves calculating the net present value of depreciation allowances and adjusting post-tax returns for those allowances, in order to derive an estimate of the effective tax rate. Hassett's results are summarised in Figures 5 and 6 below, and indicate that Australia's effective rate is located in the middle of the distribution of effective tax rates for OECD economies.

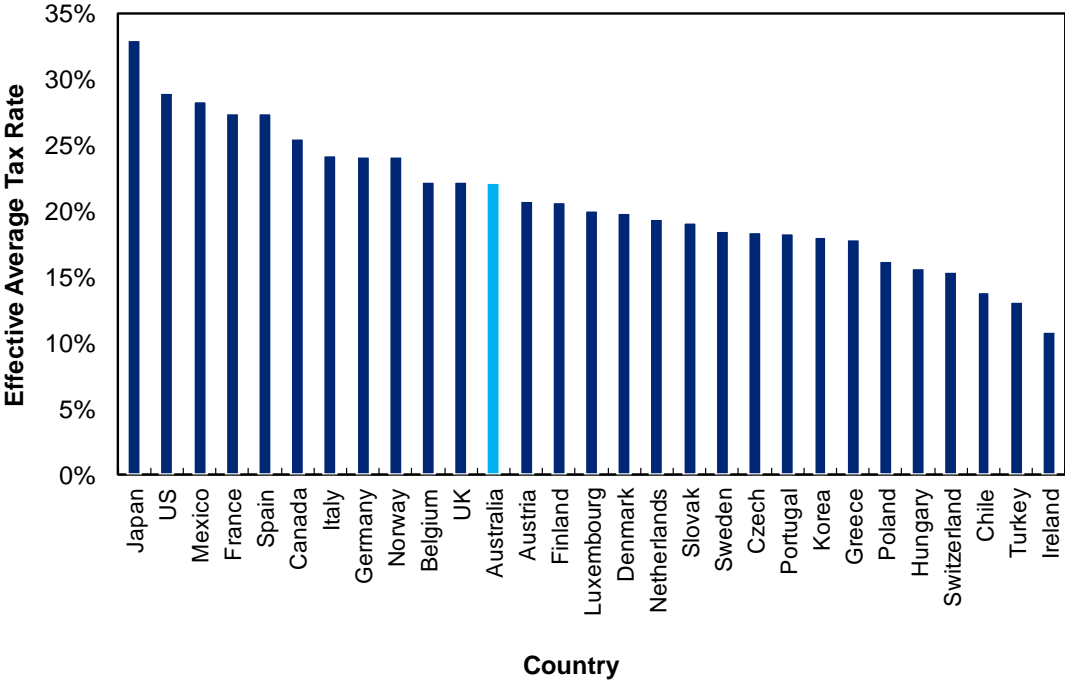
**Figure 5: Estimates of Effective Marginal Corporate Tax Rates, OECD, 2011**



Source: Hassett and Mathur (2011)

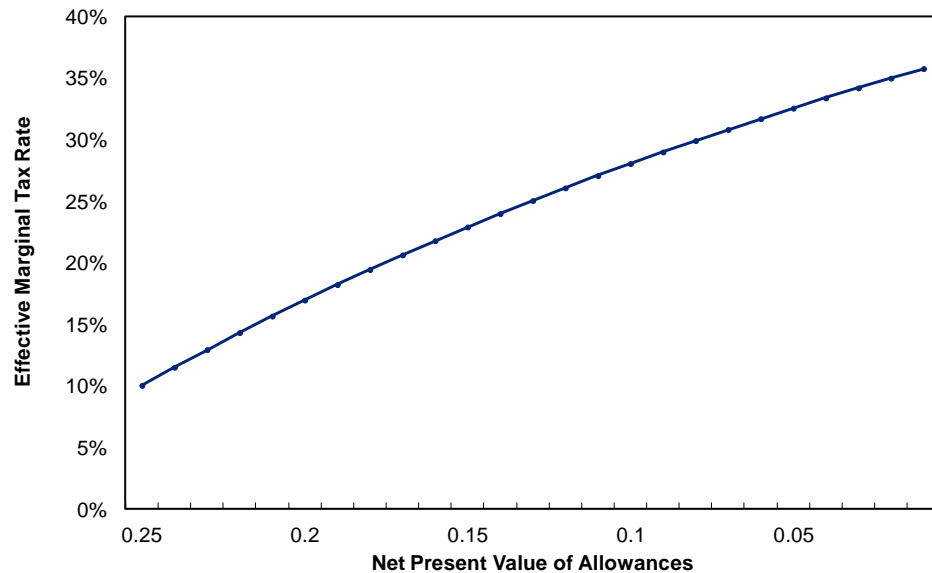
<sup>8</sup> See the Hendy-Warburton Report (2006), page 148; and Hassett (2011), page 3.

Figure 6: Estimates of Effective Average Corporate Tax Rates, OECD, 2011



Source: Hassett and Mathur (2011)

Reducing allowances increases the required rate of return on a project (the cost of capital) and increases effective marginal tax rates. To get some idea of the sensitivity of EMTRs to changes in allowances, Figure 7 below simulates a series of hypothetical examples based on the formulas derived in Devereux et al (2002), in which allowances are progressively lowered. In this example, which is based on reasonable parameter values, EMTRs can be highly sensitive to changes in allowances: for high values of allowances, halving the value of allowances more than doubles the EMTR.

**Figure 7: Lower Allowances Increase the Effective Marginal Corporate Tax Rate**

Source: Deloitte analysis, based on the expression for EMTRs for a one period investment, derived on page 461 of Devereux et al (2002). The example ignores inflation and assumes a discount rate of 10 per cent, depreciation of 3 per cent, and a statutory corporate tax rate of 30 per cent.

The above discussion focuses on comparisons of Australia's effective tax rates with OECD economies. But for Australia to remain an attractive investment destination for foreign investors over the medium to longer term, our corporate tax regime will need to be internationally competitive against a much broader set of countries. Chen and Mintz (2011) employ a slightly different methodology<sup>9</sup> for estimating effective marginal tax rates and apply it to a larger group of countries. Their estimates for Australia and selected non-OECD Asian economies are reported in Table 1 below, and suggest that Australia's effective rate is currently relatively high compared with other economies in this group.

<sup>9</sup> The methodologies of Hasset and Mathur (2011) and Chen and Mintz (2011) differ in a number of important respects. For example, the studies use different datasets, apply different discount rates to work the present value of depreciation allowances, and use different assumptions about the impact of alternative forms of financing (debt versus equity).

**Table 1: Estimates of EMTRs for Australia and Selected non-OECD Asian Economies**

| Country   | EMTR          |
|-----------|---------------|
| India     | 33.6 per cent |
| Australia | 26.0 per cent |
| Indonesia | 20.5 per cent |
| Malaysia  | 18.0 per cent |
| China     | 16.6 per cent |
| Vietnam   | 11.7 per cent |
| Taiwan    | 10.9 per cent |
| Singapore | 8.5 per cent  |
| Hong Kong | 4.0 per cent  |

Source: Chen and Mintz (2011)

## 2.3 Key findings

- There are sound economic reasons for taxing companies;
- Effective tax rates determine economic behaviour and the costs of company taxation. Effective rates can be influenced by a range of factors, including the statutory rate and determinants of the breadth or narrowness of the tax base. Because of Australia's dividend imputation system and other features, international comparisons of statutory company tax rates should be undertaken with a great deal of care;
- Notwithstanding this, even though the statutory tax rate has come down over time, there has been no change in the statutory rate for a decade. Australia now has one of the highest company tax rates in the OECD, and is located in the middle of the distribution of effective tax rates for OECD economies. Recent estimates suggest that Australia has a relatively high effective tax rate compared to non-OECD Asian economies;
- Lowering the statutory company tax rate lowers effective tax rates and improves investment incentives, but reducing allowances increases effective rates and reduces investment incentives;
- The gap between the top marginal personal tax rate and the company tax rate has increased steadily over the last 25 years.
- Australia places a relatively high degree of reliance on company tax as a source of revenue.



# 3 The Economic Effects of Company Taxation

## 3.1 Overview

Identifying and quantifying the costs of company taxation are key inputs in any examination of directions for further reform. As a first step in assessing the case for reform, it is important to determine exactly how the company tax system affects economic decisions, and who bears the costs of those effects. Secondly, it is vital to calculate the size of those economic costs, relative to the amount of revenue that the company tax raises, both on average and at the margin. Quantifying the costs of taxation allows one to proceed with a cost-benefit analysis of reform options. This section examines these two aspects of Australia's company tax system.

## 3.2 The Distortionary Effects of Company Taxation

### 3.2.1 Sources of Distortion

Whilst there are good economic reasons for company taxes, such taxes can also cause economic distortions. As outlined by King (1977), as a general matter the primary sources of potential distortion are:

- **Choice of Business Organisation:** A company tax system which distinguishes between different kinds of businesses (such as incorporated and unincorporated enterprises, or partnerships and trusts) will tend to distort economic decisions regarding the appropriate organisational form;<sup>10</sup>
- **Financial Policy:** A company tax system which allows a deduction for interest but not equity payments tends to distort the choice between debt and equity financing;
- **Investment Decisions:** Company taxes increase the pre-tax rate of return that is required to attract capital. That is, it increases the cost of capital, and this deters investment;
- **Risk-Taking and Entrepreneurship:** Company tax increases the cost of capital and so may provide a disincentive to innovate, take risks, and engage in entrepreneurial activity; and
- **International Capital Flows and Foreign Investment:** By increasing the cost of capital, company tax reduces incentives for foreign firms to invest domestically, and may provide distorted incentives for domestic savers to invest overseas to obtain more favourable rates of return. As discussed below, the extent of the distortion depends, inter alia, on the responsiveness of international capital flows to post-tax rates of return.

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<sup>10</sup> Gordon and Mackie-Mason (1997) estimate, using data for 1959-86, that the deadweight loss these distortions to choice of corporate form give rise to amount to 16 per cent of total US business tax revenues.

In addition, particular features of a company tax regime can create other economic distortions. For example, depreciation schedules and the treatment of expenses may affect the size, characteristics and timing of capital expenditures.

### 3.2.2 The Deadweight Costs of Company Taxation

As discussed above, in an open economy, the economic incidence of company taxation depend on the sensitivity of foreign capital movements to cross-border differences in company tax rates. This sensitivity is also a key determinant of the costs of company taxation.

There have been many studies of this issue, with a wide range of estimates in the literature. The most recent estimates indicate that international capital is highly sensitive to company tax rates. De Mooij and Ederveen (2005) undertook a meta-analysis (a quantitative literature survey) of 31 existing studies of the responsiveness of foreign direct investment (FDI) to company tax rates, and found that most studies find a negative relationship between taxation and FDI. Overall, they found a semi-elasticity of -3.72, which means that a one percentage point reduction in company tax rates leads to a 3.72 per cent increase in foreign direct investment. This was a key piece of evidence that was noted in the AFTS Review. Using this mean estimate, a 5 percentage point reduction in Australia's company tax rate would lead to an 18.6 per cent increase in foreign direct investment in Australia.

**Table 2: Semi-elasticity of FDI with Respect to Company Tax Rates**

| Type of Study   | Mean Semi-elasticity |
|-----------------|----------------------|
| Time series     | -2.61                |
| Cross section   | -7.16                |
| Panel           | -2.73                |
| Discrete Choice | -3.43                |
| <b>All</b>      | <b>-3.72</b>         |

Source: De Mooij and Ederveen (2005)

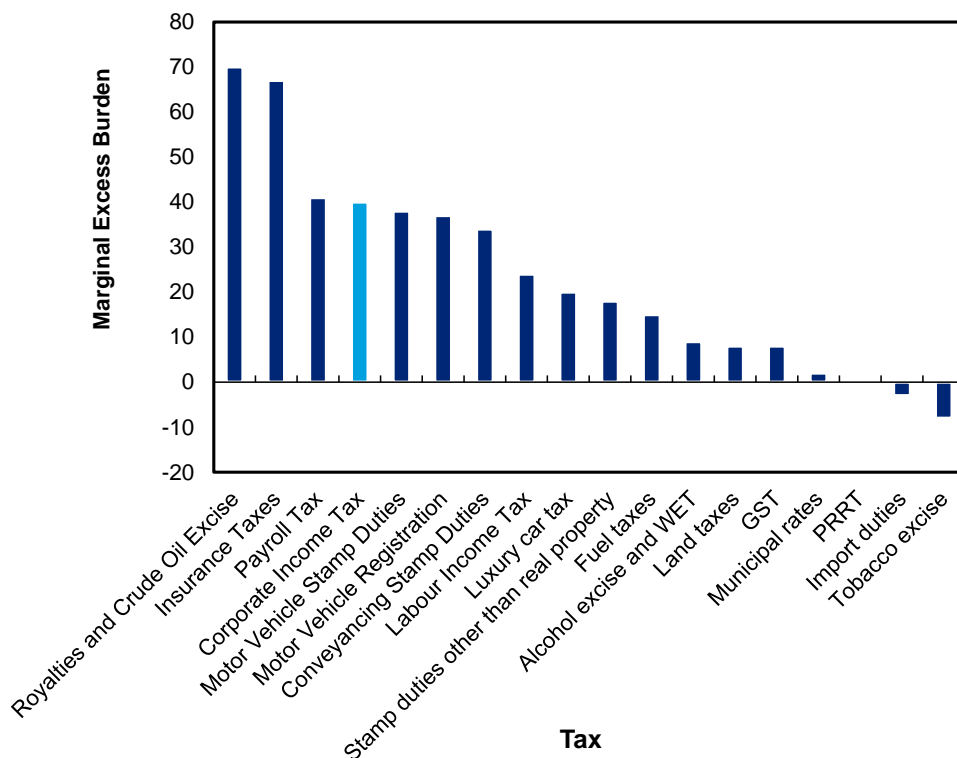
The high sensitivity of foreign investment to company tax rates means that company taxes are relatively costly. As a general rule, the direct burden of taxation – the reduction in consumer and producer welfare - is larger than the revenue that is raised by the tax. Taxes alter individual incentives and economic decisions at the margin, and therefore affect economic outcomes at the margin and in the aggregate. In driving a wedge between bid and ask prices for economic resources, taxes eradicate the opportunity for individuals to exploit all gains from trade.

Because the revenue raised is typically not sufficient to offset the value of the foregone gains from trade, the direct burden exceeds the revenue collected, and so most taxes are said to create an excess burden or deadweight loss. The size of this deadweight loss is proportional to the extent to which individuals divert resources towards lower valued uses in response to the tax.

The marginal excess burden (MEB) of a tax describes how the excess burden changes as a tax is changed by a very small amount. Some taxes have higher MEB than others, but they may also raise more revenue at the margin. Thus, a natural measure of the welfare cost of a tax that can be used to compare the efficiency consequences of different kinds of taxes is the normalised marginal excess burden (NMEB) of a tax, which measures the MEB per dollar of revenue raised.

The overall and relative economic costs of company taxation can therefore be summarised by examining the marginal excess burden of the tax per dollar of revenue raised. The deadweight costs of company taxation have been examined at length in the literature, but there are relatively few estimates for Australia. The AFTS Review published estimates of the marginal excess burden of a range of taxes (see Figure 8 below), and found that company taxes were relatively inefficient, with a marginal excess burden of 0.4. This means that a marginal reduction in the company tax rate which reduced revenue by 1 dollar would increase net economic welfare by \$0.40.

**Figure 8: Estimated Inefficiency of Australian Taxes**



Source: AFTS Review Final Report (2009), Part One Overview, page 13 and KPMG Econtech (2010), *CGE Analysis of the Current Australian Tax System*, page 5

In the 2010-11 Budget, the Government estimated that a 1 percentage point reduction in the company tax rate would reduce government revenue by \$2 billion.<sup>11</sup> Using the AFTS's estimate of the marginal excess burden of the company tax, this would mean that consumer welfare would be \$2.8 billion higher, which is roughly equivalent to 0.2 per cent of GDP.

Another way of interpreting these welfare gains is to directly estimate the effect of reductions in the company tax rate on GDP. The AFTS Review simulated the effects of a wide range of changes to Australia's tax system (including a reduction in the statutory company tax rate to

<sup>11</sup> The recent BTWG discussion paper published updated estimates of the revenue costs of rate reductions. These estimates suggest that a reduction in the company tax rate from 30 per cent to 29 per cent in 2013-14 would reduce revenue by \$1.4 billion, which is lower than the earlier estimates provided in the 2010-11 Budget. Assuming the excess burden estimated by the AFTS Review, using this updated revenue estimate would mean that a reduction in the company tax rate to 29 per cent would increase consumer welfare by \$1.96 billion.

25 per cent), and found that the potential overall gain to output would be in the order of 2 to 3 percentage points or around \$25 to \$40 billion in 2010–11 values.. Crucially, the major contributors to this final figure were “state tax reform and improved business taxation, including a reduced company tax rate and increased reliance on more efficient resource taxation.” The real wage rate was estimated to increase by between 3 and 5 per cent.

Given the estimates of the sensitivity of foreign investment to changes in the statutory company tax rate explored above, it is possible to derive some rough estimates of the effect of reductions in the statutory company tax rate on GDP. These rough estimates can be derived as follows. Assume that the aggregate production function takes the Cobb Douglas form, and is  $Y = AK^{1/3}L^{2/3}$ , where Y is GDP, A is a measure of total factor productivity, K is the flow of services provided by the capital stock, and L is flow of services provided by labour. The assumed values of the exponents capital and labour reflect the shares of income flowing to capital and labour, and are commonly used values in the literature.

Using this simple framework, a one per cent increase in the capital stock increases GDP by 1/3 of 1 per cent. If the mean semi-elasticity of FDI with respect to changes in the company tax rate is -3.72, then a reduction in the statutory corporate tax rate leads to an increase in the flow of investment, which means the capital stock is higher than it otherwise would be. Using the simple rule that annual net investment (gross investment less depreciation) is approximately equal to 3.5 per cent of the total capital stock<sup>12</sup>, we can derive estimates of the effect on GDP in the long run (after 10 years). The estimates are shown in Table 3 below.

**Table 3: Estimates of the Effect of Reductions in the Statutory Company Tax Rate on GDP**

| Reduction in Statutory Company Tax Rate | Estimate of Increase in the Long Run Level of GDP |
|---|---|
| 1%                                      | 0.36 per cent                                     |
| 2%                                      | 0.72 per cent                                     |
| 3%                                      | 1.08 per cent                                     |
| 4%                                      | 1.44 per cent                                     |
| 5%                                      | 1.80 per cent                                     |

Whilst these estimates are only indicative, they are not dissimilar to official government estimates and other estimates derived in the literature. For example, in the 2010-11 Budget the government cited modelling which estimated that the reduction in the statutory company tax rate by two percentage points, from 30 per cent to 28 per cent, would result in an increase in GDP in the long run of 0.7 per cent.<sup>13</sup> This is consistent with most of the

<sup>12</sup> See ABS Cat. No. 5204.0, Table 56.

<sup>13</sup> See page 48 of 2010-11 Budget Paper Number 2.

empirical literature, which finds that of all taxes, company income tax tends to have one of the larger negative effects on economic activity.<sup>14</sup>

### 3.3 The Incidence of Company Tax

The economic incidence of company taxation has been analysed and debated at length in the literature. Broadly speaking, the incidence of a tax describes how the economic burden of a tax is shared between economic agents, and is central to any discussion of tax reform. As a general rule, the economic incidence of a tax is almost never the same as the legal incidence.

Consider, for example, a tax on petrol which, as a legal matter, must be paid to the Australian Taxation Office by firms. Assuming that petrol is imported at a constant world price, in the long run, under perfect competition, domestic importers/sellers will exit the industry, and the domestic price will rise by exactly the same amount as the tax. In the long run, consumers bear the entire economic burden of this tax, even though the legal incidence falls on firms.

Tracing through the economic effects of company taxation is not a straightforward exercise, since there will be many adjustments in the economy in response to an economy-wide tax on all firms. However, since firms are nothing more than a collection of factors of production such as labour, land and capital, the incidence of company taxes must either fall on those factors production, or on consumers.

In Australia, the consensus appears to be that the incidence of company income tax falls on domestic immobile factors of production (such as land and labour) in the long run.<sup>15</sup> This result, and the analysis of the incidence of company tax from which it is derived, depends on whether one assumes a closed economy or an open economy.

#### 3.3.1 Company Taxation in a Closed Economy

In a closed economy, company investments must be financed from domestic savings (i.e. shareholders. As a result, part (or perhaps most<sup>16</sup>) of the economic incidence of taxes on investment returns fall on savings (and hence on income earners as savers), even though their legal incidence is on companies (i.e. it is companies that are required to pay the taxes).

Taxation of savings in itself tends to be inefficient. Individuals save so as to smooth and reallocate consumption over time. Hence, taxes on invested savings are therefore taxes on future expenditure relative to current expenditure, and tend to distort the intertemporal allocation of resources. It is therefore generally more efficient to tax consumption directly,

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<sup>14</sup> For example, Johansson et al (2008) estimate that a revenue neutral shift from consumption and property taxes to company taxes of 1 per cent of tax revenue would reduce GDP per capita by 2 per cent. See the discussion in the AFTS Review, Consolidated Final Report, page 18.

<sup>15</sup> See Henry, K. (2009) "A tax system for Australia in the global economy," Speech to Australian Business Tax Reform in Retrospect and Prospect colloquium, Sydney, 23 February.  
<http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/speeches/02.htm>

<sup>16</sup> The classic study of the incidence of corporate taxation is Harberger (1962), who found that the incidence of corporate tax fell mostly on capital rather than labour. In contrast, Krzyzaniak and Musgrave (1963) found that more than 100 per cent of the company tax was shifted to consumers in the short run. A review of recent empirical literature by Gravelle (2011) found that the majority of studies conclude that labour bears a substantial burden of the corporate tax, whilst an earlier study of open economy general equilibrium models by the same author [Gravelle (2010)] argued that capital bears virtually the entire burden.

than to tax it indirectly through the taxation of capital returns, as taxing it directly would increase incomes overall (since consumption could move closer to its preferred time path) and hence would allow the same revenue to be raised with less distortion to economic activity.

The distortion associated with taxing savings is potentially accentuated when different forms of savings are taxed differently. In effect, even if aggregate domestic savings are not especially elastic with respect to the tax system, it is highly likely that the allocation of those savings among competing uses is. These distortions can take the form of misallocations of savings as between investments, and distortions in the financing of investment as between alternative sources or forms of finance (for instance, as between debt and equity finance, and within equity finance, between issuing new equity and relying on retained earnings).

The extent of the distortions associated with taxing the return on savings obviously depends on the rate at which, and the structure according to which, savings are taxed. As discussed above, one approach (which is adopted in Australia), to reducing the extent of those distortions is to award imputation tax credits, which treat taxes paid by companies on income distributed as dividends as a 'withholding' tax against personal income tax, while taxing capital gains (which will reflect retained earnings) at a concessional rate. This reduces the distortion between sources of finance and goes some way to removing the "double taxation" of savings, but it achieves these goals only in part (for instance, because of the differing treatment of dividend income and retained earnings).

### 3.3.2 Company Taxation in an Open Economy

In an open economy, the legal incidence of the tax is not irrelevant as it is in a closed economy, where taxes may be levied on firms but where part or most of the burden actually falls on savers.

There are three types of taxation regimes in an open economy:<sup>17</sup>

- Source based company taxation taxes income from where the investment takes place.
- Residence-based taxation taxes all income, wherever earned, of a company resident in a country.
- Destination-based taxation taxes the sales, net of costs.

In a closed economy context, there is no difference between a residence-based system and a source based system. Australia's existing system is essentially a source-based tax.

Broadly speaking, in a small, open economy, residence-based taxes on the return on domestic savings affect the supply of domestic savings, but do not affect the level of investment, since any shortfall between domestic savings and the level of investment can be financed at a cost of capital that is set in world markets.

In contrast, source-based taxes on company incomes (i.e. taxes on the income companies earn in the country) do not affect the level of domestic savings, since those savings can always be used to fund investments elsewhere at the globally set rate of return. However, they can affect the level of investment. If foreign investors are indifferent between investing in Australia and investing elsewhere, they will require a higher rate of return to invest in Australia when they have to pay Australian corporate income tax, so that the return they receive after paying Australian tax is at least equal to the return they could have obtained from investing elsewhere.

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<sup>17</sup> See the AFTS Review, page 163.

Hence, in response to a reduction in the statutory company tax rate which reduces the required pre-tax rate of return, foreign investment in Australia will increase. This increases the capital intensity and productivity of factors of production which cannot shift overseas, increasing their returns as well. Ultimately, the benefit of a lower higher company tax falls on Australian wage earners and landowners: reductions in the statutory company tax rate would not make foreigners better off, but would make Australians better off. The cost of capital to Australian companies would fall (as the lower tax rates would be reflected in pre-tax rates of returns) and investment would rise. The capital stock is higher than otherwise, increasing wages. This was one of the main reasons why the AFTS Review recommended a reduction in the company tax rate, and also why the Government adopted this recommendation.

To conclude the discussion of tax incidence, it is important to note two cases where the economic incidence of the corporate tax may fall in part on foreigners, even if capital is highly mobile internationally:

1. Where the investor is liable for tax in its home country and the foreign government allows a tax credit for the Australian tax; or
2. Where the non-resident is earning economic rents. Providers of foreign direct investment will often invest in Australia precisely because they believe they can earn a higher return here than elsewhere, and as a result may not be sensitive to Australian tax rates. Clearly, a tax that fell purely on these economic rents would not reduce foreign investment.

In the first case, to the extent the foreign tax credit reduces tax paid to the foreign government, it is foreign treasuries that bear the incidence of Australian taxes rather than the non-resident investor. Some of Australia's major sources of foreign investment allow their residents to reduce their home country tax liabilities by the amount of any taxes paid elsewhere. If taxes imposed by Australia do not exceed the investor's home tax liability, the tax will not have any effect on the cost of capital in Australia. In these cases, the tax rate charged by Australia will affect where the non-resident pays tax – in Australia or at home – but not how much tax they pay.

In the second case, tax should be imposed on foreign investors so as to get back some part of the economic rent. This is efficient, as the tax (as long as it only falls on the rent), will not distort investment decisions. In Australia's case, it has been argued that these rents are mainly likely to arise from natural resource endowments. The main issue is that it is difficult to distinguish between foreign investments that are not sensitive to tax from others. In addition, the definition and measurement of economic rents is often highly problematic.

### 3.4 Key findings

- The incidence of company taxation is still debated in the literature;
- The consensus in Australia seems to be that in the long run, labour bears a significant burden of the company tax. In other words, in the long run, a reduction in company tax rates is likely to lead to capital deepening and an increase in real wages;
- Estimates of the elasticity of investment with respect to rates of return are relatively high, and suggest that a reduction in Australia's company tax rate to 25 per cent could increase foreign investment by nearly 19 per cent.
- Company taxation is relatively inefficient. Recent estimates published by the Australian Government suggest that all else being equal, a reduction in the company tax rate which reduced revenue by a dollar would increase net economic welfare by \$0.40. In practice, the extent to which a reduction in the company tax rate improved economic welfare would depend on how the rate cut was funded.
- Australian Government estimates suggest that all else being equal, reductions in the company tax rate would significantly increase output and real wages.



## 4 Recent Studies and Recommendations

Few of the observations in the previous section are new. Indeed, the gains from reducing the company tax rate have been noted on a number of previous occasions. This section provides a brief overview of the major recommendations of two recent Government reports as they relate to company tax arrangements, and examines the extent to which these recommendations have actually been implemented.

### 4.1 The Ralph Review of Business Taxation

In 1998 the Australian Government announced its overall tax reform strategy, *A New Tax System*. The subsequent Ralph Review of Business Taxation was tasked with examining the strategy for business tax reform outlined in *A New Tax System* and with providing a suitable framework with implementing those reforms in a revenue neutral manner.

Specific issues that the review was asked to consider included developing more internationally competitive tax treatment of business investments, the value of bringing tax value and commercial value closer together, the possibility of reducing the company tax rate to 30% and the potential for reforming capital gains tax.<sup>18</sup>

#### 4.1.1 Recommendations for the company tax rate

A major area in which the Review sought to achieve reform was the level of the company tax rate to improve international competitiveness. However, in order to achieve this in a revenue neutral manner the necessary trade-off was to remove existing accelerated depreciation provisions for large businesses. While the Review stated that making a judgment call between these two measures was not easy since, as discussed above, they could both potentially improve international competitiveness, it ultimately recommended a reduction in the company tax rate on that basis that eliminating accelerated depreciation would remove a major source of tax preferred income, thereby improving the simplicity of the tax system.<sup>19</sup> The Review also noted that accelerated depreciation of capital gave a tax preference to capital intensive industries, distorting the allocation of resources away from tourism and services.<sup>20</sup>

The Review recommended that the company tax rate be reduced from the current level of 36% to 34% in the 2000-01 income year and 30% in the 2001-02 income year funded through the removal of accelerated depreciation provisions for large businesses and other measures.<sup>21</sup> A number of justifications were made for reducing the level of the company tax rate:<sup>22</sup>

- reducing the company tax rate to 30% will align it with the personal income tax rate paid by most individual taxpayers;

<sup>18</sup> Review of Business Taxation 1999, 'A Tax System Redesigned: More certain, equitable and durable', Overview, pp. 10-11.

<sup>19</sup> Ibid, Overview, pp. 25-26.

<sup>20</sup> Ibid, Section 8, pp. 305-306.

<sup>21</sup> Ibid, Section 11, p. 424.

<sup>22</sup> Ibid, Section 11, p. 424.



- reducing the company tax rate to 30% will ensure that it is competitive in the Asia-Pacific region and with other capital exporting companies;
- a more competitive company tax rate reduces the possibility of overseas non-portfolio investors losing foreign tax credits because the Australian company tax rate higher and increases the after tax return for overseas portfolio investors boosting Australia's attractiveness as an international investment location; and
- provides scope for corporations to either increase dividend flows to shareholders or increase levels of retained income and investment.<sup>23</sup>

Overall, the Review supported the view that a reduction in company tax rates would stimulate investment, economic growth and jobs.<sup>24</sup> It was estimated that the reduction in company taxes would reduce company tax revenue by \$3.5 billion in 2001-02,<sup>25</sup> with a slightly smaller impact in subsequent years.

#### 4.1.2 Other recommendations

While the change in company tax rate was the most significant proposed reform in terms of net impact on the Commonwealth Budget,<sup>26</sup> the Ralph Review also recommended a number of other business tax reforms measures be pursued.

##### • Depreciation allowances

As noted above, in order to achieve the desired reduction in the company tax rate the Review had to remove the accelerated depreciation allowances for large businesses. In order to simplify taxation arrangements the review recommended that the previous 37 capital allowance schemes be replaced with two schemes: a simplified life regime for businesses generally and an optional simplified regime for small businesses.<sup>27</sup> Under the simplified life regime businesses were able to specify the expected life of an asset or choose a flat rate of 37.5% per annum for a pool of assets which are individually worth less than \$1,000.<sup>28</sup>

Small businesses (those with annual revenues of less than \$1 million) were allowed to immediately write off all wasting assets worth less than \$1,000 and access a pooling arrangement for all other assets with an effective life of less than 25 years with a depreciation rate of 30%.<sup>29</sup>

##### • Approach to income taxation

The review noted that the approach to company income taxation was complicated by differential treatment of ordinary income, statutory income which may lead to assets being taxed in a variety of ways depending on the purpose for which they are held.<sup>30</sup> The review's

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<sup>23</sup> Ibid, Section 11, p. 424.

<sup>24</sup> Ibid, Overview, p. 24.

<sup>25</sup> Ibid, Overview, p. 28. Greater detail as to the estimated changes in revenue is provided in Chapter 24, pp. 704-709.

<sup>26</sup> Ibid, Overview, p. 28.

<sup>27</sup> Ibid, Overview, p. 55.

<sup>28</sup> Ibid, Overview, p. 55.

<sup>29</sup> Ibid, Overview, p. 76.

<sup>30</sup> Ibid, Overview, pp. 37-39.

preferred approach was to use a cashflow/tax value for valuing income and assets which would minimise the likelihood of entities being taxed on unrealised asset appreciations.<sup>31</sup>

- **Other recommendations**

A number of other recommendations were made by the Review including various proposals to simplify the tax system and proposals to change how Capital Gains Tax (CGT) and Fringe Benefits Tax (FBT) are calculated as well as broadening the definition of an entity to include trusts and co-operatives.

## 4.1 The Australia's Future Tax System (AFTS) Review

In May 2010 the Australia's Future Tax System (AFTS) Review made several recommendations regarding company tax arrangements in Australia. The most important of these recommendations were as follows:

- The structure of the company income tax system should be retained in its present form, at least in the short to medium term [Recommendation 26];
- The company tax rate should be reduced to 25 per cent over the short to medium term, with the timing subject to economic and fiscal circumstances [Recommendation 27]; and
- Improved arrangements for charging for the use of non-renewable resources **should be introduced at the same time** (emphasis added) [also part of Recommendation 27].

The major recommendations of the AFTS review were therefore intended to reduce the company tax rate better target economic rents, as per the earlier discussion in section xx above.

In addition, the AFTS Review argued that Australia, in the future, should consider moving the company income tax system towards a business level expenditure tax. Finally, the AFTS Review argued that over the longer term, consideration needs to be given to eventually moving away from the dividend imputation system as a means of integrating the personal and company income tax systems.

Following the release of the AFTS Review, the Australian Government unsuccessfully attempted to introduce a Resource Super Profits Tax (RSPT) in line with the AFTS Review's Recommendation 27. The RSPT was superseded by the new Minerals Resource Rent Tax (MRRT), which was passed by both houses of the Australian Parliament on 19 March 2012 and applies as of July 1 2012.

However, whilst the Government earlier announced that the company tax rate would be reduced from 30 per cent to 29 per cent from the 2013-14 income year, this change was abandoned, with both the Greens and the Opposition announcing that they will not support these earlier announced company tax reductions.

It is therefore unclear whether the tax cut legislation - which only remains in draft form<sup>32</sup> - will ever be passed. In other words, there is a real risk that Recommendation 27 of the AFTS Review will only be partially implemented, with significant reductions in the company tax rate not being implemented "at the same time" (if at all) as the new MRRT comes into effect.

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<sup>31</sup> Ibid, Section 4, pp. 157-160.

<sup>32</sup> The draft legislation was released on March 14 2012, and can be found at <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2346>

## 4.2 Key findings

- Both the Ralph Review and the AFTS Review recommended that the company tax rate be reduced in order to stimulate investment and economic growth.
- The AFTS Review recommended that the company tax rate be reduced to 25 per cent over the short to medium term, with the timing subject to economic and fiscal circumstances. It also recommended that improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.
- With the Government's recent abandonment of proposals to reduce the company tax rate, the result of recent changes (in particular, the introduction of the MRRT which is designed to tax economic rents) is that the overall company tax burden in Australia is likely to have risen.

## 5 Broad Options for Reform

The evidence reviewed in the previous sections suggests that there would be significant economic gains from company tax reform. But the gains from reform always depend on what that reform actually looks like.

Despite the decision to not pursue the proposed reduction in the company tax rate, the case for such reductions has not changed, and remains strong. As discussed in earlier sections, when judging options for reform and proposed changes to the existing system, there are several key criteria that should be kept in mind:

- Efficiency: Do the proposed changes improve economic wellbeing?
- International Competitiveness: Do the proposed changes make the Australian economy more internationally competitive?
- Integrity: Do the proposed changes preserve the integrity of the company tax and personal tax systems?

This section considers, at a high level, a range of reform options.

### 5.1 No Policy Change

Not implementing change is always an option in any economic policy discussion. It is a mistake to conclude, however, that making no changes to policy automatically means that when it comes to domestic and international company tax arrangements, the status quo will continue to apply at all points into the future. There are costs to not acting.

One change to the status quo is already known: the Minerals Resource Rent Tax, a new tax on mining companies, came into force on July 1 2012. To the extent that the MRRT will increase the tax and compliance burden of these companies, and to the extent that it does not tax economic rents, it will tend to harm Australia's international competitiveness.

It is a virtual certainty that other countries will continue to change their company tax arrangements in the future, and if the trend of the last decade continues, this will mean that statutory rates around the world will continue to decline. This too will affect Australia's international competitiveness, even if no changes are made to our own company tax regime.

Hence, because of existing changes that are already likely to occur, and because other countries will not "sit still", there are a number of costs that are likely to be associated with abandoning the reform agenda and not making any policy changes to company tax arrangements in Australia.

### 5.2 Comprehensive Reform

Taxes on company incomes can be limited to economic rents either by cash-flow based taxes (i.e. taxes which fall on revenues minus real outlays, including acquisitions of assets<sup>33</sup>) or in systems where there is a tax shield on debt, by imputing an allowed rate of return for

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<sup>33</sup> As the present value of the revenues associated with the marginal investment project is equal to the cost of that project, a tax on cash flows does not distort investment decisions at the margin, but does tax economic rents. This form of cash flow based tax is the "R" or real version of the cash-flow based taxes considered in the Meade Report.

corporate equity.<sup>34</sup> While each of these options has strengths and weaknesses, the latter seem broadly easier to implement, though the Norwegian experience with such a tax over the period from 1992 to 2006 highlights the problems that can arise from incentives for labour income to be converted into company income.<sup>35</sup>

Motivated by these considerations, the AFTS Review canvassed a range of radical company tax reform options, including a move to a business level expenditure tax.

The case for Australia to introduce such radical changes has yet to be made out. In addition, the transitional issues and costs involved in moving to such a system would likely be considerable. Finally, this option does not satisfy all of the criteria identified above.

As discussed earlier, since the required post-tax return on capital in the economy is set in world markets, the tax wedge associated with the tax on company income will need to be offset by a higher pre-tax return. That higher pre-tax return is achieved by forgoing some investments that have earned more than the globally set cost of capital, but less than the globally set cost of capital marked up by the effective company tax rate.

As a result, company tax in a small, open economy has to deal with two sets of distortions, operating at different margins: the distortion to domestic saving associated with effects on the return to those savings (effects arising from the interaction between the company tax system and the taxation of personal income); and distortions to domestic investment arising from the wedge company tax drives between pre-tax returns and the globally set cost of capital. While integrating the company and personal tax systems along the lines of a business cash flow tax might help deal with the first of these, it does not deal with the second.

## 5.3 Reductions in Company Tax Rates

Rather than pursue comprehensive reform (where the costs and benefits are largely unknown), a simpler set of options would be to simply reduce the company tax rate. There are two main issues associated with this less radical path. First, there may be concerns with the backstop role of the company tax system, as any reduction in the company rate would increase the gap between the top marginal personal rate and the company rate. However, the AFTS Review did not seem to regard this as a major issue, and the Ralph Review focused more on the rate paid by most taxpayers rather than the top marginal rate.

Second, there is the question of how to fund rate reductions. There are several broad options, which are outlined below.

### 5.3.1 Reduction in company tax rates, funded by altering other aspects of the company tax system

One reform option, which was proposed by the Ralph Review, would be to reduce the company tax rate further and fund this in a revenue neutral fashion by altering rules associated with deductions and allowances. As the recent BTWG discussion paper notes, many of these have already been removed.

<sup>34</sup> Whether the imputed rate of return needs to include a risk premium depends on the extent of loss transferability, between projects, periods and firms. The greater the extent of the allowed loss transferability, the less the need to impute a risk factor to the cost of equity, which under complete transferability, will equal the risk-free rate. As a result, the greater the allowed transferability, the simpler the system can be as regards assessing the required rate of return. On the other hand, unrestricted transferability can give rise to “sham” projects, which waste resources so as to avoid tax payments.

<sup>35</sup> Of course, these already arise in the Australian tax system, as do many other distortions associated with income shifting.

There are a number of conceptual and practical problems associated with this option. First, whilst the BTWG has recently provided estimates of the revenue effect of a range of base-broadening options, it is still not clear that the revenue increase which would be needed to fund a non-trivial reduction in the company tax rate could be met by altering other parts of the company tax system.

Second, since it is effective tax rates rather than statutory rates which matter for investment, and since the former are affected by a range of provisions in the company tax regime, it is not clear that the overall international competitiveness of Australia's company tax system would be improved by undertaking such a change. On the one hand, a reduction in the company tax rate would lower effective tax rates and improve competitiveness; but altering other parts of the system may increase effective rates and reduce competitiveness. It could easily turn out to be the case the costs in terms of international competitiveness outweigh the benefits.

Third, as the BTWG discussion paper notes, there may be good economic reasons for allowing firms to claim deductions and allowances. Reducing or eliminating them could exacerbate, rather than improve, the economic distortions that are associated with the current system. The increase in distortions may more than offset any efficiency gains from reducing the statutory company tax rate.

Hence, as a matter of economic theory it is not at all obvious why any potential revenue gains from changes to the structure of the company tax system should necessarily be hypothecated and used to fund reductions in the company tax rate. Similarly, it is not clear why a reduction in the company tax rate needs to be funded by changes in other parts of the company tax system. If the existing system is causing distortions, then these should be remedied in any case.

Hypothecation also has policy problems associated with it. When governments introduce a tax increase in order to fund a reduction in rates somewhere else, the pressure to implement the increase, pocket the revenue, and forgo the offsetting reduction may simply be too great. Such temptations may become all the greater as fiscal demands increase.

### 5.3.2 Reduction in company tax rates, funded by increases in other taxes

A more attractive reform option may be to fund reductions in company tax rates by proposing increases in other taxes. This is less restrictive than the previous option, but would not rule out funding reductions in the company tax rate with changes elsewhere in the company tax system itself.

From an economic point of view, even if other taxes were increased, if those taxes had a lower marginal excess burden than the company tax rate, then there would be an efficiency improvement. However the risks identified earlier regarding hypothecation may still apply. Moreover, reducing Australian rates of taxation on business incomes may not improve Australia's attractiveness as an investment location if this is offset by increases in other taxes which have the effect of increasing required rates of return.

### 5.3.3 Reduction in company tax rates, funded by spending reductions

A final broad option would be to reduce company tax rates and fund these with reductions in spending. The difficulty associated with this option is identifying individual spending reductions. There are two broad categories of spending that are relevant: economically wasteful spending, which creates its own distortions and welfare costs, and economically beneficial spending, which creates benefits.

If economically wasteful spending is cut, then there is an efficiency gain from such a reduction, in addition to a revenue gain. Reducing such spending in order to fund company tax cuts would result in an unambiguous welfare gain.

If beneficial spending is cut, any revenue gain is accompanied by a loss. Reducing such spending to fund company tax cuts would no longer be guaranteed to result in an unambiguous gain and would be more difficult to argue in favour of. In order for there to be an efficiency improvement, the marginal excess burden of the company tax would need to be higher than the marginal benefit of the spending that is being reduced. This option would therefore need to be accompanied by detailed analysis of the marginal benefits of the relevant government spending programs.

## 5.4 Key findings

- There are two broad reform paths which could be pursued: radical, comprehensive reform, or rate reductions.
- The costs and benefits of radical reform are, at this stage, largely unknown.
- Existing Government studies suggest that there would be non-trivial economic gains from reductions in the company tax rate.
- The question of how to fund such reductions needs to be considered very carefully. It may turn out that funding rate reductions by raising existing taxes or altering other features of the company tax system could lead to unintended consequences whose costs could exceed the benefits.
- Funding rate reductions by proposing to reduce wasteful spending is the first best option, but these spending reductions would need to be identified and carefully costed.

## 6 Conclusion

The evidence reviewed in this paper suggests that there would be significant economic gains from company tax reform. However, the gains from reform depend on exactly which reforms are pursued.

Whilst there are good economic reasons for taxing companies, company taxes tend to be among the most distortionary in the economy. As a result, based on criteria of efficiency, international competitiveness and preserving the integrity of the tax system, the case for reducing the company tax rate remains relatively strong.

The question of how to fund such reductions needs to be considered very carefully. As the analysis in this paper has demonstrated, altering certain features of the tax base (such as allowances) tends to increase effective marginal tax rates. Hence, it is far from clear that a revenue neutral reduction in the statutory corporate rate that is funded by broadening the company tax base would reduce effective marginal tax rates and improve the efficiency of investment decisions. It may turn out that funding rate reductions by raising existing taxes or altering other features of the company tax system could lead to unintended consequences whose costs could exceed the benefits. The most economically responsible way forward is to carefully and methodically assess the costs and benefits of all possible reform options, and to choose the option(s) with the greatest net economic benefit for Australia.



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