 Document 1

TREASURY MINISTERIAL SUBMISSION

6 November 2017 PDR No. MS17-003617

Treasurer cc: Minister for Revenue and Financial Services

UNITED STATES CORPORATE TAX REFORM – UPDATE

Timing: Routine

KEY POINTS

- The US House Ways and Means committee released draft legislation (the "Tax Cuts and Jobs Bill") on 2 November 2017 outlining current Republican plans for significant US tax reform.

s.22(1)(a)(ii)

- [redacted]
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- s.22(1)(a)(ii) [redacted]

: As noted in MS17-003188, a credible expectation of the US permanently lowering their corporate tax rate will place more pressure on Australia's corporate tax system. This effect on cross-border investment incentives depends on expected future tax rates and can begin in advance of the rate change.

s.22(1)(a)(ii) [redacted]

s.22(1)(a)(ii) [redacted]

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Consultation: Washington Post, IITD, TFD s.22(1)(a)(ii)

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- [redacted]
- [redacted]

  – A permanent cut in the US corporate tax rate from 35 per cent to 20 per cent would have a negative impact on Australia's ability to attract foreign investment, and would add weight to the case for a more competitive company tax rate in Australia.

US tax plan

- US corporate tax cut - 35 to 20 per cent
- Expected to negate benefits of Australia’s current policy settings
- Two distinct impacts:
- More of the world’s capital would flow into the United States reducing domestic investment, labour productivity and incomes in other countries
- The returns to the owners of capital, including Australians will rise slightly, with the consequent increase in national incomes.

TREASURY MINISTERIAL SUBMISSION

18 December 2017 PDR No. MS17-004184

Treasurer cc: Minister for Revenue and Financial Services

IMF PRELIMINARY ANALYSIS OF A CORPORATE TAX CUT IN THE UNITED STATES – IMPLICATIONS FOR ECONOMIC GROWTH IN THE REST OF THE WORLD AND AUSTRALIA

Timing: For information.

KEY POINTS

- IMF analysis suggests the proposed US corporate tax cut plan will have an adverse effect on Australia's economic growth and on the sustainability of the Australian tax system. This is consistent with previous Treasury analysis.

- In its October 2017 World Economic Outlook (WEO), the IMF reported preliminary analysis of the cross-border effects of fiscal policy. The analysis focused on a scenario involving a 15 per cent budget-neutral reduction in corporate income tax rates in France, Germany, and the United States (US), with a consumption tax increase to offset the revenue loss.

- The US component of the scenario is broadly the same as the proposed tax reform passed by the US House of Representatives on 16 November 2017 and US Senate on 2 December 2017, including a reduction in the federal corporate tax rate from 35 to 20 per cent. However unlike the IMF scenario, the package passed by the House did not specify how it would be financed.

- The proposed changes could be expected to have two distinct impacts:
  - More of the world's capital would flow into the United States reducing domestic investment, labour productivity and incomes in other countries.
  - The returns to the owners of capital, including Australians will rise slightly, with the consequent increase in national incomes.

- The IMF's WEO analysis suggests that the reduction in corporate taxes in the US, France and Germany will reduce GDP in other countries (including Australia) by around 1 per cent. Key to considering the effects of such a corporate rate cut are the following points:
  - In the short term a reduction in the corporate tax rate in the US and other major advanced economies would raise their after-tax rates of return.
    - : That would lead to increased demand for capital to be used for investment. Consistent with our US corporate tax working paper, this increased demand would pull capital from the rest of the world, where after-tax rates of return would be unchanged.
    - : In other words, tax reforms in these major advanced economies would cause the rest of the world to face a significantly higher *required* after-tax rate of return to provide their own investment.
  - From Australia's perspective, the main modelling challenge is estimating the size of capital flows from the rest of the world. These outflows will vary from country to country depending on many factors, including industry composition and trade exposure to the US or its counterparties. The IMF analysis suggests that if distributed evenly, the

outflows would reduce Australia's GDP by 1 per cent over the next decade versus the counter-factual.

– s.22(1)(a)(ii) [redacted]

- The consequences of the lower corporate tax rates in the US, Germany and France for capital outflows and hence lower investment could in effect be offset by the implementation of the Government's Enterprise Tax Plan. Treasury modelling released with the 2016-17 Budget estimated the Government's Enterprise Tax Plan would increase Australia's GDP by around 1 per cent.
  – That is, by in effect doing nothing and remaining at 30 per cent corporate tax rate, Australia's GDP could be one per cent worse off according to the IMF. But by contrast, were Australia to implement the Government's ETP, this would in effect negate these impacts and at least ensure that Australia was left no worse off.
  – Moreover, whereas the economic benefits from inflows were expected to occur over the long run as the capital stock increased, the benefit from mitigating outflows would be immediate as it would be offsetting a decline.
  – If Australia implements policy changes to offset those of other countries Australia can maintain Australian investment and GDP.
- It is also worth noting that the link between corporate tax cuts and wages through investment is often misunderstood. It is, however, clear that higher investment, all other things being equal, supports the output and wages of workers – which is important given the current low wage environment observed globally.
  – A number of countries have already lowered corporate rates or are considering such changes as a way of promoting wage growth in an otherwise low wage growth environment.
  – For example, there have been discussions in Japan about lowering corporate taxes in exchange for higher wages.
- The global environment of reducing corporate tax rates brings into sharp focus the ongoing challenge for Australia to maintain competitiveness with regard to capital flows.
  – Historically, Australia has played a game of 'catch-up' when the rest of the OECD has reduced company tax rates.
    : That is, where we have been at or below the OECD average, and other countries have shifted, we have soon followed.
  – That nexus has now well and truly been broken. In effect, we have gradually been left behind since our last company tax cut in 2001.
  – As such, Australia is increasingly vulnerable to what are major step changes in the global tax environment, such as the US plan for a 15 percentage point company tax rate reduction.

- A reduction in the level of real GDP will exacerbate existing concerns regarding the sustainability of the Australian tax base. We may need to reconsider our medium-term tax receipt projections once the parameters of the US proposal are clearer.

s.22(1)(a)(ii)

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Consultation: Macroeconomic Modelling and Policy Division, Corporate and International Tax Division, Tax Analysis Division.

ADDITIONAL INFORMATION

- The IMF World Economic Outlook, October 2017 Chapter 4, discusses cross-border impacts of fiscal policy and assesses whether these are still relevant to the world economy.

- The chapter analyses a detailed scenario in which France, Germany, and the United States cut corporate income tax rates by 15 percentage points and completely offset the revenue loss by raising consumption tax.

- In the short term, a reduction in the corporate tax rate in the US and other major advanced economies would raise after-tax rates of return in those economies, leading to increased demand for capital to be used for investment. This increased demand would attract capital from the rest of the world (where after-tax rates of return would be unchanged), including Australia. In other words, tax reforms in major advanced economies would cause the rest of the world to face a significantly higher *required* after-tax rate of return.

- Once the expansion in the capital stock in major advanced economies has been exhausted, the global required after-tax rate of return will return to its constant long run level.

- From a modelling perspective, a major challenge is to understand the size of capital flows from the rest of the world that are required to make this happen. These outflows may vary from country to country depending on a range of factors, including industry composition.

- It is important to understand that the IMF modelling task is quite different to Treasury's 2016 modelling of a company tax cut in Australia.
  - That analysis used a small open economy model, which is not helpful for the type of global policy scenario described above. The shock in the 2016 project was a rise in the after-tax rate of return in Australia, for which the model estimated the resultant capital inflows.
  - But to assess the global scenario discussed in the IMF analysis, a model is needed that can estimate the size of the capital outflow from Australia to those major advanced economies cutting their corporate tax rates.
  - We are liaising with the IMF to obtain more information in respect of the more detailed analysis they are undertaking.

- The effects on Australia would vary depending on whether our corporate tax rate is 30 per cent or 25 per cent.
  - In the WEO scenario, the IMF's modelling found that countries that did not match the major advanced economies' tax reforms would experience a reduction in foreign direct investment of about US$400 billion, leading to a 1 per cent reduction in GDP.
  - Given we estimated that cutting our corporate tax rate to 25 per cent would generate a 1 per cent increase in GDP, doing so would be enough to completely offset the negative economic effects estimated by the IMF.
    - : Because the effect of Australia's policy would be to mitigate capital outflows, the benefit should be immediate. By contrast, if advanced economies did *not* pursue tax reform, the gains to Australia from cutting its corporate tax rate would occur over the long term (about 10 or more years). That is because those gains arise as increased capital inflows lead to higher investment, which in turn raises labour productivity and therefore wages.

- But if a broader range of countries cut their corporate tax rates to the extent described by the IMF, the outcome for Australia would be negative – even with our proposed tax cut.

- The IMF's analysis also assumed a reduction in corporate tax rates in major advanced economies would encourage profit shifting to those economies from the rest of the world.
  - However, the negative economic effect from profit shifting on the rest of the world, including Australia, would be minor compared with the negative effects of the capital outflows described above.
  - This is consistent with our own company tax analysis.

US TAX REFORM

TOP LINES:

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- US tax reform will significantly reduce the tax burden for US companies, attracting additional investment to the US and reducing Australia's relative competitiveness~~ability to~~ in attracting foreign investment.
- That is why Australia should legislate the company tax cuts under the Government's Enterprise Tax Plan. Without action, by 2020 Australia's company tax rate will be the second highest in the OECD (after Germany).

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- The reforms will significantly reduce the tax burden for US companies, attracting additional investment to the US and reducing Australia's ability to attract foreign investment.
- The impact of US tax reform on Australia will also depend on the global response.
  - If other major economies were to cut their tax rates in response, and Australia kept its corporate tax rate the same, this would increase the potential negative effect on investment in Australia.

s.22(1)(a)(ii)

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- The negative investment impact is expected to more than offset any trade boost the rest of the world, including Australia, may receive from increased demand from the US.
- Following the US tax reform – and policy announcements in Belgium and France – Australia's company tax rate of 30 per cent will be the second highest in the OECD by 2020 (after Germany).

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