

MARCH 2019

A policy paper commissioned
by the Minerals Council of Australia

Corporate tax reform

Australia watches the train go by

Philip Bazel and Jack Mintz



Corporate tax reform

Australia watches the train go by

Philip Bazel is a Research Associate at the School of Public Policy, University of Calgary. Mr Bazel has also played a role in a number of projects consulting for both governments and private organisations in the area of taxation and public finance.

Jack Mintz is the President's Fellow at the University of Calgary's School of Public Policy focusing on tax, urban and financial market regulatory policy programs. Dr Mintz was appointed the Palmer Chair and founding Director of the School of Public Policy from 1 January 2008 to 30 June 2015. He was recently awarded the Order of Canada for his fiscal advice given to governments internationally and at home. This includes leading a study of corporate tax reform in Canada as Chair of the Federal Government's Technical Committee on Business Taxation in 1996 and 1997.

The Minerals Council of Australia is the peak national body representing Australia's exploration, mining and minerals processing industry, nationally and internationally, in its contribution to sustainable economic and social development.

This publication is part of the overall program of the MCA, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board.

Minerals Council of Australia
Level 3, 44 Sydney Ave, Forrest ACT 2603
(PO Box 4497, Kingston ACT Australia 2604)
P. + 61 2 6233 0600 | F. + 61 2 6233 0699
www.minerals.org.au | info@minerals.org.au

Copyright © 2019 Minerals Council of Australia.
All rights reserved. Apart from any use permitted under the *Copyright Act 1968* and subsequent amendments, no part of this publication may be reproduced, stored in a retrieval system or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of the publisher and copyright holders.

Contents

Executive summary	5
Introduction	6
1 Business investment conditions	8
2 Australia's weakening tax competitiveness for investment	14
3 How does Australia rank in tax competitiveness?	16
4 Options for reform	20
5 Conclusions	24
Data appendix	25
Endnotes	28

Charts and tables

Chart 1	Private non-residential investment share of GDP	8
Chart 2	Gross fixed capital formation share of GDP for selected economies	9
Chart 3	Company tax revenues share of GDP for selected economies	10
Chart 4	Company income tax rates by country and major grouping	13
Chart 5	Australia and major country grouping METR	13
Chart 6	METR by country	17
Chart 7	METR by sector across countries	19
Chart 8	Comparison of METRs on manufacturing and service sectors for two company tax reform options	17
Chart 9	METR by assets for manufacturing under company tax reform options	23
Chart 10	METR by assets for services under company tax reform options	23

Executive summary

Capital investment is a critical ingredient to economic growth. Investment is sensitive to taxation as one of the key factors influencing investment decisions.

A tax system that minimises costs on capital investment helps spur broad economic growth to boost jobs and incomes for workers and tax revenues for governments to invest in health, education and social safety nets.

Australia is suffering from weak investment performance. Capital investment has been declining relative to GDP since 2015 post the strong inflows that occurred during the mining investment boom. Australia's advantages of infrastructure, education and political stability that impact investment are shared with other developed countries. Considering the role of taxation in investment is critical given many studies show changes in the cost of capital due to taxation have a strong influence on investment.

United States' corporate tax reform has changed the global tax landscape and other countries are responding. US tax reform has increased the competitiveness of the US system creating incentives to invest and locate profits there. It has also resulted in other countries lowering tax rates. Since 2018, 11 other countries including France, Belgium and Sweden have announced reductions to corporate tax rates below Australia's 30 per cent rate.

Australia slips back further in 2019

Australia's tax competitiveness for investment continues to decline. In 2019, Australia slips from having the equal fifth highest headline company income tax rate in the OECD in 2018 to having the second highest behind Portugal. Among the 43 countries examined, Australia has the equal fifth highest rate with Mexico and Colombia coming in behind only Zambia, India, Brazil and Portugal.

Australia's 30 per cent headline company tax rate is higher than the weighted average of the G7, G20 and OECD countries.

The change in the marginal effective tax rate on capital (METR) on new investments over the last decade is stark. Australia's relatively high METR of 28.4 per cent has barely moved for a decade. Australia has gone from being around the middle of the pack in 2010 to having the third highest tax burden on capital investment in the OECD in 2019. Most resource based economies, including Canada, Norway and Russia, tax capital less heavily than Australia.

Australia's options for reform

Australia has not embarked on significant company tax reform since the early 2000s. It cannot afford to remain idle for much longer. The goal for Australia should be to reduce company tax to an internationally competitive rate across the board and maintain Australia's already largely neutral system as far as possible so as not to favour any particular business activities.

Proposals by the Australian Labor Party to introduce a form of accelerated depreciation would reduce the overall tax burden to around 25.9 per cent but also create distortions in the company tax by favouring machinery-intensive businesses. As an alternative, a reduction in the company tax rate to 25 per cent, which was proposed but rejected by Parliament, would reduce the effective tax to 24.3 per cent without distorting further the company tax.

These reform options are positive, but a holistic approach looking at reforms to company tax rates and provisions that impact tax neutrality and ensuring these are consistent with international trends is the best way forward for Australia.

Australia is standing on the platform watching the train go by. It is not sustainable for Australia to be stuck with a tax rate on new investment that is higher than similar developed countries. Australia is in for a rude wakeup call if reform does not occur soon. The longer Australia snoozes, the more costly failure to achieve tax reform will be.

Introduction

Company tax reform in Australia has been a controversial topic for several years, resulting in political gridlock and insufficient support for significant change. Not since the Ralph Report and ensuing changes at the beginning of this century has Australia embarked on fundamental changes to its company income tax.¹ The company income tax rate of 30 per cent has remained unaltered since 2002 except for a recent reduction in the tax rate for small companies.

It is not that experts have not paid attention. The comprehensive 2010 Henry Report recommended a reduction in Australia's company income tax rate to 25 per cent.² This recommendation was, and remains, consistent with the international trend which shows many countries reducing investment taxes to stimulate economic growth. As we documented in our 2016 report, G20 and OECD countries have reduced company income tax rates on average by roughly 3 per cent from 2005-2015.³

The top OECD company tax rate previously belonged to the United States, and had remained unchanged since the Reagan reform of 1986 established a federal rate of 35 per cent. That, however, changed in 2018. The United States adopted a comprehensive company tax reform that reduced the federal company income tax rate by 14 points to 21 per cent, increased incentives for machinery investments on a temporary basis, and brought in new exemptions and base-broadening measures that retain profits in the United States.

The 2018 US tax reform has greatly enhanced incentives for companies to invest and keep

profits in the United States.⁴ With the United States elevating its international competitive standing, other countries must consider whether their own policies remain competitive to attract a growing share of international investments. Governments must also ensure they maintain their share of the international company tax base as multinationals restructure to move profits to the United States for the first time in decades.⁵

In light of US tax reform, governments have been reviewing their company tax policies. As we document below, 11 countries including the G7 countries of France and the United Kingdom are reducing company income tax rates by 2022, as legislated so far. A few countries are also creating incentives for capital investment, such as the United Kingdom bringing back a tax depreciation deduction for structures and Canada adopting temporary accelerated depreciation as a response to US reform.

We suspect further company tax reforms, such as those indicated by China to reduce fees and taxes, will be adopted in the next few years as companies react to various international tax policy changes and the resulting incentives to shift capital around the world. Further, governments will be concerned with investment and growth as the world economy is expected to slow down.⁶

Australia, therefore, is the passenger on the platform watching the train go by. It has so far failed to respond to calls for tax reform, holding on to a company income tax rate for almost two decades, resulting in Australia now having the second highest corporate tax rate amongst OECD countries (Portugal is highest).

Australia has so far failed to respond to calls for tax reform ... now having the second highest corporate tax rate amongst OECD countries.

In aggregate the tax on new business investment in Australia (the Marginal Effective Tax Rate or METR as described further below), considering company income tax, depreciation provisions, stamp duties and transfer taxes is third highest of OECD countries at 28.4 per cent. Indeed, Australia taxes capital more heavily than G7, G20 and OECD countries on average. On an industry basis investment in manufacturing and services face a METR of 28.6 and 28.4 per cent respectively, higher than the average for the G7, G20 and OECD country groups at present.

In the following report we will present an evaluation of tax competitiveness for manufacturing and services investments in Australia. We also present estimates for alternatives to the current tax policies in Australia, simulating the impact of company tax reform, including company tax reductions and/or the adoption of accelerated depreciation. These simulations are timely and relevant as we see similar responses to US tax reform in other OECD countries, including the United Kingdom, France, Sweden and Canada.

With regard to company tax reform in Australia we argue that a more comprehensive approach is appropriate to ensure the Australian economy remains competitive, while reducing – rather than increasing – distortions imposed by the company tax system. Arguments are raised that tax reforms, including rate reductions or accelerated depreciation, would have little effect in Australia due to the imputation system that credits corporate taxes against the dividend taxes paid by Australian shareowners. However, this ignores not just foreign capital inflows that are not affected by imputation but also

the critical role of retained-earnings-financed investment that is instead affected by capital gains taxation.

We suggest the company income tax rate reduction is the best option for Australia, keeping in mind that the primary objectives for levying a company tax are to raise revenues while introducing the fewest distortions possible and to act as a withholding tax on income to ensure that foreign and domestic investors pay Australian tax on their income in the interest of fairness.

This report is divided into three sections. The first looks at how Australia is doing in terms of investment, company tax revenues and productivity. It also considers some details of recent tax reforms around the world and the impact of foreign tax reforms – especially US reform – on Australia's competitiveness. The second section provides our ranking of Australia's company tax competitiveness with respect to the 42 countries included in this survey. The final section examines options for tax reforms that Australia could consider.

1

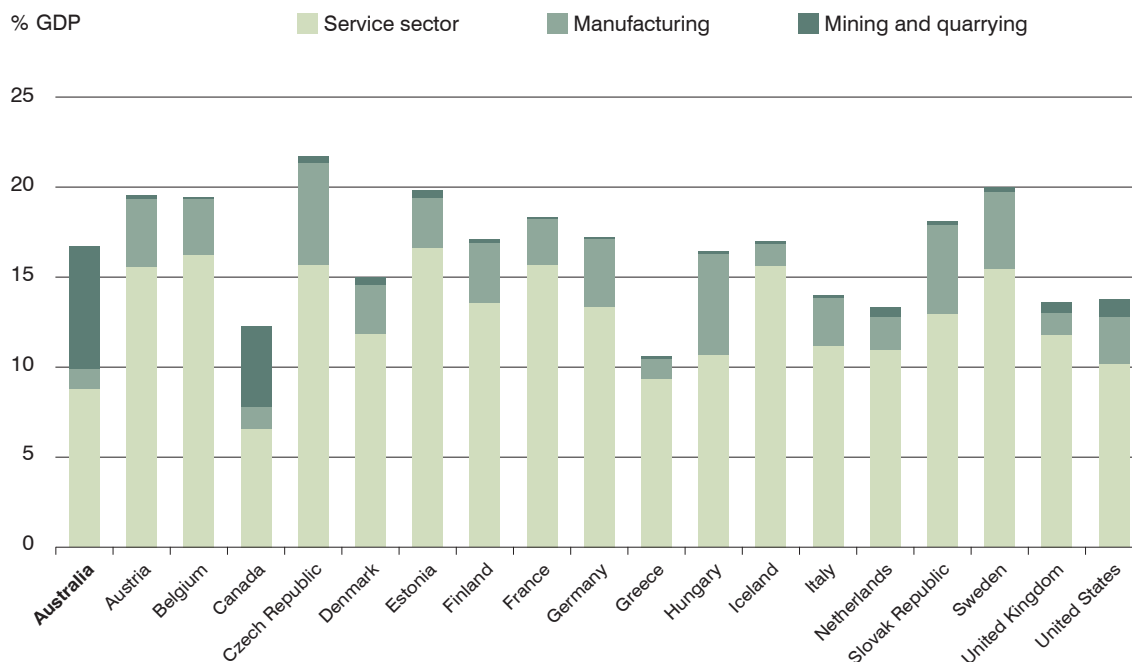
Business investment conditions

Economic growth drives the wealth and prosperity of any nation. With broad economic growth dispersed through the population, households enjoy a higher standard of living as incomes improve. Governments receive more tax revenues that can be used to invest in health, education and infrastructure as well as a stronger social safety net. Obviously, many factors influence growth – technological progress, education and training, and political stability – but capital investment is certainly one key element. With more capital, companies adopt the latest technologies improving their competitiveness. Capital investment also improves labour productivity and enables companies to export and hire more workers.

Australia enjoys many of these advantages, as do other advanced countries, but its weak investment performance particularly in manufacturing and services is concerning.

As we showed in last year's report, Australia has had to rely on strong capital investment inflows due to the prevalence of the resource sector especially mining.⁷ With the resource boom, Australia's private fixed capital formation reached over 22 per cent of GDP of which mining, oil, gas, and quarrying, accounted for an estimated 37 per cent. However, as shown in chart 1 for the latest years available, manufacturing and service sector investments have been relatively weak compared to OECD

Chart 1 **Private non-residential investment share of GDP**
Averaged 2010-2015



Source: OECD Statistics

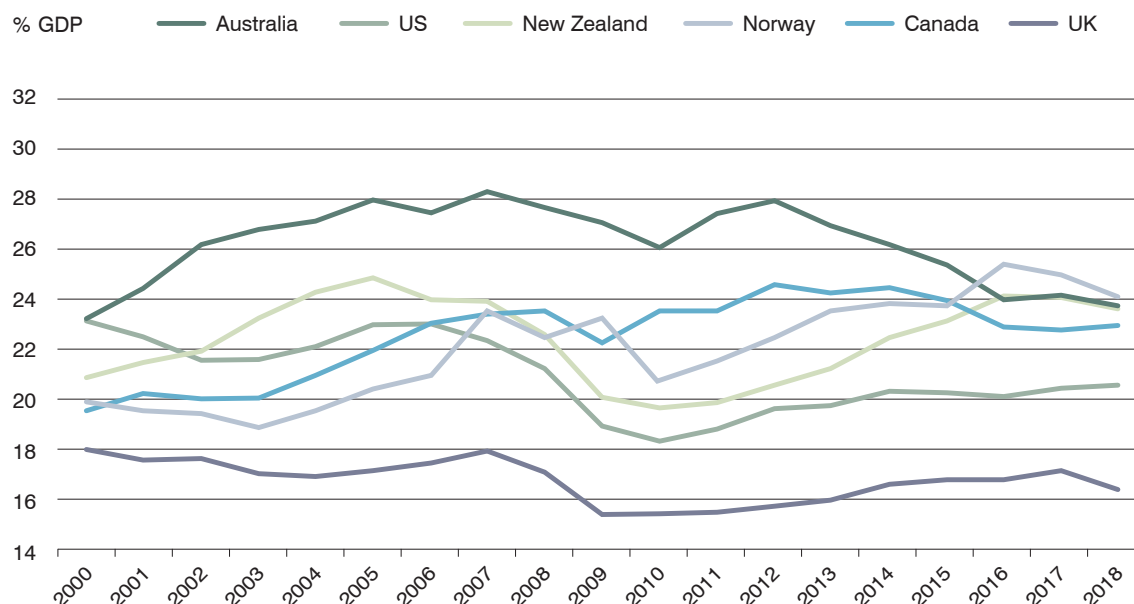
Notes: Services includes industries include construction, utilities, transport, communications, trade, finance, business and household services but excludes education, health and public administration.

countries totalling 10 per cent of GDP. Foreign direct inflows as a share of GDP reached as high as 5 per cent in 2011 to fall back to 3 per cent by 2014.

Since 2015, Australian investment has been declining relative to GDP. Chart 2 presents the most up-to-date data on private and public gross fixed capital formation (GFCF) in non-residential and residential sectors for Australia compared to other resource-based economies for the period 2000-2018 (2018 is forecasted by the OECD). Australia has undoubtedly performed well in investment after 2000 with GFCF reaching 28 per cent of GDP as late as 2012, higher than Canada, New Zealand,

Norway, the United Kingdom and the United States. Mining industries are capital intensive so it is no surprise that Australia would require significant investment in these sectors to drive growth. However after 2014, investment has declined with GFCF falling to 24 per cent of GDP, 4 points less than in 2012. In contrast, GFCF as a share of GDP grew in New Zealand and Norway from 2012 to tie with Australia. We note that all three resource-based economies have had more capital formation as a share of GDP than the United States, although US GFCF as a share of GDP has grown since 2012, including estimates for 2018, after US tax reform.

Chart 2 Gross fixed capital formation share of GDP for selected economies 2000-2018



Source: OECD Statistics, National Accounts.

Notes: Gross fixed capital formation includes both private and public capital expenditures net of disposals in non-residential and residential sectors. It is therefore a broader definition of investment than in chart 1. Forecasts by the OECD are used for 2018.

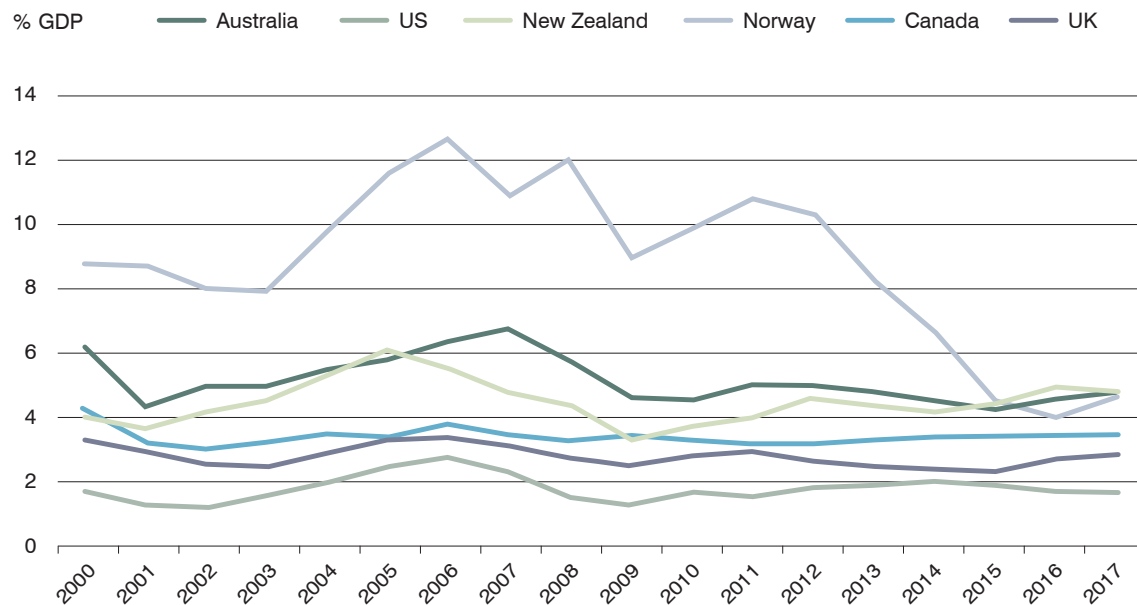
A proper analysis therefore looks at competing factors affecting investment to explain differences in performance across countries and industries. In addition to demand for business products, interest rates, inflation and government policies like regulation, economic studies have shown that private investment is also sensitive to taxation. Many studies have found that a 10 per cent increase in cost of capital due to taxation causes a decline in the range of 5 to 10 per cent although some studies have suggested impacts higher than 10 per cent.⁸ Other studies focused on foreign direct investment show a higher impact – foreign direct investment flows would rise as much as 2.5 per cent with a one point reduction in the company income tax rate.⁹

These growth gains for investment have motivated governments to reduce company income taxes. Governments have also been

concerned that they generate company tax revenues to fund public services. Such revenues are important to fund public services in most countries as illustrated in chart 3. Australia raises over 4 per cent of GDP as company tax revenues almost as much as Norway in 2017.

What is striking is how little relationship there is between company tax rates and corporate tax revenues. Unlike Australia and the United States, every other country in chart 3 reduced company tax rates from 2000 to 2017. Company tax rates in Canada dropped sharply from 43 per cent in 2000 to less than 27 per cent in 2017, yet company taxes as a share of GDP changed little. The United Kingdom dropped company tax rates from 30 per cent in 2007 to 20 per cent in 2017 yet company taxes have generally remained steady as a share of GDP. New Zealand with a tax rate of 28 per cent and

Chart 3 Company tax revenues share of GDP for selected economies 2000-2017



Source: OECD Taxation Statistics

Norway at 25 per cent have lower company tax rates than Australia, yet collected as much company tax revenue in 2017. The United States had the highest company tax rates in this period (close to 40 per cent), yet collected the least company tax revenue as a share of GDP.

Many factors explain these differences. First, booms and recessions result in cyclical collection of company taxes with more revenues as a share of GDP in strong economic times. Some countries have also benefited from resource booms (Australia, Canada and Norway) resulting in high levels of company taxes especially prior to 2008 when the global recession halted the commodity boom at that time. Second, many governments reduced company tax rates to remain competitive for investment but also reduced accelerated depreciation and other preferences to reduce distortions in the company tax system and shore up revenues. Finally, the reduction in company tax rates attracted more investment and taxable profits, thereby expanding the company tax base.

By encouraging investment, more company tax revenues can be generated in later years although an immediate revenue cost is incurred with either rate reductions or company tax incentives. These issues can be balanced by other policies so that governments can maintain the strength of their tax systems while encouraging investment. This is well illustrated by US tax reform in 2018.

The US reform includes several important changes:

- The federal rate was reduced from 35 to 21 per cent (the GDP-weighted federal-state rate was reduced from 39.1 to 26.6 per cent)
- Bonus depreciation that was to be phased-out by 2020 was increased to expensing for the next five years (to be phased out over the next five years)
- A preferential tax rate of 13.125 per cent (later to be raised to 16.406 per cent after 1 January 2026) would apply to intangible income from intellectual property, marketing, service and certain other activities
- Various base-tightening rules reduced the incentive to take deductions in the United States with respect to interest and losses
- A Base-Erosion and Anti-Avoidance minimum tax on profits in excess of certain disregarded payments paid to foreign-controlling parents by US affiliates at a rate of 10 per cent (raised to 12.5 per cent beginning 2026)
- A dividend exemption for profits remits to the US parent so money can be brought home free of tax
- A 10.5 per cent tax was introduced on global intangible income earned by US multinationals with a credit for 80 per cent of foreign taxes paid on such income (the tax rate shall be raised to 13.125 per cent beginning 2026).

The core of US reform was intended to create incentives to invest and locate profits in the United States, radically altering the status quo, which has existed in the United States since the 1986 Reagan reform. This greatly increased the US international competitive standing with implications for the investment prospects of other nations. Given the size of the US economy (roughly a fifth of world GDP), it is no surprise that countries most heavily exposed to the United States would consider tax reforms themselves. Most of the response has been to lower company tax rates, tighten rules to protect the tax base and reduce company tax distortions.

Table 1 lists of 12 countries that are reducing company income tax rates following 2018, including legislated changes beyond 2019. We also include four countries that have raised company tax rates. In addition to the United States, its fellow G7 nation of France has also committed to a dramatic reduction in company income tax rate by 9 points, to 25 per cent by 2022. Belgium is also reducing its company tax rate by 8 points by 2020. Norway has reduced its company tax rate, originally 25 per cent in 2016 to 22 per cent in 2018. On the other hand, a few countries are increasing company tax rates such as South Korea and Chile. Of note, India has not yet

moved in the direction of company tax reform after its significant reform of the value-added tax two years ago. Canada responded to US reforms by adopting accelerated depreciation on a temporary basis.

With these company tax changes, Australia has moved from having the fifth highest company income tax rate among OECD countries (tied with Mexico) to the second highest (chart 4). Among the 43 countries in this study, Australia has the fifth highest company income tax rate behind Zambia and India at 35 per cent, Brazil at 34 per cent and Portugal at 31.5 per cent.

In 2019, Australia's company income tax rate is not very competitive. It is 3.2 percentage points more than the GDP-weighted average of G7 countries and 3 percentage points more than G20 countries. It is now 3.9 percentage points more than the GDP-weighted average company tax rate of OECD countries. Even the grouping of Brazil, Russia, India and China (BRIC) which tends to tax company income most, now has a GDP-weighted company income tax rate that is 2 points less than Australia.

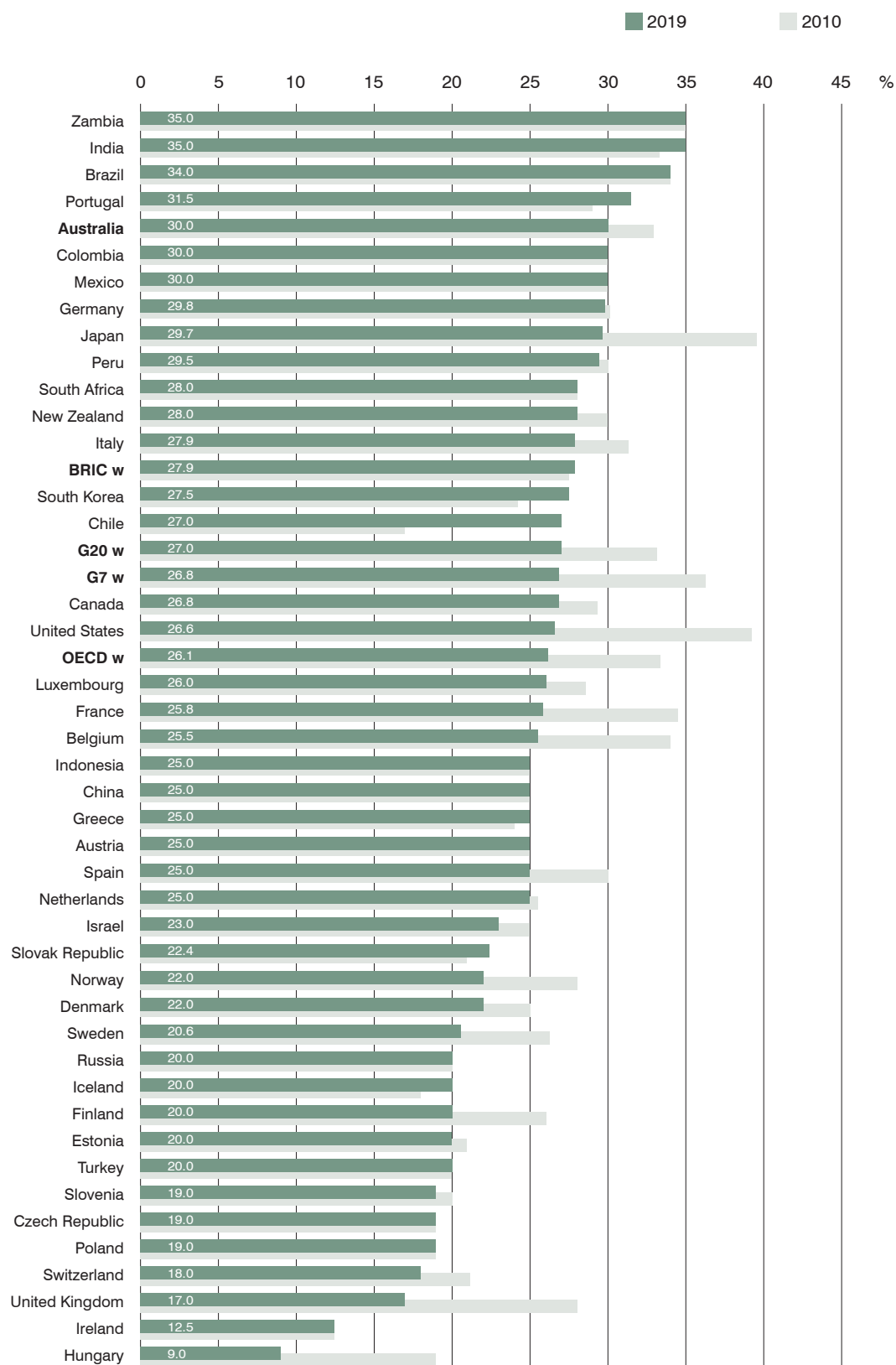
Table 1 Company income tax rate changes by country since 2017 (%)

	2017	2018	2019	Legislated future rates
Argentina	35.0	30.0	30.0	25.0
Belgium	33.9	29.58	29.58	25.0 (in 2020)
Colombia	40.0	37.0	33.0	30.0 (in 2022)
France	34.4	34.4	32.0	25.8 (in 2022)
Greece	29.0	29.0	28.0	25.0 (in 2022)
Israel	24.0	23.0	23.0	
Luxembourg	27.08	26.01	26.01	
Norway	24.0	23.0	22.0	
Netherlands	25.0	25.0	25.0	22.5 (in 2022)
Sweden	22.0	22.0	21.4	20.6 (in 2021)
United Kingdom	19.0	19.0	19.0	17.0 (in 2020)
United States **	39.1	26.6	26.6	
Increases				
Chile*	25.5	27.0	27.0	
India	34.6	35.0	35.0	
Korea	24.2	27.5	27.5	
Turkey	20.0	22.0	22.0	20.0 (in 2020)

*Semi-integrated corporate tax rate.

**OECD federal-state tax rate for US is 25.8 per cent based on distribution of personal income by state rather than GDP-weighted.

Chart 4 **Company income tax rates by country and major grouping**
2019 and 2010



w = weighted average

Source: School of Public Policy, University of Calgary.

2

Australia's weakening tax competitiveness for investment

Company tax rates are just one component of the tax system that affects investment. The company tax burden on capital will also be affected by deductions for depreciation, inventory treatment and other costs in addition to the rate on income. Other taxes directly affect capital costs such as stamp duties, transfer taxes on capital purchases and financial transactions, sales taxes on capital purchases, and wealth and other asset-based taxes. See the appendix for detailed tax provisions across countries.

Businesses invest in capital so long as the pre-tax profits (net of risk costs) are sufficient to cover investment costs including taxes. If profits are in excess of costs, the business is willing to undertake more investment and the converse is true if profits are less than costs. Taxes create a wedge between the pre-and post-tax returns on capital. The greater the tax wedge, the less profits are available to cover investment costs and taxes and businesses will invest in less capital. In this section, the tax wedge is measured across countries to determine which countries tend to tax capital most heavily and therefore discourage capital investment, all else being equal.

The METR is measured in chart 6 for 43 countries to compare tax burdens on capital. All OECD countries, BRIC and five other countries with significant mining operations competing with those in Australia (Colombia, Indonesia, Peru, South Africa and Zambia) are included. The METR is a summary measure that takes into account the annualised value of company income taxes, stamp duties, sales taxes on capital purchases and other capital-related taxes as share of pre-tax rate of return

on capital for marginal projects. (Marginal projects are those just acceptable to owners for profitability).

We stress that the METR is expressed as taxes as a percentage of the returns paid to both equity and capital owners, not just equity income. Thus, debt issued to fund investment shelters companies from paying taxes. We use a common assumption for all sectors and countries that capital is financed 40 per cent by debt. Thus, intuitively, a corporate tax rate of 30 per cent on equity income is roughly equivalent to 18 per cent on income gross of interest payments.

Investors either hold debt or equity securities issued by global companies. This analysis focuses on large companies that have access to international markets for financing. We assume an Australian company will raise financing at international market interest rates and the international investor is willing to hold Australian assets if the Australian return on assets is equal to the return in other countries, net of risk and personal taxes (the latter depend on where the investor resides). We assume that the G7 'average' investor is the marginal international investor in bonds and equity markets for Australia. Thus, personal income taxes paid by Australian shareholders have little effect on international financing costs for Australian or foreign multinationals operating in Australia that are largely determined internationally.

For example, if the pre-tax rate of return on capital is 15 per cent and company paid taxes as a share of pre-tax profits is 50 per cent, the post-tax annual rate of return on capital is

7.5 per cent (global investors receive this return on investment but further pay national personal taxes on returns depending on where they live). The business will undertake an investment so long as the post-tax rate of return is sufficient to cover returns needed to raise equity and bond capital from international markets to finance investments.

In the analysis below, we look at manufacturing and service industries that invest in four general types of capital to achieve profitability: machinery, structures, inventory and land. All relevant taxes and provisions are considered in determining taxes paid on projects. As mentioned, businesses finance capital expenditures with 40 per cent debt financing and 60 per cent from equity finance (retained earnings and new equity issues). Retained earnings account for 60 per cent of equity financing. Interest rates across countries vary according to differences in inflation rates even though the personal income tax rates of the international marginal investor holding bonds and equity securities do not vary across countries.

3

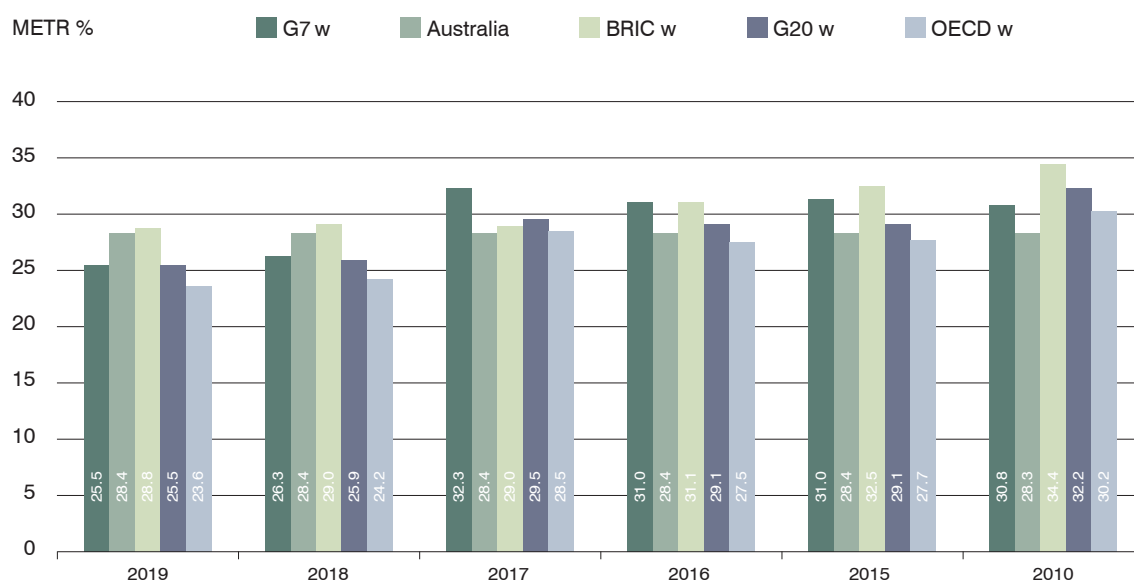
How does Australia rank in tax competitiveness?

With reforms adopted abroad, Australia has moved up the charts – in the wrong direction – since 2018 insofar as competitiveness is concerned. While in 2010, Australia's tax burden on investment was at least in the same range as, or below other large countries, this is no longer the case. As shown in chart 5, it is clear that Australia is losing by virtue of standing still. In 2019, Australia has a relatively high METR at 28.4 per cent, roughly 3 points higher than the average G7 and G20 country, both at 25.5 per cent, and 5 points higher than the average OECD country at 23.6 per cent. Only the four BRIC countries have higher tax burdens on capital at 28.8 per cent although the difference is now small. Only four years ago

in 2015, Australia METR was lower than the G7, G20 and BRIC.

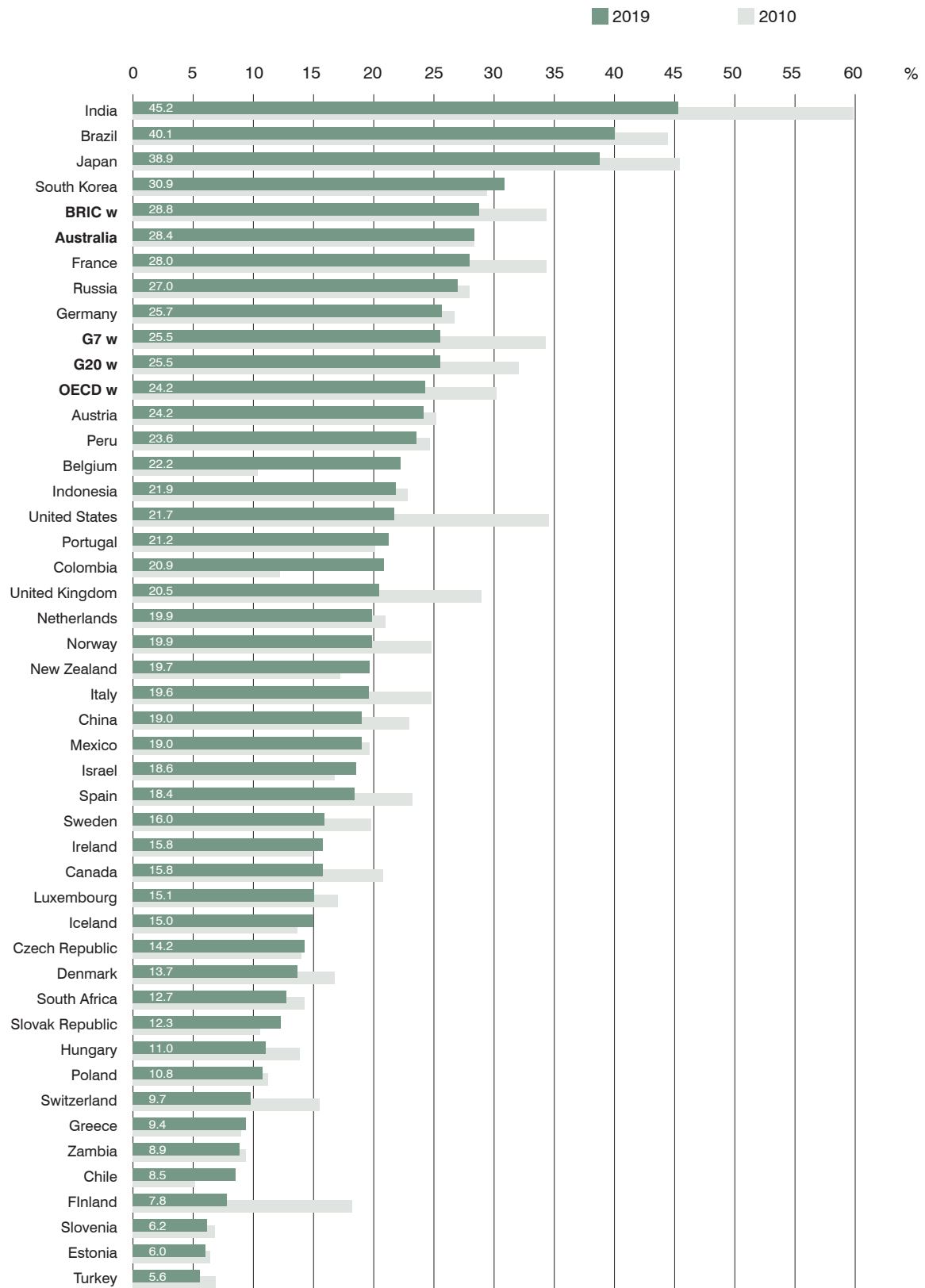
Now in 2019, Australia has the highest tax burden on capital compared to all OECD countries except Japan (which has a significant capital tax on fixed capital) and South Korea which has been raising its company tax rate while continuing various other capital-related transaction taxes. India and Brazil also tax capital more heavily than Australia although India has sharply reduced its METR with VAT reform in recent years. Most resource-based economies, including Canada, New Zealand, Norway and Russia tax capital less heavily than Australia.

Chart 5 Australia and major country grouping METR
2010, 2015-2019



Source: Own calculations

Chart 6 **METR by country**
2019 and 2010



w = weighted average

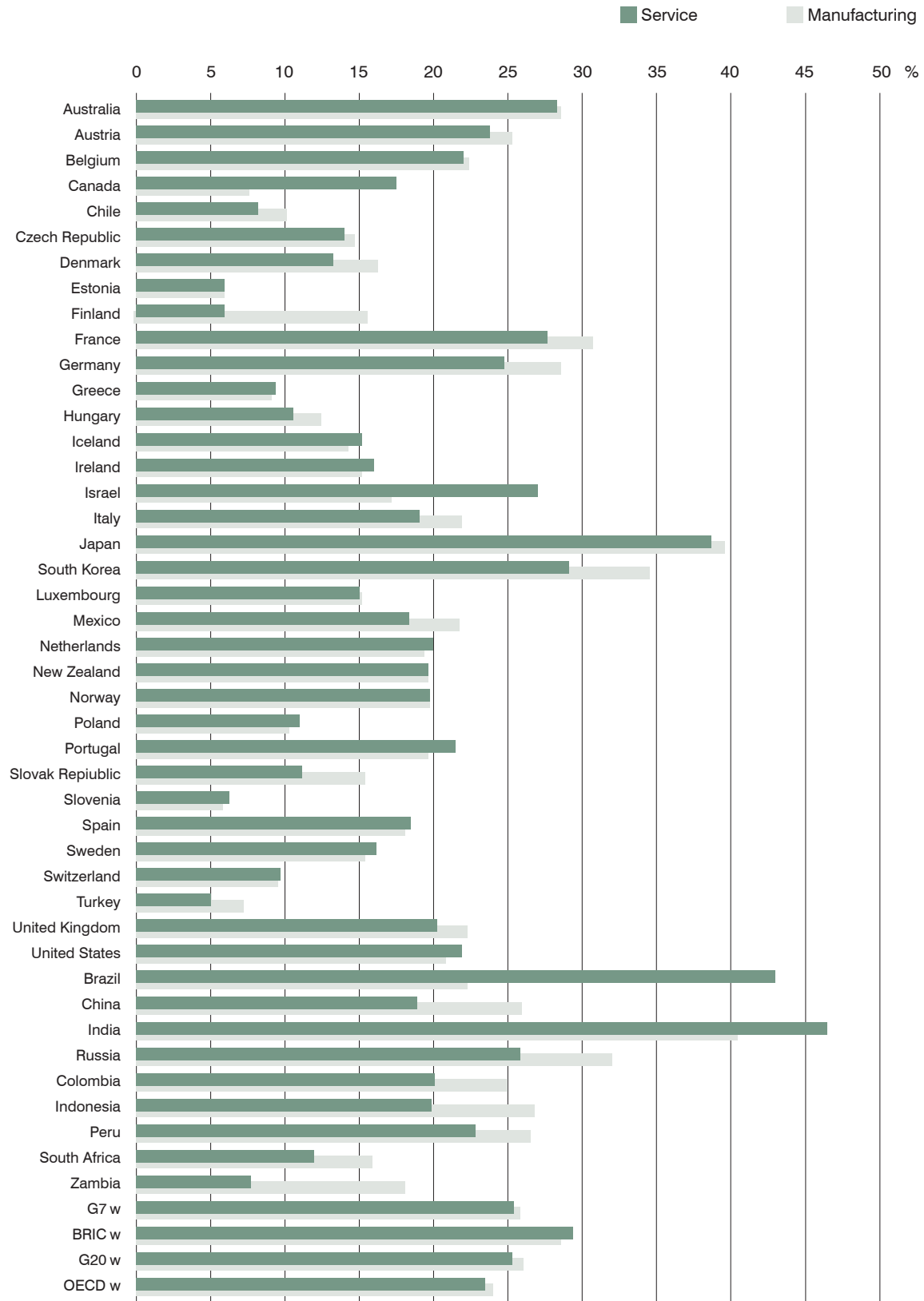
Note: Based on 2019 provisions or those legislated to be adopted

Source: Own calculations

One positive attribute of Australia's company tax system is its even-handedness across different industries and assets. As shown in chart 7, the difference in METRs for manufacturing and services is very little in Australia compared to some countries that have created significant advantages for one industry over the other. Canada, for example, favours manufacturing by 10.1 percentage points and Finland favours services by 9.7 percentage points. Tax neutrality amongst sectors is of course desirable to ensure capital flows to where it is most productive and thus most valued. Tax neutrality amongst sectors is also a source of competitiveness since businesses then invest in capital for economic profitability rather than misallocating capital to minimise taxes.

In 2019, Australia has a relatively high METR at 28.4 per cent, roughly 3 points higher than the average G7 and G20 country groups, both at 25.5 per cent, and 5 points higher than the average OECD country at 23.6 per cent.

Chart 7 **METR by sector across countries**
2019



Source: Own calculations

4

Options for reform

With tax reforms appearing in many countries, including a significant showing among G7 nations, Australia is becoming increasingly uncompetitive by being idle. Its tax burden on manufacturing and service industries is third highest and its company income tax rate is second highest amongst developed economies in 2019. Ultimately Australian policy makers must acknowledge that over the last decade their nation has become less tax attractive relative to G7 and OECD nations and that given the tax reforms enacted in other major countries, namely the United States, France and the United Kingdom, their ability to attract company investment and profits is being eroded.

In discussing company tax reform it is important to go back to first principles: why a company tax is needed as part of a modernised tax system. Two primary objectives are typically given. First, company tax shores up personal tax. Without a company tax, individuals can avoid personal tax by leaving income in the company, a consideration especially important for private companies. Second, Australia's company income tax withholds income from non-resident investors who benefit from Australia's support of business activities through infrastructure and other public services. Both these principles, however, do not suggest that Australia's company tax system should be uncompetitive internationally nor non-neutral amongst business activities. The goal, therefore, is for the company tax to be levied at internationally competitive tax rates and as neutral as possible across business activities.

On the plus side, Australia has been successful in developing a company tax system that is relatively neutral amongst business activities. Differences in effective tax burdens across industries are relatively small. As a result, Australia's company tax system imposes smaller inter-asset and inter-industry distortions than might be found in other countries. In a recent paper, removing the tax preference for machinery investments in the United States primarily due to bonus depreciation is

estimated to boost national income to some degree but more interestingly reduce inequality by lowering the premium paid to skilled over unskilled labour with the unskilled wage rising.¹⁰

Two arguments are often made against company tax reform in Australia, both of which should be called into question.

1. Myth: Company tax reductions do not increase investment

It is claimed that statutory tax rate reductions in the company do not affect investment. Yet, many factors influence investment including other tax provisions besides the company tax and non-tax factors such as export demand for products, interest costs, trade linkages etc. A full study would sort out different factors influencing investment demand of which tax is one factor, as discussed above. Not only does the myth contradict economic studies but the argument is based on two additional assertions which are themselves incorrect:

- Some argue company tax reductions do not increase investment by protected or oligopolistic industries.¹¹ While non-competitive markets might lead to a restriction in production, company tax reductions that reduce the cost of production will cause output to increase and in some cases more so than for competitive firms.¹² For example, a reduction in costs may improve competitiveness of firms allowing them to gain market share relative to dominant firms in a market.
- It is claimed that a reduction in company taxes would have no effect since it is fully offset by the dividend tax credit (dividend imputation), thus having no effect on investment and thereby undoing its impact on investment for domestic investors. At first blush this argument would suggest that the company tax payment could be doubled without any effect on investment but this is wrong on two accounts. First, retentions are a major source of equity finance for business investment. When a firm reinvests profits, the value of

shares will rise, resulting in capital gains for shareowners. The personal tax on dividends does not matter but capital gains tax paid by investors on Australian securities are certainly relevant to the investment decision financed by retentions. Second, the Australian dividend tax credit is not provided for foreign investors who provide marginal equity finance to Australian multinationals when domestic sources are exhausted.

2. Myth: Company tax reductions benefit primarily the rich

While the legal incidence of the corporate tax surely falls on the corporation, its economic incidence is another matter. People ultimately pay corporate taxes through higher consumer prices, lower wages or lower dividends, capital gains and other capital income accruing to owners.

In a small open economy like Australia, company taxes cannot be easily shifted back to domestic or non-resident owners of capital. If companies lower rates of return on capital, investors will shift their capital to other opportunities in international markets where returns are higher. The tax tends to be recovered by raising prices on consumers or by reducing payments to immobile factors of production: wage payments to labour (including layoffs) or rents paid to landowners.

The public may think that taxing corporations improves fairness by making the rich pay more, but empirical analysis confirms that this is not the case. A recent Canadian study found that an additional dollar of corporate tax payments results in a loss of wages to the order of \$1 to \$3.85 depending on the province given the lack of mobility of labour internationally and productivity effects on labour incomes.¹³ These results are consistent with much of the literature that suggests that the company tax, especially on large multinationals, is regressive by falling on labour incomes most.

Accelerated depreciation vs company tax rate reductions

Company tax reform requires urgent consideration by Australian policy makers. While concerns have been raised about the loss of revenues and increased public deficits, there are other policies, including company tax base broadening, to mitigate these effects that are typically pursued in other countries that have reduced company tax burdens in the past decade and a half.

Two possible approaches to reform could be considered. The first is to follow US accelerated depreciation for machinery investments, an approach adopted in Canada in the fall of 2018. The second is to reduce the company income tax which has happened in 11 countries since 2017, as discussed above.

The Australian Labor Party has considered and proposed a 20 per cent accelerated depreciation for investments in qualifying machinery and knowledge-based assets. The advantage of accelerated depreciation is that companies cannot benefit from the incentive unless they invest. Further, it rewards only new capital as returns from existing capital investments remain taxed at the same rate. Accelerated depreciation can also encourage the adoption of new capital with the latest technologies and increased productive capacity.

On the other hand, accelerated depreciation has limitations. First, accelerated depreciation favours industries with short-lived assets – the more often the asset is replaced the greater are accelerated depreciation claims over time. Second, large write-offs for depreciation push companies into non-taxpaying positions, blunting the effect of the incentive. Third, accelerated depreciation does little to counter tax reforms in other countries that have been reducing tax rates on company income to attract more profits by tightening deductions for interest expense and losses and concessionary tax rates on intangible income such as intellectual property and marketing.

While accelerated depreciation does reduce effective tax rates, we argue that these targeted depreciation incentives are inferior to a straight and simple policy of reducing the company income tax rates. Rate reductions are more neutral and best serve to attract investment and profits to Australia. A rate cut does not increase the incidence of non-taxpaying companies and will not favour skilled over unskilled labour. Governments have been concerned about company tax cuts that favour old capital so, for this reason, typically stage reductions in rates over time. Overall, the reduction in the company income tax rate is stronger in attracting capital and profits to Australia than accelerated depreciation.

The charts below (8, 9 and 10) illustrate the impact of two alternative policies: (1) a 20 per cent initial allowance for machinery and certain 'knowledge-based' intangible assets, which

would reduce the overall rate by 2.5 percentage points, and (2) a company tax rate cut of 5 points that would reduce the overall tax burden on manufacturing and service sectors by a deeper amount equal to 4.1 percentage points. However, accelerated depreciation would favour manufacturing which is more intensive in machinery and intangible investments (chart 9). On the other hand, the company income tax is less distortionary, reducing differentials in effective tax rates rather than increasing them (see both charts 9 and 10).¹⁴

Overall, Australia should not just look at one policy as a basis for company tax reforms. Other countries have taken on a more comprehensive approach, reducing company tax rates, re-evaluating provisions to improve neutrality in their tax systems and ensuring they are consistent with international trends.

Chart 8 Comparison of METRs on manufacturing and service sectors for two company tax reform options

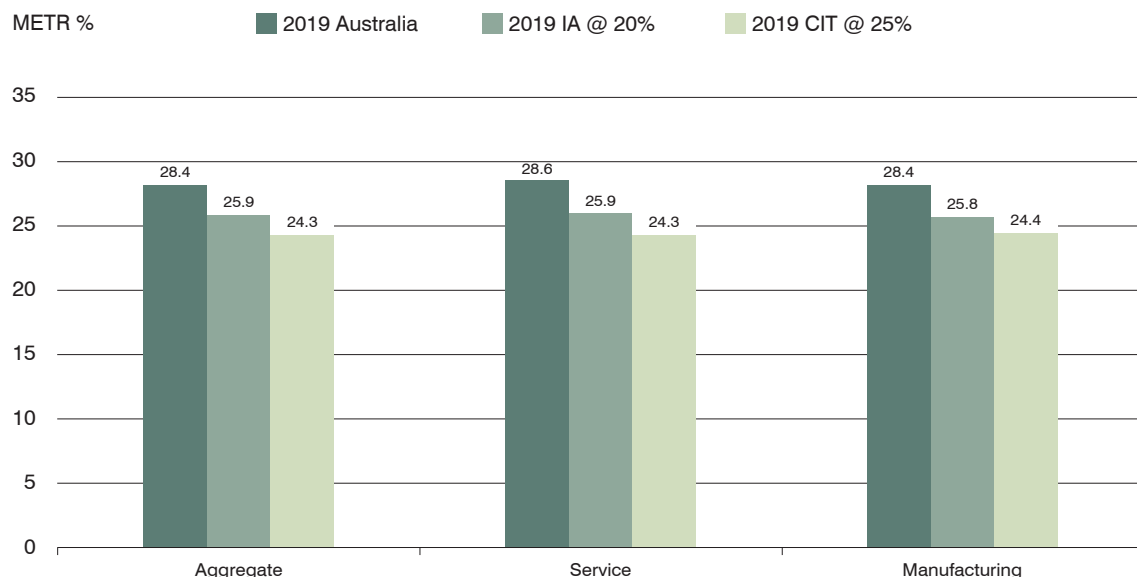


Chart 9 METR by assets for manufacturing under company tax reform options

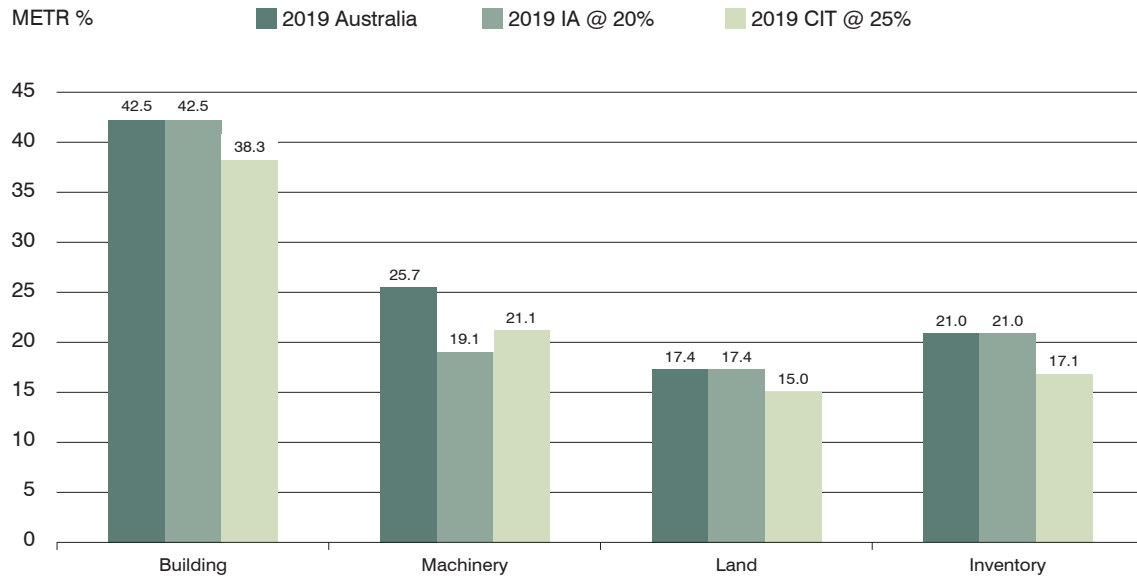
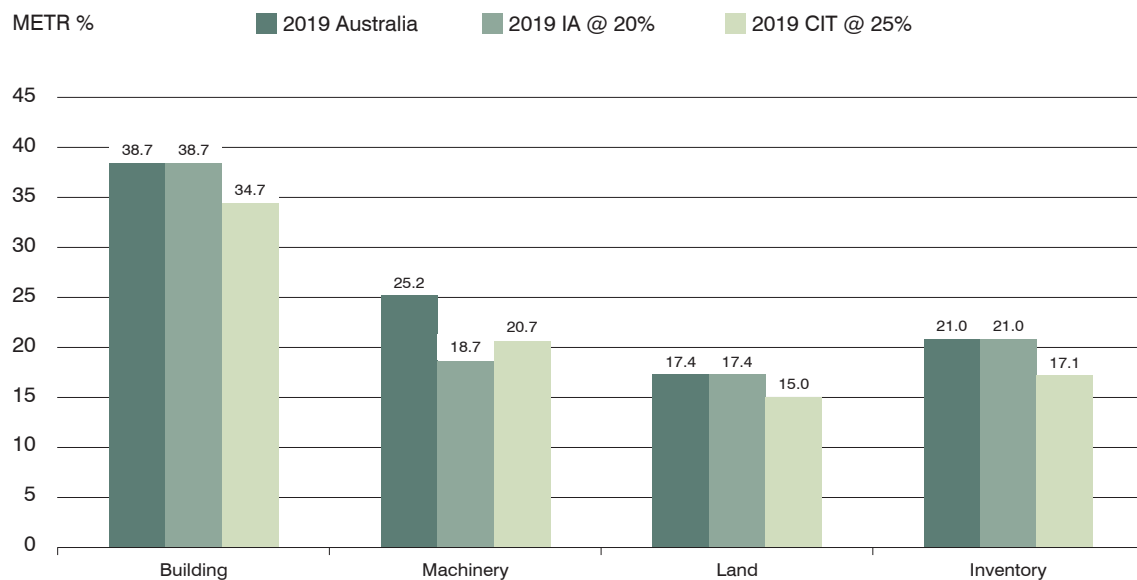


Chart 10 METR by assets for services under company tax reform options



5

Conclusions

Australia is standing on the platform watching the train go by. Policy makers have failed to take calls for tax reform seriously and now find themselves holding on to a company income tax rate that is second highest amongst OECD countries. Its tax on new business investment, considering company income tax and provisions and stamp duties, is third highest among OECD countries at 28.4 per cent.

New investments in manufacturing and services are taxed at 28.6 and 28.4 per cent respectively, higher than the weighted average of G7 and OECD countries. Indeed, Australia taxes capital more heavily when compared to G7, G20 and OECD countries in manufacturing and services.

This report considers alternative policies to company tax reform including accelerated depreciation. Both policies would reduce tax burdens on capital, but accelerated depreciation increases distortions in the company tax system unlike company rate reductions and is therefore the inferior option.

A more comprehensive approach is appropriate to company tax reform to ensure competitiveness and reduce distortions in the company tax system. Taking a broad view, we suggest the company income tax rate reduction is the best option for Australia keeping in mind the primary objectives for levying a company tax is to raise revenues with the fewest distortions as possible and to act as a withholding tax on income to ensure that foreign and domestic investors pay full tax on their income in the interest of fairness.

Policy makers have failed to take calls for tax reform seriously and now find themselves holding on to a company income tax rate that is second highest amongst OECD countries.

Data appendix

Large corporate firm model

	Overall Manufacturing Service Difference				Overall Manufacturing Service Difference				Combined CIT rate		Inflation	Tax depreciation range	Inventory accounting
	2019				2010				2019	2010	2010	2019	
Australia	28.4	28.6	28.4	0.2	28.3	29.4	28.2	1.2	30.0	30.0	1.9	2.6 - 23.9	Optional
Austria	24.2	25.4	23.8	1.6	25.2	24.8	25.3	0.5	25.0	25.0	1.5	3.1 - 10.6	Optional
Belgium	22.2	22.3	22.1	0.2	10.5	10.0	10.6	0.6	25.5	34.0	1.2	7.0 - 32.9	LIFO
Canada	15.8	7.5	17.6	10.0	20.8	15.0	24.1	9.1	26.8	29.4	2.0	4.0 - 55.0	FIFO
Chile	8.5	10.1	8.3	1.8	5.2	5.7	5.1	0.6	27.0	17.0	3.3	7.5 - 39.7	LIFO
Czech Rep.	14.2	14.6	14.1	0.5	14.0	13.9	14.0	0.1	19.0	19.0	1.0	3.1 - 20.8	Optional
Denmark	13.7	16.2	13.3	2.9	16.8	17.9	16.6	1.3	22.0	25.0	0.6	5.1 - 22.7	FIFO
Estonia	6.0	6.0	6.0	0.0	6.4	6.4	6.4	0.0	20.0	21.0	0.0	9.9 - 21.6	LIFO
Finland	7.8	15.7	6.0	9.7	18.2	19.2	18.0	1.2	20.0	26.0	0.7	8.2 - 28.7	FIFO
France	28.0	30.7	27.7	3.0	34.3	35.4	34.2	1.2	25.8	34.4	0.5	3.1 - 26.5	Optional
Germany	25.7	28.5	24.8	3.7	26.7	28.4	26.2	2.2	29.8	30.2	1.0	3.1 - 14.4	LIFO
Greece	9.4	9.0	9.4	0.4	9.0	7.9	9.1	1.2	25.0	24.0	-0.7	5.3 - 39.2	LIFO
Hungary	11.0	12.5	10.6	1.9	13.9	14.5	13.8	0.7	9.0	19.0	0.8	3.3 - 48.1	Optional
Iceland	15.0	14.1	15.2	1.1	13.6	11.6	14.1	2.5	20.0	18.0	2.2	3.3 - 30.5	FIFO
Ireland	15.8	15.1	16.1	1.0	15.0	13.9	15.3	1.4	12.5	12.5	0.1	2.0 - 12.4	FIFO
Israel	18.6	17.1	18.8	1.7	16.8	15.1	17.1	2.0	23.0	25.0	0.2	4.2 - 29.8	Optional
Italy	19.6	21.9	19.1	2.8	24.8	22.7	25.2	2.5	27.9	31.3	0.5	2.4 - 15.0	LIFO
Japan	38.9	39.5	38.7	0.8	45.4	45.2	45.5	0.3	29.7	39.5	0.9	2.0 - 21.3	Optional
South Korea	30.9	34.5	29.1	5.4	29.5	31.1	28.7	2.4	27.5	24.2	1.2	2.6 - 20.1	LIFO
Luxembourg	15.1	15.1	15.1	0.0	17.0	17.3	17.0	0.3	26.0	28.6	1.0	4.1 - 21.0	Optional
Mexico	19.0	21.7	18.4	3.3	19.7	21.1	19.4	1.7	30.0	30.0	3.9	5.1 - 15.4	LIFO
Netherlands	19.9	19.3	20.7	0.7	21.0	19.6	21.2	1.6	25.0	25.5	1.2	2.9 - 20.9	Optional
New Zealand	19.7	20.0	19.6	0.3	17.3	14.9	17.6	2.7	28.0	30.0	1.0	6.8 - 23.9	Optional
Norway	19.9	20.4	19.8	0.6	24.8	23.7	24.9	1.2	22.0	28.0	2.4	3.6 - 24.5	FIFO
Poland	10.8	10.2	11.0	0.8	11.3	10.2	11.6	1.4	19.0	19.0	0.3	2.6 - 25.8	LIFO
Portugal	21.2	19.6	21.5	1.9	20.0	17.5	20.4	2.9	31.5	29.0	0.5	2.2 - 19.8	Optional
Slovak Rep.	12.3	15.3	11.2	4.1	10.7	13.2	9.8	3.4	22.4	21.0	0.4	5.0 - 17.3	Optional
Slovenia	6.2	5.8	6.3	0.5	6.8	6.4	7.0	0.6	19.0	20.0	0.6	3.5 - 21.6	Optional
Spain	18.4	18.0	18.5	0.5	23.3	21.8	23.6	1.8	25.0	30.0	0.5	2.1 - 29.2	Optional
Sweden	16.0	15.3	16.2	0.9	19.8	18.1	20.1	2.1	20.6	26.3	0.5	3.2 - 19.5	FIFO
Switzerland	9.7	9.5	9.8	0.3	15.5	14.5	15.7	1.2	18.0	21.2	-0.3	5.7 - 31.9	LIFO
Turkey	5.6	7.2	5.1	2.1	6.9	6.2	7.1	0.9	20.0	20.0	8.6	12.5 - 48.8	Optional
UK	20.5	22.2	20.4	1.8	29.0	26.2	29.2	3.0	17.0	28.0	1.5	2.0 - 17.7	FIFO
US	21.7	20.8	22.0	1.2	34.6	32.1	36.0	3.9	26.6	39.2	2.0	4.0 - 55.0	Optional
Brazil	40.1	22.1	43.1	21.0	44.4	22.2	48.2	26.0	34.0	34.0	6.8	4.1 - 11.7	Optional
China	19.0	25.9	19.0	6.9	23.0	26.9	23.0	3.9	25.0	25.0	1.9	7.0 - 14.6	Optional
India	45.2	40.4	46.6	6.2	59.8	50.5	62.7	12.2	35.0	33.2	6.3	5.1 - 35.0	Optional
Russia	27.0	32.0	25.9	6.1	28.0	31.2	27.3	3.9	20.0	20.0	8.3	3.1 - 20.8	Optional
Colombia	20.9	24.9	20.2	4.0	12.2	15.4	11.7	3.7	30.0	33.0	4.4	5.0 - 19.4	LIFO
Indonesia	21.9	26.7	19.9	6.8	22.9	25.8	21.7	4.1	25.0	25.0	5.3	5.1 - 14.0	Optional
Peru	23.6	26.5	22.9	3.6	24.7	31.5	23.0	8.5	29.5	30.0	3.2	4.6 - 20.0	Optional
South Africa	12.7	15.9	12.1	3.8	14.3	15.6	14.0	1.6	28.0	28.0	5.6	5.0 - 25.0	Optional
Zambia	8.9	18.0	7.8	10.2	9.4	15.2	8.7	6.5	35.0	35.0	10.0	5.1 - 47.3	Optional
G7 w	25.5	25.7	25.5	0.2	34.3	32.9	35.0	2.1	26.8	36.2			
BRIC w	28.8	28.6	29.5	0.9	34.4	30.8	35.5	4.7	27.9	27.5			
G20 w	25.5	26.0	25.3	0.7	32.2	30.8	32.9	2.1	27.0	33.2			
OECD w	23.6	23.9	23.5	0.4	30.2	29.1	30.7	1.6	26.1	33.3			

*Simple average

w = weighted average

	Overall Manufacturing Service Difference				Overall Manufacturing Service Difference				Ranking competitiveness overall METR		Asset	Capital input sale	Capital transfer	Financial transfer
	2019				2010				2017	2010	Applicable taxes			
Australia	28.4	28.6	28.4	0.2	28.3	29.4	28.2	1.2	39	36		5.6		
Austria	24.2	25.4	23.8	1.6	25.2	24.8	25.3	0.5	35	33		4.6		
Belgium	22.2	23.3	22.1	0.2	10.5	10.0	10.6	0.6	33	7				
Canada	15.8	7.5	17.6	10.1	20.8	15.0	24.1	9.1	17	25	0.8	1.5		
Chile	8.5	10.1	8.3	1.8	5.2	5.7	5.1	0.6	5	1			▶	
Czech Rep.	14.2	14.6	14.1	0.5	14.0	13.9	14.0	0.1	14	13		4.0		
Denmark	13.7	16.2	13.3	2.9	16.8	17.9	16.6	1.3	13	17		0.6		
Estonia	6.0	6.0	6.0	0.0	6.4	6.4	6.4	0.0	2	2				
Finland	7.8	15.7	6.8	9.7	18.2	19.2	18.0	1.2	4	21		4.0	▶	
France	28.0	30.7	27.7	3.0	34.3	35.4	34.2	1.2	38	39		5.1	▶	
Germany	25.7	28.5	24.8	3.7	26.7	28.4	26.3	2.2	36	34		5.1		
Greece	9.4	9.0	9.4	0.4	9.0	7.9	9.1	1.2	7	5			▶	
Hungary	11.0	12.5	10.6	1.9	13.9	14.5	13.8	0.7	10	12				
Iceland	15.0	14.1	15.2	1.1	13.6	11.6	14.1	2.5	15	11		1.6		
Ireland	15.8	15.1	16.1	1.0	15.0	13.9	15.3	1.4	18	15		6.0	▶	
Israel	18.6	17.1	18.8	1.7	16.8	15.1	17.1	2.0	21	18		10.0		
Italy	19.6	21.9	19.1	2.8	24.8	22.7	25.2	2.5	24	31			▶	
Japan	38.9	39.5	38.7	0.8	45.4	45.2	45.5	0.3	41	42	1.4			
South Korea	30.9	34.5	29.1	5.4	25.5	31.1	28.7	2.4	40	38		3.5	▶	
Luxembourg	15.1	15.1	15.1	0.0	17.0	17.3	17.0	0.3	16	19		7.0		
Mexico	19.0	21.7	18.4	3.3	19.7	21.1	19.4	1.7	22	22		3.5		
Netherlands	19.9	19.3	20.7	0.7	21.0	19.6	21.2	1.6	27	26		6.0		
New Zealand	19.7	20.0	19.7	0.3	17.3	14.9	17.6	2.7	25	20				
Norway	19.9	20.4	19.8	0.6	24.8	23.7	24.9	1.2	26	32		2.5		
Poland	10.8	10.2	11.0	0.8	11.3	10.2	11.6	1.4	9	9			▶	
Portugal	21.2	19.6	21.5	1.9	20.0	17.5	20.4	2.9	30	24		0.8	▶	
Slovak Rep.	12.3	15.3	11.2	4.1	10.7	13.2	9.8	3.4	11	8				
Slovenia	6.2	5.8	6.3	0.5	6.8	6.4	7.0	0.6	3	3				
Spain	18.4	18.0	18.5	0.5	23.3	21.8	23.6	1.8	20	29		1.1		
Sweden	16.0	15.3	16.2	0.9	19.8	18.7	20.1	2.0	19	23		4.4		
Switzerland	9.7	9.5	9.8	0.3	15.5	14.5	15.7	1.2	8	16			▶	
Turkey	5.6	7.2	5.1	2.1	6.9	6.2	7.1	0.9	1	4			▶	
UK	20.5	22.2	20.4	1.8	29.0	26.2	29.2	3.0	28	37		5.0	▶	
US	21.7	20.8	22.0	1.2	34.6	32.1	36.0	3.9	31	40	3.4	0.4		
Brazil	40.0	22.1	43.1	21.0	44.4	22.2	48.2	26.0	42	41	12.5	4.0	▶	
China	19.0	25.9	19.0	6.9	23.0	26.9	23.0	3.9	23	28	1.0	4.0		
India	45.2	40.4	46.6	6.2	59.8	50.5	62.7	12.2	43	43	6.0		▶	
Russia	27.0	32.0	25.9	6.1	28.0	31.2	27.3	3.9	37	35	1.3			
Colombia	20.9	24.9	20.2	4.7	12.2	15.4	11.7	3.7	29	10			▶	
Indonesia	21.9	26.7	19.9	6.8	22.9	25.8	21.7	4.1	32	27		5.3		
Peru	23.6	26.5	22.9	3.6	24.7	31.5	23.0	8.5	34	30		3.0		
South Africa	12.7	15.9	12.1	3.8	14.3	15.6	14.0	1.6	12	14			▶	
Zambia	8.9	18.0	7.8	10.2	9.4	15.2	8.7	6.5	6	6		5.0	▶	
G7 w	25.5	25.7	25.5	0.2	34.3	32.9	35.0	2.1						
BRIC w	28.8	28.6	29.5	0.9	34.4	30.8	35.5	4.7						
G20 w	25.5	26.0	25.3	0.7	32.2	30.8	32.9	2.1						
OECD w	23.6	23.9	23.5	0.4	30.2	29.1	30.7	1.6						

*Simple average

w = weighted average

Endnotes

- ¹ Commonwealth of Australia, *Review of Business Taxation: A Tax System Redesigned* (The Ralph Report), Canberra, July 1999.
- ² Commonwealth of Australia, *Australia's Future Tax System* (Henry Report), Canberra, December 2009.
- ³ J Mintz, P Bazel and D Chen, *Growing the Australian economy with a competitive company tax*, Minerals Council of Australia, March 2016.
- ⁴ J Mintz, 'Global Implications of US Tax Reform', *Tax Notes International*, 90(11), pp. 1183-94.
- ⁵ S Beer, A Klemm and T Matheson, *Tax Spillovers from US Corporate Income Tax Reform*, International Monetary Fund, WP 19/166, Washington, D. C. July 2018.
- ⁶ For example, see recent remarks on the global outlook by Bank of England Governor, Mark Carney: <https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/the-global-outlook-speech-by-mark-carney.f?la=en&hash=6725EA590D46F11FBDF4744E4E90158D4BCECE>
- ⁷ P Bazel and J Mintz, *Australia's investment challenge in wake of 2018 US tax reform*, Minerals Council of Australia, March 2018.
- ⁸ See B Dahlby and K Hassett, 'The Economic Effects of the Corporate Tax: A Review of the Recent Literature', *Reforming the Corporate Tax in a Changing World*, edited by B Dahlby, Canadian Tax Foundation, Toronto, 2018.
- ⁹ LP Feld and J Heckemeyer, 'FDI and Taxation: A Meta-study', *Journal of Economic Surveys*, 25(2), 2011, pp. 233-72.
- ¹⁰ See J Mintz, 'Taxes, Royalties and Cross-Border Investments', *International Taxation and Extractive Industries*, edited by P Daniel, M Keen, AS Wistak and V Thuronyi, Routledge and International Monetary Fund, 2016.
- ¹¹ C Slavik and H Yazici, 'On the Consequences of Eliminating Capital Tax Differentials', *Canadian Journal of Economics*, February 2019, pp. 225-252.
- ¹² M Grudnoff and D Richardson, *Oligopoly Money: How a Company Tax Would be Wasted on Big Business*, The Australian Institute, February, 2016.
- ¹³ See S Anderson, A de Palma and B Kreider, 'Tax Incidence in a Differentiated Oligopoly', *Journal of Public Economics*, 81(2), 2001, 173-92.
- ¹⁴ K McKenzie and E Ferede, 'Who Pays the Corporate Tax?: Insights from the Literature and Evidence for Canadian Provinces', *SPP Research Papers*, 10(6), School of Public Policy, University of Calgary, 2017.



Minerals Council of Australia

Level 3, 44 Sydney Ave, Forrest ACT 2603
(PO Box 4497, Kingston ACT Australia 2604)
P. + 61 2 6233 0600 | F. + 61 2 6233 0699
www.minerals.org.au | info@minerals.org.au