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A Corporate Rate Reduction:
the case for and against

11 December 2015

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Introduction

The fundamental goal of any comprehensive reform of our tax system must be to boost the Australian economy's growth potential. This will not be possible without a significant improvement in our productivity performance. The next generation of productivity gains will come from investment in emerging technologies, production techniques and global opportunities. In a world of increasingly mobile capital, competition for investment will rise over time, not diminish. An uncompetitive corporate tax regime diminishes investment, slowing the growth in our capital stock and future living standards. While corporate tax reform is not an economic panacea, it should feature strongly in any long-term plan for growth and innovation.

Key points

- The economic case for lowering Australia's corporate tax rate is stronger now than when the Henry Review considered the matter in 2010, during the mining boom.[1] Henry concluded:

  Australia should [reduce] the company income tax rate to 25 per cent over the short to medium term, as fiscal and economic circumstances permit. This would ensure that Australia remains an attractive place to invest — not only in the resources sector but also in the non-resource sectors of the economy.[2]

- Our corporate tax is a tax on foreign investment. As the differential between our corporate tax rate and those of our competitors grows, our capacity to attract investment is undermined. Our 30 per cent rate has been in place for 14 years while our peers (small to medium Organisation for Economic Co-operation and Development (OECD) economies) have moved to an average rate of 23 per cent. Lower investment reduces the growth of our capital stock, with negative impacts on productivity and living standards.

- Those advocating a corporate rate cut should not over-egg the argument. It is not the only factor that affects foreign investment. Nor should it be viewed as an economic panacea or substitute for necessary structural reform.

- Nevertheless, as global capital becomes more mobile, the economic costs of our uncompetitive corporate tax rate are increasing. This mobility reflects the increasing economic role of intangible capital (embodied in information technologies, other forms of intellectual property and innovative processes) in value creation. If investment was not particularly sensitive to corporate tax during the recent resources boom, that will not be the case for future non-resource investment.

- Base Erosion and Profit Shifting (BEPS) is a legitimate community concern, but a mature debate should acknowledge that action on BEPS need not preclude moving to a more competitive corporate tax system. Indeed, as OECD economies take steps to counter profit shifting, competition for 'real' economic activity can be expected to intensify.

- Given Australia's heavy reliance on corporate tax as a revenue source, the question of funding any rate cut must be considered. Previous governments have paid for rate reductions by broadening the corporate tax base. The sectoral, investment and wider economic impacts of such a move should be carefully considered. A recent expert examination of base-broadening options questioned their economic merits.[3]

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[1] Australia's terms of trade peaked in September 2011 but have fallen significantly since then.

[2] K Henry *et al*, 2009, *Australia's Future Tax System Final Report*, page 40.

[3] The Business Tax Working Group, established under the Gillard Government, chaired by Chris Jordan as then Chairman of the Board of Tax and including a range of private sector and academic representatives, came to this conclusion in 2012.

- A good case can be made for phasing-in any corporate rate reduction: for example, by a percentage point each year until it reaches 25 per cent. This would send a positive signal to global investors, but minimise short-term budgetary costs.

This paper considers the case for reducing Australia's 30 per cent corporate tax rate.[4] It looks at the economic arguments for taking this step (and counter arguments), the political difficulties it would pose (given community concerns about corporate tax avoidance) and possible budgetary implications.

The economic case: investment, productivity and living standards

The case for reducing Australia's 30 per cent corporate tax rate is well known. Corporate tax is essentially a tax on foreign equity investment.[5] Australia has always been reliant on external capital and continues to be today.[6] The more heavily we tax capital inflows, the lower they will be. While the sensitivity of investment to changes in the corporate tax rate can legitimately be questioned, the existence of the effect cannot. With lower foreign investment, our capital stock will grow more slowly than it otherwise would, reducing productivity growth and future living standards.[7]

A discussion paper published by the Henry Review in 2008 quoted research which found that a one percentage point increase in the rate of corporate tax would result in a decrease in foreign direct investment of 3.72 per cent.[8] Of course, all such modelling has limitations and should accordingly be interpreted carefully.[9] The case for a corporate rate cut must, at least in part, be based on judgements about future trends in the mobility of capital and the actions taken by comparable OECD countries.

An uncompetitive corporate tax rate is also a tax on innovation. As the Henry Review pointed out, 'reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity'.[10]

The economic burden of our high corporate tax rate is not felt by global investors, who can redirect their capital elsewhere, but by the owners of less mobile factors of production in Australia, including our labour force and owners of land. When looked at from this perspective, the corporate tax is ultimately a tax, at least in part, on local employees.

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[4] In this article, we limit our focus to the case for a lower corporate tax rate given that corporations account for most business income earned in Australia. We do not discuss taxation arrangements for small businesses, partnerships or trusts. Nor do we consider wider tax system design questions, including: (i) the role of corporate tax as a backstop to our personal income tax system, the Government's main source of revenue, (ii) how we tax savings income, including interest and rents as well as dividends, and (iii) how we tax interest income from overseas borrowing. The cost of capital for Australian firms seeking international funding will be affected by the corporate tax rate, thin capitalisation rules and withholding taxes imposed on interest payments. As the Henry Review pointed out, a good case can be made for the reduction or elimination of these withholding taxes. K Henry et al, 2010, *Australia's Future Tax System*, page 41.

[5] Under Australia's imputation system, domestic investors receive full credit for corporate tax already paid on their dividends (in the form of franking credits). For this group, corporate tax can be thought of as prepayment of their personal income tax. Franking credits are only available for company tax paid in Australia and are not available for firms and investors who earn income offshore.

[6] Some rightly argue that during the recent resources boom, Australia had no difficulty in attracting foreign capital. Given the returns on offer, our high corporate tax rate was no deterrent. That phase in our history, however, is over. The next generation of foreign investors will be less focussed on our mineral wealth.

[7] For a medium-sized, capital-importing economy like Australia, our cost of capital is essentially fixed. In other words, the post-tax rate of return investors require is determined by global savings and investment plans. Australian policy settings cannot influence this. When we impose corporate tax, the pre-tax rate of return on investment in Australia must be higher than it otherwise would be. Marginal investment projects (which in after-tax terms, pay less than the required rate) are no longer undertaken. Investment will be lower.

[8] K Henry *et al*, 2008, *Architecture of Australia's tax and transfer system*, p 269.

[9] Studies conducted overseas may not be applicable to Australia. Partial rather than general equilibrium analysis will fail to capture complex interactions. Modelling results vary widely depending on the nature of the model and the assumptions employed.

[10] K Henry *et al*, 2009, *Australia's Future Tax System Final Report*, page 40.

Modelling undertaken by Treasury in 2012 supports this point. It found that a one percentage point reduction in the company tax rate could increase the level of GDP by 0.2 per cent, Australia's capital stock by 0.3 per cent and after-tax real wages by 0.2 per cent.[11]

All taxes distort behaviour and impose economic costs, but corporate tax is particularly damaging in this regard.[12] Modelling commissioned by the Henry Review, and confirmed by the current Government's tax discussion paper, shows that corporate tax imposes higher economic costs than virtually all other taxes.[13] This high economic cost is a direct result of the high mobility of international capital.[14] A lower corporate rate would reduce, if not eliminate, other distortions in our corporate tax system, including the bias in favour of debt over equity and differences between tax and economic depreciation.[15]

While personal income tax cuts feature strongly in public discussion and are politically popular, the economic costs of this tax are significantly lower, according to the modelling cited in the Henry Review, than those associated with corporate tax. The intuition is that the former is likely to have less effect on individual behaviour than the latter.

Lower personal income taxes will improve labour force participation from groups facing higher marginal rates, including second income earners and older employees. The participation response from those currently working full time is unlikely to be as large. Labour, moreover, is less mobile than capital. Lower corporate tax, by stimulating investment and raising labour productivity, will arguably have a greater positive effect on living standards in the long-run.[16]

Is our corporate rate uncompetitive?

Almost all countries levy corporate tax, notwithstanding the costs it imposes.[17] The question, therefore, is whether Australia's corporate tax is competitive.

The facts are pretty clear. Over recent decades, OECD countries have progressively reduced corporate tax rates. Our current, 30 per cent rate has been in place since 2001.[18] This is significantly above the average rate for small-to-medium sized OECD economies, which is 23 per cent.[19] Other countries competing for global capital are not standing still. As the Government's tax reform Discussion Paper has pointed out, since 2008 the United Kingdom (UK), Canada and Singapore have all reduced their main corporate tax rate.[20] The UK rate

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[11] Treasury, 2012, *Business Tax Working Group Final Report*, paragraph 42-46.

[12] Corporate tax rates, together with capital allowances, treatment of losses and financing costs, all influence effective tax rates on investments. The average effective tax rate (tax paid as a share of overall investment) will influence firms' location decisions. The marginal effective tax rate (tax paid on the last dollar of investment) will affect the scale of investment in a given location. The headline corporate tax rate will affect where profits are booked.

[13] Australian Government, 2015, *Rethink Tax Discussion Paper*, Chart 2.9 on page 25. The only tax which is more costly in economic terms is stamp duties on conveyances.

[14] One way to gauge these costs is by estimating the marginal excess burden of particular taxes. This concept represents the economic cost of a tax, expressed as a percentage of the last, or marginal, dollar of revenue it raises.

[15] Treasury, 2012, *Business Tax Working Group Final Report*, para 38. Note that for domestically funded equity investment, our imputation reduces the bias in favour of debt as well.

[16] Lower personal income tax rates for those on higher incomes might stimulate entrepreneurship and therefore productivity. The main effect of personal tax cuts, however, will be on participation.

[17] There are good reasons for them to do this rather than eliminate them entirely. To the extent that foreign investors are earning rents (returns in excess of those they require), the burden of corporate tax will fall on them rather than domestic employees and consumers. Rents are discussed further below.

[18] Some, including the Opposition Treasury spokesperson Andrew Leigh, have pointed out that, in terms of revenue actually raised, the 30 percent corporate tax rate with imputation is broadly the same as a 20 per cent corporate tax rate without imputation (Leigh's speech to the Corporate Tax and Transfer Pricing Summit on November 18 2015). In other words, that franking credits reduce net revenues raised by our corporate tax rate. This is true, but it has nothing to do with whether our corporate tax rate is competitive or not, as foreign investors do not benefit from franking credits (beyond not having to pay withholding taxes). For them, our headline rate is 30 per cent.

[19] Australian Government, 2015, *Rethink Tax Discussion Paper*, page 75.

[20] Australian Government, 2015, *Rethink Tax Discussion Paper*, page 74.

was 28 per cent in 2010 and will reach 18 per cent in 2020. There is no evidence that other forms of competition for global capital is declining.

While it is true that some larger OECD economies, including the United States of America (US), Germany and Japan, have higher corporate tax rates, they are not the best comparators.[21]

When assessed against our peer economies, therefore, our corporate rate is not competitive. This is not a suggestion that Australia adopt Singapore's or even the UK's rate. The point is that the differential between Australia's rate and those of peer economies is growing.

A broader point can also be made. Australia's reliance on both corporate and personal income taxes, as a source of revenue, is higher than in any OECD country except for Denmark.[22] The typical OECD country relies more on consumption taxes, which apart from being relatively efficient are more difficult to avoid than income taxes.

The arguments against a corporate rate cut

There are many commentators who question the merits of reducing the corporate rate. Three main arguments are:

- i That the corporate rate has a minimal effect on foreign investment.
- ii That given community concerns about BEPS a corporate rate cut is not warranted at this time.
- iii That a corporate rate reduction, while justified on economic grounds, is not affordable or not an immediate tax reform priority.

A further argument has been put. With business investment remaining relatively weak because of the uncertain economic outlook, any investment response to a corporate rate cut, it is argued, might be limited. While this may be true, no sensible advocate for a lower corporate rate would present it as a short-term stimulus measure. Our corporate tax settings, instead, form part of our medium-term economic policy framework. They should not be captive to current market circumstances or sentiment.

1. How sensitive is foreign investment to corporate tax?

A common objection to reducing the corporate rate is that it would not have a large impact on foreign investment.

The point is made that investment decisions, particularly for firms wanting to establish operations in a particular country, are not based exclusively on tax considerations. A skilled and educated workforce, high quality infrastructure, a favourable regulatory environment, political stability and the rule of law also enter into calculations. Australia is well-endowed with these structural advantages, it is argued, so we can afford to set corporate tax at a higher rate than we otherwise would. Indeed, our corporate tax can be viewed as a way of charging foreign investors for access to our social and physical infrastructure.

There is some merit in this argument, but it sets up a straw man. No advocate for a reduction in Australia's corporate tax rate would maintain that it is the only factor influencing investment. The question, rather, is one of degree. Is our relatively high corporate tax rate a major consideration, having a material impact on investment decisions? Or is it a minor factor, largely offset by location-specific advantages Australia can offer? During the recent mining investment boom, it is fair to conclude that our 30 per cent corporate rate was not a disincentive.

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[21] The US corporate tax system is highly porous. While in theory, the worldwide profits of US multinationals are subject to 35 per cent tax (closer to 40 per cent if sub-national taxes are included), foreign earnings are not taxed until repatriated. The effective corporate tax rate in the US is well below 35 per cent. The marginal investor in Germany and Japan, which are capital exporting countries, will be domestic.

[22] Australian Government, 2015, *Rethink Tax Discussion Paper*, Chart 2.3 on page 18.

The key question, however, concerns the future. In the next phase of globalisation, will the corporate tax rate grow in importance for foreign investors. Put differently, will global capital become more mobile or less mobile?

Rents: fixed or mobile?

Some economists, when discussing these non-tax advantages, invoke the concept of location-specific rents. When corporate tax is levied on these rents, it is argued, investment will not decline.[23] In these circumstances, the economic costs of corporate tax are reduced. Location-specific rents are often said to be found in the resources sector. They can also derive from any asset, endowment or structural characteristic which is unique to Australia and which generates excess returns for investors. Note the requirement for uniqueness. Australia has no monopoly over mineral wealth, so has to compete for investment with other resource rich countries.[24] While many of our non-resource advantages, including our workforce and infrastructure, are increasingly shared by lower-cost emerging economies.

While it is true that some rents are location-specific, their extent, pervasiveness and permanence are generally overstated. Increasingly, rents are mobile and can be earned in a range of locations. They derive from intellectual property, firm-specific value creation (for example, from efficient supply chains) and product innovation. They are associated with intangible capital, embodied in information technology capabilities, research and development and both human and organisational capabilities.

A new age of intangible capital

Intangible capital, and the returns it generates, is by definition highly mobile. It can be developed, deployed and exploited in a range of locations. It can be moved from one place to another to take advantage of favourable tax rates.

The Productivity Commission has found that intangible investment is almost half the size of tangible investment in the Australian economy. Since 1974-75, investment in intangibles has grown 1.3 times more rapidly than tangible investment, in average annual terms.[25] A similar trend has been observed across developed economies.

What does this imply for corporate tax? In a world where value increasingly derives from intangible capital rather than bricks and mortar, the corporate tax rate is likely to matter more for competitiveness, not less.[26]

2. BEPS

In a remarkably short period of time, BEPS has become a major tax policy and political concern.[27] If BEPS is not addressed, community confidence in the integrity of our tax system could be undermined.

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[23] They typically point to our mineral wealth during the recent resource price boom. As the value of these resources rose, the prospective returns to investors increased, giving rise to rents. In other words, returns in excess of the minimum rate investors require.

[24] Indeed, given that the supply of global capital is constrained, not all rent-producing resource projects will attract investment. Investors, in practice, have to rank projects based on their expected returns. The corporate tax rate therefore comes into play.

[25] Productivity Commission, 2009, *Investments in Intangible Assets and Australia's Productivity Growth*, Staff Working Paper. This paper estimates that market sector investment in intangibles was $57bn in 2005-06, but notes that 80 per cent of this was not treated as investment in the national accounts.

[26] In some academic quarters, there is support for narrowing the base of corporate tax so that only excess returns, or rents, are subject to tax. By leaving normal returns untaxed, the argument goes, the efficiency cost of corporate tax would be lowered and a range of other distortions would be eliminated. As we have seen, however, rents are increasingly mobile. A rent-based corporate tax, if not replicated by our competitors, would have an adverse impact on investment as firms would be free to locate their operations elsewhere. By exempting normal returns, moreover, the revenue generated by corporate tax would fall and become more volatile. The broader point to make is that corporate tax, which applies to all sectors of the economy, is too blunt an instrument to target rents. This is why, in practice, rent taxes have generally only been contemplated for natural resource projects.

At its simplest, BEPS occurs when firms seek to minimise their corporate tax bill by moving their profits to low or no-tax jurisdictions. As a result, tax on these profits is not paid in the country, or countries, in which value is created (for example, intellectual property) or where production takes place.

In the current political environment, the case for a reduction in the corporate tax rate is undoubtedly harder to make. If there is a perception that multinational firms are gaming the tax system, many in the community will understandably oppose a tax cut for them. As a result, we have seen a bifurcation in the discussion of corporate tax in Australia. Business groups make the case for a rate reduction, but do not mention BEPS. Political leaders worry about being seen as soft on BEPS, so downplay the economic importance of a lower corporate tax rate.

We would be better served by a debate which deals with both concerns (BEPS and our uncompetitive corporate rate) openly.

BEPS should be addressed in a targeted way

We should recognise that the best way to counter BEPS is through dedicated integrity measures rather than keeping a high corporate tax rate. Australia already has a strong anti-BEPS regime in place, which the Government and Opposition (in their separate ways) are committed to strengthening.[28] This regime targets the minority of firms who are not playing by the rules, but does not punish those who are.

An uncompetitive corporate tax rate, in contrast, hurts all businesses indiscriminately. It is a blunt instrument which reduces our access to foreign investment and provides an incentive for some firms to find means to reduce their tax bills.

We can be tough on BEPS and move to a more competitive rate

Indeed, there is no inconsistency in pursuing integrity and competitiveness objectives at the same time. The UK Government has adopted just this approach. It has aggressively cut its corporate rate while taking action on BEPS.[29] It would be easy for some to dismiss this as hypocrisy, but it should be borne in mind that the OECD BEPS project was never intended to stifle legitimate tax competition between nations.

As the OECD has made clear, BEPS does not occur when 'economic functions, assets and risks are effectively relocated to another country to take advantage of a low tax rate or tax credit.'[30] Further, 'no or low taxation is not *per se* a cause of concern, but it becomes so

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[27] The Henry Review, completed in 2009, made no reference to BEPS and devoted little attention to corporate tax avoidance. In 2013, the G8 and the G20 put BEPS on the international agenda, highlighting the work the OECD and its member countries were doing in this area. In early October, the OECD's final recommendations were released. These are currently being considered by national governments. In May, the Australian Government announced a multinational anti-avoidance package which is currently before parliament. The Federal Opposition has released its own policy proposals. A Senate Committee has been conducting high-profile hearings on the problem.

[28] The Government has recently passed legislation that, among other things, strengthens our general anti-avoidance rule in a targeted way. It has also asked the Board of Taxation to look at the OECD's recommendation to deal with hybrid tax mismatches. Key anti-BEPS measures currently in place include our tough transfer pricing rules, a comprehensive thin capitalisation regime, strong controlled foreign corporation (CFC) rules and a general anti-avoidance law. Our imputation system is another important BEPS defence, giving Australian-based firms an incentive to book profits in this country. Domestic investors, as mentioned earlier, receive full franking credits on corporate profits paid in Australia. These credits can be offset against their tax bill, avoiding double taxation of corporate profits. If an Australian firm shifted profits overseas, it would have fewer franking credits to allocate to local investors, who would therefore pay more tax on their dividends.

[29] Through its diverted profits tax and other measures.

[30] From the OECD's Final Report on BEPS Action Item 11, quoted in the following article: Herzfeld, M, '$240bn more in BEPS taxes – who wins, who loses?', *Worldwide Tax Daily*, November 16 2015.

when it is associated with practices that artificially segregate taxable income from the activities that generate it.'[31]

If, as a result of the BEPS project, countries successfully crack down on profit shifting, firms are likely to look more closely at where they locate production and value-creation. Profits may well become less mobile, but the underlying economic activities that generate them might become more mobile. As we have pointed out earlier, the more mobile global capital becomes, the more our corporate tax rate matters for competitiveness.[32]

An intelligent corporate tax strategy, therefore, would be to complement targeted action on BEPS with steps to improve the competitiveness of the corporate tax system. Indeed, initiatives can be mutually reinforcing. As the Henry Review noted, 'a lower company income tax rate would … reduce incentives for foreign multinationals to shift profits out of Australia.'[33]

3. A corporate tax rate reduction is not affordable

Even if the economic case for a corporate tax cut is accepted, the argument might be made that it is not affordable given the current state of the Federal Government's finances.

It is true that Australia relies more on corporate tax as a source of revenue than most other OECD countries. In 2012, corporate tax accounted for close of one fifth of the revenue raised by all Australian governments, up from just under 10 per cent in 1983. The average corporate tax take for OECD countries has been relatively stable over this period at around 8.5 per cent.[34]

While our imputation system would reduce the cost of a given corporate rate cut, some revenue losses would still be involved. Net revenue losses, of course, will be lower over time as investment responds to a lower corporate tax rate.[35] Governments managing budgets cannot responsibly factor in this economic dividend, at least in the short term.

How to fund a corporate rate reduction?

In the short-to-medium term, therefore, the question of funding necessarily arises. What other taxes will be raised to pay for a lower corporate tax rate?

Some business groups have suggested the GST as a possible revenue source. It would be an understatement to say that the politics of this would be fraught. While the public may well be prepared to accept an increase in the GST rate (or broadening of its base) to pay for personal income tax cuts, diverting part of the proceeds to foreign investors (through a corporate rate reduction) would be strongly resisted.

In the past, corporate tax cuts have been accompanied by measures to broaden the corporate tax base.[36] Indeed, this has been a worldwide trend and explains, in part, why OECD revenues from corporate tax have been relatively stable over recent decades.[37]

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[31] OECD, 2013, *BEPS Action Plan*, page 10.

[32] Put differently, when firms could engage in BEPS, they can effectively by-pass Australia's uncompetitive corporate tax rate. Australian profits might have been booked overseas, but production remained in the country. With profit shifting more difficult, our high corporate tax rate becomes more of a disincentive to locate, or remain, in Australia.

[33] K Henry *et al*, 2009, *Australia's Future Tax System Final Report*, page 40.

[34] Australian Government, 2015, *Rethink Tax Discussion Paper*, page 76.

[35] PwC modelling, drawing on OECD empirical research, suggests that the growth dividend from a 25 per cent corporate rate could result in income tax revenue being slightly higher in ten years' time. This modelling should not be considered a revenue forecast. It underlines that over time, there can be expected to be a growth and tax dividend from a lower corporate tax rate even if the OECD's specific assumptions and methodology can legitimately be questioned.

[36] Treasury, 2012, *Business Tax Working Group Consultation Guide*.

[37] J Mirrlees, 2011, *Tax by Design*, page 407.

A base-broadening funding strategy, however, would also be problematic. Most of the low hanging fruit has already been picked. Over recent decades, the generosity of capital (or depreciation) allowances has been progressively scaled back. While some sectors, including transport, oil and gas production benefit from more favourable depreciation treatment, any change to the *status quo* would be strongly opposed. Australia's thin capitalisation regime, another possible base-broadening candidate, has only recently been tightened.[38]

A 2012 Treasury led examination of ways to fund a corporate tax cut through some form of base-broadening (including these options) questioned the economic merits of this strategy.[39]

It found that:

> *There is considerable debate and uncertainty [about] the magnitude of the distortion associated with the remaining concessions in the business tax base, including concessions that promote important activity like investment in infrastructure and research and development.*[40]

This is not to suggest that targeted base broadening options should not be examined, but the sectoral, investment and broader economic impacts will need to be carefully considered.

A more radical option would be to eliminate the deductibility of interest payments for corporate taxpayers. This would, in addition to raising revenue to fund a corporate tax cut, address the tax system's bias in favour of debt financing.[41] However, it would have highly uneven effects across different businesses and sectors. Unpredictable industries like mining, which rely more on equity investment would benefit, unlike more stable industries like infrastructure which rely on debt would be penalised. For the latter, the cost of capital could rise significantly. Some profitable entities could even become loss marking unless the changes were phased-in.

A phased approach?

A case can be made to gradually phase-in any corporate rate reduction.

This approach has several advantages over a single-step reduction. It would cost less revenue in the short-term and give the Government time to consult business on ways to fund the full reduction. It would also limit windfall gains to existing investors. This is no bad thing. The economic benefits from a lower corporate tax rate come from attracting future investment, not delivering higher returns to those who have invested in the past but are earning profits today.[42] A credible commitment to move gradually to a more competitive corporate rate should still have a positive impact on future investment decisions.

A phased approach would set a clear direction, recognising that getting our corporate tax rate right can be done gradually and with minimum disruption to the government's finances.

The following table illustrates the cumulative cost of reducing the corporate tax rate by one percentage point each year over five years. We do not assume any positive investment response. As mentioned earlier, our imputation system lowers the net cost of a rate reduction.

[38] The thin capitalisation safe harbour was reduced from 75 per cent to 60 per cent in 2014. It has been suggested that it could be lowered further to 50 per cent.

[39] The Business Tax Working Group, referred to earlier in this document.

[40] Business Tax Working Group, 2012, *Final Report*, Finding 4.

[41] Although the dividend imputation system also, in part, deals with this.

[42] Although the dichotomy between new and existing investment is a little simplistic as it assumes existing investments are fixed. In practice, firms will commit additional funds to further develop or expand current projects.

Net revenue impact of annual one per cent reduction					
	2019-20 $bn	2020-21 $bn	2021-22 $bn	2022-23 $bn	2023-24 $bn
Statutory Rate	29%	28%	27%	26%	25%
Direct company tax revenue	-3,031	-6,387	-10,104	-14,159	-18,625
Income tax revenue through reduced franking credit value	933	1,966	3,110	4,359	5,733
Net revenue impact	-2,098	-4,421	-6,994	-9,801	-12,892

Alternatives to a corporate rate cut?

Some have argued that a better way to target tax relief for new investment is to offer more generous capital allowances, which reward new commitments, rather than lowering the corporate rate. This approach has several drawbacks, however. If provided for a short time, these incentives will only affect the timing of investment, not its magnitude. Permanent relief, unless offered across the board, risks distorting investment and adding complexity to the tax system. By narrowing our corporate tax base, and therefore lowering revenue, these changes would make it harder to bring the corporate tax rate down. We would be moving in the opposite policy direction of other OECD countries, who have focussed on rate reduction (and base broadening) in recent decades.[43] The BEPS consequences would also have to be considered. By offering more generous capital allowances but keeping our high corporate rate unchanged, we would give firms a stronger incentive to book expenses in Australia and shift profits overseas. If delivering windfall gains to existing investments is a concern, a better way of dealing with this is through a phased reduction in the corporate tax rate.

Conclusion

In making the case for reduction in Australia's corporate tax rate, we are not suggesting that it is an economic panacea or that it would pay for itself. Australia does offer foreign investors significant non-tax advantages, including a high quality workforce and infrastructure. Given our reliance on corporate tax as a revenue source, the question of how best to fund any rate reduction must be carefully considered. There are good reasons, however, to commit over time to a more competitive corporate tax rate as part of a wider, pro-growth tax reform blueprint. Global capital is becoming increasingly mobile, not less. Global action on profit shifting, if successful, will intensify competition for investment. Given these developments, the economic costs of our current corporate tax regime are likely to escalate if no action is taken.

While the politics will necessarily be difficult, no Government committed to innovation, investment and growth should be taking a corporate rate reduction off the tax reform table.

[43] Countries engage in legitimate tax competition by both lowering their corporate income tax rate and the use of targeted incentives. Liam Collins, 'Other countries are in the tax competition game, but Australia isn't even playing', *Australian Financial Review*, October 6.

Let's talk

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