

## **Inquiry into the Commitment to the Senate issued by the Business Council of Australia**

**Peter Swan AO FRSN FASSA\***

### **Terms of reference**

The [terms of reference](#) for the inquiry are:

The 'Commitment to the Senate' (the Commitment) issued by the Business Council of Australia (BCA) on 21 March 2018, and commitments to stronger wages and employment, with particular reference to:

(a) annually measurable benchmarks, for the period of the proposed Enterprise Tax Plan, for the companies that have co-signed the Commitment and other senior members of the BCA membership, including:

- (i) company wage growth estimates,
- (ii) employment estimates, and
- (iii) schedules of investment by state and territory;

and in each case how they vary if the Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017 is enacted, or there is no change to the existing tax law;

(b) corporate tax data for the companies that have co-signed the Commitment, and other senior members of the BCA membership, including:

- (i) the total tax paid over the past five years, and
- (ii) the expected tax benefit from the Enterprise Tax Plan; and

(c) other related matters.

### **My submission:**

I am an economist working at UNSW-Sydney Business School, one of Australia's foremost university departments. I originally advised the Campbell Committee on reforms to corporate taxation and our advice to the Government was to integrate corporate and personal taxes. This was achieved in 1987, but imperfectly so via franking credits and imputation benefits. I have conducted economic modelling of the government's imputation system and proposed company tax cuts to conclude that it will make most Australians significantly worse off.

My advice to Senators is not to approve the proposed tax cuts for the following six reasons:

#### **1. The modelling used by the government is entirely flawed.**

Proponents of the corporate tax cut argue it will make Australia a more attractive place for foreign investors, and the extra capital coming in from offshore will raise real wages and increase economic growth. The most recent pro-government modelling indicates an annual cost to revenue of almost \$5 billion in the long term and this would most likely need to be funded by 'bracket creep' with most Australians paying much higher personal taxes. The upside looks dismal, with after-tax wages rising only microscopically by about 0.29 per cent and employment falling slightly in return for a miserly 2.5 per cent rise in investment. The initial costs are of the

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order of \$65 billion over the next 10 years in loss of revenue to foreigners. This is of the order of \$2,700 per person.

Even these very modest claimed gains are unlikely to be realised, according to my modelling. This is because franking credits sizeably lower the cost of capital to Australian industry. They do so in part because the sale of tradeable franking credits by foreigners to locals passes on to foreigners about three-quarters of the value of these franking credits.

Owing to our franking credit system, Australians pay no corporate tax, since corporate income net of corporate tax paid forms part of personal income. Harvesting by foreigners means that foreigners trading in our shares pay little corporate tax either. Hence, reductions in the headline rate of tax are unlikely to have much, if any, effect on the level of investment.

**2. Labor's vow to legislate any tax cut back to the current headline rate when it regains office (likely to be quite soon) nullifies any possible impact that a tax cut could have to encourage foreign investors.**

This promise to reverse these corporate tax cut – if passed by you – cross-bench senators, gives the Labor Party a huge strategic advantage at the forthcoming election, as it can promise far deeper personal tax cuts than can the Turnbull government promising its own suicide note.

**3. The revenue loss will either have to be made up by higher taxes on all Australians or further suffer the long-term, Banana-Republic consequences of even larger budget deficits.**

It is very irresponsible, of Whitlamesque proportions, for the Turnbull government to be giving away its tax base when the deficit has blown out under its watch (and that of the previous Abbott and Labor governments) with little indication that 'bracket creep' will be sufficient to fund the sizeable long-term decline in our taxable capacity relative to massive increases in welfare spending. Wages and living standards are stagnant and inflation cannot be relied on to generate sufficient revenue from domestic sources to make up for the added shortfall in tax revenue of perhaps \$8 billion per annum, or higher, once the tax reductions take effect.

**4. There are much better uses for the \$8 billion of lost revenue per annum than giving it away with negligible benefits in return.**

If the government were serious about encouraging more investment and raising Australian living standards, it would devote some, or all, the \$8 billion per annum to building efficient base load coal-fired power stations. Alternatively, the government could abandon the Paris Accord and renewal energy targets to let the market get on with the urgent job of reducing energy prices and making it possible for foreigners (and locals) to profitably invest in Australia.

**5. Trump tax cuts.**

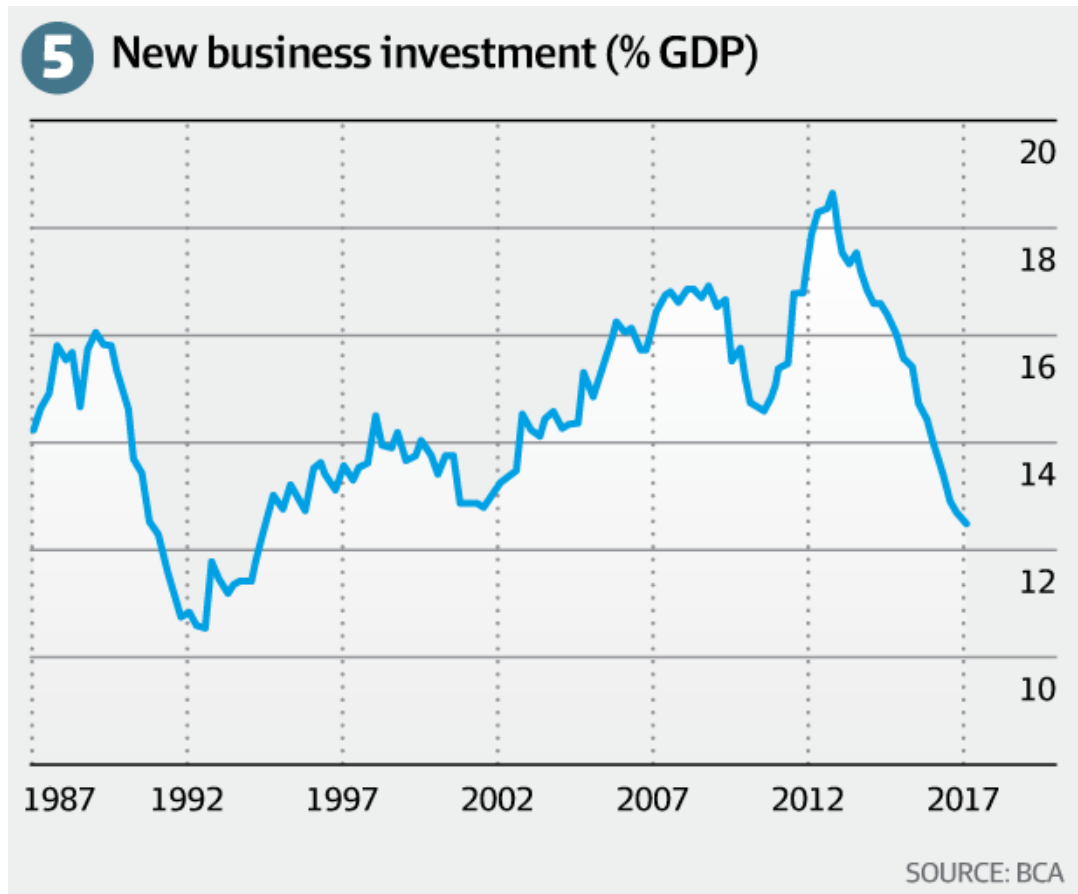
The government's excuse for the tax cuts is the Trump reduction in the US corporate tax rate from 35 per cent to 21 per cent. But, effectively the US tax rates still remains far higher than Australia's, despite our higher headline rate of 30 per cent, since Americans are taxed a second time on company income that has already been subject to tax. This is because, unlike Australia, there is no franking and no imputation benefit and no harvesting of franking credits to reduce their cost of capital down to our much lower rate.

**6. Thirty pieces of silver and lesson from the demise of the Democrats**

Any senator who horse-trades their vote on this issue, perhaps even for the benefit of one's own supporters, needs to be aware of the likely voter response. The Democrats were there 'to keep the bastards honest' but all lost their Senate places once deals were done with the government of the day, often against their own principles.

These six reasons are largely drawn from my study into the proposed tax cuts: Investment, the Corporate Tax Rate, and the Pricing of Franking Credits, which I have attached to my submission.

The BCA shows a decline in investment as a % of GDP between 2012 and 2017:



However, I am not aware of any tax-related reason to explain this decline from about 18% to 14% of GDP. A far more plausible explanation is the almost doubling of power prices over this period due to subsidies to renewable but unreliable energy such as wind and solar. These power prices are likely to double again, especially with the likely closure of Liddell. There is no way that large multinationals are going to invest in Australian industry while power prices continue to be rising virtually without limit.

The BCA claims that:

- Australia's 30 per cent company tax rate is the fifth highest among Organisation for Economic Co-operation and Development countries today, compared with 17th highest in 2001.
- Total company tax collected in 2016-17 is estimated to have been \$69 billion, representing 17 per cent of commonwealth revenue.

This is little more than propaganda as no Australian pays corporate tax if they receive a franking credit and about 70% of company income is paid out as a franking credit benefit. Members of BCA

and other firms could pay out 100% of their taxable income as a franked dividend but choose not to. Of those franked dividends distributed, a sizeable proportion is cashed in by individual and institutional investors liable for personal tax. This could be as high as two-thirds. Hence, while all Australians are liable for personal tax on their corporate income, the amount actually collected as company tax payments is probably quite small and is entirely paid by foreign investors not eligible to take advantage of franking credit benefits. When these adjustments are taken into account, company tax payments would be confined to only foreign investors and these tax payments are far lower than the grossly misleading claims made by BCA.

Moreover, a sizeable proportion of these Australian taxpayers may only be temporary owners since foreign investors seeking a capital gain can sell their cum-dividend shares about 47 days prior to the stock going ex-dividend and repurchase when it is ex-dividend. Thus, this simple trading strategy enables the foreign trader to gain about three-quarters of the value of franking credits. What is known as the 45-day rule was implemented in 1997 to prevent foreign traders from gaining close to 100% of the value of these benefits.

If the ATO, Treasury, and Government were interested in reducing this source of lost revenue, then they could fully implement mine and the Campbell Committee's plan for complete integration. In effect, the ability of shareholder to claim franking credit benefits would be prorated for partial ownership during the year and all income together with all tax paid would be apportioned to shareholders, not just franking dividends, as at the moment.

This ability of foreign investors to harvest franking credits implies that the cost of capital for Australian and foreign investors in Australia is one of the lowest in the world since portfolio (trading) investors pay close to zero corporate tax. BCA members, especially if they have a corporate structure providing franking credits, are already beneficiaries of this system. Direct investors without a means to trade franking credits are more likely to be actually paying corporate tax. Some BCA members fall into this category.

One of Australia's largest companies and large investor is BHP Billiton. Their dual-class structure, with UK investors trading the London-based shares and not eligible for franking credits and an Australian (ASX) shareholders receiving the same dividends plus franking credits, is a clever means to channel imputation benefits to those who value them the most. As a consequence, the London-arm shares sell for a sizeable discount relative to the Australian-arm shares, despite equal entitlement to dividends.

In my study, *Investment, the Corporate Tax Rate, and the Pricing of Franking Credits*, (attached) I show that franking credits are largely priced, that is, they receive a lower return than do unfranked dividends that largely reflect the earnings of Australians investing off-shore who do not pay Australian corporate tax and thus are not eligible for franking credits. This lower return largely reflects the grossed-up value of imputation benefits of 42.8% from our headline tax rate of 30%.

This finding implies that the cost of capital to domestic investors in Australia is already very low by world standards due to the harvesting of franking credits. It also leads me to believe that the proposed 17% reduction in our corporate tax rate from 30% to 25%, and potential loss of revenue of up to \$13 billion annually, is not likely to lead to significant new investment, or even wages growth in Australia, if the cuts go ahead.

According to the BCA's October 2017 Tax Booklet, Independent Economics director Chris Murphy estimates that for every \$1 of cost to the budget, a company tax cut delivers a gross benefit to Australian consumers of \$2.39. I now examine Chris Murphy's (2018) most recent findings (I have also attached this study):

## Gains from Lowering the Corporate Tax Rate in Murphy (2018) could be largely Illusory

Murphy (2018): Effect of Reducing Corporate Tax, from 30% to 25%		
Financing Method	No Change	Br Creep
Consumer welfare (2016/17, \$bn)	4.9	3.8
Budget gain (2016/17, \$bn)	-4.7	-0.2
Household Consumption (%)	0.71%	0.46%
GDP (%)	0.93%	0.72%
Business investment (%)	2.70%	2.53%
Employment (%)	0.20%	-0.02%
Real after-tax wage (%)	0.96%	0.29%
Real after-tax resident incomes	1%	0.37%

Source: Murphy (2018) Tables 8 and 10.



- ❑ Murphy (2018, Tables 8 and 9), column 1, assuming zero pricing of franking credits and long-run equilibrium, a sizeable consumer benefit of \$4.9(bn), GDP gain of 0.93%, and unfunded (or lump-sum tax) loss to government revenue of \$4.7(bn) from a 17% reduction in corporate tax rate from 30% to 25% with no change to tax regime (or a lump-sum tax);
- ❑ Column 2 shows that using bracket creep to fund the deficit is not entirely successful, employment actually falls, and there is a very small rise in the real after-tax wage of 0.29%;
- ❑ If the higher investment does not materialise due to the contraction in investment by Australians and foreign investors, additional taxes need to raise \$8(bn) p.a. or more (17% of \$48(b)) once tax rates are lowered.
- ❑ Thus, even if my analysis were entirely incorrect, the Government's case for lowering the tax rate is largely non-existent.

Column 2 shows that the claimed gain to consumers is \$3.8 billion and the long-run revenue loss, \$4.7 billion. This is a claimed gain of 80 cents per dollar of revenue loss, far below the BCA claim of \$2.39. Column 2 also shows that the claimed gain in after-tax wages is 0.29%. Since average wages inclusive of bonus and overtime are approximately \$82,000 per annum, the supposed benefit is only \$238 per annum or \$2.45 billion if we were to suppose that there were 10.7 million workers. This is way less than the supposed consumer benefit of \$3.8 billion that clearly does not take into account the much higher taxes. This very generous estimate of \$238 per worker per annum is far lower than the benefit of \$750 claimed by Mr Turnbull.

<http://www.news.com.au/finance/business/big-businesses-new-tactic-to-sell-corporate-tax-cuts-to-australians-at-work/news-story/2bfeeddab6e73bfe58acf51f4b286a6d>

These highly optimistic estimates by the strongest supporter of company tax cuts can be contrasted by the claims made by Jennifer Westacott on March 5, 2018.

<http://www.bca.com.au/media/company-tax-cuts-good-for-business-and-good-for-australia>

She claims that by giving away \$65 billion to foreign investors that this will create \$20 billion extra in GDP and \$4 billion in additional tax revenue. This is quite absurd when her most optimistic economic modeller indicates a cost to revenue of \$4.7 billion dollars per annum, a

discrepancy of \$8.7 billion per annum. Moreover, no one has produced any evidence to show that foreign investment is sensitive to the tax rate.

It is my understanding that the BCA has agreed to provide:

(a) annually measurable benchmarks, for the period of the proposed Enterprise Tax Plan, for the companies that have co-signed the Commitment and other senior members of the BCA membership, including:

- (iv) company wage growth estimates,
- (v) employment estimates, and
- (vi) schedules of investment by state and territory;

and in each case how they vary if the Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017 is enacted, or there is no change to the existing tax law;

(b) corporate tax data for the companies that have co-signed the Commitment, and other senior members of the BCA membership, including:

- (iii) the total tax paid over the past five years, and
- the expected tax benefit from the Enterprise Tax Plan.

I frankly do not see any benefit to Australia from this so-called pledge as it is entirely meaningless. The BCA and its members could put down practically anything they like in the projections for the two scenarios without the Senate or anyone else being able to hold the BCA responsible for the outcome, whether or not the Senate passes the tax cut legislation. I believe that the tax cuts will make negligible difference to either the investments undertaken, or wages paid, but we might have to wait decades before the effect of tax cuts can be seen in its entirety and, even then, it would be largely impossible to know if changes were actually driven by tax cuts or something else.

If, for example, all subsidies to renewables were removed, this is likely to set off a huge boom in manufacturing-related industry irrespective of tax rates. In the meantime, Australia would have forfeited approximately \$65 billion in tax revenue with little if anything in the way of offsetting benefit if it goes down the path of tax cuts.

I would therefore urge the Senate to reject the offer of a pledge as involving considerable expense with little prospect of any benefit and to continue to vote against the proposed tax cuts.