Submission to the Senate Economics References Committee

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Submission to the Commitment to the Senate issued by the Business Council of Australia

The Centre for Independent Studies (CIS) welcomes the opportunity to provide a submission to the Senate Economics References Committee conducting the inquiry into the 'Commitment to the Senate' issued by the Business Council of Australia on 21 March 2018.

The CIS is a leading independent public policy think tank in Australasia. Founded in 1976, its work is driven by a commitment to the principles of a free and open society. The CIS is independent and non-partisan in both its funding and research, does no commissioned research nor takes any government money to support its public policy work.

The CIS has been a strong advocate for freedom of speech and limited government for more than forty years. We have always opposed regulations that impose unnecessary restrictions on democratic participation, or that unnecessarily limit the fundamental principle of freedom of speech.

This submission is made by Robert Carling, a Senior Fellow in the economics program at the CIS. I undertake research into a wide range of public finance issues and regularly comments in the media on taxation and other budget issues. My most recent publication under the CIS banner was From Reform to Retreat: 30 Years of Australian Fiscal Policy (CIS Occasional Paper 161, December 2017).

Before joining the CIS, I was a senior official with the New South Wales Treasury and in that role was responsible for advising the state government on taxation policy and federal/state financial relations. Prior to that I was a senior official with the Australian Treasury in Canberra and both the World Bank and the International Monetary Fund in Washington, DC. I holds academic qualifications in economics and finance from the London School of Economics and Political Science, Georgetown University and the University of Queensland.

I am available to discuss this submission with the Committee should it so wish.

Yours sincerely,

Robert Carling

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Submission to the Commitment to the Senate issued by the Business Council of Australia

The Committee is considering:

- A commitment by the Business Council of Australia (BCA) and/or individual companies with respect to increases in investment, wages and employment as a consequence of company tax cuts.
- A system to monitor companies' performance relative to their commitment.

The thrust of this submission is that both the concept of the commitment, and the system to monitor performance, are damaging to economic freedom; and suggest a misunderstanding of how company tax cuts will affect the economy.

If the BCA or individual companies wish to make voluntary commitments, that is up to them. It is not surprising that the commitment they have already made is cast in very general terms. For the reasons discussed below, it would be unwise for them to make specific commitments.

It is another matter altogether for legislators to make such a commitment a pre-condition for company tax cuts. Tax cuts should enhance economic freedom. Conditional cuts would be a step in the other direction, towards central economic planning, corporatist economic management and a social contract between business and government based on the notion that business will invest more only if it is pressured into doing so by government regulation.

Tax cuts — whether corporate or personal — can enlarge economic freedom by giving taxpayers greater freedom in the use of income earned through their own efforts, and by reducing the disincentive that taxation puts in the way of individual initiative. But conditional tax cuts will not deliver these benefits. Conditionality turns a tax cut into an exercise in regulation.

In making decisions on tax reductions, governments are right to take into account budgetary scope (are tax cuts 'affordable'); priorities among different tax reduction options; and the expected relative economic benefits of the options. They are not right to make tax reductions conditional on specific actions.[i]

Legislators' assessments of the expected economic effects of company tax cuts should not be based on companies' commitments but on the large body of economic theory, taxation principles and economic modelling. While expert opinion varies and modelling cannot be precise, it is up to the political process to sift through the evidence and come to a conclusion.

The notion that companies' performance relative to their commitments should be monitored by government is fundamentally misguided, as it is based on a misunderstanding of how company tax cuts work their way through the economy. The Committee is invited to consider the following points:

- The economic case for company tax cuts does not rest on companies 'using' tax cut windfall funds to increase investment, pay shareholders more, pay employees more or add to payrolls. Rather, the case rests on how companies respond to a change in incentives — in this case, an increase in after-tax rates of return on new investments.
- Thus, there is no direct line from company tax cuts to higher wages. The direct line is to increased business investment, which in turn makes workers more productive and more valuable to their employers, which in a competitive labour market will lead to increased wages.

- Even if the company tax cut was immediate, these responses would be spread out over years. Companies' responses to a company tax cut cannot be measured in months or quarters, but in years. This point is given added force by the phased nature of the government's enterprise tax plan. For large companies to respond now — when they see no cut until the middle of the next decade — they need to be confident that the cuts will actually occur and not be reversed.
- The investment response to tax cuts is based on companies acting out of self-interest (the profit motive), not out of altruism or compliance with a social contract with government. In no sense is this reliant on a 'trickle-down' effect.
- In observing movements in investment, wages, productivity and employment in the years following a company tax cut, it will be impossible to separate out the effects of the cut. Some investment that takes place would have taken place anyway, and it is impossible to separate the two components. Ex post modelling could attempt to do so, but the results would be no more accurate than those of ex ante modelling. A performance monitoring process would be of no benefit and would likely impose costs as it would encourage companies to game the system instead of focusing on running their businesses.
- The absence of an observed acceleration in investment would not necessarily constitute evidence that the company tax cut had failed to stimulate, because the counterfactual could be a decline in investment — for example, if company tax rates continued to drift down in other countries and attract foreign investment away from Australia. In that situation a tax cut would still stimulate compared with no cut, but only by keeping pace with the rest of the world.
- The responses of individual companies will vary greatly. They will depend on conditions in their industry (declining industries are not likely to see much investment, regardless of the company tax rate); the degree of competitive pressure on individual companies; the technological opportunities they face; their balance sheet strength and ability to raise new capital; and where they are in their asset replacement cycles. Some companies will respond quickly and aggressively, some slowly or not at all. There is no 'standard' response. For economic policy, what matters is the average or aggregate response across the whole population of companies.
- Part of the response to company tax cuts will take the form of new foreign investors coming to Australia and new companies being formed here, whereas any statements of commitment can only come from existing companies operating in Australia.

These and other relevant issues are discussed in greater detail in a comprehensive research report issued by the CIS in 2016.[ii] In particular, the Committee's attention is drawn to sections 3.2–3.7 on pages 12–16, which discuss the ways in which company tax cuts affect the economy. The sections also canvas the large body of empirical research and evidence. This report makes it clear that CIS research has found a strong case for company tax cuts as a matter of priority. That case has been strengthened further since then by the enactment of a large company tax cut in the United States.

In conclusion, legislators would be well-advised to make judgements about company tax cuts based on principles of taxation, economic theory, modelling, expected overall economic effects, budgetary scope for tax cuts, and priorities among competing tax reduction options. They should be discouraged from demanding commitments from the business sector as a condition for tax cuts or expecting to be able to monitor performance following company tax cuts relative to a hypothetical situation in which tax cuts do not take place.

ANNEXURE – Michael Potter, *Fix it or Fail: Why we must cut company tax now,* CIS Research Report 20

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[i] This statement is made in relation to broad tax rates and thresholds. Clearly governments do make tax concessions available for narrowly defined activities by individuals and businesses (such as for research and development expenditure by business) and these concessions are in a sense conditional tax cuts. Whether they are appropriate is a topic beyond the scope of this submission.

[ii] Michael Potter, *Fix it or Fail: Why we must cut company tax now,* CIS Research Report 20, The Centre for Independent Studies, Sydney, October 2016.