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10 April 2018

To:
Senate Submission to the Senate Economics References Committee
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Parliament House
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RE: Inquiry into the Commitment to the Senate issued by the Business Council of Australia

I, Shumi Akhtar (Associate Professor at the University of Sydney Business School), would like to express my gratitude to the Senate Economics Reference Committee for inviting me to make this submission.

Tax is a complex matter that is intertwined with politics, society and economic growth. Senators in the Australian Parliament are currently in the midst of a key political battle; bitterly divided over how Australia should proceed with the government's recently tabled corporate tax reductions. In summary, the current Bill proposes to reduce the corporate tax rate from 30% to 27.5% from 2019 onwards, with further progressive reductions made to 25% in 2026.

While the ongoing debate on tax reform has given birth to an extraordinary raft of ideas that only serve to highlight the clash of ideology between the government, crossbenchers and the Labor party, the fact of the matter remains that all of their proposals are fatally flawed: they have been made without understanding the simple economics underlying our taxation system. The reality is that the current proposal to reduce the corporate tax rate from 30% to 27.5% is grounded in a rate that has no basis, no practicality, no merit and no use for any citizen or corporation in Australia! To give a simple example of the current dissonance between each camp: the Greens and Labor insist that no change is needed to the current corporate tax rate but the Liberals remain stubborn that a tax cut is needed to effect economic growth. Yet without a "true" estimate of what is the "correct" tax rate, who will be the judge of which course of action would best serve the Australian tax system and Australia?

There is a fundamental failure on our politicians' parts to understand that tax reform is not as simple as

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effecting a change in the tax rate either through a raise or a cut – instead, what the Australian government should do is perform a long-overdue reform of the legal structure underpinning the current Australian tax system. A thorough investigation of how the tax system interacts with and affects its micro and macro-economic systems (eg. through education, housing affordability, healthcare, infrastructure improvement, research innovation and education, employment, climate, immigration, etc), financial system (eg. foreign trade and foreign direct investment) and inequality (gender pay gap, ethnicity/cultural pay gap, homelessness, tax policy on immigrants who left their capital in their home country, tax policy on retirees/pensioners etc) is sorely needed before making a conclusion as all of these factors contribute to economic growth – it is not solely dependent on tax rate fluctuations! Furthermore, and as alluded to above the current discussion on rate hikes, cuts or no change makes one simple assumption: that Australia as a nation has already figured out what the optimal tax rate should be.

But the truth is, none of us actually know what that optimal point is yet. In fact, the oft-held belief that the current 30% corporate tax rate and its surrounding numbers straddle the nirvana of "optimum tax rates" is fatally flawed. A simple analysis of Australia's corporate tax history demonstrates this.

In the 1980s, the corporate tax rate averaged around 46%, climbing to a peak of 49% in 1986 (the highest in Australian Tax history) before gradually declining in various magnitudes over the years until bottoming at 30% in 2002 where it has since remained unchanged. In contrast, the US statutory corporate tax rate has held steady at 35% since the late 1990s until 2018 where it was slashed to 21% as a result of the newly enacted Tax Cuts and Jobs Acts (see Fig 1 and 2 for both country's corporate tax history). However, many have failed to grasp that the key justification behind the US corporate tax cut is unique to the US – that is years under an unfavourable tax regime that imposed heavy taxes on the repatriation of foreign profits had led to many large, US multinationals parking trillions of dollar's worth of cash in offshore tax haven countries; cash that could otherwise be used for economic growth and other investment purposes. Australia does not have this problem and as such, it makes no sense to cut taxes with the excuse that it will increase wages and employment as well as motivate international investors to invest in Australia, ultimately leading to economic growth. While the tax rate itself may play a role in ensuring economic welfare it is not the ultimate determinant dictating the direction of the overall economy's prosperity that so many are making it out to be.

Another heavily overlooked point is that it is not so much the headline corporate tax rate that matters, but the effective corporate tax rate i.e. the actual rate of tax paid. The effective tax rate of US listed companies has been significantly lower than the statutory tax rate, with a similar pattern observed for Australian firms. The percentage of US corporate tax revenue is alarmingly lower than the OECD's average of 34.2% of total tax revenue, and can be explained due to the existence of a barrage of loopholes such as deferred tax provisions and allowances for generous depreciation deductions. Trump himself has admitted that many high profile tycoons such as him and other multinational corporations have offset millions of dollars based on these loopholes for decades – what's the catch here? Well, these loopholes are *independent* from the corporation tax rate! As an idea of the magnitude of how the richest corporations are exploiting such loopholes, large US companies had deferred taxable income that is on average approximately 400 times higher than small corporations and 80 times higher than medium size corporations in the US over the last 35 years. Similarly, depreciation charges (which reduces taxable income) by large corporations have been on average as aggressive as 343 times higher than small size corporations and 34 times higher than medium size corporations. During this period, the US federal corporate tax rate was the highest in the OECD region and 2nd highest in the world (after the United Arab Emirates' 55% corporate tax rate). However, somewhat contradictorily the US appears to be a generally low taxing country despite its high headline corporate tax rate: it ranks 4th lowest in terms of tax revenue (as a percentage of GDP) raised among the 34 OECD member nations. This is a story that is echoed in Australia.

Taking into account the various anecdotes discussed above, it is evident that Australia does not necessarily need big changes to its corporate tax rate at this time, but what it does need to have is a discussion around the legal structure of its tax system. As the Panama Papers and Paradise Papers scandal showed, large companies are often able to enjoy advantages arising from economies of scale in terms of tax avoidance, giving them a substantial edge over smaller businesses. Australia need to shift the debate away from the specifics of one tax rate and focus on the broader impacts of combinations of macroeconomic policies and what the overall outcome will be.

From a simplistic economic perspective, tax cuts are a stimulatory measure. In the short run, they should increase nominal GDP as long as there is no monetary offset; however like numerous other macroeconomic policies, it is reasonably difficult to predict the exact effect over time given the numerous contributing factors to economic growth. While tax is a complex matter, with quality research time and funding, it is possible to scientifically examine the role that the tax rate per se versus the tax system plays vis a vis corporations and the economy overall. In fact, one of my current research grant proposal under review with the Australian Research Council (Title: The Paradox of Sin in Paradise – An Innovative Approach) addresses most of the issues mentioned here with respect to the tax rate, tax system and economic growth and welfare by benchmarking Australia with the rest of the world. The tax treatment of Multinational Corporations (MNC) is also a notable double-edged sword. Losses in national tax income through favourable tax treatment for MNCs must be balanced against the significant economic and social benefits they bring. My research proposal will benefit both governments and MNCs via effective cost-benefit analysis to develop an optimal economic environment for both parties. We will quantify the pros and cons of tax policy versus MNC tax avoidance strategies that will promote specific government initiatives to enhance economic growth, enrich fiscal flows and improve overall Australian competitiveness. The project will influence policy development in a global context, creating fair, transparent and efficient tax policies optimising the tax treatment of MNCs. Such a study is critically needed for Australia and other countries to better understand and balance the implications of tax reform with economic and welfare needs.

There is no strong, direct causal relationship between a tax cut with the oft-mooted trifecta of benefits comprising rising employment, a reduction in income inequality or wage increases. I present some simple Figures (for Australia and for the US to demonstrate this point). Graphically, Figures 3-10 show that despite the fluctuation in Australian corporate tax rate over the last three decades, there is no obvious positive or negative directional relationship between Australia's corporate tax rate fluctuations (Figure 1) with increasing productivity (Figure 3), employment (Figure 4), corporate profits (Figure 5), competitive strength (Figure 6), incremental economic growth (Figure 8), labor participation rate (Fig 9) and weekly wages (Figure 10).

Putting aside fundamental macro-economic and economic financial theories, a preliminary analysis as presented above illustrates that a tax rate cut itself is not a necessary or sufficient condition in itself for economic growth. Using the US as an example, we show that President Trump's tax cut announcement in January 2018 did not have an immediate positive knock-on effect on the USA's growth rate, in fact it had negative repercussions as the US GDP growth rate fell from 3.2% in quarter 4 2017 to 2.9% in January 2018 (Figure 11) while the level of foreign direct investment remained the same as the second quarter of 2017 (Figure 12).

If one simply considers tax cuts from a business perspective, obviously reducing the rate has an immediate positive effect on profits, providing that no other factors in the market change. One can even go one step further and argue that the tax cuts will disproportionately favour large businesses given that small businesses generally do not enjoy the same economies of scale to reduce their effective tax rate. However, the key point to consider is that this view rests on holding all other factors *equal*, which is unrealistic when the macro-economy is subject to numerous non constant effects such as supply shocks (such as the recent commodity downturn), monetary shocks, fiscal shocks and demand shocks. In addition, while a corporate tax cut may in isolation, be positive for business, this does not necessarily make it the optimum policy choice for growth - there is simply not enough information to go that far. It is vital for the Australian government to continue raising much-needed tax revenues (and not leave that $65 billion with corporations) to continue alleviating inequality and improve our education, hospitals and healthcare system, pension and retirement system, and other social issues such as homelessness and improving housing affordability for the younger generation without needlessly throwing it away on a panacea for growth that is unlikely to materialise and as I demonstrated above, is ultimately baseless.

To conclude, we must avoid in doubling down on failed approaches using tax rates as a mechanism to solve big economic problems. Rather, we should focus on creating an equitable taxation system where our revenue is drawn from areas that are easier to monitor and enforce such as corporations and individuals. This will provide both a more secure stream of revenue and a fairer and impartial outcome for all. To achieve this, the Australian government needs to be vigilant, dynamic, firm and persistent, and allow adequate time to address these critical tax issues through real-data driven evidence by researchers so that the revised policies are well-functional (eg., for domestic and multinational corporations, existing workforce population and retirees/pensioners), last longer and helps to maintain fairness, transparency and integrity in the financial system locally and globally. As one of the developed nations, Australia needs to be a leader not a follower!

Sincerely,
Shumi

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Figure 1

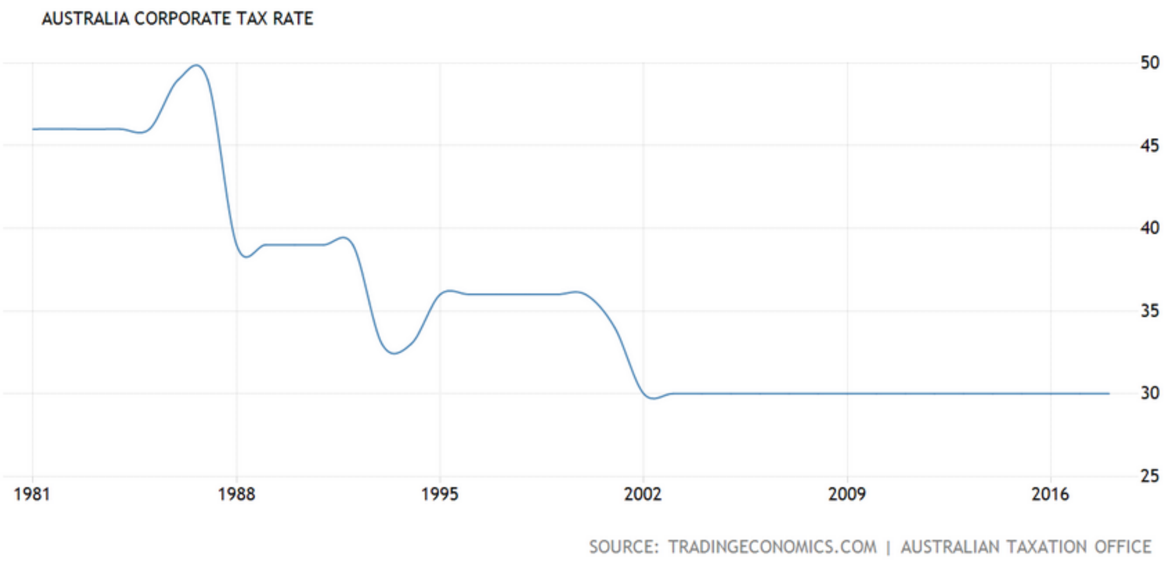

Figure 2

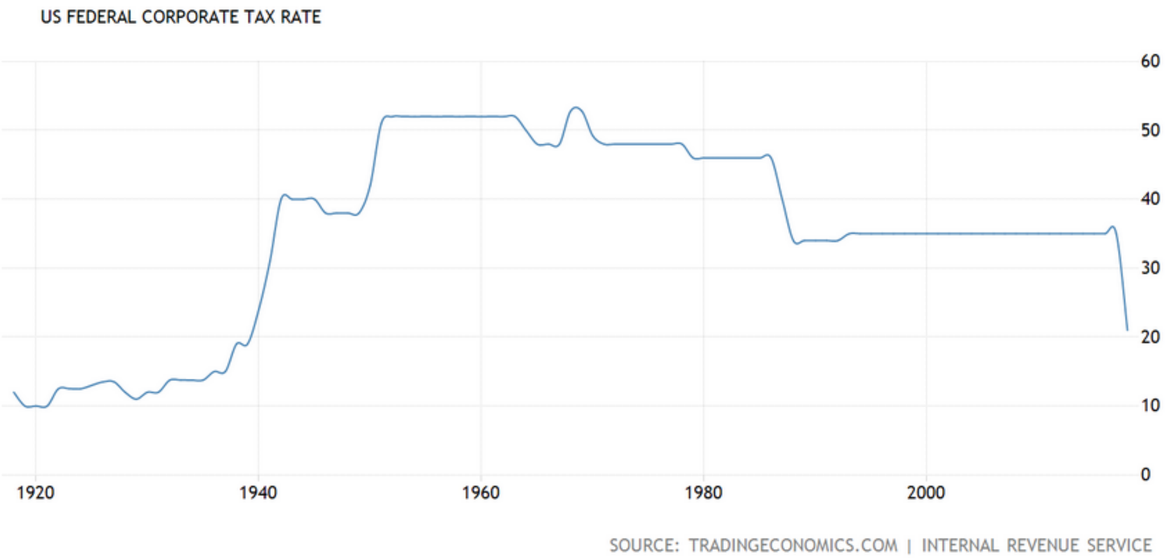

Figure 3

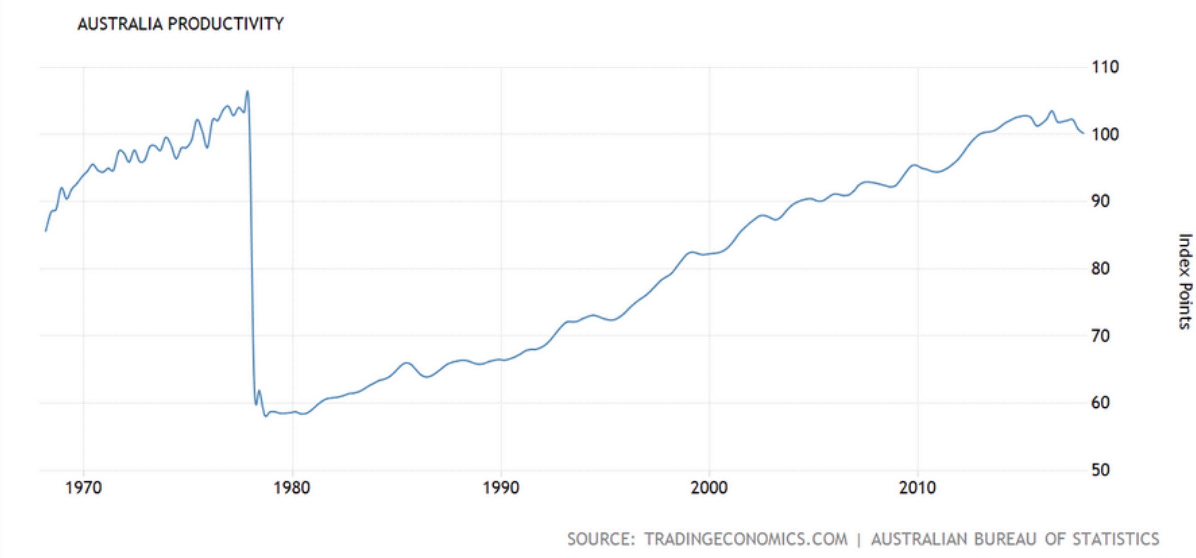

Figure 4

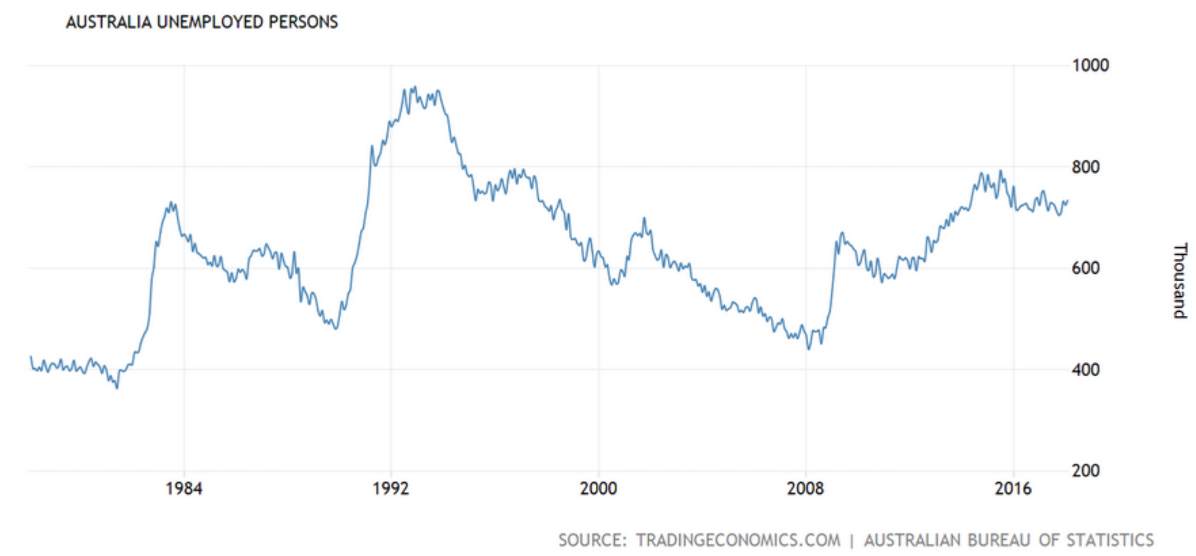

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Figure 5

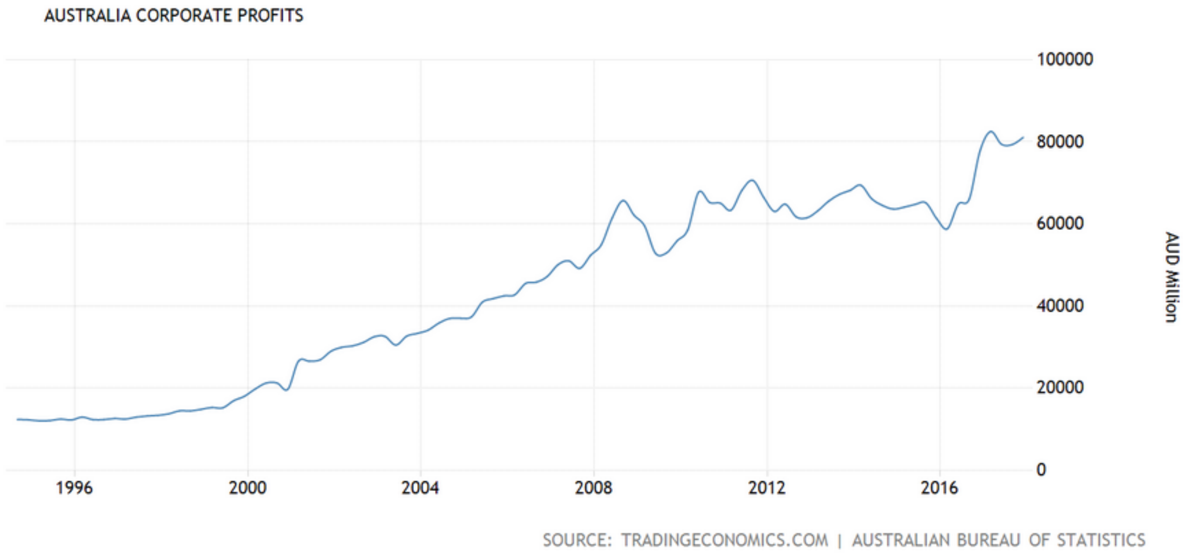

Figure 6

Figure 7

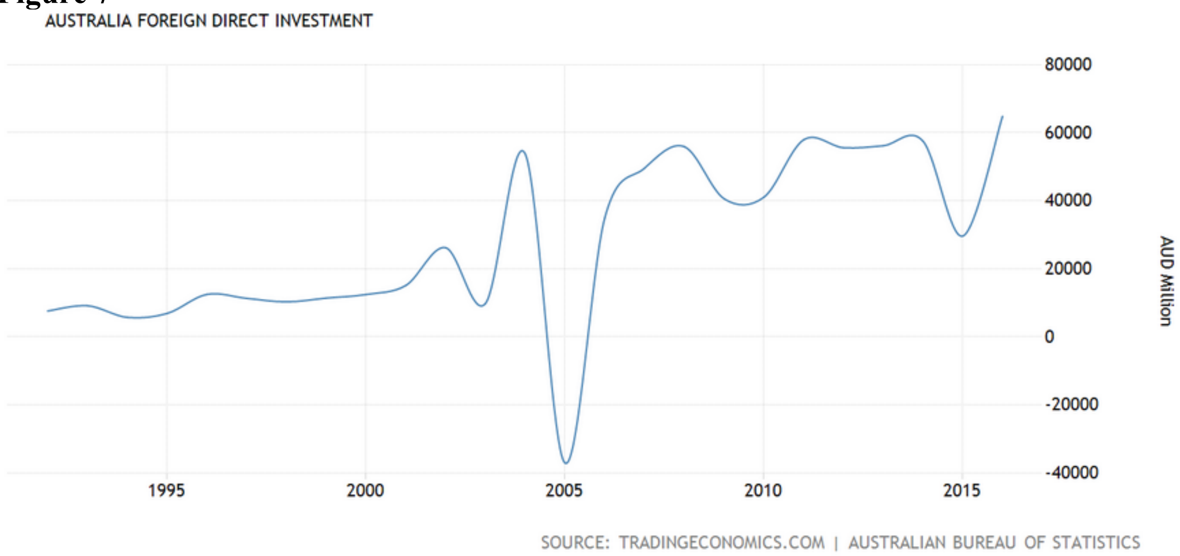

Figure 8

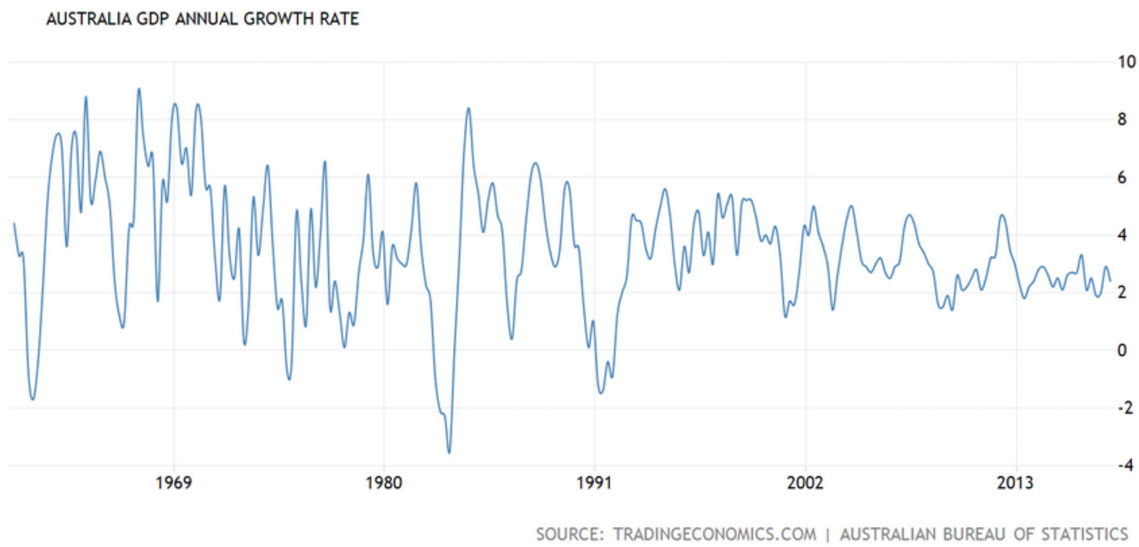

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Figure 9

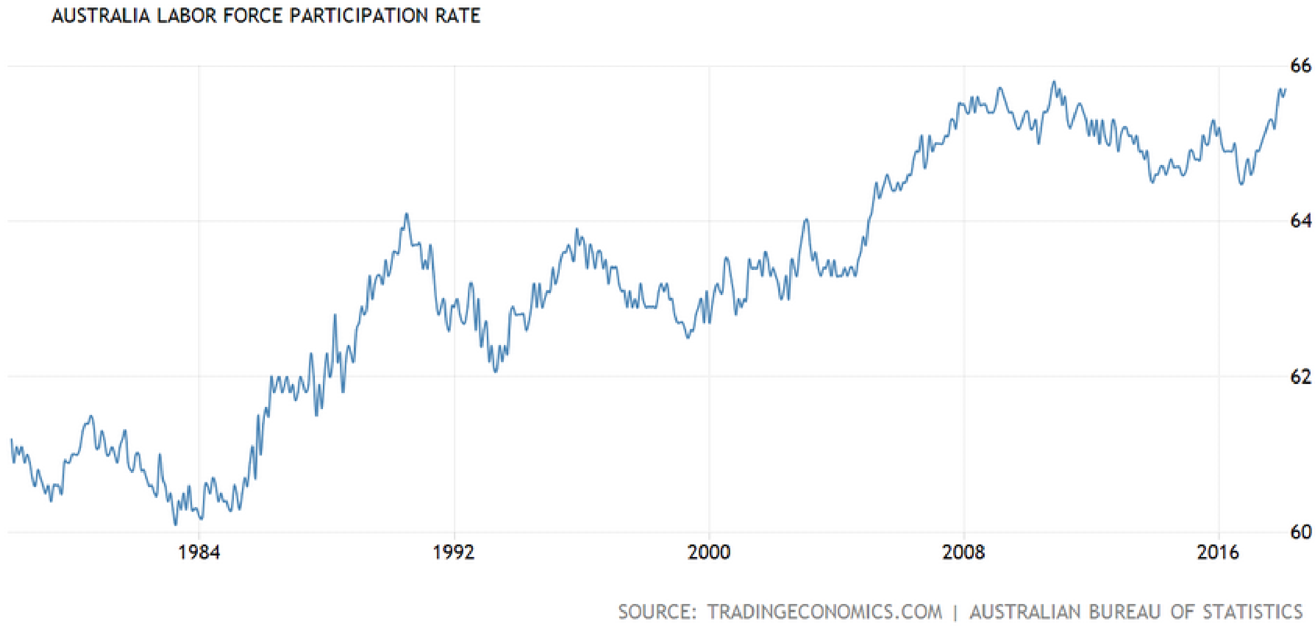

Figure 10

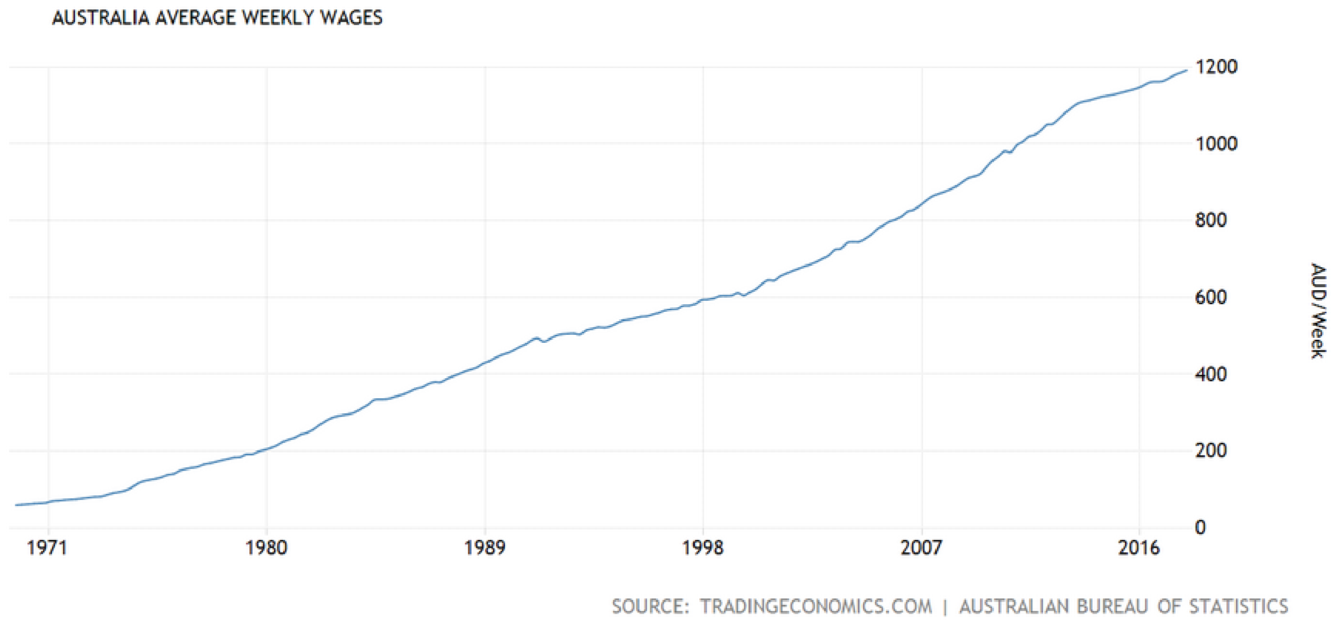

Figure 11

Figure 12

Acknowledgement (Data Sources): A number of data and graphical sources have been used to prepare this submission: Datastream, US Bureau of Statistics, Australian Bureau of Statistics, Australian Treasury, World Economic Forum, Tradingeconomics, Bloomberg, WRDS, IMF, World Bank, Internal Revenue Service and Australian Taxation Office.