

KPMG submission to the
Senate Economics Reference Committee
Taxation Laws Amendment
(Enterprise Tax Plan) Bill 2016

23 September 2016

Executive Summary

Thank you for the invitation to make a submission to the Senate Economics Reference Committee on the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*.

KPMG has written widely on tax reform generally and the need for a reduction in the corporate tax rate in particular. We welcome the proposed phased reduction in the company rate largely for the reasons outlined in the Explanatory Memorandum to the Bill.

This submission is relatively short. We have tried to deal with the main issues of concern to the Committee succinctly. We know that the Committee has a short time to deliberate and that there is a wealth of material on this subject matter produced by KPMG and others.

Put briefly, our main points are as follows:

1. While there is a divergence in the economic modelling on the degree of benefit arising from a reduction in the company tax rate, the direction and thrust of all “mainstream” models is similar. There are “outlier” models whose assumptions are not consistent with the mainstream. These outlier models should not be relied upon.
2. These mainstream models predict that corporate tax discourages investment and its incidence is largely borne by labour over the long term through lower real wages. Therefore, cutting company tax will have positive incentive effects for foreign investment and increase national income.
3. A reduction in the company tax rate is generally perceived to have a short term cost and long term benefit. This raises intergenerational equity issues. That is, in not reducing the company tax rate we place a burden on future generations. This is complex because the structural deficit is also a burden for future generations and company revenue and the structural deficit are inter-related.
4. The proposed phased approach has economic advantages as well as giving rise to greater community acceptance.
5. Alternative approaches that look to present tax advantages for new investment are “second best” options.

6. There is a growing band of international tax rates for medium size economies of between 17% and 26%. Australia needs to be within that band to be an attractive place for investment.
7. For domestic investment, the imputation system gives rise to a partial “claw-back” of revenue lost as a result of a lower company tax rate. This presents a more advantageous framework for lowering the company tax rate, rather than diminishing the need for doing so.
8. The assertion that a reduction of the Australian corporate tax rate will simply give rise to an increase in tax revenue for some foreign jurisdictions such as the US is a highly simplistic and incorrect analysis.
9. The relationship between a lower company tax rate and a change in the level of avoidance is a complex one but, in many circumstances, a lower rate will lead to lower avoidance.
10. The desirability of corporate tax reductions is a difficult message for the community, but it is important that this is more clearly articulated by policy makers and business.

Detailed comments

1. General

- 1.1 KPMG welcomes the phased reduction in the company tax rate as proposed in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*. We agree with the statement in the Explanatory Memorandum to the Bill that “a more competitive corporate tax rate will encourage investment, enhance productivity, increase the level of economic activity and over time increase real wages and living standards”.
- 1.2 KPMG has written widely on the need to reduce the company tax rate in the tax reform debate. Some of this material is contained in the attached appendix.
- 1.3 The purpose of this submission is to deal with the main issues in a succinct manner for consideration by the Senate Economics Reference Committee in the knowledge that it has a short period of time to make its deliberations.

2. Economic modelling

- 2.1 There is a substantial degree of consensus amongst economists that corporate tax:
 - has a very high economic cost or excess burden compared to most other taxes;
 - discourages foreign investment; and
 - is largely borne by labour over the long term through lower real wages.
- 2.2 That said, it is acknowledged that there are a variety of views amongst economists on the extent to which a lower corporate tax rate:
 - results in greater GDP through increased investment;
 - produces beneficial outcomes within a specific time period; and
 - gives rise to benefits to labour in the long term through increased real wages.
- 2.3 Those differences are largely dependent on various assumptions that are used to model the impacts of a corporate rate reduction. These assumptions can be divided into three categories.

- i. The responsiveness of foreign capital to the change in the company tax rate in making additional Australian investment;
 - ii. The extent to which the oligopolistic state of our economy limits the flow-through of benefits to real wages; and
 - iii. Other technical assumptions which drive the model towards a long term equilibrium.
- 2.4 In relation to (i), there is an argument that in the current international environment - with substantial holdings of cash not finding an investment home - foreign capital is not as responsive to a lower company tax rate as it would be in a normal investment environment. While this may currently be true, we believe it is unlikely to be true in the long term. That is, we need to get our settings right now, so that when the investment environment is more responsive, Australia has the policy settings in place to maximise the benefits.
- 2.5 In relation to (ii), most modelling would take into account, in one way or another, the fact that the economy does contain oligopolistic elements. However, the oligopolistic nature of our economy is not static with new disruptive models coming to the fore in many industries. This greater future flexibility in the economy both makes a reduction in the company tax rate more critical and suggests that, over the longer term, benefits flowing to labour, rather than capital, will be more substantial.
- 2.6 In relation to (iii), it is very difficult for a non-economist to make a judgement. What can be said, however, is that the available models can be divided into two groups: ‘mainstream’ and ‘outliers’. KPMG and Treasury’s models fall within the mainstream economic thinking on the likely benefits of a reduction in the corporate tax rate, along with many others. There are a number of “outlier models” which are based on assumptions which are generally not accepted in the mainstream economic community. These should be recognised for what they are: outliers. They should not be relied upon to the exclusion of mainstream economic modelling. That is, not all models are equal.
- 2.7 The following table outlines the benefits predicted by the mainstream models:

| Model | Tax cut modelled | Predicted benefits / conclusions |
|---|------------------------------|--|
| KPMG Economics (2016) ¹ | Australia – 30 to 25 percent | Increase in investment – 1.58 to 1.76 percent Increase in GDP – 0.62 to 0.78 percent Increase in GNP – 0.55 to 0.70 percent |
| Independent Economics (2016) ² | Australia – 30 to 25 percent | Increase in investment – 2.52 to 2.73 percent (\$6.8 to \$7.4b) Increase in GDP – 0.71 to 0.92 percent (\$11.6 to \$15.1b) Increase in GNI – 0.54 to 0.73 percent (\$8.8 to \$11.7b) Self-funding percentage – 55 percent |
| Treasury (2016) ³ | Australia – 30 to 25 percent | Increase in investment – 2.6 to 2.9 percent Increase in GDP – 1.0 to 1.2 percent Increase in GNI – 0.6 to 0.8 percent |
| Financial Services Council (2016) (modelling by KPMG ⁴) | Australia – 30 to 22 percent | Increase in investment – 3.4 to 4.1 percent Increase in GDP – 1.6 to 2.1 percent Increase in household consumption – 2.1 to 2.4 percent |
| PwC (2015) ⁵ | Australia – 30 to 25 percent | <i>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 become increasingly mobile, not less. Global action on profit shifting, if successful, will intensify competition for investment. Given these developments, the economic costs of [Australia's] current corporate tax regime are likely to escalate if no action is taken.</i> |

¹<http://www.treasury.gov.au/PublicationsAndMedia/Publications/2016/~media/628B02BF9F2B4CE098E9DD6196CD9D00.ashx>

²<http://www.treasury.gov.au/PublicationsAndMedia/Publications/2016/~media/ACCEB9F5E157439AAE854A9702D1136C.ashx>

³<http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2016/TWP2/Downloads/PDF/Treasury-Working-Paper-2016-02.ashx>

⁴ <http://www.fsc.org.au/downloads/file/ResearchReportsFile/GST.pdf>

⁵ <https://pwc.docalytics.com/v/pwc-protecting-our-prosperity-corporate-rate-reduction>

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| Deloitte (2015) ⁶ | Australia – 30 to 25 percent | <i>In short, lower rates of company tax encourage both Australians and the world to invest in Australia – spending more on everything from computers to mines, roads, shopping malls and office blocks. And the increased investment makes workers more productive, which in turn leads to them earning higher wages.</i> |
| Treasury (2014) ⁷ | Australia – 30 to 29 percent | Increase in capital stock – 0.25 to 0.45 percent Increase in GDP – 0.15 to 0.35 percent Increase in household consumption – 0.07 to 0.19 percent |
| UK HMRC / Treasury (2013) ⁸ | UK – 28 to 20 percent | Increase in investment – 2.5 to 4.5 percent (£3.6b to £6.2b) Increase in GDP – 0.6 to 0.8 percent (£9.6b to £12.2b) Self-funding percentage – 45 to 60 percent |
| Business Tax Working Group (2012) ⁹ | N/A | <i>[Treasury] modelling, while preliminary, suggests that a one percentage point cut in the company tax rate, depending on how it was funded, could have a positive economic impact in the long run, raising GDP and real wages by around 0.2 per cent, and increasing household consumption.</i> |
| Henry Review (2009) ¹⁰ | N/A | <i>Reducing taxes on investment would increase Australia’s attractiveness as a place to invest, particularly for foreign direct investment. Reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity. Such reforms would boost national income by building a larger and more productive capital stock and by generating technology and knowledge</i> |

⁶ http://landing.deloitte.com.au/rs/761-IBL-328/images/Tax_Reform_Paper_Pdf.PDF

⁷ <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2014/Economic-Roundup-Issue-1/Economic-Roundup-Issue-1/The-incidence-of-company-tax-in-Australia>

⁸ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263560/4069_CT_Dynamic_effects_paper_20130312_IW_v2.pdf

⁹ <http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2012/BTWG%20Final%20Report/Downloads/PDF/BTWG-Final-Report.ashx>

¹⁰ http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/afts_final_report_part_2_vol_1_consolidated.pdf

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|-----------------------------|---------------------------|---|
| | | <p><i>spillovers that would improve the productivity of Australian businesses and employees.</i></p> <p><i>... a shift away from company income tax towards greater reliance on taxing other less mobile factors of production, or on consumption, has the greatest potential to increase GDP and growth.</i></p> |
| OECD (2008) ¹¹ | N/A | <p><i>Empirical evidence obtained from both firm-level data covering a sample of 14 European OECD countries and industry-level data covering 21 industries in 16 OECD countries suggest that investment is adversely affected by corporate taxation through the user cost of capital.</i></p> <p><i>Corporate income taxes appear to have a particularly negative impact on GDP per capita. This is consistent with the previously reviewed evidence and empirical findings that lowering corporate taxes raises TFP growth and investment. Reducing the corporate tax rate also appears to be particularly beneficial for TFP growth of the most dynamic and innovative firms. Thus, it seems that corporate taxation affects performance particularly in industries and firms that are likely to add to growth.</i></p> <p><i>Shift of 1% of tax revenues from income taxes to consumption and property taxes would increase GDP per capita by between a quarter of a percentage point and one percentage point in the long run</i></p> |
| Zodrow (2008) ¹² | Canada – 22 to 15 percent | <p>Review of other studies and empirical evidence and concluded: <i>... on balance, the recent and planned reduction in corporate income tax rates in Canada seem entirely appropriate.</i></p> |

3. Long term benefits and intergenerational equity

- 3.1 It is generally thought that the benefit of a reduction in the company tax rate has a short term cost and a long term benefit, although the relative size and timing of both the cost and the benefit differs under different analyses. Notwithstanding those differences, this raises intergenerational equity issues.

¹¹ <http://www.oecd.org/tax/tax-policy/41000592.pdf>

¹² <https://www.ctf.ca/ctfweb/Documents/PDF/2008ctj/08ctj2-policy.pdf>

- 3.2 A high company tax rate which discourages future economic activity raises revenue in the short term for the benefit of this generation to the detriment of future generations. A structural deficit works in a similar manner as it is a borrowing from the future. This raises the complexity that the structural deficit and the level of company tax collected are inter-related.
- 3.3 What is attractive about the timing of the company tax rate reductions in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* is that it provides for an appropriate balance between solving the structural deficit and having the right policy settings for future investment.

4. Phasing based on size of business

- 4.1 Some may argue that there is no reason to distinguish between different sizes of businesses in the plan to reduce the company tax rate. This argument is not without merit, particularly as large foreign investment is likely to produce the most economic gain. That said, the phasing in the Bill is not inappropriate for three reasons.
- Firstly, the phased reduction is likely to achieve greater community acceptance.
 - Secondly, the immediate “claw-back” of revenue is likely to be greater under a phasing that favours smaller business. This is because smaller business is more likely to be domestically owned. For these businesses, a lower company tax rate is likely to result in lower franking of dividends and higher capital gains on sales of shares as a result of greater retained earnings. The claw-back on larger foreign owned businesses is generally less than for domestically owned businesses as franking of dividends paid to foreign shareholders only reduces withholding tax (and sometimes this withholding tax is not payable due to the operation of a tax treaty). Also capital gains on sales of Australian shares by foreigners are generally exempt from Australian tax unless the Australian company is land rich.
 - Thirdly, large businesses are more likely to have longer term investment plans. Thus a legislated reduction in a company tax rate in 8 years’ time, for instance, is more likely to result in a change in investment behaviour for a large business than for a small one.

5. New investment versus existing investment

- 5.1 A reduction in the company tax rate favours new investment and existing investment alike. This raises the question of whether one can successfully target new investment with a reduction in tax cost without providing a so-called “windfall” to existing investment. This is not an unreasonable approach and may be seen as “second best”.
- 5.2 However, the main problem with such an approach is to find the mechanism that appropriately targets new or Greenfields investment without sectorial bias. An investment allowance, for instance, has a strong bias towards mining and manufacturing and against service industries. But it is likely that our ability to compete for a share of the economic growth arising from the rise of the Asian middle class will be based on the effective tax rate in the services sector.
- 5.3 There are generally three levers for lowering the tax cost of foreign investment. They are (i) changing the thin capitalisation rules to make them more generous, (ii) capital allowances, such as an investment allowance or accelerated depreciation and (iii) lowering the company tax rate. We have recently tightened our thin capitalisation rules, consistently with international trends, and as noted above changes to capital allowances have a strong sectorial bias. Dual company tax rate models introduce great complexity and are likely to produce tax-driven restructuring which is not the best option.

6. International comparisons

- 6.1 There has been much commentary on the comparison between the Australian corporate tax rate and international tax rates. A number of observations can be made.
- Firstly, the detriment of a high corporate tax rate is generally seen to be greater for a smaller or medium size open economy, such as ours, than for a larger one. Thus a comparison of our tax rate with the US or Japan is not necessarily an appropriate one. Arguably the US and Japan can afford higher rates.

While this may be true as a general principle, it should be observed that there are substantial pressures within the US to reduce its company tax rate given that the US is experiencing a number of “inversions” and that most US-based multinationals are not repatriating cash back to the US given the additional tax cost. Many would say that it is likely that the US will decrease its corporate tax rate in the next decade. Japan, which has not relied on foreign investment for

growth, may maintain a high corporate tax rate, by way of contrast. This will have little impact on Australia.

- Secondly, it is likely that company tax rates internationally will settle within a band from 17% to 25 or 26%. Ireland is likely to remain an outlier on one side at 12.5% and India an outlier on the other side at 34.61%.
- Thirdly, the differential between the Australian tax rate and the Hong Kong (16.5%) and Singapore (17.0%) tax rates will become increasingly important throughout the 21st Century. This does not mean we need to meet their rates, but we are at a significant disadvantage to the extent that we are outside the 17% to 25 or 26% band.

7. Imputation

7.1 It is true that the imputation system significantly lowers the cost of capital for domestic investment. In one sense the company tax system needs to take into account shareholder taxation. That said, it is equally true that the substantial benefit of a reduced company tax rate arises from increased foreign investment. Non-residents receive minimal benefit from the imputation system. It plays very little or no role in determining the cost of capital for large businesses with significant foreign shareholdings.

7.2 Some would argue we do not need to lower the company tax rate because of our imputation system. The better argument is that because of the “claw-back” of otherwise lost tax revenue, the imputation system provides a superior framework for lowering the company tax rate. That is, imputation allows for greater foreign investment at the same prima facie loss of revenue produced by a reduction in the company tax rate.

8. Benefitting foreign revenues

8.1 It has been asserted that a reduction in the Australian company tax rate will largely transfer revenue from Australia to other jurisdictions, particularly the US. The reasoning behind this assertion lies in the fact that the US has a foreign tax credit system. If a dividend is paid from profits taxed in Australia, a US company recipient would receive a credit for the Australian tax paid and incur “top-up” tax to lift the tax payable based on the US tax rate, which is higher than the Australian rate. This would

reduce tax in Australia, so the argument runs, and increase tax paid to the US revenue authority.

8.2 A number of observations should be made in relation to this postulation.

- Most jurisdictions do not have a foreign tax credit system for the taxation of dividends from subsidiaries. They rely on an exemption system as Australia does. There are five countries apart from the US in the OECD that do not have exemption systems. They are Chile, Ireland, Israel, Korea and Mexico.
- A substantial portion of profits that are made in Australia are not immediately repatriated to the US or any other jurisdiction, but are reinvested in Australia. To the extent that profits are not repatriated, the analysis does not operate.
- Also the logic implies that any US investor would be indifferent to local jurisdiction tax costs if they are lower than the US tax cost. This simply does not sit with commercial reality. US businesses tend to model comparative investment returns based on local tax rates.

9. Avoidance and Base Erosion and Profit Shifting

9.1 The relationship between the corporate tax rate and avoidance is a complex one. It is certainly true that a lower tax rate reduces the incentive to transfer profits overseas. That said, there are other factors, such as the imputation system, which in some circumstances encourage enterprises who value franking credits to increase their Australian profits.

9.2 On the purely domestic front, if one looks at the behaviour within a corporation, a lower corporate tax rate reduces the incentive for aggressive tax planning. On the other hand an increase in the difference between the top marginal rate and the corporate tax rate may encourage the incorporation of certain activities that would otherwise be taxed at a higher rate.

9.3 The OECD Base Erosion and Profit Shifting (BEPS) project adds another dimension to this. To the extent that the BEPS agenda reduces what is termed double non-taxation it will put pressure on international corporate tax rates. Thus, if a US multinational with an Australian subsidiary can no longer receive the benefit of a tax deduction in the United States and Australia on the same interest cost, as is envisaged by the proposed anti-hybrid rules, then the corporate tax rate becomes more critical.

- 9.4 In our view, this is the right direction for the world to take to encourage investment and lift living standards. In the area of corporate tax, countries need to reduce the level of double non-taxation without creating double taxation and also reduce the tax cost of investment. This is the pro-growth scenario. In the absence of growth, we face a world of declining living standards and rising inequality.
- 9.5 Whatever one's view of *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*, we will all agree that this is not a world we want to leave for our grandchildren.

10. Community attitudes

- 10.1 In a fundamental way a country's tax system is the one that it wants. One that it has chosen. It reflects the way in which the multiplicity of statements of our leaders – political, business and civil society – have resonated with the broader community.
- 10.2 The desirability of corporate tax reductions is a difficult message. This is partly due to its complexity and nuance. Partly due to the diminished trust that businesses - along with political, media and religious institutions - have experienced in the last two decades. Some is due to the fact most of us do not perceive the difference between the legal incidence of a tax and its economic incidence. And also due to the fact that we focus on the here and now and not on the long term future. All these things are understandable. But they are also explainable. This is what is required for better corporate tax policy settings in the future.

Appendix

1. **Modelling the Macroeconomic Impact of Lowering the Company Tax Rate in Australia**, modelling for Treasury by KPMG Economics (2 May 2016) – [Link](#)
2. **The Economic Impact of a GST-funded Company Tax Cut**, modelling for the Financial Services Council by KPMG (14 January 2016) – [Link](#)
3. **Tax reform: KPMG’s submission to Treasury on *Re:think* tax discussion paper** (July 2015) – [Link](#)
4. **Economic Analysis of the Impacts of Using GST to Reform Taxes**, modelling for CPA Australia by KPMG Econtech (September 2011) – [Link](#)
5. **Analysis of the economic impacts of reducing the company tax rate to 29 per cent and 28.5 percent**, modelling for the Parliamentary Library by KPMG Econtech (12 August 2010)
6. **CGE Analysis of the Current Australian Tax System, Final Report**, modelling for Treasury by KPMG Econtech (26 March 2010) – [Link](#)