Mr Mark Fitt
Committee Secretary
Senate Economics References Committee

20 May 2018

Dear Mr Fitt

Thank you for your email of 3 April inviting me to make a submission to the Senate Economics References Committee regarding its "Inquiry into the Commitment to the Senate issued by the Business Council of Australia". I did not make a submission to the Inquiry because it appeared to me that the Inquiry was concerned with commitments made by certain, individual members of the BCA and that it was not concerned with economic modelling, which is my area of expertise. However, I note that two Inquiry witnesses, Professor Peter Swan and Dr Janine Dixon, have referenced my economic modelling and in the course of doing so have misinterpreted my work to the committee. The purpose of this letter is to correct the main misinterpretations.

Professor Swan, in an attachment to his submission, has already provided the Committee with a copy of my recent paper on "Modelling Australian corporate tax reforms: updated for the recent US corporate tax changes". He provided the February 2018 version, published as ANU Tax and Transfer Policy Institute Working Paper 2/2018. More recently, my paper has been published in near-identical form in the Australian Tax Forum, Vol. 33, No.1.

The main misinterpretations are as follows.

1. Significance of dividend imputation

In his submission, Professor Swan claims that the modelling of a corporate tax cut undertaken by me understates the significance of the dividend imputation system.

"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."

Thus, Professor Swan suggests that company tax does not significantly discourage investment in Australia because he supposes that most of it is claimed back as franking credits. In fact ATO data, which is presented in Table 5 of my paper, shows that this supposition is incorrect. In particular, over the last decade an average of only 30 per cent of company tax was claimed back as franking credits. My modelling is appropriately based on this ATO data, rather than on Professor Swan's incorrect supposition. The low observed utilisation rate of franking credits indicates that some company earnings are retained rather than distributed as franked dividends and that foreign investors do not sell their franking credits to domestic investors ("harvesting") on a large scale, points overlooked by Professor Swan.

2. Size of gains

Professor Swan suggests that the modelling of a corporate tax cut by me shows "very modest" gains. However, Professor Swan contradicts this claim in his own paper.

Tax economists rate the harmfulness of a tax using the concept of its marginal excess burden: the ratio of the loss in consumer living standards to the gain in government revenue when the tax rate is increased by a small amount. In commenting on a paper by Tran and Wende, Professor Swan writes that they find that "the marginal excess burden for the company income tax is incredibly high at 83 cents per dollar of tax revenue raised". My paper obtains an even higher estimate for the marginal excess burden (meb) of company income tax of 104 cents per dollar of revenue raised, as can be read from my Table 7. So if Professor Swan were being consistent, he would conclude that my paper shows that there is an "incredibly high" cost from not reducing the corporate tax rate from 30 per cent.

In my paper, reducing the corporate tax rate from 30 to 25 per cent, and fully funding this through an increase in lump sum tax, generates an annual NET gain in consumer welfare of $4.9 billion compared to an annual net budget cost of $4.7 billion, giving the meb of (100*4.9/4.7 =) 104 cents per dollar, as seen in my Table 8. This is a far more favourable net consumer gain to budget cost ratio than is available from reducing personal income tax (of 25 to 63 cents per dollar depending on the type of personal income tax cut), as can be seen from Table 7 of my paper.

3. Dynamic effects

Dr Dixon, in her testimony, suggests that "the big source of negativity towards the tax cut" is that it provides a windfall gain to "capital that's already installed on the day that the tax cut takes place".

Professor Dixon is correct in suggesting that a corporate tax cut provides a gain to "old capital", but is incorrect in suggesting that this means it is undesirable to cut the corporate tax rate. Rather, it is well established in the literature that, instead, the corporate tax cut should be phased in to limit the windfall gain to old capital, as noted in section 2.5 of my paper. Consistent with this, the proposed Australian corporate tax cut is being phased in over a long period extending to 2026-27.

The study by Tran and Wende confirms that Dr Dixon overstates the importance of the windfall gain for old capital. Like Dr Dixon, Tran and Wende use a dynamic model that is able to distinguish between new and old capital and so models the windfall gain. However, like the other modelling studies by Treasury and myself, they find that a corporate tax cut is highly beneficial.

4. Profit shifting

Dr Dixon suggests that an unreasonably large part of the benefit from reducing the corporate tax rate in my modelling arises from a reduction in profit shifting.

In fact, as documented in section 3.3 of my paper, my modelling uses the consensus in the recent literature on the sensitivity of accounting profits to the corporate tax rate. In contrast, Dr Dixon assumes profit shifting away.

My paper identifies the role of profit shifting in my results. As seen in Table 8 of my paper, reducing my profit shifting elasticity from a consensus value of 0.73 to a low value of 0.5, has only a small effect on the results. The estimated gain in consumer welfare from reducing the corporate tax rate from 30 to 25 per cent declines only slightly from $4.9 billion to $4.4 billion.

5. Dr Dixon's negative results

So why does Dr Dixon find that cutting the corporate tax rate reduces GNI when studies by Treasury, Tran and Wende and I all find that it raises GNI? As just discussed, Dr Dixon is mistaken in suggesting that the difference might be explained by the windfall gain to old capital or by profit shifting. However, it may well be explained by the fact that, in modelling the company tax cut, Dixon constrains the increase in "the ratio of net foreign liabilities to GNI". So while the main aim of the policy is to increase foreign investment, Dixon specifically limits the extent to which that can occur.

Yours sincerely

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