Company tax, investment and revenue

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Outline

1. Australian business investment remains subdued

Aggregate non-mining business investment remains subdued

Four factors account for changes in non-mining investment

2. A company tax cut would increase investment

National income could be above baseline within a decade

Investment responds to the cost of capital

The small company tax cut will have some impact on investment

3. Alternatives to a tax cut may have less budget impact

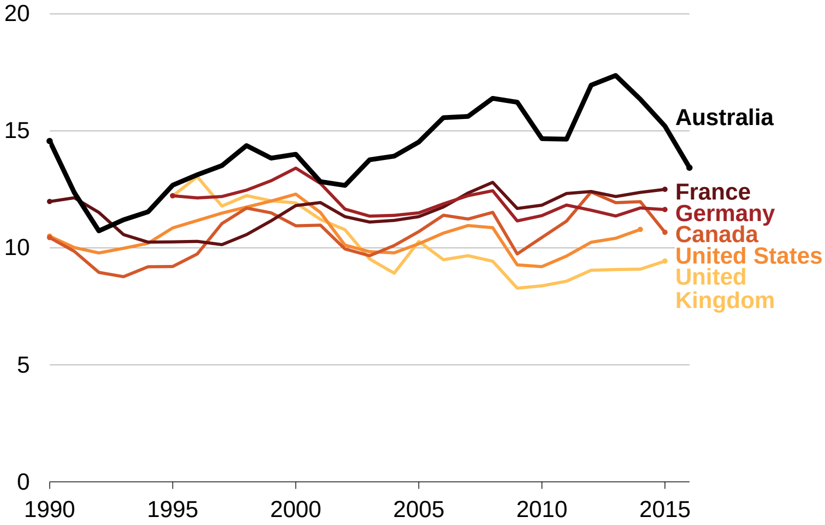
A company tax cut initially goes to the ‘back book’

Accelerated depreciation and investment allowances target the ‘front book’

Targeting new investment has downsides

After peaking in 2013, Australian business investment is moving toward the advanced-economy average

Business investment as a percentage of GDP

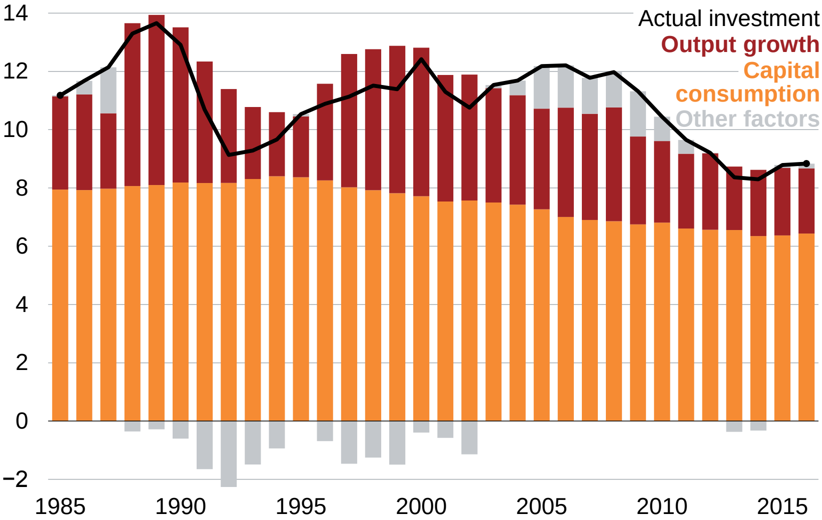


Notes: Includes mining and non-mining

Source: Grattan analysis of ABS (2016a), and OECD (2016b)

Aggregate non-mining business investment remains subdued

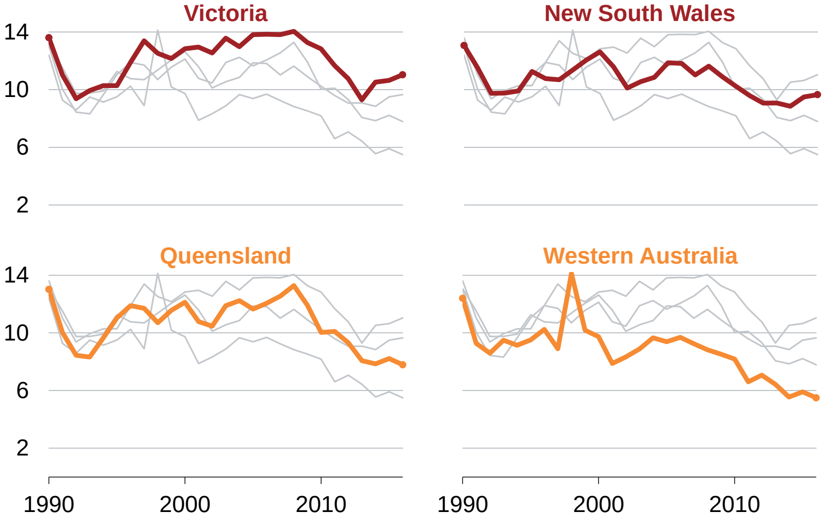
Modelled contributions to non-mining business investment as a percentage of GDP



Source: Grattan analysis of ABS (2016a)

Non-mining investment has started to pick up in the non-resource states

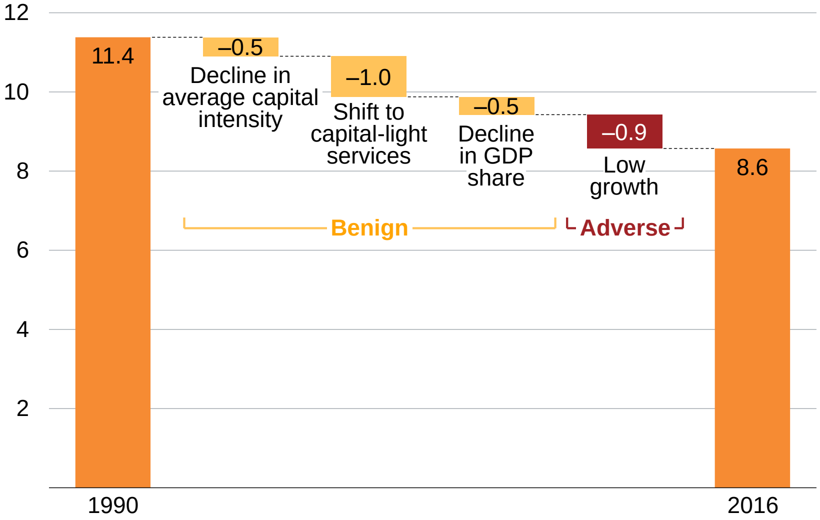
Non-mining business investment as percentage of GSP, nominal



Notes: Non-mining private business investment based on ABS experimental estimates.
Source: ABS (2016c), and ABS (2016b)

Four factors account for changes in non-mining investment

Non-mining investment as a percentage of GDP, 1990 and 2016



Notes: 1990: the average from 1986 to 1994. 2016: the average from 2012 to 2016.

Source: Grattan analysis of ABS (2016a)

A company tax cut would increase investment

Enterprise Tax Plan

- cut rate to 25 per cent over 10 years
- small companies get cut before large

- how long is the wait for benefits?
- how strong is the evidence?
- how much of a tax cut is a windfall?

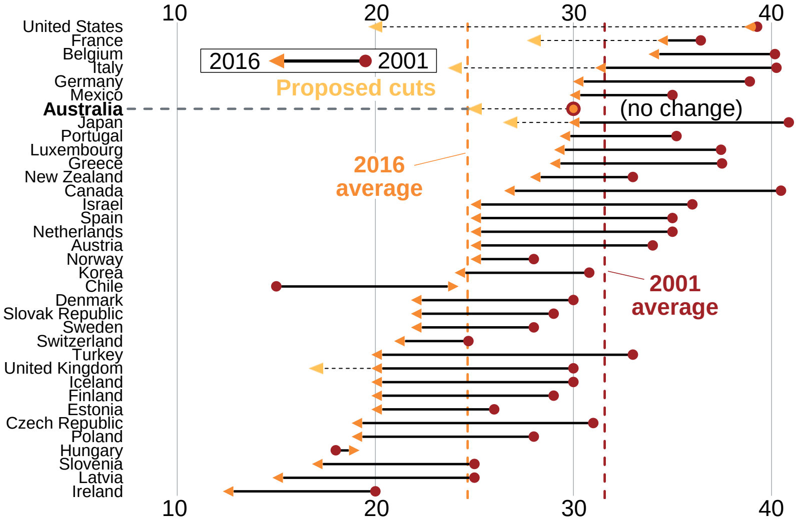
Alternatives

- accelerated depreciation
- investment allowances

- do they offer budget savings?
- do they distort investment?

Nearly all advanced economies have reduced their corporate tax rate since 2001

Corporate tax rates, percentage, OECD countries, 2001 and 2016

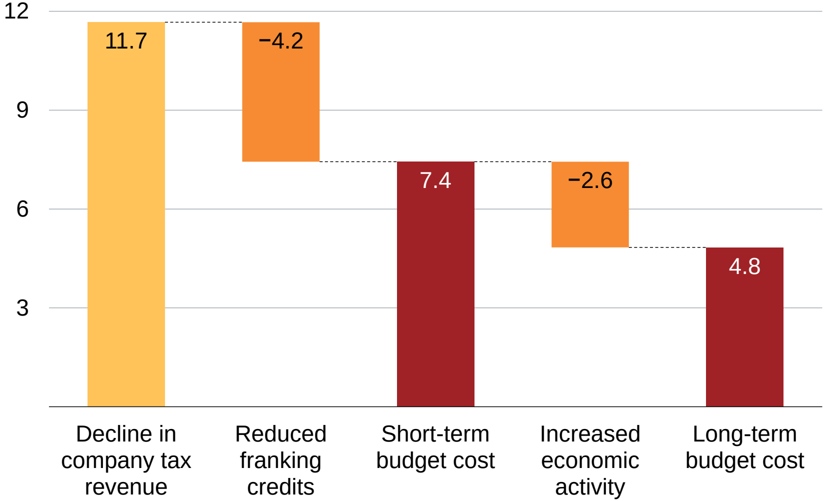


Notes: Includes taxes collected from central and sub-central governments

Source: OECD (2016a), and OECD (2016c)

The hit to the budget is partly recovered over time

Estimated contribution to budget deficit of a 5 percentage point company tax cut, $2017 billions



Notes: Treasury estimate that increased economic activity assumed generates a 35 per cent 'revenue dividend' when a company tax cut is funded by an increase to personal income tax. Long-term budget cost assumes zero baseline GDP growth
Source: Grattan analysis of Commonwealth of Australia (2016), ATO (2016), and Kouparitsas, Prihardini and Beames (2016)

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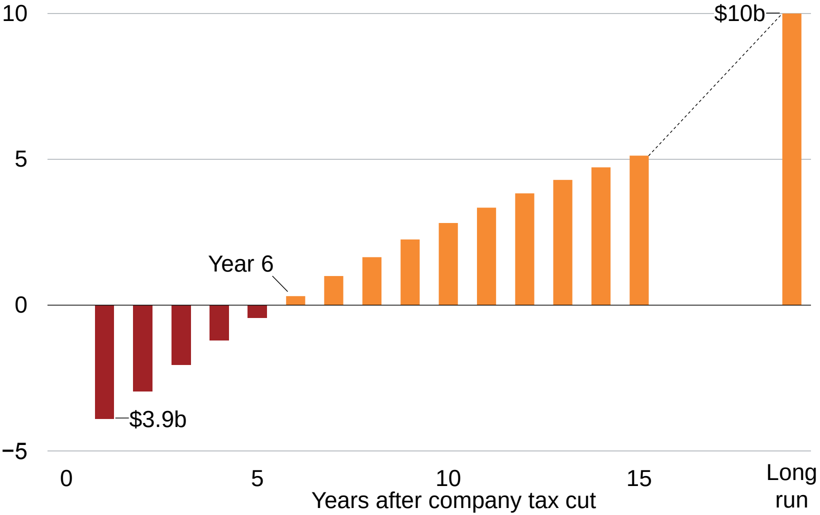
National income could be above baseline within a decade

Impact of 5 percentage point company tax cut on gross national income, $2017 billions



Notes: Assumes 50% adjustment in 10 years, and 80% in 20 years – see Kudrna and Woodland (2010)
Source: Grattan analysis of ABS (2016a), Kouparitsas, Prihardini and Beames (2016), and Kudrna and Woodland (2010)

Investment responds to the cost of capital

Three types of evidence on investment response

Foreign investment

- FDI rises by 2.3% for a 1% drop in the corporate tax rate across 45 studies[1]

Total investment

- Firm-level investment rises by 1.9% for a 5% point co. tax reduction (35 to 30%), across 21 OECD countries [2]

Australian investment

- RBA: strong negative relationship between investment and cost of capital[3]

Notes: If the average link between FDI and company tax held in Australia, a 5% point co. tax cut would increase FDI by 0.4% of GDP. Listed companies, all of whom have access to foreign capital, earn 60% of Australian taxable company income.

Source: 1. Feld and Heckemeyer (2011), 2. Arnold et al. (2011), 3. Cockerell and Pennings (2007)

The small company tax cut will have some impact on investment

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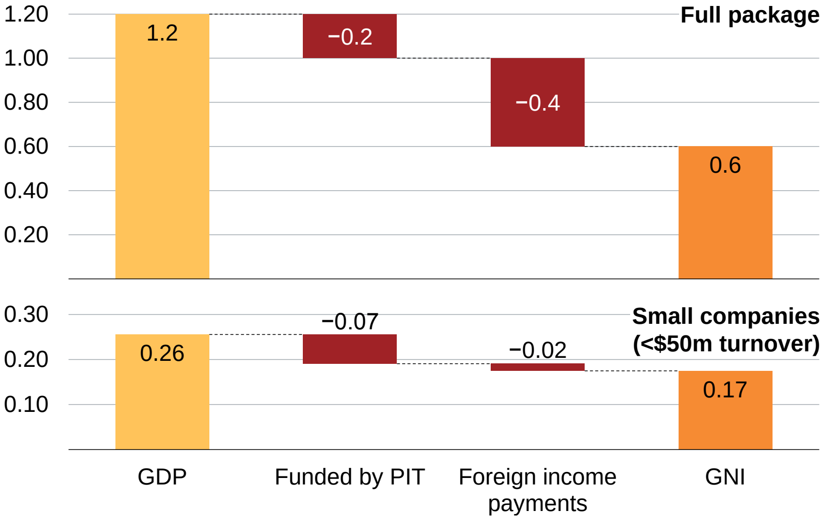
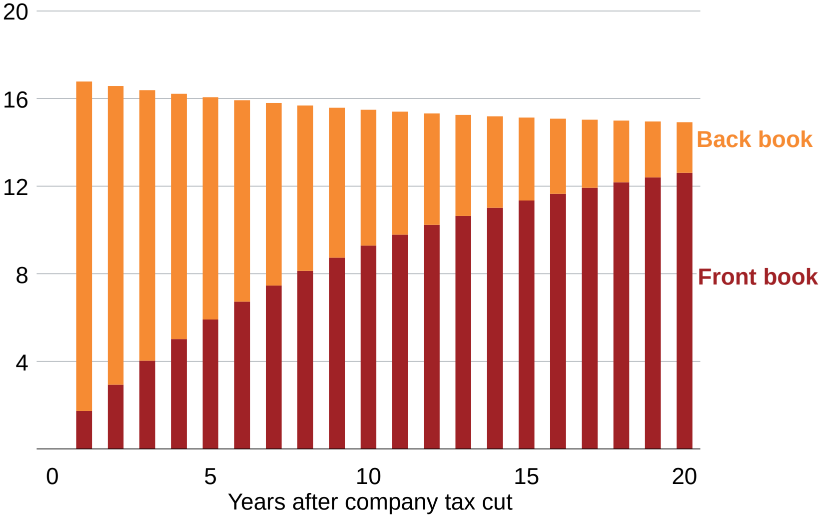
Long-run impact of 5 percentage point company tax cut, percentage points of GDP



Notes: Assumes average marginal rate of return increase of 3.3% for unlisted small companies (7% for listed companies)
0.17% increase in GNI equivalent to ∼$3 billion in today's economy
Source: Grattan analysis of ATO (2016), and Kouparitsas, Prihardini and Beames (2016)

A company tax cut initially goes to the 'back book'

Percentage of baseline company tax revenue lost



Notes: Assumptions: baseline investment-capital 10% (investment 2.5% higher under company tax cut); depreciation rate 7%; cost of capital 7.4%

Source: Grattan analysis of ABS (2016a)

Accelerated depreciation and investment allowances target the ‘front book’

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Accelerated depreciation

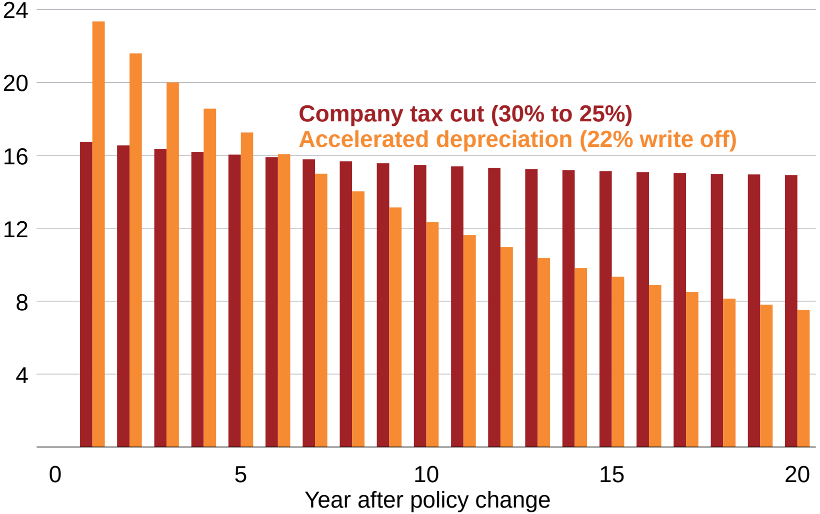
- immediately expense a proportion of all *new* capital purchases
- future depreciation schedules adjust
- similar to an interest-free loan

Investment allowances

- *bonus* expensing on a proportion of all *new* capital purchases
- no change to future depreciation schedules
- similar to an investment subsidy

Accelerated depreciation is more costly in the short run

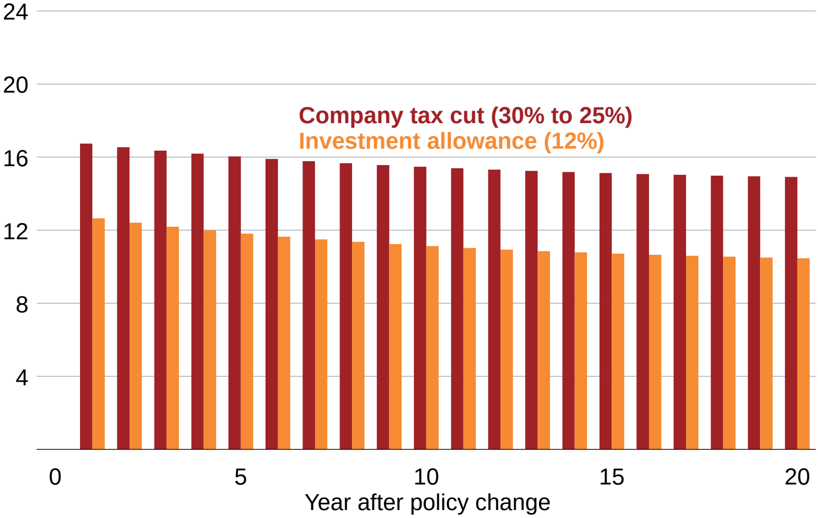
Percentage of baseline company tax revenue lost, representative firm



Notes: Assumptions: baseline investment-capital 10% (investment 2.5% higher under company tax cut); depreciation rate 7%; cost of capital 7.4%; return on capital (before tax and depreciation) 16.5%
Source: Grattan analysis of ABS (2016a)

An investment allowance would cost less than a company tax cut

Percentage of baseline company tax revenue lost, representative firm



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Source: Grattan analysis of ABS (2016a)

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Targeting new investment has downsides

	Company tax cut	Accelerated depreciation	Investment allowance
Short-term budget cost	windfall to back book	higher than co. tax cut for 6 years	about 25% less than co. tax cut
Long-term budget cost	some reduction in cost over time	about 50% less than co. tax cut	about 25% less than co. tax cut
Bias against long-life assets	reduces bias	reduces bias	does not reduce bias
Other	↑ gap between co. tax rate and top personal rate lower rate = less profit shifting rewards both investment *and* innovation	Investment timing longer before ΔGNI$>$0	Investment timing Incentive to relabel operating costs as capital expenditure

Advantage	Disadvantage

Summary

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