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Comparison of a lower corporate income tax rate for small and large businesses

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Abstract

The comparative effects of a lower corporate income tax rate on effective tax rates and investment decisions of small and large businesses are assessed, and some of the implications for the economy are explored. A lower corporate tax rate results in a larger reduction in the effective tax burden facing large businesses. This combined with the higher funds supply elasticity generates a larger investment response by large businesses, and flow on to GDP and labour incomes. Despite this, however, a larger share of the benefits of a lower corporate tax rate accrue to non-resident shareholders of large businesses.

Key words: corporate income tax, small business, large business, capital income taxation

¹ University of Melbourne. Email: j.freebairn@unimelb.edu.au. With the usual caveats, I gratefully acknowledge the informed comments of two referees.

The rest of the paper is as follows. Section 2 provides background data on: the mix of businesses by alternative measures of size and their relative contributions to the economy; and differences between small and large businesses in the sources of, and the elasticity of supply of, investment funds. The different tax treatments of capital income earned by corporate and other businesses, and for corporations between resident and non-resident shareholders are also discussed. (s) 10.8 (r)-3.9

Table 2 reports ATO data on the mix of companies classified as private and public companies, and the taxable income within each category.⁵ Over 99 per cent of the companies are private companies, and most of these are small, and family-controlled and managed. Public companies with an annual taxable income of more than \$5 million represent just 0.3 per cent of taxable companies, but they account for over 61 per cent of taxable corporate income. Many of these large companies are multinationals with a significant share of non-resident shareholders.

Table 2: Taxable Resident Companies Classified as Private/Public and by Taxable Income, 2013–14

Status and taxable income	Companies		Taxable income
	Number	Share of total (

The relative importance of small businesses varies across the different industries, with, for example, larger than average employment and value added shares in agriculture

Corporations depend on a mixture of debt and equity funds to finance their investments. Given the different characteristics of debt and equity, including a guaranteed but in general lower income and expense for debt, together with portfolio diversification preferences, debt and equity are imperfect substitutes for both savers and investors. While there is much heterogeneity across businesses in sources of investment funds and income distribution, and also across time for each business, there are some general patterns which have important implications for the effects of a lower corporate tax rate. On average, between 30 and 40 per cent of investment is financed by debt, and the majority of equity finance is from retained earnings rather than the issue of new equity (Fang et al., 2015). Supporting the latter is the observation that on average, two-thirds of the after-corporate income tax return on shareholder equity is distributed as dividends, and one-third retained, with a slightly higher payout rate for non-ASX and smaller corporates (Bergmann, 2016).

Since colonisation, Australia has been a net capital importer, and non-resident shareholders hold a large share of the equity used to fund investment by the larger companies. Across the business sector, average foreign ownership is around 33 per cent (ABS, 2016a). For most of the multinationals, non-resident shareholders represent 50 per cent or more, including around 80 per cent for mining companies (Connolly & Orsmond, 2011).

Most small businesses, both unincorporated businesses and family-controlled companies, are highly dependent for business equity on family savings and reinvested, or non-distributed, business income. Mati et al. (2012) estimate that less than 20 per cent of small businesses draw on outside debt or equity. Family-funded small businesses have to compete for limited household saving against alternative investments in owner-occupied housing,⁸ other property, publi(i)-4.u<</MCID opero7

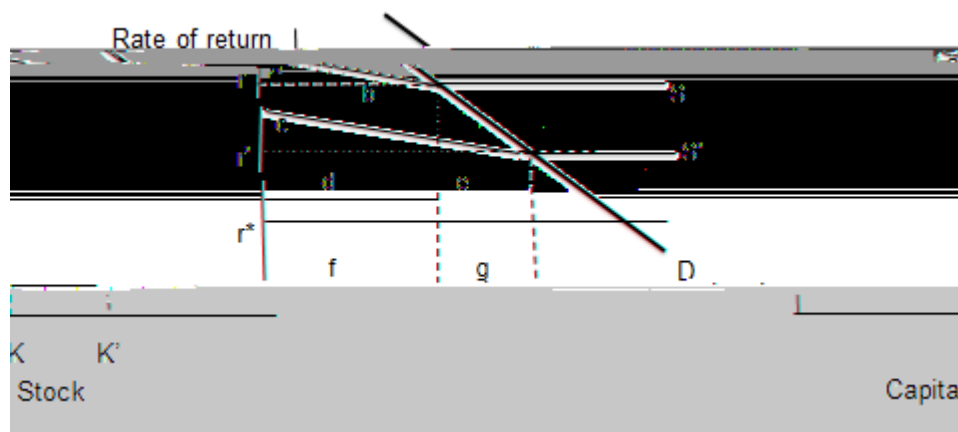
4. E

the import share of investment for small versus large businesses. The lower corporate tax rate induced expansion in the demand for labour, and increased labour incomes will be larger the greater the elasticity of substitution of labour for capital and the greater the share of geographic mobile investment (as illustrated in the sensitivity results from the computable equilibrium model studies of Cao et al. (2015) and Dixon and Nassios (2016)).

The increase in gross national income (GNI) will be less than the increase in GDP for large companies. Non-resident shareholders who are more important in large rather than small businesses receive much of the first round benefits of the lower corporate tax rate on existing investments, and they receive most of the after-corporate tax income earned on the additional investment (with a more detailed explanation in Figure 1 below). By contrast, for small businesses, and for those primarily with resident investors, most of the additional GDP stimulated by a lower corporate tax rate flows as higher after-tax incomes to resident shareholders and to employees. Bearing in mind that the available computable general equilibrium models employ a typical firm by industry and do not disaggregate for small and large businesses, the Treasury modellers (Kouparitsas et al., 2016) and Murphy (2016) estimate a positive GNI increase but less than the GDP increase, and Dixon and Nassios (2016) estimate a positive GDP increase but a negative GNI effect.

values available in the literature, would the revenue gain on extra investment, e , exceed the revenue loss on existing investment, $a + b$.

Figure 1: A Lower Corporate Income Tax Rate



In addition, and not shown in Figure 1, a lower Australian corporate income tax rate will likely reduce the magnitude of profit shifting by multinational companies from Australia to lower tax rate countries. If estimates of profit shifting to lower statutory tax rates for Europe by de Mooij and Devereux (2011) are generally applicable to Australia, a lower statutory corporate tax rate would reduce the magnitude of profit shifting by multinational companies and provide additional Australian company tax revenue to that shown in Figure 1.

By contrast, for small companies with resident shareholders, the first round government revenue loss from a lower corporate tax rate will be much less than for large companies with non-resident shareholders. For resident shareholders, under the imputation system a reduction of franking credits on dividends with a lower corporate tax rate is offset by a higher personal tax payment, and over time some of the lower corporate tax paid on retained earnings is recaptured as tax on higher capital gains or future higher dividends.

In addition to the partial recapture of the first round revenue cost of a lower corporate tax rate from shareholders, in the longer run the larger economy as measured by the increase in GDP means higher other tax bases and additional revenue. These gains include the larger labour income induced by the larger capital stock to increase income tax and payroll tax receipts. With a lower corporate tax rate inducing a larger investment increase, and then GDP increase, these second round revenue gains will be larger for a reduction of the corporate tax rate for large companies than for small companies.

An idea of the magnitude of revenue recapture from a larger economy promoted by a lower corporate income tax rate is given by the computable general equilibrium model studies. Assuming a representative firm for each industry, as opposed to the disaggregation into small and large businesses considered in this paper, the reported

Given that the increase in GNI is less than the increase in GDP, and extra tax revenue of area e is collected on the additional investment, the reported model results in the bulk of these papers seeming more consistent with the Figure 1 model than with the above wording in these papers.

net revenue gain is an aggregate or average. In aggregate, Kouparitsas et al. (2016) and Murphy (2016) estimate that about half of the first round revenue cost of a lower corporate tax rate would be recaptured; the smaller investment and GDP response estimate by Dixon and Nassios (2016) would generate a smaller recapture rate.

5. CONCLUSION

The many potential definitions of small and large businesses using characteristics such as turnover and employment, and then the characteristic quantity, are arbitrary. There is no general evidence that any of these measures of business size effectivel.6 (z)11.

Other important drivers of the magnitude of the investment response to a lower corporate tax rate include the elasticity of the investment demand function, the share of debt and equity, and the share of income distributed. On average, the elasticity of the investment demand function and the time profile of investment response to a lower effective tax rate

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