THE AUSTRALIAN

Tax system isn't broken, and 'fixing' it may not pay off

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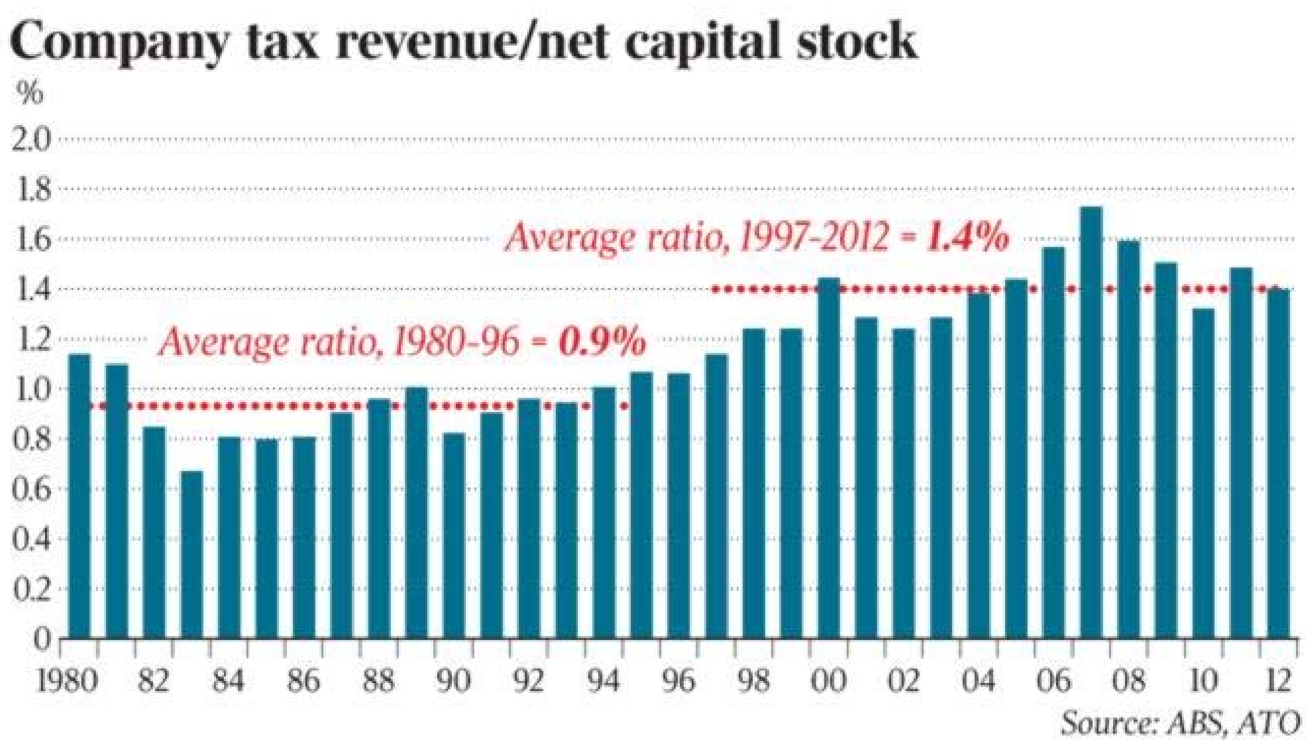

Company tax revenue / net capital stock. Source: TheAustralian

The trouble, it seems, is not that we spend too much: it's that we tax too little. And the Senate inquiry into corporate tax avoidance, chaired by Labor senator Sam Dastyari, is unlikely to leave much uncertainty about the culprits: those tax-dodging, revenue-shifting multinationals.

Now, conversions to virtue should always be celebrated. Bells will therefore have pealed in heaven when Dastyari, who was secretary of the NSW ALP during Eddie Obeid's final years, emerged as a poster boy for fiscal probity. And the fact the Abbott government has leapt on to his inquiry's bandwagon, foreshadowing drastic action against tax avoidance by multinationals, only underscores Dastyari's achievement.

After all, in these polarised times, it would take a heart of stone not be moved by the prospect of Joe Hockey, Bill Shorten and Christine Milne linking arms on a frosty Canberra morning as they chant "Tax the Fortune 500!"

But awkward questions remain. If company tax is purely voluntary, as Milne suggests, why are ruthless bean counters signing cheques worth nearly $70 billion to the tax commissioner? Surely the chief financial officers of the 10 companies that shell out a third of that total should be transported, presumably by private plane, to the Cayman Islands where, the inquiry was told, money slides into tax-free hideaways as smoothly as aged rum?

As for BHP Billiton and Rio — who in 2011-12 donated close to $12bn to the taxman, so contributing more than the 230,000 businesses in Australia's four largest industry sectors — what explains their folly? Was it merely that the rush to dig ore out of the ground left them no time to doctor their tax returns? And while we're on to puzzles, why are our corporates becoming increasingly tender-hearted, with the ratio of company tax "voluntarily'' paid to the market sector's net capital stock some 50 per cent higher in recent years than it was in earlier decades?

Perhaps love is in the air. But there is an alternative hypothesis: that as David Bradbury, then assistant treasurer in the Gillard government, said in September 2013, "our company tax system is far from broken". And plenty of reasons suggest Bradbury's assessment is the more plausible.

To begin with, our laws give the tax commissioner a general anti-avoidance power that, compared with the other advanced economies, stands out for its breadth and depth.

Nor do our laws leave many tools in the tax avoider's armoury: we have stringent controls on transfer pricing, tight limitations on intra-company interest payments and sweeping restrictions on financial transfers between related entities.

Yes, the "double Irish Dutch sandwich", that complex tax minimisation ploy which endlessly titillates the Fairfax press, may or may not have been legal in the US; what is certain, however, is that our "controlled foreign company" rules proscribe it.

The result is that avoiding, much less evading, company tax is costly, complex and risky. Dastyari's inquiry can therefore "roar its terrible roars and gnash its terrible teeth and roll its terrible eyes and show its terrible claws": the notion that billions of dollars are escaping the tax net will still make no sense.

That is not to deny some profit shifting occurs; as Cervantes' Don Quixote put it centuries ago, "what errant knight ever paid taxes?" But truckloads of doctoral theses give us a reasonable idea about the magnitudes involved. And not only are those magnitudes small, but the evidence suggests they have become smaller.

In the 1990s, for example, the textbook consensus was that the "semi-elasticity" of multinationals' pre-tax income to the company tax rate was about 0.8. Translated into English, that means a 10 percentage point difference between the Australian company tax rate and the average rate overseas would reduce multinationals' reported pre-tax income by about 8 per cent.

However, as tax laws have become more restrictive, the "semi-elasticity" has fallen to between 0.2 and

0.4. On those estimates, even if multinationals paid half of all Australian company tax, profit shifting would reduce the company tax take by one-half of 1 per cent, which is less than one-tenth of 1 per cent of Commonwealth revenues.

There are, of course, many uncertainties around those estimates. But even were the revenue losses larger, it is by no means obvious they make us worse off.

On the contrary, as the Henry report argued, and recent Treasury studies have confirmed, our high tax rates on globally mobile capital reduce investment and productivity, lowering Australian wages. By lessening that impact, profit shifting presumably creates benefits that Australian workers capture as higher incomes in the longer term.

And for the same reason, closing any remaining loopholes will ultimately reduce our wellbeing, not that of foreign shareholders, especially as the mining boom subsides.

Would outcomes be better were the clampdown co-ordinated internationally, eliminating the bolt-holes into which capital could flee? The experience of the 1920s and 30s, when the first great wave of double tax treaties occurred, suggests the opposite. With each country convinced it could fleece the sheep without skinning it, tax rates climbed, magnifying investment risk.

Rather, the best way to boost revenues is to increase productivity, not reduce it.

Lifting our gross domestic product by 1 per cent through higher productivity and labour force participation would, Treasury's modelling finds, raise tax receipts by nearly $4bn in its first year alone, 10 times any plausible gains from curbing profit shifting.

Unfortunately, that requires reforming industrial relations, as well as tackling wasteful programs such as the renewable energy targets: all of which would be anything but "dull and boring". And while Dastyari may have found virtue, sainthood is still some distance away.

Far easier then, to bash the multinationals. And if investment, productivity and living standards suffer, who's to know?