Just how important is cutting company tax rates?

The government is placing huge weight on its rather small cut in the company tax rate. However, Australia has an imputation tax system. That means that dividends that are 'franked' are effectively pre-payments of personal income tax. As a result, the company tax bites most when companies are paying dividends to foreign shareholders. Those dividends are typically covered by double tax agreements: so payments made on investments in Australia to foreign investors are taxed at the higher of the Australian or foreign tax rate. When the Australian rate of company tax is cut, the investor's tax liability only decreases if the effective Australian tax rate is higher than the tax rate overseas. In other cases, the result of cutting the Australian tax rate is simply to transfer tax from the ATO to its foreign counterparts.

This doesn't mean the company tax rate is irrelevant. But many of the problems with the company tax relate less to the rate itself than to aspects of its structure (what it taxes and when). And that is especially so given an imputation tax system.

Moreover, the government seems to be ignoring the problems, even in an imputation system, that arise when there is a large gap between the company tax rate and top marginal income tax rates. Increasing that gap strengthens the incentives for tax shifting and hence increases both the effective complexity of the tax system and the costs of ensuring compliance. With the government increasing effective marginal rates at the top (through measures such as the means-testing of the PHI rebate and the – supposedly temporary –flood levy), those issues are in any event becoming more acute.

Finally, there is more than a touch of exaggeration to the government's claims about small and medium sized firms. ATO data indicates that for 2008-09:

• There were 762,440 companies for company tax purposes.
• Of these, most (452,135) paid no tax or negative tax.

But according to ABS data (ABS 8165.0 - Counts of Australian Businesses, including Entries and Exits , Jun 2007 to Jun 2011), there were 2.05 million businesses during the same year. So it seems that most businesses aren't liable to pay company tax anyway, and that at least in 2008-09 (admittedly, a year affected by the GFC), most of those that are companies for company tax purposes didn't actually pay it (i.e. didn't have taxable income).