BUSINESS TAX REFORM: A COMPROMISE

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If the debate over the merits of the Government's Enterprise Tax Plan cannot be turned around in the next few weeks, we face the risk that this sorry political impasse will strand the entire plan. In this event, it would be better to compromise and lock in an achievable near-term goal while setting in train a more substantial evaluation of how we can build a more competitive tax system.

The business tax debate is complicated by several factors. These include the confusion over the role played by Australia's imputation system and the daunting budgetary outlook. But the need to increase our competitiveness and make Australia a more favourable destination for investment and reinvestment is undeniable.

While not the only positive of the Enterprise Tax Plan, the biggest benefit to Australia from a reduction in the company tax rate would come from improving the attractiveness of our country as a destination for foreign investment. By lowering the tax per dollar of profit, we would more successfully compete with the overwhelming majority of countries that do not tax investment as heavily as we do in Australia. The lift in inbound investment would help boost productivity, employment and wages.

Despite the strength of this argument and the favourable impact on new foreign investment and future growth, opponents nevertheless still portray the company tax cut as nothing more than a windfall to non-resident investors who were content to make their existing investments on the basis of the 30 per cent company tax rate.

So is there a way out of this impasse? I think there is.

Under the timetable set out in the Government's Enterprise Tax Plan, by July 2019 a company tax rate of 27.5 per cent would phase-in for companies with annual taxable incomes of $100 million or less. This would cover what the Australian Taxation Office (ATO) categorises as micro, small or medium-sized businesses.

As currently proposed, the Enterprise Tax Plan would then see the 27.5 per cent rate gradually extended between 2019-20 and 2023-24 to what the ATO call large and very large companies. Then over three more years the rate of company tax would gradually drop so that from the start of the 2026-27 year all companies would pay a rate of 25 per cent.

If the Enterprise Tax Plan is not acceptable to the parliament in its current form, we would propose a compromise. Rather than persisting with legislating the full Plan, only the initial tranche could be put to the parliament. This would see the 27.5 per cent phase in only for micro, small and medium-sized companies.

The Government and other supporters of a more competitive business tax system need not abandon the ambition of making further progress. And indeed the timetable as currently proposed need not alter either. However, the Government and other advocates would need to re-prosecute the case ahead of the next election and, if successful, re-present the remainder of the Enterprise Tax Plan to the next parliament.

While of a much smaller scale than the full Enterprise Tax Plan, the initial tranche is worth doing in its own right. Using the latest available statistics (for the 2013-14 year) from the ATO as a guide, in the 2019-20 year the 27.5 per cent rate would apply to close to 90 per cent of all taxable companies. For all these companies, investment incentives would improve, they would be more likely to employ additional staff and their competitiveness would lift.

At the same time, the cost to the revenue of the legislated tranche would be very much smaller than the cost of the full Enterprise Tax Plan. While they comprise about 90 per cent of taxable companies, micro, small and medium-sized companies account for only about one third of total corporate taxable income and tax paid. (The other two-thirds is accounted for by large and very large companies).

A further virtue of focusing the company tax cut on the small to medium end of town is that the reduction in the company tax rate is very tightly targeted to profits that are reinvested rather than distributed.

This is because, overwhelmingly, these companies are owned by Australian residents and under our imputation system profits distributed to domestic shareholders are taxed at shareholders' marginal tax rates less the credit for the company tax paid. With lower company tax paid and fewer imputation credits available, the total quantity of tax paid on distributed profits does not change even though the company tax rate is lower. As a result, the revenue cost of the measure arises only from profits that are retained and reinvested in the company.

Australia's GDP fell in the September quarter of 2016. Employment growth has been weak and business investment is in the doldrums. A cut in the company tax rate tightly targeted to profits that are reinvested makes a lot of sense, both in its own right and as a much-needed display of morale-boosting bipartisanship.