Globalisation and the dilemmas of income taxation in Australia

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Abstract: Over the past two decades there has been a worldwide fall in statutory corporate tax rates. Focusing on Australia, this article establishes three empirical facts which challenge much of the existing literature. First, corporate tax competition was the crucial driving force behind corporate tax cuts. Second, policymakers had to abandon tax related investment incentives in order to pay for lower corporate tax rates. This broadening of the corporate tax base is costly, because it potentially disadvantages domestic firms and may, over the longer term, erode the corporate tax base. Third, corporate tax cuts have put pressure on the personal income tax base, as low corporate rates provide tax avoidance opportunities for high-income earners.

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Introduction

One of the most striking trends in corporate taxation over the past two decades has been the sustained fall in corporate tax (CT) rates. Between 1980 and 2003 the average tax rate (inclusive of surcharges and sub-national taxes) for 21 OECD countries fell by almost two-fifths, from around 50 to almost 30 percent, and this trend shows no sign of abating (Figure 1 below). Despite the strength and significance of this downward trend, its causes and its likely implications continue to be debated. While early accounts emphasised international tax competition as being a major cause (Steinmo 1994; Lee and McKenzie 1989; Hallerberg and Basinger 1998), most subsequent work has been wary off exaggerating the effects of internationalisation (Quinn 1997; Swank 1998; Garrett 1998; Swank and Steinmo 2002; Hobson 2003; Ganghof 2000). These 'revisionist' explanations of recent developments in corporate taxation emphasise the diffusion of ideas in relation to what constitutes 'good' tax policy and domestic policy learning as the driving force behind income tax reforms. They stress that domestic policymakers chose to cut corporate and personal income tax rates and broadened tax bases in order to achieve the goal of a more 'neutral' or 'market-conforming' tax base (Swank 1998). According to Swank and Steinmo (2002, 645), this ideational shift amounted to a new 'policy paradigm' (Hall 1993) in which domestic policy makers recast the rational for corporate and personal income taxation (see also Steinmo 2003b). The second claim made in this revisionist literature is that the consequences of corporate tax cuts are relatively minor. It is argued that as most governments broadened the corporate tax base, little or no revenue has been lost due to corporate tax cuts.

Figure 1 about there

This article argues that while the revisionist literature captures important aspects of recent corporate tax cuts and rightly warns against exaggerating the effects of 'globalisation', it may underestimate the importance and long-term impact of corporate tax competition. It seems that while there certainly are many benefits from economic globalisation, such processes are constraining the policy capacity of nation states in the income tax arena. More specifically, focussing on the Australian case, we advance three general claims about the competitive pressure on *statutory* CT rates:

1. Competitive pressures have been a crucial driving force behind the trend toward lower CT rates. Even if policymakers wanted to persist with high CT rates, the costs of persisting with such a policy became too high.
2. A combination of competitive pressures on statutory CT rates and the need to maintain revenue yield has forced governments to broaden the CT base. Removing CT concessions in this manner has shifted the corporate tax burden towards new investment by domestic companies. This may result in a long-term reduction in the tax burden on corporations.
3. Competitive pressures on statutory CT rates also tend to 'spill over' into personal income taxation. More specifically, a large tax rate gap between the CT rate and the top rate on personal income makes sustaining high marginal personal income tax rates significantly more *expensive* – economically, administratively, and politically. In the long run it creates a bias in favour of 'flattening' personal income taxes.

These findings are important on at least two levels. Not only do they further our understanding of how globalisation impacts taxation, they also provide broader insights into the role of ideas and institutions in the domestic politics of income tax reform. While institutions have the potential to play a significant role in mediating the impact of international developments on domestic politics, we argue – in line with the comparative evidence reported by Ganghof (2001) – that while domestic actors had little impact on corporate tax cuts, they played a crucial role in the debate relating to personal income taxation. This differential can be explained by the relative politicisation of the two policy arenas. Essentially there was bi-partisan support for the imperative of lowing the CT. Under these circumstances the institutional capacity of the government of the day to push ahead with CT rate reductions was not tested by so called 'veto players' (Tsebelis 2002). In contrast, the implications of CT rate reductions for the personal income tax base have been highly politicised in the Australian context. Under such circumstances institutional factors and the cut and thrust of interest group and electoral politics have a much greater influence over policy trajectory. However, arguments about veto power and institutional vulnerability can only explain policy outputs in the short run, because they take

actor's (both parties and interest groups) policy preferences as given (Ganghof 2003). The more important issue is how these preferences change in the long run, and why. In this respect the article sheds light on the role of ideas in income tax reform (Steinmo 2003). The recent literature has moved beyond pitching 'ideas' and 'interests' against each other as causal factors and highlighted the ways in which new ideas and changing material conditions interact. However a pre-condition for such analysis is a clear empirical account of how actors' material incentives changed (cf. Brooks and Wohlforth 2000; 2002). This article provides such a foundation by demonstrating in the Australian context how corporate tax competition has compromised the long term economic viability of high marginal personal income tax rates.

It must however be emphasised that our primary goal is to explore the mechanisms of CT competition rather than estimate or determine its precise effects. It is therefore difficult to draw strong conclusions about *how much* competitive pressure has or will reduce states' policy autonomy. At this level we believe that the debate about the constraining versus enabling role of globalisation (e.g. Hobson and Ramesh 2002) would profit from amore detailed understanding of the causal pathways through which competitive pressure limit domestic policy options. While the 'revisionist' literature has rightly emphasised the fact that *on average* corporate or capital income tax revenues have not fallen, these observations have shed little light on the more complex patterns of intersectoral or international variation in tax revenue trends, nor do they allow any firm predictions about the future (Ganghof 2000).

Reflecting these objectives the following section reviews the mechanisms of corporate tax competition. Section three describes the structure of the Australian income tax system before the watershed US tax reforms of 1986. Sections four and five then analyse the direct and indirect effects of increasing tax competition. The article concludes by assessing the implications of international tax competition for Australian policy makers as they address the issue of income tax reform.

The mechanisms of corporate tax competition

Corporate tax competition manifests itself in a number of ways. Here we are only concerned with the competition on the *statutory* CT rate (as opposed to the *effective* rate), although we do assess the impacts of this competition on the broader income tax base. There are three main reasons why statutory CT rates matter in an open economy.

First, for multi-national enterprises (MNEs) in particular, statutory tax rates play an important role in strategies of *international tax avoidance* (Ganghof 2000; Hallerberg and Basinger 1998). MNEs can shift profits from high-tax into low-tax jurisdictions, so that the tax base of MNEs might migrate even though investment does not. The most important technique is the manipulation of transfer prices – the prices charged in intra-company trade. Since this intra-firm trade makes up a growing share of international trade in goods and services, transfer pricing is a serious problem putting significant pressure on policymakers to reduce statutory CT rates.

A second reason for MNE's sensitivity to statutory rates of corporate taxation relate to procedures for the *treatment of foreign sourced income*. In many OECD countries, a parent company can claim a foreign tax credit for the repatriated profits of a foreign subsidiary in order to avoid double taxation of foreign income. However, such countries invariably do not pay refunds when their taxpayers pay a foreign income tax at a rate that is higher than the domestic rate (OECD 1996, Article 23B; Arnold and McIntyre 1995, 44). In addition, the tax code of some countries, most notably the U.S., attempts to redefine the base on which foreign taxes are levied to bring them in line with U.S. definitions (Arnold, Li and Sandler 1996; Chennells and Griffith 1997, 172, n. 50). Hence, it is the statutory rate that defines the credit limitation. For example, a U.S. parent pays the U.S. rate on foreign profits as long as the foreign statutory rate is lower than in the U.S.; if the foreign rate is higher, however, the firm pays the foreign tax. American MNEs thus have an incentive to locate subsidiaries in countries with a tax rate lower than or equal to the U.S. domestic rate. In turn, governments have an incentive to keep their rate in line with other countries.

This link between statutory CT rates and foreign tax credits assumed particular importance after the U.S. tax reforms of 1986. The reason was not only that U.S. foreign direct investment is especially important for many countries, but also that the 1986 reform changed a number of important technical details that made American MNE's even more sensitive to tax rate differentials (e.g., Bossons 1988; Lyon 1996). This was immediately recognized by the bureaucrats in national Ministries of Finance (Thomas Menck in McLure et al 1990, 45). As Australia's recent Review of Business Taxation summarises:

> By providing a competitive CT rate, non-portfolio foreign investors in Australian companies can benefit because they will be better placed to utilize foreign tax credits available in their home jurisdictions – reducing the possibility of foreign tax credits being lost because the Australian tax rate is higher than their home country rates. (Review of Business Taxation 1999, 425)

Finally, competition for *profitable* foreign direct investment places pressure on statutory tax rates. Economic tax theory distinguishes between the 'normal return on capital' and 'pure profits'. Investment projects that just earn their own financing costs – so-called marginal investments – are said to generate a 'normal' return on capital. In contrast, inframarginal investment projects also generate pure profits. Since investment allowances tend to work at the margin, the tax rate on pure profits is to a large extent defined by the statutory tax rate. The real importance of this argument is that the significance of the statutory rate of corporate tax increases with the profitability of investments. Owing to their very profitable nature, there is increasing empirical evidence that MNE's locational decisions are to a significant extent based on the tax rate on pure profits (e.g., Devereux and Griffith 2003). Therefore, if countries aim at attracting *profitable* foreign direct investment, they have a strong incentive to decrease the statutory CT rate.

These three mechanisms go a long way explaining the strong downward trend in CT rates after the US tax reform of 1986. Furthermore, as the theory of tax competition predicts, there is a clear statistical relationship between country size (measured by population) and CT rates (Sørensen 2000; Ganghof 2001). Smaller countries reacted more quickly to the 'shock' of the US reform and have consistently

maintained lower CT rates than larger ones. Hence, while Australia's CT rate has generally tracked the average rate of advanced OECD countries (Figure 1), it is not particularly low compared to other smaller countries. For example, Ireland has a CT rate of 12.5% and all of the Scandinavian 'high-tax' countries have rates below 30%.

Tax competition and the dilemmas of Australian income taxation

In the 1970s Australia's tax system was in many ways typical of other Anglo-economies. The total tax/GDP ratio was moderate at around 30%, but after the inflation of the 1970s Australia was highly dependent on income taxes, a situation which was compounded by the absence of a comprehensive consumption tax. Top marginal rates on corporate and personal income were somewhat below the OECD-average: 46% and 60% respectively (Figure 1). As in other countries, however, many of the concessions and exemptions in the income tax code were systematically exploited by professionals and the self-employed to minimise their tax obligations.

One core concern of policymakers was the corporate tax system. Australia operated a so-called 'classical' system which taxed distributed corporate profits (at least those not flowing to tax-exempt shareholders) twice: at the level of the corporation and once more in the hands of the shareholder. Tax experts and policymakers believed that this system created serious economic distortions (Evans 1988, 17; Evans and McKenzie 1989; Freebairn 1997), for it lacked neutrality between different entity structures (incorporated versus unincorporated businesses) and between different types of finance (debt versus equity). Indeed, with a CT rate of 46% and a top personal rate of 60%, distributed corporate profits were taxed more heavily than any labour income. For example, a shareholder on the highest marginal income tax rate may face a total tax burden of up to 78% on distributed dividends: 46% at the corporate level plus up to 32% at the personal level ([1 – 0.46] * 0.60). These concerns about the absence of neutrality in business taxation were to a large extent motivated by the potential for tax avoidance. The differentiation of tax rates provided strong incentives to avoid taxes by shifting taxable income into the 'sectors' of lenient taxation, opportunities that were particularly numerous prior to the capital gains tax reforms of 1985 (Vann 1997, 16-17).

Reflecting these concerns, the Hawke Labor Government embraced the cause of tax reform in 1984, releasing a Draft White Paper in 1985. The basic features of this initiative so far as direct taxation was concerned, included broadening the income tax base through the inclusion of realised capital gains and income taken as fringe benefits, while reducing the top personal income tax rate from 60 to 49 percent. Later in 1985 it was announced that the classical corporate tax system would be replaced with a 'full imputation system', which gave shareholders a tax credit for taxes paid at the level of the corporation. A significant feature of the reform was that it *increased* the CT rate in order to align it with the reduced top personal rate – a feature which we hereafter call taxation 'symmetry'. This symmetric imputation system had been proposed by the Canadian 'Carter Commission' in 1966 in order to achieve maximum neutrality between different legal forms and different types of financing (Royal Commission on Taxation 1966). Even for taxpayers in the top income tax bracket there was no tax-incentive to adopt a particular entity structure or to retain profits that would otherwise be distributed. Apart from Germany, Australia and New Zealand were the first countries in the world to fully implement this symmetric system of business taxation in the mid-1980s. The symmetric imputation system was therefore regarded as a major achievement that set Australia apart from almost all other OECD countries (Evans 1988). While the new corporate tax regime involved increasing the statutory rate from 46 to 49 percent, business was generally supportive of the proposal on the basis that ending double taxation was expected to reduce net revenue yield by approximately four percent (Keating and Dixon 1989, 39).

It is also important to note that these reforms did *not* aim to completely remove investment incentives from the corporate tax base. With respect to the accelerated depreciation of investment in particular, the Government argued that it was necessary to provide inflation-adjustment (Porter and Trengove 1990, 66; Jones 1993, 60). There was no intention at that point to move toward a regime of 'real economic depreciation'.

As part of its ambitious reform agenda of the mid-1980s the Hawke Government had planned to further reduce marginal and average income tax rates by shifting the tax mix onto indirect taxes (Review of the Australian Taxation System Draft White Paper 1985). As part of the initial 1985 reforms Treasurer Keating was determined to introduce a broad-based 12.5% retail sales tax. However, the

Government failed to win support for broad-based consumption tax and was forced to abandon this proposal. This failure, while not of direct relevance to this article, had significant ramifications for tax reform between 1985 and 1998. More specifically, by restricting the growth of the indirect tax base it made the revenue-raising function of the income tax base (both corporate and personal) more important and thus income tax cuts more difficult to achieve.

The *direct* effect of tax competition: tax-cut-cum-base-broadening

The reforms announced in September 1985 had not even been implemented when Treasury experts and policymakers expressed concerns about the increasing pressure of tax competition. Initially, there was a hope that foreign corporate investors would carefully assess the overall corporate tax system and the effective level of taxation rather than focus on the high statutory 49% rate (Evans 1988, 30-37). However, bureaucrats and policymakers clearly understood the above-outlined mechanisms of tax competition and anticipated future tax cuts:

> At present there is a major incentive for resident corporations to maximize their taxable deductions in Australia while minimizing reported income. Income may instead be recognized in a low-tax country so that the total tax liability can be minimized on a worldwide basis, with the major loser being the Australian revenue. My understanding is that the recent reductions of the U.S. and U.K. corporate tax rates have raised concerns in other countries that this type of practice will become widespread. (...) The only effective reaction seems to be for other countries to follow the lead of the United States by lowering their corporate tax rates through a process of base broadening (Evans 1988, 37).

Since the late 1980s there has been a reasonable consensus across partisan lines that the CT rate needs to be competitive (Head 1989, 13; see also Sandford 1993, 98; Hobson 2003). After the 1987 federal election, the Labor government cut the rate to 39 percent (Figure 1). Given the governments' budgetary and macroeconomic policy goals, revenue-neutrality was essential. Hence, the only way to achieve a competitive CT rate was to broaden the corporate tax base. Under the prevailing circumstances the government had no alternative other than to wind back existing accelerated depreciation provisions. Given that these provisions had historically been justified as implicit inflation adjustment, removing depreciation provisions and embracing a 'real

economic depreciation' regime should have been associated with the indexation of the tax base. However, given the costs of establishing real economic depreciation, the Treasurer now argued that cuts in depreciation allowances were a trade-off to fund a lower CT rate. It thus appears that the 1988 cuts to accelerated depreciation allowances were not motivated by the policy preferences of domestic actors but were necessitated by international tax competition (cf. Head 1989, 13).

Beyond providing *ad hoc* inflation adjustment policymakers had used domestic investment incentives as an instrument to promote investment. In 1993 the Labor Party, confronting a persistent recession and waning electoral support, increased corporate tax allowances in order to stimulate domestic investment (Sandford 1993, 105; Chennells and Griffith 1997, 104-106). These increased concessions were combined with a further cut in the CT rate to 33%, resulting in a significant reduction of corporate tax revenue. In the face of persistent budget deficits such an approach was not sustainable and, in 1996, the CT rate was *increased* to 36% while depreciation allowances were either maintained or increased (Hobson 2003, 11).

This evidence strongly suggests policy makers regarded depreciation allowances and other corporate tax incentives as legitimate policy instruments. However, with competitive pressure on the CT rate increasing, it was only a question of time before a further review of depreciation provisions became necessary. Indeed such changes were made in 1996 by the then newly elected Howard Coalition Government. As can be seen from Figure 1, this was a time when many countries further cut their CT rate to enhance their competitive position. Unsurprisingly, therefore, the Howard government continued Labor's policy of giving competitiveness (in terms of a low CT rate) priority over domestic investment stimulation (Harris 1999, 251; Ferrers 2000, 32). As part of a broader *Review of Business Taxation*, the government cut the CT rate further from 36 to 30%, which became effective in 2002 (Figure 1). According to the Ralph Committee which formulated the corporate tax reforms, the tax cut was designed to 'make the headline rate of corporate tax internationally competitive, both in terms of the Asia Pacific region and compared to the CT rate operating in capital exporting countries' (Review of Business Taxation 1999, 425).

As before, revenue had to be recouped by reducing domestic investment incentives, especially by decelerating depreciation. Again, this was a price to be paid

for competitiveness, rather than being a conscious decision to eliminate tax based investment allowances. The Ralph Committee argued that these rules were an important policy tool and made it clear that the decision to abolish such allowances was solely a concession to the combined effect of competitive pressures and budgetary constraints. Since business tax reform had to be revenue-neutral, the committee had to choose between cutting the CT rate or maintaining accelerated depreciation. It found this trade-off to be the 'most difficult of all'. In the absence of corporate tax competition, the decision would almost certainly have been against a lower CT rate and for retaining accelerated depreciation.

But why is this decision important? Does it really make a difference whether countries choose a regime with high tax rates and a narrow tax base (due to investment incentives) or one with low rates and a broader base? The political economy of tax literature generally argues that over the long run, the structure of the tax system will influence the *level* of taxation (Hettich and Winer 1999; Ganghof 2000). Hence, the less 'efficient' the structure of corporate taxation, the less revenue governments can extract, *ceteris paribus*. A high-rate-narrow-base regime has long been regarded as being *more efficient* in the political economy literature. This is precisely because it reduces the tax burden on the 'normal return on capital', which affects domestic incentives to reinvest, and increases the burden on 'pure profits' as well as (if intended) old capital, which is largely irrelevant for domestic investment (Przeworski and Wallerstein 1988). To the extent that this view is correct, tax competition on statutory rates has clearly forced countries to adopt a tax structure which is *less efficient* for domestic companies and is therefore likely to limit corporate revenue yield in the long run.

In summary, the Australian experience provides compelling evidence that broadening the CT base was *not* a consequence of the policy preferences of domestic policy makers *as per* 'revisionist' accounts of the impact of globalisation on domestic taxation (Swank 1998; Swank 2003; Swank and Steinmo 2002). Indeed, it is significant that orthodox policy elites, such as former Treasury Secretary Ted Evans, consistently emphasised the legitimacy of tax based depreciation allowances for companies. In this context reigning in such allowances was regarded as being an extremely difficult policy trade-off. Secondly, at a theoretical level, if improving the

neutrality of the corporate tax base was a motivation for the base broadening since the 1980s, a technically superior approach might have been to move to a direct expenditure tax (e.g., Wallerstein and Przeworki 1995; Sinn 1998). While there would have been significant transitional costs associated with such a reform, the absence of any serious discussion of such a proposal – which would imply *higher* statutory tax rates – was made very unattractive by the pressure on statutory corporate tax rates. Taken together this evidence suggests that international tax competition was indeed the main force driving corporate income tax policy in Australian over the study period.

The indirect effect of tax competition: wither progressive income taxation?

Tax competition on statutory corporate tax rates also has an indirect effect on the broader personal income tax base. Recall that the Hawke Government was at pains to achieve a perfect alignment of the CT rate and the top personal tax rate ('tax symmetry') in order to achieve neutrality in business taxation and prevent tax avoidance. With increasing tax competition, governments now face the choice between cutting the top personal income tax rate in line with the corporate rate or abandoning the goal of tax symmetry in order to defend the progressivity and revenue-raising potential of the income tax system.

The Labor government's more neo-liberal counterparts in New Zealand chose the first option and reduced the top personal rate to 33%, thereby constraining public spending and delivering the greatest cuts to the well-off (Chapman 1992; Boston 1999). For the Hawke Government, this option was out of the question. Not only would it have been difficult to win support for regressive tax cuts among the ALP's rank and file membership and in the Senate, but such cuts would also have been contradicted Labor's fiscal priorities: to maintain a balanced budget and the progressivity of the income tax base (cf. Head 1989). As a result, the government had little choice other than to implement an isolated cut in the CT rate and accept a widening gap between the corporate and the top personal income tax rate. As shown in Figure 1, the only reduction in the highest income tax rate was from 49 to 47% (48.5 percent including the medicare levy) in 1991 where it has remained since.

Various changes were made to the intermediate rates and tax thresholds, but the detail owed more to wages policy than to structural tax reform (Sandford 1993, 81, 103-105).

The isolated corporate tax cut was thus associated with significant domestic costs. As Head (1997, xxix) summarised:

> [T]he wide [tax rate] gap...has served...to reintroduce some of the worst distortions and inequities of the classical system of company tax which dividend imputation was supposed to eliminate. Indeed, there are now serious new problems of tax avoidance with the use of private company structures to shelter the investment portfolios of the wealthy and the labour incomes of self-employed professionals and consultants.

The tax rate gap provided high-income earners, especially the self-employed, with a significant incentive to establish closely held private companies as tax shelters. Incorporating is beneficial because the CT rate is lower than the marginal income tax rate for upper and middle income earners and there are significantly more opportunities to pay expenses from pre-tax income.[1] While some of these benefits are eliminated if the profits are distributed directly to high income shareholders, there are a variety of strategies available to minimise taxation. For example, Quiggin argues that through properly managing the structure and timing of dividends it is possible to ensure that little or no tax is paid beyond the initial tax burden at the corporate level (Quiggin 1998, 35). This view is supported by tax professionals, with a senior partner in a national accounting firm being quoted as saying:

> The effective top marginal tax rate for wealthy people in this country is effectively 30 percent (the company tax rate). The only people paying 48.5 cents in the dollar will be PAYE taxpayers who can’t afford top accountants and lawyers (as quoted in Kohler 2000).

The aggregate effect of this incentive structure is reflected in the increase in the number of private companies. According to statistics of the Australian Taxation Office, this number increased by 32 percent between 1991 and 1999, while

[1] Under the existing regime average personal income tax exceeds the 30% corporate rate for incomes above $68 000 per annum.

employment grew by only 10 percent over the same period (ACOSS [Australian Council of Social Service] 1999). Tax avoidance is undoubtedly one of the main factors behind this growth, with both the Treasury and the Australian Taxation Office repeatedly expressing their concerns. More recently ACOSS (2003) published a report estimating that tax planning through incorporation and the use of trusts leaches approximately $4 billion from the federal budget annually. Similar effects of the tax rate gap are also corroborated by econometric evidence from other countries. For instance, Gordon and Slemrod (2000) show for the U.S. differences between the personal and the corporate tax rates have a significant impact on reported labor income and corporate rates of return. Moreover, comparative research across a panel of 13 OECD countries (Fuest and Weichenrieder 2002) has revealed that when individuals earn a significant amount form personal capital income then the 'rate gap' has a significant influence on decisions to incorporate. They conclude that '[s]een from the perspective of tax competition, a reduction in corporate tax rates may therefore shift significant amounts of saving from the household sector to the corporate sector' (Fuest/Weichenrieder 2002, 61).

As was to be expected, the Howard Government has demonstrated a greater commitment to reducing personal income tax rates which would alleviate the tax rate gap between corporate and personal tax rates. As early as the *Fightback!* proposal of 1991, the Liberals had proposed to reduce the top personal rate from 47 to 42 percent and to increase the respective income threshold from $ 50 000 to $ 75 000. The intermediate marginal rate was to fall from 46 to 36 percent for those in the $ 50 000 to A$ 75 000 bracket, and the CT rate was to be increased to at least restore the corporate-personal rate alignment at this intermediate level (Quiggin 1992).

In government, the Coalition pursued a similar but moderated strategy. Most importantly, it resisted reducing the top marginal tax rate from 47% but wanted to align the intermediate personal rate (which would apply to 80% of taxpayers) with the corporate rate of 30% (Kobetsky 2000, 73; Harris 1999, 252). That the Coalition stepped back from its earlier proposal to reduce the top rate can be explained by domestic political strategy. For one thing, the Howard Government certainly knew *in advance* that it would be difficult to win a Senate majority for such cuts. Moreover, the government was acutely aware of the electorate's sensitivity to the overall

distributional impact of its entire tax reform agenda. This is because income tax cuts were inexorably linked to the very contentious introduction of the Goods and Services Tax (GST). Since a major complaint about the GST was its regressive effect on the tax system (Eccleston 2002), it was certainly prudent for the Coalition to postpone further cuts in the top marginal rate until after the introduction of GST was completed (see below).[2]

But even though the Coalition did not propose a cut in the top personal rate, the tax rate gap, induced by tax competition, also contributed indirectly to the pressure for tax reform. The above-mentioned tax avoidance strategies employed by high-income earners, which were facilitated by the tax rate gap, contributed to 'middle income taxpayer revolts (which led the Liberal-National Coalition government to successfully lower the rate on the middle-income earners in the late 1990s)' (Hobson 2003, 57).

In May 1999 the government struck a deal with the Australian Democrats in the Senate, so that the new tax system could take effect from July 2000. In the present context, the most important concessions made to the Democrats were to increase the threshold for the top personal income tax rate from $ 50 000 to $ 60 000 (instead of the originally envisaged $ 75 000) and to establish an intermediate rate of 42 percent (instead of 40 percent) for those in the $ 50 000 to $ 60 000 bracket.[3] While this compromise reduced the tax cuts for high-income earners, it still resulted in some 80% of taxpayers having a marginal tax rate of 30% or lower (OECD 2000, 123).

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[2] Income tax cuts and GST introduction were also linked through the budget constraint. In the lead up to the 1996 poll, the Howard Government had specifically ruled out introducing a GST, which meant that it had little scope to offer income tax cuts during the first five years in office. In 1997 the government, desperately trying to establish its economic reform credentials, championed the cause of tax reform, with a GST as its centerpiece. While the decision was largely a response to pressures from business and industry for comprehensive tax reform (Eccleston 2000), the need for further income tax cuts certainly played a role as well. The objective was to broaden and modernise Australia's consumption tax base and to use some of this revenue to finance cuts in personal income tax rates.

[3] In the 2002-2003 federal budget these thresholds were increased to $52 000 and $62 500 respectively.

Consistent with our explanation of the Coalition's tax reform proposal, the calls for further income tax cuts did not stop after the tax reform package had been accepted by both houses of parliament. To the contrary: freed from the need to muster broad support behind the GST, the Coalition Government has intensified its calls for further tax to the top income tax rate and/or threshold (e.g., Costello 2001). More surprising – but well in line with our account – is that fact that some elements within the Latham led ALP are also increasingly accepting that something will have to be done about narrowing the tax gap (Latham 2003). It thus seems that corporate tax competition has contributed, along with arguments about enhancing work incentives and a desire to appeal to the 'hip pocket nerve' of aspirational voters, to a broadening consensus about the need for lower top marginal income tax rates. While further tax cuts will be limited by revenue needs, at least in the short run, the tide is turning against those who stand for progressive income taxation.

Conclusion: the likely consequences of international tax competition

The analysis presented in this article supplements and partly modifies existing accounts of the impact of globalisation on corporate taxation in the comparative political economy literature. Focussing on the Australian case, we have advanced three claims about the competitive pressure on *statutory* CT rates. Firstly competitive pressures were indeed a crucial driving force behind the trend toward lower CT rates. Australian policymakers continued to believe in the efficiency of investment incentives and would therefore have continued the imposition of a relatively high CT rate. With increasing tax competition, however, the costs of continuing this policy became significant, especially for a small state like Australia. Secondly, this tax competition not only limited the state's policy autonomy, but shifting the tax burden towards new investments by domestic companies may, as many economists claim, lead to a less efficient and effective (in terms of revenue yield) corporate tax base. Finally, competitive pressures on statutory CT rates are also important because they tend to 'spill over' into personal income taxation. Given a large tax rate gap between the CT rate and the top rate on personal income makes sustaining high marginal rates significantly more *expensive* – economically, administratively, and politically – it

creates a *bias*, in Australia and elsewhere, in favour of a further reduction and flattening of the personal income tax.

We argue that this indirect pressure on the personal income tax is less strong than the direct pressure on corporate tax rate, mainly because all advanced OECD countries nowadays accept at least a minor gap (i.e. asymmetry) between the CT rate and the top rate on personal incomes. Thus, institutionally situated domestic actors have more leeway in shaping income tax reform according to their values and ideas. The way Australian policymakers decided the trade-off between tax symmetry on the one hand and progressivity/revenue-raising on the other was decisively shaped by the partisan composition of government and the Senate: Labor accepted a large rate gap between the corporate and top personal tax rates, the Coalition put greater emphasis on income tax cuts, but was moderated by minor parties (and independents) in the Senate.

This political-institutional explanation of the patterns of Australian tax reform between the mid-1980s and the early 2000s is corroborated by the experience of the other two countries that had adopted an imputation system with a strict alignment between corporate and personal rates: Germany and New Zealand. In Germany, right-of-centre parties (Liberals and Christian Democrats) were more committed to defending tax symmetry then their Australian counterparts (Economist 2003). They wanted to reduce personal income tax rates in line with the CT rate. Their tax reform proposal of 1997/98 was blocked, however, by Social Democrats in the second chamber which wanted to sacrifice tax symmetry rather than accept a reduction or revenue and progressivity in the personal income tax. In 2000, however, when the Social Democrats were in power (together with the Greens), the opposition parties used their veto power in the second chamber to keep the government from increasing the tax rate gap too much. The top personal income tax rate thus had to fall from 56 to 44 percent in order to allow a reduction in the (general government) CT rate to 38.5 percent (Ganghof 2001).

In New Zealand, the right-of-centre governments of the 1990s maintained a fully symmetric income tax system with CT and top personal rates of 33 percent. In 2000, reflecting partisan preferences, the Labour-led coalition increased the top PIT

rate from 33 to 39 percent, thus accepting a new tax rate gap of 6 percentage points. However, considerations of tax symmetry played a role in preventing a larger increase in the top personal rate (see e.g. Treasury 1999). And, indeed, New Zealand's top personal rate is still low relative *to its very high income tax ratio* (income and profit tax revenue as a percentage of GDP) of around 20 percent. Other countries with similar income tax ratios have much higher top personal rates: e.g., in 2003, Finland's general government rate was 53% and Sweden's 56%.

Such comparative perspectives clearly support our conclusions about the Australian case: On the one hand, corporate tax competition partly 'spills over' into personal income taxation and strengthens the position of political leaders seeking to reduce personal income tax rates. On the other hand, since this pressure is indirect and less strong than the direct pressure on CT rates, the progressivity of the income tax schedule remains very much a political choice, influenced by the partisan composition of government and the allocation of legislative power. So while the tax gap problem has increased the costs of progressive income taxation domestic institutions and politics still matter.

It is worth emphasising that all of our claims are probabilistic, not deterministic (cf. Brooks and Wohlforth 2002). Our goal was to show how changing competitive pressures changed the incentives and trade-offs faced by domestic actors, thus making certain results more likely than others. We do not argue, however, that domestic ideas and policy preferences are solely determined by competitive pressure. It is useful therefore to end this article with a somewhat more speculative discussion about domestic actors' leeway in shaping future income tax reforms.

In terms of the CT rate, it seems that the policy autonomy of nation states is relatively limited. All OECD countries have felt the need to keep their rates in line with their competitors, with small, capital dependent economies being especially vulnerable to the pressures of international tax competition. Much will therefore depend on whether or not the downward trend in CT rates will continue. One scenario would be that this trend was itself the result of the fact that countries' could easily slash investment incentives in return for a lower CT rate. From this perspective, then,

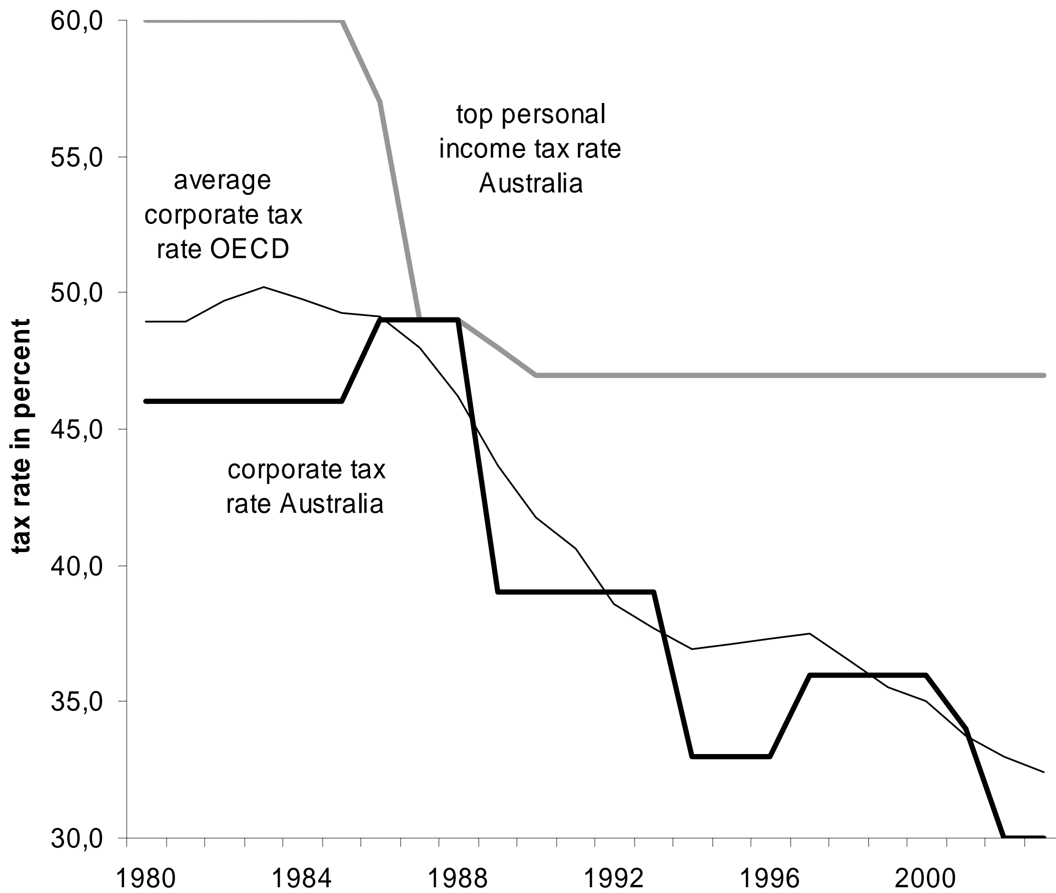
the downward trend should moderate as the costs of further cuts in corporate rates increase.

The problem with this view is that the nations driving international tax competition game still have ample opportunity to lower the tax rate on retained corporate profits. One way – recently adopted by many countries – to do this is to move back to a classical system of corporate taxation effectively shifting the tax burden away from the level of the corporation and onto shareholders. Another is to eliminate the deductibility of corporate interest payments, as has been suggested in the U.S. under the label of 'comprehensive business income taxation' (US Department of Treasury 1992; Bond 2000). Hence, tax competition on statutory tax rates may continue unabated. This trend is consistent with recent Australian experiences. While the Australian government has recently conducted a review of possible options to ameliorate the impact of the impact of competitive pressures on the corporate tax base, the recommendations of the *Review of International Taxation Arrangements* have been criticised for being superficial in their scope. For example, the Australian Institute of Company Directors (2002) suggested that measures aimed at improving foreign tax credit arrangements overlooked the cause of the problem – an uncompetitive statutory CT rate. Given such criticisms Australian governments may need to consider more fundamental corporate tax reforms.

As to personal income taxation, Australian governments' have more policy leeway. Indeed, while the pressure to reduce the Australian tax rate gap will continue, there might be ways to reduce its force. One source of inspiration could be countries like Finland or Sweden, which – as we have seen – both have lower CT rates and higher top personal rates than Australia and thus accept a larger tax rate gap. Both countries, however, have moved to so-called 'dual income taxes' that in principle tax *all* types of capital income at a uniform and proportional tax rate, while subjecting wages to a progressive rate schedule (Sørensen 1998). Such a system obviously does not help to enforce progressive taxation of corporate profits and other capital income, but it makes capital income taxation more efficient *and* defends the revenue-raising capacity of the income tax system.

Ultimately we can only speculate about whether or not such a system will be attractive for Australian government. Our main goal, however, was not to speculate about the future of the income tax or the tax state but to systematically analyse the *mechanisms* through which international tax competition impacts income taxation. Such an analysis can complement the many studies that have looked at aggregate tax policy outcomes and thus contribute to a stronger empirical and theoretical basis on which to base predictions about the future.

Figure 1: Top marginal personal income (PIT) and corporate income tax (CT) rates in Australia, 1980-2003



***Notes*:** The top personal income tax rate for Australia neglects the medicare levy. The 'average corporate tax rate OECD' is an unweighted average for 21 advanced OECD countries (Western Europe without Luxembourg, as well as Australia, Canada, Japan, New Zealand, the U.S.). Corporate tax rates include surcharges and local taxes that fall on profits (ie. corporate taxes as well as local business taxes such as the German *Gewerbesteuer*).

***Sources*:** German Ministry of Finance, KPMG, Institute for Fiscal Studies (London), World Tax Data Base (University of Michigan).

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