Australian Journal of Political Science
Publication details, including instructions for authors and subscription information:
http://www.informaworld.com/smpp/title~content=t713404457

Globalisation and the dilemmas of income taxation in Australia

Steffen Ganghof [a]; Richard Eccleston [b]
[a] Max Planck Institute for the Study of Societies, [b] Griffith University,

To cite this Article Ganghof, Steffen and Eccleston, Richard(2004) 'Globalisation and the dilemmas of income taxation in Australia', Australian Journal of Political Science, 39: 3, 519 — 534
To link to this Article: DOI: 10.1080/103614042000295129
URL: http://dx.doi.org/10.1080/103614042000295129

Australian Journal of Political Science,
Vol. 39, No. 3, November, pp. 519–534

Carfax Publishing
Taylor & Francis Group

Globalisation and the Dilemmas of Income Taxation in Australia

STEFFEN GANGHOF

Max Planck Institute for the Study of Societies

AND

RICHARD ECCLESTON

Griffith University

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

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%, and this trend shows no sign of abating (see Figure 1). 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),

Steffen Ganghof is Research Fellow at the Max Planck Institute for the Study of Societies, Cologne, Germany. He has recently published (in German) a monograph on the politics of German income tax reform in comparative perspective and an edited volume on analytical approaches to the German political system. Richard Eccleston is a Lecturer in the Department of Politics and Public Policy at Griffith University. His book *The Thirty Year Problem: The Politics of Australian Taxation Reform* is being published by the Australian Tax Research Foundation. The authors thank Brett Freudenberg and this journal's anonymous referees for their very helpful comments, and Miro Bogner for able research assistance. An earlier version of this article was presented to the 2003 Australasian Political Studies Association Conference.

ISSN 1036-1146 print; ISSN 1363-030X online/01/030519-16
DOI: 10.1080/1036114042000295129

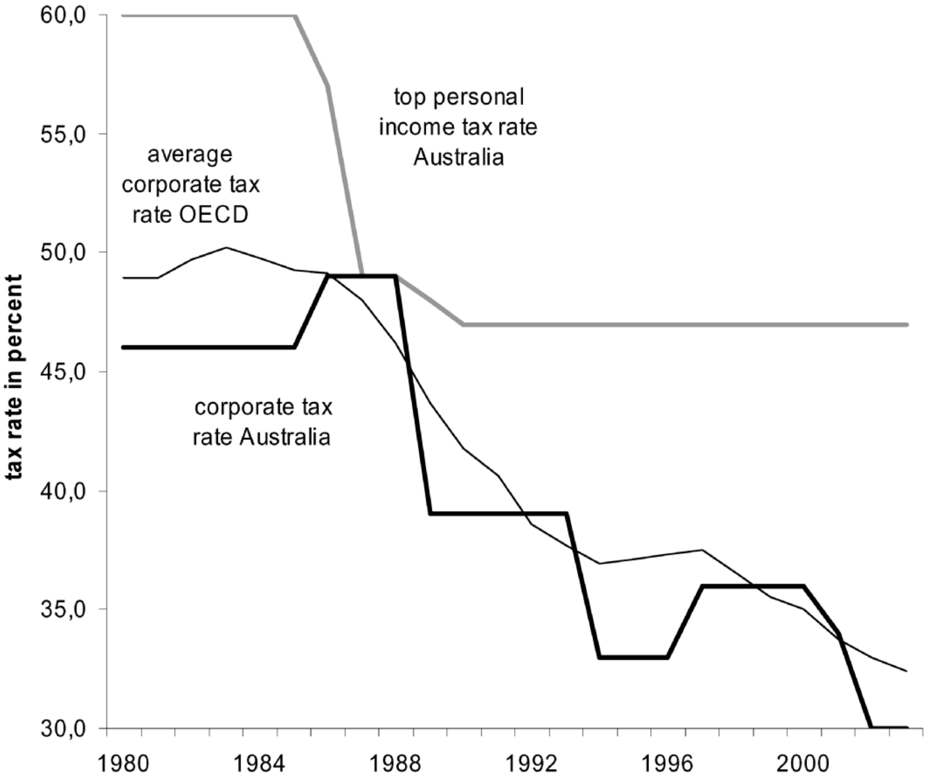

Figure 1. Top marginal personal income and corporate income tax rates in Australia, 1980–2003. *Notes*: The top personal income tax rate for Australia neglects the Medicare levy. The 'average corporate tax rate OECD' is an unweighted average for 21 advanced OECD countries (Western Europe without Luxembourg, as well as Australia, Canada, Japan, New Zealand, the United States). 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*).
Source: See Ganghof (2004).

most subsequent work has been wary of 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 policy makers 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 rationale for corporate and personal income taxation (see also Steinmo 2003). The second claim made in this revisionist literature is that the consequences of CT cuts are relatively minor. It is argued that as most governments broadened the CT base, little or no revenue has been lost due to CT cuts.

This article argues that, while the revisionist literature captures important aspects of recent CT cuts and rightly warns against exaggerating the effects of 'globalisation', it may underestimate the importance and long-term impact of CT 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, focusing 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 towards lower CT rates. Even if policy makers 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 CT 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 but 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 CT 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 bipartisan 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 explain policy outputs only in the short run, because they take actors' (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 precondition 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 CT 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 to 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 (eg Hobson and Ramesh 2002) would profit from a more detailed understanding of the causal pathways through which competitive pressures 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 CT competition. The article then describes the structure of the Australian income tax system before the watershed US tax reforms of 1986. The two subsequent sections 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 concerned only 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 multinational 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 policy makers to reduce statutory CT rates.

A second reason for MNEs' sensitivity to statutory rates of corporate taxation relates 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 United States, attempts to redefine the base on which foreign taxes are levied to bring them in line with US 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 US parent pays the US rate on foreign profits as long as the foreign statutory rate is lower than in the United States; 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 US 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 US tax reforms of 1986. The reason was not only that US foreign direct investment is especially important for many countries but also that the 1986 reform changed a number of important technical details that made US MNEs even more sensitive to tax rate differentials (eg Bossons 1988; Lyon 1996). This was immediately recognised 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 CT increases with the profitability of investments. Owing to their very profitable nature, there is increasing empirical evidence that MNEs' locational decisions are to a significant extent based on the tax rate on pure profits (eg 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 in 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 (see Figure 1), it is not particularly low compared with 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, at 46% and 60%, respectively (see 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 policy makers was the CT 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 policy makers believed that this system created serious economic distortions (Evans 1988, 17; Evans and McKenzie 1989; Freebairn 1997) in that 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 might 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 ($[1 - 0.46] \times 0.60$). 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, in 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%. Later in 1985 it was announced that the classical CT 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 symmetrical 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 CT regime involved increasing the statutory rate from 46% to 49%, business was generally supportive of the proposal on the basis that ending double taxation was expected to reduce net revenue yield by approximately 4% (Keating and Dixon 1989, 39).

It is also important to note that these reforms did *not* aim to completely remove investment incentives from the CT 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 towards a regime of 'real economic depreciation'.

As part of its ambitious reform agenda of the mid-1980s, the Hawke government had planned to reduce marginal and average income tax rates further by shifting the tax mix on to indirect taxes (*Review of the Australian Taxation System* 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 a 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 policy makers expressed concerns about the increasing pressure of tax competition. Initially, there was a hope that foreign corporate investors would carefully assess the overall CT system and the effective level of taxation rather than focus on the high statutory 49% rate (Evans 1988, 30–7). However, bureaucrats and policy makers 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 US and UK 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% (see Figure 1). Given the government's budgetary and macroeconomic policy goals, revenue neutrality was essential. Hence, the only way to achieve a competitive CT rate was to broaden the CT 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, policy makers had used domestic investment incentives as an instrument to promote investment. In 1993 the Labor government, confronting a persistent recession and waning electoral support, increased CT allowances in order to stimulate domestic investment (Sandford 1993, 105; Chennells and Griffith 1997, 104–6). These increased concessions were combined with a further cut in the CT rate to 33%, resulting in a significant reduction of CT 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 that policy makers regarded depreciation allowances and other CT 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 cut their CT rate further 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% with effect from 2002 (see Figure 1). According to the Ralph Committee, which formulated the CT reforms, the tax cut was designed to 'make the headline rate of CT 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 CT 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 literature on the political economy of tax 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, 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 an extremely difficult policy trade-off. Second, at a theoretical level, if improving the neutrality of the CT 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 (eg Wallerstein and Przeworski 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 CT 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: Whither Progressive Income Taxation?

Tax competition on statutory CT 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 Australian 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 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% 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, 103–5).

The isolated CT cut was thus associated with significant domestic costs. As Head and Krever (1997, xxix) have 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. (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 from the Australian Taxation Office, this number increased by 32% between 1991 and 1999, while employment grew by only 10% over the same period (ACOSS 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, the Australian Council of Social Service published a report estimating that tax planning through incorporation and the use of trusts leaches approximately $4bn from the federal budget annually (ACOSS 2003). 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 United States that differences between the personal and the CT rates have a significant impact on reported labour 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 from personal capital income then the 'rate gap' has a large influence on decisions to incorporate. They conclude that '[s]een from the perspective of tax competition, a reduction in CT rates may therefore shift significant amounts of saving from the household sector to the corporate sector' (Fuest and 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% and to increase the respective income threshold from $50,000 to $75,000. The intermediate marginal rate was to fall from 46% to 36% for those in

[1] Under the existing regime (2003–04), average personal income tax exceeds the 30% corporate rate for incomes above $68,000 per annum.

the $50,000–75,000 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). Given the political sensitivity of the GST's regressive impact, it was certainly prudent for the Coalition to postpone further cuts in the top marginal rate until after the introduction of the 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% (instead of 40%) for those in the $50,000–60,000 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).

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 cuts to the top income tax rate and/or threshold (eg Costello 2001). More surprising—but well in line with our account—is the 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 CT

[2] Income tax cuts and the introduction of the GST 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 centrepiece. 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 2002–03 federal budget these thresholds were increased to $52,000 and $62,500, respectively.

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. Focusing on the Australian case, we have advanced three claims about the competitive pressure on *statutory* CT rates. First, competitive pressures were indeed a crucial driving force behind the trend towards lower CT rates. Australian policy makers 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. Second, 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) CT 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 personal income tax rates.

We argue that this indirect pressure on personal income tax is less strong than the direct pressure on the CT rate, mainly because all advanced OECD countries nowadays accept at least a minor gap (ie 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 policy makers decided to resolve the trade-off between tax symmetry, on the one hand, and progressivity/revenue raising, on the other, was shaped decisively 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, namely 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 (*The Economist* 22 January 2004). 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 who wanted to sacrifice tax symmetry rather than accept a reduction of revenue and progressivity in 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% in order to allow a reduction in the (general government) CT rate to 38.5% (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%. In 2000, reflecting partisan preferences, the Labour-led coalition increased the top PIT rate from 33% to 39%, 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, for example, NZ 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%. Other countries with similar income tax ratios have much higher top personal rates: eg 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, CT 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 determined solely 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 the 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 on to shareholders. Another is to eliminate the deductibility of corporate interest payments, as has been suggested in the United States 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 competitive pressures on the

CT 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 CT reforms.

Australian governments have more policy leeway in relation to personal income taxation. 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 an 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.

References

ACOSS [Australian Council of Social Service]. 1999. *Review of Business Taxation. ACOSS Response to First Discussion Paper*. Sydney.

ACOSS [Australian Council of Social Service]. 2003. *Taxation in Australia: Home Truths and International Comparisons*. Sydney.

Arnold, B.J., J. Li and D. Sandler. 1996. *Comparison and Assessment of the Tax Treatment of Foreign-source Income in Canada, Australia, France, Germany and the United States*. Working Paper no. 96-1 prepared for the Technical Committee on Business Taxation. Ottawa.

Arnold, B.J. and M.J. McIntyre. 1995. *International Tax Primer*. Boston: Kluwer Law International.

Australian Institute of Company Directors. 2002. Submission to the Board of Taxation's Report on Australia's International Taxation Arrangements. Melbourne: AICD.

Bond, S.R. 2000. 'Levelling Up or Levelling Down? Some Reflections on the ACE and CBIT Proposals, and the Future of the Corporate Tax Base.' In *Taxing Capital Income in the European Union*, ed. S. Cnossen. Oxford: Oxford University Press.

Bossons, J. 1988. 'International Tax Competition: The Foreign Government Response in Canada and Other Countries.' *National Tax Journal* 41(3): 347–55.

Boston, J. 1999. 'New Zealand's Welfare State in Transition.' In *Redesigning the Welfare State in New Zealand: Problems, Policies, Prospects*, eds J. Boston, P. Dalziel and S.S. John. Oxford: Oxford University Press.

Brooks, S.G. and W.C. Wohlforth. 2000. 'Power, Globalization and the End of the Cold War. Reevaluating: A Landmark Case for Ideas.' *International Security* 25(3): 5–53.

Brooks, S.G. and W.C. Wohlforth. 2002. 'From Old Thinking to New Thinking in Qualitative Research.' *International Security* 26(4): 93–111.

Chapman, R. 1992. 'A Political Culture under Pressure: The Struggle to Preserve a Progressive Tax Base for Welfare and the Positive State.' *Political Science* 44(1): 1–27.

Chennells, L. and R. Griffith 1997. *Taxing Profits in a Changing World*. London: Institute for Fiscal Studies.

Costello, P. 2001. Transcript of interview by the Hon. Peter Costello MP, Treasurer, with Paul Murray, Radio 6PR Perth. 3 August. <www.treasurer.gov.au/treasurer/transcripts>.

Devereux, M.P. and R. Griffith. 2003. 'Evaluating Tax Policy for Location Decisions.' *International Tax and Public Finance* 20: 107–26.

Eccleston, R. 2000. 'The Significance of Business Interest Associations in Economic Policy Reform: The Case of Australian Taxation Policy.' *Business and Politics* 2(3): 309–25.

Eccleston, R. 2004. *The Thirty Year Problem: The Politics of Australian Taxation Reform*. Sydney: Australian Tax Research Foundation.

Evans, E.A. 1988. 'Australia.' *World Tax Reform: A Progress Report*, ed. J.A. Pechman. Washington, DC: Brookings Institution.

Evans, E.A. and I.M. McKenzie. 1989. 'Some Macroeconomic Implications of Tax Reform.' In *Australian Tax Reform in Retrospect and Prospect*, ed. J.G. Head. Sydney: Australian Tax Research Foundation.

Ferrers, T. 2000. 'The New Business Tax System for Australia.' *Intertax* 28(1): 30–5.

Freebairn, J. 1997. 'Taxation Reform: An Overview.' In *Taxation Towards 2000*, eds J.G. Head and R. Krever. Sydney: Australian Tax Research Foundation.

Fuest, C. and A. Weichenrieder. 2002. 'Tax Competition and Profit Shifting: On the Relationship between Personal and Corporate Tax Rates.' *Ifo-Studien* 48: 611–32.

Ganghof, S. 2000. 'Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes.' In *Welfare and Work in the Open Economy*, vol. II: *Diverse Responses to Common Challenges*, eds F.W. Scharpf and V.A. Schmidt. Oxford: Oxford University Press.

Ganghof, S. 2001. *Global Markets, National Tax Systems, and Domestic Politics: Rebalancing Efficiency and Equity in Open States' Income Taxation*. Discussion Paper 9/01. Cologne: Max Planck Institut für Gesellschaftsforschung.

Ganghof, S. 2003. 'Promises and Pitfalls of Veto Player Analysis.' *Swiss Political Science Review* 9(2): 1–25.

Ganghof, S. 2004. *Wer Regiert in der Steuerpolitik: Einkommensteuerreform zwischen Internationalem Wettbewerb und Nationalen Verteilungskonflikten*. Frankfurt/Main: Campus.

Garrett, G. 1998. *Partisan Politics in the Global Economy*. Cambridge: Cambridge University Press.

Gordon, R. and Slemrod, J. 2000. 'Are "Real" Responses to Taxes Simply Income Shifting between Corporate and Personal Tax Bases?' In *Does Atlas Shrug? The Economics Consequences of Taxing the Rich*, ed. J. Slemrod. New York: Russell Sage and Harvard University Press.

Hall, P.A. 1993. 'Policy Paradigms, Social Learning, and the State. The Case of Economic Policymaking in Britain.' *Comparative Politics* 25: 275–96.

Hallerberg, M. and S. Basinger 1998. 'Internationalization and Changes in Tax Policy in OECD Countries: The Importance of Domestic Veto Players.' *Comparative Political Studies* 31(3): 321–52.

Harris, P. 1999. 'Australia: Corporate Tax Reform Down-under: Maybe Not the Full Monty But.' *Bulletin for International Fiscal Documentation* 53(6): 249–66.

Head, J.G. 1989. 'Australian Tax Reform: An Overview.' In *Australian Tax Reform in Retrospect and Prospect*, ed. J.G. Head. Sydney: Australian Tax Research Foundation.

Head, J.G. and R. Krever. 1997. 'Introduction and Summary.' In *Taxation Towards 2000*, eds J.G. Head and R. Krever. Melbourne: Australian Tax Research Foundation.

Hettich, W. and S.L. Winer. 1999. *Democratic Choice and Taxation. A Theoretical and Empirical Analysis*. Cambridge: Cambridge University Press.

Hobson, J.M. 2003. 'Disappearing Taxes or the "Race to the Middle"? Fiscal Policy in the OECD.' In *States in the Global Economy*, ed. L. Weiss. Sydney: Cambridge University Press.

Hobson, J.M. and M. Ramesh. 2002. 'Globalisation Makes of States What States Make of It: Between Agency and Structure in the State/Globalisation Debate.' *New Political Economy* 7(1): 5–22.

Jones, R. 1993. 'Australia.' In *Tax Reform and the Cost of Capital*, eds D.W. Jorgenson and R. Landau. Washington, DC: Brookings Institution.

Keating, M.S. and G. Dixon. 1989. *Making Economic Policy in Australia*. Sydney: Longman Cheshire.

Kobetsky, M. 2000. 'Tax Reform in Australia—The New Tax System.' *Bulletin for International Fiscal Documentation* 54(2): 67–79.

Kohler, A. 2000. 'Down for the Count.' *Australian Financial Review* 21 October.

Latham, M. 2003. 'Those Chains are Stifling Spirit.' *Australian* 18 November.

Lee, D. and McKenzie, R. 1989. 'The International Political Economy of Declining Tax Rates.' *National Tax Journal* 42(1): 79–83.

Lyon, A.B. 1996. *International Implications of U.S. Business Tax Reform*. Working Paper no. 96-6 prepared for the Technical Committee on Business Taxation. Ottawa.

McLure, C., H.-W. Sinn, R. Musgrave and P. Musgrave, eds. 1990. *Influence of Tax Differentials on International Competitiveness*. Deventer: Kluwer.

NZ Treasury [New Zealand Treasury]. 1999: *Tax Policy Report: Implementing a 39% Top Personal Income Tax Rate*. Confidential document released under the Official Information Act. Wellington.

OECD [Organisation for Economic Cooperation and Development]. 1996. *Model Tax Convention on Income and on Capital. September 1996. Condensed Version*. Paris.
OECD [Organisation for Economic Cooperation and Development]. 2000. *OECD Economic Surveys: Australia 1999–2000*. Paris.
Porter, M.G. and C. Trengove. 1990. 'Tax Reform in Australia.' In *World Tax Reform: Case Studies of Developed and Developing Countries*, eds M.J. Boskin and C.J. McLure. San Francisco: ICS Press.
Przeworski, A. and M. Wallerstein. 1988. 'The Structural Dependence of the State on Capital.' *American Political Science Review* 82: 11–29.
Quiggin, J. 1992. 'Fightback and One Nation: A Comparative Analysis.' *Australian Tax Forum* 9(2): 127–54.
Quiggin, J. 1998. *Taxing Times: A Guide to Australia's Tax Debate*. Sydney: UNSW Press.
Quinn, D. 1997. 'The Correlates of Change in International Financial Regulation.' *American Political Science Review* 91(3): 531–51.
Review of Business Taxation. 1999. *A Platform of Consultation: Discussion Paper 2. Building on a Strong Foundation*. Canberra: AGPS.
Review of the Australian Taxation System. 1985. Draft White Paper. Canberra: AGPS.
Royal Commission on Taxation. 1966. *Report*. Ottawa: Queen's Press.
Sandford, C. 1993. *Successful Tax Reform. Lessons from an Analysis of Tax Reform in Six Countries*. Fersfield: Fiscal Publications.
Sinn, H.-W. 1998. 'European Integration and the Future of the Welfare State.' *Swedish Economic Policy Review* 5(1): 113–32.
Sørensen, P.B., ed. 1998. *Tax Policy in Nordic Countries*. Basingstoke: Macmillan.
Sørensen, P.B. 2000. 'Tax Co-ordination. Its Desirability and Redistributional Consequences.' *Economic Policy* 15(31): 429–61.
Steinmo, S. 1994. 'The End of Redistribution? International Pressures and Domestic Tax Policy Choices.' *Challenge* (November–December): 9–17.
Steinmo, S. 2003. 'The Evolution of Policy Ideas: Tax Policy in the 20th Century.' *British Journal of Politics and International Relations* 5(2): 206–36.
Swank, D. 1998. 'Funding the Welfare State: Globalization and the Taxation of Business in Advanced Market Economies.' *Political Studies* 46(4): 671–92.
Swank, D. 2003. 'Tax Policy in an Era of Internationalization: An Assessment of a Conditional Diffusion Model of the Spread of Neoliberalism.' Unpublished manuscript. Milwaukee: Department of Political Science, Marquette University.
Swank, D. and S. Steinmo. 2002. 'The New Political Economy of Taxation in Advanced Capitalist Democracies.' *American Journal of Political Science* 46(3): 642–55.
Tsebelis, G. 2002. *Veto Players: How Political Institutions Work*. Princeton: Princeton University Press.
US Department of Treasury. 1992. *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*. Washington, DC: US Government Printing Office.
Vann, R. 1997. 'General Description: Australia.' In *Comparative Income Taxation: A Structural Analysis*, ed. H. Ault. New York: Aspen.
Wallerstein, M. and A. Przeworski. 1995. 'Capital Taxation with Open Borders.' *Review of International Political Economy* 2(3): 425–45.