Suppose the government had about A$10 billion a year to fund lower income tax. It could reduce personal income tax by about 6%, or lower each marginal rate by about 1.5 percentage points. Alternatively it could reduce company tax by about 15%, or reduce the current 30% rate to 24%. Which option has more merit?

The government is currently making the economic case for a company tax cut , after Treasurer Scott Morrison backed away from the personal income tax cut he had been previously hinting at.

But the answer as to which is more likely to drive the "jobs and growth" the government has been promising is not that simple. And it is difficult if not impossible to comprehensively model which option is better.

Income tax affects households differently

The two lower income tax options have different implications for the distribution of the tax burden over time. They also impact changes in incentives and rewards to promote a larger economy and higher future living standards, and how much can be clawed back after the first round revenue loss.

A reduction of personal income tax rates provides a more direct and explicit increase in household income, and a quicker gain, when compared with a reduction of the corporate tax rate. Also, lower personal tax rates allow greater government discretion in the distribution of the benefits across households with different incomes, demographic and other characteristics.

Company tax cuts can impact wages and investment

Individuals benefit from lower corporate tax rates with higher market wages. But the higher wage rates will take some years to materialise, and the magnitude of increase attributed to the lower corporate tax rate, versus other factors, is open to debate.

Benefits of a lower corporate tax rate, and in time the flow of these benefits as higher wage rates, involves a chain of decision changes. Australian corporations depend on the savings of international investors for an important share of their investment funds. They use this money to invest in machinery, buildings technology and so forth. But to get it they must show investors they will get a superior return, after Australian corporate income tax is paid, compared to alternative investments in other countries.

If Australia’s company tax rate was cut, this would lower the bar on the required return to attract investment. In the end the lower corporate tax rate induces an increase in investment, resulting in a larger stock of capital and associated technology and expertise. But, this capital accumulation process takes many years.

The enlarged stock of capital, technology and expertise per worker becomes a key driver of increased worker productivity. In time, more productive workers are able to negotiate higher wages. Via this chain of decision changes, employees benefit from the lower corporate tax rate.

Personal tax cuts promote productivity

Lower personal income tax rates provide incentives for a more productive economy and higher living standards through two main mechanisms. Lower marginal income tax rates increase the incentive for, and the rewards from, joining the workforce, working more hours, and putting more into education and skill acquisition. These incentives are especially important for women with children and older workers.

Also, lower personal income tax rates reduce distortions to household decisions on how much to save and where to invest savings in owner occupied homes, other property, financial deposits, shares, superannuation and other options.

The current income tax system imposes different forms of income tax on the different options with very different effective tax rates. For example, income earned on owner occupied housing (of imputed rent and capital gains) is exempt from income tax while the nominal interest on financial deposits (associated with offsetting inflation as well as the returns for delayed consumption) faces the personal rate. Lower personal income tax rates reduce the magnitudes of the distortions caused by different effective tax rates on different saving and investment options.

The difference is in the timing

Lowering the rate of corporate or personal income tax will generate a larger and more productive economy. A larger economy means larger tax bases, and not just income tax, but also GST, payroll and excise. The enlarged tax bases generate larger tax revenues and a partial recapture over time of the first round revenue cost of the income tax rate reductions.

The revenue recapture is expected to be larger for the corporate income tax rate reduction option. With the imputation system , for domestic shareholders a reduction in corporate income tax and less franking credits would be offset by a larger direct personal income tax payment on dividend income.

The greater price sensitivity of the international supply of funds to Australia enticed by a lower corporate tax rate is expected to boost the size of the Australian economy, and tax bases, more than the labour supply response to lower personal tax rates.

Models don't have the answer

Ultimately, quantifying the relative national productivity, distribution and revenue effects of the lower corporate tax and personal income tax options requires detailed computable general equilibrium models .

Arguably, available models, including those used by government, lack the detail of progressive personal income tax rates for different households, and details of household choices among different investment options with different effective tax rates, to confidently measure the relative effects of the two options.

John Freebairn does not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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