President Donald Trump has proposed cutting the US corporate tax rate from 35% to 15% and ending the practice of taxing the foreign income of US businesses. Trump may be hoping that such a massive corporate tax cut will result in new investment. Indeed, historical data suggests companies will respond by shifting profits to where the tax is low.

This profit shifting will hurt investment in Australia, as companies move their profits to America rather than reinvesting in Australia. If the tax cut goes ahead, Australia and other countries will have to respond by either cutting taxes as well, or totally reforming the way we tax corporate income.

Alternative ways of taxing corporate income exist. The US Republican Party, for example, recently proposed a " destination-based cash flow tax ". Under this system, companies would be taxed on their revenues in the US minus labour costs.

The European Union is currently proposing a formula apportionment taxing system within its member countries. With this system, profit is allocated to be taxed by member countries based on how much activity (i.e. sales, employment and assets) occurs in each country.

Both of these tax activity rather than income, and thus are less prone to manipulation and profit shifting.

As you can see from the chart above, during the last three decades corporate tax rates have fallen across the OECD. But at the same time the amount of money raised through corporate taxes, both as a percentage of total tax revenues and as a percentage of GDP, has remained almost constant.

This is not because changes in total tax revenues or GDP have exactly matched the changes in corporate tax. The story is more complicated than that. With total tax revenues and GDP increasing, the amount of money raised through corporate taxes has actually been increasing at the same time as the rates have been cut.

Companies have simply been declaring more of their existing profits.

To understand why this has happened, you have to understand how firms react to tax rate changes. There are three general guidelines :

1. The statutory tax rate (the headline 15% or 35%) affects where firms report their profits
2. The average effective tax rate (the percentage paid by the firm after taking deductions) affects where firms locate their new plants - whether domestically or abroad
3. The marginal effective tax rate (the percentage paid by the firms on their marginal investment) affects where the firms make new investments in existing plants.

Given these guidelines, one explanation for the increase in corporate tax revenues over the last thirty years is that the average and marginal tax rates have not fallen, i.e. even if corporate tax rates have fallen, the effective taxes have risen due to reductions in tax deductions.

But studies have shown this is not the case. Both average and marginal effective tax rates have fallen in this period, but not as dramatically as the statutory rates.

Another explanation could be that lower taxes remove a burden from firms, who are then able to create more activity and thus profits. This is the narrative behind President Trump's tax plan.

If this is true, then we should see that periods with tax reductions lead to periods with higher economic activity and thus growth. But, again, studies show this is not the case.

A third, more plausible explanation is that lower taxes induce firms to report more profits to the tax authorities. In other words, they declare already existing profits from other countries.

We don't yet have details about whether Trump will eliminate tax deductions along with lowering the rate, but the signal is clear. With the US willing to compete with a low tax country like Ireland, we in Australia will have to react.

There is no doubt that if a large country like the US lowers tax so much, it will divert investment from other countries such as Australia, along with profits (and hence Australia's tax revenue).

It is a textbook "beggar thy neighbor" tax policy. Australia, and any other country that has high tax rates, will have to react by either reducing its corporate tax rate as well, or by totally reforming the way we tax corporate income.

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