The argument that cutting the Australian company tax rate will lead to higher investment and wages, more employment and faster GDP growth does not have solid empirical or theoretical backing.

A close look at the economic research in this area shows a lack of consensus. Different studies, looking at different samples of countries, over different periods of time, reach different conclusions.

And the predictions made by theoretical models are sensitive to the underlying assumptions and structures built into the models themselves.

Many of the issues surrounding tax cuts remain unsettled – such as the size or length of the impact, how it affects inequality and the relationship with other government policies.

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The recent International Monetary Fund (IMF) forecast for the American economy highlights some of the issues.

In short, the IMF acknowledges that the recent US tax cuts will have a positive impact on economic growth in 2018-19. However, this is conditional on the US government not cutting expenditure, is likely to be short-lived, and will come at the cost of increased government deficits.

In this light, corporate tax cuts seem to be a long-term pain for a short-term gain, which is probably not what we need in Australia.

Conflicting information

Let's start with the point that is probably least controversial – that a reduction in the corporate tax rate will lead to an increase in wages.

Think of the output produced by a corporation as a pie. This pie is shared among shareholders (in the form of dividends), banks and other lenders (in the form of interest paid on loans), workers (in the form of wages) and the government (in the form of taxes).

If we reduce the government's share then there is more for everybody else, including workers. And some data do suggest that wages increase when corporate tax rates decline.

Yet economists disagree on the extent to which wages would actually increase in response to a tax cut.

Some research suggests that this increase might be small, even in a country like Germany, which is often used as an example of the beneficial impact of tax cuts on wages.

Certain aspects of the German economy and industrial relations system make it more likely that German workers will benefit from corporate tax cuts compared to Australian workers.

In Germany, workers' representatives sit on company supervisory boards , which monitor and appoint members of management boards.

This means German workers have a stronger say when it comes to sharing the pie. For any given decrease in the slice of the government, German workers are more likely to get a bigger slice for themselves. This is not necessarily the case in Australia.

It is therefore difficult to draw implications for Australia from studies that look at the experience of Germany or other countries with significantly different institutional arrangements.

Furthermore, the fact that wages should increase in response to a corporate tax cut does not automatically imply that other economic variables will also respond positively. For instance, the more wages increase in response to a corporate tax cut, the smaller the increase in employment is likely to be.

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This leads to an even more controversial question: what is the effect of corporate tax cuts on real economic activity, such as employment and GDP growth?

The trickle-down effect of corporate tax cuts rests on the idea that business investment would increase once taxes are cut, which in turn leads to the creation of more jobs and faster economic growth.

However, this line of reasoning neglects the fact that investment decisions in today's globalised world are not necessarily driven by the corporate tax rate .

Many other factors come into corporate investment decisions, such as the quality of institutions , the proximity to important markets, and the cost of labour (wages).

Because of these other factors, the impacts of tax cuts on employment and growth can be small , short-lived

, or conditional on other government policy actions, such as managing debt.

In a similar vein, recent theoretical work that incorporates more realistic assumptions about the economy (such as the distribution of entrepreneurial skills in the population) suggests that a tax cut only has a significant impact on economic growth when the tax rate is initially high.

This means that even within a given country, the effect of a corporate tax cut can change depending on initial economic and policy conditions.

Putting tax cuts in a broader context

Beyond growth and employment, the effects of corporate tax cuts should also be considered in terms of deficit and inequality.

From the point of view of the public budget, a cut in the tax rate has to be somehow financed. How?

A first possibility is that the tax cut pays for itself. This is essentially the idea that as the tax rate goes down, the increase in the tax base (e.g. pre-tax corporate profit) is sufficiently large to ensure that the total tax revenue increases.

However, an increase in the tax base would require a significant and sustained increase in business investment, which, as we have already seen, does not necessarily happen.

The government could increase other taxes, but this means the government would effectively be taking from one group of taxpayers (possibly workers themselves) to give to corporations.

Another option is to reduce some government expenditures. But this could also involve taking from one group to give to another. If the decision is made to cut social welfare and public goods like education and health, then more vulnerable segments of the population will bear the cost of lowering the corporate tax rate. This means more inequality in the economy.

Of course the government could decide to just let the deficit be. This would result in higher debt. But can Prime Minister Turnbull (or President Trump for that matter) accept that?

The central economic challenge for Australia is to promote long-term, inclusive growth. Are we confident that this is what corporate tax cuts will deliver? Based on the economic research that I have read, the answer is no.

Fabrizio Carmignani has received funding from the Australian Research Council for a project on the estimation of the piecewise continuous linear model and its applications in macroeconomics.

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