

AUSTRALIAN POLITICS |

Proposed cuts to company tax rates are flawed and would make Australians worse off

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n Australia, cutting the company tax rate is not the only way to improve post-tax returns for investors. *Photo: Getty*

The Productivity Commission has again floated the idea that cutting company income tax would boost national prosperity.

Its interim report claims it would attract more foreign investment, raise wages, and ultimately grow the economy. But our modelling suggests Australians would be less prosperous by almost \$300 per person.

There are three key reasons for this.

1. Modelling windfall gains is critical

The PC commissioned two studies on the impact of company income tax cuts. One, by economist Chris Murphy, relies on what is called a long-run comparative static computable general equilibrium (CGE) model. This type of model assumes the economy jumps straight to a new steady state, ignoring what happens during the adjustment period.

The second study, by researchers at the Centre of Policy Studies (CoPS) at Victoria University, uses a dynamic framework that traces the policy's effects over time.

Unlike the Murphy model, this approach accounts for who gains and who loses during the transition period.

The two studies agree in many respects on the impact of company income tax cuts: They will boost investment, drive up employment, improve pre-tax real wages and increase GDP.

But GDP isn't the same as the prosperity of Australian residents. In fact, the key point of difference is on prosperity of Australian residents – the so-called welfare effect.

Murphy's model ranks company income tax among Australia's most distortionary, leading to a conclusion that reducing it must be good for Australian residents. The CoPS study finds the opposite: Company income tax cuts make us worse off.

Why these starkly different results? The reason is that much of the initial impact of a company income tax

The beneficiaries are overseas shareholders, not Australian households.

This flaw was highlighted by CoPS researchers in a [working paper](#) back in 2018.

Ignoring the transition period, as happens when utilising long-run comparative static modelling, overstates domestic welfare gains and masks who really pockets the benefits.

2. Distortions could further undermine the policy

The PC acknowledges – but does not model – the effects of thresholds in the company income tax system, where tax rates change at specific levels of company turnover.

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Two decades ago, CoPS researchers analysed these thresholds under two assumptions about industry competition.

Under perfect competition the effects were small. But as the PC itself notes, Australia's industries are far from perfectly competitive.

In concentrated markets, thresholds can distort decisions about firm size and create deadweight costs. They might, for example, break up their companies into smaller ones to qualify for the lower company income tax rates for firms with an annual turnover of less than \$1 billion that the PC is recommending

These distortions can be significant. They could even offset the supposed gains from the tax cuts. Modelling should be commissioned to measure them.

3. Same mechanisms, different strength

There are two further mechanisms at play when cutting the company income tax rate in Australia.

First, the Murphy modelling assumes the domestic economy can more easily absorb large inflows of foreign capital. This elevates the long-run investment response.

Second, assumptions regarding Australia's level of market power for our traded goods differ.

Murphy assumes that Australia can export as much as it wants without having much impact on prices. We think that an increase in Australian supply of commodities such as iron ore or LNG will have a negative effect on world prices, and while export volumes will increase, incomes will increase by less.

Where to from here?

Before Canberra considers this proposal – which we estimate will reduce the welfare of Australian residents by about \$292 a person in real terms – the PC must address the gaps that we have identified.

Alternatives to tax reform should also be considered. A motivation the PC notes for proposing company income tax cuts for Australian small businesses is to alleviate capital constraints faced by these firms.

The best way to address issues such as credit barriers is at their source.

For example, we could focus on improving the depth and liquidity of the domestic corporate bond market. We might also look at improving banking sector competition directly, which the PC has supported in the past.

Investors are attracted by projects that provide competitive risk-adjusted post-tax rate of return.

In Australia, cutting the company tax rate is not the only way to improve post-tax returns for investors.

Reforms that focus on improving the skills base of the domestic labour force, or reducing investor risk by providing a stable and efficient operating and regulatory environment, will go a long way towards elevating investment with no need for large losses in national income.

Jason Nassios and Janine Dixon are co-authors of the Centre of Policy Studies report into company tax cuts commissioned by the Productivity Commission.