



# **The economic impacts of the Australian investment guarantee**

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## Executive summary

The Australian Labor Party (ALP) has announced an Australian Investment Guarantee to increase private-sector investment in projects offering high-paying jobs in the lead up to the 2019 federal election.

The Australian Investment Guarantee allows all businesses to immediately deduct 20 per cent of investment in eligible depreciable assets, except structures such as buildings. The remaining investment in eligible depreciable assets not immediately deducted would continue to be deductible over the effective life of each asset.

This discussion paper offers an economic analysis of this policy initiative. Its findings are set out below.

## Key Findings

**Finding 1:** The Australian Investment Guarantee would not only stimulate investment in physical capital such as mining, manufacturing and infrastructure, it would also increase investment in the services sector by supporting expenditure on depreciable intangible assets such as intellectual property and computer software.

**Finding 2:** Unlike most investment allowances, which typically are temporary in nature, the Australian Investment Guarantee would be ongoing, providing a permanent lift in investment incorporating the most modern technologies.

**Finding 3:** The Australian Investment Guarantee would be more effective in stimulating investment than a company tax rate cut of equivalent cost.

**Finding 4:** Since the ALP has supported the Government's company tax rate cuts for small and medium-sized enterprises (SMEs) and the extra instant asset write-off provisions announced in the 2019 Budget, the Australian Investment Guarantee for small, medium and large businesses provides greater economic incentives to invest than the Coalition's tax policies.

**Finding 5:** The Australian Investment Guarantee would reduce the effective tax rate on new investment to less than 26 per cent.

**Finding 6:** Based on US modelling of the effects of accelerated depreciation, the Australian Investment Guarantee could create up to around 77,000 new jobs and increase average wages by up to \$1,500 per annum.

**Finding 7:** Job-creating investment responses to accelerated depreciation provisions such as the Australian Investment Guarantee, particularly by SMEs, are likely to be relatively rapid.

## Outline of Australian Investment Guarantee

The Australian Investment Guarantee would apply to assets above \$20,000 in value. Pooling of lower-value assets would not be permitted. Eligible assets would include tangible machinery, plant and equipment, and depreciating intangible assets for both upgrades of existing assets and purchases of new assets.

The Australian Investment Guarantee would not apply to passenger motor vehicles, but it would apply to:

- Non-passenger motor vehicles such as lorries, vans, utes and trucks that are used to support trade businesses; and
- Electric vehicles that are powered solely by batteries charged from an external power source.

The Australian Investment Guarantee would not apply to otherwise eligible expenditure currently claimed under the existing R&D tax concession.

The Australian Investment Guarantee would commence on 1 July 2021.

Unlike other investment allowances that have been designed to stimulate investment in an economic downturn, the Australian investment Guarantee would continue indefinitely.

## Economic impacts of the Australian Investment Guarantee

The economic effect of the Australian Investment Guarantee would be to increase the after-tax expected net present value (ENPV) of investment proposals. This would turn marginal and a range of sub-marginal investment proposals under the existing company tax arrangements into profitable proposals after taking account of the Australian Investment Guarantee.

The Australian Investment Guarantee would increase capital investment from both foreign and domestic sources. It would lift labour productivity and multifactor productivity, since new investments could be expected to incorporate the latest productivity-raising technologies. Rising productivity would lay the foundations for wage increases, since workers would be using the best available plant, equipment and digital technologies.

While the Australian Investment Guarantee could be expected to incentivise

capital-intensive activities such as food processing, the construction of infrastructure and the installation of new energy-generation facilities, it would also boost investment in high-technology, service-based activities. The reason is that it applies to depreciating intangible assets for upgrades and for new purchases, such as copyrights and patents.

The application of the Australian Investment Guarantee to depreciating intangible assets is important, since intangibles have grown strongly as a proportion of total capital investment over the last few years (Minife 2017, pp. 49-50) and can be expected to continue doing so in the Digital Age.

The McKell Institute has examined relevant literature and modelling of the economic impacts of investment allowances, as set out below.

## 1. OECD tax policy study

An OECD study of company income tax incentives (OECD 2015) found that accelerated depreciation provides stronger investment incentives than company tax rate reductions of equal budgetary cost:

*“Tax incentives based on investment expenditures, such as accelerated or enhanced depreciation, immediate expensing of some proportion of capital costs and investment tax credits, provide a larger investment response for each dollar of tax revenue foregone, compared to a corporate tax rate reduction.*

*“Unlike a corporate tax rate reduction, tax preferences tied to the cost of purchasing capital benefit only new investment and therefore may provide a larger reduction in the effective tax rate on investment at a lower revenue cost.*

*“In contrast, a reduction in the statutory corporate tax rate benefits “new” as well as “old” capital, providing existing investors with a windfall gain by increasing the present value of the future stream of after-tax earnings from existing capital” (p. 63).*

## 2. OECD analysis of US immediate expensing

An OECD analysis of the recent move to full immediate expensing of depreciable assets in the US supports the reform (OECD 2018) but points out that the economic benefits fall away after a decade, owing to the temporary nature of the incentive. The OECD concludes:

*“If, on the other hand, these provisions were permanent ... the impact on the level of GDP could be substantial” (p. 44).*

As evidence of its contention, the OECD report cites economic modelling by the Brookings Institute, which estimates that making the immediate expensing provision permanent could treble its economic impact (Barro and Furman 2018, p. 41).

### 3. Centre of Policy Studies, Victoria University

A working paper prepared by the Centre of Policy Studies (CoPS) at Victoria University (Dixon and Nassios 2018) compares the impact of two policies, each costing the federal budget the same amount,<sup>1</sup> designed to stimulate investment in Australia:

1. A permanent reduction in Australia’s corporate tax rate; and
2. A permanent subsidy on investment expenditure.

The macroeconomic impacts of the policies were studied using a computable general equilibrium model of Australia.

Dixon and Nassios (2018) conclude:

*“With both policies calibrated to the same budgetary cost, the investment subsidy is more effective in raising the volume of investment;*

*“The impact on gross national income (GNI), an indicator of domestic material welfare, is positive for the investment subsidy but not for the company tax rate cut;*

*“Based on these results, we strongly recommend that policy-makers consider an investment subsidy instead of a cut to company tax as a better value-for-money policy initiative to increase both investment and domestic material welfare (p. 2).”*

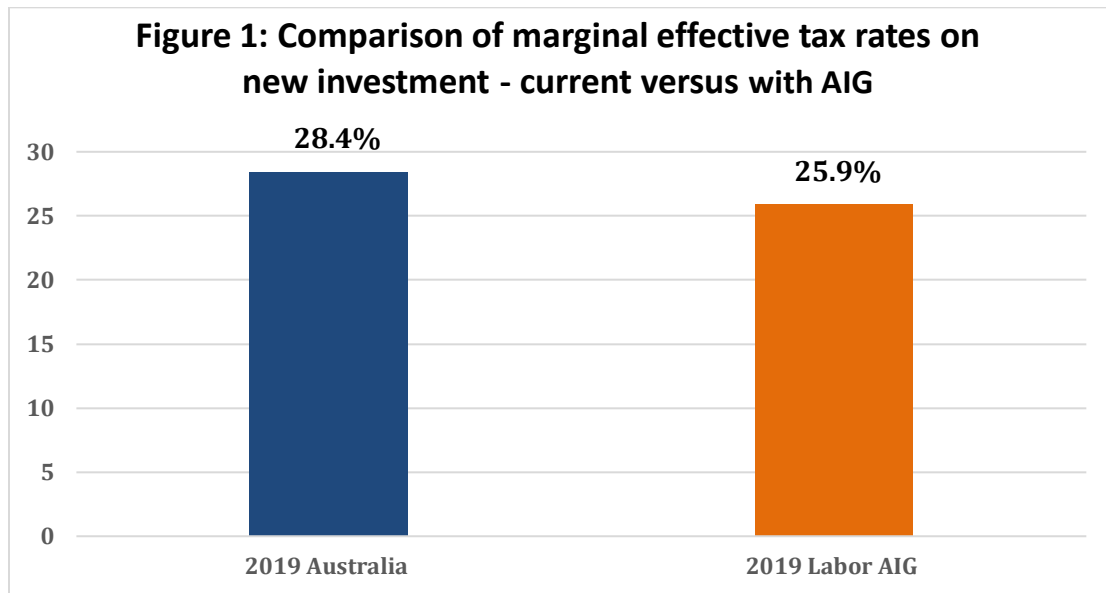
### 4. Minerals Council of Australia effective tax rate modelling

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<sup>1</sup> The CoPS modelling exercise did not specifically model the Australian Investment Guarantee or the 5-percentage point company tax rate cut that was being proposed by the Coalition government at the time, but rather an investment subsidy and a company tax rate of equal cost to the budget.

The Minerals Council of Australia (MCA) recently undertook modelling of the marginal effective tax rate (METR) on new business associated with the existing company tax regime, a 5-percentage point cut in the company tax rate, and the 20 per cent Australian Investment Guarantee (Bazel and Mintz 2019).

The modelling shows the Australian Investment Guarantee reduces the METR on new investment from 28.4 per cent to 25.9 per cent (Figure 1).



Source: Bazel and Mintz (2019, Chart 8, p. 22).

**Since the ALP has the same company tax rate policy as the Coalition, but the Coalition policy does not provide for accelerated depreciation, the ALP’s Australian Investment Guarantee provides greater incentives for new private-sector investment than the Coalition’s policy.**

It might be presumed that the benefits of the Australian Investment Guarantee are confined mainly to the manufacturing sector. This is not the case; with the inclusion of intangible depreciating assets in the Australian Investment Guarantee, the modelling yields similar results for both the manufacturing and services sectors (Bazel and Mintz 2019, Chart 8).

While maintaining their preference for a company tax rate cut, Bazel and Mintz (2019) acknowledge that:

*“The advantage of accelerated depreciation is that companies cannot benefit from the incentive unless they invest. Further, it rewards only new capital, as returns from existing capital investments remain taxed at the same rate. Accelerated depreciation can also encourage the adoption of new capital with*



*the latest technologies and increased productive capacity” (p. 21).*

**The Australian Investment Guarantee offers similar investment incentives for both the manufacturing and services sectors.**

## 5. Tax Foundation modelling of US immediate expensing

A tax reform blueprint released in 2016 by the Republican members of the House Ways and Means Committee of the US Congress included full, immediate expensing of eligible depreciable assets excluding structures. The blueprint allowed taxpayers to expense immediately the entire cost of eligible depreciable assets, up from the pre-existing allowance of immediate expensing of 50 per cent of the value of those assets.

Analysis by the Tax Foundation (2017) demonstrates that the immediate expensing component of the tax package could be expected to dramatically increase the profitability of capital investment – accounting for more than half of the GDP estimated to be generated by the entire House Ways and Means Committee’s tax reform blueprint.

The Tax Foundation’s modelling estimates that the House Ways and Means Committee’s proposal for full, immediate expensing would raise US hours worked by about 1 per cent, representing almost one million jobs:

*“Wages are about 4 percent higher, and hours worked about 1 percent higher, representing nearly a million full time equivalent jobs.”*

The Trump Administration’s tax policy adopted the full immediate expensing proposal, but made it temporary, phasing out after 2023.

## Adaptation of modelling to the Australian Investment Guarantee

There are clear differences between the US immediate expensing policy and the ALP's Australian Investment Guarantee. First, the US already had 50 per cent immediate expensing in place for specified depreciable assets, while large Australian businesses do not have general access to immediate expensing. Second, the Australian Investment Guarantee is for 20 per cent immediate expensing, less than the 100 per cent (up from 50 per cent) arrangement in the US. Nevertheless, the Tax Foundation's analysis is instructive.

The US increase in the immediate expensing ratio from 50 per cent to 100 per cent is a 50-percentage point increase. The Australian Investment Guarantee's increase in immediate expensing from zero to 20 per cent is a 20-percentage point increase, which is two-fifths (40 per cent) of the US increase.

Even if the Australian Investment Guarantee increased hours worked by just 0.4 per cent (40 per cent of 1 per cent), then based on 12.8 million people currently in employment, this would lift overall employment in Australia by 51,200 jobs.

This is likely to be a conservative estimate for two reasons. First, owing to the declining marginal product of capital, the marginal benefit of each percentage point of extra immediate expensing could be expected to decline. That is, allowing for an initial 20 per cent immediate expensing is likely to have a bigger positive impact than a similar move towards 100 per cent immediate expensing, since it brings into viability investment proposals that are just beneath investors' hurdle rates.

Second, the immediate expensing in the US applies to tangible assets but typically not to intangible assets.<sup>2</sup> The Australian Investment Guarantee applies to both depreciable tangible assets and depreciable intangible assets. Intangible assets are often referred to as "knowledge assets" because of the embedded human capital. Grattan Institute analysis (Minife 2018) suggests intangible investments account for around one-third of total private business investments, and they are expected to make up an increasingly larger component of non-mining investment over time.

If the US immediate expensing provisions applied to two-thirds of depreciating assets (other than buildings) while, through its application to intangible depreciating assets, the Australian Investment Guarantee applied to 100 per cent of depreciating assets (other than buildings), the Australian Investment Guarantee would be around 60 per

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<sup>2</sup> <https://www.irs.gov/newsroom/new-tax-law-allows-small-businesses-to-expense-more-expands-bonus-depreciation>

cent as effective as the US immediate expensing incentive. That is, instead of lifting hours worked by 0.4 per cent, the Australian Investment Guarantee would increase hours worked by 0.6 per cent, or an estimated 76,700 jobs.

However, not all intangibles are likely to be depreciating assets. In these circumstances, the estimate of 76,700 jobs would be an upper limit.

**Based on Tax Foundation methodology and results, it is estimated that the Australian Investment Guarantee could increase employment by 50,000-77,000 jobs.**

Turning to impacts on wages, the Tax Foundation estimates that the full immediate expensing component of the House Ways and Means Committee's tax reform blueprint would increase US wages by 4 per cent. Based on the Tax Foundation's modelling and the analysis above of the comparative US and ALP immediate expensing proposals, the Australian Investment Guarantee could be expected to increase Australian wages by at least  $0.4 \times 4$  per cent = 1.6 per cent and up to  $0.6 \times 4$  per cent = 2.4 per cent.

Using the most recent ABS data, annualised average weekly earnings for all employees in Australia are around \$63,700.<sup>3</sup> A 2.4 per cent increase in average weekly earnings for all employees in Australia equates to \$1,529 per annum.

**The Australian Investment Guarantee is estimated to increase Australian wages on average by up to \$1,500 per annum.**

As to the timing of these new jobs, empirical evidence suggests that SMEs in particular respond quickly to accelerated depreciation provisions. For example, the Reserve Bank of Australia (RBA) found that SMEs increased non-mining capital investment strongly, and within one year, in response to the stimulatory accelerated depreciation allowances introduced by the Rudd government in December 2008 and early 2009 to deal with the fallout from the Global Financial Crisis (Rodgers and Hambur 2018).

The RBA cites US evidence of responses to accelerated depreciation provisions. For example, Zwick and Mahon (2017) found that financially constrained companies (typically SMEs) reacted more strongly to accelerated depreciation incentives than other companies, and that companies only responded when incentives reduced tax payable in the current year. Further, the RBA analysis reveals that companies did not bring forward investment but added to the total investment stock.

While the RBA makes clear that its empirical analysis does not necessarily translate to other forms of accelerated depreciation and to different periods, the results suggest

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<sup>3</sup> ABS, AWOTE, November 2018.

that investment responses by SMEs are likely to be swift.

**There is evidence to suggest that job-creating investment responses by SMEs to accelerated depreciation incentives are likely to be relatively rapid.**

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