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Determinants of the variability in corporate effective tax rates and tax reform: Evidence from Australia

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Abstract

This study examines the determinants of the variability in corporate effective tax rates in Australia spanning the Ralph Review of Business Taxation reform. Our results indicate that corporate effective tax rates are associated with several major firm-specific characteristics, including firm size, capital structure (leverage) and asset mix (capital intensity, inventory intensity and R&D intensity). While the Ralph Review tax reform had a significant impact on many of these associations, corporate effective tax rates continue to be associated with firm size, capital structure and asset mix after the tax reform.

Keywords: Corporate effective tax rates; Ralph Review tax reform; Size; Capital structure; Asset mix

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1. Introduction

Corporate effective tax rates (ETRs)[1] are often used by policy-makers and interest groups as a tool to make inferences about corporate tax systems because they provide a convenient summary statistic of the cumulative effect of various tax incentive and corporate tax rate changes (Kern and Morris, 1992, p. 81; Gupta and Newberry, 1997, p. 1). Evidence in the US has shown that ETRs vary across firms and over time, which suggested that the corporate tax system was inequitable and so was used as a major justification for tax reform (Shevlin and Porter, 1992, p. 60). However, there is a lack of research on ETRs and tax reform, especially in countries outside the US.

A potential reason for the lack of research in this area is that corporate tax reform is infrequent; hence the opportunity for undertaking such research is limited. The Ralph Review of Business Taxation represented a major event in corporate tax reform in Australia (Cooper et al., 2002, p. 20; Gilders et al., 2004, p. 16). The Ralph Review was given a mandate by the Australian Government to broadly assess the adequacy of the country's business income tax policy (Ralph, 1999, p. 10). It submitted its proposals to the Australian Government on July 30, 1999. Several of the Ralph Review's key proposals could affect the characteristics normally associated with ETRs. Accelerated depreciation was recommended for removal. Moreover, a phased-in reduction of the corporate tax rate was also suggested. The Australian Government accepted these key proposals, and they were codified in the Income Tax Assessment Act (1997), with application from the 1999–2000 tax year.

The Ralph Review tax reform provides a unique opportunity to treat this important tax policy event as a natural experiment for examining the determinants of the variability in corporate ETRs in Australia spanning the tax reform. In so doing, our study adds to the sparse literature about ETRs and tax reform. Moreover, our results provide some further insights into ETRs that should be useful to policy-makers. We investigate the impact of firm size, capital structure (leverage) and asset mix (capital intensity, inventory intensity and R&D intensity) on ETRs covering the Ralph Review. Formal tests of the impact of the tax reform on these associations and whether ETRs are associated with these characteristics after the tax reform are also considered.

[1] There are many different types of corporate ETRs in the literature (see, e.g. Plesko, 2003, p. 206). Distinctions are made between average ETRs and marginal ETRs. Average ETRs are defined as tax liability divided by income, while marginal ETRs are defined as the change in tax for a given change in income. The suitability of each type depends on a study's research question. Average ETRs are appropriate to examine the distribution of tax burdens across firms or industries, while marginal ETRs are suitable to analyze the incentives of new investments (Gupta and Newberry, 1997, p. 1). This study uses the term ETRs to denote average effective tax rates, and two different measures are used to improve the robustness of our results: income tax expense divided by book income and income tax expense divided by operating cash flows.