

## Re 4 May paper: 3.2 Company Tax Rate Issues – Supplementary information

### Bill Rosenberg

The paper models the domestic impacts of a decrease in the company tax rate. As it states, this is difficult. I would just add that the type of model used by the Australian modelling is based on a number of assumptions that further limit confidence in its results. For example the Australian model uses a single representative household, so it does not allow modelling of distributional effects (and also ignores the progressive personal tax structure) nor the impacts on household debt (and a fixed savings rate is assumed). Because the single household is the sole supplier of labour (and owner of all domestically owned capital), the model is unable to model unemployment nor imbalances in bargaining power impacting wages. It is difficult to guess the impact of these simplifications, but certainly a reduction in the company tax could have distributional effects. It is not clear whether the New Zealand modelling presented differs significantly in this regard.

Section 3 of the paper (p.18ff) discusses impacts of company tax rates on foreign investment. In a footnote it estimates the net inflows of capital from abroad over the last decade from the current account deficit at 3.5% of GDP. However care needs to be taken in doing this.

It is important here to distinguish finance capital from other forms. Not all always brings capital deepening. The potential benefits of foreign investment in capital deepening, technology diffusion, know-how, transfer of skills (human capital) and export markets come principally from Foreign Direct Investment, the majority of which is equity sufficient to confer a degree of control of the firm. Finance capital in the form of debt may allow capital deepening but at the margin is used for buying houses (and appears to be in plentiful supply); in addition income from it is not taxed at the New Zealand company income tax rate. Finance capital in the form of portfolio equity investment (where no control is involved) is similar to debt in that it does not provide those additional benefits, but differs in the distribution of risk and in being subject to company income tax. Foreign direct investment is partly equity (subject to company income tax) and partly debt. Only the equity is taxed as company income, and so this is the key area of concern regarding the impacts of company tax rates. The other forms of foreign investment could in theory assist capital deepening but that depends on where they are invested (significant given so much ends up in housing) and other factors. If FDI is used to acquire existing assets, the question is how the financial proceeds from the takeover are used.

Over the last decade, FDI equity inward flow has averaged 7.1% of business investment (gross fixed capital formation excluding residential buildings and weapon systems). FDI equity plus non-equity was 5.3% of business investment (there was an outflow of non-equity FDI in eight of the ten years). This is about a third of the 15.9% the paper estimates for all foreign investment using the current account deficit. Of the \$397.9 bn stock of foreign investment in New Zealand at March 2017, \$70.1 bn or 17.8% was FDI equity and \$42.1 bn or 10.6% was FDI non-equity. Portfolio equity plus debt was another \$185.1 bn of which

\$39.1 bn was equity. The remainder was \$25.1 bn in financial derivative liabilities and \$74.7bn in “Other investment liabilities” which is mainly loans, currency and deposits. The return on equity is, as would be expected, significantly higher than on debt, and the after-tax rate of return to FDI equity (not including capital gain) averaged 11.8%, double the 5.6% return to portfolio equity over the decade. (Data from Statistics New Zealand’s Balance of Payments, International Investment Position and National Accounts: Infoshare series BOP058AA, IIP088AA, SNE034AA.)

The question arises whether the FDI does in fact provide those potential benefits in New Zealand. The paper quotes Fabling and Sanderson (2011) whose research has cast some doubt on this. (Fabling, R., & Sanderson, L. (2011). Foreign Acquisition and the Performance of New Zealand Firms (Treasury Working Paper No. WP 11/06). Wellington, New Zealand: The Treasury. Retrieved from <http://purl.oclc.org/nzt/p-1425>).

There is further research on other aspects:

Sanderson, Fabling and Maré found that in contrast to international experience, which shows significant wage premiums for working in foreign-owned firms, the wage premium in New Zealand is only 2.7 per cent to 3.5 per cent after taking account of factors such as firm size, location, industry, and the tendency of such firms to hire more highly skilled workers. They also comment: “These findings give little support to the argument that foreign firms provide substantial indirect or spillover benefits to domestic firms through human capital accumulation and labour mobility.” Maré, D. C., Sanderson, L., & Fabling, R. (2014). Earnings and Employment in Foreign-owned Firms (Treasury Working Papers No. 14/16). Wellington, New Zealand: Treasury. Retrieved from <http://purl.oclc.org/nzt/p-1696>

Doan, Iyer and Maré looked for increased productivity through three types of potential “spillovers” in the form of local firms learning from their interactions with overseas firms. They concluded: “We find little evidence of substantial positive spillover effects from FDI to local firms’ productivity”. (Doan, T. T., Iyer, K. G., & Maré, D. C. (2014). Productivity spillovers from foreign direct investment in New Zealand (MBIE Occasional Paper Series). Wellington, New Zealand: Ministry of Business Innovation & Employment. Retrieved from <http://tinyurl.com/ya8zospz>)