Tax Working Group Public Submissions Information Release

Release Document

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Submission to Tax Working Group

Thank you for the opportunity to comment on the above document.

The Manufacturers' Network (formerly known as the New Zealand Manufacturers and Exporters Association) represents the interests of manufacturers throughout New Zealand. Virtually all of our manufacturing members are engaged in exporting or import-competing.

The Manufacturers' Network is New Zealand's only focused and independent voice for manufacturers, tracing its history back to 1879. Manufacturing makes up 12% of New Zealand's GDP, is worth $23bn per year and employs over 250,000 people in mostly highly-qualified and well-paid jobs.

Introduction

The core issue we believe the Tax Working Group (TWG) should be focused on is how the tax system influences investment incentives for productivity activity, and how the tax system can be more fairly balanced in a way that will facilitate higher growth in productive industries.

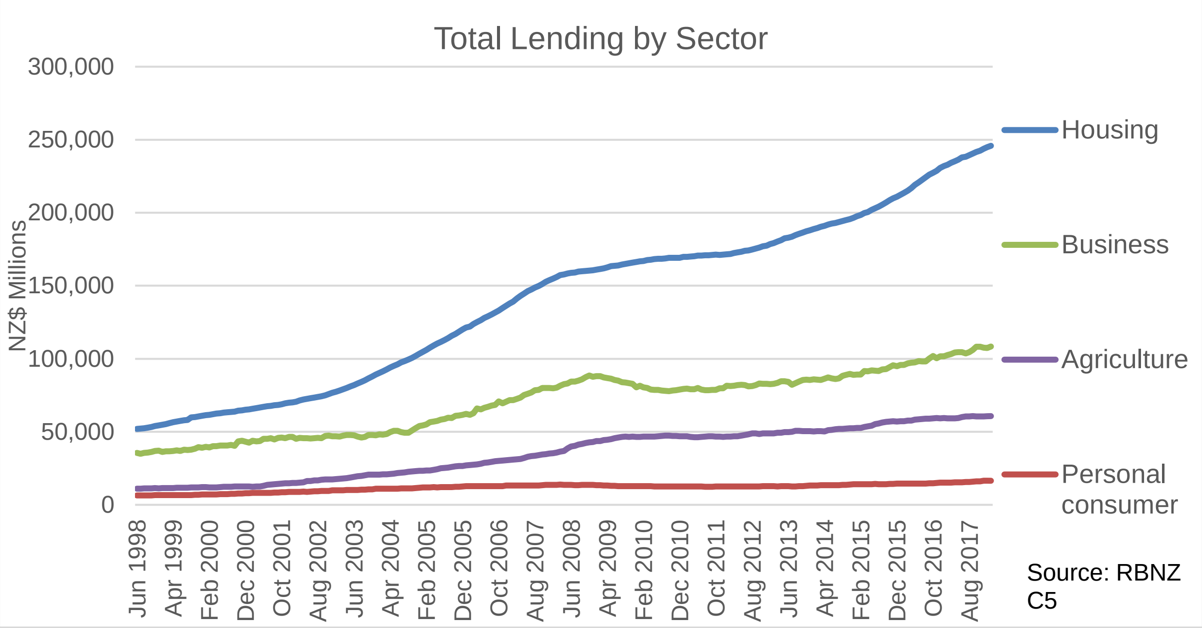
This needs to especially focus on high-value activities which provide exports and import-competing income and well paid jobs, like manufacturing. Productivity in New Zealand has lagged for decades behind many of our competitors and all manufacturers know the challenges involved in trying to access capital for investment in their businesses.

Promoting growth in high value sectors of our economy critical for ensuring long term sustainable growth for New Zealand – this growth allows living standards for everyone to increase over time, and helps expand the tax base to allow New Zealand to pay for the services and infrastructure investments we need to make a more prosperous country.

One of the most obvious and most significant areas of misalignment in our tax system is that while productive activities are taxed in the form of wages and profits, speculative activities, such as the capital gain obtained through investment properties, are largely untaxed. While the introduction of the bright line test appears to have helped as a stop-gap measure, the Tax Working Group should investigate more long term policy that avoid an arbitrary time frame as the measure for speculation and investment.

The test for what's a speculative activity is quite simple – it's an investment where the operational returns alone wouldn't be enough to justify the investment. (Auckland) rental properties and many dairy farms, which rely on capital gains for returns, with profits largely used for debt servicing are prime examples.

What that means is that the vast majority of capital and new money through bank loans goes into existing assets – which not only crowds out productive investment, but has other social implications, such as the house price inflation we have seen over recent decades. House price inflation has made owning a home, particularly in Auckland, near to impossible for many first home buyers, and has added wage pressure for businesses as workers find housing costs taking up a larger proportion of their income.

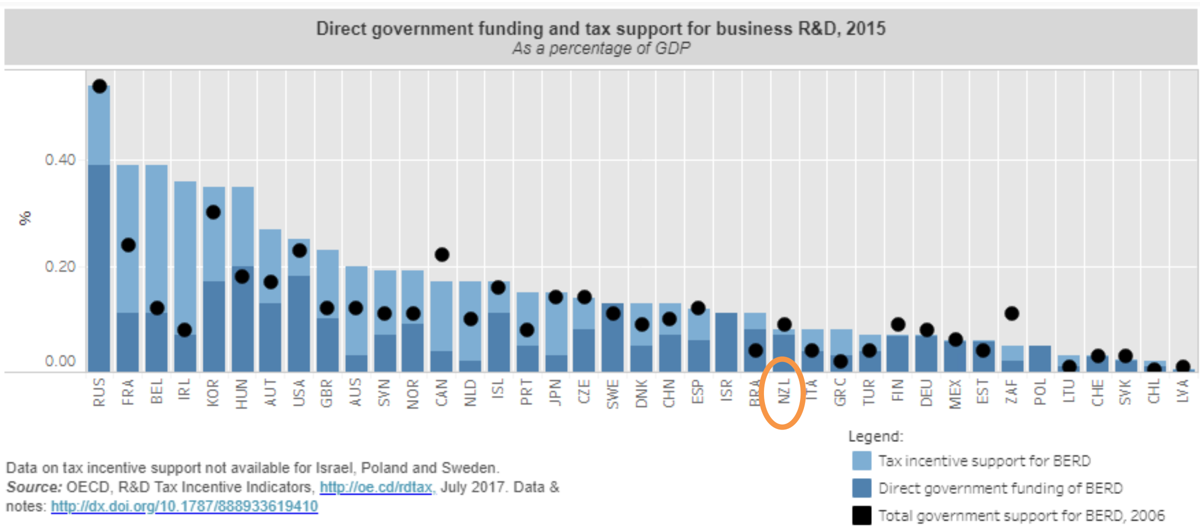


The above graph shows total lending (including bank and non-bank sources) across four sectors. The divergence of housing lending from business lending is clear. While the difference was not overly significant at the start of the series in 1998 (housing lending represented 146% of business lending), now the gap between housing and business lending is vast (226%) – a fact that is self-reinforced by the big appreciation of house prices.

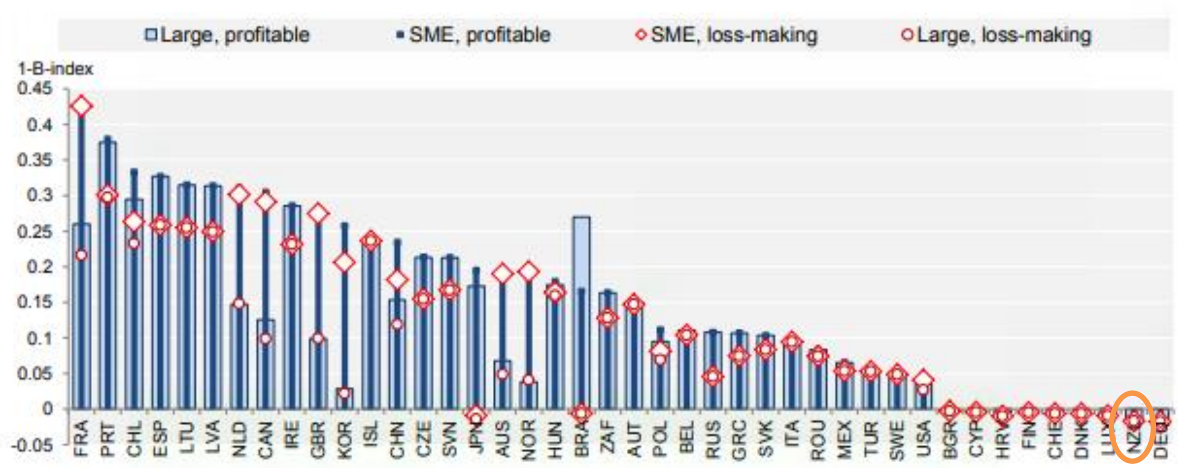
Not to forget – while this is outside the remit of the Tax Working Group – that the excessive levels of borrowing in the housing sector, largely financed from off-shore, puts an additional burden on exporters through artificially elevated exchange rates.

Over the years, there has been a lot of discussion around how exactly this imbalance could be addressed. From our perspective, the challenge is finding the most effective and efficient way to do so, helping to direct our economy towards more productive investment while still meeting the housing needs of the growing population, particularly in Auckland. Whatever changes are made, these need to work with a wider Government strategy to move our economy towards high-value and productive activities.

In addition, we believe there are a number of other changes within the tax system which can help promote productive growth in New Zealand, such as the expansion of R&D tax credits, with a focus on ensuring these are easily and efficiently accessible for companies in areas of process innovation as well as product innovation. It is critical that any R&D tax policy has a significant focus on the development side, which under the current system does not receive much attention. We now have a discussion document for the current Governments policy to re-introduce R&D tax credits, with an aim of increase our R&D spent to 2% of GDP – however, the Tax Working Group should also review the case for further expansion in the future.



Panel 3C. Profit and Loss-making scenario combined



Note: Figures reflect the tax treatment of R&D expenditure for SMEs and large enterprises in OECD, EU and other major economies, some countries of which but not all, offer tax incentive support for business R&D expenditure. No estimates are available for Argentina, Estonia, Israel and Malta. Figures do not reflect preferential provisions for start-ups, young firms or a specific subset of SMEs (e.g. innovative SMEs).

Source: OECD, R&D Tax Incentive Indicators, http://oe.cd/rdtax, March 2018.

The above graphs, sourced from the OECD, show New Zealand's R&D spend vs the rest of the OECD, as well as how R&D expenditure is treated in terms of tax. It is evident that we are in the bottom half of the park, and have work to do to raise our R&D spending and subsequent innovation levels.

Accelerated depreciation for plant and equipment is another critical policy the TWG should consider to push our economy in a more productive direction. Accelerated depreciation for productive plant and equipment is commonplace in many countries around the world – the fact we do not have a similar policy, puts our manufacturing and export businesses at a disadvantage.

This policy would also better reflect the productive life of equipment, many of which need to be upgraded before they are fully depreciated under the current system. As a matter of fact, the current depreciation regime stifles innovation in manufacturing processes, as it acts as a disincentive to investing in current manufacturing technologies.

Accelerated depreciation would have positive flow on effects, in terms of productivity and competitiveness, particularly at a time where even more rapid changes in technological requirements are expected to keep up with the competition globally. This policy can also be achieve in a largely revenue neutral way over the medium term – while there may be additional costs in the first few years of implementation, as companies are able to claim higher levels of depreciation, this will be offset in later years, where lower levels of depreciation can be claim and through increased tax revenue via higher profits and productivity.

Specific questions in the background paper

1. **What do you see as the main risks, challenges, and opportunities for the tax system over the medium- to long-term? Which of these are most important?**

The core issue we face as a country is positioning our economy and businesses to thrive and become more competitive and productivity. This in turn, and paired with more balanced tax settings, will enable a more fair economy with higher living standards.

This does, however, come with a number of challenges:

- Effectively correcting tax imbalances that favour unproductivity assets (largely existing housing) over productive investment. This imbalance also worsens inequality, as owners of existing assets accrue the most wealth via rent seeking and tax free capital gains, at the expense of those without homes as well as businesses and individuals who bear a higher proportion of the tax burden because of this.
- Effectively supporting and incentives investment in innovation and R&D to build more high value businesses who can dominate export niches and effectively compete with imports – this requires both product and process innovation, and any policy needs to explicitly reflect this.
- Meeting the investment needs of a rapidly changing technology environment – we must keep up with new developments in order to stay internationally competitive. Manufacturers face the need to continuously update plant equipment to increase productivity and maintain competitiveness, as well as the spectre of networked manufacturing technology, which holds great opportunities but will require significant ongoing investment.
- Creating a tax system that can meet the challenges which come with supporting an aging populations.
- Meeting the needs of an education system which will need to continue to improve and develop to meet changing skill requirements from businesses.

2. **How should the tax system change in response to the risks, challenges, and opportunities you have identified?**

Firstly, the introduction of a capital gains tax, or similar policy, aimed at correcting the imbalances that favour investment in existing assets over productive businesses.

Follow through on the Government's policy to introduce R&D tax credits to incentivise innovation and work to expand these credits in a way which will boost New Zealand's total R&D spending (both business and Government) closer to that of the OECD average. We need to see continued investment in education and training to deal with the changing skills needs into the future, as well as addressing the skill shortages that already exist. In house training of staff will continue to be a critical part of up skilling existing staff to ensure companies can improve productivity and deal with an aging work force. In house and other forms of training by businesses could be supported through the tax system – for example, there could be some tax loading on the cost of training and up-skilling staff, such as a 120% deduction on such costs. Such a policy would, however, need very clear rules around what is eligible training to ensure the policy is not misused.

Increased training and continued up-skilling of staff will not only help businesses continue to compete, but will help move our people into better paying jobs and help them cope with the futures changing skill requirements.

3. **How could tikanga Māori (in particular manaakitanga, whanaungatanga, and kaitiakitanga) help create a more future focussed tax system?**

No comment.

4. **What principles would you use to assess the performance of the tax system?**

In the longer term, if the tax imbalances which favor investment in existing assets can be corrected, we would want to see more capital moving into productive businesses, both as a proportion of total capital and of new lending.

A measureable outcome would be increased investment in capital goods in productive industries. We would want to see this leading to growth in exports, import-competing businesses and productivity.

5. **How would you define 'fairness' in the context of the tax system? What would a fair tax system look like?**

One challenge to fairness in the tax system going forward is how offshore companies are treated when compared to New Zealand companies. This is most obvious with the ongoing issue of creating settings where large multinational companies, i.e. Facebook, Google, Apple and Amazon, who hold significant market share in New Zealand are able to pay little to no tax for their sales. This creates an unfair advantage for any local company visiting to compete in similar spaces and adds additional tax burden onto individuals and local companies who correctly pay their fair share of tax.

New Zealand needs to continue its work with other jurisdictions and the OECD as this issue is worked on. It is very likely that a cross jurisdiction approach will be needed to solve the issue and ensure such multinationals pay tax in the countries they operate.

6. **New Zealand's 'broad-based, low-rate' system, with few exemptions for GST and income tax, has been in place for over thirty years. Looking to the future, is it still the best approach for New Zealand? If not, what approach should replace it?**

We currently see this as a good approach. The simplicity of the system allows it to be relatively efficient and simple. The more complex we make the tax system, the more opportunities will arise for tax avoidance and increase the cost of operating the system, and for businesses to comply.

7. **Should there be a greater role in the tax system for taxes that intentionally modify behaviour? If so, which behaviours and/or what type of taxes?**

For manufacturers and the wider aim of increasing productivity and innovation in New Zealand, we do see a case where adjustments to the tax system could effectively encourage and support activities that would enable these outcomes – which would flow on to wider growth in the economy and enable higher wages and living standards.

The first would be around support for innovation – R&D Tax Credits – as detailed in our introduction.

These second is accelerated depreciation for plant and equipment – also detailed in the introduction. This can facilitated increased investment in critical plant and equipment needed to improve productivity and remain international competitive. The policy can also be achieve in a revenue natural way – depreciation can be claimed at an earlier stage of an investments life cycle, but the overall size of the deduction would remain the same.

8. **Should the tax system encourage saving for retirement as a goal in its own right? If so, what changes would you suggest to achieve this goal?**

Currently, owning homes and benefitting from future expected capital gains is the largest form of retirement saving in New Zealand. Settings over decades has hardwired this into our culture.

We do believe there is scope for better encouraging retirement savings, which should largely come in the form of making sure investment incentives between other forms of retirement savings and investment in housing are more equal.

This would also have other benefits, in moderating demand for existing housing for investment (pushing up prices) and increasing the capital stock in other areas (such as Kiwi saver, bank deposits, stock investment and business investment) that would help to flow on to higher capital availability for productive investment.

9. **Does the tax system strike the right balance between supporting the productive economy and the speculative economy? If it does not, what would need to change to achieve a better balance?**

Currently, our tax system does not get the balance right between the productive economy and the speculative economy. This is evident in the continued cycles of rapid house price appreciation and the large proportion of new bank lending going into the purchase of existing homes and by the ongoing struggles that productive companies have to access new capital at a fair rate for investment.

10. **Does the tax system do enough to minimise costs on business?**

While our tax system is relatively efficient, it can always be made simpler for businesses to comply. The TWG should investigate any areas where compliance costs can be efficiently reduced while maintaining the integrity of the system.

11. **Does the tax system do enough to maintain natural capital?**

Firstly, any tax measure aimed at maintaining natural capital needs to be implemented in a balanced and fair way. For example, the current emissions trading scheme, which has flaws in its exemptions towards agricultural emissions.

Secondly, there is room for better incentivising for companies to upgrade plant and equipment to reduce emissions. Both the previously mentioned R&D tax credits and accelerated deprecation policies could help in this area. However, this could also come in the form of a specific tax credit or deduction for companies who are reducing their emissions. This would needs consideration as to its specific set up and rules to ensure it could not be misused.

12. **Are there types of businesses benefiting from low effective tax rates because of excessive deductions, timing of deductions or non-taxation of certain types of income?**

One deduction which further promotes investment in non-productive assets is how tax can be deducted from interest payments on loans for rental and investment properties. This provides an unfair advantage for investors, who already benefit from large capital bases which make access to new capital much easier, over first home buyers.

13. **What are the main inconsistencies in the current tax system? Which of these inconsistencies are most important to address?**

Refer to introduction and previous questions.

14. **Is there a case to consider the introduction of any new taxes that are not currently levied? Should any taxes be reduced if new taxes are introduced?**

No additional comment.

15. **How, and to what extent, does the tax system affect housing affordability for owners and renters? Is there a case to change the tax system to promote greater housing affordability? If so, what changes would you recommend?**

As we have seen in recent decades, the tax imbalance favoring investment in assets, paired with supply issues and the failure to keep up with demand, especially in Auckland, has resulted in dramatic increases in house prices.

This obviously impacts everyone who is trying to find a house, especially impacting those without existing assets, who have benefitted from the rapid appreciation.

The other side of this coin, is the pressure it has put on businesses. As housing costs have risen, workers find it hard and harder to afford to live in good homes close to where they work. This has added significant wage pressure and lost productivity through increased travel times, while businesses have not seen any corresponding increase in productivity or profits.

16. **Should New Zealand introduce a capital gains tax (that excludes the family home)? If so, what features should it have?**

The main concern we have is that any tax policy is well designed to effectively correct the imbalance between productive and speculative investment. While this may take the form of a capital gains tax, we are interested in any policy proposition that has the best change of efficiently solving the issue.

However, while we would largely agree with a capital gains tax on residential and commercial investment property, we need policy makers to put serious consideration into how this may impact businesses, if they policy had any reach into sales of businesses beyond their land and commercial properties used for business. The value of – in our case – manufacturing businesses grows, when owner and staff are able to grow their business through better processes and better products and services. This should lead to increasing profits, which are then taxed. So a capital gains tax must not punish owners who add value to their business, aside from increases in land and property value. Therefore, any capital gains should focus on speculation in assets but not add additional taxes onto productive businesses.

If New Zealand does introduce a capital gains tax, this would need to be implemented across all residential house investors fairly and with little to no exemptions.

17. **Should New Zealand introduce a land tax (that excludes the land under the family home)? If so, what features should it have?**

Our main concern around a land tax is how it would impact businesses.

For example, if such a tax came in the form of an ongoing fair rate of return tax, this could favor big businesses, who have the capital backing and ability to pay. Where smaller business, who are more likely to have cash flow issues between orders may be hit hard if such a bill happens to fall at the wrong time.

18. **What are the main opportunities for effective environmental taxation?**

Any environmental tax needs to be implemented and charged across all emitting sectors in a fair way – this is to ensure that any emissions we do have a spent in the most productive way.

We currently have an imbalance in this area, which the exemptions to the emissions trading scheme, leaving out agriculture emissions, while other sources have to pay. This exemption simply incentivises further investment in agriculture in a way which does not take into account its environmental impact, at the expense of businesses who do bear the cost of their emissions.

19. **Should the tax system do more to support small businesses? In particular, is there a case for a progressive company tax?**

Firstly, the introduction of an R&D Tax Credit, as we are expecting in some form from the current Government, would help small businesses investment more in innovation. Currently, the R&D grants system favors larger, more established companies who are able to put in the time and effort to apply and win grants. The current support system, administered through Callaghan Innovation, makes it comparatively easy for larger firms to in effect receive a 20% R&D tax credit, while smaller firms have to go through a complicated application process to receive a ‘Project Grant’ - and most SMEs find that not to be worth their while. As such, it constitutes a *regressive* tax.

Small businesses find it hard to keep with investment needs in equipment. The introduction of accelerated depreciation for productive equipment could really help small businesses overcome these hurdles to grow and remain competitive, especially as technology requirements continue to increase.

Lastly, there is some merit in a progressive tax rate for companies. We do not have any specific proposals in this area, but we would be very interested in any work the TWG could put forward in this area.

20. Should the tax system exclude some goods and services from GST? If so, what should be excluded? What else should be taxed to make up for the lost revenue?

No comment.

I appreciate being giving the opportunity to promote comment on behalf of our manufacturing members to this Tax Working Group.

Regards,

Dr Dieter Adam

Chief Executive

The Manufacturers’ Network