

Tax Working Group Public Submissions Information Release

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TAX WORKING GROUP: SUBMISSION FROM THE MINISTRY OF FOREIGN AFFAIRS AND TRADE

Introduction

This submission responds to the request to the Chief Executive from the Chair of the Tax Working Group (TWG) on 21 March seeking the Ministry's direct input in the form of a submission to the TWG. This submission has been informed by the Ministry's role, among other things, to act in the world to make New Zealanders more prosperous; the Ministry's experience in engaging with other countries and international institutions; our expertise regarding New Zealand's international obligations; and the TWG Submissions Background Paper.

Trade, investment and the wider New Zealand economy

In addition to the challenges of productivity, sustainability and inclusiveness, New Zealand faces enduring challenges of scale, distance from markets and an export mix that is vulnerable to global protectionism. Compounding this situation New Zealand's productivity performance has been poor relative to a number of other OECD countries in recent decades. Weak international connections – including through trade and investment links – may be one factor contributing to New Zealand's relatively low productivity.¹ International connections help lift productivity through a number of channels, including increased competition, by providing New Zealand businesses access to more customers, to frontier technologies and ideas, and to broader sources of capital. These connections are particularly important given New Zealand's small domestic markets which limit the scope for relatively productive firms to expand and benefit from scale effects.

There are many external barriers (tariffs, non-tariff barriers and so on) to firms engaging internationally. Domestic policies and domestic economic conditions have an important bearing, however, on the extent to which New Zealand firms can effectively engage internationally, and on the level of participation by foreign firms and investors in New Zealand. This has broader economic and fiscal implications.

Globally, New Zealand is well-regarded in terms of the ease of doing business, ranking first in the World Bank's 2017 Doing Business Survey. The relative simplicity of New Zealand's tax regime is one factor underlying New Zealand's ranking. This is

¹ Conway, P. (2016), "Achieving New Zealand's productivity potential", Productivity Commission Research Paper, 2016/1.

an important consideration for New Zealand, given our small scale and distance from concentrations of global economic activity relative to other more attractive, much larger and better located, economies.

MBIE's briefing for the incoming Minister² observes that the performance of the housing market is one factor weighing on the tradeables sector, and consequently affects productivity in the economy more broadly. High and consistent appreciation in house prices hinders the efficiency of capital allocation in the economy by skewing investment away from more productive, tradable sectors. High house prices in some areas may also hinder labour mobility, and impede the process of matching jobs (including those related to trade) and workers. This can make it more difficult for productive firms to attract the staff they need to expand.

New Zealand has had a persistent shortfall of national saving relative to investment (reflected in a persistent current account deficit). A range of New Zealand publications³ suggest that this shortfall contributes to New Zealand's relatively high real long-term interest rates, which in turn puts upward pressure on the real exchange rate. New Zealand's real exchange rate has an important bearing on the competitiveness of New Zealand's firms internationally. For example, research on New Zealand firms found that a 10% increase in the bilateral exchange rate reduces exports to that destination market by about 3% among firms that are already exporting.⁴ A persistently high real exchange rate relative to fundamentals will weaken New Zealand's trade performance and encourage resources into the lower-productivity non-tradable part of the economy and away from higher productivity activity, much of it in the tradable sectors.

A number of factors are likely to contribute to the functioning of New Zealand's housing market and therefore, by extension to New Zealand's real exchange rate. Given the role that stronger international connections can play in lifting living standards for New Zealanders, it is important to consider the implications of tax policy settings for New Zealand's trade exposed sectors in particular and New Zealand's global connectedness. These include the role that tax settings play in influencing (and potentially distorting) saving and investment decisions in New Zealand, the effect these have on New Zealand's global connectedness, and the simplicity or complexity of New Zealand's tax regime relative to other economies. The TWG may wish to further investigate these factors.

² MBIE (2017), *Briefing for the incoming Minister of Housing and Urban Development*.

³ A. M. Brook (2014), "Options to Narrow New Zealand's Saving-Investment imbalance", New Zealand Treasury Working Paper 14/17, and the references therein.

⁴ R. Fabling and L. Sanderson (2015), *Exchange rate fluctuations and the margins of exports*, New Zealand Treasury Working Paper 15/08

Australia: the Single Economic Market and considerations for our tax regime

The economic integration agenda or Single Economic Market (SEM) seeks to develop a seamless trans-Tasman business environment – where a New Zealand enterprise finds it as easy to do business in Sydney as in Auckland, and vice-versa for an Australian firm. The SEM agenda has successfully advanced a range of taxation cooperation and alignment measures, with the capacity to achieve much more.

A long-standing objective for New Zealand in the SEM is trans-Tasman **mutual recognition of imputation credits (MRIC)**. Australia and New Zealand are the only two OECD countries to apply imputation credits (called franking credits in Australia).

New Zealand has long promoted MRIC as a logical next step for the SEM, as have business leaders. However, the Australian Government has been reluctant to engage due to the associated fiscal cost. The TWG could usefully reinforce the argument for MRIC, particularly in light of the deliberate move by both Australia and New Zealand away from consideration purely of national benefits in policy development, to consideration of the net trans-Tasman benefit. This is now a key SEM principle formally adopted by the two Prime Ministers in 2009⁵. Applying a new trans-Tasman benefit lens to MRIC should in theory underline the need for change. The narrow application of imputation and franking credits to domestically earned dividends results in the inefficient allocation of capital within the SEM. Economic modelling shows MRIC would increase trans-Tasman welfare, with a \$7.0 billion gain by 2030 (2012 estimate⁶). Currently some NZ\$7.4 billion of trans-Tasman equity investment dividends could potentially be taxed twice through company tax and later personal tax regimes. Australian equity investors in New Zealand face an effective tax rate of some 60%, and New Zealand investors in Australia face an effective tax rate of 53%⁷. The significance of these issues is underlined by the importance of investment in each other's economies. Currently, Australia has portfolio investment stock of NZ\$27.0 billion in New Zealand, and New Zealand has NZ\$34 billion stock of

⁵ The Single Economic Market Principles and Outcomes Framework was announced by Prime Ministers Key and Rudd in their joint statement of 20 August 2009.

<https://www.beehive.govt.nz/release/joint-statement-prime-ministers-rudd-and-key>

⁶ NZIER and CIE final report, August 2012 [https://nzier.org.nz/static/media/filer_public/ca/8c/ca8ca43d-703e-4f6a-b12a-](https://nzier.org.nz/static/media/filer_public/ca/8c/ca8ca43d-703e-4f6a-b12a-59e17a8808e9/120831_report_on_costs_and_benefits_of_mutual_recognition_of_imputation_and_franking_credits.pdf)

[59e17a8808e9/120831_report_on_costs_and_benefits_of_mutual_recognition_of_imputation_and_franking_credits.pdf](https://nzier.org.nz/static/media/filer_public/ca/8c/ca8ca43d-703e-4f6a-b12a-59e17a8808e9/120831_report_on_costs_and_benefits_of_mutual_recognition_of_imputation_and_franking_credits.pdf)

⁷ "Strengthening Trans-Tasman Economic Relations: A Joint Study" undertaken by the Australian Government and NZ Government Productivity Commissions in November 2012. : <https://www.productivity.govt.nz/inquiry-content/1774?stage=4>

portfolio investment in Australia (March 2017 figures). Total trans-Tasman portfolio investment flows reached \$2.2 billion in the year to March 2017.

Ministers on both sides of the Tasman have also shown interest in working together on a “one-stop shop” registration for the application of **goods and services tax on goods purchased online**. The initiative is on hold after the mandate to consider any new policy in relation to GST levied on offshore suppliers was shifted to the TWG. This has important linkages with trade and investment. The initiative should be advanced, including by consideration of the likely positive effect on competitiveness both across the SEM, but also more generally.

The digital economy

As outlined in the TWG background paper, there is growing international concern and interest in relation to the current ability of taxation structures and systems to deal with the increasing digitalisation of economies.

Considerable work has occurred to date in forums such as the OECD’s ‘Taskforce on the Digital Economy’ to try to achieve a multilateral consensus on the appropriate definitions for the “digital economy” for taxation purposes, and an appropriate suite of international measures and disciplines to govern the application of taxation rules by 2020.

As a small, open, and export-led economy that relies heavily on the international rules-based system, we recommend that work towards a broad consensus and multilateral solutions continues to be New Zealand’s overarching priority in relation to possible responses to the effect of the digital economy. New Zealand should continue to support and participate fully in this international policy dialogue regarding a possible multilateral agreement on appropriate definitions, measures and potential disciplines. This agreement needs to be an ‘open-plurilateral’ – open to all economies and apply ‘best practice’ for both tax and trade agreements. Work towards similar (open plurilateral) arrangements on investment and e-commerce is under way in the WTO context, though these are less ambitious and less likely to have an impact on fiscal matters.

Pending accepted multilateral rules in this area, some countries have been examining the possibility of interim measures such as equalisation taxes. MFAT recommends that if it is decided to examine further the potential of temporary, interim measures in the New Zealand context, thorough consideration should be given to

New Zealand's existing international legal and trade obligations and policy objectives. It would also be desirable to consider international best practice by other countries. In addition, any potential impact or influence on New Zealand's ability to attract and retain cross-border investment as well as maintaining (and enhancing) a transparent, attractive and stable business environment should also be considered.

New Zealand's international obligations: Trade Agreements

New Zealand has a network of high quality and comprehensive trade agreements in place. This architecture includes the World Trade Organisation (WTO) agreements and a range of bilateral, regional and plurilateral Free Trade Agreements (FTAs). We are continuing to negotiate further such agreements (including to update these). The need for this architecture which provides enforceable rules and disciplines has been reinforced by increasing turbulence in the global economy. The Ministry of Foreign Affairs and Trade leads the negotiation and implementation of the international agreements.

New Zealand's trade agreements, however, have only a limited impact on domestic tax policy. This is partly because New Zealand's free trade agreements generally include broadly drafted exceptions which preserve the government's right to regulate in the area of domestic tax policy. This reflects a reluctance to allow the disciplines particularly in a FTA to impact on domestic tax measures except where there is a clear need to do so. Other countries generally adopt a similar view. Taxation-related exceptions preserve the carefully negotiated rights and obligations with respect to taxation that exist in the WTO agreements. Those provisions that do apply to taxation measures limit countries' ability to discriminate against or unfairly disadvantage foreign goods, services and investment. These includes obligations that limit governments' ability to condition tax advantages on specified 'performance requirements' for foreign investments, among other things. As an export-dependent country New Zealand has important interests in seeking to ensure an appropriate balance between protecting the government's right to regulate particularly for domestic tax policy while limiting the scope for other countries to disadvantage our exporters, for example through use of the tax regime to deliver trade and investment distorting subsidies.

International tax policy, including measures to address multinational tax avoidance, is largely dealt with in bilateral and multilateral tax agreements negotiated by the Inland Revenue Department. New Zealand's trade agreements typically give primacy to these agreements.

There is a potential question worth considering around investment incentives some of which relate to fiscal policy. This is an area where disciplines could be applied internationally, although there is at present no ready basis for agreement to discipline tax incentives. The competitiveness of New Zealand as an investment destination is influenced by New Zealand's own tax settings but also the tax settings of other countries, particularly where other countries provide investment or related tax incentives in the form of exemptions, tax holidays and rebates or other potentially distorting measures. The impact of tax competition is potentially inflated where other factors such as political and regulatory stability are not at play. Aside from the WTO Agreement on Trade Related Investment Measures (TRIMs) which is relatively narrow in scope, there are no meaningful multilateral disciplines on investment incentives designed to affect FDI to a particular location. The need for transparent and non-discriminatory rules and disciplines in this area is clear, but countries – particularly those with 'deep pockets' - continue to be reluctant to work multilaterally to address this significant gap in the international trade and investment rules-based system. This may be something for the TWG to consider further in terms of the intended issues before it, including to encourage an intensification of focus on these issues in New Zealand's international trade policy agenda.

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