Tax, investment and productivity

Consultation on the scope of Inland Revenue’s
long-term insights briefing

August 2021

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Tax, investment and productivity – consultation on the scope of Inland Revenue’s long-term insights briefing

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# Consultation on the scope of Inland Revenue’slong-term insights briefing

## Introduction

* 1. New Zealand’s poor performance on productivity has been a longstanding concern. An important question is whether New Zealand’s tax settings are a significant contributor. Despite other public sector work on productivity, there has not been any broad analysis of the effects of taxes on inbound investment and their impacts on investment and productivity.
	2. Questions of how best to address weak productivity and poor economic performance are complex and there is unlikely to be a single ‘silver bullet’. Many other important productivity issues could be considered including:
		+ competition policy and the degree of monopoly power
		+ migration settings and incentives for firms to invest in productivity improving technology or bring in cheaper labour, and
		+ broader policy settings which may affect the housing market and incentives to invest there.
	3. Despite other public sector work on productivity, there has not been any broad analysis of the effects of taxes on productivity. There are likely to be many channels through which taxes affect productivity, but one that will be an important influence of the level of New Zealand’s capital stock is taxes on inbound investment and their impacts on investment.
	4. The long-term insights briefing (LTIB) we propose is looking at one particular set of issues. It should be noted that agencies are also looking at productivity issues in their LTIBs, including for example, the Ministry of Business, Innovation, and Employment’s LTIB on The future of business for Aotearoa New Zealand.[[1]](#footnote-1) Our LTIB is narrower but aims to be complementary to and supportive of other work in this area.
	5. Work on this topic has been facilitated by work at the OECD which allows us to benchmark how tax provisions are likely to be affecting costs of capital (for example, hurdle rates of return on inbound investment) in New Zealand compared with impacts in other OECD countries. Analysing the effects of taxes on costs of capital will allow us to document the likely cumulative effects of tax changes in New Zealand. It will also help in examining the pros and cons of possible future business tax changes which may impact on costs of capital, capital accumulation and productivity.
	6. We are proposing that Inland Revenue’s 2022 LTIB focuses on tax, investment and productivity. We are seeking input from the public on the topics we are proposing to cover in our LTIB.

## Background

* 1. Alongside the Treasury, Inland Revenue provides advice to the Ministers of Finance and of Revenue on the tax and social policies administered through the tax system. As part of providing advice, Inland Revenue has an important stewardship role to ensure that we are well placed to advise present and future governments on tax policy issues which are likely to be of vital interest to New Zealand in the future.
	2. Under the Public Service Act 2020 there is a new legislative requirement for public service chief executives to undertake public consultation on the topics to be included in an LTIB as well as on a draft of the briefing.[[2]](#footnote-2) This is required to happen at least once every three years.
	3. The purpose of a briefing is to make available to the public:
		+ information about medium and long-term trends, risks, and opportunities that affect or may affect New Zealand society, and
		+ information and impartial analysis, including policy options for responding to the trends, risks and opportunities that have been identified.
	4. This is Inland Revenue’s first long term insights briefing and the aim of this paper is to consult the public on the subject matter which should be included in the briefing.

## What do you think?

* 1. We are seeking your feedback on the proposed topics outlined in this document for our 2022 long-term insights briefing on tax, investment and productivity.
	2. Please indicate whether officials from Inland Revenue may contact you to discuss the points raised, if required.
	3. The closing date for submission on the topics to be covered in our LTIB is **6 September 2021**.
	4. Submissions may be made:
		+ by email to policy.webmaster@ird.govt.nz with “LTIB topics” in the subject line, or
		+ by post to:

LTIB topics

c/- Deputy Commissioner, Policy and Regulatory Stewardship

Inland Revenue Department

PO Box 2198

Wellington 6140

* 1. Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of responses on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that any part of your submission should properly be withheld under the Act please clearly indicate this.
	2. There will be a further opportunity to provide feedback when Inland Revenue’s draft LTIB is put out for consultation in early 2022. The LTIB will then be finalised and provided to the House of Representatives in mid-2022.

## Proposed scope of the LTIB

* 1. Inland Revenue is proposing to focus its 2022 LTIB on tax and its impact on investment and productivity. Investment and productivity are important factors affecting long-term living standards in New Zealand.

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| **Key question to consider*** Is tax and its impact on investment and productivity a worthwhile subject to investigate further through an LTIB?
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* 1. Our suggested LTIB aims to obtain a better understanding of how taxes are likely to be affecting costs of capital and the likely implications for inbound investment, productivity and economic performance. It also aims to seek views on the merits of reducing costs of capital and making these more uniform and of the pros and cons of different ways of achieving this, should this become a future priority. It considers the possibility that New Zealand may be getting out of line with tax treatments in other countries and that this may be reducing economic performance and well-being in New Zealand.
	2. Taxing income generated by inbound investment helps generate government tax revenue to finance government spending. At the same time it will tend to increase costs of capital, lower New Zealand’s capital stock and put downward pressure on wages because with less capital stock labour will become less productive. The main way that this happens is through taxes imposed at the company level. Non-neutral taxes which result in variability of costs of capital across different types of investment can reduce economic performance further if they encourage firms to invest because of the tax benefits rather than on the basis of the best underlying returns.

## Key trends and issues

### The company tax rate

* 1. In the late 1980s and early 1990s New Zealand had a relatively low company tax rate compared to most other OECD countries which, other things equal, will have made New Zealand a relatively attractive place to invest. Since then there has been an ongoing trend for OECD countries to cut their company tax rates prompted by concerns about promoting investment (or at least not discouraging it too much) and reducing international tax avoidance pressures. These tax avoidance pressures are most pressing in countries with relatively high company tax rates.
	2. Most other OECD countries have cut their company tax rates more than New Zealand and our relative company tax rate has increased despite cuts in our company tax rate in 2008 and 2011. This is shown in figure 1.[[3]](#footnote-3) In 2020 New Zealand had the ninth highest company tax rate of the 38 OECD countries at that time (combining taxes levied at different levels of government if more than one level of government imposes company tax). Substantial cuts in company tax rates have occurred in non-OECD countries as well.

Figure 1: Company tax rates in NZ and some other OECD countries[[4]](#footnote-4)

* 1. The fact that many other countries have been cutting company tax rates more quickly than New Zealand does not necessarily mean that New Zealand should follow suit. As the New Zealand Productivity Commission has stated “New Zealand’s disappointing productivity performance has held back its standard of living, and wellbeing more generally. New Zealand’s productivity performance has continued to lag despite various significant policy efforts, which highlights how difficult it is to lift national productivity. This decades-old problem has persisted through large structural changes in the economy.”[[5]](#footnote-5) This includes times when New Zealand’s company tax rate has been relatively low and when it has been relatively high. But it is nonetheless sensible to examine whether New Zealand’s tax settings are the most appropriate.
	2. It should also be noted that there may be some movement back towards higher company tax rates internationally. For example, the United Kingdom has announced an intention to increase its company tax rate from 19% to 25%, the United States has announced its intention to increase its Federal company tax rate from 19% to 28% and, most recently, 130 out of 139 jurisdictions have signed up to a new international tax framework promoted by the OECD which would result in a global minimum company tax rate of 15%. Many countries are examining how best to repair their fiscal positions after having responded to COVID-19 and this may reduce the downward pressure on company tax rates.
	3. The company tax rate is only one of a much broader set of tax considerations that can influence incentives to invest. Measures such as tax depreciation provisions, other tax incentives such as New Zealand’s R&D Tax Incentive and thin capitalisation rules (which constrain the ability of firms to deduct their interest payments) can all impact on hurdle rates of return and affect investment.

### Effective marginal tax rates

* 1. The OECD has attempted to measure the overall effects of tax provisions on incentives to invest taking account of not only the company tax rate but also tax depreciation provisions. The OECD measures do not take account of more detailed tax provisions which are harder to analyse such as thin capitalisation provisions. The OECD reports a range of possible measures including effective marginal tax rates (EMTRs) under a range of macroeconomic assumptions. The higher the EMTRs, the higher the hurdle rates of return will tend to be. Results under their high interest rate and high inflation assumptions are reported in figure 2 for OECD countries in 2019, the latest year for which data are available.

Figure 2: Composite EMTRs for OECD countries in 2019

* 1. By the OECD’s estimates, New Zealand was at the high end of composite EMTRs in 2019 for OECD countries although not as high as some other countries including Australia. At the same time, New Zealand had very high estimated costs of capital and EMTRs for some categories of asset including non-residential buildings (highest EMTRs) and inventories (third highest EMTRs). Despite the reintroduction of building depreciation in 2020 costs of capital and EMTRs for some assets are still likely to be very high relative to other countries.

### Foreign direct investment and outbound direct investment

* 1. In its recent report on frontier firms, the New Zealand Productivity Commission suggests that attracting high-quality foreign direct investment (FDI) and outbound direct investment (ODI) are both critical for very high performing frontier firms to develop in small advanced economies.[[6]](#footnote-6) Figure 3 shows how FDI as a percentage of GDP has been flat or declining in New Zealand whereas it has generally been growing in other OECD countries including Australia and the United Kingdom.

Figure 3: FDI as a percentage of GDP

* 1. As is shown in figure 4 New Zealand’s ODI has been particularly weak.

Figure 4: ODI as a percentage of GDP

### Economic performance

* 1. In 1950 New Zealand’s GDP per capita was very similar to that of Australia and the United States.[[7]](#footnote-7) OECD data indicates that by 1970 New Zealand’s GDP per capita had fallen to 75% of that in the United States. There had also been a decline in Australia (although a much smaller decline) to around 89% of US GDP per capita.
	2. Since 1970 there were further declines in GDP per capita relative to the US until the early 1990s. After that our relative decline appears to have halted and OECD data suggests some small recovery over the last 15 years. But our levels of GDP per capita are much lower than they once were relative to the United States, Australia and many other countries. This is shown in figure 5.

Figure 5: Real GDP per capita relative to the US

* 1. As the New Zealand Productivity Commission has pointed out, our relative levels of GDP per capita look better than they would otherwise look because of hours of work increasing in New Zealand relative to the United States. Labour productivity (GDP per hour worked) has shown no significant sign of recovery. Labour productivity in New Zealand is now 60% of what it is in the United States and lower than what it was (as a percentage of US labour productivity) in the early 1990s as is shown in figure 6.

Figure 6: NZ GDP per capita and GDP per hour worked relative to the US

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| **Key question to consider*** Are there other global tax trends that are critical to this study which should be considered?
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## Suggested outline

* 1. The first part of the LTIB will be aiming to establish the facts. We will benchmark costs of capital and EMTRs in New Zealand against other countries drawing on work of the OECD. However, we will also be aiming to explore what has happened in New Zealand over a longer period of time (the last 20 years rather than the much shorter period available in the OECD analysis).[[8]](#footnote-8) We will also be looking to at least touch on a broader set of tax changes than those included in the OECD study, including some likely effects of changes in the thin capitalisation provisions. Our analysis for New Zealand is also intended to be helpful in analysing the effects of possible tax changes.
	2. The aim of the briefing is to open up the question of whether or not New Zealand’s business tax settings have been part of the reason for New Zealand’s relatively poor productivity performance. We will discuss ways in which tax settings can impact on investment and productivity. An important focus will be on FDI by foreign-owned firms. However, we are also interested in the impacts on other New Zealand firms including companies listed on the NZX and small and medium enterprises (SMEs) which may have little or no foreign shareholding.
	3. Measures which lower costs of capital and EMTRs on inbound investment and which make these more uniform are likely to be helpful in improving productivity and economic performance. However, governments will have important distributional goals for the tax system as well as concerns about economic efficiency and productivity.
	4. There are many ways of lowering costs of capital which can have different distributional effects. For example, lowering the company tax rate by itself could make it harder for the Government to levy as progressive an income tax on individuals (because high income earners may be able to shelter their income in companies and have this taxed at the company rate rather than at higher personal tax rates). There are obviously measures aimed at maintaining or increasing progressivity which could accompany measures reducing costs of capital such as increasing taxes at the shareholder level.
	5. The briefing will be seeking feedback on the pros and cons of different possible approaches which might lower costs of capital and whether these are likely to be improvements on the status quo. Possible measures which might lower costs of capital are likely to include:
		+ reductions in the company tax rate
		+ measures which increase the present value of capital write offs for capital expenditure
		+ measures to take account of inflation to reduce overstatements or understatements of capital income
		+ changes to thin-capitalisation rules which might allow multinational firms to claim greater deductions for interest expense
		+ changes to allow multinational firms or other firms with foreign shareholders a notional interest deduction on their equity
		+ specific incentives for particular types of investment or specific types of business, and
		+ more fundamental changes in the tax base such as the dual income tax structure adopted in Nordic countries with a relatively low flat marginal tax rate on capital income with higher progressive tax rates on labour income.
	6. It will also be important to consider how these changes might affect the neutrality of tax settings. There will be other issues to consider as well. For example, to what extent should tax reforms in New Zealand be influenced by what is happening in other countries including whether company tax rates are decreasing or increasing? At end of the day many factors will influence future tax policy settings including concerns about the progressivity and integrity of the overall tax system. The aim of the briefing is not to resolve all of these issues but to attempt to benchmark New Zealand’s setting against other countries and to seek views on the merits of reducing the cost of capital on inbound investment and the pros and cons of different ways of achieving this should this become a pressing priority in the future.

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| **Key questions to consider*** Are these sensible policy options to consider?
* Are there other reforms which should also be considered?
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1. Ministry of Business, Innovation and Employment (2021), The future of business for Aotearoa New Zealand: Opportunities and implications for productivity and wellbeing, available at <https://www.mbie.govt.nz/dmsdocument/15644-the-future-of-business-for-aotearoa-new-zealand-opportunities-and-implications-for-productivity-and-wellbeing> [↑](#footnote-ref-1)
2. See schedule 6, clauses 8 and 9 of the Public Service Act 2020. [↑](#footnote-ref-2)
3. Data for figures 1 to 6 are available on the OECD website at <https://stats.oecd.org/> Data for figure 1 was supplemented by some additional information for early years provided to us by the OECD but which is not available on their website. [↑](#footnote-ref-3)
4. This is OECD data and combines taxes on company profits levied at all levels of government. For example, the United States company tax rate is 25.8% in 2020 which combines a federal company tax rate of 19% with tax levied at the State level. [↑](#footnote-ref-4)
5. New Zealand Productivity Commission (2021), New Zealand Firms: Reaching for the Frontier, April, page 1, available at <https://www.productivity.govt.nz/assets/Documents/Final-report-Frontier-firms.pdf> [↑](#footnote-ref-5)
6. New Zealand Productivity Commission (2021), New Zealand Firms: Reaching for the Frontier, op cit. [↑](#footnote-ref-6)
7. In Productivity by the Numbers, May 2021, page 21, available at <https://www.productivity.govt.nz/research/productivity-by-the-numbers/>, the New Zealand Productivity Commission provides a longer time series which goes back to 1950 using Conference Board Total Economy Data. This suggests that New Zealand’s GDP per capita declined from 101% to 67% of US GDP over the period 1950 to 2019. [↑](#footnote-ref-7)
8. See the data available at <https://stats.oecd.org/> under Public Sector, Taxation and Market Regulation » Taxation » Corporate Tax Statistics » Effective Tax Rates. [↑](#footnote-ref-8)