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Deputy Commissioner
Policy and Regulatory Stewardship, Inland Revenue
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Dear Sir

Long Term Insights Briefing

Inland Revenue is proposing to focus on tax, investment and productivity for its first Long Term Insights Briefing (LTIB) due in 2022. Specifically, it will consider:

- How taxes are likely to be affecting the cost of capital and the likely implications for inbound investment;
- Whether New Zealand is out of line with the tax treatments in other countries; and
- Views on the merits of reducing (tax) costs of capital and making these more uniform as well as the pros and cons of different ways of achieving this.

Is this a worthwhile topic?

We make some observations before answering this specific question.

The universe of possible topics of interest for the tax system is vast. For example, the Treasury's draft 2021 Long Term Fiscal Position ("Draft LTFP") raise two questions:

- The role of the tax system. Is it to raise revenue to fund Government's spending commitments, influence behaviour, or some combination thereof? If the former, one approach which the Draft LTFP raises as an alternative is to control (i.e. limit or reduce) the Government's spending track. We note that the Tax Working Group considered and ultimately rejected a role for the tax system in influencing behaviour (other than in specific areas relating to environmental outcomes). However, we note that neither of these are an "official" statement of the policy principles for the tax system.
- The applicable rates of taxation on capital income. The Draft LTFP uses, as a starting point, an average tax rate on capital income of 30%. We assume this is the rate on capital income that is subject to tax. As you will be aware not all capital income is presently taxable. You will also be aware the Tax Working Group lamented the lack of data on tax rates applicable to different types of capital income. Inland Revenue has on its work programme the taxation of high net worth individuals, but this is only one data point. It will not provide a general determination of the average tax rate on capital income.

This particular topic has apparently been chosen because investment and productivity are important factors affecting long-term living standards in New Zealand (paragraph 17). The scoping document also notes that MBIE is consulting on: *The future of business for Aotearoa*

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New Zealand, which includes productivity issues. We also note the Productivity Commission's ongoing focus on New Zealand's poor productivity performance (most recently in its 2021 inquiry benchmarking New Zealand's frontier firms against those in peer countries). We understand Inland Revenue's work is intended to be complementary to these other studies.

Productivity is a measure of how efficiently "inputs", such as labour and capital, are being used to produce "outputs". Higher productivity means the ability to produce more output for less input. At an economy-wide level, however, an increase in national output could also be achieved by:

- Selling the same product (however efficiently produced) at a higher price; or
- Reducing the cost of labour or capital (either fixed assets or funding costs) for producing the same product. This does not necessarily require those inputs to be more efficiently used.

Of course, a combination of all of the above may be possible, and preferred, for any particular product.

Although tax policy settings may influence productivity, of equal, if not greater importance, are likely to be factors such as:

- What comparative advantage does New Zealand have in terms of its economy? Tourism and primary production are two sectors which are highlighted as areas we excel at. International tourism was a large part of our pre-COVID economy. We have location advantages but our ability to "produce" from that has capacity constraints and also price constraints. In relation to the latter, we are still a price "taker" in the global market. As a simple example, producing a cup of coffee for tourists has both price and capacity constraints. There is a market price limit and, although we may have not reached the maximum production level, there is a physical limit to how many a barista can make in any given hour. Primary production is similar, in that while a significant export contributor, there are both capacity and price constraints (again, NZ is a price taker). This can be contrasted to economies which have comparative advantages in sectors where, given the size of the global market (demand) and/or limited supply, mean they are price "makers". The point here is that New Zealand's inability to affect price and/or capacity constraints in the economy (due to our small size) may have as much a bearing on our long run economic performance as productivity gains. Conversely, this suggests that New Zealand cannot be a laggard, from a productivity perspective, lest we fall further behind.
- Managing the domestic and export economy through non-fiscal policy settings (e.g. monetary policy). If we recall correctly, an analysis we saw a few years ago showed that New Zealand had produced and sold more dairy product in a period but had received less in NZD. Higher interest rates, because of domestic pressures on the housing market and inflation, led to a higher exchange rate and therefore a lower return for exports. Despite productivity increases, more was being physically produced, the sales price in NZD did not hold up. This illustrates to us that productivity gains may be limited by the impact of other policies, which may reduce the overall return to New Zealand.
- Productivity is a measure of the efficiency of output, which is a financial metric. The Living Standards Framework takes a more holistic view of wellbeing. While greater productivity will boost livings standards, the source of productivity gains needs to be carefully evaluated. For example, to see if it is detrimental to the natural and social capitals – that is, is the productivity gain made at the cost of environmental degradation or mass unemployment?

Although the topic is a worthwhile one, given other topics are available and other agencies are also considering productivity, it is not clear that it is a topic which should take priority. To us, it makes more sense for New Zealand's "productivity problem" to be considered holistically.

However, we assume that Inland Revenue will proceed with its chosen topic and therefore provide further comments.

Comments on the key trends and issues section

The current FDI framework

Implicit in the topic is consideration of New Zealand's current framework - the 2016 draft *New Zealand's taxation framework for inbound investment* (https://taxpolicy.ird.govt.nz/publications/2016/2016-other-nz-framework-inbound-investment and which does not appear to have been finalised.).

In brief, we describe this framework as "if you are prepared to pay tax in New Zealand, you are welcome." The LTIB needs to describe the policy and its implications for New Zealand tax policy.

The company tax rate

We agree that the headline rate is important for New Zealand. In our experience, if there is a choice of location, the headline rate can act as a gateway, or barrier, for further analysis.

Effective marginal tax rates

Generally

However, the effective marginal tax rate is what actually applies. The overseas company rate reductions have generally been accompanied by tax base changes (for example, the Base Erosion and Profit Shifting changes). The overall result may not be an actual tax reduction. This contrasts with New Zealand's approach which has widened the base while retaining the rate.

We note the OECD's calculations of effective marginal tax rates (EMTRs) are limited. This is surprising. The OECD has access to member states' revenue authorities (and with the Inclusive Framework, many more countries). It could, for example, have each country determine the EMTRs for a number of standardised company examples. (We are mindful that the BEPS project may make this type of analysis sensitive however.)

The risk for New Zealand is that it does this work in isolation. If this produces a high EMTR, along with a high headline rate, this may make New Zealand less attractive.

Any EMTR work should be done with an encouragement to the OECD to do this work more broadly.

Specific items

We note there are stated to be high EMTRs for non-residential buildings and inventory. We have not reviewed the OECD work but note, for buildings, the high EMTR may not take into account the likely nil EMTR on sale.

FDI and Outbound investment

For FDI, we note that disinvestment, as a result of the global financial crisis (as multi-nationals "retreated" home), and potentially tighter overseas investment rules, particularly with relation to land, may have had an in impact. Controlling for these factors, so the effect of tax can be isolated, may be difficult.

We are also aware that Inland Revenue has previously argued that the presence of "economic rents" may justify a comparatively higher company rate, as New Zealand company tax is effectively a final tax for non-residents. In contrast, cost of capital arguments have typically justified lower rates on debt (e.g. the Approved Issuer Levy). We assume both of these positions will be tested in the LTIB.

Economic performance

New Zealand's economic performance has been much studied. A solution to the "productivity problem" is not apparent. We expect there are many relevant studies but our comments regarding productivity suggest that there is a "what can we sell and to who" constraint.

Statements of Australia's position, albeit from a geo-political perspective, (and found at https://arena.org.au/the-rules-based-order and Greenfields, cash cows and the regulation of foreign investment in Australia (aph.gov.au), illustrate possible analyses we have in mind. (Note the references are simply illustrative, we should not be taken to accept the analysis as correct.) An equivalent analysis for New Zealand is likely to suggest that taxation is less instructive as an explanation of New Zealand's performance.

With some hesitation, we also suggest that the performance of the housing market may have an impact. It has an effect on interest rates and therefore on the exchange rate. However, tax settings for residential housing are part of another stream of work and so, we assume, can be excluded from the LTIB.

Other global tax trends

We suggest that global trends, per se, are likely to have more impact than global tax trends.

However, we consider an important determinant that should be taken into account is the prevalence of classical corporate tax systems globally.

In New Zealand, we tend to think of company taxation as a withholding tax for shareholders because of the imputation system. This is true for domestic investors.

It is also true for non-resident investors from a New Zealand tax perspective. However, it is not true from a "home country" tax perspective.

New Zealand tax is an expense for them (assuming the shareholders receive no underlying foreign tax credit). If the home country provides no foreign tax credit for New Zealand company tax paid, there is a potential for at least double taxation of New Zealand profits for non-residents.

In a New Zealand context, we see imputation as producing a home country investment bias (which may be of interest for the analysis of outbound investment). In a classical tax system, the bias is to have tax apply at the shareholder level as that is a single tax. (Even better if the shareholder's return can be received by a tax preferred vehicle.)

Accordingly, the global tax trend that we consider is important is the general absence of imputation systems.

Suggested outline and possible response

Work to be done

The outline seems reasonable. We consider that it is best for comments on the work to be done, apart from comments already made above, to wait for the draft briefing. We would of course be happy to discuss.

Possible responses

We consider the possible responses identified appear appropriate issues. This does not mean we support any particular response at this point. In our view, it is important to know why a particular path has not been chosen as well as why another has been. Considering the available options will help with this.

We make two specific comments:

— The present value of capital write offs has another aspect. If it encourages greater capital investment this will generally be at the cost of labour. That obviously has revenue and societal impacts that need to be considered.

- A present value approach would also consider the tax effects of termination values of FDI for a New Zealand business. Generally, tax on the sale of capital equipment is limited to taxing depreciation recovered. A wider focus would also consider the tax effect of goodwill and other capital assets sold. It may also include consideration of exit taxes. The lack of such taxes may explain reductions in FDI (as there is limited tax penalty for extracting assets from New Zealand). As with some of our other comments, this is not support of such taxes but consideration of them may:
  - Confirm why they should not apply; and/or
  - Provide information to investors when they compare EMTRs for New Zealand with other countries.

General

We are happy to discuss our comments. Please do not hesitate to contact John Cantin (04) 816 4518 or Darshana Elwela (09) 367 5940.

Yours sincerely

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