Comments on: "Draft Long-term Insights Briefing Paper: Tax, Foreign Investment and Productivity"

These comments combine reflections on both elements of the Draft LTIB: the Main Report (MR) and the Technical Appendices (TA).

A. Overall Assessment

This is impressive work, and was a pleasure to read. I learnt a good deal, not only on New Zealand specifics, but also on the assessment of alternative corporate tax regimes more broadly.

The coverage is comprehensive and appropriate.[1] The technical analysis is careful and clear—it is of the highest professional standards. The presentation of pros and cons of the reform options is very balanced. And the exposition strikes a good balance between comprehensibility and rigor. The Draft LTIB thus does an admirable job of reaching the objective set out in MR ¶12 "of "start[ing] a conversation on what people see as the most important objectives for reform and whether particular reforms are worth considering further. enabling an informed public discussion of these issues."

All this means that my comments are relatively minor, being mainly suggestions for clarification or elaboration. I hope they are helpful.

B. General Observations

1. Framing the Problem

Exaggerating somewhat, the report is rooted in two claims: (1) Conceptually, a higher EMTR than is found in other countries is a—implicitly, the—major potential tax impediment to inward investment, and (2) Empirically, there is reason to suppose that EMTRs in New Zealand are indeed high relative to those found elsewhere, because of the OECD work cited. Both elements—especially (1)—may merit some elaboration. In turn:

What about the effective <u>average</u> rate of tax?

One strand in the literature has highlighted the potential importance of the effective *average* tax rate (EATR),[2] rather than the EMTR, in driving cross-border location decisions. The classic example is of a case in which some lumpy investment must be located in either of two countries: if pre-tax profitability is the same, it will be located wherever total tax is the lowest; and that total tax will reflect not just the EMTR but also, independently, the statutory rate (because the latter influences the rate at which intra-marginal earnings (rent) are taxed). And of course EATRs and EMTRs, while linked, do not necessarily track each other, in the sense that a high (or low) EATR can go with a low (or high) EMTR.

The authors are of course fully aware of this, and mention the EATR in MR ¶3.2. So it seems to be a conscious decision not to pursue the EATR aspect—it would be helpful to know the reason! Some working in this area do appear to see the arbitrariness of the assumptions needed to calculate

[1] I have just one observation on this below.

[2] Following in particular Devereux and Griffiths (2003).

forward-looking EATRs as a major weakness (this not the first paper I have noted to be quietly reluctant to use EATRs)—but they are arguably not much more so than those needed to calculate EMTRs. Or perhaps the view is that a comparison of EMTRs and statutory rates is just as informative—though then perhaps the report might linger a little more on the statutory rate aspects and their significance not just for transfer pricing issues but also for location decisions.

In any case, the reader may wonder if available EATR numbers tell much the same story as the OECD's EMTRs. Table A below reports two such readily available sets of numbers for OECD members: one is from the Oxford University Center of Business Taxation (CBT), the other from one column (chosen more of less randomly) in Table 3 of Hannapi (cited in the report). These do show New Zealand as being on the high side in terms of the EATR, though not dramatically so: New Zealand has the 9th or 13th (respectively) highest EATR. In both sets of figures, moreover, this is not far off the mean:[3] less than one standard deviation in each case.

What about other estimates of the EMTR?

The OECD estimates of EMTRs naturally come with some stamp of authority. But they are not the only estimates, and one might wonder if others—not necessarily better, but also not necessarily worse—tell the same story. The last two columns of Table A report estimates from CBT and Bazel and Mintz (2021). These leave rather different impressions: New Zealand is 5th in the CBT numbers, which us reassuringly similar to the OECD, but noticeably lower, at 13th, in Barzel-Mintz. If one looks beyond the ranking, however, to the likely significance of New Zealand's difference from others, even in the CBT case the EMTR is only a little more than one standard deviation from the mean.[4]

So,,,,

One takeaway from all this may be that New Zealand may not be quite such an outlier as the Table in MR Figure 3.1 Panel B may suggest, at least in terms of the EATR that arguably most matters for Inward investment.

Perhaps more important, however, it may be worth highlighting earlies the health warnings around the use of METRs: that they provide "no more than a partial insight" (MR ¶3.2) and that " Small changes in assumptions can lead to large differences in reported EMTRs. Moreover, as will be discussed in later chapters, they can affect conclusions." (TA ¶2.72)—not least, it might be added, they can also change rankings; and rankings themselves can mislead if they reflect very small differences. Indeed one

[3] The mean turns out to be much the same as the median.

[4] What also stands out from the table is how different can be the estimated EMTRs, for the same country, under the different methodologies: for Japan, for instance, CBT has an EMTR of 19.2 while Bazel-Mintz has 28.7. (Strikingly, however, those for New Zealand are very similar: though not much can be read into that, given the apparent differences in methodologies, reflected in a very different means). This also implied that the ordering of countries—not just the position of New Zealand—can be very different: for instance, the 4 countries with the highest EMTRs are entirely different in the CBT and Bazel and Mintz (2021) numbers.

The differences (beyond levels) between the estimates are much smaller for the EATR, though other columns in Hannapi might give a different conclusion.

lesson of the report—implicit, but perhaps worth making explicitly—is that one needs to look much deeper than the kinds of rankings of "the" METR that so naturally attract attention.

2. What significance of the Inclusive Framework agreement?

While there a few references to developments in the Inclusive Framework, this is such a major development in cross-border international taxation, that it might be useful to consider explicitly its implications for New Zealand and for thinking about the various reform options. These implications may be limited—and I imagine much work on this is underway!—but if so it would be helpful to understand if and why that is the view taken in the Report.

Two aspects come to mind in relation to Pillar 2 (the minimum tax):

a. It may very well be that the moderately high rate and broad base mean that few entities in New Zealand will currently have effective rates below 15 percent and so be subject to the top up. Is that a basic assumption of the analysis? Even if that is so, one could imagine that some of the incentives discussed in general terms in Chapter 11 might bring effective rates for affected entities below 15 percent, so that their effect would be to some degree (though not wholly) diluted—this may be worth noting as potentially limiting their effectiveness. (Perhaps too, as noted below, mention might be made of non-refundable tax credits as one way to get an entity's total tax below the otherwise absolute minimum of 15 percent of excess profit).

   The Pillar 2 rules of course will only apply, however, for multinational groups large enough to be in-scope of the minimum: is the presumption that there are or will be no such multinationals large enough to be likely affected by any incentives that New Zealand might consider, or an implication that they would/ought to be designed not to apply to such entities?

b. Even if New Zealand is not directly affected by the minimum, its application elsewhere will have indirect effects that might be significant:

   - Outward profit shifting will presumably be less of a concern, as, with global adoption, the lowest rate achievable elsewhere would be in the region of 15 percent. That may reduce pressures on the level of the statutory rate. (This is mentioned briefly in MR ¶6.13).

   - In relative terms, higher taxation elsewhere may make New Zealand a more attractive location even with unchanged policies there (because EA/MTRs rise elsewhere).

   - Less positively, a reduced ability to shift profits out of New Zealand makes investing there less attractive: in effect, it raises the EMTR.[5] The importance of this effect is likely to remain largely imponderable, but: to get a broad sense: Is there any readily available information on the likely extent of outward profit shifting from New Zealand?

[5] This point goes back (I think) to Hines and Rice (1994). It may be worth noting in the Report that the calculated EMTRs do not include a profit shifting-induced reduction.

Also:

c. Any reflections to offer on Pillar 1? Perhaps this is more a matter of revenue than of incentives for inward investment?

3. Another option: Cash flow taxation?

The selection of reform options for consideration in the LTIB is well done, and wholly appropriate. There is just one other alternative that it might be useful to mention (or indicate why it is not pursued): cash flow taxation. This has been so prominent in the debate on corporate tax reform—and with interest revived by elements of the 2017 Tax Cuts and Jobs Act in the US—that the absence of any mention is striking.

If felt worthwhile, it may be that offering some remarks on this option would not seem to require additional simulation work, since, as with the ACE (and is indeed hinted in MR ¶10.), the key feature is that the EMTR would be zero. Much of the discussion of the ACE might apply here too: e.g. the implications for integration with personal taxation if the normal return is excluded from tax at corporate level. But perhaps the transition problems (MR 10.24) would be less with a cash flow tax?

3. Mix and match?

It might be worth addressing in the MR the question of whether the various reform options considered could be combined. My sense is that a health warning may be appropriate on this: for example, I don't think one would want to *both* provide more accelerated depreciation *and* loosen thin cap rules.

4. Scene-setting

It might be helpful to set out at the start of—or in an Appendix to—the MR a short summary description of core aspects of the New Zealand tax system that will come into play in the discussion (corporate and personal tax rates, imputation, typical treatment of depreciation, NRWT, AIL—and the perhaps the quite striking numbers in MR footnote 9 and on the share of profits accruing to foreign companies.) Most readers will of course be more familiar with all this than I am—but I imagine that even for them, as well as for the wider international readership the LTIB will deserve, it may be useful to have all this set out clearly in one place.

C. More specific comments

These are (more or less) in the order they arise in the MR and TA respectively, rather than by possible significance.

Main report:

1. ¶2.3: Are there also property taxes in New Zealand that might be relevant?

2. Perhaps use the same color for NZ in Figures 1.1-1.4?

3. Perhaps, in the discussion following ¶2.7, spell out that the argument points to a low EMTR but a high EATR on location-specific rents? The text nearly does this, but not quite—and being explicit here might help the reader understand some of the later discussion

4. It might be helpful too if were possible to give some sense of the extent to which major inward investors into New Zealand may in fact be able to credit taxes paid there (e.g. under GILTI), nuancing the zero-tax argument. The implicit assumption here appears to be that generally they will not be able to—is there good reason to suppose that the be the case?

5. Five lines from end of ¶2.11: specify *pre-tax* interest rate?

6. In ¶2.20, does the 8.3 percent number reflect/assume no distribution of profits?

7. In ¶2:40, presumably the evidence cited includes effects through domestic investment, not just inward real FDI?

8. P.33, first bullet: I always find counter-intuitive the (perfectly correct, I think)[6] claim that, with historic cost depreciation, higher inflation favors longer-lived assets. My (bad) intuition is that with higher inflation you really value near-term allowances, so that favors short-lived assets. Is the (good, or at least correct) intuition rather that with longer-lived assets the allowances are so far away that in present value they are worth very little even with zero inflation, so further erosion by inflation makes little difference? In any case, a brief explanation would be helpful for the puzzled likes of me.

9. ¶4.7 Explain that *b* indicates the debt ratio?

10. Footnotes 18-19 dealing with inflation effects are a bit cryptic: a few words explaining how these equations are derived might be helpful (or perhaps that would be best done in the TA).

11. In ¶4.20:

    (a) I found the argument initially hard to follow: I take it that the key point here is the reference to "cost…to New Zealand" the point being that the actual borrower pays 3 but now the government also collects some tax? Perhaps state this more explicitly? (The point is made much more clearly in the TA than in the MR).

    (b) I'm not sure why it would be inappropriate to calculate the EMR using the rate actually paid by the borrower—the concept is after all related to private incentives. But I may misunderstand.

[6] Perhaps wrongly, I think of this as coming, intuitively, from: The present value of depreciation allowances is $D = \delta/(r + \pi + \delta)$; so $\frac{\partial^2 D}{\partial \pi \partial \delta} < 0$. But this may be wrong.

12. In ¶4.23:

    (a) Is there a reason to support focusing on this case rather than the other? It seems from the TA that this is because they lead to much the same results, but as noted below my initial suspicion (hence maybe also that of other readers) when reading the MR was that the absence of a CGT would make them quite different.

    (b) Why 33 percent? (I now presume this is because that is the trust rate—but did not learn for several pages more—the summary suggested above would have helped me!)

13. I also struggled with intuiting the point in ¶4.25 that "There will be small positive EMTRs for very short-lived PME and inventories, but significantly negative EMTRs for…assets where capital expenditure can be expensed": this is because I would think of expensing as the ultimate short-lived case.

14. In ¶5.19:

    (a) first bullet: and also reduce transfer pricing concerns?

    (b) (b) 5th bullet; the ACE might though forego revenue on non-location specific rents (depending on the rate at which it is set—an EATR issue).

15. In ¶6.24: why now 39 percent?! (Only in the next para do I learn that it's the top personal marginal rate).

16. The important point in ¶6.23 about the being signs of movement to higher CIT rates may risk being buried away here: perhaps mention at the start of the chapter, or perhaps around Figure 1?

17. In ¶7.5, I didn't understand the: "An alternative might be to allow some level of partial expensing in lieu of depreciation loading for those for which $d = d^* = 100\%$." Does that not also mean deducting more than 100%? I am missing something here!

18. In ¶7.13: Isn't though another (reasonable) reason to give accelerated depreciation as rough compensation for inflation, which might, I think, sensibly also be done for 'old' investment?

19. In ¶7.15: very good point, but perhaps "no benefit" is a bit strong as presumably there will be an effect when losses carried forward are used?

20. In ¶7.17, I am struck by the unqualified: "assets that depreciate more slowly tend to face lower costs of capital and EMTRs" I thought that, at inflation of zero, historic cost depreciation 'gets it right' (as indeed some tables in the MR seem to neatly show). Or does this statement have in mind situations of non-zero inflation?

21. In ¶7.18: Might it be helpful to refer to the evidence on the impact of bonus deprecation in the US? I am not expert on this, but there seem to be some indications that it was at least good for employment; I have in mind e.g. Garrett et al. (2020).

22. Table 7.2: Explain "m" in the title?

23. Example 8.1: Might this usefully be extended to show the 'right' tax treatment of interest income?

24. Last bullet after Table 8.1, first sentence: since the table does show negative EMTRs for full expensing, is the point being made here an "even without full expensing" one?

25. In ¶8.18: Why not the actual change in the CPI, which is what the previous arguments would seem to suggest? Is this to counter the risk that indexation will reduce determination to bring inflation back down? Or is it the argument in the next para that is in mind? Or something else?

26. In ¶9.25 (and elsewhere), perhaps clarify that the remark about tax being paid elsewhere is not to inherently devalue tax paid to any country other than New Zealand (which is how it might read) but (I think) to indicate that from the perspective of the investor the effectiveness of the measure is to some degree undermined.

27. On the ACE: Perhaps worth noting one other issue often remarked upon: the likely loss of tax revenue, and the risk of driving non-location specific rents elsewhere, if an attempt is made to recover this by raising the statutory rate. (Though against this, the increased efficiency in the allocation of capital should in itself generate some additional revenue).

28. Around ¶11.3: Perhaps now one should add the possibility of refundable tax credits envisaged under Pillar 2?

29. In Chapter 11: is there any experience with sector-specific incentives in New Zealand to draw on? Foreigners like me may wonder e.g. if the film tax credit (which there is/was?) is seen as a success—or as dissipating some potential revenue from location-specific rents. And on the R&D tax credit?

30. In ¶12.2: What is 'PIE'?

31. In ¶12.19, lines 3-4: It isn't clear to me if the claim here is that the capital income part of the dual income tax (i) inherently taxes only the risk-free return (by a portfolio adjustment story) or (ii) less subtly, (as it may later appear, with the Norwegian example) can be designed to do so. If (i), that may need some (not easy!) explanation for the reader.

32. In 12.31, near the end: It is not clear to mean how the Norwegian approach alleviates the lock-in problem: it may be worth elaborating.

Technical Appendices

33. In ¶2.9, in saying that no account is taken of inflation, does that mean inflation is taken to be zero? The reader may also wonder: Why the change of policy on accelerated deprecation in 2010?

34. Table A2,2: expositionally, might there a case for putting this before Table A2.1, so starting with the benchmark against which inflation effects can be assessed?

35. Footnote 11: This methodological difference is very interesting. Do we know if it is a general feature that the OECD approach will give a higher overall METR (some kind of convexity in calculating the METR) or is this just a chance feature of the particular example?

36. I puzzled over the distinction between immediate expensing and full depreciation over the first year (and similarly between full depreciation and expensing in MR ¶7.9) until I came upon footnote 12 in the TA ; it would be helpful to include this clarification where it first arises (MR ¶4.25?).

37. In ¶2.43, how it is that the AIL is (it seems) generally not creditable abroad when the NRWT is?

38. In ¶2.55, first bullet: I have lost the plot! Which of the cost of capital expressions derived earlier are being used (amended for the AIL) in Table A2.7 for "all companies" and "domestic companies with marginal foreign shareholder"?

39. In ¶2.64: This is a very interesting table. Could one not (at a bit of a stretch, admittedly) see some signs of clustering in that the 50-60% group has a higher number of groups than any other band? Of course fuller analysis would be required to tease out anything definite: I might be inclined to take a tone here of 'further research would be needed, but it seems…' rather than be quite so dismissive of the possibility.

40. In ¶2.75:

    (a) First bullet: I would find it helpful to have an explanation of why these EMTRs are so similar. Presumably part of it is that the assumed personal tax rate is not far off the CIT rate. But that still leaves me unclear why it is actually lower with full distribution (e.g. where does that come from in comparing (2') and (2'')?).

    (b) Penultimate bullet: I had trouble following the explanation of why there are no longer the high EMTRs: perhaps, for the likes of me, it would help to explicitly compare (2') or (2'') with (2)?

41. Table A2.11: I wasn't immediately clear of the purpose of this; but it seems to relate to the last bullet of ¶2.75, so may be worth referring to it there.

42. In ¶3.3, it wasn't clear to me how the point attributed to Bulow and Summers fits with what sounds like the quite different conclusion of Summers in ¶3.2.

Table A: Various Estimates of EATRs and EMTRs

	AETR		METR	
	CBT /1	OECD /2	CBT /1	Bazel and Mintz /3
Australia	26.6	24.8	19	28.3
Austria	21.5	29.2	13.1	20.6
Belgium	28.3	28.1	14.4	22.7
Canada	23.3	25.6	14.9	15.5
Chile	24.3	23.7	24.8	9.6
Czech	16.1	18.3	8.3	15.1
Denmark	19.7	22.9	14.1	13.7
Estonia	24	18	30.1	8.1
Finland	18	19.4	13	14.4
France	32.4	37.7	20	27.9
Germany	27	29.9	18.2	26.1
Greece	25.4	25.3	17.1	9.7
Hungary	9.7	19.3	6.2	10.6
Iceland	17.7	19.1	12	14.9
Ireland	11.3	12.2	8.1	16.3
Israel	21.3	27	12.1	19.5
Italy	21.3	26.2	-7.6	19.9
Japan	27.3	32	19.2	28.7
Korea	18		7.2	29.5
Luxembourg	24.2	28.4	11.4	15.7
Mexico	26.1	28.8	17.1	19.3
Netherlands	19.1	23	8.1	17.5
New Zealand	**25.8**	**26.3**	**21**	**19.7**
Norway	22.2	27.1	18.1	20
Poland	16.7	17.8	10.7	11.4
Portugal	25.2	28.4	14.9	21.9
Slovak	19.3	21.1	12.6	12.5
Slovenia	14.9	16.8	9.1	7.4
Spain	27.6	27.7	24	18.9
Sweden	19.4	21.4	13	17
Switzerland		20.4		10.2
Turkey	16.9	15.9	14.6	4.3
UK	18.5	23.1	17.1	20.5
US	34.8	38.4	23.2	22.6
Mean (unweighted)	21.9	24.3	14.5	17.4
Standard deviation	5.04	5.31	6.7	6.4

Notes: 1/ Data from CBT, at https://oxfordtax.sbs.ox.ac.uk/cbt-tax-database. These are for 2017, before the US Tax Cuts and Jobs Act. 2/ From Table 10 of Hannapi (authors' reference), first column ("Manufacturing plants") 3/ From Bazel and Mintz (2021).

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