

13 April 2010

Professor Bob Buckle  
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Dear Bob

Can I repeat my thanks for speaking to our Council and CEO Forum in March. You will recall that there was a great deal of appreciation for the work reported by the Tax Working Group (TWG) and considerable agreement with many of their conclusions. One area of disagreement that emerged was around the depreciation of plant and equipment, at that time I committed to write to you on the matter.

Depreciation rates are a matter of competitive difference, in much the same way as is characterised by the competition in headline corporate tax rates. If we pay more than our competitors in trade, we carry a greater competitive burden and are less competitive.

You mentioned that the TWG review referenced a paper by Chen & Mintz, "Capital Taxation in New Zealand - a Review from an International Perspective". That paper presented a comparison of the marginal effective corporate tax rate on capital from 20 countries. Their results showed that given the above average company tax rate, New Zealand still has a relatively low marginal effective tax rate, and the reason for this is largely due to the over generous tax depreciation allowance on plant and equipment. Based on this evidence, the TWG has suggested that the 20% depreciation loading on economic depreciation rates on assets (with the exception of buildings, second-hand imported motor vehicles and fixed-life intangible property) is distorting investment decisions and the neutrality of the tax system would be improved by removing it.

However, the study might be biased due to the following reasons:

First, the study assumes the financing cost of capital to be the same across all the countries. In fact the cost of capital is considerably higher in New Zealand due to high Official Cash Rate and risk profile. The 20% loading is insufficient to offset the additional cost, hence there is very little incentive for businesses to invest in plant and equipment.

Secondly, the study suggests that the tax depreciation allowance is overly generous when it surpasses the estimated economic depreciation rate by 50% or more. The economic depreciation rates used are based on Canadian studies undertaken by the Department of Finance. Generally, the economic depreciation rates are set according to the formula:

$$1 - ((\text{residual value} / \text{cost})^{(1 / \text{estimated useful life})})$$

Unlike most developed economies, New Zealand has a relatively inactive second-hand equipment market and businesses are likely to be unable to dispose of the asset to the other users. The estimated useful life will be shorter and the residual value will also be lower in New Zealand in comparison to other markets. As a result the economic depreciation rate in New Zealand should be higher.

New Zealand Manufacturers and Exporters Association

Another factor is that often other investment incentives are offered in addition to depreciation allowances; many jurisdictions use terms like “capital allowances” or “investment allowances” where capital spending can be expensed<sup>i</sup>.

Bob, I know the work of the TWG is complete but I am sure development will continue one way or another. Investment in plant and equipment is necessary to lift productivity, local players are at a competitive disadvantage if that investment costs more here than elsewhere.

Competitiveness of plant and equipment investment is just as critical as competitiveness at the headline rate for New Zealand’s industrial development and ability to keep up with the play.

Yours sincerely

**John Walley**  
**Chief Executive**

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<sup>i</sup> <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00175431.htm>  
<http://www.businesslink.gov.uk/bdotg/action/detail?r.s=sc&r.l1=1073858799&r.lc=en&r.l3=1073868259&r.l2=1081626979&type=RESOURCES&itemId=1073789928>  
<http://www.irs.gov/pub/irs-pdf/i4562.pdf>  
[http://www.invest-in-france.org/Medias/Publications/862/09-08-26\\_114927\\_Doing\\_Business\\_2009\\_UK\\_complet\\_WEB.pdf](http://www.invest-in-france.org/Medias/Publications/862/09-08-26_114927_Doing_Business_2009_UK_complet_WEB.pdf)