Business investment in New Zealand – summary

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Highlights

This research:

- examines a range of questions about business investment in New Zealand, including: why is our business investment weak?
- defines business investment as "the purchase of new tangible and intangible assets by businesses for production purposes"
- is based on a review of existing studies about business investment
- finds that:
  - business investment is important as it contributes to a range of economic and non-economic outcomes
  - compared with many other countries, New Zealand has low levels of business investment per worker, and in particular has low levels of investment in business research and development (R&D)
  - weak business investment appears to reflect that, compared with their counterparts overseas, New Zealand businesses face comparatively high costs, and may receive limited benefits, from their investment
  - in particular, while higher business investment is associated with firm growth and some other outcomes, New Zealand firms do not appear to receive the productivity gains from business investment experienced by firms in many other countries, based on the findings of a small number of studies.
- implies that:
  - reducing the costs of business investment, and creating an environment where firms gain more benefits from their investment, might help lift business investment
  - if the firm-level relationship between business investment and productivity is indeed weak, lifting business investment may do little to increase productivity across the economy as a whole.

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

New Zealand Government

Why did we do this study, and what is it about?

Productivity growth has slowed in New Zealand and elsewhere over the last couple of decades. Part of New Zealand's productivity diagnosis is our weak business investment.

There are some outstanding questions about business investment in New Zealand, in particular what might be holding business investment back. Examining existing evidence on these questions should contribute to a shared understanding of any 'problems' where these have been investigated, and inform future research where not.

To do this, we reviewed existing literature on the topic of business investment. In our search we emphasised New Zealand studies, studies that use firm-level data, and overview studies. We conducted the literature search in early 2020.

What is business investment?

Investment is the purchase of goods that are not consumed today but are used to create future wealth. Business investment is "the purchase of new tangible and intangible assets by businesses for production purposes". Tangible assets are things like buildings, machinery and inventories. Intangible, or knowledge-based, assets are computerised information, innovative property and economic competencies.

Business investment is a flow that adds to the stock of capital (or stock of assets). The capital stock increases as long as there is enough new annual investment to replace the worn out capital and still contribute some extra.

Why do firms invest?

The main determinant of business investment is firms' expectations about the anticipated returns (benefits versus costs) from that investment. In theory, the main benefit that firms receive is the extra revenue from an additional unit of capital. The main cost is the 'user cost of capital' – the total cost to the firm of using one more unit of capital, which takes account of interest rates, the depreciation rate, any capital gain or loss associated with a change in the price of capital, and taxes. Uncertainty also affects business investment. In terms of the level of business investment, increased uncertainty is expected to lower investment. In terms of the timing of business investment, increased uncertainty is expected to delay investment decisions; by holding off investment, firms gain more information about the uncertain future.

Why is business investment important?

Business investment is important because it:

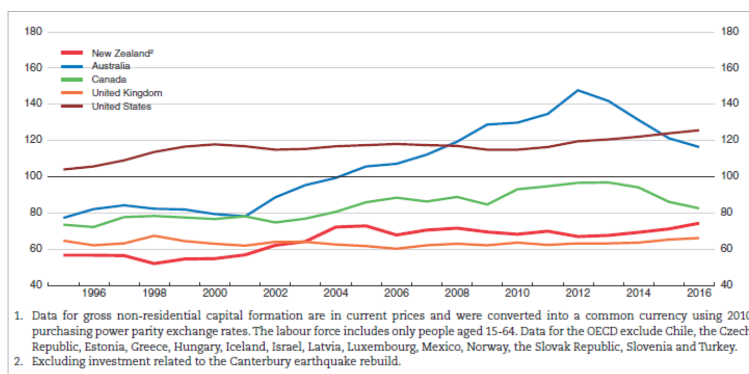
- increases current output – by spending on other firms' capital goods, business investment directly contributes to the current level of economic activity
- expands future productive capacity – by increasing the capital stock, business investment contributes to the future level of what the economy can sustainably produce
- lifts productivity – for example, adding to the stock of capital that workers have at their disposal allows them to produce more from their time at work, thus lifting labour productivity
- is a key economic link between the present and the future – by foregoing consumption today, firms expect to increase their future consumption through their increased capital stock
- can effect environmental and distributional outcomes, depending on the nature of the investment.

How does New Zealand compare?

We assessed that New Zealand's business investment as a share of economic activity (GDP) is not far off the OECD average. However, business investment per worker is much lower, reflecting New Zealand's strong labour input such as relatively high labour force participation rate. Figure 1 shows New Zealand's low investment per worker (red line) compared with the median across OECD countries (X axis).

Figure 1: Investment per person in the labour force

Gross fixed non-residential capital formation per person in the labour force, OECD=100



In particular, New Zealand has low levels of business expenditure on research and development (R&D) – less than half that of the total across OECD countries in 2017 when expressed as a percentage of GDP. Business R&D is part of firms' investment in intangible assets.

Source: *OECD (2017) OECD Economic Surveys: New Zealand 2017.*

What are some of the reasons for our weak business investment?

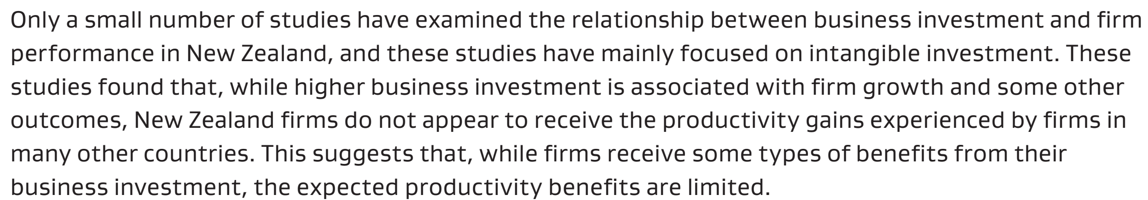
The main 'problem' we identified with business investment relates to the high costs, and low benefits, of business investment for New Zealand firms relative to their counterparts overseas, depicted in Figure 2 below.

Figure 2: Low return on investment

Source: *Author, based on studies covered in this report*

On the cost side of the benefit-cost ratio, historically New Zealand has had comparatively high interest rates, although in recent years interest rates have fallen and the gap between interest rates here and overseas has narrowed. In addition, New Zealand has high corporate tax rates (and potential tax distortions including the favourable treatment of housing), and expensive capital goods, compared with many other countries.

On the benefit side, there are a number of reasons to think that the benefits to New Zealand firms from business investment might be restricted. These reasons include New Zealand's small domestic markets, and preponderance of small firms, which mean that firms may lack the scale and sales volumes necessary to justify significant capital outlays.



Only a small number of studies have examined the relationship between business investment and firm performance in New Zealand, and these studies have mainly focused on intangible investment. These studies found that, while higher business investment is associated with firm growth and some other outcomes, New Zealand firms do not appear to receive the productivity gains experienced by firms in many other countries. This suggests that, while firms receive some types of benefits from their business investment, the expected productivity benefits are limited.

What about finance constraints?

One potential problem with business investment relates to finance constraints. Finance constraints are when financiers are reluctant to finance objectively sound projects. Finance constraints mainly arise due to information problems – firms know more about their investment projects than financiers do. Small, young and innovative firms are expected to be most prone to finance constraints. Finance constraints are inherently difficult to measure, as firms that struggle to access finance may just be poor performers, in which case the financial system is acting as expected in denying them access.

Survey evidence suggests that few New Zealand firms suffer from finance constraints. The small number of New Zealand studies on this topic also find little evidence of finance constraints, with the possible exception of small, young and innovative firms, as expected.

What might be done to address weak business investment?

Some have argued that weak business investment is a major reason for New Zealand's poor productivity performance, and so efforts should be made to lift business investment. Proposed policies aim to tilt firms' investment benefit-cost ratios, for example by lowering corporate tax rates, addressing New Zealand's interest rate premium by boosting saving etc, improving access to finance via financial market development, as well as providing direct fiscal support such as via R&D tax incentives.

However, while these policies may help lift business investment, it is less clear that this in turn will lift productivity. If, as indicated from a small number of studies, firms gain little of the expected productivity benefits from their investment, then lifting business investment may not provide the expected productivity boost for the economy as a whole.

It may therefore be beneficial to address the underlying causes of weak returns from business investment where these are known, or to further investigate these underlying causes where not. The underlying causes potentially include that New Zealand firms seem to combine capital and labour less efficiently than firms in other countries, implying a role for skills policy and policies that encourage an entrepreneurial environment.

Conclusions and implications

New Zealand firms seem to face comparatively high costs and limited (productivity) benefits from their business investment. So perhaps it is not surprising that firms are reluctant to invest.

Lifting business investment in New Zealand might involve reducing the costs of business investment, and creating an environment where firms gain more benefits from their investment. However, if the relationship between business investment and productivity is indeed weak, lifting business investment may do little to increase productivity across the economy as a whole.

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