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Budget incentives to increase investment are expensive, poorly targeted and will do little to improve productivity.

Discussion paper

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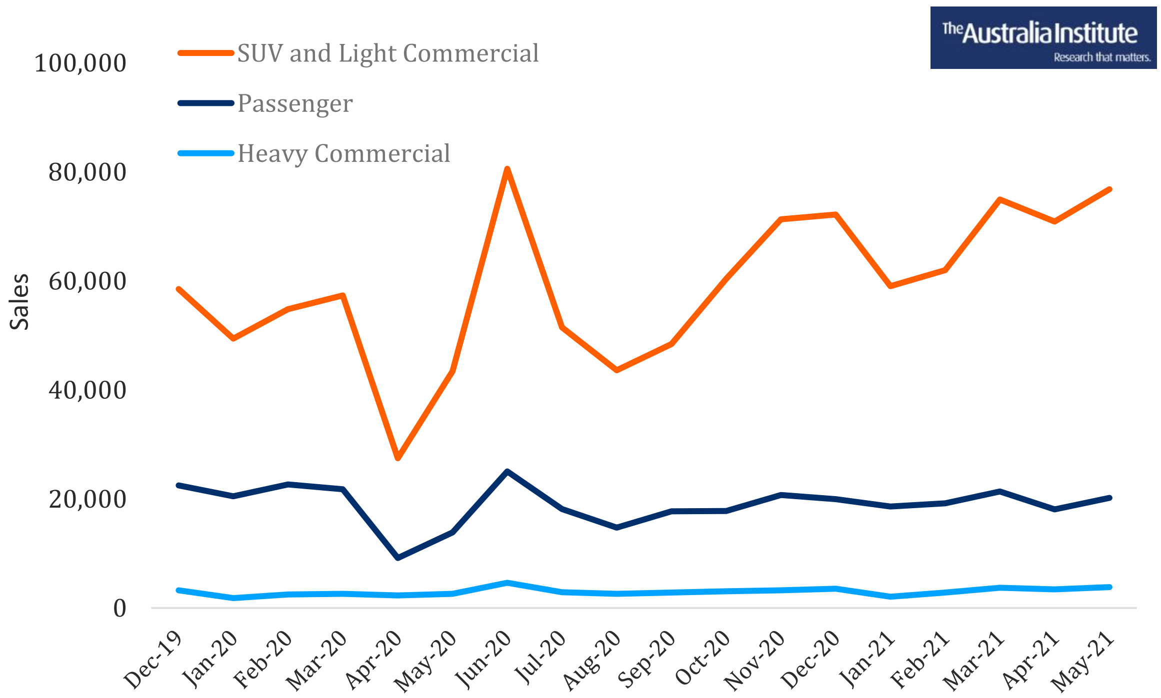
Introduction

In the 2021 budget the Morrison Government introduced and extended a number of measures to encourage businesses to increase their expenditure on capital investment in order to boost economic growth. The most expensive new measure was the extension of the instant asset write-off scheme at a cost of $17.9 billion over four years. The instant asset write-off provisions work in conjunction with the so called 'loss carry back provisions' (projected to cost an additional $2.8 billion over four years) to allow businesses to use tax paid in previous years to cover the 'losses' incurred this financial year caused by, for example, the purchase of an expensive new vehicle. While much of the pre-budget commentary focussed on the construction of a so called 'women's budget', the day after the budget the headline of *The Daily Telegraph* screamed 'Ute-Beauty'.

The Morrison Government's tax incentives to encourage Australians to buy larger vehicles are working well, with very strong growth in the sport utility vehicle (SUV) and light commercial vehicle segments of the market and flat sales of passenger vehicles and heavy commercial vehicles. In May 2021 there were nearly four SUVs and light commercial vehicles sold for every passenger car (Figure 1).

Figure 1: Recent new vehicle sales, December 2019 to May 2021



Source: Monthly press releases from Federal Chamber of Automotive Industries, https://www.fcai.com.au/news

Over the 12 months to May 2021 sales of SUVs and light commercial vehicle have nearly doubled. While some of this is related by to the general economic recovery, the more subdued growth in regular passenger vehicles suggests that a structural change in the vehicle purchasing patterns of Australians has occurred.

The detailed breakdown of the latest car sales data shows that three of the top four vehicles sold in Australia were twin cab utes and eight of the top 10 highest selling vehicles were utes, SUVs or 4WDs (Table 1). In May 2021, more than twice as many Toyota Hiluxes were sold than the top selling passenger vehicle, the Hyundai i30. According to one source, one in four vehicle sales in Australia are utes.[1]

Significantly in terms of the impact of government policy, all 10 of the top 10 vehicles purchased under novated lease schemes (which offer a tax benefit) are either SUVs or dual cab utes.[2]

Table 1: Top 10 selling vehicles of May 2021

Model	Volume May 2021	Change year-on-year
Toyota Hilux	4,402	up 24.8 per cent
Ford Ranger	4,254	up 59.7 per cent
Toyota RAV4	4,014	up 71.2 per cent
Isuzu D-Max	3,058	up 202.8 per cent
Toyota LandCruiser	2,795	up 121.8 per cent
Mazda CX-5	2,768	up 87.2 per cent
Mitsubishi Triton	2,317	up 167.6 per cent
Toyota Prado	2,214	up 63.0 per cent
Toyota Corolla	2,190	up 34.7 per cent
Hyundai i30	2,127	up 78.6 per cent

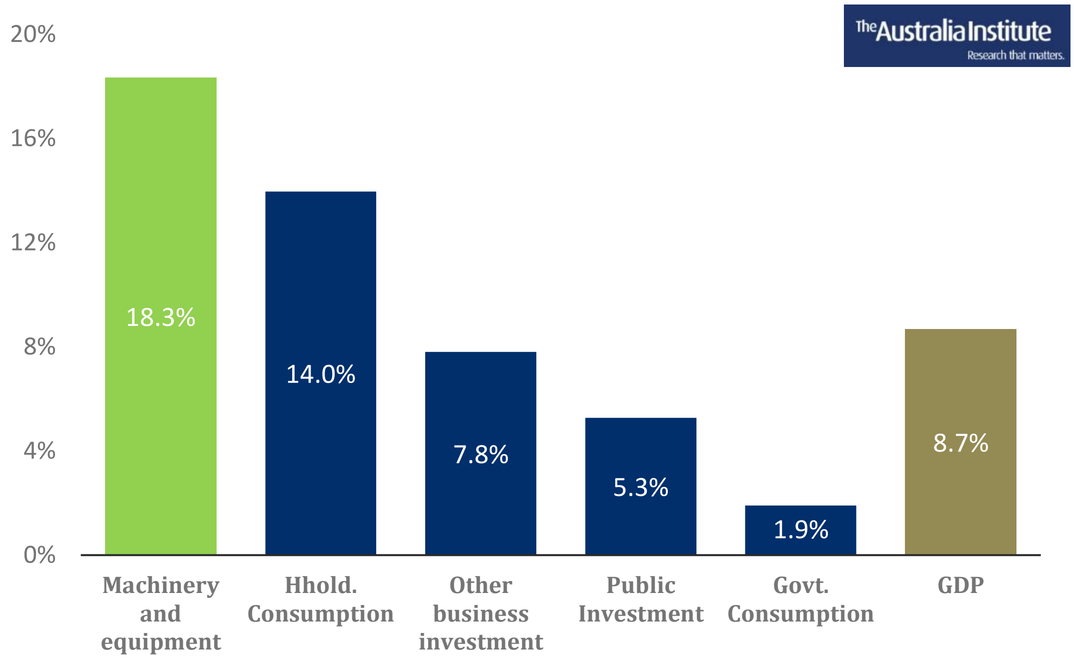
Source: Reproduced from Dowling (2021) *VFACTS May 2021: Toyota HiLux, Ford Ranger and Isuzu D-Max take out the Top Four, drive record ute sales,* https://www.caradvice.com.au/957832/vfacts-may-2021-toyota-hilux-ford-ranger-and-isuzu-d-max-take-out-the-top-four-drive-record-ute-sales/

The pattern of sales looks to reflect a strong trend of vehicle sales for business use. A pattern that looks to be confirmed by the recent national accounts data showing private machinery and equipment investment (officially termed capital formation) was the strongest growth component of Gross Domestic Product (GDP) in the COVID recovery phase (Figure 2).

[1] Dowling (2021) *VFACTS May 2021: Toyota HiLux, Ford Ranger and Isuzu D-Max take out the Top Four, drive record ute sales,* https://www.caradvice.com.au/957832/vfacts-may-2021-toyota-hilux-ford-ranger-and-isuzu-d-max-take-out-the-top-four-drive-record-ute-sales/

[2] The Fan Team (2021) *Images of the Top 10 novated lease vehicles from 2020, Fleet Auto News*, https://fleetautonews.com.au/images-of-the-top-10-novated-lease-vehicles-from-2020/

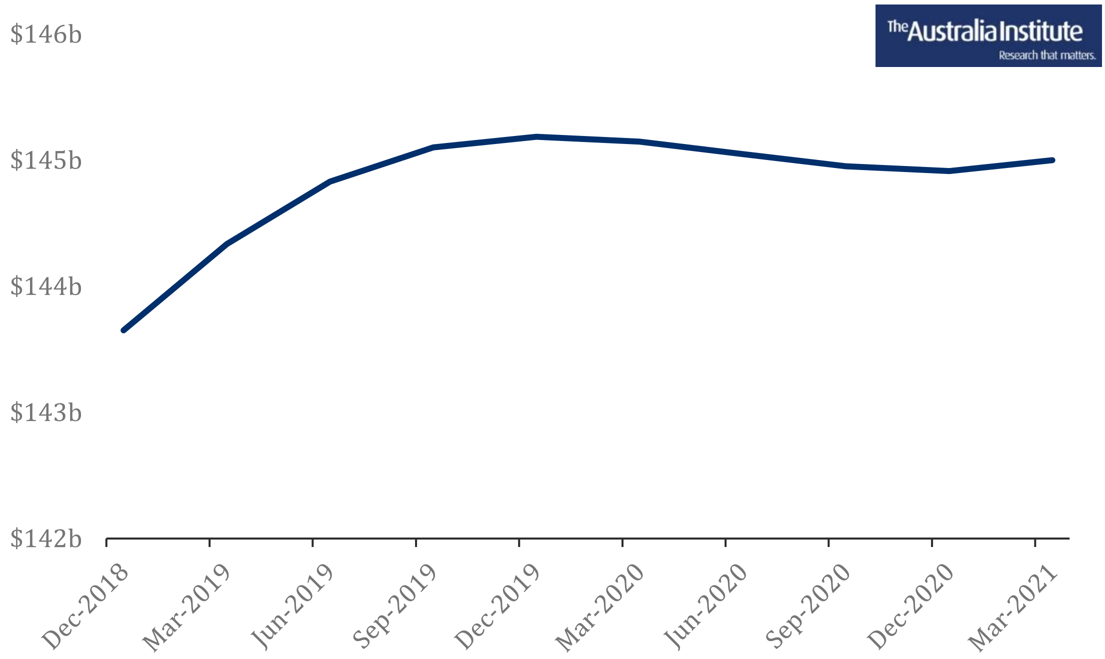
Figure 2: Growth in GDP by selected component, June 2020 to March 2021



Source: Analysis of ABS (2021) *National Accounts: National Income, Expenditure & Product, May 2021,* https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release

The composition of the new car sales data and the strong growth in the 'Machinery and Equipment' component of the National Accounts suggest that it is business owners (including sole traders) who are driving the shape and rate of growth in car sales. This interpretation is supported by an analysis of a rarely discussed subset of National Accounts data known as the Modellers' Database which shows that value of the stock of motor vehicles held by households has flatlined in recent years; it has shown no post-COVID recovery, and is below pre-COVID levels (Figure 3).

Figure 3: Value of household capital stock of motor vehicles, $ billion



Source: Analysis of ABS (2021) *Modellers' Database, March 2021,* https://www.abs.gov.au/statistics/economy/national-accounts/modellers-database

Figure 3 suggests that households, rather than updating their fleet to higher valued (new) vehicles, are simply making do with existing vehicles or purchasing second-hand vehicles of similar or lower value than their previous cars.

Finally, there is one last trend in the vehicle market that supports the conclusion that there is a structural shift in both who is buying vehicles and what kind of vehicles they are buying. The price of second-hand utes has risen rapidly over the same time that the sales of new light commercial vehicles have surged. Between March and November 2020, the price of second-hand Mitsubishi Tritons rose by 41 per cent, and all of the top five second-hand vehicle models experiencing the fastest price growth were light commercial vehicles, while 9 of the top 10 were light commercial vehicles or SUVs.[3] It is important to note that the purchase of second-hand vehicles is still eligible for the instant asset write-off and the loss carry back provisions.

What then is driving these trends and why do they matter?

[3] Johnson (2020) *Australian used car prices surge by 40% since start of pandemic*, https://www.msn.com/en-au/news/australia/australian-used-car-prices-surge-by-40-since-start-of-pandemic/ar-BB1b5vc2

Budget 2021 – Another extension to asset write-off

In a big spending budget, the largest tax announcement was the extension of the instant asset write-off scheme at $17.9 billion over the four years to 2024-25. After the extension of the low-income tax offset the third largest tax break was the extension of the loss carry-back scheme, at $2.8 billion over the same period.

The instant asset write-off and loss carry-back schemes are open to any business that has less than $5 billion of revenue in Australia. Together the combined cost is $21 billion over the period to 2024-25, with the greatest cost in 2023-24. The cost of the scheme extends well beyond the one-year policy extension since businesses submit their tax returns long after the new assets are instantly written off.

In his budget speech the Treasurer said the tax cuts were put in place "so a tradie can buy a new ute, a farmer a new harvester and a manufacturer expand their production line". The Treasurer made no mention in his speech of just how the most expensive new measure in the budget would create jobs and economic growth and his speech quickly turned to the issue of housing.

While the Treasurer's speech was silent on the issue, the detailed budget papers and the accompanying webpages suggested the extension of the schemes, combined with the existing impacts, were expected to boost GDP by $8 billion and 60,000 jobs by 2022-23.

Interestingly, the estimated GDP impact for 2021-22 of $7.5 billion is down from the $10 billion forecast in the 2020 budget papers. While this downward revision is not explained, it does suggest that the policy is not working as effectively as expected, which raises an interesting question. If instant asset write-offs are designed to 'bring forward' good investment ideas, and previous attempts to do so have been less successful than expected, how does extending such a scheme make it more effective?

On the jobs front, last year's budget paper said it would create 50,000 jobs by 2021-22 and the recent budget papers estimate 60,000 jobs by 2022-23. A straight reading suggests the extension of the schemes will create an additional 10,000 jobs.

If these figures are taken at face value, then the cost per job of the tax incentives for new investment are very high. That said, estimating that cost requires some caution due to the ambiguity with which the government reports its projections over the two budget papers.

In short, a close reading of the tea leaves across the two budgets suggests the cost per job is between $307,000 and $690,000, depending on whether the extension creates an extra

22,500, or 10,000 jobs. The ambiguity on the jobs number comes from the fact that since the GDP impacts from the last budget have been revised down, so too should the employment impacts from last year. This then increases the estimated (and implied) employment impacts of the new extension to the policy.

Significantly, and irrespective of the true jobs estimate, if the government were to spend a similar amount of money in the health, education and arts sectors they could generate close to 54,000 direct jobs.

What are the benefits of the ‘tradie tax cuts’?

In the normal operation of a business, firms purchase new capital equipment because it helps them to increase the expected long run profitability of the organisation. Without tax incentives, it is generally assumed that businesses prefer to spend as little as possible on capital investment (and indeed all factors of production) and only invest in new equipment if doing so will deliver greater benefits than retaining existing equipment, repairing old equipment or spending more money on labour. Put simply, economists and shareholders typically assume that a business will not purchase a new coffee machine, or ute, or factory, if the existing one is doing its job well. This would particularly be the case if the existing machinery had recently been purchased due to existing incentives to ‘bring forward’ investment.

Significantly, when the expanded instant asset write-off scheme was announced in the 2020 Budget the budget papers strongly made the point that the time limited nature of such schemes is a major part of what makes them work.[4] Given that similar schemes (with smaller caps) have been in place since 2015, combined with the recent surge in ute and tractor sales, it is important to consider the possibility that there may not be many more ‘rational purchase’ items remaining on the list for the types of businesses the Treasurer was hoping to stimulate.

But once tax concessions are introduced into the equation, along with the fact that some ‘business assets’ might provide personal benefits to the owners and managers, the calculation of ‘how often should I buy a new ute’ can differ radically from the question of ‘how often should I buy a new cash register’.

Consider the following:

If a business is on track to make a profit of $100,000 in 2020-21 but decides to buy a new ute for $130,000 then the business would make a loss, for tax purposes, in that year of $30,000 and no income tax would be payable.

The existence of the ‘loss carry back provisions’ however mean that companies can, in effect, get a refund for previous tax paid to cover the $30,000 ‘loss’ associated with the purchase of the new ute.

[4] Australian Government (2020) *Budget 2020-21, Budget Strategy and Outlook, Budget Paper 1,* p.1-19, https://archive.budget.gov.au/2020-21/bp1/download/bp1_w.pdf

In the words of the Australian Tax Office:

> On 6 October 2020 as part of the 2020–21 federal Budget, the Australian Government announced that it will target support to businesses and encourage new investment through a loss carry back regime. Eligible corporate entities that previously had an income tax liability in a relevant year and have subsequently made taxable losses can claim a refundable tax offset up to the amount of their previous income tax liabilities.
>
> The measure interacts with the announcement on JobMaker Plan – temporary full expensing to support investment measure. This will allow new investment to generate significant tax losses which can then be carried back to generate cash refunds for eligible businesses.[5]

From an economic point of view, the optimal time for a firm to purchase a new commercial vehicle would be when the benefits of the new vehicle (in terms of lower operating and maintenance costs) exceed the significant costs of a new vehicle purchase.

However, from a tax planning point of view, businesses that have paid tax in previous years may wish to purchase expensive new vehicles even if the savings to the business in terms of operating or maintenance costs are trivial or even negative. This is especially the case when small business owners receive personal benefits from the ownership of new vehicles.

Under the old tax system, the "lumpy" cost of capital equipment is spread over an unknown future (which may or may not be profitable). With the combination of instant asset write-offs and loss carry back provisions the cost of a new investment can be spread over a certain past. Such an approach does little to encourage firms to take risks with new investments but does much to encourage firms to engage in tax engineering and prioritise expenditure on capital goods that will deliver personal benefits to the owners and/or managers of a business such as new vehicles.

While encouraging new vehicle sales might be beneficial to the broader economy as it emerges from recession, even if they were of negligible benefit to the companies concerned, the fact that virtually all vehicles are imported to Australia means that the amount of job creation, per dollar spent, is particularly low.

That said, had the new incentives been directed towards the kind of investments that could deliver lasting social, environmental or economic benefits then the broad long-term benefits might be expected to exceed the narrow short-term costs. But the existing data suggests this has not been the case. For example, if the loss carry back provisions were only available for electric vehicles or vehicles with high levels of fuel efficiency then the short-term cost of

[5] Australian Tax Office (2021) *Temporary loss carry-back extension*, https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Loss-carry-back/

the policy would deliver benefits in the form of reduced emissions for the next decade. But while a $130,000 twin cab ute is eligible for the tax concessions if it has the capacity to carry over 1 tonne of cargo, a $130,000 electric vehicle is not, even if both vehicles were purchased by a graphic design business in Sydney or Melbourne. The availability of the most generous tax concessions for vehicles is defined by the capacity of a vehicle to carry cargo, not the actual use to which the vehicle is put.

Do new utes boost productivity?

One possible argument in favour of the incentives described above is that they encourage the turnover of machinery and equipment, utes and tractors, for newer more productive tools. Bringing forward such productive new investments would both increase productivity growth and increase aggregate demand at a time in which the government nis trying to stimulate private sector growth.

However, while buying new office computers each time the policy is extended may provide a slight CPU speed boost the impacts on office productivity would be microscopic at best. When it comes to utes, a new ute each year will hardly help the tradies to get to a job any quicker.

The reality is businesses turnover their utes and other machinery and equipment frequently to avoid maintenance, reliability, and warranty issues. The policy may well encourage a quicker turnover of some existing assets and the boom in second-hand ute prices and the waiting lists for new models suggests it has. But there is no reason to expect any increase in productivity as a result of such a shift.

The sad reality is that we are using the tax system to impact the choices of small business owners and the result is that we are subsidising a shift towards larger, less fuel-efficient vehicles.

Conclusion

The fact that all commercial vehicles sold in Australia, and the vast majority of plant and equipment are imported means that stimulating the purchase of new and used utes will do little to create jobs in Australia. Depending on the reading of Treasury's analysis, between 10,000 and 22,500 jobs will be created, suggesting that the cost per job of the instant asset write-off is between $307,000 and $690,000. By comparison, a similar expenditure on labour intensive industries such as health, education or the arts would create around 54,000 direct jobs.

Leaving aside the ineffectiveness of the tax policy as a way to create jobs, it is likely that one of the major lasting legacies of this initiative will be to increase the average weight of the Australian vehicle fleet as businesses both turn over their existing commercial vehicles more rapidly (and make them available in the second-hand car market more quickly) and, more concerningly, substitute smaller passenger vehicles for heavier commercial vehicles in order to maximise the tax benefits, as opposed to economic benefits, of that vehicle choice.

The IEA has recently spelt out the importance of rapidly increasing the fuel efficiency of national vehicle fleets if the world is to reduce greenhouse gas emissions in line with a 1.5 degree increase in temperature. The IEA has also singled out Australia for its heavy, and growing reliance on SUVs for passenger transport:

> Shares (of SUVs) in North America and Australia were particularly high, around 50%. In addition to SUVs, pickup trucks – which tend to be even larger – also make up a significant share of sales in these markets.[6]

In the lead up to the 2019 federal election Prime Minister Scott Morrison was widely mocked for stating that:

> Its (an Electric Vehicle is) not going to tow your trailer. It's not going to tow your boat. It's not going to get you out to your favourite camping spot with your family.
>
> Bill Shorten wants to end the weekend when it comes to his policy on electric vehicles where you've got Australians who love being out there in their four-wheel drives.

[6] Paoli, Teter, Tattini & Raghavan (2020) *Fuel Consumption of Cars and Vans, International Energy Agency*, https://www.iea.org/reports/fuel-consumption-of-cars-and-vans

> He wants to say see you later to the SUV when it comes to the choices of Australians. And this is fundamentally the difference between us and Labor when it comes to these issues.[7]

But after the election the Prime Minister was praised for his carefully targeted approach to the election and his focus on key demographics in key electorates.[8] While it is possible to assume that his repeated focus on the desirability of utes over electric vehicles was a distraction or a mistake, it is also important to consider the possibility that it was a carefully targeted strategy to align himself with a key voting bloc.

Given the subsequent post-election focus on tax concessions that deliver enormous tax benefits to those in a position to purchase large utes through their small companies, and given the lack of any compelling evidence that such expenditure will create a significant amount of jobs or deliver lasting benefits, it seems likely that the major benefit of the instant asset write-off and the loss carry back provisions is that they provide a unique form of 'demographic pork barrelling'.

While such an approach may deliver significant political benefits to the Morrison Government, it will certainly deliver a large increase in the amount of fuel use, road damage and greenhouse gas emissions for years to come.

[7] Remeikis (2019) *'Shorten wants to end the weekend': Morrison attacks Labor's electric vehicle policy*, https://www.theguardian.com/australia-news/2019/apr/07/shorten-wants-to-end-the-weekend-morrison-attacks-labors-electric-vehicle-policy

[8] Henderson (2019) *There was always a path to victory for Morrison's Libs*, https://www.theaustralian.com.au/inquirer/there-was-always-a-path-to-victory-for-morrisons-libs/news-story/632470fdcb555facb5e6b39eeb36cb8e