3 May 2002

Minister of Finance and Revenue (Hon Dr Michael Cullen)
cc: Associate Minister of Finance (Hon Trevor Mallard)
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Taxation of inbound investment

Executive summary

The Tax Review proposed that the Government decrease tax on Foreign Direct Investment (FDI). It recommended doing so in a way that produced a dramatic reduction in the headline rates as follows:

- Reduce the company tax rate for foreigners from 33% to 18%; and
- Reduce the non-resident withholding tax rate on dividends (NRWT) from 15% to 2%

The Tax Review also recommended increasing the effectiveness of other taxes that apply to FDI. The net result would be to reduce effective tax rates on FDI from the current approximate range of 15.75% to 33% to an approximate range of 12.41% to 19.64%.

Two options were advanced as a way forward. Policy Option One was to apply the lower tax rate to all FDI. Policy Option Two (the Review's preferred option) was to apply the lower tax rate only to new FDI.

Benefits and Costs of FDI

FDI provides productive capital without having to rely on domestic savings. This can contribute to achieving higher economic output. However, to be of benefit to New Zealanders' increased FDI must produce benefits to New Zealanders over and above the return provided to the foreign investor. This is likely to come in the form of higher incomes for New Zealand employees. In simple terms this means more or better jobs than would exist in the absence of the FDI. These benefits need to be greater than the welfare cost of raising tax from other revenue sources.

Economic framework for taxing FDI

The economic framework considers how tax revenue can be collected in a way that minimises economic costs. As a general principle this means taxing residents on a broad base at a low as possible rate on their world-wide income (the residence principle). This is on the assumption that New Zealand residents cannot avoid the incidence or burden of New Zealand tax so that it should be applied equally to all types of investment.

Foreign investors, on the other hand, may be able to avoid New Zealand tax by investing elsewhere. If they have complete freedom to do so they will be able to withdraw investment from New Zealand until the point where any tax New Zealand imposes is offset by higher returns on their New Zealand investment. In such a case none of the incidence of tax is borne by the foreign investor and all of the incidence of tax is borne by New Zealanders, for example in the form of lower investment and lower wages. In these extreme circumstances it would be more efficient for New Zealand not to tax FDI at all.

In determining the best tax treatment of FDI, therefore, an important issue concerns a judgement as to how sensitive FDI is to New Zealand tax. If New Zealand can impose high taxes on FDI and FDI is insensitive to tax so that the level and type of FDI is unaffected this would be an efficient New Zealand tax since New Zealand is then obtaining government revenue at no economic cost.

FDI will be insensitive to New Zealand tax if any tax New Zealand imposes on a foreign investor does not reduce the after-all-taxes return to the non-resident investor because, for instance, the New Zealand tax is offset by a reduction in overseas taxes on that investor, by way of foreign tax credits. Alternatively, FDI may be insensitive to New Zealand tax if the investment is returning economic rents, that is, earnings in excess of that required to keep it in New Zealand.

If FDI is sensitive to New Zealand tax the issue is how sensitive, and to what degree can New Zealand raise tax revenue at a low economic cost. Any reduction of tax on tax-sensitive FDI is still likely to result in a fiscal cost so that the welfare costs arising from replacing the net revenue loss need to be offset by net benefits to New Zealand, most likely in the form of more or better-paid jobs.

Application to the Review's proposals

The Review's proposals had two elements:

- reduce the level of New Zealand tax on FDI; and
- have this reduction focused on the company and NRWT "headline" rates so as to produce substantial reduction in these headline rates.

The Review also preferred that tax rate reductions be limited to new FDI.

A difficulty in determining whether New Zealand should reduce the level of tax on FDI is that, as noted above, this turns on the sensitivity to tax of FDI and we have no accurate gauge

of that. Moreover, it is highly likely that FDI spans the spectrum from highly tax sensitive to highly tax insensitive with no simple mechanism of distinguishing between these different reactions to tax.

This difficulty is illustrated by the fact that the ability of FDI to offset New Zealand tax by using foreign tax credits is a significant reason why FDI might be insensitive to tax. Yet, about half of New Zealand's existing FDI comes from countries that do not provide such credits and of those that do provide credits these are normally limited to tax only on repatriated profit. Even where foreign tax credits do offset New Zealand tax it is possible that an adverse reaction by foreign governments could have the same effect of offsetting New Zealand tax reductions with overseas tax increases.

There is no reliable New Zealand evidence on the marginal tax sensitivity of FDI. Overseas evidence suggests that the sensitivity elsewhere is moderate but growing. Using relatively high estimates of FDI tax sensitivity suggests that New Zealand would still have a significant ($370 million pa) net revenue loss from reducing tax on all FDI as proposed by the Review and that even on generous assumptions it would seem unlikely that any such net revenue loss would be offset by a sufficient increase in benefits to New Zealanders such as more or better paid jobs. (Note that the revenue loss, prior to factoring in any increase in FDI, is around 500 million.)

If a cut in taxes on FDI could be targeted, as the Review preferred, by limiting any such tax reduction to new FDI it is more likely that this would produce net benefits to New Zealand. However, our view is that any such limitation would be unsustainable after a relatively short period (5-10 years).

For these reasons we conclude that, in our judgement, it is not desirable to implement the Review's recommended changes to the taxation of FDI at this time.

A second aspect of the Review's recommendations was to focus any reduction of tax on headline tax rates. We can see the value of greater transparency of what are effective tax rates and compressing the extent to which they are determined by the mechanism used to finance FDI. However, there seems little room to manoeuvre on this point if there is no prior decision to reduce overall effective tax rates on FDI.

Recommendations

It is recommended that you:

(a) **Agree** that application of the recommended lower rates of tax cannot be restricted to new FDI except as a transitional measure. As a result, the annual fiscal cost of implementing the Review's reforms is around $500 million per annum.

Agreed/Not agreed

(b) **Note** officials' analysis is that a reduction in tax on FDI seems unlikely to produce sufficient benefits to New Zealand to offset the welfare costs of raising the revenue on other productive activity in New Zealand.

Noted

(c) **Agree** that it is necessary to keep the current tax treatment of FDI under review, in view of the importance of FDI to New Zealand's economic development and in order to improve our understanding of the impacts of tax on FDI.

Agreed/Not agreed

(d) **Agree** to include a statement in the Budget indicating:

- the Review's recommended changes to the current tax treatment of FDI and the rationale underlying those recommendations;
- that the Government shares the Review's concerns regarding the significant and rising economic costs of taxing FDI and has considered the merits of the Review's recommended reforms;
- the Government is persuaded by officials' comments that the revenue loss from reducing tax on all FDI as proposed by the Review is unlikely to be offset by a sufficient increase in benefits to New Zealanders;
- the Government will release an analysis along the lines of this report, of the Review's recommendations for private sector comment.

Agreed/Not agreed

Peter Wilson
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Hon Dr Michael Cullen
Minister of Finance and Revenue

Background

1. The Tax Review recommended that the Government consider reducing the tax burden on foreign direct investment (FDI) as a means of attracting more FDI.

2. You subsequently asked us to analyse whether implementing the Review's recommendation would be desirable (T2001/2075: PAD2001/334 of 14 December 2001 refers).

3. This report assesses the extent to which New Zealand would gain from implementing the Review's recommended changes to the current tax treatment of FDI.

Strategic Context

4. The two key aspects to the Government's strategy for building an economy capable of sustaining higher growth rates are:

- Strengthening the foundations; and
- Building more effective innovation.

5. More and better FDI is part of more effective innovation. The Tax Review's recommendations on inbound investment stemmed from its view that an increase in FDI is imperative in order for New Zealand to prosper in the global economy, the expectation is that more FDI will benefit New Zealand by increasing the population's entrepreneurial, managerial and scientific skills.

6. In this report, we examine the Review's expectation. In particular, we look at the role the tax system can play in ensuring that New Zealand has enough FDI to prosper and grow.

7. At the same time, non-residents own a large proportion of the corporate tax base, so any tax reduction on FDI potentially has high fiscal costs, especially if applied to existing investments. Maintaining tax revenues is part of ensuring strong foundations.

Outline of this report

8. The remainder of this report is organised as follows:

- We discuss the costs and benefits of FDI to New Zealand; and
- We then set out an economic framework for deciding how a small open economy should tax inbound investment in general;
- To put the Review's recommendations in context, we briefly discuss how FDI (and other inwards investment for comparison purposes) is currently taxed;

- We conclude by assessing the Review's specific recommendations.

The Nature of FDI, its Benefits and Costs

9. FDI can be defined in two broad ways, that undertaken respectively by "vertically" and "horizontally" integrated firms.

10. Vertically integrated firms fragment the production process into stages based on factor intensities and locate activities according to international differences in factor prices. Examples here are car firms building different parts of a car in different countries, and then bringing the parts together for assembly at multiple plants.

11. Horizontally integrated multinationals are firms that produce the same product in multiple plants, serving local markets by local production. Examples here are banking, computers and telecommunications.

12. We would stress, and this is very important to the question of taxing FDI below, that these categories, while helpful in explaining why FDI occurs, should not be taken to imply that FDI can be neatly compartmentalized. Many multinational firms are both vertically and horizontally integrated.

The Benefits

13. The primary benefit of FDI is its contribution to higher productivity for New Zealand. Benefits to New Zealand occur particularly through positive externalities and knowledge spillovers including technology transfers, innovation and human capital accumulation. Spillovers arise from both vertical and horizontal FDI.

14. FDI provides productive capital without having to rely on domestic savings. Investment is higher than domestic savings, resulting in more jobs and increases in output. By the same token FDI allows New Zealanders to invest offshore, diversify their investment portfolios and minimise volatility, without compromising domestic capital accumulation.

15. Finally, like all productive activity in the economy, FDI raises revenue both from tax on the investment return to foreigners and from tax on higher New Zealand incomes.

16. The quality of FDI is as important as quantity. However, the often-popular distinction that a green field is 'good FDI' and mergers & acquisitions is 'bad FDI' is a false one. FDI is good to the degree that it facilitates the sorts of spillover discussed above and realises productivity benefits in New Zealand, which in turn translate into higher real incomes for New Zealand workers.

17. The benefits to New Zealand of FDI come from higher incomes and taxes. They do not accrue from the profits of the investment - since these accrue to the foreign investor. The distinction here is between Gross Domestic product (GDP) and Gross National Product

(GNP). GDP measures the amount of goods and services produced in New Zealand, regardless of the ownership of the returns from that production. GNP, on the other hand, measures the returns to New Zealanders from the production of goods and services anywhere in the world.

18. FDI increases GDP: it results in more goods and services being produced in New Zealand. It will increase GNP if there are spillovers: higher real incomes and improved production processes that can be mimicked by domestically owned firms.

19. An extreme example shows that FDI attracted to New Zealand by a zero tax rate might not bring any material benefits to New Zealand. Imagine a new factory that is owned by non-residents and is staffed by foreign workers, imports all its intermediate goods and that exports its entire product. The exports would count as GDP. Leaving aside the construction phase of the factory and incidental inputs like power and water, there would be no GNP from this plant: all the gains accrue to non-residents. On paper, in terms of GDP per head, New Zealand would look wealthier, but in terms of how much we could consume or save (GNP per head) there would be no change.

20. This is an extreme example, but it is presented to make a point: the benefits of FDI come from **net additions** to GNP. If the advent of the factory resulted in increased employment, GNP would increase (the wages paid to previously unemployed people). Likewise if New Zealand entrepreneurs could learn from the example of the new factory – for example by observing best practice stock control, that would allow GNP to increase over time.

Costs of FDI

21. FDI is not, however, without costs to an economy.

22. The domestic resources that are employed by FDI are an **opportunity cost** to the rest of the economy: a worker employed in a factory owned by a non-resident cannot be employed in a domestically owned firm. Thus an economy at or close to full-employment might not benefit from FDI if it simply results in resources being moved from one productive sector to another.

23. This does not mean that economies at full employment should eschew FDI. Rather, it shows that the benefits from FDI have to be measured at the margin:

- what is the increase in total employment coming from FDI, not how many people are employed in the new factory;
- what is the increase in wages paid to people who move from an old employer to a new employer, not the wage bill of the new employer?

Measuring the costs and benefits

24. Quantifying the costs and benefits of FDI is difficult. What is needed is information at the margin about: (i) how much existing economic activity is displaced by FDI; (ii) the extent of increases in incomes to New Zealanders; (iii) net changes in employment and (iv) the welfare costs of raising tax from other sources.

25. In a tax system that is not optimal, a change for which the benefits outweigh the costs would represent a movement to a more efficient system. However, the above argument has stressed that the marginal costs and benefits need to be measured in terms of changes in the welfare of New Zealanders. It would be quite possible, for example, for FDI to increase by substantially more than the extra revenue that needs to be raised from New Zealand residents, while at the same time the extra benefits are considerably lower than the burden (the efficiency losses) caused by the distortions arising from the need to raise extra tax. In other words, the proper metrics in this context are:

- On the benefits side: the net addition to GNP from FDI; and
- On the cost side, the change in total deadweight loss that comes from a shift from taxing FDI to taxing some other activity.

26. For example, suppose that the effect of taxes on FDI is to raise the cost of capital in New Zealand, thereby shifting the burden to fixed factors in New Zealand. A reduction in taxes on FDI, combined with a revenue-neutral increase in taxes on those New Zealand fixed factors, would have no effect on the burden they face. This represents an unambiguous gain to New Zealand, to the extent that the tax change increases the amount of FDI and, in turn, that GNP (rather than simply GDP) is increased.

The economics of taxing FDI

27. We now turn to the twin issues of how taxes affect FDI and how taxing FDI can affect the rest of the economy.

The Basic Framework

28. In this section, we analyse the Tax Review's recommendations in "optimal taxation" terms. That is, we ask the question "is taxing non-residents on the income they earn in New Zealand the least-cost (i.e., least deadweight loss) way of raising revenue in terms of national welfare?" This is not an easy question to answer, either analytically or empirically. What follows is a summary of our analysis of the issue. Further details can be supplied if you wish.

29. We would also stress that this sort of analysis is not a different principle from measuring the costs and benefits of FDI outlined above, it just makes the same point differently.

30. The answer to this question critically turns on the issue of the economic incidence of a tax on non-residents. That is, do non-residents actually bear the economic burden of taxes

that New Zealand seeks to impose of them, or can they shift that burden to New Zealanders and if they do so, what are the economic consequences?

31. If New Zealand can lower the after-all-taxes rate of return that non-residents earn in New Zealand without affecting their behaviour, then taxing them will involve a net gain to New Zealand. In other words, if we can tax FDI without an effect on the level or type of FDI in New Zealand real economic resources will be transferred from the rest of the world to New Zealand **in addition to** the economic gains from any investment undertaken in New Zealand by those non-residents.

32. If, however, non-residents can shift the incidence of any New Zealand tax to factors of production in New Zealand, then New Zealand will be worse off. No resources will be extracted from non-residents and there will be less investment in New Zealand.

33. The simplest example of the effects of taxing non-residents is the portfolio debt market. Below we consider whether there is anything different about foreign direct investment that might lead to a modification of the conclusions of the analysis of the debt market.

34. Investors in the portfolio debt market are motivated solely by the (risk-adjusted) rate of return they can earn from their investments: they are not investing to take a stake in the management of their investment target. Such investor from off-shore will, therefore, compare the **after-all-taxes** return they can earn in New Zealand with the **after-all-taxes** return they can earn elsewhere when deciding where to invest.

35. This point is critical to the analysis: non-residents have investment choices outside New Zealand. It is this that drives how they respond to any tax that New Zealand might seek to impose on them.

36. Consider non-resident portfolio investors who can earn a 10% return after paying taxes at home. If they are to invest in New Zealand, they will need to earn at least 10% after New Zealand **and** home taxes[1].

37. Consider now an investment project in New Zealand paying 10% **before** New Zealand taxes, but upon which New Zealand imposed a 33% tax. The **after** New Zealand rate of return is now 6.7%. Non-residents will not take up this opportunity, because they have better options at home.

38. The only way to induce non-residents to invest in New Zealand is for the **before**-New Zealand tax rate to increase, so that the **after**-New Zealand tax return at least equals the alternatives available elsewhere.

39. Returning to our example, a pre-New Zealand tax rate of return of 15% would be required to attract non-resident investors.

40. The end result is:

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[1] This assumes that the non-resident's home country taxes its residents on their worldwide income at the same rate as it taxes domestic income. The results of what follows are not altered if this is not the case

- Non-resident investors earns the required post-New Zealand tax rate of return, in this case 10%;
- New Zealand has raised some revenue; **but**
- New Zealand borrowers have to pay a higher cost of capital: in this case, 15%.

41. What has happened is that the burden of the tax imposed on non-residents has been shifted to New Zealand borrowers. And, because of the way capital markets work, it means that the cost of capital to all New Zealand borrowers will be increased.

42. In terms of optimal tax policy, what this suggests is that New Zealand should seek to raise revenue from borrowers **directly**, say through a higher income tax or consumption tax rate[2]. If it did so, then:

- the level of government spending can be maintained;
- borrowers are no worse off (they pay a tax directly, rather than having the incidence of a tax shifted onto them indirectly); and
- the economy is better off by the reduction in the cost of capital – there is more investment.

43. This is another key point: the economic analysis of taxing non-residents is **not** saying the economy can be improved by reducing a tax on one sector, with that reduction financed by a reduction in spending elsewhere. Rather, it is saying that there is a better way **to raise the same amount of revenue**.

The residence principle

44. The discussion above suggests that, as a starting point, New Zealand should adopt the "residence principle", under which:

- New Zealanders are taxed on their world-wide income on a broad base under the same income measurement rules at a uniform rate: the "broad base, low rate" approach; but
- Non-residents are not taxed by New Zealand on income they earn here.

45. The desirability of the residence principle is subject to the caveat that New Zealanders with capital are also not mobile. There are considerable administrative and compliance difficulties involved in taxing New Zealanders on offshore income derived especially via intermediaries. However, we can approximate the taxation of worldwide income through mechanisms such as CFC and FIF rules. We cannot, however, stop New Zealanders leaving the country, establishing residence in another country and investing into New Zealand.

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[2] This is the application of the "production efficiency result", due to Nobel Prize winning-economist Sir James Mirrlees that says that governments should impose distorting taxes on outputs from the production process, not on inputs to that process. So, for example, a GST-style tax on consumption is to be preferred to a revenue-equivalent cascading wholesale sales tax.

46. If the capital of non-residents and New Zealand residents with capital are both perfectly mobile, then the viability of taxing any income from capital needs to be questioned. We do not think that we have yet reached that point. We can say that both capital and high wealth individuals are becoming more mobile but at this point capital seems, overall more mobile than residence.

When should FDI be taxed?

47. There are two circumstances when New Zealand gathers what might be termed “free revenue” from taxing non-residents, that is revenue at low (or even zero) economic cost to New Zealand. These circumstances are when:

- The non-resident is earning “economic rents” and is thus not sensitive to the New Zealand tax; and
- The foreign government allows a foreign tax credit for New Zealand tax. In this case the after-tax return of the non-resident does not change making the non-resident less sensitive to tax. Instead the foreign treasury bears the burden of the tax imposed on the non-resident investor.

48. Using this sort of approach, the desirability of any given regime for taxing FDI is determined by the extent to which non-residents (or foreign treasuries) bear the economic burden of a tax imposed on them. If foreign investors bear the burden of tax this means that they are not sensitive to tax and will not reduce or change the level of FDI in New Zealand because of tax. If that is the case removal of tax on FDI will :

- Constitute a wealth transfer from New Zealand to the non-resident and/or the foreign treasury equal to the amount of tax forgone; and
- Not result in an increase in FDI.

How FDI is currently taxed

49. Government policy is that the imputation system does not apply to non-resident investors. Therefore, New Zealand **potentially** imposes two layers of tax on investments by non-residents into New Zealand companies, the company tax (at 33%) and Non-residents Withholding Taxes (NRWT) of between 15% and 30% (depending on whether new Zealand has a Double Tax Agreement with the country of residence of the investor) imposed on dividends and interest.

50. However, the effective tax rate on FDI is generally much lower than the statutory rates. This is because:

- interest on debt is tax deductible;
- the Foreign Investor Tax Credit (FITC) reduces the level of company tax to 21.18%; and

- often the non-resident taxpayer is entitled to a foreign tax credit for the NRWT.

Equity Investment

51. Equity, whether FDI or portfolio investment, is taxed under the normal company tax regime. NRWT applies to dividends, with the rate varying between 15% and 30%, depending on whether New Zealand has a double tax agreement with the country of residence of the investor.

52. The combined effect of these two regimes can be very high effective tax rates on distributed income: between 43.05% and 52.8%.

53. However, the Foreign Investor Tax Credit or "FITC" works to reduce the combined company tax rate and NRWT to rate 33%, where the NRWT rate is 15%. FITC reduces the 33% level of company tax to 21.18% for non-residents. The tax saving must be passed out to the non-resident shareholders at the time of dividend distribution in the form of a supplementary dividend. The combined distribution is then subject to NRWT. If the taxpayer is entitled to a foreign tax credit for the NRWT then the total New Zealand tax is 21.18%. Otherwise it is 33%.

54. The same mathematical result could have been reached by eliminating the 15% NRWT on dividends to non-residents. The reason it was not done this way is because the regime was designed to ensure the benefit of the lower tax rate was passed onto non-residents (and thus indirectly New Zealand through lower cost of capital) rather than the foreign treasuries in the jurisdictions of the non-residents.

Debt Investments

55. Debt investment is taxed at a very low rate. This policy is designed to keep the cost of capital low in New Zealand.

56. At the company level, debt is in effect, taxed at a rate of zero, since companies can receive a deduction for their interest expense: there is an exception to this rule – thin capitalisation – which is discussed further below.

57. At the NRWT level, the Approved Issue Levy or "AIL" regime sets a rate of NRWT of zero where the borrower and lender are operating at arms-length. Instead of NRWT, the borrower has to pay a tax-deductible levy of 2%, meaning that the overall effective rate of tax on debt investments is 1.34%. The borrower will usually elect to pay NRWT when the lender can receive a foreign tax credit for that NRWT.

58. The thin capitalisation rules apply to controlled firms that are heavily debt-financed (the benchmark being the world-wide ratio of debt to the sum of debt and equity of the parent group). These rules mean that no more than 75% of the capital of a firm controlled by a non-resident can be debt, with the remaining 25% being taxed as equity.

59. Non-residents undertaking capital intensive FDI into New Zealand have considerable freedom to finance their investments in the way that is most tax effective. Subject to commercial constraints, and the need for capital in particular, there is considerable flexibility as to whether they provide any internal finance, i.e. finance from the parent to the local subsidiary, in the form of debt or equity. (For external reporting purposes, such intra-firm payments will net out.) They have less flexibility when it comes to external debt (i.e. debt finance provided to the group by third parties like banks and bond-holders), since the interests of the lender need to be taken into account. However, within commercial limits, multi-national firms can treat equity finance, internal debt and external debt as close, if not perfect, substitutes. This means that when considering effective tax rates, it is appropriate to think about the taxation imposed on external debt as forming part of the equation.

Combined effect

60. The different tax treatments applied to debt and equity financing and the flexibility that multi-national investors have in structuring their investments means that it is misleading to look only at the company tax rate when analysing the tax treatment of FDI.

61. What matters is the bottom line: how much tax does New Zealand impose, regardless of the form in which an investment is financed.

62. Table 1 summarises the various treatments of inbound investment. These are the New Zealand tax rates. The total tax rate might be higher, depending on home country treatment.

63. The effective rates for equity in Table 1 below are calculated on the basis that, within commercial constraints, firms structure their investments to minimise their New Zealand tax liabilities. We think that this is consistent with reality.

Table 1: Summary of Current Treatments[3]

	Minimum Effective Tax Rates (%)	Maximum Effective Tax Rates (%)
Portfolio Debt	0[4]	1.34[5]
Portfolio equity	22.18[6]	33[7]
FDI	0[8]	21.5%[9]

Analysis of the Review's recommendations to reduce FDI

64. The Tax Review presented two policy options for reducing tax on FDI:

- **Policy Option One** reduces the company tax rate to 18% to the extent a New Zealand company is owned by non-residents (with a 2% NRWT for FDI investors and repeal of the FITC regime, and 15% NRWT with an extended FITC regime for portfolio investors).

- **Policy Option Two** is the same a Policy Option One except that the 18% rate only applies to **new investment** by non-residents (being either investment in new activities or certain significant expansions of existing activities).

65. The Review said that, in principle, they preferred Policy Option Two because the tax rate reduction is targeted at new investment. However, this preference was predicated on the ability to distinguish between new and existing investment. Consequently, if it transpires that this distinction is not workable, the Review suggested that the Government consider the merits of Policy Option One. Accordingly, before analysing, in general terms, the Review's recommendation to lower tax on FDI, we first consider whether it is viable to restrict the low tax rates to new FDI.

Limiting the low rate to "new FDI"

66. As mentioned above, the Review favoured Policy Option Two. This is because:

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[3] All calculations assume the underlying effective New Zealand tax rate is 33 percent. Discrepancies in the tax base mean this will, in general, be only approximately correct.

[4] Assumes full foreign tax credits available for interest NRWT.

[5] Assumes AIL paid.

[6] Assumes full foreign tax credit available for dividend NRWT; no foreign tax credits for underlying company tax

[7] Assumes no foreign tax credit available for dividend NRWT. Assumes DTA reduces the rate of NRWT to 15%

[8] Assumes full foreign tax credit available for interest and dividend NRWT and for underlying company tax.

[9] Assumes no foreign tax credits available. The 21.5 percent is calculated assuming a level of internal debt to equity of 50:50 as follows (.50 x 10%) + (.50 x 33%). We believe the range of "maximum" effective tax rates is 15.75% - 33%. The 15.75 percent is calculated assuming 75 percent associated party debt–financing, as follows: (0.75 x 10%) + (0.25 x 33%) = 15.75 percent. The maximum 33% effective tax rate assumes no associated party debt funding.

- new FDI is more sensitive to tax; and
- reducing the rates of tax for all FDI would involve a large fiscal cost to the Government and, would provide a significant windfall gain to all non-residents with existing investments in New Zealand, with no offsetting benefit to New Zealand in the form of additional FDI.

67. The estimated fiscal cost of Policy Option Two is around $50 million per annum[10]. By contrast, the estimated fiscal costs of Policy Option One, which would reduce headline rates for all FDI, is approximately $500 million per annum[11].

68. As noted by the Review, the viability of Policy Option Two depends upon the design of a satisfactory mechanism to quarantine the application of the tax reductions to income from new FDI in New Zealand.

69. The Review provided suggestions on the design of Policy Option Two. Officials believe that the Review's idea of an "advance certification" regime supported by legislative criteria for determining new investment could be designed and should work for a limited period. (Although though we note that deciding whether IRD or an economic development agency should administer this regime would require further consideration.)

70. The regime would very likely have some arbitrary features to facilitate administration and minimise tax avoidance associated with recharacterisation of old investment as new investment. Even so, we expect mechanisms for exploiting the boundary between new and old investment would erode the regime over time.

71. Moreover, the costs of the regime would inevitably rise as existing capital stocks were, legitimately, replaced with new capital stocks. In other words, non-residents who currently have FDI in New Zealand and who replace their old capital stock with new capital stock, would expect to qualify for the new low rate. Consequently the proportion of FDI under the new rate would increase over time.

72. At some point the boundary would become unsustainable both politically and economically. We estimate that this point would be reached in 5 to 10 years.

73. We conclude, therefore, that Policy Option Two can only be regarded as a transitional means of ultimately implementing Policy Option One. If the Government decided to pursue Policy Option Two it would be highly desirable to signal at the outset when the dual rate system would expire and whether the single rate would be set at the new low rate for all FDI.

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[10] Assuming a robust distinction could be drawn between new and existing FDI activity, we estimated the static revenue cost of Policy Option One was a maximum of $50 million each year. This calculation assumes no growth in FDI and treats all flows of FDI as "new" investment. Of course this cost would compound each year so that in year two the reduction in revenue from the current level would be $100 million, in year three $150 million, and so on. Further more, although such a static revenue estimate is consistent with Government budgetary requirements, officials would need to incorporate some of the dynamic factors to provide a more complete picture of the revenue implications. For instance this would need to include the effect on costings of new FDI that would have come to NZ anyway under existing tax rates: New FDI is made each year under existing tax rates. Reducing the rates represents a loss of tax on investment that would have to come to New Zealand regardless.

[11] Our estimated costs for Policy Option One is slightly more than the estimate provided in the Tax Review's Final Report. (The estimate in that report was $460 million.) Obtaining reliable costings is difficult. We propose to undertake further work on costings prior to this analysis being released for consultation.

Analysis of the Review's recommendation to lower tax rates on FDI

74. We now turn to assessing the Review's proposed changes to the current tax treatment of FDI from the perspective of whether tax rates should be changed as a way of attracting more FDI (or a particular amount of additional FDI).

75. In analysing the Review's recommendations we focus on the extent to which:

- a reduction in New Zealand's taxation of FDI would reduce the after-all taxes rates of return earned by non-resident investors; and
- FDI is sensitive to changes in the after-all taxes rates of return available to non-resident investors; and
- the fiscal cost of lowering taxes on FDI results in additional economic costs.

Impact of lowering the tax rates on FDI on after-all-taxes returns to non-residents from FDI

76. In principle, the Review's recommended reforms have the potential to increase the amount of FDI in New Zealand by:

- increasing the after-all-taxes rates of return to non-resident investors, thereby reducing the extent to which New Zealand taxes reduce the level of FDI in New Zealand; and
- reducing differences in the rates of tax that New Zealand applies to substitutable forms of FDI in New Zealand, thereby reducing the extent to which the New Zealand tax system distorts patterns of FDI in New Zealand.

  (Although as we noted at paragraph 25, only certain forms of FDI brings benefits to New Zealand.)

77. In practice, however, the extent to which the recommended reforms will achieve these objectives depends on a number of factors including the extent to which:

- the reduction in statutory rates will reduce the effective rates of tax that New Zealand imposes on FDI and differences in those effective rates of tax between alternative forms of FDI; and
- reductions in the rates of New Zealand tax are offset by increases in the rates of foreign tax applying to that income, due to reductions in the foreign tax credits that can be claimed by non-resident investors; and
- other countries retaliate by raising the amount of tax levied on income from FDI in New Zealand.

78. We deal with each of these three items in turn below.

(i) Impact on effective rates of New Zealand tax

79. As discussed in section 8.45 of the Review's Final Report, the recommended reforms to the tax treatment of FDI have the potential to reduce the economic costs of taxing FDI by:

- Reducing the effective rates of tax New Zealand imposes on the income non-residents derive from their FDI. At the moment, assuming (i) a 50:50 debt equity ratio; and (ii) no foreign tax credits, the effective tax rate on FDI is around 21.5 percent. By contrast, the Review's recommended approach (company tax rate of 18 percent plus NRWT at 2 percent) would, using the same assumptions, reduce the effective tax rate for non-resident investors to around 14.82 percent.
- Reducing differences in the effective rates of tax imposed on alternative forms of FDI. Under the current tax treatment of FDI, assuming no foreign tax credits are available, the effective tax rates of New Zealand tax on the income of non-residents from FDI can range from approximately 15.75 percent to 33 percent. By contrast, under the Review's recommended tax treatment of FDI, effective tax rates on FDI would range from 12.41% percent to 19.64 percent.

(ii) Effect of foreign tax credits on "after all tax" returns derived by non-residents

80. The actual level and pattern of FDI in New Zealand depends not only on the rates of tax that New Zealand imposes on that investment income, but also on the rates of tax that are imposed by the home country in which non-resident investors reside.

81. If a non-resident investor is resident in a country that exempts New Zealand FDI income from tax (eg Australia, Canada and Hong Kong), then the recommended reductions in the headline rates of New Zealand tax would reduce the total rates of tax imposed on that income. In other words, FDI by non-residents located in those jurisdictions that operate exemption regimes is likely to be sensitive to changes in New Zealand's headline rates of company tax and NRWT. Some indication of the major sources of FDI in New Zealand is provided in Table 2, which indicates the stock of direct investment by country. Table 2 indicates that countries that exempt foreign dividends from tax account for around 51 percent of the total stock of FDI in New Zealand, whereas those countries that provide credits for underlying foreign tax only account for about 30 - 40 percent of New Zealand's stock of FDI.

82. By contrast, if a non-resident investor is resident in a country that offers foreign tax credits for underlying tax paid in New Zealand (eg the United States, United Kingdom, Japan and Germany), then reductions in New Zealand's headline rates of tax would correspondingly reduce the underlying foreign tax credits. This would increase the amount of home country tax those non-resident investors have to pay on income repatriated from FDI in New Zealand. In other words, the Review's recommended reductions in the rates of New Zealand NRWT would be offset, on repatriation of the income[12], by increases in the rates of foreign tax applying to that income, thereby leaving the total rate of tax levied on that income largely unaffected.

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[12] Assuming the income from FDI is not taxed on an accrual basis by virtue of the application of an active income exemption.

Table 2: Stock of Direct Investment by Country[13]
(Year ended 31 March 2001)

Exemption method countries	**NZ$m**	**%**
Australia	17,245	35.0%
Netherlands	7,069	14.3%
6	1,124	2.3%
Canada		
Switzerland	175	0.4%
Total	**25,613**	**51.9%**
Foreign tax credit country		
United States of America	6,971	14.1%
United Kingdom	6,741	13.7%
Singapore	1,165	2.4%
Japan	749	1.5%
Germany	340	0.7%
Total	**15,966**	**32.4%**
Other	7,734	15.7%
Total FDI in New Zealand	**49,313**	**100.0%**

83. One option for reducing revenue loss would be to target the reduction in 'headline' rates to income on FDI from exemption countries and thus increase the investors' after tax return, thereby reducing the extent to which New Zealand taxes reduce the level of FDI in New Zealand. However, such an approach would increase the likelihood of retaliation by those exemption countries, particularly Australia, which is the largest single source of FDI in New Zealand.

(iii) Effect of reactions by other jurisdictions on after all taxes returns to non-residents

84. Competition between nations for FDI is intense. The Harmful Tax Practices project initiated by the OECD is a collective response to the perception that countries, including member states, are destructively engaged in a "race to the bottom".

85. We do not believe that either Policy Option One or Policy Option Two would constitute a harmful tax practice. However, it is ultimately up to the OECD to make that judgement and it is possible that some members might object to the ring-fencing aspects of the Review's recommendations[14].

86. In any event, it is probable that some countries will take unilateral action in response to New Zealand cutting rates on FDI. The net effect of their reaction would be to increase the foreign tax on the NZ sourced income and thereby neutralise the beneficial effect of such a

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13 Statistics New Zealand

14 "Ring Fencing" refers to tax regimes that provide preferential treatment for non-residents, as opposed to applying across-the-board.

rate reduction. This would, in turn, make the affected non-resident investor less sensitive to the cutting of the tax rate.

87. For instance, the proposed reduction of the New Zealand company tax rate for new residents may have the effect of changing the tax status of New Zealand under the Australian CFC rules.

88. New Zealand is currently one of the seven broad-exemption listed countries under the Australian CFC regime. The broad list exemption countries are considered to have tax systems closely comparable to Australia. Australian officials have indicated that were New Zealand to drop its corporate tax rate to 18% for non-residents the Australian Government would need to consider whether New Zealand should be dropped from the broad-exemption list.

89. Under Australian CFC rules income from broad-exemption list countries is taxed on a repatriation basis. Income derived from all other countries is taxed on an accruals basis unless it passes the 'active income test'. If New Zealand were to be dropped from the broad-exemption list this would remove the tax deferral advantage for Australian controlled foreign companies (CFCs) in New Zealand earning "passive" income in New Zealand, which is conferred by being exempt from accruals taxation. "Active income" would continue to be exempt from current taxation.

90. New Zealand's current approach to taxing FDI, which involves regimes like AIL and FITC, are well known to tax policy makers in our major investment partners. To date, they have not elicited adverse reaction. One important reason for this is that New Zealand has been careful to ensure that its tax regimes do not reduce the ability of other countries to impose tax on the New Zealand sourced income of their residents. That is, we have limited reductions in tax to the amount New Zealand imposes. Indeed, through avenues like exchange of information between IRD and other tax administrations, we actively assist other countries in the taxation of their residents.

Impact of change to the after-all-taxes returns to non-resident investors on the level of FDI in New Zealand

91. Having examined the impact that the Review's recommendations on the after-all taxes returns to non-resident investors, we now turn our attention to an assessment of how those expected changes in after-all-tax rates of return are likely to alter the level of FDI in New Zealand.

92. As noted by the Review in the Final Report, the sensitivity of FDI in New Zealand to taxes imposed by New Zealand and the home country of non-resident investors depends on the extent to which there are economic rents arising from FDI in New Zealand.

93. FDI is often thought to be associated with the earning of economic rents. Economic rents are earnings in excess of those needed to keep resources in their present use. Firms earn economic rents when they have firm specific knowledge about a product or process that they

can only exploit by investing directly into New Zealand. The existence of economic rents is a key factor in explaining the relative insensitivity of FDI to taxation.

94. FDI is less sensitive to changes in tax than portfolio investment since tax rates are not necessarily the most important factor that determines non-resident investors' decisions about the level and pattern of their FDI in New Zealand. Other non-tax factors, including: improved access to overseas markets; physical, regulatory and political infrastructure; cost of labour and natural resources, are equally if not more important.

95. For example, consider the case of FDI from Australia. This accounts for 35% of total FDI in New Zealand and is the most important source of FDI from a country that exempts their companies from tax on income from FDI. Recent research conducted by the Australian Productivity Commission[15] found that commercial (or market related) factors are more important overall than matters subject to government control in influencing decisions about outbound FDI. In particular, the Productivity Commission found that:

- improved access to overseas markets is by far the most important commercial factor influencing the decisions by Australian firms to produce offshore; and
- although much less important, foreign and domestic tax regimes are next in line and are the most significant government-related influence.

96. In other words, tax is certainly not the most important factor influencing outbound Australian FDI. However, tax is still the most important factor influencing the level of FDI that is under the direct control of the government.

97. Similarly, consider the case of FDI from the US. (The US, Japan and the UK together account for around 30 percent of total FDI in New Zealand and together are the most important sources of FDI from countries that provide credits for underlying foreign tax.) Research conducted by the National Bureau of Economic Research in the USA (NBER) in 1998[16] found:

- that the elasticity of real capital to after-tax rates of return was close to 3 in 1992. That is, a 1 percent reduction in the after-tax rate of return was estimated to produce a 3 percent increase in FDI; and
- that the sensitivity of FDI to tax is increasing over time. The NBER estimated that the elasticity of real capital to after-tax rates of return increased from 1.5 in 1984 to 3 in 1992. As noted by the NBER, this result is consistent with the view that the increasing globalisation of production is increasing the sensitivity of FDI to tax rates.

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[15] *Offshore Investment by Australian Firms: Survey Evidence,* Commission Research Paper, AusInfo, Canberra, 2002

[16] Rosanne Altshuter, Harry Grubert and T Scott Newton "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" NBER Working Paper No. W6383, January 1998

Costs and Benefits of the Review's proposal

98. Given officials' view that any reduction in FDI would (at least over time) need to apply to old as well as new FDI, this suggests that there would be a substantial reduction in tax revenue from existing FDI without any obvious benefit to New Zealand. The reduction in tax revenue collected from existing FDI would simply constitute a wind-fall gain to existing FDI.

99. This sunk cost means that there would need to be substantial benefits from any increase in FDI resulting from the tax cuts. Using a set of assumptions that are very favourable to the case that a reduction in tax on FDI will lead to a significant increase in FDI and taxation, Table 3 shows that there would be revenue short-fall in the order of $370m from implementing the Review's recommendation.

Table 3 The Effects of Reducing Effective Tax rates

- The Review's recommendations would reduce the average effective tax rate on FDI from 21.5 per cent to 14.82 percent (assuming that all new FDI will come from countries that exempt foreign dividend income from tax);
- Using a pre-tax rate of return of 8 percent the Review's recommendations would increase the post-tax rate of return from 6.3 percent to 6.8 percent (i.e, an 8 percent increase);
- a one percent increase in the after-tax rate of return rate produces a 2.8 percent increase in FDI (as suggested by the NBER study), so an 8 percent increase in the post-tax rate of return would produce a 22 percent increase in the level of FDI;
- the amount of FDI is $50b (i.e, all of existing FDI is eligible for the reduced taxation). Therefore FDI increases by around $11b;
- Under these assumptions, the estimated increase in FDI would have to be capable of producing benefits for New Zealand of at least $500m to offset the fiscal cost. The estimated increase in FDI would produce additional tax revenue of $130m (given 8 percent pre-tax rate of return and average effective tax rate of 14.82 percent).
- This means that the additional $11b of FDI would have to produce more than $370m of additional benefits to New Zealand. For example, it would have to produce at least $370m of increased labour income for New Zealand. This would be equivalent to an additional 10,882 new jobs if we were to assume those employees were paid incomes of $34,000 per annum.

100. The critical question that arises from the example in Table 2 is whether lowering tax rates would actually result in an additional 11b in FDI into New Zealand. The answer to this question turns on the accuracy of the assumptions that drive this result. In other words, to be confident of this result we would need to be much more confident than we are about:

- the accuracy of (i) the current effective tax rate and (ii) the new effective tax rate. These effective tax rates are themselves based upon assumptions about average debt:equity ratios of FDI;
- the level of the stock of FDI in New Zealand;
- the elasticity of FDI into New Zealand;

- whether New Zealand would attract the right sort of FDI – i.e. FDI that brings benefits to New Zealand.

101. These are matters on which there is currently little information. Consequently it is impossible to predict the outcome of lowering effective tax rates on FDI with any certainty.

Additional economic costs of raising lost revenue from elsewhere

102. Table 2 above suggests that, assuming a given increase in FDI, the Government would need to raise an additional 175 million of revenue. In assessing the Review's recommended reforms to the current tax treatment of FDI, it is essential to consider the additional economic costs that may arise from the manner in which the fiscal cost of implementing those reforms is financed by the Government.

103. The magnitude of those additional economic costs depends on the manner in which those fiscal costs are financed. For example, if the fiscal costs are financed by:

- increasing other tax rates, or the deferral of future tax cuts, then the economic costs of implementing the Review's recommendations will be increased by the deadweight costs arising from those taxes (which increase disproportionately with the tax rate);
- reducing the Government's Budget surplus, then the economic costs of implementing the Review's recommendations will be increased by the costs of delaying planned reductions in Government debt (eg higher cost of capital).

Alignment of statutory and effective tax rates

104. The Review expressed a preference for reducing the effective rates of tax on FDI through a reduction in 'headline rates'. For example, the Review noted that:

- 'Reducing the headline corporate tax rate applying to non-residents, for example, would be a more transparent reduction in the effective tax rate but not a fundamental change to the existing position'[17]; and
- 'Relative to other ways of reducing effective tax rates on non-residents' investment into New Zealand, a reduction in the company tax rate for companies owned by non-residents has the considerable advantage of being markedly more visible and therefore more clearly establishing New Zealand's receptiveness to foreign investment'[18]. Lowering 'headline' rates of company tax and NRWT was seen as a means of making New Zealand 'stand out from the crowd'.

105. So far, we have assumed that non-resident investors base their investment decisions on the actual after-all-taxes rates of return from FDI. We recognise, however, that the determination of the actual effective rate of tax imposed on income from can be a complex

[17] Paragraph 6.58 of the Review's Issues Paper.
[18] Paragraph 6.73 of the Review's Issues Paper.

and costly exercise for certain types of FDI. As a result, some potential non-resident investors in New Zealand may base the initial investment decisions on 'headline' as opposed to actual effective tax rates as a means of reducing the 'transactions costs' associated with estimating actual effective tax rates. In other words, the higher headline company tax rate in New Zealand might be deterring some investors from exploring in more detail the scope for FDI in New Zealand as opposed to other countries such as Australia that have lower headline company tax rates. This would tend to reduce the sensitivity of FDI decisions to reductions in actual effective rates of tax if those tax reductions are implemented other than via reductions in 'headline' rates of tax.

106. Having said that, we believe that this issue of transparency should be considered separately from the proposal to reduce rates on FDI. That is, the primary issue to be determined is whether the effective tax rates on FDI into New Zealand should be lowered. The question of whether any such reductions should be delivered through lower statutory rates or through some other mechanism such as FITC is a secondary matter.

107. We note, however, that in order to align current statutory rates with current effective rates it would be necessary to eliminate the distinction in tax treatment between equity and inter-group financing. We do not believe that this type of reform would be likely to attract more FDI.

Conclusions

108. On the basis of available information, we have reached the following conclusions:

- It would be difficult to restrict the recommended reductions in tax rates to new FDI. As a result, the annual fiscal cost of implementing the Review's reforms could be expected to increase over time from around $50 million per annum to around $500 million per annum.
- The Review's recommendations would increase the after-all-tax rates of return to non-resident investors located in those jurisdictions that:
    - provide credits for underlying New Zealand tax (eg US, UK, Japan). However, the magnitude of this increase in after-all-tax rates of return is likely to be very small since the recommended reductions in New Zealand rates of tax would reduce the foreign tax credits that can be claimed by the non-resident investor. As a result, most of the reduction in New Zealand taxes would be offset automatically by an increase in the home country rates of tax on that FDI income. This means that most of the benefits of the reduction in New Zealand tax rates would go to the foreign revenue authorities rather than increase after tax returns to non-resident investors and stimulate FDI in New Zealand;
    - exempt the dividend income from FDI in New Zealand (eg Australia, Netherlands, Hong Kong). The Review's recommended reforms are more likely to reduce the after-all-tax rates of return on investments from these jurisdictions. However, even in this case, there is a risk that some countries would retaliate by altering their tax

treatment of income from FDI in New Zealand. For example, Australian officials have already indicated that the Australian Government would need to consider whether New Zealand should be dropped from the 'broad exemption list'.

- There is uncertainty surrounding the magnitude of the responsiveness of FDI to any consequential increases in after-all-tax rates of return. However, we believe FDI is relatively insensitive to tax.
- There would be additional economic costs associated with making up the fiscal cost of implementing the Review's proposal.

109. For these reasons, we conclude that it is not desirable for New Zealand to implement the Review's recommended changes to the taxation of FDI at this time.

110. However, it is important to note that that the sensitivity of FDI to taxation is likely to be increasing over time due to a range of factors including:

- increases in the mobility of capital;
- changes in production technology; and
- increases in tax competition between countries for FDI.

111. This means that it is important for the Government to keep the tax treatment of FDI under review. In particular, we believe it is important for the Government to explore initiatives designed to improve:

- the Government's understanding of levels and patterns of FDI, the sensitivity of FDI to tax, the amount of revenue raised from the current taxation of FDI, and the magnitude of the economic costs arising from taxing FDI. For example, it might be worthwhile for officials to explore the scope for working in partnership with interested parties in the private sector to develop a much better picture of the nature and extent of both inwards and outwards FDI and the main factors that drive those investment decisions; and
- non-resident investors understanding the current tax treatment of the income from FDI in New Zealand, particularly the actual effective tax rates New Zealand currently applies to those investments. For example, it might be worthwhile for officials to explore options for improving the transparency of actual effective rates of tax currently applying to non-resident investors.