10 September 2003

Minister of Finance and Revenue
cc: Associate Minister of Finance (Hon Trevor Mallard)
Associate Minister of Finance and Revenue (Hon David Cunliffe)

Taxing inbound investment

Executive summary

The Tax Review recommended that the Government dramatically reduce headline tax rates on foreign direct investment (FDI) as a means of stimulating economic growth. The Review favoured an approach (Policy Option 2) whereby the rate reduction would apply only to new FDI so as to reduce the fiscal cost of the proposal.

Officials did not support the McLeod proposal, concluding that targeting new FDI was unworkable except as a transitional measure and that there was insufficient evidence to suggest that a rate reduction for all FDI would produce the magnitude of spill-over benefits required to offset the fiscal cost of the proposal. You released that report for further consultation.

We received a range of submissions – mostly in support of introducing Policy Option 2, either as a permanent solution or on a trial basis. Submitters believe that Policy Option 2 is "worth a punt" even if only for a limited period. They think that, at best, it could net New Zealand considerable benefits. At worst, the initiative would be a low cost experiment.

Officials' analysis of the points raised in submissions are contained in Annex 1 of this report. A description of each of the submissions is contained in Annex 2. Notwithstanding these submissions, we confirm our view that Policy Option 2 is not a workable solution and recommend that it not be implemented. This is because applying different tax rates to FDI depending on the date of the investment is not sustainable as a permanent feature of the tax system.

We do accept that it is theoretically possible to introduce a temporary tax concession for new FDI. However, the Government would need to be committed to removing the concession after a fixed period of time, say, seven to ten years. The main danger with this approach is that lobbying to extend or broaden the concession beyond that period would undoubtedly be intense. Firms that are attracted to this type of concession are usually able to move their business to another jurisdiction with ease and so can lobby effectively for an extension of the concession. We are sceptical about whether the Government would be able to terminate the

tax concession in practice. Also, we believe the costs of such a measure would outweigh the benefits — especially in view of the inherently mobile nature of the investment that it would likely attract. Accordingly, we do not recommend that Policy Option 2 be adopted as a temporary measure.

Over the past few months we have compared the McLeod proposal with other options for reducing tax on FDI, either in relation to headline rates or effective tax rates. These options would attempt to target tax-sensitive FDI. They would also all involve fiscal economic costs.

Before any further work can be done on the issue of tax incentives, however, the Government needs to address the primary issue of whether it actually wants to subsidise FDI (either directly or through the tax system) as a means of increasing the flow of FDI to New Zealand. A key related issue is whether the Government wants to target particular forms of FDI (for example, attempt to aim at those that deliver the most spill-over benefits) or particular sectors, because targeting might be better achieved through grants rather than tax incentives. These are fundamentally economic development issues rather than tax policy issues.

Both the Treasury and the Ministry of Economic Development are working on FDI and are currently collaborating with each other, the Ministry of Foreign Affairs and Trade and others as part of a range of work to promote New Zealand's global connectedness. An interdepartmental Steering Group on Global Connectedness (whose role is to coordinate work leading up to the GIF component of the 2004 budget) is setting up several working groups including one on FDI. We recommend that FDI as an economic development issue be considered within this working group and within the context of the Government's broader "Global Connectedness" initiative. However, responsibility for any advice on decisions that have tax policy implications should remain with Inland Revenue and Treasury.

We have consulted with the Ministry of Economic Development on this report.

Recommended action

It is recommended that you:

(a) **Agree** that the Government should not implement Policy Option 2, recommended by the McLeod Committee.

Agreed/Not Agreed

(b) **Agree** that Treasury and the Ministry of Economic Development continue to explore the importance of FDI to the economy and ways to reduce barriers to investment in New Zealand, within the context of the Government's broader "Global Connectedness" initiative.

Agreed/Not Agreed

(c) **Refer** this report to the Minister of Economic Development.

Referred

Richard Lynch
for Secretary to the Treasury

Carmel Peters
Portfolio Manager, Policy
Inland Revenue Department

Hon Dr Michael Cullen
Minister of Finance and Revenue

Background

1. The Tax Review recommended that the Government consider reducing the tax burden on FDI as a means of attracting more FDI. It recommended doing so in a way that dramatically reduced headline rates as follows:

- reduce the company rates for non-residents from 33% to 18%; and
- reduce the non-resident withholding tax (NRWT) rate on dividends from 15% to 2%.

2. Two options were advanced as a way forward. Policy Option One was to apply the lower rate to all FDI. Policy Option 2 (the Tax Review's preferred option) was to apply the lower rate only to new FDI.

3. Officials reported to the Government on the Tax Review's recommendations in a report dated 3 May 2002 (T2002/610; PAD2002/93 (the May report)). The report was released at the ICANZ conference in October 2002 so that further consultation with the private sector could be undertaken. Seven submissions were received in total, being from David Patterson, Rob McLeod, and John Shewan (the practitioners' submission), KPMG, ICANZ, the Corporate Taxpayer Group, Vodafone, Fonterra, and Business New Zealand.

Review of submissions

4. The May report considered the extent to which New Zealand would gain from implementing the Tax Review's recommended changes to the current tax treatment of FDI. It focused on the links with the Government's strategy for building an economy capable of sustaining higher growth rates. It discussed the costs and benefits of FDI to New Zealand. The report described the economic framework for deciding how a small, open economy should tax inbound investment in general and described how FDI and other inbound investment is taxed.

5. The report then analysed the Tax Review's recommendations to reduce FDI in light of the underlying economic framework. Officials concluded that targeting a low rate at new FDI would be unworkable, except as a transitional measure. Therefore the rate reduction had to be evaluated on the assumption that it would apply to all FDI. Officials then argued that an across-the-board reduction in tax was unlikely to produce sufficient benefits to New Zealand to offset the welfare costs of raising the revenue on other productive activity in New Zealand.

6. A range of submissions were received in response to the May report. By and large, submissions did not dispute the underlying economic framework upon which the current taxation of inbound investment (including FDI) is based. (Accordingly, we do not revisit the question of whether New Zealand applies the correct economic analysis to the taxation of FDI. Nor do we restate those principles. Rather we take as a given that the principles described in the May report that underpin New Zealand's international tax regime as it applies to inbound investment are broadly correct.)

7. Submissions did, however, challenge officials' assessment of whether the Review's proposed changes to the current tax treatment of FDI should be adopted as a way of attracting more FDI (or a particular amount of FDI). Broadly, the submissions traversed the following matters:

- the relative importance of attracting more FDI to New Zealand;
- whether headline rates should be changed to attract more FDI;
- whether the new/old distinction inherent in Policy Option 2 is workable; and
- whether Policy Option 2 would disadvantage domestic industry.

8. Annex 1 contains a summary of submissions. Annex 2 analyses the submissions on each of the above points. We also analyse key aspects of those submissions in the body of this report.

9. In our view, submitters did not substantially challenge the conclusion reached by officials in the May report that the costs of lowering the tax rate on all FDI would exceed the benefits that would likely be generated by such an approach. As discussed below, however, there was a general concern amongst submitters that officials had overstated the cost and understated the benefits associated with lowering tax rates.

10. The key point of difference that emerges between the conclusions in the May report and submissions is around the question of whether the Government should proceed with Policy Option 2. Submitters were not unanimous on this point. Business New Zealand and Fonterra did not support the 18% rate for new FDI. KPMG and Business New Zealand both favoured lowering the corporate rates generally – although KPMG supported Policy Option 2 in the absence of lowering the corporate rate.

11. By contrast, the practitioners' submission, ICANZ, Corporate Taxpayer Group and Vodafone New Zealand gave broad support to the adoption of Policy Option 2 in one form or another. These submissions disagreed with officials' views that a "new/old distinction" could not be implemented on a permanent basis. Notwithstanding these submissions, we still hold to the view that it is not viable for the Government to offer a low rate limited to new FDI, as a permanent feature of the tax system. Tax rates are a fundamental feature of our income tax system. Levying different rates of tax purely on the basis of whether the investment was made before or after a specific date is inherently arbitrary and therefore unsustainable. Although some submitters argue that businesses would tolerate this level of arbitrariness in exchange for the perceived overall benefits of lower rates, we do not believe that businesses would find a dual rate acceptable in the long run.

12. Submitters also said that if the Government was not prepared to lower the tax rate for new FDI on a permanent basis it should move to consider whether a "new/old" distinction should be made as a *temporary* incentive to attract new FDI. Consequently, the process of consultation has, in our view, narrowed the debate on the Tax Review proposal to the issue of whether Policy Option 2 is worth pursuing as a temporary measure.

Policy Option 2 as a temporary measure

Could Policy Option 2 be implemented as a temporary measure?

13. Some submitters said that even if the new/old distinction is unsustainable in the long term that it should be introduced for a limited period of time, possibly as an initial step towards a more permanent low tax rate for all FDI. Others suggested that the lowering of the rate for FDI could be staggered to reduce the cost of such a move.

14. The practitioners' submission advocated a "wait and see" approach. They envisaged three possible outcomes in the seven to ten-year period following the introduction of the 18% rate for new investment:

- continue with the regime if it works or;
- align rates as the general company tax rate trends down or if the number of businesses in the existing business category becomes very small;
- abandon it after ten years if it does not produce the anticipated benefits for New Zealand.

15. By contrast, ICANZ favoured Policy Option 2 being introduced for a finite period of time. ICANZ considers that this would allow its costs and benefits to be evaluated and allow the drafting of robust criteria and anti-avoidance legislation to minimise the risk of exploitation. ICANZ notes, however, that several issues that would need to be explored to determine the feasibility of such a scheme including the transportability of FDI at the expiry of the finite period and the impact this would have on the New Zealand economy.

16. The Government could proceed with this initiative by being clear at the outset that the measure was temporary and would be removed after a fixed period. (In order to be transparent about this a sunset clause would need to be inserted into the legislation.)

17. This raises the question of whether, in order to proceed with Policy Option 2 as a temporary measure, the Government needs to determine, at the outset, whether the rate would increase to the corporate rate or be aligned at some new lower rate for FDI. Our view is that the Government could adopt the position that it is guaranteeing a low rate for new FDI for a fixed period. At the end of the fixed period the rate would move back to the normal corporate rate unless the Government decided otherwise, based on an objective evaluation of the net benefits of the lower rate.

Should Policy Option 2 be implemented as a temporary measure?

18. While implementing Policy Option 2 is technically feasible, we do not recommend such an approach. There is a risk that, as a practical matter, it will be extremely difficult for the Government to terminate the concession — even if it has produced little in the way of spill-over benefits. We would expect lobbying to extend the concession and possibly broaden the ambit of the concession to intensify closer to the date the concession is due to expire. Businesses that are attracted to a jurisdiction offering a temporary, concessionary tax rate are

usually able to demonstrate that they will relocate out of the jurisdiction if the concession is not extended. This gives rise to a serious risk that a low tax rate for FDI will continue to exist, or even be extended, when it is undesirable for it to do so.

19. The May report focused primarily on the costs and benefits of lowering the tax rate on all FDI. The same principles apply in considering whether to lower the tax rate for new FDI on a temporary basis. In other words, the Government should pursue Policy Option 2 on a temporary basis only if it believes that the reduction in tax on new FDI will produce sufficient benefits to New Zealand to offset the welfare costs of raising revenue on other productive activity in New Zealand over that period.

20. The Tax Review and the May Report estimated that the static revenue cost of lowering tax rates on new FDI was a maximum of $50 million per annum. This calculation assumes no growth in FDI and treats all flows of FDI as "new" investment. This cost would compound each year and would need to be collected elsewhere in the economy.

21. Submitters had a general concern that officials had overstated the fiscal and economic costs of the Tax Review proposals whilst down-playing the expected benefits of the rate reduction. Concerns were also raised in relation to the consistency of the assumptions underlying the numerical illustration in Table 3, which demonstrates the potential effects of the proposed reform. This issue is discussed further in Annex 1.

22. In terms of the costings, submitters were critical of the fact that the costings were static and did not take account of second round effects. The difficulty is that second round effects are usually linked to behavioural responses, which cannot be predicted with any certainty. Consequently, the revenue effects are simply too speculative to quantify. Accordingly, we prefer to rely on static costings whilst recognising their limitations. In any event, the economic costs of imposing a higher tax on other productive activity to make up the revenue shortfall are likely to be more significant than the fiscal costs, although more difficult to estimate and identify.

23. On the positive side of the ledger, submitters were convinced that attracting more FDI would produce substantial fiscal and economic benefits. They said fiscal benefits would include income tax on FDI that would otherwise not have come to New Zealand and an increase in the PAYE and GST take associated with the new FDI. More importantly, they envisage that the economic benefits associated with an increase in FDI (spill-over benefits) would more than offset the fiscal and economic cost associated with the rate reduction.

24. We agree with submitters that the benefits associated with new FDI come in the form of higher incomes for New Zealanders, tax on those incomes, and tax on the returns to foreign investors. The difference in views between officials and submitters is with regard to the *extent* of the benefits that would be generated by Policy Option 2. This, in turn, stems from the different judgments made by submitters and officials as to how much new FDI would come to New Zealand as a result of a major decrease in tax rates.

25. As we explained in our May report, the level of sensitivity depends on the investor's circumstances. If a reduction in New Zealand tax does not result in an increase in the

investor's after-all-taxes profit because it reduces the availability of a usable tax credit to the investor, that investor will not be encouraged by the rate reduction. On the other hand, if the investor's after-all-taxes profit is increased because the investor is resident in a country that exempts incoming dividends or is unable to use, or fully use, the tax credit, the taxpayer will be encouraged to invest in New Zealand. The extent to which that encouragement translates to an investor choosing New Zealand as an investment destination will depend on how much tax rates matter to that investor relative to other non-tax factors, including infrastructure, political stability, and location advantages. Overseas evidence on the sensitivity of FDI to tax incentives is inconclusive. However, recent studies suggest that the level of sensitivity of FDI is only moderate but increasing.[1]

26. Furthermore, the necessarily temporary nature of the proposal means only mobile FDI is likely to be attracted to New Zealand as a result of this initiative. This has adverse implications in terms of spill-over benefits. Mobile FDI is unlikely to result in the establishment of long term sustainable businesses in New Zealand that produce higher value-added products and/or establish linkages between New Zealand businesses and overseas markets. Our judgment is that the costs, when both economic and fiscal costs are taken into account, would outweigh the benefits. Accordingly, we are unable to recommend adoption of Policy Option 2 as a temporary measure.

27. If the Government is interested in investigating Policy Option 2 further, officials should report to the Government on key design issues including:

(a) how the approval process would work;

(b) the scope of the concession, in particular, whether the concession should be available to significant extensions of existing FDI or activities which are the same as activities currently carried on in New Zealand;

(c) whether the incentive should be targeted at specific industries such as biotechnology and information and communication technology, which are the industries currently targeted by the Growth and Innovation Framework taskforces;

(d) whether New Zealand investors should also be eligible for the same type of incentive; and

(e) whether the concession should be gradually phased out.

Future direction of FDI policy

28. There are other potential tax options, currently in use around the world, which could be used to try and attract FDI to New Zealand. These include tax incentives designed to lower the effective tax rate and tax holidays for FDI.

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[1] 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.

29. Some countries provide tax incentives to lower the effective tax rate — for example, concessionary research and development rules, concessionary depreciation rules or loss carry-forward. We do not favour these approaches to attract FDI because they can distort investment decisions towards particular activities. Moreover, tax incentives designed to lower the effective tax rate do not address the Tax Review's perception that the tax deterrent to FDI in New Zealand is high headline rates.

30. Another approach is a tax holiday. Tax holidays usually involve the provision of tax relief or a tax exemption for a limited period of time running from the commencement of the investment. Sometimes tax holidays are limited to green-fields investment. Other conditions can be imposed – for instance, requiring a minimum amount of expenditure.

31. Tax holidays have been criticised by fiscal experts, however[2] they give rise to the same type of problems as Policy Option 2 implemented as a temporary measure. That is, they tend to attract primarily short-term investments which can move quickly between jurisdictions, creating the danger that the firm will exit at the end of the holiday. Moreover, targeting of tax holidays raises definitional problems and targeting by sector raises additional problems of how to treat firms engaged in both qualifying and non-qualifying activities.

32. There are other options that could be pursued in the context of our own international tax regime, including:

(a) targeting investors who cannot use foreign tax credits either because they are investing from a jurisdiction that exempts foreign dividends or because the entity itself cannot utilise the foreign tax credits, — for example, an Approved Issue Levy (AIL) type of approach could be used for equity;

(b) modifying the foreign investor tax credit regime so that the credit is available prior to the repatriation of dividends;

(c) reviewing the Foreign Investor Tax Credit rules to determine whether simplification and improvements could be made.

33. We have not considered any of these options in any detail. In addition, the Treasury is also concerned that portfolio equity is arguably "over taxed" relative to FDI.

34. All the options would involve some (possibly substantial) fiscal cost and potentially some economic cost depending on the extent to which the Government wants to target certain activities or certain taxpayers. To some extent there is a trade-off between fiscal and economic costs. For instance, targeting the tax incentive to specific activities (say, the task force activities) might reduce fiscal costs but runs the risk of increasing economic costs by distorting investment decisions.

35. Before any further work can be done on the issue of tax incentives, however, the Government needs to address the primary issue of whether it actually wants to subsidise FDI (either directly or through the tax system) as a means of increasing the flow of FDI to New

[2] For example: Jacques Morisset in "Tax Incentives: Using Tax Incentives to Attract Foreign Direct Investment" View Point, World Bank, January 2003; and W. Stephen Clark "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options" Canadian Tax Journal (2000) Vol . 48, No. 4.

Zealand. A key related issue is whether the Government wants to target particular forms of FDI (for example, attempt to aim at those that deliver the most spill-over benefits) or particular sectors, because targeting might be better achieved through grants rather than tax incentives. These are fundamentally economic development issues rather than tax policy issues.

36. Both the Treasury and the Ministry of Economic Development have a role in developing FDI policy and are currently collaborating with each other, the Ministry of Foreign Affairs and Trade and others as part of a range of work to promote New Zealand's global connectedness. An interdepartmental Steering Group on Global Connectedness (whose role is to coordinate work leading up to the GIF component of the 2004 budget) is setting up several working groups including one on FDI. We recommend that FDI as an economic development issue be considered within this working group and within the context of the Government's broader "Global Connectedness" initiative. However, responsibility for any advice on decisions that have tax policy implications should remain with Inland Revenue and Treasury. Moreover, if you wish to explore any of the options in outlined above in paragraphs 29 and 32 these should be directed to tax policy officials.

37. We have consulted with the Ministry of Economic Development on this report.

ANNEX 1

THE MAIN THEMES IN THE SUBMISSIONS

THE RELATIVE IMPORTANCE OF ATTRACTING MORE FDI TO NEW ZEALAND

Submissions

1. Submissions were generally of the view that New Zealand needs more FDI. They emphasised the importance of increased levels of FDI in promoting economic growth. Submissions also focused on the advantages of FDI, such as spill-over effects in the form of increased expertise. Many felt that the officials' report did not place enough importance on these spill-over effects. Submissions also focused on the danger of doing nothing to attract new FDI or retain existing FDI. KPMG and the Corporate Taxpayer Group questioned the assumption that the corporate tax base and current levels of FDI would be retained in the absence of such initiatives as a lower tax rate for FDI.

2. The Tax Review 2001 believed that New Zealand needs more FDI, and this is also the operating assumption of the practitioners' submission. Business New Zealand maintained that New Zealand has done poorly in recent years in growing business investment and attracting FDI. Vodafone New Zealand and KPMG emphasised the need for New Zealand to compete within multinational enterprises for regional company business. ICANZ submitted that encouragement of FDI is crucial to the growth of the New Zealand economy.

Officials' comments

3. Officials agree that in most situations FDI is beneficial to New Zealand. New Zealand will continue to need and attract FDI.

4. FDI provides capital without having to rely on domestic savings. It can also provide spill-over benefits including technology transfers from foreign companies, offshore networks and human capital accumulation. Not all FDI generates positive spill-overs, and it is not possible ex ante to identify which FDI will generate these benefits. To be beneficial 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 be in the form of higher incomes for New Zealanders through more or better jobs than exist in the absence of FDI.

5. It is, however, very difficult to identify optimal levels of FDI for the New Zealand economy. Further, attracting FDI inevitably imposes costs on the New Zealand economy and cannot be viewed in isolation or as an end in itself. Therefore the question is not whether New Zealand needs more FDI but whether the benefits of attracting FDI above current levels will outweigh the costs and therefore result in a welfare gain for New Zealand.

SHOULD HEADLINE RATES BE CHANGED TO ATTRACT FDI?

Are headline rates important?

Submissions

6. Most submitters recommended a lower corporate tax rate to reduce the overall tax burden faced by business generally. They accepted, however, that this is not on the Government's agenda.

7. Submitters also commented on the importance of low headline rates relative to low effective rates. They recognised that effective tax rates on foreign investment can currently be reduced (through various mechanisms) to well below the 33% headline rate. There is concern, however, that the current headline rates are discouraging foreign investors from considering New Zealand as an investment destination. The effective rate is considered not visible enough to potential investors. By aligning effective and headline rates more closely it is considered that New Zealand could "stand out from the crowd" among competing capital importing nations.

8. The Corporate Taxpayer Group and the practitioners' submission both contend that investment decisions are often based on headline rates. They stress the fact that headline rates have an impact on investors' attitudes, especially in relation to initial investment decisions, and that the 33% rate prevents New Zealand being considered any further.

9. The practitioners' submission, along with Business New Zealand and KPMG, contend that New Zealand's statutory corporate tax rate is now comparatively high, especially in the Asia/Pacific region, making New Zealand unattractive for investors at first glance and preventing further analysis of New Zealand as a destination for FDI. These submissions also point out that calculating the effective tax rate can be difficult especially for new investors and that schemes such as Foreign Investor Tax Credit (FITC), designed to reduce the tax on non-residents, are not well understood. This inability to access the effective rates increases the need for a reduction in headline rates.

10. KPMG and Business New Zealand refer to increasing international tax competition among countries in support of their submission that New Zealand needs to lower its headline rates to "stand out from the crowd" in an increasingly competitive environment.

Officials' comments

11. There are several points in submissions that need to be addressed. First, New Zealand's corporate tax rate is within international norms – albeit at the higher end of international norms. [3]

[3] Other headline corporate rates are as follows: Australia 30%, Canada 23% (reducing to 21% by Jan 2004), Ireland 12.5%, Japan 30%, Singapore 22%, UK 30%, US 35%. These rates represent the main federal headline rates. In the case of Japan, Canada and the US, state and local taxes significantly increase the statutory tax rate.

12. Second, officials agree that headline rates have a role to play in investment decisions. Low headline rates are more accessible and provide a higher level of clarity for investors in determining their potential tax liability than do low effective rates. There is a range of effective rates because different investors will achieve different rates depending on their financial structure, their ability to debt fund their activities, and their appetite for tax planning. Consequently determining the effective rate involves a high level of complexity and will vary from taxpayer to taxpayer.

13. Of the total pool of investors who consider New Zealand as a potential destination for FDI, some investors will eliminate New Zealand as a candidate purely on the basis of headline rates. Others will undertake more research to determine the relevant effective rate. There is no reliable information on the proportion of those potential investors that reject New Zealand based on headline rates.

14. In 1999 the Treasury contracted KPMG to conduct a survey of businesses in Australia, the US and the UK, concerning the supply of foreign tax credits. It appeared that respondents had a good understanding of New Zealand's FITC rule, although not all were using them effectively. Furthermore, those responding already held investments in New Zealand. Accordingly, the survey may not be a good indicator for potential investors who are yet to invest in New Zealand.

15. In any event, the conventional wisdom is that in most case it is the underlying economics of the investment that initially drives the investment, rather than tax. In those marginal situations where tax is the key issue some investors will make the effort to determine potential host country effective tax rates. In other cases decisions will be made on the basis of their headline rates.

16. Third, as mentioned above, the Tax Review's proposal was predicated on the notion that the Government should pursue closer alignment of statutory and effective rates. However, the issue cannot be reduced solely to a debate about whether it is better to have a low statutory rate or a low effective rate, or whether the statutory rate should be aligned with the effective rate. This is because a lower statutory rate usually leads to an even lower effective tax rate.

17. Currently, the statutory corporate tax rate is 33%, with the effective tax rate on FDI ranging between 0% to 21.5% (assuming a certain level of debt funding). The Tax Review observed that a reduction in headline rates to 18% would lead to effective tax rates of between 0 and 14.5%. (These figures also assumed some tightening of the current treatment of debt.) As a result, lowering the headline rate results in a lower effective rate which, in turn, gives rise to fiscal costs.

18. The practitioners' submission argues that low headline rates may not lead to a reduction in effective tax rates if multinationals respond by substituting debt with equity. This argument rests on the notion that multinationals have flexibility in the relative proportions of debt and equity allocated to the various jurisdictions in which investments are made. In this context, a multinational will "over allocate" lowly taxed debt to high tax jurisdictions and "under allocate" highly taxed equity to low tax jurisdictions – thus achieving an optimal tax

rate for its global activities. It is thought that if New Zealand became a "low tax" jurisdiction, multinationals would respond by reducing their level of debt financing into New Zealand and increasing their level of equity.

19. Officials accept that some multinationals may restructure in response to a headline rate reduction, in such a way that their effective tax rate in New Zealand does not change significantly but their global rate of tax does. But this type of response will depend very much on the ability of multinationals to juggle their debt in this fashion and cannot be predicted with any certainty. It also depends on any particular multinational's desire to do so as in many cases their New Zealand investments may be small in proportion to their overall investments.

Will a lower headline rate result in an increase in the rate of return for a foreign investor?

Submissions

20. The practitioners' submission and the Corporate Taxpayer Group indicated that in certain circumstances a reduction in New Zealand tax rates would increase the rate of return to the foreign investor. This includes where the home jurisdiction exempts dividends from FDI in New Zealand (such as Australia). It also includes the situation where the investor's home country grants foreign tax credits and:

- the investor defers repatriation of income and retains the income within New Zealand at a lower rate of tax than in their home country; or
- the investor cannot fully utilise foreign tax credits because:
  - the foreign investor has excess foreign tax credits (either from pooling of foreign earnings or because the investor's home jurisdiction has a lower tax rate than New Zealand) and therefore the reduction of New Zealand tax produces an absolute benefit for the investor; or
  - the investor has losses in their home jurisdiction.

21. Submitters concluded that in many instances a reduction in the New Zealand tax rate on FDI would produce an increase in the after-all taxes rate of return and not just provide a benefit to foreign treasuries.

Officials' comment

22. Officials agree with the analysis above. There will, however, be situations where the reduction in New Zealand rates will merely reduce the underlying foreign tax credits available to the foreign investor from a jurisdiction that offers foreign tax credits, therefore it will have no impact on the after-all taxes return of the foreign investor.

23. One reason this whole issue is difficult to analyse is that we do not have good information about how effective our FITC rules are. We acknowledge that some investors may not be able to fully utilise any foreign income tax credits, but we do not know how widespread this problem is. If this is problematic, it should be addressed. Developing a better understanding of this issue is one possible direction of future work.

24. While not considering it a major threat, officials note that, in response to New Zealand lowering its rates on FDI, some countries may take unilateral action, the effect of which would be to increase the foreign tax on income from investment in New Zealand, thereby negating the beneficial effect of the rate reduction.

Is FDI sensitive to a change in the after-all taxes rate of return?

Submissions

25. Most submissions indicated that FDI was sensitive to a change in the after-all taxes rate of return and therefore sensitive to tax, although few submissions addressed this point in any detail.

26. Vodafone New Zealand considers that its own opportunities for new investment would be greatly improved if New Zealand had a more attractive tax regime. It considers that the current headline rates create a barrier to its competing for regional group company business. KPMG also addresses the issue of foreign-owned corporate taxpayers being unable to compete for business with other subsidiaries because of the high tax cost it faces in New Zealand, compared with branches in other parts of the world.

27. The ICANZ submission accepts the finding of officials that there is no reliable evidence on the marginal sensitivity of FDI, while noting that overseas studies indicate that FDI is becoming more sensitive to tax over time.

28. The practitioners' submission is inclined to the view that there are good reasons to be conservative about assuming that all FDI is highly elastic. This is the reason the Tax Review focused the suggested concession only on new FDI. The submission considers that the key factors affecting the elasticity of FDI are the availability of substitutable investments, the transaction costs of switching from New Zealand and the availability of foreign tax credits for New Zealand tax paid.

29. The practitioners' submission characterises new investment as marginal investment. In their view, with some limited exception, investment in new activities does not generally contain rents. Moreover any new investor into existing activities will not contain rents because the market will capitalise rents into the entry price of the investment. The practitioners' submission did not consider that new FDI will be inelastic owing to high relocation costs or the availability of foreign tax credits.

30. While recognising that the elasticity or sensitivity of particular FDI cannot be known, the practitioners' submission concludes that because new investment does not contain rents, new investment is tax sensitive.

Officials' comment

31. The extent to which FDI is sensitive to a change in the after-all taxes rate of return is difficult to determine and depends on a large number of factors. It is likely that FDI ranges from highly tax-sensitive to highly tax-insensitive. There is no reliable New Zealand evidence on the marginal sensitivity of FDI. International research suggests that the sensitivity elsewhere is moderate but growing over time.

32. Overseas studies indicate that tax is just one of many potential factors that affect the location and amount of FDI. A country's overall economic characteristics are more important for attracting FDI. The available evidence suggests that political, macroeconomic and social stability are critical factors, with quality of infrastructure, openness to trade, size of the domestic market and a transparent and administratively certain tax regime being more important than tax incentives. Thus, while tax is one factor affecting FDI that the government has influence over, it is not the most important factor.

33. One factor that does determine the sensitivity of FDI is the issue of economic rents or above normal rates of return. Research suggests that FDI is almost invariably associated with the earning of rents, of one of two types:

- firm-specific rents, where a company uses a particular factor, such as a patent or unique way of doing business to earn higher than normal rates of return; or
- country-specific rents, where a firm uses the location of investment to earn above normal returns.

34. In general, rent-earning capital is less sensitive to tax than investments earning normal rates of return. Of the two types of rents, location-specific rents are probably less sensitive to tax, since by definition the investment must be in the specific location to earn the rent, but both are likely to be somewhat tax insensitive.

35. Officials believe that some, if not a majority, of FDI in New Zealand is earning firm-specific rents and will therefore be relatively insensitive to tax. We hold this view, in part, because New Zealand has few location-specific advantages compared to other small, open economies like Singapore and Ireland. The Ministry of Economic Development has argued that spill-overs may be greater where FDI is used to exploit international markets. However, this may not be the same as tax sensitivity, as it is possible that this opportunity is based on, say, New Zealand biotechnology that is generating rents. Thus it is possible to have both rents and spill-overs.

36. New investment is at best likely to be only an imperfect proxy for tax sensitive investment. While lowering the tax impost on FDI is likely to increase the amount of FDI, and therefore it is tempting to argue that this "new investment" is tax sensitive, some of this investment would have entered New Zealand anyway. The real question is whether the benefits of obtaining this additional investment outweigh the economic and fiscal costs of tax forgone on new investment that would have come anyway.

37. While lowering the tax impost on FDI is likely to increase the amount of FDI, and therefore it is tempting to argue that this "new investment" is tax sensitive, some of this investment would have entered New Zealand anyway, and it fails to address the question of whether the benefits of this new investment outweighs the costs of attracting this investment. Therefore new investment is at best likely to be only an imperfect proxy for tax-sensitive investment.

38. Given that foreign investors are continuously seeking new markets and developing new technologies and products, there are always likely to be rents available – albeit in some situations temporarily. In addition, depending on where in their life cycle existing firms are, some are likely to enter New Zealand at a future date, even though they may only earn a normal rate of return.

Consistency of assumptions underlying the example in Table 3

Submission

39. The practitioners' submission draws attention to an apparent contradiction in the data used to for the purposes of the illustration in Table 3 of the potential effects of the proposed reduction in tax rates on income from FDI:

> *... we understand that Officials' estimates at Table 3 of this paper contain an inherent contradiction in that the model used to calculate the benefits of the reform has assumed that the 18% tax rate results in a tax reduction of only $250 million and thus necessarily underestimates the benefits if the tax reduction is in fact $500 million. We ask that Officials reconsider their estimates and make public the basis on which they are calculated (particularly as regards the $500 million) and assess their reliability before this Option is discarded.*

Officials' comment

40. The purpose of Table 3 was to illustrate the potential effects of reducing tax rates on FDI using the limited data available and a set of assumptions. Its was not intended to generate an accurate estimate of the net effect of the proposed reform for the purposes of determining whether or not to implement the proposed reform, since the detailed information required to undertake such an accurate assessment does not exist.

41. As outlined in more detail below, the apparent contradiction noted by practitioners arises due to the use of different approaches and data sets to estimate the extent to which the proposed reform would increase tax revenue by increasing FDI and reduce tax revenue by decreasing the effective tax rate on income from FDI.

42. In order to estimate the extent to which the increase in FDI would increase tax revenue, the example used Statistics New Zealand data on the stock of FDI, National Bureau of Economic Research (NBER) estimates of the elasticity of FDI to changes in after-tax rates of return, and various assumptions about the pre-tax rate of return, the debt/equity ratio, the effective tax rates on income from debt and equity investments, and the rate of NRWT.

43. By contrast, in order to estimate the extent to which the reduction in the effective tax rate on income from FDI reduces tax revenue, the example used data on actual tax revenue collected from FDI. (In this regard, we note that we have greater confidence in the accuracy of that actual tax revenue data, as opposed to theoretical estimates of the amount of potential revenue Inland Revenue should be able to collect given the level of capital stock estimated by Statistics NZ and the set of simplifying assumptions outlined above.)

44. As suggested by practitioners, we have re-worked the example using a more consistent set of assumptions. It is important to note, however, that this does not alter the views reached by officials on this option. The critical question is still whether the proposed reform would actually generate a sufficiently large increase in FDI, tax revenue, and external benefits to offset the estimated fiscal cost of this option, which is estimated to be in the order of $500 million. There is still too much uncertainty surrounding the potential benefits of the proposed reform to warrant the introduction of such a reform at this time.

Original calculations

45. For the purposes of estimating the extent to which such a tax reduction would increase the level of FDI, it was assumed in the example that:

- the stock of FDI in New Zealand is $50b (this was sourced from Statistics NZ) and the income from all of that FDI would be subject to the reduced tax rate;
- implementation of the Review's recommendations would reduce the after-tax rate of return on FDI by approximately 8 per cent. This estimate was obtained by assuming that:
  - the pre-tax rate of return is 8 per cent;
  - the debt/equity ratio is 50 per cent;
  - the effective tax rate on debt is 10 per cent;
  - the effective tax rate on equity is reduced from 33 per cent to 18 per cent by the introduction of the Review's recommendations;
  - the rate of NRWT on dividends is 2 per cent;
  - the average effective tax rate before reform is 21.5 per cent (i.e. [0.5*0.1] + [0.5 * 0.33]);
  - the average effective tax rate post-reform is 14.82 per cent (i.e. [0.5 * 0.1] + [0.5 * 0.18] + [0.5 * 0.02 * (1 - 0.18)]);
  - implementation of the Review's recommendations would increase the post tax rate of return on FDI from approximately 6.3 per cent (i.e. 0.08 * [1 – 0.215]) to approximately 6.8 per cent (i.e. 0.08 * [1 – 0.1482]);
  - consequently, implementation of the review's recommendations would increase the after tax rate of return by approximately 0.5 percentage points (i.e. approximately 6.8 – 6.3) or by approximately 8 per cent (i.e. approximately 0.5/6.3)[4];

- a one per cent increase in the after tax rate of return produces a 2.8 per cent increase in FDI (this obtained from an NBER study);

[4] Note that this figure is approximately 8.5% if we do not round off the after tax rates of return of 6.3% and 6.8% to one decimal place.

- consequently, the estimated 8 per cent increase in the after tax rate of return would increase FDI by approximately 22 per cent (i.e. 2.8 * 8)[5];
- consequently, the estimated 22 per cent increase in FDI would increase the stock of FDI by approximately $11 billion (i.e. $50b * [1 + 0.22] – $50b)[6];
- consequently, the $11 billion increase in FDI would increase tax revenue by approximately $130 million[7] assuming an 8 per cent pre-tax rate of return and an effective tax rate of 14.82 per cent (i.e. 11 * 0.08 * 0.1482]).

46. By contrast, for the purposes of estimating the extent to which such a tax reduction would reduce tax revenue, officials used data on the actual taxes paid in respect of dividends and interest flowing to foreign investors (i.e. NRWT and Foreign Investor Tax Credits) to estimate the underlying profits generated by foreign investment and hence the cost of the proposed change in effective tax rates. This process yielded an estimate of $500 million

47. Overall, the example therefore concluded that:

- the net effect of the proposed reform would be to reduce tax revenue by approximately $370 million (i.e $500m – $130m)[8]; and
- the estimated increase in FDI would have to produce more than $370 million[9] of additional benefits to New Zealand to produce a net overall benefit.

48. It is this difference in approach, outlined above, that is responsible for the apparent contradiction noted by practitioners. If we had estimated the fiscal cost of the reform using Statistics NZ data on FDI and the simplifying assumptions outlined above, the estimated cost would have been less than $500m. For example if we assume that FDI does not increase following implementation of the Review's recommendations, we would expect the reduction in tax revenue to be approximately $250 million (i.e. $50b x 0.5 per cent)[10].

49. Since the assumptions underlying the example are consistent with a fiscal cost of less than $500m, practitioners have expressed concern that the example underestimates the potential increase in tax revenue generated by the proposed reform and have asked officials to recalculate the example using a more consistent set of assumptions (i.e. a set of assumptions consistent with a fiscal cost of $500m).

Revised calculations

50. There are numerous amendments that could be made to the assumptions underlying the example that would increase the potential fiscal cost of the proposed reform to approximately $500 million including:

- increasing the assumed stock of FDI from $50 billion to approximately $75.6 billion. Under this assumption, the reform would have to produce additional benefits of

[5] Note that this figure is approximately 24% assuming an 8.5% increase in the after tax rate of return.
[6] Note that this figure is approximarely $12b assuming a 24% increase in FDI.
[7] Note that this figure is approximately $141m assuming a $12b increase in FDI.
[8] Note that this figure is approximately $359m assuming a $12b increase in FDI.
[9] Note that this figure is approximately $359m assuming a $12b increase in FDI.
[10] Note that this figure is approximately $267m if we do not round off the after tax rates of return of 6.3% and 6.8% to one decimal place.

approximately $287 million to offset the estimated net revenue loss. However, such an assumed stock of FDI is significantly higher than that suggested by Statistics NZ estimates;

- increasing the assumed responsiveness of FDI to an increase in the after tax rate of return from 24 per cent to approximately 87 per cent. Under this assumption, the reform would produce a net benefit of approximately $16 million. However, such an assumed elasticity is much higher than the NBER estimate. Even if the reform produced a 30 to 40 per cent increase in FDI, there would still be a significant net fiscal cost that would have to be offset by additional spill over benefits. For example, if the reform resulted in $15 billion of new FDI (i.e. a 30% increase in FDI) there would be a net reduction in tax revenue of $322 million. Similarly, if the reform resulted in an additional $20 million of FDI (i.e. a 40% increase) then the net reduction in tax revenue would be $263 million;
- increasing the assumed pre-tax rate of return from 8 per cent to approximately 12.1 per cent. Under this assumption, the reform would have to produce additional benefits of approximately $287 million to offset the estimated net revenue loss; or
- changing the assumed debt/equity ratio from 50/50 to approximately 31/69. Under this assumption, the reform would have to produce additional benefits of approximately $266 million to offset the estimated net revenue loss.

51. However, although it may be possible to improve the consistency of the assumptions underlying the example set out in Table 3, such amendments do not alter the conclusions reached by officials on this option for reform. The key question is still whether lowering tax rates would actually result in an increase in FDI that is sufficient to produce an increase in tax revenue and additional benefits that are more than sufficient to offset the reduction in tax revenue that arises from that reduction in tax rates. As noted in the text following Table 3 of the report:

> *The answer to this question turns on the accuracy of the assumptions that drive the 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.*
>
> *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.*

52. As a result, in view of the significant uncertainty surrounding the magnitude of the benefits of lowering taxes, officials still hold the view that there is currently insufficient evidence to suggest that such a reform would be of net benefit to New Zealand.

IS THE NEW/OLD DISTINCTION WORKABLE?

Distinguishing new investment from old investment

Submissions

53. In the absence of a lowering of the general corporate tax rate, most submissions favoured the Tax Review's Policy Option 2. Generally, submitters felt that even if the new/old distinction is unsustainable in the long term, it should be introduced for a limited period of time, as an initial step towards a more permanent low tax rate for all FDI.

54. The practitioners' submission addressed in detail the issue of how new FDI would be identified for the purposes of targeting it with a lower tax rate. In their view, the new tax rates would only apply to activities begun after a certain date or to significant expansions after a certain date.

55. The practitioners' submission sees the distinction between new and old being based on an agency approval system, with a "know it when you see it" type of test. It does not anticipate a problem of uncertainty with the test as it considers that a majority of cases will not fall near the distinguishing line. It suggests that the test could be modelled along the lines of the British Columbian or Czech arrangements. The major tests in distinguishing new investment from old investment under the British Columbian model include:

- the degree of similarity of products and services with existing products or services;
- the degree of similarity of income producing assets with existing income producing assets;
- continuity of operations between new business and existing business; and
- whether continuity of customers and employees remain the same as an existing or prior business.

56. There is a suggestion that in the case of expansions of existing businesses, other requirements, such as a minimum level of investment, might be imposed.

57. The rate would be available only to non-resident owned activities or to the extent an activity is non-resident owned. The 18% rate would be quarantined to non-resident investors where a company has both resident and non-resident shareholders.

Officials' comment

58. According to the practitioners' submission, the way to make a new/old distinction work, whilst protecting the existing FDI base, is not to pursue a detailed statutory standard conferring rights to status as a "new activity" but rather to confer broad administrative discretion on the IRD/IPA to approve the status. This approval process would be binding and would be subject only to administrative review.

59. The rationale for a broad administrative discretion is to protect the existing base of FDI from reconstituting itself as new FDI within the rules by achieving a form over substance result. We accept that such an approach has these advantages. However, the disadvantages that arise with broad administrative discretions of this nature are as follows:

- The administration of the approval is inherently subjective. This subjectivity may result in inconsistency in the allocation of approvals.
- Compared with statutory rules, an approval process is also a deterrent for applicants. The subjectivity of the process means that applicants are not assured of being granted the lower rate. Accordingly, the value of the tax relief will be discounted to reflect the uncertainty that the investment will be eligible for the tax relief. Furthermore, it imposes an added compliance cost for doing business in New Zealand at the lower rate.
- Guidelines would need to be developed which may have some of the problems the approval process is trying to avoid.
- There are difficulties associated with designing an approval system that is unable to be challenged in the courts.

60. That an approval process can be designed is not in dispute. However, the mechanics of such a process are not straightforward and may impose added costs and complexities to the scheme.

Should the new/old distinction could be implemented as a permanent feature of the tax system?

Submissions

61. The issue of whether the new/old distinction can be made to “work”, focuses, in part, on whether tax rates can be targeted solely at new FDI, as a permanent feature of our tax system.

62. In the May report, officials indicated that it would be possible to target new FDI only for a limited period of time, say, five to ten years. On that basis we concluded that the new/old distinction would be unworkable, except as a transitional measure to a lower rate for all FDI.

63. KPMG disputed officials’ views that the new/old distinction would be eroded over time. As with the practitioners’ submission, KPMG considers that leakage from old to new investment could be minimised through the use of a specialist body appointed to manage and monitor entry into the lower tax regime. In addition, KPMG considered that some leakage of existing FDI to new investment may not be entirely undesirable as it will ensure existing FDI is not attracted elsewhere.

64. The practitioners’ submission also disagreed with officials’ views that the new/old distinction is unsustainable in the medium to long term for several reasons. First, it is argued

that there is logical economic rationale for limiting the test to new investors, and this will protect the regime from political pressure. The 18% rate will retain businesses in New Zealand and attract new businesses. These beneficial outcomes should ensure that the 18% rate remains economically and politically viable. Second, it is argued that countries with tax holidays, even lasting ten to twenty years, use such a test.

Officials' comments

65. We do not agree with submissions that suggest that it would be possible to provide for a lower tax rate for new FDI on a permanent basis. The main reason is that it is not viable to sustain tax rate differences that are predicated solely on whether investment was made before or after a particular date (being the date of application of the rate to the "new" investment). Just how long a new/old distinction would endure in the face of the political pressures that would likely be brought to bear is a judgment call. Even if the weight of opinion supported the introduction of a low rate for new FDI, we expect that lobbying for extensions of the regime to existing FDI or other activity would intensify in the short to medium term.

66. Furthermore, we would expect the boundary would erode over time as capital stocks were replaced and the inherent difficulties associated with the approval process gradually became more pronounced. Officials remain convinced that the new/old distinction would become unsustainable after a period of, say, five to ten years.

67. We believe the practitioners' submission overstates the precedent value of tax holiday systems in other countries. Overseas evidence on the success of such regimes in attracting investment is at best mixed. Moreover, of those examples provided in the submission only a minority focus solely on whether the activity undertaken by the investor is "new" (Korea, Philippines, and India). (Others are focused on whether the investor is a new investor into the country.) Those countries that do adopt a "new/old" distinction also have the additional protection of a time limit on the tax relief provided by the tax holiday. This means that if the approval is given in error the consequences are capped by the time limit associated with the holiday. By contrast, the Tax Review's proposal, at least in theory, involves a permanent distinction – thus putting all the base maintenance pressure on the effectiveness of the "new/old" criterion.

Whether a new/old distinction could be implemented as a temporary measure

Submissions

68. Most submitters consider that even if the new/old distinction is unsustainable in the long term, should be introduced for a limited period of time, possibly as an initial step towards a more permanent low tax rate for all FDI. Several submitters suggested that the lowering of the rate for FDI could be staggered to reduce the cost of such a move.

69. ICANZ is in favour of Policy Option 2 being introduced for a finite period of time. It considers that this would allow its costs and benefits to be evaluated and allow the drafting of robust criteria and anti-avoidance legislation to minimise the risk of exploitation. ICANZ notes, however, that several issues that would need to be explored to determine the feasibility

of such a scheme, including the transportability of FDI at the expiry of the finite period and the impact this would have on the New Zealand economy.

70. The practitioners' submission envisages three possible outcomes in the seven to ten-year period following the introduction of the 18% rate for new investment:

- continue with the regime if it works; or
- the Government can align rates as the general company tax rate trends down or if the number of businesses in the existing business category becomes very small; or
- abandon it after ten years if it doesn't produce the anticipated benefits for New Zealand.

Officials' comments

71. If the Government wished to proceed with this initiative, it should be clear at the outset that the measure is a temporary one. In other words, the Government should proceed on the basis that the concession would be removed after a fixed period. (In order to be transparent about this, a sunset clause would need to be inserted into the legislation.)

72. This raises the question of whether, in order to proceed with Policy Option 2 as a temporary measure, the Government would need to determine, at the outset, whether the rate would increase to the corporate rate or be aligned at some new lower rate for FDI. Our view is that the Government could adopt the position that it is guaranteeing a low rate for new FDI for a fixed period. At the end of the fixed period the rate would move back to the normal corporate rate unless the Government decides otherwise, based on an objective evaluation of the net benefits of a lower rate.

73. While implementing Policy Option 2 on a time limited basis is technically feasible, officials do not support such an approach. There is a risk that, as a practical matter, it would be extremely difficult for the Government to terminate the concession — even if it has produced little in the way of spill-over benefits. We would expect that lobbying to extend the concession and possibly broaden the ambit of the concession would intensify closer to the date the concession was due to expire. Businesses that are attracted to a jurisdiction offering a temporary, concessionary tax rate are usually able to demonstrate that they will relocate out of the jurisdiction if the concession is not extended. This gives rise to a serious risk that a low tax rate for FDI will continue to exist, or even be extended, when it is undesirable for it to do so.

Whether Policy Option 2 should be implemented as a temporary measure

Submissions

74. The May report focused primarily on the costs and benefits of lowering the tax rate on all FDI. The same principles apply in considering whether to lower the tax rate for new FDI on a temporary basis. In other words, the Government should pursue Policy Option 2 on a temporary basis only if it believes that the reduction in tax on new FDI will produce

sufficient benefits to New Zealand to offset the welfare costs of raising revenue on other productive activity in New Zealand over that period.

75. The Tax Review and the May Report estimated that the static revenue cost of lowering tax rates on new FDI was a maximum of $50 million per annum. This calculation assumes no growth in FDI and treats all flows of FDI as "new" investment. This cost would compound each year and would need to be collected elsewhere in the economy.

76. Submitters had a general concern that officials had overstated the fiscal and economic costs of the Tax Review proposals whilst down-playing the expected benefits of the rate reduction. In terms of the costings, submitters were critical of the fact that the costings were static and did not take account of second-round effects.

77. On the positive side of the ledger, submitters were convinced that attracting more FDI would produce substantial fiscal and economic benefits. They said fiscal benefits would include income tax on FDI that would otherwise not have come to New Zealand and an increase in the PAYE and GST take associated with the new FDI. More importantly, they envisage that the economic benefits associated with an increase in FDI (spill-over benefits) would more than offset the fiscal and economic cost associated with the rate reduction.

Officials' comments

78. In relation to the nature of the costings, the difficulty is that second round effects are usually linked to behavioural responses, which cannot be predicted with any certainty. Consequently, the revenue effects are simply too speculative to quantify. Accordingly, we prefer to rely on static costings whilst recognising their limitations. In any event, the economic costs of imposing a higher tax on other productive activity to make up the revenue shortfall are likely to be more significant than the fiscal costs, although more difficult to estimate and identify.

79. We agree with submitters that the benefits associated with new FDI come in the form of higher incomes for New Zealanders, tax on those incomes, and tax on the returns to foreign investors. The difference in views between officials and submitters is with regard to the extent of the benefits that would be generated by Policy Option 2. This, in turn, stems from the different judgments made by submitters and officials as to how much new FDI would come to New Zealand as a result of a major decrease in tax rates.

80. As we explained in our May report, the level of sensitivity depends on the investor's circumstances. If a reduction in New Zealand tax does not result in an increase in the investor's after-all-taxes profit because it reduces the availability of a usable tax credit to the investor, that investor will not be encouraged by the rate reduction. On the other hand, if the investor's after-all-taxes profit is increased because the investor is resident in a country that exempts incoming dividends or is unable to use, or fully use, the tax credit, the taxpayer will be encouraged to invest in New Zealand. The extent to which that encouragement translates to an investor choosing New Zealand as an investment destination will depend on how much tax rates matter to that investor relative to other non-tax factors, including infrastructure, political stability, and location advantages. Overseas evidence on the sensitivity of FDI to tax

incentives is inconclusive. However, recent studies suggest that the level of sensitivity of FDI is only moderate but increasing.[11]

81. Furthermore, the necessarily temporary nature of the proposal means only mobile FDI is likely to be attracted to New Zealand as a result of this initiative. This has adverse implications in terms of spill-over benefits. Mobile FDI is unlikely to result in the establishment of long-term sustainable businesses in New Zealand. Our judgment is that the costs, when both economic and fiscal costs are taken into account, would outweigh the benefits. Accordingly, we are unable to recommend adoption of Policy Option 2 as a temporary measure.

WOULD POLICY OPTION 2 DISADVANTAGE DOMESTIC INDUSTRIES?

Submissions

82. Fonterra and Business New Zealand believe that a lower rate should not be introduced only for new foreign direct investment. Fonterra's view was based on the belief that it would create a competitive advantage for new FDI at the expense of New Zealand residents. Business New Zealand believes it is inappropriate to lower rates on FDI while New Zealand companies face high rates. It believes a lowering of the general rate is more appropriate.

83. The practitioners' submission addressed the issue of perceived unfairness or competitive advantage if a lower rate is introduced for FDI. It submitted that the answer to the criticism of unfairness is that the country as a whole will be better off. It also points out that under the current system, non-residents may be taxed at a lower rate than residents and that it is not aware of any evidence that this differential produce adverse effects for New Zealand businesses.

Officials' comments

84. Whether a lower tax rate affects other firms' ability to compete in the market turns on the issue of the economic incidence of that tax: who, in reality, bears the burden? Put another way, does income tax on non-residents result in:

- higher prices charged to the non-resident firms' customers?
- lower wages paid to its employees?
- lower returns to the non-resident owners of that capital?
- a higher cost of capital in the host country, leading to less overall investment and lower real wages in the economy in general?

85. While judging the economic incidence of taxes is not a simple matter, what evidence there is suggests that in small open economies like New Zealand it is the last of these alternatives. In other words, the burden of income taxes on non-residents falls on the

[11] 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.

economy generally, through a higher cost of capital. This was the evidence when New Zealand reduced its taxes on non-residents, in the form of the FITC rules introduced in 1991. On introduction, the rule had an immediate impact on the cost of capital, but did not seem to lead to a reduction in prices charged by non-resident owned firms.

86. The next likely alternative is that the burden falls on the non-resident owners, especially if they are earning economic rents that can be taxed away without altering the level of investment.

87. We consider that the least likely alternative is the former - that taxes on income are passed-through to consumers in the form of higher prices. It is this alternative that submitters have in mind when they refer to effects on the competitiveness of domestic firms.

88. Competitive advantage is a specific economic term referring to a situation where a market player has the ability to distort the market by, for example, charging a lower than market price. While it appears a reduced tax rate for non-residents will not lead to market-changing behaviour, the reduced tax rate may allow foreign companies to attain a financially stronger position and grow faster than their New Zealand counterparts. This may allow these foreign companies to take advantage of opportunities before New Zealand competitors are in a position to exploit them.

ANNEX 2

SUMMARY OF SUBMISSIONS ON THE OFFICIALS' REPORT ON FOREIGN DIRECT INVESTMENT

The practitioners' submission prepared by Rob McLeod, David Patterson and John Shewan

1. The practitioners' submission is a comprehensive submission on the merits of adopting Policy Option 2. Two of the authors participated in the Tax Review and their views are in line with the McLeod Committee.

2. The basis for the practitioners' submission is the Government's stated objectives of achieving higher levels of growth necessary to move New Zealand back to the top half of the OECD on a GDP per capital basis. They believe the government needs to attract more FDI in order to achieve these aims. They stressed the importance of headline rates to help New Zealand "standout from the crowd" and support the adoption of the 18% rate for new activities to the extent they are owned by non-residents because it is (in their view) preferable to any other alternative, including the status quo, which they emphasise will not achieve these objectives.

3. The practitioners' submission concedes the benefits of Policy Option 2 cannot be proved in advance but considers the small cost of the proposal will ensure the move is welfare enhancing while recommending Policy Option 2 as a permanent measure. If this proposal is not advanced, however, they would like to see the 18% rate introduced for a limited time period (possibly seven to ten years) for new activities which meet a national interest criteria.

4. The submission considers that new FDI is marginal investment and therefore does not harbour rents. In the absence of rents they believe that FDI is sensitive to tax and therefore taxing such investment creates high deadweight costs. They also believe that such investment produces significant positive externalities.

5. The practitioner's submission considers that investors would be likely to substitute equity for debt if an 18% rate were introduced. They believe that this would significantly offset officials' estimated cost of the proposal.

6. The submitters outline the key features of the 18% rate for new investment. The rate would be available only to non-resident owned activities or to the extent an activity is non-resident owned. It would apply only to activities or significant expansions commenced after a certain date. The 18% rate would be quarantined to non-resident investors where a company has both resident and non-resident shareholders. The 18% rate would not be available for existing FDI.

7. They disagree with officials' conclusions that the new/old distinction is unsustainable and comment that officials have provided no evidence to support their view. They base their opinion mainly on the fact that many other countries operate some form of the new/old distinction through tax holiday incentives. The submitters see the distinction being operated in New Zealand through an agency approval system with a "know it when you see it" type test. They do not anticipate a problem of uncertainty with the test as they point out that a majority of cases will not fall near the distinguishing line.

8. The submission suggests that the test could be modelled along the lines of the British Columbian or Czech arrangements. The major tests in distinguishing new investment from old investment under the British Columbian model include the degree of similarity of products and services, income producing assets, customers and employees and the continuity of business.

9. They do not consider that the new/old distinction is unsustainable for several reasons. Firstly, countries with tax holidays which last for ten to twenty years use such a test. Secondly, there is logical economic rationale for limiting the test to new investors, and this will protect the regime from political pressure. Lastly, the 18% rate will retain businesses in New Zealand and attract new businesses to the extent that the 18% rate will remain economically and politically viable.

10. The group anticipates three broad outcomes if the 18% rate for new investment is introduced:

- the government can align rates as the general company tax rate trends down or if the number of businesses in the existing business category becomes very small;
- keep the regime if it works; or
- abandon it after ten years if it doesn't work.

11. They summarise the advantages of Policy Option 2 when compared with other options, as follows:

- the proposal results in the lowering of important headline rates;
- the response of foreign investors is measurable and therefore the government can monitor as a type of controlled experiment;
- the proposal encourages investors to substitute equity for debt thus reducing the cost of the initiative;
- the rate is narrowly targeted and is consistent with government policy.

12. The submission discounts the anticipated problems with introducing such a regime. It also argues that the tax reduction will not benefit foreign treasuries, rather than the investors, either because the tax regimes of those countries which are the main sources of FDI in New Zealand either exempt foreign income (for example, Australia), or the investors have excess foreign tax credits. The submission further argues the adverse reaction of other countries to the introduction of the low rate would not be significant as many countries have similar

concessionary regimes. They contend that the perception of discriminatory treatment of old FDI will be offset by the fact that New Zealand as a whole will be economically better off.

13. The submission promotes the 18% rate for new investment over any alternatives, which it dismisses as not targeted narrowly enough and therefore too expensive, not providing the benefits of FDI, or risking national welfare reduction.

Business New Zealand

14. Business New Zealand favours a reduction in the overall tax rate, particularly a lowering of the corporate tax rate for all businesses over time from 33% to 20%. However, it does not support a low rate for FDI only. Business New Zealand feels New Zealand has done poorly in recent years at growing business investment and attracting and retaining FDI. It also feels that the government needs to recognise the important role that higher levels of investment, both foreign and domestic, play in obtaining a higher rate of economic growth. Business New Zealand stresses the need for an internationally competitive tax system and the need for dynamic rather than static forecasting methods.

Vodafone New Zealand and Vodafone Group Services

15. Vodafone supports an 18% tax rate for new investment into New Zealand by non-residents. As part of a global group, Vodafone New Zealand must compete within the group for regional company business such as the provision of group service centres or the development of new technology. Vodafone New Zealand feels it would be better placed to be considered for these opportunities within the Asia Pacific region if New Zealand had a more attractive tax regime which encouraged foreign investment. Vodafone Group Services has confirmed that it is in the process of establishing regional centres for several activities and has restated that a competitive tax environment would greatly increase the attractiveness of New Zealand as a location for these activities.

Corporate Taxpayer Group

16. The Corporate Taxpayer Group generally supports a lower tax rate for FDI. The submission takes issue with a number of specific assumptions and comments made in the May report. Of the more important issues, the Corporate Taxpayer Group believes that the report does not address the following satisfactorily:

- the possibility of a new/old distinction for an initial limited period of time;
- the possibility of a loss of FDI if a lower tax rate is not implemented;
- the benefits of spill-over effects; and
- the cost calculations, which are static.

17. The submission also notes that investors may still be sensitive to New Zealand tax in a number of situations where tax credits are available and that unilateral action in response to New Zealand cutting tax rates on FDI is unlikely. The Corporate Taxpayer Group is of the opinion that the fact that the effect of lowering the tax rate is impossible to predict is not a

reason to do nothing. The submission considers that the initial fiscal impact of introducing a lower FDI rate will eventually be offset by increased FDI and long-term benefits. It also suggests that this cost can be addressed by staggering the rate reduction.

KPMG

18. KPMG is of the view that New Zealand's traditional tax policy approach and defensive approach to tax competition discourages investment, especially in cases where tax costs are important. It considers the New Zealand rate is high and is contrary to international trends. KPMG notes the actions of other countries, particularly New Zealand's Asia Pacific neighbours, in taking initiatives through their tax systems to encourage FDI.

19. KPMG's preference is for a lower corporate rate, and it emphasises that the headline rate is important. However, in the absence of a reduction in the headline rate, KPMG favours Policy Option 2. It challenges the assumption that the corporate tax base will be maintained in the absence of positive initiatives and notes that not all new FDI has an associated tax cost. KPMG raises the same point about regional opportunities for group companies in New Zealand as Vodafone.

ICANZ

20. ICANZ considers that the encouragement of FDI is crucial to the growth of the New Zealand economy. While recognising the limitations of Policy Option 2, ICANZ recommends that this option be seriously considered as a "step up" solution for a finite period. ICANZ considers that the introduction of such a regime would allow its costs and benefits to be assessed and robust legislative criteria to be formed while reducing the risk involved in introducing Policy Option 2. ICANZ notes several issues to be considered in introducing such a policy for a finite period of time. ICANZ also comments on the need for new tax treatment of intellectual property and inbound royalties.

Fonterra

21. Fonterra does not support an 18% tax rate for new FDI. Fonterra feels that a reduced rate on FDI would give foreign investments a competitive advantage over New Zealand residents. It considers exporters should get similar treatment to FDI as they produce similar or better benefits to New Zealand. It considers a simplified tax system is the best way to attract investment into New Zealand and, like ICANZ, comments on the tax treatment of intellectual property rights and royalties. Fonterra also comments that low headline rates do not influence whether it invests offshore or not.