How Should New Zealand Tax its Inbound Investors?

The development of a tax policy framework and an analysis of current settings against the framework.

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Abstract

Tax competition has put pressure on policy makers around the globe to reduce the tax burden on mobile forms of capital, including from inbound investors. New Zealand has not been immune to this trend. Many inbound debt investors will not contribute any tax to New Zealand's tax base and inbound equity investors pay significantly less tax than a domestic equity investor. The question in this thesis is how New Zealand should tax its inbound investors? The approach taken in the thesis is first to determine whether a state has a theoretical right to tax inbound investors. The thesis argues that a person with an economic participation in a state can legitimately fall within the state's tax base. Upon establishing this right to tax, the thesis then examines the principles that should determine how the tax burden should be spread across the tax base; that is, who should pay what. An argument is mounted that fairness and prosperity should be the guiding principles determining both the allocation of the tax burden and how much tax revenue a state should seek to collect overall. Making tax policy based on the principle of fairness is not new. However, in recent decades, tax policy settings have increasingly been set with the goal of economic growth in mind. This thesis argues that a wider goal of prosperity is a more suitable objective, and its implementation can result in quite different tax policy settings to the ones we have today. Tax settings that entrench or exacerbate inequalities of market outcomes run counter to sustained and shared prosperity. The conclusion of this thesis is that inbound investors currently receive preferential tax treatment, and the objectives of fairness and prosperity are better met by adjusting tax settings toward a neutral position with regard to inbound investors and other taxpayers.

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Contents

Abstract i

Acknowledgements ii

1 Introduction 1

1.1 Background to the thesis 1

1.2 New Zealand as a case study 7

1.3 Research questions 9

1.4 Framework of the thesis 10

1.5 Methodology 12

1.5.1 Research framework 12

1.5.2 Research approach 16

1.5.3 Research methods 17

1.6 Literature review 19

1.6.1 Can tax on inbound investors be justified? 19

1.6.2 What principles should guide tax policy setting? 21

1.7 Contributions of the thesis 22

1.8 Limitations of the research 23

2 The justification for taxation of non-resident investors 26

2.1 Introduction 26

2.2 Theoretical justification for tax 27

2.2.1 Development of the justification for taxation 28

2.2.2 Hobbes and Locke 28

2.2.3 Benefit theory 32

2.2.4 Toward sacrifice theory 35

2.2.5 View of the modern administrative state 38

2.3 The purpose of tax 39

2.3.1 Redistribution as a purpose of tax 40

2.4 Two schools of thought 43
2.5 Determining who should contribute to the tax base of a state 45
2.5.1 Taxing non-residents and benefit theory 45
2.5.2 Taxing non-residents and 'internation' equity 48
2.5.3 Doctrine of economic allegiance 49
2.6 Legitimising tax based upon economic participation 52
2.7 Conclusion 55
3 A normative framework for tax policy setting in New Zealand 58
3.1 Introduction 58
3.2 Development of tax policy frameworks 59
3.2.1 Adam Smith and his four canons for a good tax 59
3.2.2 Expansion and adaptation of the four canons by tax review groups 67
3.2.3 The Living Standards Framework 75
3.2.4 Conclusions on frameworks 89
3.3 Fairness 89
3.4 Economic growth as a tax policy principle 92
3.5 Rethinking the principles guiding tax policy setting 97
3.5.1 Purpose of the state 99
3.5.2 Prosperity 103
3.6 The Framework 104
3.7 Conclusion 106
4 Sub-aims of the tax policy setting framework 108
4.1 Introduction 108
4.2 Conception of fairness 108
4.3 Conception of prosperity 112
4.4 Sub-aims toward fairness and prosperity 114
4.4.1 Progressivity 114

4.4.2 Neutrality 117
4.4.3 Participation and human capital 125
4.4.4 Productivity and financial and physical capital 129
4.5 Conclusion 139
5 A tax system in disarray 141
5.1 Introduction 141
5.2 Domestic background during the discriminatory period 145
5.3 Tax policy settings in the discriminatory phase 148
5.3.1 Taxation of dividends prior to 1964 149
5.3.2 Taxation of interest prior to 1964 150
5.3.3 Introduction of non-resident withholding tax in 1964 150
5.4 Tax Review Groups during the 'discriminatory' phase 155
5.4.1 Ross Review 1967 155
5.4.2 McCaw Taskforce Review 1982 157
5.4.3 The Treasury's economic review 1984 158
5.4.4 Consultative document on international tax reform 1987 159
5.5 Development of tax treaty network 163
5.6 Conclusion 168
6 Early stages of tax competition 170
6.1 Introduction 170
6.2 Development of the neo-liberal agenda 171
6.2.1 Economic and political background 171
6.2.2 Corporate growth and shareholder primacy 175
6.3 Domestic background in the transitional phase 177
6.3.1 Tax policy aims of the 1990s 181
6.4 Tax changes during the transitional phase 184
6.4.1 Introduction of Approved Issuer Levy in 1991 184

6.4.2 Portfolio investment in equities 187
6.4.3 Direct investment into equities 193
6.4.4 Tax changes for direct investors 194
6.5 Conclusion 196
7 Favouring inbound investors 198
7.1 Introduction 198
7.2 Domestic background in preferential phase 198
7.3 Tax and business reviews 202
7.3.1 McLeod Tax Review 203
7.3.2 Business Tax Review 2006 207
7.3.3 Further corporate tax cuts in the preferential phase 212
7.3.4 Capital Markets Taskforce 213
7.3.5 Victoria University of Wellington Tax Working Group 216
7.3.6 Mirrlees Review 2011 (UK) 218
7.3.7 International Tax Review 2016 219
7.4 Tax changes during the preferential phase 222
7.4.1 Tax on non-resident investors into equities 222
7.4.2 Tax on non-resident lenders 226
7.4.3 Tax treatment of foreign companies doing business in New Zealand 231
7.5 Conclusion 247
8 Conclusion 250
8.1 Overview 250
8.2 Can tax on inbound investors be justified? 251
8.3 What principles should guide tax policy setting? 251
8.4 How does New Zealand tax its inbound investors? 252
8.5 How should New Zealand tax its inbound investors? 253
8.5.1 Progressivity 253

8.5.2 Neutrality 256

8.5.3 Participation 258

8.5.4 Productivity 260

8.5.5 Should New Zealand favour non-residents for economic reasons? 263

8.5.6 Inequality and the preferential regime 265

8.6 How should New Zealand tax its inbound investors? 265

8.7 New Zealand as a case study 266

Bibliography 268

1 Introduction

1.1 Background to the thesis

In 2017, a journalist for the New Zealand Herald investigated the top twenty multinational tax avoiders in New Zealand.[1] By looking at more than 100 multinational companies, Matt Nippert identified that despite recording almost $10 billion of sales in New Zealand, they paid very little tax. Just as an example, Apple Sales New Zealand Limited had revenue of over $965 million in the year to 26 September 2020 but paid less than $7 million of tax in New Zealand.[2] Of the $965 million in revenue, $929 million was paid to other group entities in other jurisdictions, removing much of the potential profit from New Zealand through intragroup charges for goods and services.[3] However, it is not only New Zealand who finds itself in this position. Even the United States reports that Apple Inc is not paying "their fair share" of tax in their home country.[4]

The problem of declining tax revenues took centre stage after the global financial crisis ("GFC") in 2007.[5] While tax evasion and avoidance have long been a concern for governments, the GFC resulted in reduced tax revenues and increased pressure on public

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[1] Matt Nippert "Top multinationals pay almost no tax in New Zealand" *The New Zealand Herald* (online ed., Auckland, 7 June 2017).

[2] Apple Sales NZ Limited, financial statements for the year to 26 September 2020. Retrieved from the Companies Office at <Scanned Document (companiesoffice.govt.nz)>. Tax figures obtained from note 12 of the financial statements.

[3] At note 16 of the financial statements.

[4] "Offshore Profit Shifting and the US Tax Code – Part 2 (Apple Inc.)" *Hearing of the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs United States Senate,* 113th congress, first session, 21 May 2013.

[5] OECD *OECD/G20 Inclusive Framework on BEPS: Progress report July 2019-July 2020* (OECD, Paris, 2020) at 2.

resources.[6] As people lost their jobs and businesses failed, income tax collection was put under pressure at the same time as claims for state assistance grew. This pressure forced governments to look to those who could afford to pay but chose not to. One of the most visible examples of this is the US government's public investigations into Apple, Microsoft, Caterpillar, and Hewlett Packard's tax affairs.[7] The OECD and G20 have maintained the pressure for reform in this area too.[8] The economic impact of the COVID-19 pandemic adds further pressure to collect tax from those who can afford to pay but choose not to.[9]

From 2008 until today, the G8 and subsequently the G20 meetings have been dominated by discussions on tax avoidance of multinationals.[10] The OECD has been working with their members and other nations on initiatives to reduce the impact of negative tax behaviours.[11] There are two areas of focus: transparency and information sharing and the tax rules that enable base erosion and profit shifting ("BEPS").[12] The OECD, in conjunction with the G20,

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[6] For example, see Matt Grudnoff "Taxing times: the impact of the GFC on tax revenue in Australia" *The Australia Institute* (Canberra, December 2016); Conor Dougherty "Falling Tax Revenues Slam States" *The Wall Street Journal* (New York, 30 September 2009).

[7] The United States government was particularly active in this respect and the Senate Permanent Subcommittee on Investigations investigated the tax avoidance activities of Apple Inc, Microsoft, and Hewlett Packard. See above n 4.

[8] The OECD, supported by the G20, has undertaken a large and complex project known as the Inclusive Framework on BEPS (base erosion and profit shifting). See <Base erosion and profit shifting - OECD BEPS> for more information on this project. Also, see n 12 below.

[9] OECD *Tax Policy Reforms 2021: Special Edition on Tax Policy during the COVID-19 Pandemic* (OECD Publishing, Paris, 2021).

[10] The G8 or Group of 8 were a group of 8 nations that voluntarily formed a collective due to their dominance as large wealthy nations. The G20 (Group of 19 wealthy nations plus the EU) was established in 1999 and replaced the G8 from 2014.

[11] Above n 8.

[12] OECD *Action Plan on Base Erosion and Profit Shifting* (OECD, Paris, 2013) at 13-14 provides a plan for measures targeted at plugging tax gaps through coherence in international tax standards and aligning taxation with commercial substance, and secondly for improved transparency and information sharing.

developed 15 action points.[13] These action points include recommendations in areas such as transfer pricing[14] and limitations on interest deductions.[15] They also include minimum standards on treaty shopping practices[16] and country-by-country reporting of profits and taxes paid by multinationals.[17] Perhaps most onerous of all the actions is that of dealing with the growing problem of ensuring full taxation of digital business.[18] This action has been subject to significant discussion and consultation. The latest position is the release of two proposals, "pillar one" and "pillar two", that seek to allocate taxing rights of all income across the relevant states and then ensure a minimum level of tax is paid by these digital businesses.[19] This ambitious proposal is now supported by 130 countries and jurisdictions, including the United States and China.[20]

Also within the 15 action points is Action 5, which deals with minimum standards for Harmful Tax Practices.[21] This report arose from the 2013 development of the 15 actions but also followed on from earlier work undertaken around harmful tax competition.[22] With regard to "harmful tax practices", the 2015 report states the work is intended to reduce the

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[13] OECD *Action Plan*, above n 12.

[14] Actions 8-10.

[15] Action 4.

[16] Action 6.

[17] Action 13.

[18] Action 1.

[19] OECD *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* (OECD, Paris, 14 October 2020); OECD *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint* (OECD, Paris, 14 October 2020).

[20] OECD "130 countries and jurisdictions join bold new framework for international tax reform" (press release, 1 July 2021).

[21] OECD *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report* (OECD, Paris, 2015).

[22] OECD *Harmful Tax Competition: An Emerging Global Issue* (OECD, Paris, 1998).

"distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place."[23]

The OECD has set out criteria to define a harmful preferential tax regime. Harmful preferential regimes often arise in a jurisdiction with plenty of business activity going on quite apart from the ring-fenced activities subject to tax incentives or concessions.[24] These jurisdictions isolate the preferential tax treatment from domestic activity, so the benefits are only enjoyed by non-residents.[25] Like tax havens, harmful preferential tax regimes will offer investors privacy and will avoid sharing information with the investor's home country.[26] Typically, harmful preferential activities do not involve any substantial business activity.[27]

Gabriel Zucman's research in 2014 demonstrates that in 2012, 50 per cent of US-controlled multinationals' profits were attributed to just six countries: Ireland, Bermuda, Luxembourg, Switzerland, Singapore, and the Netherlands.[28] These are regimes that have actively sought foreign investors with little physical presence required and low to no tax imposition on profits not sourced in the state. The practice of parking profits in these preferential regimes was exacerbated by the exemption from taxation of worldwide profits of US multinationals until they were repatriated.[29]

The significance of the problem of BEPS cannot be underestimated. The practices of many of these harmful regimes are so aggressive that the amount of untaxed wealth is estimated to be

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[23] At 11.

[24] 2015 report, above n 21, at 20.

[25] Above n 22.

[26] Above n 22, at 28-29.

[27] At 24.

[28] Gabriel Zucman "Taxing across borders: Tracking Personal Wealth and Corporate Profits" (2014) 28(4) *The Journal of Economic Perspectives* 121 at 128.

[29] The US tax laws have altered since this time to tax corporates on a territorial basis from 2018: The Tax Cuts and Jobs Act 2017 115 USC. Prior to this, however, the introduction of the "check-the-box" provisions in the Sub-Part F rules in 1996 provided opportunity for US multinationals to accumulate income abroad without having to pay US tax on attributed foreign profits.

somewhere between USD 8 and 22 trillion.[30] The loss of tax revenue on these sums has a direct correlation with the loss of the provision of public goods and services in the jurisdictions where the beneficiaries of this wealth reside and invest. Tax havens and harmful tax regimes are merely conduits for hidden wealth – not locations for investment. This is the most aggressive and overt end of the spectrum upon which tax is dodged and avoided on vast amounts of income and wealth.

Aside from these extreme and harmful preferential tax regimes, there are many practices that are regarded as less than harmful, and yet they still create opportunities for reduced tax burdens for those with wealth and the resources to manage that wealth tax effectively. Many jurisdictions have altered their tax settings to make their state more attractive to mobile forms of capital – participating in the global competition for mobile capital using favourable tax settings for the most desirable investment. In a world with large amounts of hidden wealth in tax havens, corporate tax may be the only tax paid on the income generated by investors. Despite this, the OECD corporate statistics report shows that corporate tax rates have been falling dramatically and quickly. In 2000, the average corporate tax rate across the world was 28 percent and by 2020 it was just over 20 per cent.[31] It is notable, however, that the United Kingdom made a move to reverse this trend since the commencement of the COVID-19 pandemic by raising the corporate tax rate from 19 per cent to 25 per cent for profits exceeding GBP 250,000 from 2023.[32]

Tax competition has been described as "states in competition for residents and investments".[33] It drives a state to lower the tax incidence on non-resident investors to attract

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[30] Zucman estimates US$8 trillion while James Henry suggests it is US$21 trillion in Gabriel Zucman *The Hidden Wealth of Nations: The scourge of tax havens* (University of Chicago Press, Chicago, 2015) at 40-41.

[31] OECD *Corporate Statistics Report 3rd ed* (Paris, 29 July 2021) at 9. Since the Covid-19 pandemic, there have been some new targeted taxes on corporates in a few jurisdictions. The United Kingdom have introduced a corporate tax rate increase from 19% to 25%. See OECD "Tax Policy Reforms 2021: Special edition on tax policy during the Covid-19 pandemic" (21 April 2021).

[32] Finance Act 2021 (UK), ss 6 and 7.

[33] Tsilly Dagan *Between Competition and Cooperation* (Cambridge University Press, Cambridge, 2018), Chapter 1 at 12.

mobile capital and sometimes wealthy mobile individuals.[34] Some commentators suggest it should be referred to as tax 'wars', rather than competition – in the same vein as trade wars and other interstate disharmony.[35] The term 'competition' may carry positive connotations as it encourages efficiency and improvements in the private sector. However, 'tax competition' is not usually viewed in such a positive light.[36] Reducing the tax incidence on income from non-resident capital results in a reduction of the tax imposition on the wealthy – it is inherent that those who have wealth have capital. The result of this is either to shift the tax burden onto the less wealthy or to cut public expenditure.

This thesis has been written over the course of the global COVID-19 pandemic. Like the global financial crisis, some commentators predict that the pressure to collect tax revenue in an environment where governments are spending and borrowing heavily will increase.[37] Tax policy is a key economic tool for the management of an economy and now, more than ever, with growing inequality, increased need for public provision of goods and services, and reduction in tax revenues, tax settings are coming under scrutiny. In the author's opinion, the world is at a crossroads where the demand for increased tax revenue coincides and conflicts with the pressure for tax systems to be competitive.

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[34] Christian von Haldenwang "Tax Competition" *G20 Insights* (online ed, 30 May 2018) <Tax Competition - G20 Insights (g20-insights.org)>.

[35] Alepin, Moreno-Dodson, Otis (eds) *Winning the Tax Wars: Tax competition and cooperation* (Alphen aaan den Rijn: Kluwer Law International, the Netherlands, 2018).

[36] The OECD usually refer to "harmful tax competition" at the point where tax competition becomes detrimental to overall welfare (in their view). See their report on harmful tax competition, above n 22.

[37] OECD "Tax and fiscal policies central to governments' responses to Covid-19 crisis" (press release, 4 May 2020); de Mooij, Fenochietto, Hebous, Leduc and Osorio-Buitron *Tax Policy for Inclusive Growth after the Pandemic* (IMF Special Series, 16 December 2020).

1.2 New Zealand as a case study

New Zealand has a tax system that is relatively benign if judged against the harmful preferential regimes being targeted by the OECD's Action Plans.[38] New Zealand's corporate tax rate is relatively high at 28 percent.[39] It collects 15 percent of its total tax revenue from corporate taxes, compared to the OECD average of just over 9 percent.[40] New Zealand does not have any harmful preferential tax regimes according to the peer reviews under the OECD's Action 5, unlike many of its contemporaries.[41]

However, New Zealand has not been immune to participation in tax competition practices. Like other nations, it has come under pressure to adjust its tax settings to favour mobile forms of capital.[42] It is New Zealand's relatively conventional tax competition practices that are the subject of this thesis.

The objective of this thesis is to analyse whether the income tax settings on inbound investors, under pressure from tax competition, are best calibrated for overall wellbeing. The study takes a theoretical approach to the question by observing the tax policy settings in New Zealand with reference to a normative framework, free of political or commercial pressures. For example, New Zealand is a member of the OECD, and this is accompanied by member obligations. This thesis ignores those obligations.

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[38] New Zealand was found to have no harmful preferential regime in the peer reviews under Action 5. See OECD *Harmful Tax Practices – Peer Review Reports on the Exchange of Information on Tax Rulings* (OECD, Paris, 2017) at 215.

[39] OECD tax database "Statutory corporate tax rates" 2020 statistics found at <Table II.1. Statutory corporate income tax rate (oecd.org)> shows New Zealand has the fifth highest corporate tax rate in the OECD in 2020.

[40] However, the OECD indicates New Zealand is about average on a global basis: OECD *Corporate Tax Statistics Report second edition* (OECD, Paris, 2020) at 5. Note that for many New Zealand investors, the corporate tax is the only tax paid on company profits due to imputation and preferential investment regimes such as PIEs (portfolio investments entities). Hence, other jurisdictions may impose lower corporate taxes but tax the dividend income at the shareholder level.

[41] For example, the United Kingdom, Ireland, and The Netherlands (amongst many other nations) all had intellectual property regimes subject to OECD minimum standards in Action 5. Above n 38.

[42] This is examined in chapters five to seven.

While this is the study of the tax settings of a small country, it is a global issue. Tax policy has been under pressure from tax competition for decades.[43] While a few jurisdictions have implemented regimes that provide a low-or-no-tax location to effectively hide wealth, almost all jurisdictions have developed settings that make them more attractive in the global competition for mobile capital.[44]

The momentum for tax competition is driven by arguments developed out of neo-liberal economic theory.[45] The expression "a rising tide lifts all boats" refers to the belief that policies that focus on broad economic improvement will benefit all participants, including the poorest. This is a term associated with 'supply-side' economics espoused by neo-liberal thinkers such as Milton Friedman: deregulation and tax cuts will improve the performance of the economy and make everyone better off through the supply of goods and services and employment.[46] These theories lead to the rationale that lowering taxes on mobile factors of production such as financial capital and highly skilled labour will result in increased economic growth and greater overall wellbeing. Economic growth, measured primarily by gross domestic product ("GDP"), became a primary goal of many governments' policy settings, including tax.[47]

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[43] Above n 38.

[44] This is evidenced by the global fall in corporate tax rates: OECD *Corporate Tax Statistics Report*, above n 31, at 9.

[45] The term "neo-liberal" is used extensively in this thesis and is used to denote policies and theories that promote the free-market economy and minimisation of the size of the state. Chapters five to seven examine the impact of neo-liberal economic theory in driving the shift in tax policy toward preferential treatment of mobile forms of capital and highly skilled labour.

[46] Milton Friedman *Capitalism and Freedom* (University of Chicago Press, United States, 1962).

[47] Fitoussi, Stiglitz and Sen *Report by the Commission on the Measurement of Economic Performance and Social Progress* (2009) www.stiglitz-sen-fitoussi.fr.

However, not all commentators agree with the theory that deregulation and lower tax creates better economic outcomes for all. Many are highly critical of these theories and suggest they have created enormous inequalities of wealth as opposed to better sharing of wealth.[48]

Criticism of the over-reliance on neo-liberal theories led to the establishment of a broader set of goals to achieve overall wellbeing, beyond GDP alone.[49] This includes measuring factors such as the health and education of the population. The OECD and numerous individual nations, including New Zealand, have developed a broad range of indicators that contribute to the picture of overall wellbeing.[50]

Tax is inextricably linked with many of the wellbeing outcomes identified in the OECD's wellbeing index. Tax, at its essence, takes wealth out of the private sector and puts it into the control of the public sector. The amount of tax revenue generated by a government influences the amount available for expenditure on provision of public goods and services – including publicly funded health, education, and other social services. Who pays how much is determined by how the tax settings are calibrated. If the wealthy pay a larger amount of tax than the poor, then tax redistributes some of that wealth. Tax is also used as a tool to influence certain social, economic, and environmental goals.

This study examines New Zealand's tax policy settings on inbound investors as they are now, against the broader wellbeing objectives developed in the 21st century. In doing this, the thesis considers current tax policy settings that have been developed according to a neo-liberal narrative against a framework that draws from the more recent and broader conception of wellbeing.

1.3 Research questions

The ultimate research question being asked in this thesis is: "How should New Zealand tax its inbound investors? The development of a tax policy framework and an analysis of current

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[48] See Stiglitz *The Price of Inequality* (WW Norton & Co, New York, 2012); Wilkinson and Pickett *The Spirit Level* (Penguin, London, 2010).

[49] Fitoussi Commission report, above n 47; OECD "How's Life?" project measures wellbeing in 41 countries including the members of the OECD.: see <How's Life? 2020: Measuring Well-being | en | OECD>.

[50] OECD "How's Life?", above n 49; The Treasury "Living Standards Framework" (2017) The Treasury New Zealand <Our living standards framework (treasury.govt.nz)>.

settings against the framework". However, in reaching a conclusion on this question, sub-questions arose which have been addressed in chapters two to seven. These sub-questions are:

1. Can tax on inbound investors be justified?
2. What principles should guide tax policy setting?
3. How does New Zealand tax its inbound investors?

It is only when these sub-questions are examined that the overall question of how New Zealand should tax its inbound investors can be answered.

1.4 Framework of the thesis

This thesis is a case study of the New Zealand experience of tax competition and whether current tax settings are consistent with modern objectives for overall wellbeing.

Before the main research question can be answered, two underpinning theoretical questions and an empirically based question must be examined. The first theoretical question involves the examination of the justification or legitimation of a state taxing those persons who physically reside outside the territory: that is, is there a theoretical basis for including inbound investors within the tax net of a host state? Chapter two explores the theories that have sought to explain the justification and purpose of taxation in the past. It concludes that the existing theories fail to address non-residents adequately. A new theory is considered. The new theory applies to residents and non-residents alike and forms the justification for the balance of the thesis. This justification recognises a taxing right for a state to legitimately impose tax on those persons who participate in an economy while not being present. The theory also provides a boundary within which the tax base of a state can be formed.

Once the inclusion of inbound investors is justified, the theoretical question of how the tax burden is distributed amongst the participants of the tax base arises. There is significant theoretical and practical discussion on this issue already. This is an area that is constantly evolving, although the basis for most tax policy frameworks used today is still derived from the principles set out by Adam Smith in 1776.[51] Smith's canons have been adapted and expanded over the past two and a half centuries. More recently, neo-liberalism has stamped

[51] Smith developed the canons of equity, efficiency, convenience, and certainty that are still taught in tax courses and used by policy makers worldwide. See Adam Smith *An Inquiry into the Nature and Causes of the Wealth of Nations* (Strahan and Cadell, London, 1776) at book V, chapter II, part II.

its own brand on these traditional principles with the introduction of an objective for economic growth.[52] However, a recent global trend in the wider policy-making domain has been toward the establishment of multi-dimensional frameworks identifying a multiplicity of factors that indicate the wellbeing of a nation.[53] This trend is, in part, a response to the singularity of focus upon GDP over the past century.[54] New Zealand has responded to this trend and developed a framework, the *Living Standards Framework* ("LSF"), based mainly upon work undertaken in Europe.[55] The objectives of the LSF, alongside more traditional objectives of taxation, are analysed in this thesis and distilled into two primary modern objectives of tax policy setting: *fairness* and *prosperity*. These two objectives are supported by several sub-aims highlighted in the framework developed in chapter three.

Chapter four considers the sub-aims of the new tax framework developed in chapter three. Fairness and prosperity are aspirational goals in that they denote more visionary objectives than measurable objectives. The four sub-aims of progressivity, neutrality, participation, and productivity seek to provide some more specific and practical aims that support the higher objectives.

Chapters two to four set the groundwork for the empirical work undertaken in chapters five to seven. These chapters examine the development of New Zealand's tax settings on inbound investors from the 1960s until today. The aim of the three empirical chapters is to observe the impact of international tax competition upon the development of tax law and the narrative influencing its development. The purpose of these chapters is to understand New Zealand's current tax settings for assessment against the normative framework, and to gain an insight into the rationale for the settings. These chapters answer the third research question: how does New Zealand impose tax on its inbound investors? Chapters five to seven demonstrate that inbound investors are taxed more favourably than domestic investors. They also

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[52] Buckle et al. *A Tax system for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, Wellington, January 2010) at 21.

[53] This is discussed fully in chapter three but for an introduction to the topic, see Fitoussi Commission report, above n 47 at 12.

[54] There is significant discussion on this point in the introduction to the Fitoussi Commission report, above n 47.

[55] Living Standards Framework, above n 50.

demonstrate that the income tax settings on inbound investors have shifted toward a preferential treatment, to attract mobile investment into New Zealand, consistent with a global trend.

Chapter eight applies the theoretical conclusions found in chapters two to four to the current tax settings to determine whether the tax settings are consistent with the framework. This chapter relies upon research seeking to determine how fairness and prosperity can be achieved. For example, research indicates modern conceptions of fairness include redistribution of wealth to reduce excessive inequality produced by pre-tax market factors.[56] To the extent current tax settings fail to redistribute wealth, they do not meet the objective of fairness. This may be a result of offsetting factors such as a desire for prosperity. Chapter eight seeks to assess and address these offsetting factors.

1.5 Methodology

Margaret McKerchar describes three levels of methodology to set the scene for the research being undertaken.[57] First is the overall research framework, then the research approach, and finally the methods used to conduct the research. These distinctions will be used here to outline the methodology used in this thesis.

The research framework communicates the overall design and philosophy of the research. The research approach describes the broad plan of study – bridging the gap between the framework and the detail of the research methods employed. Finally, the research methods describe the steps taken in conducting the research.

1.5.1 Research framework

As this research is about how the law interacts with society, it falls within the broad area that is described as *socio-legal studies*.[58] It is mainly a study *about* law, as opposed to *in* law, and

[56] This is discussed in chapter four.

[57] Margaret McKerchar *Design and Conduct of Research in Tax, Law and Accounting* (2010, Sydney, Thomson Reuters).

[58] See Naomi Cretzfeldt, Marc Mason, Kirsten McConnachie (eds) *Routledge Handbook of Socio-Legal Theory and Methods* (2019, Routledge, London).

must be grounded in sociological analysis.[59] The study is broader than just legal doctrine or black-letter law.[60] Chapter two, in seeking to justify the taxation of non-residents, draws from the work of great thinkers such as Thomas Hobbes, John Locke, Jean-Jacques Rousseau and Adam Smith, who might be said to stem from the area of political philosophy. Chapters three and four are concerned with sociological areas of study, such as determining a conception of fairness and prosperity for use in the tax policy assessment framework. Even in chapters five to seven, where some black-letter law analysis takes place, there is observation of the drivers underpinning tax change during the decades under observation, which are largely based upon economic theory, such as what we now term, neo-liberalism. The thesis mainly concerns itself with questions about the law and draws from a range of areas outside law.

As stated above, the purpose of identifying the research framework is to communicate the overall design and philosophy of the research.[61] In designing research, there are two distinct frameworks: positivist and non-positivist (or interpretivist) research. Positivism is research that is usually characterised by objectivity, deductive reasoning, and often, the use of quantitative methods. Positivist research seeks to uncover greater knowledge of what already exists in nature.[62]

Positivist research often follows a scientific method. The Oxford English Dictionary defines 'scientific method' in this way:[63]

> The scientific method is now commonly represented as ideally comprising some or all of (a) systematic observation, measurement, and experimentation, (b) induction and

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[59] Roger Cotterrell *Law's Community: Legal Theory in Sociological Perspective* (1997, Oxford University Press, online version).

[60] The Pearce Committee in Australia recognised that legal studies encompass two areas of research: doctrinal and non-doctrinal: Pearce, Campbell, and Harding *Australian Law Schools: A discipline assessment for the Commonwealth Tertiary Education Commission* (AGPS, Canberra, 1987).

[61] McKerchar, above n 57, at 63-64.

[62] Wilhelm Dilthey *Ideas for a Descriptive and Analytic Psychology* trans. Rudolf A. Makkreel and Donald Moore (Princeton: Princeton University Press, 2010) [trans. of Ideen über eine beschreibende und zergliedernde Psychologie (1894), Gesammelte Schriften V, 8. Aufl. (Stuttgart: B.G. Teubner, 1990)], 119.

[63] Oxford English Dictionary 'scientific method', <OED.com>.

the formulation of hypotheses, (*c*) the making of deductions from the hypotheses, (*d*) the experimental testing of the deductions, and (if necessary) (*e*) the modification of the hypotheses; though there are great differences in practice in the way the scientific method is employed in different disciplines (e.g. palaeontology relies on induction more than does chemistry, because past events cannot be repeated experimentally).

The scientific method has been used for centuries.[64] The research methods are well established and accepted.[65] Positivist research will usually begin with a hypothesis, and through well-designed scientific methods, go about proving or disproving it. The hypothesis must be able to be tested in order to find a true-false answer (or some permutation of that).

There are two ways of approaching research in law.[66] By assuming the law is real rather than socially constructed, some research may be undertaken that follows the scientific method. Research in law can be through the study of doctrine – that is, the study of what the law is. Doctrinal research is undertaken by academics but also widely covered by those in professional practice.[67] This type of research is positivist in nature in that it involves the study of what is there – it is descriptive in nature and does not seek to overlay the subjectivity of the researcher. It may be the study of the application of the law to a problem, or it could be the study of legal theory.[68] Doctrinal research is the study of the practices and 'doctrines' developed in practice.[69]

This thesis has an element of doctrinal research. Chapters five to seven involve analysis of the law, as it is written. These chapters analyse the development of the income tax imposition on inbound investors from the 1960s onward. This has involved examination of the

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[64] Margaret McKerchar "Philosophical Paradigms, Inquiry Strategies and Knowledge Claim: Applying the principles of research design and conduct to taxation" [2008] *eJITaxR* 1.

[65] McKerchar states they can be traced back as far as Hippocrates c.450BC.

[66] Pearce Committee, above n 60.

[67] Laura Lammasniemi *Law Dissertations: A step-by-step guide 1st ed.* (2018, Routledge, London) at 72.

[68] Chris Dent "A Law Student-Oriented Taxonomy for Research in Law" [2017] *VUWLawRew* 371 at 377-378.

[69] Daniël Coetsee "Policy research in accounting: A doctrinal research perspective" 12(1) *Journal of Economic and Financial Sciences* 405 at 409.

legislative changes that have occurred during this period of time and how they have affected the overall tax imposition on inbound investors, compared with an equivalent domestic investor.

The other way to approach legal research is through non-doctrinal research.[70] This type of research is categorised by being *about* law and falls into the interpretivist or non-positivist paradigm.[71] The research framework of this thesis is mainly interpretative.[72] The work is subjective and open to the interpretation and perspective of the researcher.[73] Hence, the conclusions reached in research of this nature may not be as defined and conclusive as research grounded in the positivist paradigm.[74] Interpretivism may be defined as a study that attempts to understand social reality based upon subjective interpretation.[75]

Interpretivist research seeks to build understanding in the human sciences – psychology, sociology, history, and hermeneutics.[76] It often looks at areas of research that are socially constructed, like law, rather than something occurring in nature.[77] Therefore, it may not be able to be tested through rigorous scientific methodology.[78]

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[70] Pearce Committee report, above n 60.

[71] McKerchar's Philosophical Paradigms, above n 64, at 19.

[72] McKerchar's Philosophical Paradigms, above n 64, at 7.

[73] As above.

[74] Denscombe *Ground Rules for Good Research: A ten-point guide for social researchers* (Open University Press, Buckingham, 2002) at 21-22.

[75] McKerchar, above n 57, at 75.

[76] Schwartz-Shea and Yanow "Interpretivism" in Atkinson, Delamont, Cernat, Sakshaug and Williams (eds) *Sage Research Methods* (online ed, 2020).

[77] As above.

[78] Virgo, G. "Why study Law? The relevance of legal information to the law student, researcher and practitioner" (2011) 11(04) *Legal Information Management* 221.

Non-doctrinal research can be further distinguished into two categories: reform-oriented research and theoretical research.[79]

This thesis has components of both types of non-doctrinal research. Ultimately, the question asks "how" our law should be. This implies the objective is a "reform-oriented" outcome. The goal is to propose that the law should be different to how it currently is. However, in reaching these conclusions, theoretical analysis is undertaken. The underpinning theoretical basis for tax policy setting is analysed and synthesised in order to develop the normative framework against which to assess the current tax settings. To this extent, the research is also theoretical.

1.5.2 Research approach

The research approach describes the broad plan of study. It provides the bridge to span the research philosophy and the detailed methods.[80] In this study, the research approach is qualitative with a, mainly, inductive approach to resolving the question.

A normative framework is built and applied using an inductive approach. Inductive research is typical of studies within the socio-legal research paradigm as these studies seek to induce conclusions from the interpretation of qualitative research results.[81] This can be contrasted with a deductive research project that will follow the scientific approach by seeking to prove or disprove a hypothesis through deductive techniques.[82] This research project seeks to develop or induce conclusions by various means. By analysing the work of previous theorists on the justification and purpose of tax, alongside the objectives for New Zealand policymakers, an evaluative standard is developed to form the normative framework for determining whether New Zealand's current tax settings meet the standard.

There is a deductive aspect to the research in chapters five to seven, where the law, as it is written, is analysed, and conclusions are reached on the general approach to taxation of

[79] Pearce Committee report, above n 60.

[80] McKerchar, above n 57, at 89-90.

[81] McKerchar, above n 57, at 90.

[82] At 72.

inbound investors compared with domestic investors. In this respect, the thesis reaches conclusions, through deductive methods, that the current tax settings on inbound investors are favourable or preferential.

Once the empirical work is undertaken, analysing the current tax policy settings with respect to inbound investors, an inductive approach is used to synthesise the law with the normative framework.

1.5.3 Research methods

Describing the research method is essentially the step-by-step approach or procedure to undertaking the research.[83] In scientific study, these steps may follow a defined and logical path which supports the deductive methodology. However, this thesis has developed through a review of a wide range of literature. This has not taken place in any order. Literature has been reviewed and written up in one area, and then a different area has been tackled, prompting a return to previously written work. This circular approach has assisted with the synthesis of the information and ideas.

Building a normative framework

Building a normative argument, as required by the research question of this thesis, requires an evaluative standard.[84] This is consistent with the common meaning of the term *normative* which means 'norm or standard'.[85] In order to determine if the tax settings are as they should be, a standard is required against which an assessment can be made. The assessment of the current settings cannot be made in isolation. The standard is established through the interpretative analysis of established literature. Finding a normative framework of this nature is inherently subjective. The normative framework is developed from the knowledge built by others (verstehen)[86] and the interpretivism of the researcher in a socially constructed

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[83] Thomas Schwandt *The Sage Dictionary of Qualitative Inquiry* (Sage, online ed., 2007).

[84] Ralph Wedgwood *The Nature of Normativity* (2007, Oxford Scholarship online).

[85] Oxford English Dictionary (online ed, <www.OED.com>).

[86] 'Verstehen' is a German word roughly translated as understanding or interpretation: see Wilhelm Dilthey *Ideas for a Descriptive and Analytic Psychology*, above n 62.

paradigm. The framework comes about through an inductive approach, as described above under the 'research approach'.[87]

Case study method

The research question assesses New Zealand's tax settings in a framework also developed in a New Zealand context. However, there is a broader application of the research for any jurisdiction, making tax policy decisions in an environment of competing tax competition and tax equity considerations. A number of jurisdictions around the world are adopting multidimensional wellbeing frameworks to guide policymakers.[88] To the extent this research may be useful for other jurisdictions, it acts as a *case study*. Robert Stake considers case studies as primarily addressing the more specific case-related question.[89] Any broader application is secondary. Stake even states, "case study seems a poor basis for generalisation."[90]

This approach is taken in this research. The primary question being addressed is the position of New Zealand's tax policy in relation to inbound investors. Application outside New Zealand may be 'of interest' but is not intended to be the primary goal of the researcher. However, it is a secondary goal. As tax competition is not only a New Zealand phenomenon, the experience described in this thesis may be similar to that of other states. Equally, many other nations are adopting multi-dimensional wellbeing models to inform policy development. The conclusions drawn from this research may also be useful in those contexts. The normative framework used to evaluate New Zealand tax policy settings is unique to New Zealand as it draws from the LSF. However, the underlying principles for the purpose and justification of taxation are drawn from international academic sources that may be accepted and applied widely. Therefore, while being a New Zealand study, the findings may be adaptable to other jurisdictions.

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[87] McKerchar, above n 57, at 89-90.

[88] There is an analysis of the development of these frameworks in chapter three.

[89] Robert Stake *The Art of Case Study Research* (Sage, California, 1995) at 7.

[90] At 7.

1.6 Literature review

In the initial stages of this research, two supporting questions arose while considering whether New Zealand's tax settings on inbound investors are fair and optimal. The first one is fundamental – is there a justification for the inclusion of inbound investors in the tax net? Unless taxing non-residents is legitimate and justifiable, the rest of the thesis is redundant. The second question, reliant upon a positive answer to the first, is, what criteria might be adopted to determine how tax should apply to non-residents? Both questions rely heavily on literature review as the predominant research method.

1.6.1 Can tax on inbound investors be justified?

Given the importance and fundamental nature of the first question, it is surprising to find so little literature in this domain. Many great writers have written on this subject and yet universal agreement has not been met.[91] This is probably due to the inherently subjective nature of the question.

Klaus Vogel is the most prominent modern writer on this question. When discussing the justification for taxation, Vogel is careful to distinguish between its role in legitimation, equality, and integrity.[92] Legitimation is the justification for tax between the state and the taxpayer.[93] Equality concerns fairness of tax settings between taxpayers – that is, the distribution of the tax burden between taxpayers must be justifiable.[94] Last, integrity refers to a fair distribution of the tax burden across income sources.[95] In the context of this research, it is the legitimation of taxation that is relevant: that is, how the state can justify the imposition of tax upon its constituents.

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[91] Klaus Vogel "The Justification for Taxation: A Forgotten Question" (1988) 33 *American Journal of Jurisprudence* 19.

[92] Klaus Vogel "Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part III)" (1988) 11 *Intertax* 393 at 394-397.

[93] At 394.

[94] At 395.

[95] At 396.

Vogel argues that taxation of non-residents is only justifiable on the basis of payment for benefits received by the non-resident.[96] This justification arises out of "benefit theory". Until Vogel, benefit theory had been widely discredited as a justification for taxation.[97] From the 19th century onward, the dominant theory for justification of taxation was the "sacrifice" or "ability-to-pay" theory.[98]

Despite a shift away from benefit theory and toward the sacrifice or ability-to-pay group of theories, justifying taxation of non-residents has proved challenging. Some theorists, while generally aligning as sacrifice theorists, suggest tax on non-residents can only be justified using benefit theory.[99]

The theoretical or even moral basis for taxing non-residents therefore remains unclear. Of course, the subjective and interpretative nature of the question means that it will never be completely clear or certain. However, in reviewing the existing literature, what did become apparent is that the current position is unfinished. There is room in this space for different contributions of ideas to the legitimisation or justification for taxation of all potential taxpayers, including non-residents. In response, this thesis introduces the idea that taxation can be justified based upon *economic participation*. While writing this thesis, it is notable that the OECD, in their work on taxation of digital business have proposed a new taxing right based upon a similar principle - that tax should be paid in the state or states where an enterprise participates in the economy.[100] This participation-based taxing right will result in

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[96] At 395.

[97] Seligman "Progressive Taxation in Theory and Practice" (1908) 9(4) *American Economic Association Quarterly* (3rd series) 1 at 155.

[98] At 157.

[99] Pigou *A Study in Public Finance* (3rd ed, MacMillan, London, 1960) at 172; Josiah Stamp *The Principles of Taxation* (3rd ed, MacMillan and Co, London, 1936) at 139.

[100] OECD blueprints for pillars one and two, above n 19, at 19.

increased source-based taxation and has been supported by 130 states and jurisdictions.[101] This is discussed further below under contributions of this research.

1.6.2 What principles should guide tax policy setting?

Adam Smith developed four canons for good tax policy in the 18th century.[102] These principles are equity, efficiency, certainty, and convenience.[103] These have remained the foundation for tax policy settings in many areas of the world, including New Zealand.[104] In particular, equity and efficiency remain key criteria.[105]

However, the literature review revealed that tax policy setting in New Zealand was expanded from the 1990s onward to include the goal of economic growth.[106] The criteria of "efficiency", which had once meant that tax should be collected in an efficient manner and it should not unduly disrupt ordinary business activity,[107] had grown to include the goal that tax should not be an impediment to economic growth.[108] In some discussions, this was extended to designing tax policy that promotes economic growth.[109]

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[101] OECD "130 countries and jurisdictions join bold new framework for international tax reform" (press release, 1 July 2021). These 130 countries include the United States and China.

[102] Adam Smith, above n 51.

[103] At book V, chapter II, part II.

[104] VUW report, above n 52, at 15.

[105] As above.

[106] For example, McLeod et al. *Tax Review 2001 Issues Paper: Frameworks Chapter One* (New Zealand Treasury 2001) at 5.

[107] Adam Smith, above n 51, at book V, chapter II, part II.

[108] VUW report, above n 52.

[109] The Hon Michael Cullen, Minister of Finance and Hon Peter Dunne, Minister of Revenue "Business Tax Review" (press release, 25 July 2006).

The literature review also includes an examination of New Zealand's LSF.[110] The framework has been developed to "prompt… thinking about policy impacts across the different dimensions of wellbeing, as well as the long-term and distributional issues and implications".[111]

The literature review, together with discussions with officials from both the Inland Revenue Department and Treasury made it apparent that a synthesis of "traditional" tax policy setting criteria with the LSF was yet to happen. The Tax Working Group of 2019 was set up to consider the fairness, integrity, and balance of the tax system. It introduced a system for using the two sets of criteria alongside each other.[112] However, there are still clearly opportunities to integrate the two frameworks into a single tax policymaking framework rather than continuing to use them independently.

Chapters three and four make a first attempt at creating a single framework based upon both traditional and modern principles.

1.7 Contributions of the thesis

This research makes four contributions to the existing body of knowledge in this area:

1. The thesis argues that taxation of non-residents can be justified based on their economic participation in the host state.
2. A normative framework for tax policy settings is developed by synthesising existing policy setting tools into a single framework.
3. An analysis of New Zealand income tax settings on inbound investors is undertaken, with discussion on the influences driving the direction of change.
4. Finally, the thesis contributes an argument that the pressures of tax competition in New Zealand have resulted in tax policy settings on inbound investors that are not consistent with tax policy-setting goals.

[110] Living Standards Framework, above n 50.

[111] As above.

[112] Cullen et al. *Future of Tax: Final Report Volume I* (The Tax Working Group, Wellington, February 2019) at 7.

The first contribution, the introduction of what is referred to as the "economic participation theory" in the thesis, is made in chapter two. The second contribution, the normative framework for tax policy setting, is developed in chapters three and four. An analysis of New Zealand tax policy settings, showing influences on the direction of change over the past several decades, is covered in chapters five to seven. Lastly, the conclusions reached in chapter eight are the final original contribution of the thesis – that the pressure of tax competition has resulted in a sub-optimal policy setting.

1.8 Limitations of the research

It is acknowledged that this research has inherent limitations. While efforts have been made to minimise these limitations, there are areas where shortcomings are unavoidable.

Perhaps most significant is the inherently subjective nature of the research. Throughout the work, as with other socio-legal studies, value judgements are made. Development of the theoretical justification for taxation and the framework for the application of tax policy, while informed by research, take the perspective of the researcher. Much of the research is critical of neo-liberal economic perspectives, which is a subjective position to adopt. It is also critical of libertarian perspectives, including that of Nozick.[113] While supported by research, it is acknowledged that a researcher with a different worldview might reach very different conclusions. However, the view of the research undertaken here does follow recent trends which seek to question the neo-liberal perspectives that have dominated the economic narrative in recent decades.[114]

The research presented here is silent on consumption tax. The settings analysed in chapters five to seven are income tax settings. The principles developed in chapters two to four are not intended to exclude consumption taxes per se. However, consumption taxes tend to be applied based on consumption taking place in the territory and normally would not apply to non-resident investors deriving income from capital.

Another limitation is that the research looks at New Zealand's tax settings by comparing them against a normative framework developed as an ideal set of objectives and aims. Despite the acknowledgement that the tax settings on inbound investors are a result of the

[113] Nozick *Anarchy, State and Utopia* (Basil Blackwell, Oxford, 1974).

[114] For example, the Fitoussi Commission report, above n 47.

pressure of international tax competition, the research does not consider this pressure in its findings. The objective is to assess the tax settings against an ideal or norm in a domestic context only. The practical implementation of such findings may rely upon other jurisdictions also adjusting their tax settings in a way that ignores the pressure of tax competition.

Although the development of both economic participation theory and the tax objectives framework are part of the originality of the work, these also result in a limitation to the assessment of the overall research question. If the researcher were able to make the assessment based upon already well-established theoretical bases, the assessment would be grounded in theory that had been subject to peer review and critical analysis and possibly further development. This has not been possible due to a lack of development in this field.

Another limitation is that the research only deals with tax settings that affect the general taxpaying population. The use of very specific tax levers such as environmental taxes and 'sin' taxes are not considered.

Further to this, the research in chapter seven, does not consider New Zealand's international obligations as a member of the OECD. It must be acknowledged that countries agree under the OECD Convention that they will work toward achieving the OECD's aim of pursuing sustainable economic growth.[115] One tool the OECD uses to promote its economic growth objective is the encouragement of capital flows where the most optimal economic growth will arise.[116] Double tax agreements are one way to achieve this goal by removing juridical double taxation and providing certainty to taxpayers operating across borders.[117] As a member of the OECD, New Zealand has an obligation to comply with the recommendations and directions of the organisation.[118]

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[115] *Convention on the Organisation for Economic Co-operation and Development* OECD, Paris, December 14, 1960, available at *http://www.oecd.org/document/7/0,3746,en_2649_201185_1915847_1_1_1_1,00.html*., Articles 1 and 2.

[116] At article 2(e).

[117] *OECD Model Tax Convention on Income and on Capital 2017* OECD, Paris, 2017 at I- 1.

[118] See article 5(a) of the Convention, above n 115, that allows the OECD to enter into agreements and make decisions on behalf of its members.

However, the intention of the research is not to contradict the role of the OECD in New Zealand's tax policy. That is a matter for politicians. This research is concerned with application of the normative framework, unconstrained by political expedience or influence.

Another matter to be cognisant of is the changing landscape regarding taxing multinational organisations, particularly those using digital platforms within their business models. The OECD has been working on developing principles that seek to capture income from digital business.[119] These changes will have a substantial impact upon many of the principles that have long been upheld by the OECD's conventions, including the concept of *permanent establishment*. At the time of writing, these changes have been broadly endorsed but there is still work to be done before implementation.[120] However, when the proposed changes take place, this will result in a swing toward source-based taxation for digital businesses. New Zealand is supportive of this direction of change.[121] This does indicate a shift in policy.

[119] OECD blueprints for pillars one and two, above n 19.

[120] See OECD press release, above n 101.

[121] In the event that the OECD proposal does not come to fruition, New Zealand policy makers have considered alternatives to capture tax from some multinationals making sales in New Zealand: Inland Revenue Department *Options for Taxing the Digital Economy* (IRD, Wellington, June 2019) at 1. New Zealand is, however, one of the 130 countries supporting the OECD unified approach.

2 The justification for taxation of non-resident investors

2.1 Introduction

In order to answer the broader question of what New Zealand's income tax settings should be on inbound investors, the question of who should be included in the tax base needs to be addressed. Non-residents are, arguably, on the fringe of a state's tax base. They are not physically present in the state and therefore their participation is limited to an economic presence only. In order to explore who should be included in the tax base, an understanding of the purpose and justification for tax is required: what are taxes for, and more challenging, how can the imposition of taxes be justified? Without understanding the theoretical basis upon which taxes apply, a full and consistent understanding of the limits of a jurisdiction's tax base is difficult to reach.

Given the significant impact of taxation upon all individuals, one would expect its theoretical justification would be well-established. However, there is surprisingly little literature addressing this question, particularly in modern scholarship. Over the course of history, the justification for taxation is roughly divided into two camps: the benefit theorists and the ability to pay or sacrifice theorists. These two theories also form the basis for the purposes of taxation which are primarily two-fold: to fund public expenditure on goods and services and to redistribute wealth across the population.

This chapter explores the theoretical foundations for taxation more broadly and then focusses more specifically on non-residents. This chapter proposes a theory justifying the taxation of non-residents based upon economic participation in a state. This theory supports a wide interpretation of who can form part of a state's tax base, consistent with the increasing demands of globalisation and digitalisation.

The chapter is set out as follows. Part 2.2 considers the theoretical justification for taxation from the early writing of Hobbes and Locke in the 17th century to today. This explores the development of the benefit theory and the sacrifice theory which, in part, determines who is included in the tax base of a state. Part 2.3 introduces the dual purposes of taxation and how these purposes have evolved with the changing role of the state. One of the recognised purposes of taxation is redistribution of wealth. This is included in this chapter as the purpose for tax contributes, in part, to the determination of who might justifiably be included in the tax base. This introduction to redistribution also leads into the following chapter which

considers the principles that underpin the distribution of the taxpaying obligation. Part 2.4 summarises the theories on justification and purpose into two schools of thought: one based upon the benefit theory and one based upon the sacrifice group of theories. Then, part 2.5 considers the application of the justification and purpose for tax in determining who should be included in the tax base of a state – in particular, part 2.5 looks at the justification for inclusion of non-resident investors in a state's pool of taxpayers. Part 2.6 introduces the idea that taxation should be based upon economic participation. This theory is applied in this thesis to justify why non-residents should be taxed on the same basis as a state's residents.

2.2 Theoretical justification for tax

Twentieth-century theorist Klaus Vogel considers the "forgotten" question of the justification for taxation.[122] Vogel states ""to justify" …is to show to be just that which appears unjust".[123] For many people today, taxation may be perceived as an infringement upon individuals' rights – that is, taxation takes from individuals a portion of what they have legitimately earned.[124] For this reason, it is only right that taxation is subject to justification.

To examine the justification for tax in a modern state, it is useful to consider the evolution of tax and how it has been justified in the past. It sets the scene and deepens our understanding of our present situation.

In considering this question, Vogel gives particular emphasis to the work of Lorenz von Stein, a 19th-century German fiscal policy theorist. Vogel describes Stein's justification for tax as follows:[125]

> Stein developed his theory of justification for taxes from the consideration that "one of the two major conditions for all development," aside from "the application of individual effort," is "the community of human beings in the reciprocal activity of all individuals successively." It is, however, "-- even mathematically -- impossible that this community can provide for the individual, even economically, the conditions necessary for progress if individuals do not return to the community a portion of the

[122] Vogel, above n 91.

[123] At 23.

[124] For example, the mission of the New Zealand Taxpayer's Union includes: "We want out politicians spending money as if they'd worked as hard as the taxpayers who earned it."

[125] Vogel, above n 91, at 39-40.

> economic progress that they derive from it." The State contributes "order and measure" to this progress through the expression of its will, the law. "So it occurs, that the payments of the individual to the community in and of themselves originate in the general human essence of the latter; taxes, however, in turn originate from the development of the concept of the State."

Stein, as quoted here by Vogel, observes that individuals gain from communal efforts in a way that is not achievable alone. The progress we rely upon every moment of every day is inconceivable without the organisation enabled by tax. We must therefore return to the community a portion of what we derive from it. This analysis justifies tax as a necessary accompaniment to the existence of the state and therefore relies upon the justification of the state itself to justify taxation. This will be considered further below and forms the basis for the theoretical justification for taxation of non-residents in this thesis. However, for now, the history of how taxation has been justified in the past is examined.

2.2.1 Development of the justification for taxation

The justification for tax has been traced back as far as Thomas Aquinas who said, "As regards princes, the public power is entrusted to them that they may be the guardians of justice… whatever is taken by violence of this kind is not the spoils of robbery, since it is not contrary to justice".[126] During the 15th century, most parts of Europe were ruled in feudal societies. Taxes were not typically levied as a general source of revenue. Income from the large landholdings sufficed for supporting fiefdoms. However, Aquinas does state that a general levy may be justified in exceptional circumstances such as wartime.[127] This indicates early acceptance that rulers could impose taxation upon their subjects, albeit on an exceptional basis and for a specific purpose.

2.2.2 Hobbes and Locke

About 200 years on, two 17th century British theorists, Hobbes and Locke, consider the justification for tax. Seventeenth century Britain was no longer feudal. The century began under absolute monarchy but saw the uprising and eventual overthrow of the King in favour

[126] Thomas Aquinas *Summa Theologica* (Musaicum Books, online, 2017), originally published in 1485 in Latin.

[127] John Snape "The 'Sinews of the State': Historical Justifications for Taxes and Tax Law" in Monica Bhandari (ed) *Philosophical Foundations of Tax Law* (Oxford University Press, Oxford, 2017) 9 at 13.

of parliamentarian rule.[128] By the end of the century, the monarchy had returned alongside parliament to form a constitutional monarchy such as the one they have today.[129] Hobbes is most well-known for his work, *Leviathan*, first published in 1651.[130] Locke published *Two Treatises of Government* with his own views on government within the *Second Treatise*, in 1689.[131] Despite the short period between the works of the two theorists and the number of similarities between the theories they espouse, they are often regarded as developing two distinct lines of reasoning in many areas, whether it be justification for taxation, or property rights,[132] or democracy and consent.[133]

Hobbes writes during the period of the English Civil War that ended in 1649 with the overthrow of King Charles I by the parliamentarian, Oliver Cromwell.[134] Hobbes justifies government, and deference to government, as the better option than its alternative. The alternative is described as Hobbes' 'state of nature' in which no political community exists.[135] Each individual must fend for him or herself. In this 'state of nature', Hobbes suggests there would be no industry, no development of knowledge, and people would live in fear. Because of this natural state, government is justified on the basis that people will contract to forego some freedoms in exchange for the benefits of organisation – also referred to as 'social contract theory'.

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[128] Antonia Fraser *The Lives of the Kings and Queens of England* (Phoenix Illustrated, London, 1997) at 232.

[129] At 249.

[130] Thomas Hobbes *Leviathan Chapter XVII.: Of the Causes, Generation, and Definition of a Commonwealth* (National Library of Canada, Canada, 2002 Martinich edition).

[131] John Locke *The Second Treatise of Civil Government and A Letter Concerning Toleration* (Oxford: B Blackwell, 1689) chapter II.

[132] Murphy and Nagel *The Myth of Ownership: Taxes and Justice* (Oxford University Press, New York, 2002) at 43-45.

[133] Wolfgang Schön "Taxation and Democracy" (2019) 72 *Tax Law Review* 235.

[134] Fraser, above n 128, at 231.

[135] Hobbes, above n 130, at 85.

Locke writes around the time of the Glorious Revolution. Britain had returned to a monarchy under the reign of King Charles II.[136] However, the Catholic Charles II was deposed in favour of William and Mary, restoring the country to Protestant rule under a constitutional monarchy.[137] Locke makes similar observations with respect to a social contract existing between the individual and the state. He argues the state of nature is not necessarily as lawless as Hobbes' observations, but interactions would be subject to an individual's perception of a 'natural law'.[138] Locke also endorses government or 'civil society' over the uncertainty and insecurity of the state of nature.[139] To this end, the two views bear similarities – they both perceive organisation to be preferred over the state of nature, and this, in itself, justifies adherence to the rules of government and the accompanying forsaking of some individual freedoms.

For the purpose of this thesis, it is the common ground of the two 17th century philosophers that is most insightful. They both agree that government is necessary for a civil society. The justification for members of society to comply with the will of the state is the social contract between individuals and the state, granting protection in exchange for some loss of freedom.

If we accept that government is justified, then, as Stein observes, the justification for tax must be observed in the context of the existence of some form of government. With the social contract theory in mind, Hobbes says, regarding taxes, they are "nothing more than the price of their bought peace".[140] This reference can be interpreted in two ways. First, that tax is a natural result of government. It must be paid for in some way. Second, it also envisages tax as the cost of defence or of an individual's protection under the state. This is consistent with the role of government until well into the 20th century, where states were essentially funded to

[136] Fraser, above n 128, at 232.

[137] At 249.

[138] Locke, above n 131.

[139] At chapter IX.

[140] Thomas Hobbes and Sterling Lamprecht (ed.) *de Cive* (Appleton-Century-Crofts Inc, New York, 1949) at Chap. XIII, para 10.

provide law and order, prior to the introduction of the welfare state.[141] Locke also recognises that "every one who enjoys his share of the protection, should pay out of his estate his proportion for the maintenance of it".[142] This justification for tax stuck. A century later, Montesquieu also observed the role taxes play in the protection of property: "The revenues of the state are a part of his property which each citizen gives in order to be sure of the other part, or in order to enjoy it in comfort".[143]

The fundamental difference between Hobbes and Locke, in relation to taxes, comes down to their differing views on property rights.

Hobbes, consistent with his authoritarian view of government, is generally understood to support the view that there are no property rights antecedent to the state: that is, there are no (or few) property rights in the state of nature.[144] As we shall see later, this perspective is shared by modern philosophers such as Liam Murphy and Thomas Nagel.[145] Hobbes' view assumes private property rights do not crystallise until the state grants these rights. Locke, on the other hand, is widely regarded (although not unanimously) as having proposed that even in the state of nature, some minimal natural property rights exist.[146]

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[141] Reuven Avi-Yonah "Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113(7) *Harvard Law Review* 1575 at 1576. In a New Zealand context, this is discussed in: Paul Goldsmith *We Won, You Lost. Eat That! A Political History of Tax in New Zealand since 1840* (David Ling Publishing Ltd, Auckland, 2008) in chapters 8 and 9.

[142] Locke, above n 131, at para 140.

[143] "Les revenus de l'Etat sont une portion que chaque citoyen donne de son bien pour avoir la suirete de l'autre, ou pour en jouir agruablement." Montesquieu, L'Esprit des Lois, 1748, livre I3, chap I, quoted by Seligman, above n 97, at 163.

[144] Benjamin Lopata "Property Theory in Hobbes" (1973) 1.2 *Political Theory* 203, 204. This article does suggest Hobbes' view is a little more nuanced than this but for the purpose of this thesis, this perspective is sufficient.

[145] Murphy and Nagel, above n 132.

[146] Murphy and Nagel, above n 132, 45. Although Michael Davis concludes that Locke's view on property rights is the same as that of Hobbes: see Davis "Locke (and Hobbes) on "Property" in the State of Nature" (2013) 53.3 *International Philosophical Quarterly* 271.

The interpretation of Locke's work that private property rights exist before the existence of the state, has formed the basis for the libertarian view of property rights and the corresponding view that taxes should be minimised.[147] The view that property rights exist prior to the existence of the state means there must be a justification for tax independent of the state's existence. If tax is paid from property that already belongs to the individual, then the state is taking from the individual some of their own property – requiring justification for the confiscation of private property. On the other hand, if private property rights do not exist prior to the existence of the state, tax does not take what belongs to the individual. The individual does not 'own' the property until the tax is taken from it. If tax does not take private property, justification for taxation is wholly dependent on the state's existence. This binary view could be more nuanced. Theorists supporting the existence of some level of natural rights to property may have differing conceptions as to quantity and range of those rights.

2.2.3 Benefit theory

Despite the potential differences in their views on property rights, both Hobbes and Locke adhere to a 'benefit' approach to justify tax – that is, it is the price paid for the protection granted by the state. It is a *quid pro qu*o for something received by the state in return.[148] This assumes the key relationship, when considering justification for taxation, is between the individual and the state.[149] Up until the last century, the benefits were confined mainly to protection of citizens of a state, that is, law and justice. As the welfare state was yet to develop, the tax relationship was mainly concerned with the individual and the state.[150]

Subsequent to Hobbes and Locke, the benefit approach has had many followers over the centuries. Jeremy Bentham, an 18th-century legal theorist, also adhered to the benefit theory of taxation. Unlike Hobbes and Locke, he was in favour of a *utilitarian* approach rather than

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[147] Kerry Hunter "Rights-Based Theory and Contemporary Political Challenges: A Fresh Reading of Locke in Light of Bentham and Burke" (2016) 14 *NZJPIL* 209.

[148] The quid pro quo relationship is examined in James Buchanan "The Pure Theory of Government Finance: A suggested approach" (1949) 57(6) *Journal of Political Economy* 496.

[149] At 499.

[150] At 499.

a *social contract* approach. The utilitarian approach followed an objective of providing "the greatest good to the greatest number of people".[151] Bentham's view of benefit theory differs from social contract theorists as it takes a whole population view rather than an individualistic view. This distinction is discussed further below.

Adam Smith is also widely regarded as a proponent of benefit theory. He dominated English speaking economic discourse in the 18th century and remains relevant today. His now renowned statements on what a 'good' tax should look like includes the following:[152]

> The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

This statement echoes that of Hobbes and Locke: that citizens should contribute to the state because they enjoy protection of the state.

Supporters of the benefit approach, including Hobbes,[153] Locke,[154] Rousseau,[155] Bentham[156] and Smith,[157] all viewed tax as the cost of protection. Some even compared tax to an insurance premium.[158] Most of these supporters also considered the protection afforded by

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[151] Jeremy Bentham *An Introduction to the Principles of Morals and Legislation* (T. Payne & Son, London, 1789).

[152] Smith, above n 51, at book V, chapter II, part II.

[153] Hobbes, above n 130.

[154] Locke, above n 131.

[155] Jean Jacques Rousseau "A discourse on political economy" in *Social Contract & Discourses* (E. P. Dutton and Company, New York, 1950) at 320-322.

[156] Bentham, above n 151.

[157] Smith, above n 51, at book V, chapter II, part II.

[158] J. R. McCulloch *A Treatise on the Principles and Practical Influence of Taxation, or the Funding System, I845* 3rd ed. (I863) at I7, as quoted in Edwin Seligman, above n 97.

the state either operated in proportion to the wealth of its subjects, or benefitted those wealthier subjects exponentially compared with their wealth.[159]

The allegiance to benefit theory to justify taxation waned during the 19th century.[160] However, in the late 19th and early 20th century it regained acceptance and became popular with economists who came up with models attempting to measure the benefit received by taxpayers in order to determine how the tax burden should be distributed amongst its beneficiaries. Sax, Wicksell, de Viti de Marco, and Lindahl, all produced theories on how benefits could be measured.[161] Seligman describes the earlier benefit theories as being the "insurance" or "protection" group of theories, while the latter group formed the "give-and-take" theories.[162] The latter group made various attempts to calculate the cost of the services provided by the state, none of which have gained widespread acceptance and perhaps only served to prove the impossibility of the task.

Benefits are difficult to define, especially since the emergence of the welfare state.[163] There are obvious benefits, such as receipt of medical services when one visits a hospital and attendance at an educational institution. There are also less visible benefits that arise through societal membership. Operating a business in an environment where skilled people are readily available is undoubtedly a benefit, but it is very difficult to measure. It is probably due to the difficulty of measuring these less tangible benefits that a new theory emerged as a substitute to benefit theory.

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[159] See discussion in Seligman, above n 97, at 166.

[160] The emergence of the sacrifice theory is discussed in 2.2.4.

[161] Analysis of these proponents of the benefit theory can be found in Richard Musgrave *The Theory of Public Finance* (McGraw Hill, USA, 1959) at 69-73.

[162] Seligman, above n 97, Historical Appendix I, 158-180.

[163] Buchanan, above n 148 at 499.

2.2.4 Toward sacrifice theory

The development of the justification for taxation altered in the 19th century with a shift away from benefit theory and toward a new group of theories, the ability-to-pay or sacrifice theories.[164]

The benefit and sacrifice theories reflect two different views of the state and its relationship with its citizens. Buchanan distinguishes between the *organic view* and the *individualistic view*.[165] Under the organic view of the state, the state acts as a single organism, acting in the interests of society as a whole.[166] This can be distinguished from the individualistic view of the state that perceives the individual as a single unit rather than the state.[167] Under the individualistic view, the state only exists to the extent a group of individuals consent "to fulfil a portion of their wants collectively".[168]

The benefit theory is the natural companion to an individualistic view of the state: that is, in its purist form, social contract theory means the individual has a social contract with the state for the provision of goods and services in exchange for taxes paid.[169] However, the view that taxation is a payment for an individual's receipt of public goods and services was rejected by many theorists due to its compulsory nature and because tax paid is not an exact reciprocation of the goods and services received.[170]

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[164] Buchanan, above n 148. Buchanan refers to the "organismic" view of the state and the "individualistic" view of the state.

[165] James Buchanan "The Pure Theory of Government Finance: A suggested approach" (1949) 57(6) *Journal of Political Economy* 496.

[166] At 496.

[167] At 498.

[168] At 498.

[169] Both Hobbes and Locke are credited with having referred to a social contract when they argue an individual will prefer to give up some of their natural rights in favour of civil society (Hobbes, above n 130, at 85; Locke, above n 131, at Chp IX.)

[170] Schön, above n 133, at 255.

The organic theory views the relationship as one between the state and *all* the people.[171] Rather than being a contract with each individual, it is a contract with the collective members of the state. This theory views the state as an almost God-like being. This theory was developed by German scholars such as Rau, Schäffle and Wagner.[172] All these proponents of the organic theory reject the benefit theory of taxation. In addition to the German group, John Stuart Mill supports the new view of taxation.[173]

Like the benefit theory, the sacrifice theory is relied upon to both justify the imposition of tax and the distribution of the tax obligation across members of the state. The basis for tax allocation is that each member should make an equal sacrifice – that is, "apportioning the contribution of each person toward the expenses of government so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his."[174] Despite the focus on the distribution of taxation, the underpinning principle is the membership of the state as opposed to the exchange approach of the benefit theory: that is, as members of a state, we are obliged to make an equal sacrifice toward the common good.

Wolfgang Schön quotes Friedrich Julius Stahl, a 19th-century German theorist, on the matter of taxation: "The very essence of the State leads consequentially to taxation – not as a quasi-contractual consideration but as an obligation arising from the individual's membership in the Nation".[175] Schön refers to the obligation to pay tax as based upon what he calls 'solidarity'.[176]

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[171] Buchanan, above n 148, at 496.

[172] Vogel, above n 91, at 28-29.

[173] In John Stuart Mill *Principles of Political Economy: Vol 2* (JW Parker and Son, London, 1848) at 350 he states, "Government must be regarded as so pre-eminently a concern of all, that to determine who is most interested in it is of no real importance".

[174] Mill, above n 173, at book V, chap ii, para 2.

[175] Schön, above n 133, at 255. The original text is in German.

[176] At 264.

This concept of taxation as part of a membership of the state has been adopted more prevalently in European states, such as Germany and France. In Germany, Wagner regards the state as the "highest form of compulsory community" and distinguishes this from the contractarian point of view.[177] Even in the early 20th century, American economist Edwin Seligman states:[178]

> ...the benefit theory of taxation is inadequate… [Every man] does not measure the benefits of state action to himself first, because these benefits are quantitatively unmeasurable: and secondly, because such measurement implies a decidedly erroneous conception of the relation of the individual to the modern state. …It is now generally agreed that we pay taxes not because the state protects us, or because we get any benefits from the state, but simply because the state is part of us. … He does not choose the state but is born into it… we pay taxes not because we get benefits from the state, but because it is as much our duty to support the state as to support ourselves or our family; because, in short, the state is an integral part of us.

Richard Ely, also a 19th and 20th-century American economist, goes even further in stating:[179]

> [Taxes] are one-sided transfers of goods and services and are not mutual. The citizen pays because he is a citizen, and it is his duty as a citizen to do so. It is one of those consequences which flow from the fact that he is a member of organized society. Man, as a human being, owes services to his fellow, and one of the first of these is to support government, which makes civilisation possible. Only an anarchist can take any other view. To the ordinary man it appears right that he should be called upon to give not only his property for the promotion of common interests, but even his life, if need be.

These two economists suggest that tax is justified in American society upon the basis of belonging to a social union in the same way observed by European economists and political philosophers. At this time, the tide of opinion had shifted away from taxation on the basis of a social contract to the basis of belonging. No longer could taxpaying citizens demand goods and services in exchange for their taxes – taxes were due merely as a result of being part of the state by virtue of having been born in that state.

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[177] Schön, above n 133, at 27.

[178] Edwin Seligman *Essays in Taxation* (MacMillan, New York, 1921) at 72-73.

[179] Richard Ely *Taxation in American State and Cities* (TY Crowell & Sons, New York, 1888) at 13.

2.2.5 View of the modern administrative state

The two groups of theories almost certainly reflect the changing role of the state. For this reason, it is useful to observe the nature of the modern state in order to gain perspective and insight into the current justification for tax. John Snape argues that modern-day governments are typically categorised as an "administrative state".[180] This is distinguishable from previous eras where parliamentary, feudal, and absolutist states have been the norm.[181] The administrative state combines the norm of representative consent with the "extensive administrative apparatus" required to realise the extended range of activities governments are involved in.[182] The extensive apparatus referred to by Martin Loughlin recognises the role of government in regulating the workings of business and the economy as a whole.

The administrative state has two arms – the unelected administrative arm and the elected representatives of parliament.[183] Parliament, as a democratically elected body, is often known as the "House of Representatives", indicating its role in representing its constituents. Democracy, on the face of it, aligns itself with the individualistic view of the state – the state represents the interests of its voters. However, the democratically elected representatives must consider the interests of the constituency as a whole as well. The unelected and underlying administrative arm of government would appear more closely aligned with the organic view of the state: that is, it acts as a single body that concerns itself with the ongoing interests of society overall.

Modern, democratically elected governments have elements of both the organic and individualistic views of the state. On the one hand, modern democratic governments operate so that individuals (or voters) determine the composition of the legislature. States (ideally) have regular changes in leadership dependent upon the will of the people. While it is recognised that the 'will' of the people may be influenced by a multitude of external forces, on a basic level, individuals make their own voting decisions. If it is accepted that in a

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[180] Snape, above n 127.

[181] Snape, above n 127.

[182] Martin Loughlin *Foundations of Public Law* (Oxford University Press, Oxford, 2010) at 435.

[183] Loughlin, above n 182.

democracy, individuals (voters) determine who makes the law, then it clearly aligns with the individualistic view of the state.

On the other hand, the influence of the institutions that support the state shouldn't be underestimated. They may influence what is on the agenda, and they certainly influence, or even determine policy and law. They are not selected by voters. Their influence pervades successive democratically elected representatives. The existence of the administrative arm of government is consistent with an organic view of the state.

Free and democratic nations are led by lawmakers who are elected by individuals. However, it would be simplistic and naïve to believe that voting decisions are made purely based on policy matching between the voter and the candidate. Equally naïve is that the elected candidate is free to represent the will of 'their' people as they choose. For this reason, it is difficult to select a single view. The organic view is apparent to the extent one accepts the influence of the underlying institutions of democracy, the processes, and the state. However, if any respect for democracy remains, one would surely perceive the state from an individualistic view as well. If there is no representation of the individual voters, then this essentially makes a farce of democracy.

This research, therefore, proceeds on the basis that both the organic and individualistic views have validity. The state is an independent body looking after the welfare of its people. Equally, it is the embodiment of the people's will.

2.3 The purpose of tax

An examination of the purpose of tax could just as easily fit into chapter three. It sits a little on the periphery of justification for tax. However, given the importance of the subject to the overall question of how inbound investors should be taxed, it is included in this chapter. The objective or purpose for tax assists in developing a picture for its underlying justification even if it does not sit in the centre of that question. The purposes of tax support its legitimacy even if they do not contribute directly to the question of who forms part of the tax base of a state.

The two main purposes of taxation are to fund government expenditure and redistribution of wealth.[184] These are generally accepted and broadly align to the benefit and sacrifice

[184] Murphy and Nagel, above n 132, at 76.

theories. The first objective, to fund the provision of goods and services, aligns with the benefit theory. Individuals pay tax and, in return, receive benefits. The second objective of taxation, that of redistribution, aligns more closely to the sacrifice theory. As a member of society, one has a duty to look after others – not directly but through the communal efforts of the state. However, redistribution has an element of individual benefit as well by raising the overall welfare of the state.

Funding government expenditures has been the fundamental purpose of taxation since the days of Hobbes and Locke. Both theorists refer to taxation in terms of the social contract between individual and the state – the state provides the individual protection and tax is the price paid.[185] This is the principle underpinning the original form of benefit theory.

It is the purpose of redistribution that is more interesting and controversial. Even in the 18th century, Adam Smith refers to the ability to pay principle – effectively endorsing the view that the wealthier should pay higher taxes.[186] However, the welfare state that has grown since the second world war takes redistribution to a much higher level.

2.3.1 Redistribution as a purpose of tax

With the growth of the welfare function of a state, taxation became a significant tool for redistribution. Snape regards the purpose of tax under the modern administrative state as to "instantiate and prioritize rival, inconsistent, and ultimately irresolvable conceptions of fairness and, in so doing, to repair inefficiencies in the process of economic growth".[187]

This modern conception of the purpose of tax is far more complex than that discussed centuries earlier by Hobbes and Locke. Far from the simple provision of public goods and services, justified by the benefit theory, taxation becomes a tool for redistribution of wealth and behavioural influence. This purpose aligns more closely with the sacrifice theory: redistribution as an objective of tax relies upon taxation being justified based upon the good of society overall, rather than provision of goods and services to individuals directly.

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[185] Hobbes, above n 130, at 85; Locke, above n 131, at Chp IX.

[186] Smith, above n 51, at book V, chapter II, part II.

[187] Snape, above n 127, at 28.

The purpose of redistribution leads to more complex questions around the objectives of redistribution and what fairness might look like. However, not all theorists agree that taxation should be used for redistribution.

Nozick aligns himself with the libertarian movement, and he argues that tax should only be collected to fund the most basic state provision, including government provision of defence and police, and the protection of property rights.[188] He believes in a fundamental premise of self-possession and the existence of inherent property rights. Nozick sets out two principles to establish whether property is held legitimately: the principle of justice in acquisition and the principle of justice in transfer. That is, provided property comes to the person either through a just claim on the initial holding or a just claim by transfer, then they have the right to retain that property.[189] The individual holds a fundamental right to that private property provided it comes about under one of his two principles of justice. He refers to this as his 'entitlement theory'.[190]

Specifically, with respect to taxation, Nozick makes the statement, "taxation of earnings from labor is on a par with forced labor".[191] He argues that if, as he states, individuals have a right over property they justly acquire, then taxation amounts to taking part of what has been legitimately earned and this equates to forcing an individual to work for free. He compares an individual who chooses to work longer hours to earn more than a basic income and someone who chooses to earn a basic income and enjoy more leisure time. He questions why the individual who chooses to work longer hours has their rights constrained while the person who does not work longer hours is free. On this matter, he says "seizing the results of someone's labor is equivalent to seizing hours from him and directing him to carry on various activities".[192]

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[188] Nozick, above n 113, at 149. He states: "The minimal state is the most extensive state that can be justified."

[189] At 151.

[190] At 150.

[191] At 169.

[192] At 169.

This reasoning forms the basis for Nozick's argument against distributive justice. Nozick presupposes the efficiency of the free market to determine a fair distribution of property. Nozick relates increased earnings to the choice to work more hours – hence his arguments regarding forced labour. However, this ignores that redistribution objectives are often there to address the inequalities between labour rates. This may, in part, reflect the growing inequality in the 50 intervening years since Nozick published his theories. His view also relies upon the premise that holding property is an inviolable natural right.[193] Further, it presupposes that a democratically elected government is not entitled to limit property rights beyond that of a basic defender state.[194] This view conflicts with that of other theorists. Nozick's view also is not consistent with the fact that taxation does not force an individual to participate in labour.[195] It only takes a portion of income earned from labour – these are not the same thing.

John Snape takes the view that the administrative state is, at its essence, a welfare state. He argues that taxes are not an infringement upon individual property rights as property rights are redefined under the conditions of an administrative state.[196]

Murphy and Nagel also explore taxation from the perspective of property rights in a modern administrative state. They argue that property rights cannot be conceived antecedent to the imposition of taxes.[197] As property rights are reliant upon the systems of state, tax is part of what defines property rights. Put another way, tax is *imposed* before the consideration of any property rights. Property rights only exist in the presence of the state – and taxation is one measure the state takes to define who gets what.

The difference between the argument of libertarians such as Nozick and the view of Murphy and Nagel comes down to the existence of pre-state property rights.

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[193] At 151.

[194] At 149.

[195] Although it is recognised that Nozick did not mean this entirely literally. He emphasises the use of the words "on a par" with forced labour in a footnote on p 169.

[196] Snape, above n 127, at 32.

[197] Murphy and Nagel, above n 132, at 7-8.

Despite the libertarian objection to taxation for redistribution, most modern states employ redistribution practices on top of the provision of public goods and services. In fact, for many states, the purpose of redistribution is constitutionally entrenched.[198] Italy, Spain and Germany have all included the ability to pay concept within their law. The question of progressivity of taxes and redistribution comes down to notions of justice – and this is, by its nature, a moral argument.

Redistribution may take the form of providing equal opportunity through education, healthcare and other social services, or it may be provision of a minimum standard of living.[199] It could take a utilitarian form by redistributing for maximum marginal utility,[200] or it could take the approach that redistribution has the objective of improving the lives of the least advantaged.[201] However, this chapter will not explore methods for distribution any further as it is outside the scope of the research question being addressed here. At this point, it is enough to observe that the redistribution purpose is widely accepted as a purpose for taxation and is employed by most OECD nations in their tax policy.[202]

2.4 Two schools of thought

So far, the research has observed two main theories for the justification of taxation and two main purposes of tax. There are links between them, and they can be distinguished as two schools of thought.

The first school of thought originates from the days of Hobbes and Locke and provides the foundations for the benefit theory: that is, taxes are paid in exchange for benefits received in the form of public goods and services. This theory is based upon an individualistic view of the state. The state and the individual have a contract for provision of goods and services in

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[198] Vanistendael "Legal Framework for Taxation" in Thuronyi (ed) *Tax Law Design and Drafting* (IMF, online ed, 1996) at 22-24.

[199] Murphy and Nagel, above n 132, at 88.

[200] Bentham, above n 151.

[201] John Rawls *A Theory of Justice* (Oxford University Press, Oxford, 1973 paperback edition).

[202] Perhaps excluding Turkey and Chile: See Joumard, Pisu and Bloch "Tackling Income Inequality: The role of taxes and transfers" (2012) *OECD Journal: Economic Studies* 3.

exchange for individual forfeiture of some rights. This is known as the social contract theory. Under benefit theory, the purpose of taxation is to fund the public goods and services enjoyed by participants of the state. On this basis, tax should be paid by those who benefit, regardless of citizenship or residence. Depending on the tax base (whether it be income or consumption, or landholding), benefit theory leans toward source-based taxation. That is, tax is paid where the tax base is located because of the benefits received.

The second school of thought evolved during the 19th century. This is the sacrifice theory whereby tax is justified on the basis of membership of a state. The view of the state is organic – the state acts in the interests of the whole body of people. This perspective of taxation considers the welfare of the whole group rather than on an individual basis. Often the burden of taxation is regarded as based on equal sacrifice from all members of the state. This theory lends itself to taxation based upon ability to pay and an overall objective of redistribution of wealth. Sacrifice theorists also lean toward taxation based upon membership or residency in that state.

In contrast to the justification for tax, the question of purpose is reasonably well settled – most theorists, practitioners and state officials would agree that the two purposes of funding public goods and services and redistributing wealth are the goals of taxation. Some libertarians will disagree, but the practice of most developed nations has been to adopt redistribution as one of the purposes for tax.[203] The justification for taxation is less obvious. Some theorists support the benefit theory while others support the sacrifice theory (or theories). Others, like Stein, follow neither of these theories.

As discussed above, a modern administrative state has elements of both the organic and individualistic view: that is, the state acts both as representative of the people and in the interests of the participants as a group. In acting as representative, the state provides benefits to individuals under a social contract. In acting in the interests of the group as a whole, the state redistributes wealth and provides goods and services that provide higher wellbeing outcomes overall. In an administrative state, the justification for taxation must be a combination of both the sacrifice and the benefit theories. Tax is justified both because of the benefits created by taxation and because of member's obligations to each other. However,

[203] Murphy and Nagel, above n 132, at 76.

this justification does not necessarily define who is included in the tax base: that is, who should pay tax in a state?

2.5 Determining who should contribute to the tax base of a state

This discussion is focused upon non-residents as the broader research question asks how inbound investors should be taxed. The inclusion of residents of a state within the tax base is less contentious. Whether a benefit or sacrifice theory justification for tax is adopted, those natural persons who inhabit that state will fall within the tax base, although the extent of their inclusion is debatable. These are the persons who visibly participate in the daily economic life of a state. On the other hand, a non-resident investor does not have a physical presence and so the question of whether they should be included in the tax base is less obvious.

An inbound investor may not be aware of his or her investment into another state. They may not be able to point that state out on a map, nor have visited it. For example, a resident of the United States may have investments in a pension fund that invests beyond the borders. They are participating in the economic life of the other state through their investment, so the question of whether they should be included in the tax base is raised. While they may gain from a financial investment in that other state, they are not present and do not consume in the state. The question of a non-resident's inclusion in the tax base will depend upon how taxation by a state is justified.

2.5.1 Taxing non-residents and benefit theory

The sacrifice and benefit theories are used as the basis for justifying or denying taxing rights over non-residents. In the case of the benefit theory, where benefits arise to an individual or entity, a tax liability is justified. In the case of sacrifice theory, an obligation arises where the individual or entity is a member of that community.

According to some theorists,[204] taxing non-residents can only be justified using the benefit theory. Pigou argues that while a resident of a state enjoys both protection of income and protection of his or her person, a non-resident investor only enjoys protection of income. For this reason, he regards the taxation of non-residents on the same basis as residents as

[204] Pigou, above n 99, at 172; Stamp, above n 99, at 139.

potentially exploitative and ethically indefensible.[205] Pigou states that taxation of non-residents should not exceed the value of the services provided.[206]

In 1918, the US legislature enacted the foreign tax credit, recognising that tax would be imposed at source on the foreign investments of its residents. This is credited to the policy design work undertaken by Thomas Sewall Adams.[207] Adams believed taxation should be imposed upon businesses in the jurisdiction in which the business takes place because "it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market".[208] In effect, Adams is justifying taxation of inbound investors on a benefit theory basis.

Like Adams, Seligman (along with Bruins, Senator and Stamp) viewed source-based taxation as bound in benefit theory.[209] However, unlike Adams, Seligman believed the benefit theory was a relic of the past. He saw modern tax policy proceeding based on the ability to pay and the principle of personal faculty: he favoured taxation based upon the residence of the taxpayer and not the source of the income.[210]

In a late 20th century analysis, Vogel rejects the sacrifice theory in justifying taxation upon non-residents and reverts to benefit theory.[211] He argues that sacrifice theory may have been acceptable when tax rates were relatively low, but it is no longer a viable justification.[212] Vogel argues in a modern state, "its claim for taxes is legitimized...because taxation returns to

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[205] Pigou, above n 99, at 172–173.

[206] Pigou, above n 99, at 172; Stamp, above n 99, at 139.

[207] Graetz and O'Hear "The "Original Intent" of U.S. International Taxation" (1997) 46.5 *Duke Law Journal* 1020 at 1045.

[208] Thomas Adams "The Taxation of Business" (1917) 11 *National Tax Association Proceedings* 185 at 186.

[209] Bruins, Einaudi, Seligman and Stamp *Report on Double Taxation: Submitted to the Financial Committee* (League of Nations, 1923) at 40.

[210] Bruins, Einaudi, Seligman and Stamp, above n 209.

[211] This is stated directly in Vogel's "Worldwide vs Source taxation", above n 92, at 394-395 where he refers to his article Vogel's "A Forgotten Question", above n 91.

[212] At 20.

the state a portion of the economic value that the State for its own part has assisted in producing".[213] While Vogel takes a benefit theory approach, he does not believe a quantification of benefits received per individual is required. His version of benefit theory relies upon a broader concept of reciprocity.[214] Vogel goes further and argues that as taxation is only legitimised through receipt of benefits, this undermines taxation of residents' worldwide income. Vogel supports taxation on a territorial basis.[215]

Wolfgang Schön raises the problem that inbound investors "cannot be expected to show the same degree of solidarity as a local citizen".[216] In other words, a non-resident may regard taxation in a host state as just the cost of operating in that country without having a commitment to the welfare of the host state. While this may explain a non-resident's unwillingness to be taxed, it does not necessarily deny a state the right to tax these investors.

Elkins considers this issue in relation to taxation of non-resident corporates.[217] He argues that the underpinning principles of sacrifice or ability to pay theory are based upon redistribution objectives – that is, those who can afford to pay more should pay more for the benefit of those who do not. Elkins argues that these principles are inherently human and corporations are simply a means of furthering human welfare.[218] Given the distributive justice basis for taxation, residence as a concept is only really applicable to a natural person and trying to attribute residency to a corporate entity is irrational.[219] This is particularly relevant to inbound investors who usually operate through corporate vehicles in foreign jurisdictions, and often are only subject to the corporate taxation in the host country.

Theorists find it challenging to justify the inclusion of non-residents in the tax base using the sacrifice theory. Justification for tax using the sacrifice theory relies upon a membership or,

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[213] At 57.

[214] At 57.

[215] Vogel's "Worldwide vs Source taxation", above n 92, at 403.

[216] Schön, above n 133, at 298.

[217] David Elkins "The Myth of Corporate Tax Residence" (2017) 9.5 *Colombia Journal of Tax Law* 5.

[218] At 27.

[219] At 24.

as Schön describes it, a solidarity. With solidarity comes an emotive connection and a sense of belonging that one might get as a resident or citizen of a nation. We therefore find taxation based upon residence often justified on the basis of sacrifice theory and taxation of non-residents based upon benefit theory. Effectively, we have two theories being utilised to justify taxation depending upon the situation. While benefit theory is used to justify the imposition of source taxation, ability to pay is used to determine how much tax will apply. This position has been described as unsustainable.[220]

There is little doubt that non-resident investors receive benefits from host country states. These are difficult to measure and impossible to attribute to their recipients – however, the benefits almost certainly exist. The problem with using benefit theory to determine who is included in the tax base is that it imports a sense of duty on the part of the state to provide value to its non-resident taxpayers. Determining who is included in the tax base based on benefits received, even if a broad interpretation of benefits is taken, imports a sense of owing or quid pro quo. This seems to run counter to the modern conception of taxes as one-sided transfers.

2.5.2 Taxing non-residents and 'internation' equity

Kaufman argues source taxation may not rely strictly on a benefit theory approach.[221] Rather, it is a question of a state's competence to tax: that is, does the state have a moral or theoretical right to tax the income derived by non-residents within its jurisdiction. This question is not bound in benefit theory but in the concept of internation equity: does the host country have a right to tax income derived in their state because of its fiscal interest in the income?[222]

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[220] David Elkins "The case against income taxation of multinational enterprises" (2017) 36(2) *Virginia Tax Review* 144.

[221] Nancy Kaufman "Fairness and the taxation of international income" (1998) 29(2) *Law and Policy in International Business* 145 at 202.

[222] At 183.

Peggy Musgrave (or Richman as she was) introduced the concept of internation equity in 1963.[223] Up to that point, theorists had been concerned only with equity between individuals, especially within a state. However, Musgrave identifies the problem of equity between nations where residence taxation is favoured. As capital exporting countries will be the wealthier states, favouring residence taxation and limiting source-based taxation keeps the tax revenue in the wealthier states, reinforcing the lack of equity between nations.

If source taxation is couched in terms of a host country's right to tax based upon the fiscal interest in the income rather than the benefits it provides, this alters the basis for a host country's justification for taxing non-residents. Musgrave and Kaufman shift the focus from the rights of the taxpayer toward the rights of the state.

This change in perspective is fundamental. Benefit theory justifies the imposition of tax based on the benefits the taxpayer receives. Sacrifice theory justifies taxation based on the obligations of a member of the state. They are not mutually exclusive ideas. However, neither have proved to be satisfactory for determining who and what is included within a state's tax base. Kaufman argues the allocation of taxing rights between states relies upon a competence to tax.[224] The question in this chapter is how we determine this competence to tax. We will return to this question in part 2.6 after examining the role of the doctrine of economic allegiance in relation to the residence and source principles established in the 20th century.

2.5.3 Doctrine of economic allegiance

The concepts of residence and source, based on the doctrine of economic allegiance, have been developed to allocate taxing rights between states. During the 1920s, the League of Nations was established and part of its remit was to "remove the evil consequences of double taxation."[225] They focus on how states should share these taxing rights on income derived in one jurisdiction by residents of another jurisdiction. Their work went on to form the basis for global bilateral tax agreements.

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[223] Peggy Brewer Richman *Taxation of Foreign Investment Income: An Economic Analysis* (John Hopkins Press, 1963).

[224] Kaufman, above n 221.

[225] Bruins, Einaudi, Seligman and Stamp, above n 209, at 5.

The report of the Four Economists concludes that citizenship (or political allegiance) is not the best basis for applying taxation as "in modern times", people may live abroad and any loyalty to the old country may disappear.[226] In other words, the beginnings of globalisation were apparent even then. They recommend a preferred basis for determining if a right to tax income exists is the doctrine of *economic allegiance.*[227] However, there is little discussion on the principle of economic allegiance itself with the focus being on its application. According to the report, economic allegiance can be found in any of four places that may have an interest in the wealth that is subject to tax. These are (1) the origin of the wealth; (2) the situs of the wealth; (3) the enforcement of the rights to wealth; and (4) the residence or domicile of the recipient of the wealth. The report concludes that the first and fourth elements are the most significant in determining where taxing rights arise: the source of the wealth and the residence of the recipient of the wealth. Hence, we have the inception of residence and source principles.

The Report allocates these taxing rights between the residence and source countries in order to avoid double taxation on the same income. It categorises various forms of wealth accumulation according to whether primary taxing rights should be allocated to the source state or the residence state. The Four Economists recommend business and land-based income be taxed on a source basis while income from personal property and personal exertion be taxed on the basis of residence of the recipient.[228] Despite the formation of a doctrine of economic allegiance, the conclusions of the report largely favour taxing rights remaining with the residence state, except to the extent the income is from land or a business conducted in another state.

The principles laid down in the Four Economists' Report have not remained static. Taxation of investment income and personal exertion are usually taxed at source prior to taxing on a

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[226] Bruins, Einaudi, Seligman and Stamp, above n 209, at 21. The doctrine of economic allegiance was developed earlier by a German scholar, Schanz (see Klaus Vogel "Worldwide vs source taxation Part I" (1988) 8-9 *Intertax* 216 at 219). However, Schanz sought to share taxing rights between residence and source nations on arbitrary bases such as allocating three quarters of the income to a source country and the remaining quarter to the country of residence.

[227] Bruins, Einaudi, Seligman and Stamp, above n 209, at 20.

[228] Bruins, Einaudi, Seligman and Stamp, above n 209, at Part II, section II.

residence basis, contrary to the recommendation in the report.[229] Usually, personal exertion is taxed in the jurisdiction in which the services are performed. Dividend and interest income are usually subject to a limited tax in the country of source, prior to their repatriation to the country of the recipient's residence. Source-based taxation, and taxation of non-residents, has persisted.

The residence and source principles have had a sustained influence on how the tax burden of an individual taxpayer should be shared between the tax jurisdictions in which he or she has an economic interest. However, the doctrine of economic allegiance, to the author's knowledge, has not been further developed to address the underlying legitimisation of a state's right to tax a non-resident.

More recently, the European Commission's approach to the allocation of taxing rights is that taxation should apply where "value is created".[230] Some commentators have declared the concept of value creation is a profound elaboration of the economic allegiance doctrine.[231] Others, however, have suggested it is simply a development of the existing benefit theory.[232] The concept of value creation is referred to briefly in the latest work undertaken by the OECD on the taxation of multinational digital businesses.[233] However, it is by no means emphasised as the basis for the allocation of taxing rights. Rather, it is the participation in the economic life of market jurisdictions that forms the basis for the proposed allocation of taxing rights.[234]

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[229] See Articles 10, 11, and 15 of the OECD Model Tax Convention, above n 117.

[230] European Commission *Communication from the Commission to the European Parliament and the Council* (COM, Brussels, 21 March 2018) at 4. This has been reinforced by the OECD: OECD *Action Plan on Base Erosion and Profit Shifting* (OECD, Paris, 2013) at 14.

[231] Jinyan Li, Nathan Jin Bao, and Huaning Li "Value Creation: A Constant Principle in a Changing World of International Taxation" (2019) 67(4) *Canadian Tax Journal* 1107.

[232] Craig Elliffe *Taxing the Digital Economy: Theory, Policy, and Practice* (Cambridge University Press, Cambridge, 2021) at 41.

[233] OECD blueprints for pillar one and two, above n 19.

[234] Above n 19, at [187].

2.6 Legitimising tax based upon economic participation

At the beginning of this chapter, Lorenz von Stein was introduced, whose work on the justification for taxation has been analysed and introduced to the English-speaking world by Klaus Vogel.[235] Stein argues the entire justification for tax is based upon the justification for the state.[236] When a state imposes tax beyond its own justification, then it is operating outside its boundaries. This justification for tax legitimises a state's imposition of taxation without obligation other than to operate within the parameters of the state's raison d'être. In putting forward his rationale for taxation, Stein rejects both the benefit and sacrifice theories.[237]

There are two aspects to Stein's reasoning. First is his reliance upon the purpose of the state to justify taxation. This can help to determine who falls within the tax base of a state. Second is his rationale that a state's right to tax is not unlimited. To the extent the state collects tax for activities outside its own purpose, it acts ultra vires. The purpose of this chapter is to provide a theoretical underpinning for the taxation of non-residents. Therefore, it is the first aspect of Stein's rationale that is relevant here.

As Stein argues, taxes originate from the development of the state and are therefore because of, and reliant upon, the existence of the state.[238] As taxes exist only because the state exists, a state must have a legitimate right to impose tax upon those who form part of and take part in the state.

Organisation through states is the accepted form of modern society and no corner of the globe lives in a 'state of nature' without organisation. Murphy and Nagel describe members of a state as "beings formed by a civilization and leading lives that would be inconceivable without it".[239] That is, we accept that being organised into communities has allowed us to develop in ways that would not have been possible in a natural state.

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[235] Vogel, above n 91, at 38.

[236] At 40.

[237] At 39.

[238] Per Vogel, above n 91, at 40.

[239] Murphy and Nagel, above n 132, at 42; For more discussion on the alternative to an organised state, see Nozick, above n 113.

A state's role is to enable human progress and improve wellbeing through organisation.[240] A state "concerns itself with whatever appears to hold humans together as a collective institution".[241] The administrative state not only provides law and order but a much-expanded range of activities "for furthering economic and social development, managing the economy, and providing welfare for their citizens".[242]

While a state has a role in regulating social and political organisation, the main purpose of the state is to manage the economy, in the widest sense. The economy may be described as a system of production, distribution, trade, and consumption of goods and services.[243] Therefore, the economy will include those interactions between humans that serve the objective of human progress. The economy is enabled by the existence of the state. Tax, at its essence, redistributes financial resources around the economy and is the main source of funding for the entire government sector. It takes from some areas of the private sector, invests in public infrastructure, and redirects resources to other areas of the private sector. Taxation is a fundamental component of a state's economy.

Therefore, it stands to reason that it is participation in the state's economy that should form the basis for who is included within the tax base. As taxation serves the purposes of the state, it is those participating within the state that should be included in the tax base of the state. This includes those participants who fall into the category of non-residents.

This rationale forms the basis for economic participation to determine who is included in a state's tax base or perhaps, more accurately, who a state can exercise taxing rights over. This could be a wide group of persons, both natural persons and corporate. For example, an economic participation occurs when a person makes sales of products or services into a state or when they purchase products or services from a state. While the state may not choose to tax all persons that fall within this group, their economic participation in the host state means

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[240] Vogel, above n 91, at 39, quotes Lorenz von Stein as having stated that the state contributes "order and measure" to economic progress.

[241] Loughlin, above n 182, at 435.

[242] Loughlin, above n 182, at 435.

[243] Cambridge Dictionary defines "economy" as "the system of trade and industry by which the wealth of a country is made and used".

they become part of the economy of that state, giving the state a legitimate right to include them within their tax base.

While the focus of this thesis is broader than digital business, this is an area of the global economy that has been subject to scrutiny with regard to taxation in recent years. Digital businesses, in particular, can easily avoid taxes by minimising physical presence in jurisdictions that seek to impose taxes based upon traditional residence and source principles.[244] Beyond digital business, other businesses have successfully avoided large amounts of tax by shifting their valuable intellectual property to low-or-no-tax jurisdictions.[245] The OECD and governments around the world are waking up to the limitations of physical residence and source principles for determining taxing rights.[246] The OECD blueprints on taxation of digital business seek to allocate new taxing rights to the profits of large multinationals across the jurisdictions in which they operate: a "unified approach". The basis for the new taxing right is explained as follows:[247]

> The existing international tax rules generally attach a taxing right to profits deriving from a physical presence in a jurisdiction. However, given globalisation and the digitalisation of the economy, businesses can, with or within the benefit of local physical operations, participate in an active and sustained manner in the economic life of a market jurisdiction, through engagement extending beyond the mere conclusion of sales, in order to increase the value of their products, their sales and thus their profits. Such participation is attributable to the nature of what is being supplied, how it is being supplied and the active interaction or engagement with market jurisdictions. This means that the allocation of taxable profits can no longer be exclusively circumscribed by reference to physical presence.

The existence of the proposed new taxing right relies upon a sustained participation in the economy of a state. The blueprints attempt to find pragmatic solutions to ensuring profits of these large multinational enterprises are taxed. What is of most interest here is the determination of a taxing right based upon the economic participation in a state. The justification in the blueprint is that the derivation of profits can come about through the

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[244] OECD blueprints for pillar one and two, above n 19.

[245] Examples include Apple Inc, Microsoft, Google.

[246] OECD blueprints for pillar one and two, above n 19.

[247] At 19.

participation in the economic life of a jurisdiction. It is not clear how this principle has come about. However, it is a significant shift from the residence-based recommendations made by the Four Economists a century ago.[248]

The extension of Stein's rationale in this thesis to justify the state's tax jurisdiction based upon those who are economic participants in the state is consistent with the principle adopted by the OECD to support their new taxing right in the Pillar one and two blueprints.

Economic participation, in its effect, incorporates both residents and non-residents who conduct business and other economic activity in the state. Economic participation may arise either through a natural person's physical presence in the state, as a consumer and worker, or through the choice to invest in business in the state, or to distribute and trade within that state.

At its essence, the principle of economic participation supports source-based taxation of non-residents. How the allocation of the tax burden should apply to non-residents will be discussed further in chapters three and four.

2.7 Conclusion

This chapter examines the theoretical justification for taxing non-residents. Typically, this question has been observed with reference to the benefit and sacrifice theories. These theories have been used to support an even wider ambit of questions such as why tax is imposed, who tax is imposed upon and, sometimes, how tax should be allocated across the tax base. However, in determining who should form part of the tax base of a state, some theorists have difficulty applying the existing theories to non-residents.[249] While there is a practice and expectation that non-residents should be taxed in the host state, justifying their inclusion is often on the basis of the benefit theory, while justifying the taxation of residents often relies upon the sacrifice theory.

The benefit and sacrifice theories both provide sound bases for the justification for taxation. Undoubtedly receipt of benefits justifies the imposition of tax, and benefits are enjoyed widely in a modern state. Equally, the sacrifice theory validly imposes an obligation upon a

[248] Bruins, Einaudi, Seligman and Stamp, above n 209.

[249] See the discussion above at 2.5.1.

‘member’ of a state to pay tax. However, globalisation has made the determination of who is a ‘member’ more complex.

This chapter, while accepting the validity of both the benefit and sacrifice theories, applies a different basis for determining who is in or out of the tax base. The ‘new’ basis for justifying a state’s taxing right over a person is ‘economic participation’. Those who participate in the economic life of a state are legitimately included within the tax base of the state. Potentially, this group could be the same group who enjoy the benefits and hold the obligations under the benefit and sacrifice theories.

This new basis is perhaps reminiscent of ‘economic allegiance’. However, the economic allegiance doctrine has never been well established, developed, or understood. While referred to by the “four economists”, their recommendations seemed more pragmatic than theoretically consistent with the doctrine.[250]

This chapter relies upon two sources for the establishment of the economic participation basis. First, the work of Lorenz von Stein, as interpreted by Klaus Vogel, imports the notion that the justification for tax should be based upon the justification of the state more broadly.[251] Second is the work undertaken by the OECD in determining taxation of digital businesses in a multinational context.[252]

The purpose of a state is not clearly defined and is highly subjective. However, there is broad support that the goal of improving human wellbeing forms a central objective. [253] This might come about through protection of people and property. It also comes about through human progress achieved through segregation of work and organisation. Taxation supports the goals of the state and it is these goals that provide the justification for tax, according to Stein. For the purpose of this thesis, where a person participates in this communal organisation (the state), this is the only justification required to include that person within their tax base. This communal organisation for human progress is the economy of the state.

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[250] See the discussion above in 2.5.3.

[251] Vogel, above n 91, at 38.

[252] OECD blueprints for pillar one and two, above n 19.

[253] See the discussion above in 2.6.

It is this basis that the OECD has used to determine the new taxing right where digitally based businesses operate across multiple borders. In determining the allocation of taxing rights, the OECD has created new "rights" according to the economic participation of the multinational in the state – including where the business is marketing and making sales in the state.[254]

This thesis proceeds on the basis that a state has a legitimate right to tax a person, including a non-resident, where that person participates in the economy of the state. The next chapter establishes a framework for how the tax burden should be distributed amongst the tax base.

[254] OECD blueprints for pillar one and two, above n 19, at 19.

3 A normative framework for tax policy setting in New Zealand

3.1 Introduction

In addressing the question of how New Zealand should tax its inbound investors, a standard or norm must be applied against which an assessment of the tax settings can be made. This is the purpose of this chapter – to establish a normative framework upon which to make this assessment.

In late 2017, the newly elected government of New Zealand established a working group to consider the "structure, fairness and balance" of the tax system.[255] Like working groups preceding them, they needed a framework upon which to make their assessment. This working group used the traditional canons established by Adam Smith, and adapted for modern conditions by subsequent groups and commentators. They were also introduced to New Zealand's relatively recent multidimensional policy-making framework: the Living Standards Framework ("LSF").[256] This working group used both traditional tax assessment criteria and the LSF to assess the existing tax system and to support their recommendations.[257]

While the tax working group used the multidimensional wellbeing framework and the traditional tax criteria side by side, there is little doubt there is room to redefine our tax assessment criteria. While the traditional tax canons have been used for two and a half centuries, recent decades have seen these altered in line with our changing economic environment. This chapter focuses on the expansion of the traditional efficiency canon to include the objective that tax should not inhibit economic growth. Alongside this, the emergence of multidimensional wellbeing frameworks has added further complexity to tax policy design.

Tax design involves determining the tax base and tax rates. The tax base is what and who is subject to taxation. The tax rates determine how much tax is taken from the tax base. These

[255] TWG report, above n 112, at 7.

[256] LSF, above n 50.

[257] Inland Revenue Department and The Treasury "Tax Working Group Assessment Framework: Decision Paper for Session 3 of the Tax Working Group" (February 2018) at 4.

decisions are the result of much bigger questions of tax policy design. First, a government needs to decide how much revenue it requires to fulfil its spending and redistributive obligations. Within this decision are underpinning philosophies around how much wealth should remain in the private sector and how much can be better utilised in the public sector. The second major decision within tax policy setting is how the tax burden should be shared amongst the members of the private sector. Essentially, the question is who should pay how much – should some people pay more tax than others or should the burden be shared equally? These significant decisions are assisted where there is a framework within which to operate.

This chapter introduces a modern tax policy framework derived from the existing frameworks and incorporates the objectives of New Zealand's LSF. The framework employs two significant tax policy principles underpinning the development of substantive law: fairness and prosperity. Fairness is not new. It has been a consistent feature of all policy frameworks since Adam Smith's articulation of his four canons, although its interpretation is constantly evolving. Prosperity is new. This chapter will discuss the development and the application of the prosperity objective.

The chapter is in several parts. Part 3.2 considers the historical development of the tax policy setting frameworks in New Zealand. Part 3.3 examines the objective of fairness in tax policy setting. Part 3.4 argues that economic growth is not a suitable objective for tax policy setting, despite its recent prevalence in tax policy development. Part 3.5 argues that prosperity is a better alternative objective for tax policy setting. Part 3.6 introduces the proposed tax policy framework using the dual principles of fairness and prosperity.

3.2 Development of tax policy frameworks

3.2.1 Adam Smith and his four canons for a good tax

Adam Smith was an 18th-century Scottish economist. He is considered by many to be the "father of economics" after writing his magnus opus, *An Inquiry into the Nature and Causes of the Wealth of Nations*, first published in 1776.[258] Smith is perhaps best known for his reference to the "invisible hand" that guides the free market without the need for government intervention, a principle still referred to frequently by neo-classical economists.

[258] Smith, above n 51.

In his treatise on taxation, Adam Smith contributed four principles that remain relevant and widely used today by policy setters globally. These four principles are abbreviated as follows:[259]

> I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.
>
> II. The tax which each individual is bound to pay ought to be certain, and not arbitrary.
>
> III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.
>
> IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.

These four canons are referred to as equity, certainty, convenience, and efficiency.

The first canon we refer to is the principle of equity. This canon is divided into two sub-aims of vertical and horizontal equity.

Vertical equity derives from Smith's statement that subjects of the state should contribute "in proportion to their respective abilities". Smith is stating that the proportion of a subject's income that is paid in tax should be increased as revenue increases. Smith justifies proportional tax on the basis that a taxpayer's revenue is only enjoyed because it receives protection of the state; the higher the income, the more protection received.

Horizontal equity ensures that taxpayers in the same financial position are taxed in the same amount.

The second and third canons, certainty, and convenience, are vital for an effective tax system but subject to less contemporary analysis because of the modern legal framework and tools available. The canon of certainty refers to the notion that subjects of a state must have certainty around the amount of tax they have to pay and how this must be paid. Given the

[259] Smith, above n 51, at book V, chapter II, part II.

detailed codification of tax laws, certainty is a foregone conclusion.[260] The third canon of convenience, that is taxes need to be imposed when the subject has the wherewithal to pay, may be relevant where taxes are imposed upon unrealised income. However, generally, taxes are imposed upon realised gains.

The last canon is known as 'efficiency'. Essentially, the principle of efficiency refers to the cost of complying with the tax law - both from the perspective of the tax collection agency and the taxpayer. Those costs may come in the form of tax collectors, inefficient business choices, costs of compliance, or avoidance activities. An example is where a tax is imposed upon one activity and not another; then investors may choose to invest in the non-taxed activity over the taxed activity, possibly to the detriment of the economy. Where tax distorts investment decisions, it will prevent an economy from operating at optimal performance.

The following sections will examine the canons of equity and efficiency in more detail.

3.2.1.1 The development of Adam Smith's canon of equity

The longer form of Adam Smith's canon of equity is:[261]

> The subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation.

Smith's statement remains true even today – tax is an obligation to contribute to the expense of the nation. How that burden is shared is the subject of the canon of equity. Smith suggests the tax expense be allocated in proportion with the revenue derived by the taxpayer and protected by the state. He does not elaborate further on how this allocation might be made. He does, however, state that failure to observe this maxim results in inequality of taxation.

Equity is simply about fairness. While the concept is simple, it is complex to apply. Sharing the tax burden fairly is highly subjective. One person may believe tax should be shared

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[260] While it is recognised that there are many areas of tax law where different positions may be taken, on the whole the tax system is clear and certain for most taxpayers.

[261] Smith, above n 51, at book V, chapter II, part II.

equally like a poll tax, while another may believe only the wealthiest one per cent should bear the whole tax burden.

Modern tax design is always evaluated according to its 'equity' or 'fairness'.[262] While it is recognised that modern tax principles derive from Smith's canons, as is to be expected, these canons have been developed to fit into modern society. In the last sentence of Smith's statement on equity, he refers to the canon as the maxim of 'equality'. Equity and equality are not the same things. However, given the references Smith makes to ability to pay, it seems our modern understanding of equity is what he refers to.[263] It is universally accepted that tax should be equitable, but there is no universal understanding of what that means.

As mentioned above, equity is broken down in tax analysis into horizontal equity and vertical equity. Horizontal equity, although subject to some debate,[264] is quite straight forward to understand. Those in the same economic position should be treated equally. Vertical equity, on the other hand, is more complex. Vertical equity can be interpreted in many ways and goes to the heart of taxation as a means of redistribution. It can be implemented as proportionate tax rates, meaning the tax burden increases proportionately with an increasing tax base. Or it can be interpreted as progressive tax rates, where the proportion of tax increases as the tax base increases. This will be discussed next.

Vertical equity, ability to pay, and progressivity

Since Smith's time, the 'ability to pay' principle has continued to be accepted when discussing an equitable distribution of the tax burden. However, while the principle gains ready acceptance in its theoretical form, it is more difficult to put into practice. As stated above, ability to pay can mean proportionate tax rates or progressive tax rates. Equally, it could mean some people pay and some do not.

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[262] TWG report, above n 112, at 28; Adam, Besley et al. *Tax by Design: The Mirrlees Review* (Oxford University Press, Oxford, 2011) at 33.

[263] Note that Smith is a proponent for Benefit Theory and his reference to "ability to pay" is not a reference to the Sacrifice Theory: Seligman, above n 97, at 165.

[264] A good discussion on whether horizontal equity is a concept distinct from vertical equity is found in McDaniel and Repetti "Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange" (1993) 10(1) *Florida Tax Review* 607.

When Smith referred to ability to pay, he appeared to have in mind a proportionate tax imposition: that is, tax should be a fixed proportion of income derived, regardless of the amount of income derived. There are two statements that lead his readers to this conclusion. First, in his statement on the canon of equity, he refers to the contribution of tax being 'in proportion' to each taxpayer's revenue, leading to an assumption of a proportionate tax.[265] Secondly, Smith implies a 'benefit theory' justification for tax: that is, tax is justified based on an individual's enjoyment of the protection of the state, with specific reference to the protection of one's revenue. This implies tax must be proportionate with the income being protected. This justification for taxation implies one's tax liability is for benefits received – a quid pro quo relationship.

Since the 19th century, many theorists have rejected the benefit theory in favour of sacrifice theory.[266] The concept of 'sacrifice' is used to determine 'ability to pay':[267] hence the sacrifice theory aligns with a distribution based upon ability to pay. Whereas the benefit theory justifies tax based upon benefits received by the taxpayer, the sacrifice theory justifies tax based on membership of the state alone.[268] Sacrifice theorists, on the whole, support taxation as a means of redistribution.[269] This justification lends itself to progressive tax rates as a means of redistribution.[270]

In 1848, John Stuart Mill discussed vertical equity in his version of sacrifice theory.[271] He says, "equality of taxation… means equality of sacrifice".[272] The foundations laid down by Smith are developed for use within the context of sacrifice theory. Mill argues that a

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[265] Smith, above n 51, at book V, chapter II, part II.

[266] See the discussion above at 2.2.4.

[267] For an analysis of "sacrifice" and different approaches, see Slade Kendrick "The Ability-to-Pay Theory of Taxation" (1939) 29(1) *The American Economic Review* 92.

[268] See discussion above at 2.2.4.

[269] Vogel, above n 91, at 30.

[270] Vogel, above n 91, at 30; Seligman, above n 97, at 292-293.

[271] Mill, above n 173, at Book V, Chp II, §2.

[272] At 927.

proportionate tax can be more burdensome for those on lower incomes and he recommends tax only apply to incomes above subsistence level.[273] Beyond the tax-free threshold, Mill advocates against progressive taxation on the basis that it is counterproductive for commerce.[274]

It is Seligman's influential work in the early 20th century, that provides strong support for progressive taxation.[275] While acknowledging that proportional taxation provides greater certainty, and progressive tax settings are less certain, Seligman concludes that it is better to have less certainty but increased justice than certainty with greater injustice. Seligman states that the burden of proportional taxation upon 'the poor man' is untenable and therefore, progressive taxation is essential for fairness and consistency with the ability-to-pay theory of taxation.[276]

As the 20th century progressed, commentators mainly favoured progressive tax systems.[277] While earlier theorists such as Smith support proportional taxation to achieve equity, later theorists, overall, support progressive tax rates.[278] The movement away from proportionate tax systems is consistent with other changes regarding the place of tax in society. The changing justification for taxation away from benefit theory and toward sacrifice theory, alongside the modern purpose of tax to redistribute wealth, shows a shift in the role of taxation in society. Equity is no longer about equality, but about using tax as a tool for redistribution. This is best achieved with a progressive tax system.

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[273] At 930.

[274] At 931.

[275] Seligman, above n 97.

[276] At 294.

[277] Pigou, above n 99; Vogel's A Forgotten Question, above n 91.

[278] Not only do theorists move toward supporting progressivity in the tax system, but also Seligman's analysis of worldwide tax systems concludes that there is a global movement toward progressivity: Seligman, above n 97, at 124.

3.2.1.2 The development of Adam Smith's canon of efficiency

The other canon that still stands as a pillar in tax policy development is Smith's principle of efficiency. Smith states:[279]

> Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have derived from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression.

Inefficiency, according to Smith, may come about in any of these four ways. Where the cost of tax collection or the oppression of tax audits is too costly, it may not be worth the tax collected. Smith also raises the potential for tax to encourage people to make inefficient choices in order to avoid a tax cost. This is often referred to as the principle of neutrality in modern tax analysis. Tax policy makers ideally make policy that does not influence economic decisions unless a specific outcome is desired.[280] Smith also refers to the potential inefficiency of taxation and the related penalties of non-compliance having a negative impact on the economy.

Efficiency is multi-faceted and is often interpreted as providing a taxpayer friendly defence against 'unjust' taxes. Some of the situations Smith describes are obvious. There would have to be a very good reason to introduce a tax that costs as much to collect as the tax that is collected. It is possible that this might be done to encourage taxpayers to make different choices. Possibly in a modern context, with the proliferation of tax avoidance, Smith's

[279] Smith, above n 51, at book V, chapter II, part II.

[280] For example, policy makers may introduce duties on imported goods to encourage the use of domestic goods.

statements on the oppression of tax audits or the potential loss of business through tax evasion penalties may be met with less sympathy.

The concept of neutrality generates significant interest, particularly in the area of international tax policy setting. That is, tax should not divert resources toward less productive activities.

Neutrality

The objective of neutrality is that tax should not influence taxpayers' decisions or choices. Where the imposition of taxation affects taxpayers' choices, this may result in sub-optimal decision making. Decisions should be made free of tax considerations in order to produce the best results for society and the economy. For example, an individual would like to buy an apple. There are two apples available. One is a Granny Smith, and the other is the far more delicious Gala. Both apples have a cost of 50 cents. However, the Gala apple has a goods and services tax upon it of 20 per cent, whereas the Granny Smith does not. With the tax, the Gala apple becomes 60 cents. The taxpayer may choose the Granny Smith because it is cheaper, resulting in a less enjoyable experience for the taxpayer and encouraging further production of the inferior apple. The arbitrary imposition of this tax means the better apple remains unsold while the customer has a less than optimal experience. A neutral tax imposition should avoid these situations.

In the context of international taxation, several neutrality concepts have been developed, including capital import neutrality and capital export neutrality.[281] These concepts require that capital export and import decisions should be neutral regarding tax. Sometimes specific neutrality objectives cannot be achieved in tandem.[282] It is possible, depending upon the reasons for taxation, that one or more of these neutralities may be prioritised. These conflicts between neutralities are a reminder that the broader objective of efficiency is that tax should have as little distortionary impact as possible in order to optimise economic decision-making.

[281] Brewer Richman, above n 223.

[282] Capital import and export neutralities are regarded as inconsistent with each other: Thomas Horst "A Note on the Optimal Taxation of International Investment Income" (1980) 84 *Q.J. Econ*. 793.

3.2.2 Expansion and adaptation of the four canons by tax review groups

All tax policy development in New Zealand continues to use Adam Smith's four canons as the basis for evaluation. Equity and efficiency consistently appear in every policy framework in tax policy documents produced by government policy advisers and by the review groups that have evaluated the tax system.[283] There have been several tax reviews that have taken place in New Zealand, with the earliest being in 1922.[284] This chapter will look at the policy-setting frameworks used by these groups over the past half-century, starting with the Ross Review in 1967.

3.2.2.1 The Ross Review

The 1967 Ross Review was mandated to "carry out a comprehensive review of the rates, structure, and incidence of the whole field of central Government taxation".[285] The review considered the future of the tax system in light of continued revenue needs and the desire to promote economic growth and stability. The review relied on Smith's canons of equity, efficiency, certainty, and convenience, but repackaged convenience and certainty into "administration and public acceptance".[286] Public acceptance recognises that public opinion matters for voluntary compliance.

The Ross Review focused on the issues most relevant to the time. They called for simplification of the income tax system by reducing concessions and reducing the complexity of the tax rate scale. They also called for the introduction of a fringe benefit tax and a capital gains tax, increased sales taxes, retention of estate duties, amongst other suggestions.[287] These recommendations are issues of equity.

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[283] This is discussed and examined in this part of the thesis.

[284] See Adrian Sawyer "The Contributions of Tax Committees: A New Zealand Perspective" (Tax Administration Research Centre (TARC) Annual Conference, April 2018) for an analysis of New Zealand's tax committees up to 2018.

[285] Lewis Ross et al. *Taxation in New Zealand: Report of the Taxation Review Committee* (RE Owen, Wellington, October 1967) at 8.

[286] At 12–13.

[287] The recommendations are summarised at pp 433-453 of the Ross report, above n 285.

The Ross Review group recognise the role of taxes in redistribution of wealth and emphasise the importance of equity.[288] The group also recognise the use of taxes to encourage "the optimum allocation and use of resources to achieve national economic objectives".[289] This reflects a tension in tax policy development where it should both avoid interference in investment choices while also maximising attainment of the nation's economic goals.

The Ross Review group made their recommendations with an emphasis on equity and redistribution of wealth, public trust and confidence in the fairness of the tax system, and the delicate balance between encouraging the right type of production while not creating unproductive distortion. This focus upon equity is probably reflective of the post-war era, when Keynesian economics was still the dominant ideal.[290]

3.2.2.2 McCaw Taskforce

Appointed in 1981, the Rt Hon Robert Muldoon was Minister of Finance, Minister of Foreign Affairs and Prime Minister for much of the 14 intervening years between the time of the Ross Committee and the McCaw Taskforce. This formidable figure of New Zealand politics had a significant role in driving new policy. The 1970s were difficult years economically and culturally.[291] Muldoon and his government used concessions and incentives generously in order to achieve economic goals. By the early 1980s, the tax system was widely considered to be unfair with a narrow group of taxpayers paying very high rates of tax, while many others paid little or none.[292] The recommendations made by the Ross Review group had not been implemented during the Muldoon era. If anything, the government had further complicated the tax system.

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[288] At 13 and 15.

[289] At 15.

[290] As stated by Skidelsky and Backhouse, "Keynesianism dominated the political economy of the developed world from roughly the 1950s through to the middle of the 1970s." in Skidelsky and Backhouse "The Keynesian Revolution and the Theory of Countervailing Powers" in Skidelsky and Craig (eds) *Who Runs the Economy? The Role of Power in Economics* (Palgrave MacMillan, London 2016) 59 at 62.

[291] This is examined in part 5.2 of chapter 5.

[292] Malcolm McCaw et al. *Report of the Task Force on Tax Reform* (Government Printer, Wellington, April 1982).

Like the Ross Review group, the McCaw Taskforce refer to "traditional principles of taxation": namely, fairness, simplicity, certainty, and neutrality.[293] Fairness derives from Smith's canon of equity. Simplicity does not directly relate to one of Smith's canons. However, the Taskforce states that simplicity in a tax system will ensure greater ability to comply and improve integrity of the tax base – so it is a means toward the goals of efficiency and equity. This is because a system that collects tax easily and evenly will result in fairer outcomes and will collect more revenue for less cost. Certainty is one of Smith's canons. Neutrality is one aspect of Smith's canon of efficiency. While the McCaw Taskforce alters the principles a little, they broadly adhere to the canons set down by Smith.

Like the Ross Review group, the recommendations of the McCaw Taskforce had a strong focus on fairness because that was where the greatest need was at the time. Because of the narrow tax base, the review concentrated its recommendations on broadening the tax base in order to reduce rates across the board. This improves the integrity of the system which also has a positive impact upon efficiency. While neo-liberalism had a significant impact in the United Kingdom and the United States, it was yet to take hold in New Zealand. New Zealand still regarded itself as entrenched in the egalitarian notions of the post-war era.[294] A lot changed in the years between the McCaw Taskforce of 1981 and the next comprehensive tax system review in 2001, the McLeod Review.

3.2.2.3 McLeod Review

The Tax Review of 2001 was established by the incoming Labour-led coalition government of 1999.[295] They put together a group of tax specialists and economists to consider the effectiveness of the current tax system.[296] The group was led by Rob McLeod and became known as the McLeod Review.

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[293] At 69.

[294] This movement is examined at the beginning of chapter 5.

[295] Hon Dr Michael Cullen "Terms of Tax Inquiry" (press release, 31 July 2000).

[296] Hon Dr Michael Cullen "Members of tax review team announced" (press release, 5 October 2000).

The Report of the McLeod Review group was underpinned by an objective to improve New Zealand's economic wellbeing. The issues paper that preceded the report, states:[297]

> The key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes – or making the tax system more efficient – while promoting fairness and continuing to raise sufficient revenue.

In the group's preparatory papers, they identify the framework they use for their assessments. They recognise the two main objectives in setting tax policy as fairness and efficiency.

With respect to fairness, the McLeod Review identify four different principles of fairness.[298] These are ability to pay, even-handedness, user pays, and transitional fairness. Ability to pay refers directly to the principle put forward by Smith, also referred to as vertical equity; that is, the tax burden should be distributed across the population on the basis that those who can pay more should pay more. Even-handedness also refers to the established principle of horizontal equity. The user pays principle, also referred to as the benefit principle, is identified by the group but dismissed as a useful tool for policy setting. Finally, transitional fairness refers to the way new tax settings are transitioned into law.

The McLeod Review group highlight the importance of efficiency in policy setting. To this end, the group focus upon where the economic incidence of a tax falls, rather than the legal incidence.[299] They give an example of two employees – one who has skills that are not in high demand and another whose skills are in high demand.[300] The group rationalise that given the mobility of the taxpayer, the tax cost of the 'in-demand' skill base will fall upon the employer. They conclude that promoting efficiency necessitates lightly taxing mobile factors of production.[301]

While the McLeod Review group have described their goals under the label of efficiency, the focus of this group is upon economic wellbeing. This is evident by the group's main

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[297] McLeod Issues Paper, above n 106, at 5.

[298] At 8.

[299] At 9.

[300] At 9.

[301] At 13.

recommendations which are: to decrease the tax impost on mobile factors of production, including inbound investors and high net worth migrants, with the aim of improving economic outcomes;[302] the introduction of a risk-free return method for taxation of savings;[303] to flatten out the tax rate structure to make it less progressive;[304] and, to reduce corporate tax rates aligning with global trends.[305] These recommendations are aimed at improving economic growth rather than equity objectives.

3.2.2.4 Victoria University of Wellington Tax Working Group

Like previous tax review groups, the Victoria University of Wellington ("VUW") Tax Working Group used a tax assessment framework based upon traditional principles derived from Smith's four canons. They use six principles for their assessment: efficiency and growth; equity and fairness; revenue integrity; fiscal cost; compliance and administration costs; and coherence.[306]

The principle of fiscal cost requires tax change to be "affordable given fiscal constraints".[307] The principle that compliance and administration costs should be as low as possible is of a similar vein. This research refers to these types of criteria as administrative in nature. They do not seek to consider the substance of a proposed tax setting, but rather they take a pragmatic approach to the costs associated with revenue collection. The principle of coherence considers how a tax fits with the overall tax scheme.[308] An incoherent tax proposal is likely to distort equity and efficiency principles as well. However, it is a reminder to policy setters that the system should have an overall coherence and not be viewed on a piecemeal

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[302] McLeod et al. *Tax Review 2001: Final Report* (New Zealand Treasury, Wellington, 2001) at 82.

[303] At 72.

[304] At 67.

[305] At 66.

[306] VUW report, above n 52, at 15.

[307] At 15.

[308] At 15.

basis. Like previous working groups, the final recommendations of the VUW report places the greatest emphasis upon equity and efficiency.[309]

Smith's canon of equity is embodied within the VUW group's principles of equity and fairness and, to some extent, revenue integrity. Revenue integrity refers to the sustainability of the tax revenue stream by minimising tax avoidance and tax evasion behaviour.[310] To the extent structures can arise that reduce the tax liabilities of some taxpayers, this impacts upon horizontal equity and vertical equity. Horizontal equity is impacted because taxpayers in the same economic position may have different tax outcomes. Vertical equity is impacted because typically these structures are available to those with more resources to seek tax structuring advice.

Efficiency and growth are described as ensuring taxes are efficient and minimise impediments to economic growth.[311] This is a derivation of Smith's canon of efficiency: tax should be efficient in terms of costs of collection and should distort investment decisions as little as possible. However, the VUW review extends the efficiency concept to encompass the objective that tax should minimise its detrimental impact upon economic growth.[312]

Like the McLeod Review group, the VUW group recommendations are based upon the primary objective of increasing growth in GDP. While it is difficult to find explicit mention of this, the impact of selected tax policy settings reference mainly to their impact upon GDP.[313] Overall, they recommend reductions in the top tax rates and an increase in GST.[314] These recommendations are regressive in nature and are aimed at reducing the tax impact on

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[309] At 14.

[310] At 15.

[311] At 15.

[312] At 15.

[313] For example, see The Treasury *Medium Term Tax Challenges and Opportunities* (The New Zealand Treasury, 2009).

[314] VUW report, above n 52, at 65-66.

those areas most sensitive to economic growth.[315] They also suggest less reliance upon taxes on mobile factors of production such as capital and skilled labour.[316]

Like the McLeod Review, the objective of economic growth results in tax policy recommendations that favour the reduction of tax costs upon mobile factors of production. Underpinning this is the proposition that economic growth is essential to the nation's prosperity, and economic growth is best achieved by encouraging mobile factors of production to invest in New Zealand. This narrative is examined in more detail in chapter 6.

3.2.2.5 The Tax Working Group 2019

The most recent New Zealand Tax Working Group ("TWG"), appointed by the Labour-New Zealand First coalition Government in 2017, was asked to consider the structure, fairness, and balance of the tax system.[317] This group placed significant emphasis upon the frameworks they used to assess the current system and to make their recommendations.

Three frameworks are used by the TWG. First, to assess a specific tax setting, the group used established principles of tax policy design.[318] They refer to those same principles used by the previous tax review group in New Zealand, the VUW group. These are set out above. As with the VUW group, efficiency is expanded to include minimising impediments to economic growth. Also, 'equity and fairness' are expanded to include procedural fairness.

The TWG has adopted the use of two additional frameworks: The Living Standards Framework ("LSF") and He Ara Waiora.[319]

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[315] At 18.

[316] At 64.

[317] TWG report, above n 112, at 7.

[318] Inland Revenue Department and the Treasury *Tax Working Group Assessment Framework* (decision paper for session 3 of the Tax Working Group, February 2018) at 4.

[319] TWG report, above n 112, at 25-28.

The LSF was introduced to the TWG by Treasury officials in the second meeting of the group in February 2018.[320] The framework was still under development at that stage. However, the TWG embraced the concept of a multi-dimensional approach to tax policy setting and integrated it into its own analysis.[321]

Further to the LSF, during the TWG's broad consultation with a wide cross-section of New Zealand, including Māori groups, the group worked on a separate framework encompassing Te Ao Māori perspectives.[322] This framework is known as He Ara Waiora, and it integrates Māori concepts of wellbeing alongside the concepts drawn from the LSF.

The significance of these two additional frameworks is that they require a more holistic approach to tax policy design. As the TWG state, while the tax system is an essential source of tax revenue, it is also an important tool for pursuing distributional goals, shaping behaviour, improving living standards, and promoting sustainable development.[323]

The TWG consider a broad range of ideas for change to the tax system, but their final report focuses on two areas in particular: the introduction of a capital gains tax and the introduction of 'environmental taxes'.[324] In assessing the options, the TWG considered the multi-dimensional aspects of the LSF, which serves to highlight those parts of the framework most relevant to tax policy setting.

The recommendation to introduce an array of environmental taxes was based upon targeted objectives to enhance New Zealand's stocks of 'natural capital', one of the LSF capitals necessary for wellbeing.[325] Given the climate crisis, the group recommended the use of taxes

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[320] Inland Revenue Department and The Treasury *Frameworks for Evaluating Tax Reform: Discussion paper for session 2 of the Tax Working Group* (The Treasury and IRD, Wellington, September 2018).

[321] TWG report, above n 112, at 25-28.

[322] At 27.

[323] At 23.

[324] By environmental taxes is meant taxes that deter undesirable behaviour or encourage desirable behaviour regarding the natural environment.

[325] TWG report, above n 112, at 37.

for the purpose of encouraging positive or discouraging damaging behaviour.[326] The objective of environmental taxes is not for general revenue-raising or redistribution purposes.

The recommendation to introduce a capital gains tax is underpinned by multiple objectives in the LSF and traditional tax policy models. Failure to tax capital gains was considered to exacerbate vertical and horizontal inequities,[327] perceptions of a lack of fairness,[328] and potentially the deterioration of New Zealand's financial and physical capitals.[329]

While He Ara Waiora is part of an evolution toward a bicultural approach, the LSF is far more developed right now and therefore, the principles we can draw from the LSF will be examined further.[330] The LSF and its impact upon tax policy are examined next.

3.2.3 The Living Standards Framework

The LSF was developed to provide a "practical policy advice tool" for The Treasury of New Zealand.[331] It has been under development since 2008 and was adopted formally by the government in 2018 when they announced they would use the framework to develop a "wellbeing" budget in 2019.[332]

While the LSF is a uniquely New Zealand framework, and its purpose is to establish goals for New Zealand policy-making, the concept is by no means unique to New Zealand. Before the Treasury began the project to establish the LSF, there was dissatisfaction around the world with current measurements of 'success', in particular with the dominance of gross domestic

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[326] At 37.

[327] At 31-33.

[328] At 31-33.

[329] This is due to the distortionary effects of the tax system that encourages investment in tax free assets: see TWG report, above n 112, at 34.

[330] The LSF is supported by numerous measurable indicators for each of its many objectives.

[331] See <https://treasury.govt.nz/information-and-services/nz-economy/higher-living-standards> for a summary of the purpose of the framework.

[332] Grant Robertson, Rt Hon Minister of Finance "Wellbeing of New Zealanders at the heart of Budget priorities" (press release, 13 December 2018).

product per capita ("GDP per capita").[333] This dissatisfaction led academics and policymakers to question how a successful economy should be measured and evaluated.

3.2.3.1 Development of multi-dimensional wellbeing frameworks

Three economists, Stiglitz, Sen and Fitoussi were commissioned in 2008 by the (then) French President, Nicolas Sarkozy,[334] to consider the effectiveness of the widely accepted measure of economic success, GDP per capita.[335] Their report highlights the emerging importance of measuring a broader concept of "wellbeing" rather than the previously more popular measures of production. This involves considering multiple dimensions of wellbeing including material living standards (income, consumption, and wealth), health, education, social connections, political voice, personal activities, and insecurity.[336]

The Stiglitz, Sen and Fitoussi project had the following objectives:[337]

> …to identify the limits of GDP as an indicator of economic performance and social progress, including the problems with its measurement; to consider what additional information might be required for the production of more relevant indicators of social progress; to assess the feasibility of alternative measurement tools, and to discuss how to present the statistical information in an appropriate way.

The report makes valuable observations regarding the limitations of the use of GDP per capita as a measure of wellbeing. First, production measures fail to capture changes in the *quality* of goods and services.[338] As the measure is quantitative, it cannot account for the fact that goods and services may change in quality without a change in cost. Second, the Commission finds that measures of productivity fail to include vital parts of the economy,

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[333] Fitoussi Commission report, above n 47, at 12.

[334] Nicolas Sarkozy was the President of France from 2007 until 2012.

[335] Fitoussi Commission report, above n 47.

[336] These are the factors identified in frameworks such as the OECD's "How's Life" index and New Zealand's Living Standards Framework that are discussed in this chapter.

[337] Fitoussi Commission report, above n 47, at "Executive Summary".

[338] At 11.

including Government outputs and voluntary labour.[339] Third, the report finds that production measures such as GDP do not necessarily measure people's wellbeing – even material wellbeing is not necessarily well represented by measures of GDP per capita as it does not take account of the sustainability of material wellbeing, nor does it take into account the distribution of wealth.[340] The report makes the distinction between current wellbeing and sustainability – both being important objectives to keep in balance. The Report's list of limitations echo those of Simon Kuznets when he introduced the concept of GDP as a measurement tool for government accounts to the US Congress in 1934.[341] In delivering the concept, Kuznets warned of these limitations and the pitfalls of an over-reliance on this measure.

The Fitoussi Commission highlight the importance of measuring inequalities and determining the impact of how improvements in one quality of life indicator might impact upon another one.[342] For example, legalising the sale of drugs may have a positive impact upon the economy but a detrimental effect upon health outcomes. The Fitoussi Commission also highlight the importance of using a variety of methods for measuring wellbeing – including both subjective measures and objective measures.[343] Subjective measures will arise by asking survey participants how they perceive their quality of life. Objective measures analyse externally observable data such as education levels, health, income etc. Some of the research discussed further below uses measures of a more limited dimension, such as only subjective data.

The findings of the Fitoussi Commission are drawn upon by the OECD to analyse the wellbeing of citizens in its member countries.[344] The Better Life Initiative analyses wellbeing

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[339] At 11 -12.

[340] At 12.

[341] Simon Kuznets "A Report of National Income 1929-32" (Letter from Simon Kuznets to the US Congress on January 4, 1934).

[342] At 13 – 15.

[343] At 16.

[344] OECD *How's Life in New Zealand?* (OECD, November 2020).

in the OECD's 41 member countries by using indicators adapted from the Fitoussi Commission report. The OECD index uses data contributing to 11 areas of wellbeing to gain an overall impression of life in that country.

New Zealand's measurements in November 2020 are shown as follows:

New Zealand's Current Wellbeing

OECD "How's Life in New Zealand?" (OECD, November 2020)

As can be seen in the figure above, wellbeing under the Better Life Index is measured using factors as diverse as air quality, voter turnout, and financial earnings.

Further to the development of the OECD's Better Life Index, individual countries, such as New Zealand, have developed their own models. Perhaps leading the way in this regard is Wales who have not only built a model but given it legislative force. The Well-being of Future Generations Act 2015 (Wales) places a duty upon public bodies to carry out 'sustainable development'.[345] Sustainable development here means the improvement of the economic, social, environmental, and cultural wellbeing of Wales.[346] The Welsh model

[345] Well-being of Future Generations Act 2015 (Wales), s 3.

[346] At s 2.

requires its government ministers to put in place indicators that can be used to track progress toward the legislated wellbeing goals.[347] The goals are aspirational and are written into legislation. They are for a prosperous, resilient, healthier, more equal, cohesive, culturally vibrant, and globally responsible Wales.[348] The United Kingdom, German, Icelandic, French and Scottish governments have also developed wellbeing measures, recognising that factors beyond GDP per capita are relevant in assessing living standards.

While this might be a predominantly Western trend, it was Bhutan that entrenched a Gross National Happiness index into its constitution in 2008, before the Fitoussi Commission's report was released.[349] In 1979, the 4th King of Bhutan, King Jigme Singye Wangchuck, is credited with having said: "We do not believe in Gross National Product because Gross National Happiness is more important."[350]

This brief history is laid out because multi-dimensional frameworks are not just a New Zealand development. The dissatisfaction with growth in GDP as the dominant measure for success and the demand for broader measures has resulted in the growth and ready acceptance of multi-dimensional wellbeing models. These appear to be more than a passing fad. They are supported by governments and academic research globally.[351]

The diversity of these multi-dimensional models indicates the unique values of each jurisdiction. Bhutan places emphasis on its spiritual values, with its constitution grounded in Buddhist foundations.[352] Wales places emphasis on a vibrant culture and thriving Welsh

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[347] At s 8.

[348] At s 4.

[349] Kingdom of Bhutan "Constitution of Bhutan" Article 9[2].

[350] Tashi Dorji "The story of a king, a poor country, and a rich idea" *Business Bhutan* (online ed, Brazil, 15 June 2012).

[351] Not examined here but equally visible and influential are the United Nation's Sustainable Development Goals promoting a range of social, environmental, and economic objectives.

[352] Kingdom of Bhutan "Constitution", above n 349.

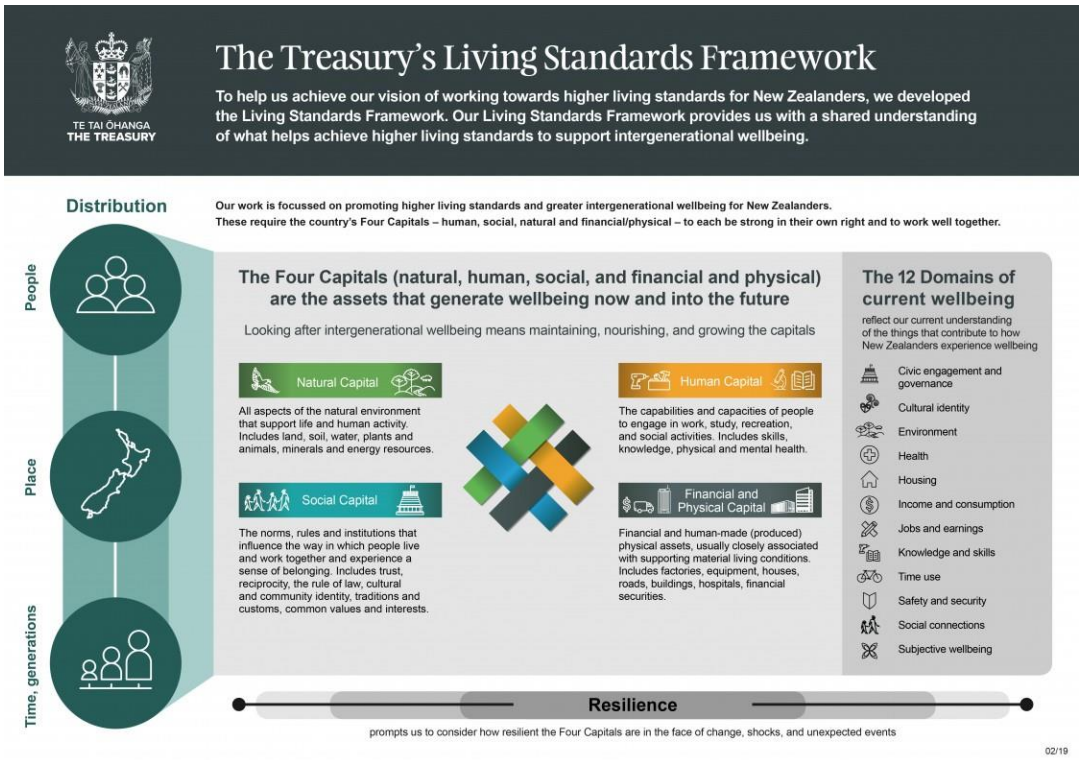
language.[353] The German indicators emphasise security – in terms of income, personal safety, and global stability.[354]

More striking, however, is the similarities between all the models. The values in the LSF are largely a replication of those in the models developed by other states. Although this chapter bases its normative framework upon the LSF, these values are widely shared with other jurisdictions.

3.2.3.2 The New Zealand model

New Zealand's LSF supports the objective of improving *intergenerational wellbeing* and *higher living standards* for all New Zealanders. The framework is illustrated as follows:

New Zealand's Living Standards Framework



New Zealand Treasury "The Living Standards Framework" (February 2019)

[353] Well-being of Future Generations Act 2015 (Wales), s 4.

[354] Die Bundesregierung "Government Report on Wellbeing in Germany" (Federal Press Office, Berlin, May 2017) at 16-17. The German model includes 12 indicators of which 3 highlight security: acting with global responsibility and securing peace, a secure income, and living a life in security and freedom.

There are several parts to this framework. The term *intergenerational wellbeing* refers to the wellbeing of current and future generations of New Zealanders. The large box in the centre shows the *four capitals* – these are the assets that we need for our wellbeing. They are natural capital, social capital, human capital, and financial and physical capital. To provide for future generations, we have a duty to maintain and improve these capitals. The four capitals are represented by the harakeke[355] woven into a whāriki.[356] This symbolism means the four capitals must each be strong for overall wellbeing to be strong. If any one of the capitals is weak, this weakens the whole. The dark grey box on the right of the framework shows the 12 areas of current wellbeing, i.e., areas that indicate the wellbeing of New Zealanders today.

The column on the left-hand side of the framework, "distribution", refers to how the wellbeing measures are shared across the population now, across time, and across geographical areas. One of the major concerns with recent economic developments is the growing inequality that has arisen across the world, even in 'wealthy' societies such as the United States. Inequality is now linked with deterioration in many areas of wellbeing.[357] A major finding of the Fitoussi Commission is how whole country measures such as GDP per capita fail to consider how that GDP is spread across the population.[358] Measuring average figures is undoubtedly a useful tool but doesn't show the distribution of what is being measured – and this is key to analysing wellbeing.[359]

3.2.3.3 Current Wellbeing

The current wellbeing domains draw heavily from those in the OECD's better life indicators: income and wealth; jobs and earnings; housing; work-life balance; health status; education and skills; social connections; civic engagement and governance; environmental quality; personal security; and subjective wellbeing. However, the LSF adds an additional domain

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[355] This is a group of native plants of New Zealand that are members of the genus, Phormium.

[356] The English translation of this Māori word is "mat".

[357] Wilkinson and Pickett, above n 48.

[358] Fitoussi Commission Report, above n 47, at 13-14.

[359] At 13- 14, Recommendation 4: Give more prominence to the distribution of income, consumption, and wealth.

(making 12 domains in total): ‘cultural identity’, a reflection of New Zealand’s unique bi-cultural partnership. The numerous domains reflect the multi-dimensional nature of each person’s wellbeing.

Tax has an impact upon many aspects of an individual’s current wellbeing. Tax, in particular, affects income and wealth, jobs and earnings, and civic engagement and governance. It also has an impact on the accumulation of wealth. Tax plays a big role in the structure and organisation of the economy, which has an impact on people’s daily lives. With an objective of higher living standards for all New Zealanders, the tax settings will ideally support a shared prosperity. Perceptions that the tax system is fair support civic engagement. This is discussed further under social capital.

3.2.3.4 Cultural identity and distribution

The addition of cultural identity to the LSF reflects the origins of New Zealand’s bicultural partnership and the ongoing obligations to honour the two cultures (and indeed others that have become part of New Zealand’s diverse population). Underlying measures supporting wellbeing indicators of cultural identity include measures of the proportion of the population who are fluent in Te Reo Māori, how many people feel it is easy to express their identity, and connection to a marae.[360] The LSF is expected to evolve and recent research recommends the measurement of cultural identity should be extended to consider cultural vibrancy as well – that is, the depth and richness of the culture itself rather than the individual connection with culture measured under the cultural identity banner.[361]

The importance of cultural identity in wellbeing measures has been recognised widely because of its links to human dignity.[362] Unless individuals feel their cultural heritage is

[360] The Treasury *The Living Standards Framework Dashboard* <Living Standards Framework - Dashboard (treasury.govt.nz)>.

[361] Dalziel, Saunders, and Savage *Culture, Wellbeing, and the Living Standards Framework: A perspective* (DP 19/02, Wellington).

[362] Dalziel, Saunders, and Savage, above n 361 at 2.

respected, this undermines their personal dignity and contributes toward societal ills such as increased crime,[363] poverty, and poor health.[364]

Aside from the benefits of rich cultural identity, New Zealand is in the unique position of having a contractual relationship between the Crown and New Zealand's indigenous population that has evolved into a partnership between the two groups.[365] Like any partnership, there are duties to act in good faith toward each other. However, New Zealand's permanent Commission of Inquiry, the Waitangi Tribunal, has gone further to adopt the principle of active protection: the Crown must take active steps to ensure Māori interests are protected.[366] Not only are cultural identity and vibrancy contributors to wellbeing, but the New Zealand government has obligations to actively protect Māori interests.

Protection of Māori interests extends far beyond encouraging the enrichment of cultural identity. Māori, as a group, fare poorly in many areas of wellbeing including economic, health, education, and crime.[367]

The importance of distribution is heightened because of the impacts of colonisation.[368] Tax is perhaps the most important tool a government has for redistribution. Redistribution comes about through use of progressive tax rates, and via targeted provisions of public goods and services. Tax policy that is well designed and achieves redistribution goals, therefore, not only serves to improve current wellbeing but also helps fulfil New Zealand's Treaty of Waitangi obligations.

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[363] Brittain and Tuffin "Ko tēhea te ara tike? A discourse analysis of Māori experience in the criminal justice system" (2017) 46(2) *New Zealand Journal of Psychology* 99.

[364] McIntosh and Mulholland (eds) *Māori and Social Issues* (2011, Huia, Wellington).

[365] The contractual agreement is Te Tiriti o Waitangi (The Treaty of Waitangi) (1840).

[366] The Principles of the Treaty of Waitangi as expressed by the Courts and the Waitangi Tribunal, retrieved from <https://waitangitribunal.govt.nz/treaty-of-waitangi/principles-of-the-treaty/>.

[367] Te Puni Kōkiri and The Treasury "An Indigenous Approach to the Living Standards Framework" (DP 19/01, January 2019) at Appendix 2.

[368] Fiona Cram "Poverty" in McIntosh and Mulholland (eds), above n 364, at 96.

3.2.3.5 Four capitals

The inclusion of four capitals in the LSF is to provide indicators of New Zealand's *future* resilience.[369] The capitals are those stocks that New Zealand considers necessary for wellbeing in the future. Future wellbeing is essential to ensure fair distribution of wellbeing outcomes to latter generations. Each stock is of equal importance: if New Zealand has high levels of financial capital but no natural capital, then wellbeing will be undermined. Each needs to be nourished in order to maximise the wellbeing in the future.

Natural Capital refers to our natural environment.[370] The health of the natural environment is considered essential to support ongoing wellbeing of New Zealanders. Human Capital includes people's skills, knowledge, and physical and mental health.[371] Social Capital is the norms and values that underpin society.[372] Financial and Physical Capital is the physical infrastructure like roads, buildings, equipment, and financial investments.[373] If the LSF is followed, the objectives of New Zealand policymakers must include sharing and sustaining these four capitals.[374]

Natural capital

The stock of natural capital appears to be the most difficult to measure.[375] There are two distinct areas of this stock: one is the measurement of the quality of our environment for our wellbeing, and the second is the stock of natural assets available for future use.[376] Quality of

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[369] Conal Smith *Treasury Living Standards Dashboard: Monitoring Intergenerational Wellbeing* (Kōtātā Insight, Wellington, June 2018) at 6.

[370] At 69.

[371] At 69.

[372] At 72.

[373] At 68.

[374] At 5.

[375] Conal Smith, above n 369, at 29.

[376] At 30.

the environment is essential for current and future wellbeing. The stocks of natural capital are mainly for future wellbeing.

From the viewpoint of tax policy, tax may be used as a tool to promote the preservation and development of natural capital. While not undermining the validity and importance of using taxation to promote environmental objectives, using tax in this way is targeted and is not reflective of more fundamental policy design. Fundamental tax policy design is largely concerned with deriving revenue to fund government expenditures and redistributing wealth. The preservation and development of the natural environment, while key to intergenerational wellbeing, is therefore unlikely to play a part in the generic tax policy. It will involve targeted measures that are focused on encouraging or discouraging behaviours or actions.

Social capital

Social capital is a stock made up of social connections, attitudes, norms, and formal rules that contribute to societal wellbeing. Frieling summarises the impact of social capital as:[377]

> … a well-evidenced predictor of economic performance, democratic functioning, public safety, educational outcomes, labour market outcomes and individual health and wellbeing. Unless government systematically accounts for social capital, social capital risks and opportunities are easily taken for granted or overlooked in policy development.

Social capital is a complex stock to define and measure. However, its importance shouldn't be underestimated and Frieling's research links it to many wellbeing outcomes. She quotes from Woolcock's research which states that well-connected individuals are more likely to be "hired, housed, healthy and happy".[378] This means high social capital is associated with an individual's ability to find work and housing, and have better physical and mental health outcomes.

Aside from the many benefits at an individual level, social capital is also linked with societal benefits. Increased public involvement has been linked to the better performance of

[377] Margreet Frieling *The Start of a Conversation on the Value of New Zealand's Social Capital* (The Treasury, DP 18/04, February 2018) at i.

[378] Frieling, above n 377, quoting from Woolcock "The place of social capital in understanding social and economic outcomes" (2001) 2(1) *Canadian Journal of Policy Research* 65 at 68.

democratic institutions.[379] Equally, the quality of those public institutions has an impact on social capital. Social capital is built, in part, on trust. Where public institutions are trusted, the public are more likely to obey rules.[380] This is relevant for taxation as compliance with tax law is fundamental to funding public expenditure, particularly in a 'self-assessment' environment.[381]

Further to trust in institutions, income inequality erodes this trust and undermines social capital.[382] Trust requires a sense of fairness. Where members of a society perceive a lack of fairness, this will erode social capital and trust in institutions. This is highlighted by the most recent tax working group in New Zealand where they link perceptions of equity, both horizontal and vertical, with the integrity of the tax system.[383]

On a societal level, higher social capital is linked with better economic performance, better educational outcomes, and a healthier and safer society.[384] With respect to improved economic performance, Knack and Keefer explain this is because less time and money is spent on reducing risk and monitoring.[385] High trust societies are more likely to encourage information sharing, resulting in successful business innovation.[386]

Relevant to the New Zealand experience is the research on the diversity of population and social capital. US studies tend to find a negative relationship here – perhaps indicating more work needs to be done to build social capital in areas where more diverse populations exist.[387]

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[379] Frieling, above n 377, at 5.

[380] Frieling, above n 377, at 16.

[381] Tax Administration Act, s 92.

[382] Frieling, above n 377, at 17.

[383] TWG report, above n 112, at 31.

[384] Frieling, above n 377, at 6.

[385] Knack and Keefer "Does social capital have an economic payoff? A cross-country investigation" (1997) 112(4) *The Quarterly Journal of Economics* 1251 at 1252.

[386] Frieling, above n 377, at 5.

[387] Frieling, above n 377, at 19.

However, there are other studies that show less influence of diverse communities on social capital, aside from the clear links between suppressed minority groups and inequality.[388]

All in all, social capital is an influential and central factor in wellbeing measures. It is also central to tax policy setting. Social capital is undermined where there is a lack of trust in institutions and a perception that the distribution of the tax burden is unfair. In this case, tax preferences extended to those more able to pay, such as investors, are expected to result in reduced social capital. This is explored further in chapter 8.

Human Capital

Human Capital is the 'stock' that measures the human ability to participate in work, study, recreation, and other aspects of society.[389] It is measured by considering educational achievement, skills, and health.[390] Under the LSF, four measures are used at present: cognitive skills at 15 years old; education achievement of adults; life expectancy; and non-communicable diseases.[391] All measures are objective.

Human Capital, perhaps more than any other capital, is closely linked to the objectives of the other capitals. For example, we want human capital to be high to maximise opportunities to improve financial and physical capital, and to enhance social capital. High rates of knowledge and skill translate well into better economic performance, hence building on financial and physical capitals. High rates of education and skills also enrich participation in civil society, enriching social capital. Good health outcomes also lead to better workforce participation, and hence financial and physical capital. Equally, a healthy population also increases social capital. So, while human capital is essentially a measure of the ability of each human to participate, its societal objectives are also found in the enrichment of the other capitals.

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[388] Frieling, above n 377, at 19.

[389] Suzy Morrissey *The Start of a Conversation on the Value of New Zealand's Human Capital* (The Treasury, DP 18/02, February 2018).

[390] At 2.

[391] LSF dashboard, above n 360.

Tax policy plays a role in the development and enhancement of human capital where it may impact education and skills or participation in the workforce. For example, where tax policy incentivises investment in people, human capital will be improved. Like natural capital, tax will impact human capital through targeted tax measures designed to promote social and economic goals. Human capital may also be impacted by incentives to participate in the workforce. Where the tax burden falls heavily upon labour, this could disincentive workforce participation. Preferential settings on income from capital necessarily places a heavier burden upon income from labour and other human effort.

Financial and Physical Capital

Financial and physical capital is New Zealand's stock of financial, physical, and intangible assets.[392] These are used to support material living conditions. This may be in the form of financial assets such as money, shares, and bonds, or it could be physical assets such as plant, equipment, buildings, ships, and vehicles. Intangible assets can be as diverse as know-how, brands, or prototypes. Measurement of financial and physical capital is well-developed and has been used extensively over the past century.[393]

The LSF uses the following measures as indicators of New Zealand's financial and physical capital: investment in research and development; growth in productivity; the amount of intangible fixed assets; net international investment position; Crown net worth as a percentage of GDP; and total fixed assets per capita.[394] The net international investment position measures New Zealand's assets and obligations with respect to the rest of the world as a proportion of GDP.[395] These are all well-established measurements.

Tax policy has a significant impact upon the stock of financial and physical capital. As tax is a payment of cash, it is a transfer from the stock of financial capital generated in the private

[392] LSF dashboard, above n 360.

[393] Conal Smith, above n 369, at 28-29.

[394] LSF dashboard, above n 360.

[395] Stats NZ *Wellbeing data for New Zealanders: Net international investment position* updated quarterly by stats NZ <Net international investment position | Ngā Tūtohu Aotearoa – Indicators Aotearoa New Zealand (stats.govt.nz)>.

sector to the public sector. Tax may be used for a number of purposes, including redistribution to others as financial capital, spending on the provision of public goods and services that may improve human, social or natural capitals, or investment into publicly owned physical capital. In order to maximise New Zealand's physical and financial capital, tax should ideally be positioned at the balancing point where public and private investment and spending are optimised. Naturally, this point only exists in a theoretical sense.

3.2.4 Conclusions on frameworks

The introduction of multidimensional wellbeing frameworks has added new depth and complexity to tax policy settings. The principles of fairness and efficiency, however, share a long history of reliance by policy setters. The TWG took the frameworks and applied them side by side – the traditional principles for individual tax proposals and the LSF (and He Ara Waiora) for the impact on the whole tax system. This research proposes that while the LSF informs the principle of equity, or fairness as it is called in this chapter, the canon of efficiency needs a rethink. The research will now consider the principle of fairness before turning to efficiency and its development toward promotion of economic growth goals, in light of the LSF.

3.3 Fairness

The constant attribute that runs through Smith's canons, the tax review groups, and the LSF is the notion of fairness. Fairness goes to the heart of tax policy setting. Fairness may be progressivity of the tax system, it may be horizontal equity, perceptions of fairness, fair reward for effort, and preservation of the integrity of the system.

Fairness was articulated as the canon of equality by Adam Smith in 1776.[396] This was adopted by the Ross Review group in 1967 and drove the recommendations made in the report. Fairness had an equally important role in the recommendations made by the McCaw Taskforce in 1982. Equity was identified as a key pillar for the reviews undertaken by the McLeod and VUW review groups – although these groups placed greater emphasis upon

[396] See discussion above at 3.2.1.1.

economic growth objectives than the previous two groups.[397] However, the TWG in 2019, with the guidance of the LSF, elevated the role of fairness in tax policy again.[398]

Given the universal acceptance of equity or fairness as a key principle of tax policy development, it barely needs revalidating. However, it is worth examining the tax objective of fairness and its links with the broader goal of 'wellbeing'. Unfortunately, at this point in time, there is not a large body of research in this domain.

Oishi, Schimmack and Diener studied the effect of progressivity upon subjective wellbeing.[399] Subjective wellbeing measures one's perception of their own wellbeing, rather than using objective measures. The authors of the study observed 54 nations where they could obtain relevant information on the progression of tax rates as well as data on wellbeing from the Gallup World Polls. The findings showed a positive correlation between progressivity of tax rates and subjective wellbeing. One of the findings of the study links higher quality provision of public goods and services such as public transport, education, and healthcare with high levels of subjective wellbeing.[400] Oishi, Schimmack and Diener established that tax policy with more redistributive settings is linked to improved subjective wellbeing.

A New Zealand based research organisation, Mōtu, analysed the impact of taxes on subjective wellbeing.[401] Using data from the World Values Survey and European Values Survey to assess subjective wellbeing, and fiscal data from the IMF Government Finance

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[397] See discussion above at 3.2.2.3 and 3.2.2.4.

[398] See discussion above at 3.2.2.5.

[399] Oishi, Schimmack and Diener "Progressive Taxation and the Subjective Well-being of Nations" (2012) 23.1 *Psychological Science* 86.

[400] This is also found in a study by Mōtu (Grimes, Ormsby, Robinson, Wong *Subjective Wellbeing Impacts of National and Subnational Fiscal Policies* (Mōtu Economic and Public Policy Research, Mōtu Working Paper 16-05, April 2016)). Mōtu find that "productive expenditure" improves the subjective wellbeing of the people compared with "unproductive spending". Productive spending is on infrastructure such as health, education, housing, and transportation while unproductive expenditure is welfare payments, recreation, and economic services.

[401] Mōtu, above n 400.

Statistics database, Mōtu analysed the impact of distortionary taxes (e.g., taxes on income) and non-distortionary taxes (e.g., goods and services tax) upon subjective wellbeing. Mōtu found that favouring income tax over consumption tax has a positive relationship with subjective wellbeing. Mōtu's finding that subjective wellbeing is improved with the use of income taxes is consistent with Oishi, Schimmack and Diener's findings that progressivity increases subjective wellbeing. Consumption taxes are regarded as regressive, so it is consistent that a progressive income tax results in higher subjective wellbeing.

Redistribution through the tax system decreases the inequalities produced by the market. Reduced inequality promotes not only subjective wellbeing but objective wellbeing.[402] Objective wellbeing may be measured in many ways. The LSF uses measures such as income, wealth, education, health, and quality of housing, amongst many others.[403] The link between inequality and these objective measures of wellbeing is already well established by many researchers, some of which are discussed in chapter four.[404]

Fairness not only contributes to current wellbeing but also to social capital. People need to feel the tax system is fair, both substantively and procedurally, in order to build trust in the system.[405] This sense of fairness and trust is essential for the integrity of the system and people's willingness to comply with their obligations.

These findings are essential to the normative question of how New Zealand should tax its inbound investors. In order for current wellbeing and social capital to be maximised, the tax system needs to engender trust and fairness. If tax settings favour passive income over income from labour and other human efforts, resulting in a sense of injustice, this has the potential to undermine the integrity of the tax system. Not only this, favouring income from capital over labour is inherently regressive and therefore, in the absence of other more

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[402] Dalziel, Saunders, and Savage, above n 361, at 2-3.

[403] LSF dashboard, above n 360.

[404] Wilkinson and Picket, above n 48.

[405] Torgler, Schneider, and Schaltegger "With or Against the People? The Impact of a Bottom-Up Approach on Tax Morale and the Shadow Economy" (University of California Berkeley, Berkeley Program in Law and Economics, Working Paper Series, 2007) at 30; Joel Slemrod "On Voluntary Compliance, Voluntary Taxes, and Social Capital" (1998) 51(3) *National Tax Journal* 480.

pressing objectives, exacerbates the inequalities produced by the market. Conceptions of fairness and its impact on tax settings will be taken up again in the following chapters. Next, the focus on economic growth as a tax policy setting objective is considered.

3.4 Economic growth as a tax policy principle

In recent years, the canon of efficiency has been expanded to include minimisation of impediments to economic growth.[406] A modern interpretation of Smith's efficiency principle includes the view that taxation should not inhibit business prosperity. In some cases, this is interpreted as minimising tax on certain business interests, such as inbound investors.[407] This is undoubtedly an expansion of Smith's original efficiency principle and is consistent with the development of economic thought throughout the latter decades of the 20th century.

Principles or canons are used in tax policy setting from which an assessment is made of the quality of any tax change proposal. The expansion of the efficiency canon to economic growth does not fit. Adam Smith's canons represent broad based principles that provide guidance on whether a proposed tax setting is going to create unfair or distortionary outcomes. This new principle has been interpreted as supporting distortionary tax policy.[408] This follows the development of neo-liberal economics during the 1980s onward in New Zealand.[409]

One aspect of the neo-liberal perspective is that lower taxes on businesses and investors, results in more profit being kept in the private sector, thereby increasing investment, and creating increased prosperity, employment, and wage levels. The theory is that economic

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[406] This appeared to come about from the McLeod Review, above n 302, and continued through to the most recent TWG, above n 112. The latest TWG deemphasised the objective, however, in its recommendations.

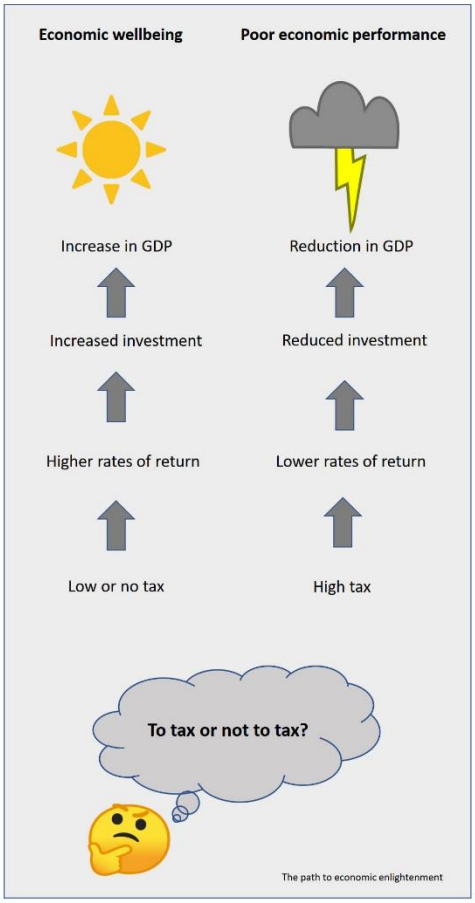
[407] Inbound debt investors are frequently not subjected to any tax in New Zealand at all. Inbound equity investors generally only pay a maximum of the corporate tax rate of 28 per cent.

[408] For example, the McLeod Report, above n 302, relied upon this principle to support suggestions such as the reduced corporate tax rate for non-resident shareholders only.

[409] Like the United States and the United Kingdom, New Zealand undertook significant economic reforms in the 1980s. This included deregulation of the financial sector, floating the New Zealand dollar, relaxation of exchange controls, removal of interest rate restrictions, and loosening of rules around foreign ownership.

growth leads to higher overall prosperity. Economic growth is an increase in GDP per capita.[410] This theory can be illustrated as follows:

Tax and Economic Wellbeing Theory



When considering how tax might impede economic growth, policy setters will consider whether imposing tax on those persons producing economic growth is optimal for the economy. The principle of efficiency, with its economic growth objective, would lean away from taxing providers of capital based upon the theory of economic growth illustrated above. More specifically, in recent times, there has been a reluctance to tax those providers of the most mobile forms of capital too heavily.[411]

[410] Acemoglu, Laibson, and List *Economics* (Global ed., Pearson, Boston, 2016) at 518.

[411] For example, this is evident in the McLeod Issues Paper, above n 106, at 5.

There are two problems with pursuing an objective of economic growth for tax policy making. First, economic growth is a means to an end, rather than an end in itself. Second, economic growth does not always result in higher levels of wellbeing for members of a state.

Economic growth as a means and not an end

Although, overall, economic growth is regarded as a positive outcome, it is due to the impact it has on the wellbeing of the nation rather than the growth itself. The objective of broader economic policy is the enhanced wellbeing of people.[412] While economic growth may be one factor that can contribute to greater wellbeing, this is not always the result.

Economists are not focused solely on an objective of economic growth per se, but rather a broader objective of improved welfare or wellbeing.[413] The measure of GDP (and other figures contributing to a nation's accounts), was developed by Simon Kuznets for the United States government in the 1930s.[414] In developing these tools, he warned of the over reliance on figures as a measurement of the welfare of a nation. Kuznets makes a number of caveats around use of the information without considering the assumptions upon which it relies.[415] He even goes so far as to state that: "The welfare of a nation can, therefore, scarcely be inferred from a measurement of national income as defined above".[416] Kuznets points out that national income (including GDP) does not take into account the personal distribution of this income, nor the contributions made by those that do not get paid for their work. Neither does the measure consider the qualitative side of the effort that goes into producing that income. All in all, while GDP and national income measures have been an extremely positive contribution to a nation's ability to assess the productivity and earnings of the collective, they do not

[412] Dalziel, Saunders, and Saunders *Wellbeing Economics: The capabilities approach to prosperity* (online ed, Palgrave Macmillan, Switzerland, 2018) at 2-3.

[413] Dalziel, Saunders, and Saunders, above n 412, consider the objectives of a line of economists to support this statement.

[414] Kuznets, above n 341.

[415] At 7.

[416] At 7.

measure the welfare of a nation. GDP is a significant but by no means sole contributor to national wellbeing.

Kuznets advocated for economic growth as a pathway to improved wellbeing because he had a theory that inequality would reduce as economic growth increased. The "Kuznets Curve", developed in the 1950s, hypothesised that as economic growth increased, inequality would decrease.[417] The curve is a bell shape because Kuznets posited that, initially, economic growth would cause inequality to grow and then reduce as economic growth reached a level where over 50 per cent of the poorer rural workers moved to industrialised urban jobs and higher wages.

Of course, the Kuznets Curve hypothesis was inaccurate; while growth persisted in the major developed economies, inequality increased. Piketty suggests this is because Kuznets relied upon "extremely fragile" empirical underpinnings, and much of the post-war experience of decreased inequality was because of the effect of war rather than the effects of economic growth.[418]

Undoubtedly economic growth has many positive effects, especially in lifting developing nations out of poverty.[419] However, growth that is effective in building the prosperity of those who need it most must ensure participation of the nation's poorest and must also ensure environmental protection is managed sustainably.[420] Growth is only one part of improving the wellbeing of a nation's inhabitants.[421] Growth, in itself, does not guarantee improved wellbeing. It is a pathway rather than being the objective or outcome sought. In addition, economic growth is by no means a failsafe pathway toward improved wellbeing outcomes.

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[417] Simon Kuznets "Economic Growth and Income Inequality" (1955) 45 (March) *American Economic Review* 1.

[418] Thomas Piketty *Capital in the Twenty-First Century* (Belknap, Harvard, 2014) at 19.

[419] Department of International Development *Growth: Building Jobs and Prosperity in Developing Countries* (DFID, Great Britain, 2008).

[420] Above n 419, at 2. Also see Stiglitz "8. Inequality and Economic Growth" (2016) 86 *The Political Quarterly* 134 at 140-142.

[421] The Treasury of New Zealand *Towards an Inclusive Economy* (The Treasury, DP 01/15, 2001) at 7.

Economic growth does not always result in improved wellbeing

There have been many economists that are critical of the assumption that economic growth improves overall wellbeing. Dalziel, Saunders and Saunders accumulate the findings of many studies to summarise "it is not reasonable to presume that GDP growth, regardless of the nature of that growth, will increase wellbeing. Indeed, certain patterns of growth can cause harm to wellbeing, and so economics must recover a deeper understanding of how wellbeing is enhanced."[422]

Stiglitz, Piketty, Atkinson, and Wilkinson and Pickett all provide evidence that the focus on economic growth has resulted in negative wellbeing outcomes for many people as a result of the growth in inequality.[423] Wilkinson and Pickett, in particular, provide ample evidence of a multitude of social ills that are linked with the growth in inequality, including poorer health and educational outcomes. Tim Jackson identifies the cost on the health of the planet and future generations as a result of growth without regard to environmental consequences.[424] Where economic growth is prioritised over environmental protections, our wellbeing will deteriorate as a result of degradation of our environment and natural resources. Jackson argues this is not sustainable in a world projected to further increase its population. While economic growth may therefore have positive wellbeing outcomes in some instances, this is not always the case.

Not only is economic growth sometimes linked with negative wellbeing outcomes but there is even evidence that policies promoting economic growth can have the perverse effect of doing exactly the opposite. Policies promoting economic growth often promote the welfare of businesses and this can have the detrimental effect of increasing inequality. Evidence now shows that inequality is linked with lower growth and that better distribution leads to higher

[422] Dalziel, Saunders, and Saunders, above n 412, at 8.

[423] Wilkinson and Pickett, above n 48.

[424] Tim Jackson *Prosperity Without Growth: Foundations for the economy of tomorrow* (Routledge, London, 2017).

growth.[425] The neo-liberal arguments for economic growth may, therefore, be having a detrimental impact upon growth.

For these reasons, the goal of economic growth should not be elevated to drive tax policy setting in the way it has done over the past few decades in New Zealand.[426] There is also little empirical evidence to show that tax policy, per se, has a significant impact upon economic growth in any case.[427]

While economic growth can be good for a nation, as an objective without restraint, it can produce outcomes that do not improve the wellbeing of the nation's inhabitants. Using taxation to improve the material living conditions of New Zealanders therefore needs to be re-evaluated.

In the next section, the inclusion of prosperity as a principle of tax policy setting is discussed.

3.5 Rethinking the principles guiding tax policy setting

As stated in the introduction, when determining tax settings, decisions need to be made as to what the tax base should be, who will be included in the pool of taxpayers and where the rates should be set. These decisions are supported by the tax policy setting framework. There is no doubt that these decisions are highly subjective and are influenced by the political system of the state in question. The tax settings of a highly libertarian nation may not be accepted as 'good' settings in a nation that leans toward socialism.

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[425] Anna Campos *Dossier: The Consequences of Inequality* (2017) Caixa Bank Research, Macroeconomics Unit, Strategic Planning and Research; Federico Cingano *Trends in Income Inequality and its Impact on Economic growth* (2014) OECD Social, Employment and Migration Working Papers No.163; Brueckner and Lederman *Effects of income inequality on aggregate output* (The World Bank, Policy Research Working Paper Series, no. 7317, 2015).

[426] Evidence supporting this statement can be found in the examination of tax settings in chapters 5 to 7.

[427] Gareth Myles "Taxation and economic growth" (2000) 21(1) *Fiscal Studies* 141; Easterly and Rebelo "Fiscal policy and economic growth" (1993) 32 *Journal of Monetary Economics* 417; Stokey and Rebelo "Growth effects of flat-rate taxes" (1995) 103(3) *The Journal of Political Economy* 519; Gale and Samwick "Effects of Income Tax Changes in Economic Growth" in Auerbach and Smetters (ed) *The Economics of Tax Policy* (Oxford Scholarship online, 2017).

Tax settings need to find their position, depending on the political system of the state, along a spectrum of possibilities with respect to two areas of tension. The first is the question of how much a state should allocate to the private sector and how much to the public sector – in other words, how much total tax should a state levy on the private sector? This is discussed further below. Once the allocation of public and private is determined, the second tension is how should the allocation of taxation occur within the private sector?

Determining who should pay what, or the second tension, occupies significant discussion. This decision concerns questions of what the tax base should be and what rates should apply. In New Zealand, this conversation has dominated recent public discussions with politicians debating whether income from capital should be taxed.[428] This debate is broader than determining a tax base – it is a question of whether those with wealth should contribute more to the public funds than they currently do.

Decisions around how the tax burden should be distributed amongst the private sector, mainly rests on the principles of fairness or equity. Debate around the second tension also centres around the economic growth objective as owners of mobile factors of production argue that if they are taxed leniently, everyone will prosper through increased jobs and wealth in the economy – the neo-liberal narrative. As discussed above, the economic growth objective has too many weaknesses to drive decisions around how the tax 'burden' will be allocated. Before examining the recommendation to adopt the objective of prosperity, the first tension is considered.

The first tension concerns the broader picture of what sort of state is desired and how much tax revenue is needed to fulfil that vision. Taxation is an allocation of wealth between the private and the public sector. Determining how much wealth should be allocated to each sector is fundamental to the role of the public sector in the state. A libertarian view of a state will wish to minimise the transfers to the public fund to only that amount required for basic protections to be met.[429] A socialist view of a state will want to transfer a much larger amount of wealth out of the private sector in order to fund high levels of public provision of goods and services. The objective of this chapter is not to ask which view of the state should be

[428] Andrew Maples and Sue Yong "The Tax Working Group and Capital Gains Tax in New Zealand – a missed opportunity?" (2019) 21(2) *Journal of Australian Taxation* 66.

[429] For example, Nozick, above n 113, advocates for a state with only the most basic protections.

adopted but what principles should be used to assess where on that spectrum New Zealand may find its equilibrium.

Murphy and Nagel refer to the decision on how much tax should be allocated from the private sector into the public sector as the public-private decision. In this context, they state:[430]

> Efficiency requires that we not employ resources publicly if their private use would do more good, and vice versa: Ideally the boundary between the two should be drawn in a way that equalizes the marginal value, by some appropriate measure, of public and private expenditures.

Although Murphy and Nagel refer to "efficiency", they are not referring to administrative efficiency but rather to employing resources where the best economic outcomes are found. By doing "more good", Murphy and Nagel refer to the value of decisions across the population rather than just to one individual.

To determine the principles a state may use to guide how much revenue should be reallocated to the public fund, the broader question of the purpose of the state should be considered. Understanding the purpose of cooperating as a community gives us insight into what we want to achieve through this cooperation.

3.5.1 Purpose of the state

The purpose of a state was addressed in chapter two at 2.6. For the purpose of chapter two, the purpose of the state was examined to inform the justification for tax. In this chapter, the purpose of the state is viewed through the lens of determining the principles upon which tax policy should be based.

Both Hobbes and Locke justify the existence of a state on the basis that it is better than the alternative "state of nature". Hobbes describes the state of nature in gruelling terms as a chaotic and frightening place with no industry and no development of knowledge.[431] He concludes that people are willing to forego some of their personal freedoms in exchange for the benefits of organisation.[432] John Locke justifies the state in a similar way. While his

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[430] Murphy and Nagel, above n 132, at 77.

[431] Hobbes' "Leviathan", above n 130.

[432] This exchange is later referred to by theorists such as Rousseau as the "social contract theory". See Rousseau *The Social Contract* (JM Dent and Sons, London, 1913) at 69.

version of the state of nature is not quite so dismal and lawless as Hobbes' portrayal, he too takes the view that civil society is preferred to the uncertainty and insecurity of a world without organisation.[433]

In Leviathan, Hobbes described the purpose of the state as:[434]

> …for defence from invasion of foreigners and the injuries of one another, and thereby to secure them in such sort as that by their own industry and by the fruits of the earth they may nourish themselves and live contentedly, is to confer all their power and strength upon one man or upon one assembly of men to bear their person…

Hobbes describes the objective of state protection and the resulting enjoyment of industry. Locke, too, in his Second Treatise of Government, describes the objective of the state in terms of preservation of property and the resulting peace and safety.[435] Rousseau, in his essay on the Social Contract, describes the objective of Government as being for "the preservation and prosperity of its members".[436]

Hobbes, Locke, and Rousseau share a common view of the purpose of a state: to provide protection of property and person so members can go about their business and prosper. Without state protection, individuals are liable to suffer personal injury or loss of assets and will expend undue effort on protecting themselves and their property.

In more recent commentary, Yuval Harari rationalises the human tendency toward communing as a state.[437] He argues that groups formed by social bonds only are ideally formed in quantities of 150 at the maximum as this is the limit of natural connections.[438] The formation of groups far beyond this size means the bond must be made for other reasons.

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[433] Locke's "Second Treatise", above n 131.

[434] Hobbes' "Leviathan", above n 130, Part II, Chapter XVII at 128.

[435] Locke's "Second Treatise", above n 131, at 66.

[436] Rousseau, above n 432.

[437] Yuval Noah Harari *Sapiens: A brief history of humankind* (Vintage, London, 2011).

[438] At 30.

Harari argues these larger groups are formed by shared belief systems.[439] However, more relevant for this thesis is that Harari attributes the need for organisation to facilitate cooperation.[440] States provide the organisation and protection to enable trade to take place between individuals who would not usually have a connection.[441]

Therefore, the purpose of a state is, and always has been, to organise large groups for cooperation, innovation, and trade to achieve higher levels of prosperity and wellbeing.

Many states have a document that sets out the common purpose and rules of their state. For example, the United States of America has a constitution that begins with the preamble:[442]

> We the People of the United States, in order to form a more perfect union, establish justice, insure tranquillity, provide for the common defence, promote the general welfare, and secure the blessings of liberty to ourselves and our posterity, do ordain and establish this constitution for the United States of America.

This document provides significant guidance on the purpose of the union, including establishing a defence and justice system, and promoting the general welfare.

New Zealand does not have a single constitutional document for guidance on the purpose of the state. The original agreement between the British Crown and a group of Māori tribes, The Treaty of Waitangi or Te Tiriti o Waitangi, offered the Māori tribes protection by the Crown in exchange for the ability to govern the lands. The treaty refers to the purpose of the government to maintain peace and order.

Murphy and Nagel describe the role of a modern administrative state to its members:[443]

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[439] At 31.

[440] At 118.

[441] The nation state is the most prevalent form of political organisation today, although in the past, empires have facilitated social, economic, political, and cultural structure: Robert Marks *The Origins of the Modern World: A global and environmental narrative from the fifteenth to the twenty-first century* (3rd ed, Rowman & Littlefield, 2015). As both Locke and Hobbes state, we choose organisation over a "state of nature" as we can achieve higher standards of wellbeing: above notes 130 and 131.

[442] United States Constitution, preamble.

[443] Murphy and Nagel, above n 132, at 41.

> It is essential to keep in mind, when considering these questions, that government doesn't only regulate people's lives. By providing the institutional conditions without which modern civilization and economic activity could not exist, government is substantially responsible for the lives that people can lead.

The provision of protection and justice allows people to make contracts and go about their business in the knowledge their rights are enforceable under the protections granted by the state. Protection and order are the bases for improving people's living conditions. Not only do they feel safer, but they are also able to work together under the protection of organisation. This is enabled when a set of enforceable rules govern the transactions and interactions between members of the community. Of course, every state and every newly elected government will have its own set of objectives. The underlying objective of communing as a state, however, is for the prospect of progress to enable more prosperous lives. Without the state, as described by Hobbes and Locke, we are left in a state of nature, without protection and unable to rely on transacting with others for mutual benefit.

As the role of taxation is to support the broader aims of government, in determining both how much tax revenue should be reallocated from the private sector and how the tax burden should be shared across the private sector, the broader goals of government should be considered. In this context, the role of government in enabling human progress is paramount.

This thesis proposes that tax settings should not only be fair but should encourage prosperity as well. The conception of prosperity is discussed further below. The aim of prosperity reflects the underpinning objectives of the state in enabling humans to specialise, trade, innovate, and flourish. Prosperity also reflects the significant role tax plays in the economy by reallocating resources from the private sector to the public sector, redistributing resources around. While it is recognised that broader conceptions of wellbeing incorporate factors beyond material outcomes,[444] general tax settings are concerned with funding public goods and services, and redistribution objectives.[445]

The principle that tax settings should not inhibit economic activity supports the objective that as a community, we work toward greater prosperity. If tax inhibits economic activity, it undermines one of the fundamental purposes of the state. The Mirrlees Review of the UK tax

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[444] Per the LSF, above n 50.

[445] Murphy and Nagel, above n 132.

system states in its chapter on the economic approach to tax design that a good tax system should "promote economic welfare".[446] The group also state the objectives of a tax system should not "unnecessarily discourage economic activity" and should also achieve "distributional objectives".[447] It is notable that the group state this objective in the negative; rather than taking a role in promoting economic activity, the tax system should aim not to inhibit economic activity. The same observation can be made regarding the New Zealand tax review groups who have worked within a set of principles including one of "minimising impediments to economic growth and avoiding distortions to the use of resources."[448] However, as discussed above, there are weaknesses in focussing on economic growth alone.[449] This chapter proposes that the existing objective that tax should not impede economic growth should be reframed as a principle that tax should promote prosperity, allowing for a much broader conception of wellbeing to be incorporated.

Tax policy should be set with the principles of both fairness and prosperity in mind. The objective of fairness satisfies the need for a tax system that is just. The objective of prosperity satisfies the need for the tax system to support our broader goal of cooperation – the reason we choose not to live in a 'state of nature'. As will be seen throughout the thesis, these two objectives are usually consistent.

3.5.2 Prosperity

Prosperity, like fairness, is a complex objective. The Oxford English Dictionary defines prosperity as "the state of being prosperous".[450] Prosperous is described as "successful in material terms; flourishing financially". This definition highlights the importance of material wealth for prosperity.

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[446] Mirrlees review, above n 262, at 23.

[447] At 35.

[448] TWG report, above n 112.

[449] See discussion above at 3.4.

[450] Angus Stevenson (ed) *Oxford Dictionary of English* (Oxford University Press, online ed, 2020).

Tax policy settings can contribute toward shared prosperity, through redistributive measures and by encouraging participation and productiveness in the economy.

The OECD has found that government spending initiatives that stimulate workforce participation improve economic growth.[451] Workforce participation not only improves economic growth, and therefore financial capital, but human and social capitals too.[452]

However, tax measures aimed at improving economic growth may not always be consistent with a broader conception of prosperity. For example, some existing tax settings favour income from capital and income derived by non-resident investors.[453] These favourable tax settings may increase inequality by putting more wealth into the hands of owners of capital. This may then lead to a negative impact upon participation. Aside from issues of fairness, this may not enhance prosperity either as the objective is higher living standards for all, not just owners of capital.

To achieve prosperity, New Zealand's tax settings need to encourage production of goods and services, and investment into technology and human capital. Participation in the workforce is essential to overall wellbeing and should not be inhibited by the tax system. However, tax settings that favour income from capital do not necessarily contribute to higher living standards for all. All of this is examined more closely in the next chapter.

3.6 The Framework

The purpose of this chapter is to develop a modern normative framework as the basis for assessing the overall question of this thesis. This chapter proposes that fairness and prosperity are the two key principles of tax policy setting in a modern economy. These two principles go to the heart of substantive policymaking. In the main, they should work in harmony if a

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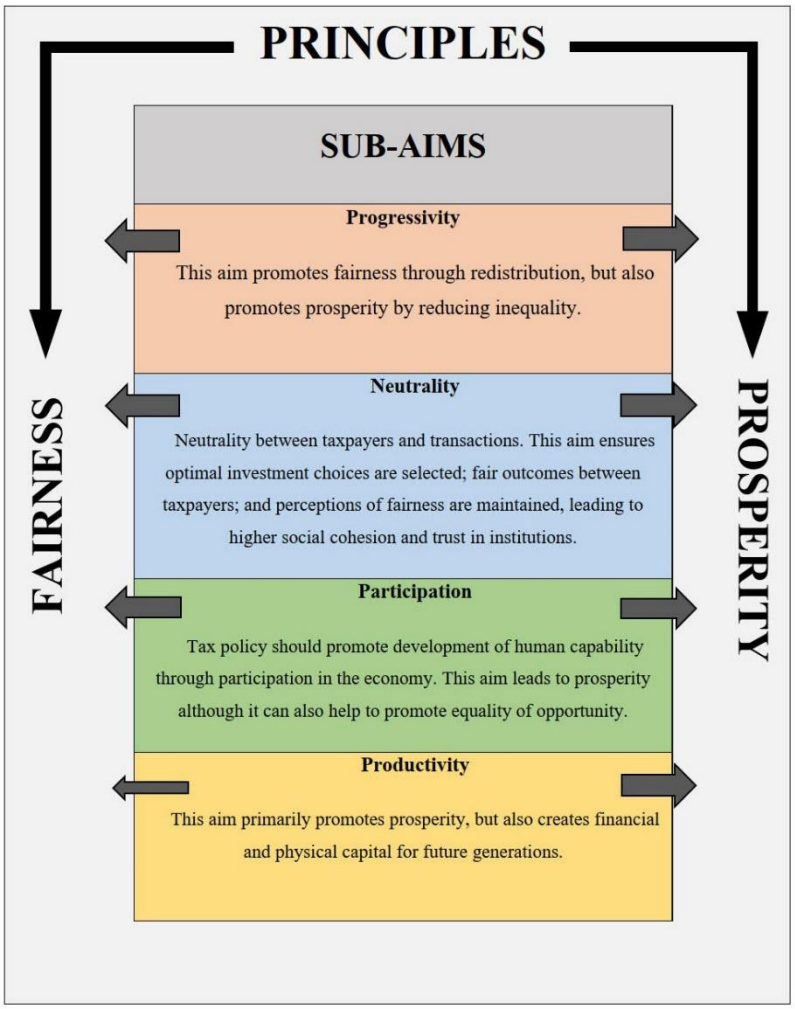
[451] Arjona, Ladaique, and Pearson "Growth, Inequality and Social Protection" (OECD Labour Market and Social Policy Occasional Papers No.51, June 2001).

[452] As above.

[453] New Zealand generally does not tax income from the sale of capital assets, favouring owners of capital. Non-residents are favoured through Approved Issuer Levy which results in many foreign lenders having no tax liability in New Zealand for interest derived in New Zealand. Also, the Foreign Investor Tax Credit regime and the reduction in NRWT for some investors to 0 per cent means many foreign investors into New Zealand based companies have no tax liability beyond the corporate tax paid.

modern interpretation of both objectives is adopted. Fairness should encompass elements of reward for enterprise. Prosperity should be shared and encourage wide participation in the economy. The proposed tax policy framework includes four sub-aims: progressivity, neutrality, participation, and productivity. These sub-aims are introduced below but will be analysed in more depth in chapter four. The framework is as follows:

Tax Policy Framework



As New Zealand policymakers have articulated the importance of distribution of outcomes in the LSF, progressivity of tax settings to support redistribution necessarily follows. Progressivity of tax settings leads to greater fairness by rebalancing the inequalities of market distributions. It can also lead toward higher levels of shared prosperity by increasing the opportunities of those who fare worst in the market. By improving the outcomes of the least advantaged, this enables greater participation in education and the workforce.

Fairness is also supported by the aim of neutrality. Tax should not distort market outcomes as this will lead to sub-optimal decision making. Sub-optimal decision-making decreases overall prosperity and fairness. Neutrality is achieved when taxpayers in the same position are treated in the same way. It is also achieved when alternative investment decisions are treated equally.

Participation leads to greater prosperity by encouraging individuals to take part in education and employment. This improves the situation of the individual, in terms of human capital and wider society with respect to the opportunity to tap into a greater pool of talent and to increase productivity. Participation is integral to both fairness and prosperity and the impact of tax settings upon participation should be considered when developing tax policy.

Productivity means efficient production of goods and services. Goods and services increase our material living standards and quality of life. Material abundance is key to our overall prosperity and wealth. However, this must be undertaken in a manner that is sustainable and doesn't utilise an excessive quantity of inputs. Government policy may have an impact on productivity because it is affected by how and who makes investment decisions, by the quality and quantity of skills and knowledge, and by the amount of physical and financial capital available. Tax policy is integral to all these factors. Tax settings impact how much financial capital is available in the private and public sectors. Tax settings may also operate in ways that are not neutral, by encouraging or discouraging investment choices. When tax settings are being developed, the impact upon the whole economy's productivity should be considered.

3.7 Conclusion

The purpose of this chapter is to analyse the tax policy frameworks used in New Zealand over the course of history with a view to recommending a new tax policy framework. This chapter proposes that fairness and prosperity are the two key principles of tax policy setting in a modern economy. These two principles go to the heart of substantive policymaking. In the main, they should work in harmony if a modern interpretation of both objectives is adopted.

Prosperity is a new principle that has evolved over recent decades in tax policy commentary. It has been categorised under the canon of efficiency – or extended from efficiency but with a focus on economic growth. When Smith referred to efficiency, he essentially referred to the tax system in an administrative sense. The costs of collecting taxes should not exceed or absorb the tax revenue itself. He also refers to the inefficiencies that can result where taxation

distorts investment or spending decisions. Smith recommends taxation remain as neutral as possible to avoid these unnecessary losses. From the McLeod Committee onward, however, efficiency was expanded to include the goal of economic growth.

The goal of economic growth has been deemphasised since the development of the LSF. Many of the components of wellbeing under the LSF relate to material living standards. However, this is a much broader goal than economic growth alone. In fact, where economic growth is being achieved alongside increased inequality, material living standards for many may be deteriorating. The LSF conception of higher living standards involves shared opportunities and prosperity.

Tax settings are an integral part of a state's economy, and they have a significant impact upon the material wellbeing of its residents and other economic participants. This author believes enhancing material wellbeing should be a goal of tax policy. As, arguably, the state exists for the purpose of enabling human progress, it stands to reason that tax policy should support the purpose of the state, especially given the strong connection between taxation and economic wellbeing. Being framed as prosperity, however, ensures tax policy settings are focused on sustained and shared economic wellbeing.

4 Sub-aims of the tax policy setting framework

4.1 Introduction

This chapter expands upon the framework developed in chapter three. The purpose is to justify and deepen the explanation of the sub-aims of the framework that support the overall objectives of fairness and prosperity in tax policy design. These sub-aims are more easily applied than the objectives as they are less aspirational and more specific in their preferred outcome. Therefore, in assessing the overall question in this thesis, how New Zealand should tax its inbound investors, these sub-aims can provide the applied link between the overall objectives and the tax settings themselves.

This chapter will consider the conceptions of fairness and prosperity in parts 4.2 and 4.3 in relation to the applicability of the framework. It will then examine how each sub-aim underpins the overall objectives of the framework in part 4.4.

4.2 Conception of fairness

Fairness has always been the foundation principle for tax policy discussions. From Adam Smith through to modern policy analysis, 'equity' or 'fairness'[454] is cited as the leading canon for tax policy development.[455] Despite that, recent decades have seen a shift toward tax settings that prioritise economic growth, based upon a theoretical foundation that this will result in better overall wellbeing.[456] In New Zealand, this turning point is evident from the early 1990s when the Hon Ruth Richardson, Minister of Finance, adopted a policy to minimise tax on non-residents in order to attract foreign investment into New Zealand.[457]

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[454] In this thesis the term 'fairness' is used instead of equity. The conceptions of both fairness and equity are varied and therefore exchanging these terms is not expected to have any consequence. Therefore, when referring to Smith's canon, the term "equity" will be used. However, the modern use of this canon will be referred to as "fairness".

[455] Above n 51, at book V, chapter II, part II.; above n 112, at 28.

[456] See discussion above at part 3.5.

[457] New Zealand Government *Taxing Income Across International Borders: A Policy Framework* (30 July 1991) at 10.

New Zealand is not unique in this regard. The competition for international capital through attractive taxation regimes is a global issue.[458]

Conceptions of fairness differ dependent upon the underpinning moral or political philosophy adopted. A libertarian perspective places high value and confidence in the workings of the free market – or the freedom of individuals to contract with others as they please.[459] To a libertarian, fairness encompasses economic freedom. Provided arrangements come about through legitimate means, then the division of property is validated, and the recipient of property effectively has a "right" to keep that property.[460] This perspective seems to run counter to a state's redistribution objectives. If a state chooses to use the tax system to reallocate resources from its wealthier citizens to its poorer citizens, this action takes from the wealthy the property they are rightfully entitled to.

Nozick, a libertarian, believes only the most basic state provision can be justified, effectively through voluntary taxes. Nozick views the state as evolving from the "outsourcing" of one's need for protection.[461] He suggests that everyone can assign their rights to protection to an external agency and for this, they are willing to pay a "fee". Nozick specifically rejects taxation as compulsory as he regards it as a form of slavery – that is, one is forced to work to pay tax.[462] Equally, Nozick outright rejects any redistribution aims of government as an infringement of one's natural rights.[463]

An alternative view is that of John Rawls. Rawls' conception of justice is underpinned by a view of the state as a hypothetical agreement between individuals for the betterment of

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[458] This is one of the drivers for the OECDs long running BEPS programme: <Base erosion and profit shifting - OECD BEPS>.

[459] Nozick, above n 113.

[460] At 150.

[461] At 12.

[462] At 169.

[463] At 149, 172.

society.[464] Rawls argues that no one would contract to make themselves worse off: the hypothetical contract should have terms and conditions that work in everyone's favour.[465] This contract is entered into by all participants in society behind a "veil of ignorance": that is, contractors do not know where their own place in society will be or how they, as individuals, will be advantaged or disadvantaged by the contract.[466] This enables participants to contract without self-interest.

Rawls's social contract basis allows him to develop his principles of justice. These are:[467]

> First: each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others.
>
> Second: social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all.

Rawls states his principles must be applied in this order: the second principle cannot justify breaching the first.[468] Regardless of any efficiency arguments able to be made under the second principle, the liberties of equal citizenship and equal opportunities must be prioritised.[469]

The second principle allows for division of income and assets generated by society on an unequal basis to the extent it serves to benefit the least advantaged. Rawls summarises the effect of the principles as follows:[470]

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[464] Rawls, above n 201, at 11. Rawls' theory of justice builds on the social contract theory established by theorists such as Locke, Kant, and Rousseau.

[465] At 13.

[466] At 12.

[467] At 61

[468] At 61.

[469] At 61

[470] At 62.

> All social values – liberty and opportunity, income and wealth, and the bases of self-respect – are to be distributed equally unless an unequal distribution of any, or all, of these values is to everyone's advantage.

In terms of conceptions of justice, we therefore have two extremes. Rawls advocates equality of opportunity and outcomes unless an unequal distribution gives advantage to the least well off. Nozick, at the other extreme, advocates complete freedom to contract as one pleases and for the right to retain property acquired through legitimate means.

These two arguments take different approaches to individual rights. Nozick views property rights as a natural right that should be protected.[471] Nozick believes individuals should be able to exploit their natural advantages for personal gain – be they strength, intelligence, wealth, or inheritance. Taxation, especially for redistribution purposes, infringes upon these natural rights.[472] Rawls' view, on the other hand, is that individuals are willing to forego some of their natural rights in favour of the benefits of participating in a state.[473] He takes the position that in an interdependent society, individuals should not be able to exploit those natural advantages or "accidents of birth" to the detriment of others.[474] Rawls relies upon a social contract to support his theory of justice.

These two perspectives demonstrate an underlying difference in the role of the state. Nozick is in favour of a minimal state and maximisation of personal freedoms. Rawls is in favour of the state taking a far more significant role in people's lives.

For the purpose of this thesis, our framework, as established in chapter three, follows a redistributive approach.[475] The role of taxes in modern society has expanded far beyond a night-watchman state. During the 20th century, modern administrative states have taken a

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[471] Nozick, above n 113, at 171.

[472] At 172.

[473] Rawls, above n 201, at 136.

[474] At 510 – 511. Rawls refers to the distribution of natural abilities.

[475] See framework at 3.6 above.

strong role in redistributive policies.[476] In a modern context, the question is not whether redistribution is a role of the government but how redistribution should be implemented.

While fairness has been a canon of tax policy setting since Adam Smith's time, the conception of what is fair has undoubtedly evolved. While Smith was a benefit theorist, and redistribution did not play a role in the principles he laid down, tax policy has developed from this time to include redistribution within its goals.[477]

Chapter three proposes a framework upon which the distribution of taxation should be spread across those within its tax base catchment. Within the framework, fairness is a paramount objective.[478] The conception of fairness in the framework includes maximising equality of opportunities and minimising inequalities of outcome. This conception of fairness more closely reflects that of Rawls than Nozick. However, the fairness objective must be balanced against the objective to improve prosperity.

4.3 Conception of prosperity

Prosperity is a term that primarily refers to flourishing material wealth. Chapter three has established that one of the objectives of the tax system is to encourage prosperity. As the main raison d'être for a state's existence is to advance human progress,[479] prosperity is integral to that mission. Without prosperity, progress cannot be achieved. This does not mean a state should always focus on maximising wealth. However, certain base levels of economic wellbeing are required to enjoy overall wellbeing in the broader sense.[480]

Developing and maintaining prosperity is a complex matter. Recent decades have had a strong focus on economic growth. However, this focus has been criticised for being too

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[476] For example, in New Zealand, the introduction of the comprehensive welfare state in the 1930s resulted in significant tax increases: Paul Goldsmith, above n 141, at 186.

[477] See the discussion above at 2.3.1.

[478] See above at 3.6.

[479] Rousseau describes the ends of political association as being "the preservation and prosperity of its members" in Rousseau, above n 432, at 69.

[480] Wilkinson and Pickett, above n 48, at 6: the authors demonstrate that economic growth improves outcomes for a state's population up to a point and then the marginal benefits reduce to nil.

narrow.[481] Recent research suggests that overall prosperity is best achieved when inequality is not excessive.[482] Also, prosperity can be assessed on a global basis but also on an individual basis. It is challengeable whether a state achieves the goal of prosperity when some enjoy immense wealth and increase the average wealth per capita while many suffer extreme poverty. To be regarded as a successfully prosperous nation, a certain base level of wealth must be required for all participants. This means that policies may need to be adopted that do not necessarily maximise GDP per capita but enhance the prosperity of the broader group. For this reason, the goal of prosperity will usually be consistent with the redistributive aims associated with the objective of fairness.

Prosperity is primarily encouraged by a tax system that avoids distorting investment decisions, so optimal decisions are made without the interference of tax considerations. This is referred to as neutrality. A tax system that allows room for tax avoidance practices, or favours one investment over another, results in distortion to the overall economy as taxpayers over-invest in the tax favoured activity. This may produce sub-optimal investment decisions.

The goal of prosperity is best achieved by encouraging *sustainable* and *shared* production of goods and services.[483] Sustainable practices mean production needs to be limited to the extent it preserves resources for future enjoyment. These resources will be natural resources such as forests, waterways, and air quality. However, they will also be the development of human capital such as skills and knowledge, and social capital. Prosperity must be shared, not only in a financial sense but as shared participation in the economy.

Prosperity relies upon production of goods and services. The effectiveness and efficiency with which a nation produces goods and services is referred to as productivity. Productivity is a measure of the resources required for production – productivity is improved where fewer inputs are required to produce the same level of output.[484]

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[481] Fitoussi Commission report, above n 47.

[482] Campos, above n 425; Cingano, above n 425; Breueckner and Lederman, above n 425.

[483] This is discussed in more detail further on in this chapter at 4.4.4.

[484] New Zealand Productivity Commission define productivity as "a measure of how much output we produce from a given quantity of inputs" <https://www.productivity.govt.nz/productivity/>.

A tax system that encourages productivity is a system that works toward greater prosperity. Of course, productivity must be sustainable to facilitate intergenerational prosperity. Productivity that is based upon maximum extraction of resources without regard for the future is clearly not consistent with the overall goal of intergenerational wellbeing. Equally, productivity-based upon the participation of a few, and the exclusion of others is not a sustainable approach to wellbeing.

With this conception of the dual objectives of fairness and prosperity clarified, the sub-aims that support these objectives will be explored next.

4.4 Sub-aims toward fairness and prosperity

4.4.1 Progressivity

Progressivity is one conception of vertical equity: the tax burden should fall more heavily on those who can afford to pay. The proportion of tax on income will increase as income increases if the system is progressive. Progressivity promotes fairness through redistribution of pre-tax market outcomes. It also improves prosperity by reducing inequalities. Furthermore, it can lead to improved social capital where the progressivity results in perceptions of fairness.

Discussion on issues of equity in relation to the provision of beneficial tax treatment of inbound investors can be divided into considerations of inter-nation equity and inter-individual equity; that is, equity between nations and equity within a nation.[485] This thesis is mainly concerned with inter-individual equity: equity within a nation. However, this thesis is also strongly connected with inter-nation equity. Avi-Yonah explains how reducing taxes for inbound investors in a developed nation with good provision of public goods and services is harmful.[486] The provision of public goods and services must be paid for and this burden will fall on less mobile domestic residents. This creates inequities. The inbound investors are still able to benefit from investing in a well-developed economy without a fair contribution back into the economy.[487] Avi-Yonah compares this with investing in a nation without an

[485] Brewer Richman, above n 223.

[486] Avi-Yonah, above n 141, at 1625.

[487] At 1625.

advanced level of provision of public goods and services. In this case, the investor may have to invest in basic infrastructure to support their activity, for example, upskilling staff or building energy plants. Where the infrastructure has already been paid for by existing taxpayers, a discounted tax liability transfers wealth from local taxpayers to the inbound investor. There would need to be a strong case for improvements in prosperity to justify such a value transfer that negates vertical equity considerations.

Some public economists recommend the use of taxation to even out the inequalities in wealth that are created by market-driven activity.[488] This is the underlying driver for progressivity of the tax system.

However, in practice, tax may also be a significant cause of distributive injustice.[489] Globalisation has resulted in increasing competition between states for the most desirable residents and capital.[490] States want to attract capital to increase production of goods and services and the ensuing economic benefits that come from that.[491] Capital enables production and, hopefully, economic growth – making everyone in the state better off through increased employment and wages. The argument is that to improve economic wellbeing, a state must attract investment – "a rising tide lifts all boats".

Tax competition has created pressure upon governments to incentivise inward investment using taxation measures. Tsilly Dagan states:[492]

> …the decentralized nature of international taxation puts states in competition for residents and investment... In conditions of competition the state-citizen relationship is transformed in that states become, to a large degree, market actors competing for residents (individuals as well as businesses), factors of production, and tax revenues.

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[488] This is one of the key recommendations of Thomas Piketty, above n 418.

[489] Dagan, above n 33; Avi-Yonah, above n 141.

[490] Avi-Yonah, above n 141, at 1565.

[491] Inland Revenue Department and The Treasury *New Zealand's taxation framework for inbound investment: A draft overview of current tax policy settings* (IRD and The Treasury, Wellington, June 2016) at 8.

[492] Avi-Yonah, above n 141, at 13.

Dagan points out that states compete for both desirable residents and for capital. These residents and capital are typically the most mobile; that is, residents that have highly sought-after skills are more readily able to move from one state to another. Equally, mobile capital is highly sought-after as it is easily transferred from one place to another, even though more committed forms of investment may be equally or more desirable.

One of the cornerstones of Dagan's argument is that tax treaties benefit those wealthy capital exporting countries by favouring taxation based upon residence.[493] She argues that while tax treaties purport to be for the alleviation of double taxation, this can also be achieved (and typically is achieved) by unilateral measures.[494] Dagan proves, using the methodology of game theory, that unilateral measures will usually find an equilibrium that favours host country taxation over residence country taxation.[495] This is contrary to the OECD model tax treaty's effect, which favours the country of residence.

Regardless of the reasons for entering double taxation agreements, the overall effect is to transfer taxing rights from the capital importing state to the capital exporting state.[496] Where a state imposes taxation based upon residence and source principles, an agreement with another state that alters taxing rights will either maintain the status quo under the domestic law, or it will reduce the source-based taxing rights. Effectively, a global shift of tax revenue takes place, from developing states who are importing much needed capital, to wealthier capital exporting states. As stated above, this thesis is not concerned with inter-nation equity but as New Zealand is a capital importing nation, the practice of entering double tax agreements will result in a shift of tax revenue offshore, usually to wealthier states or to the wealthy inbound investors.

Incentivising inbound investment through preferential tax measures results in reduced progressivity and the associated negative consequences. Decreased progressivity exacerbates our growing inequality which contravenes our sense of fairness. This erodes perceptions of fairness and social capital. Inequality is also associated with a decline of economic growth

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[493] Dagan, above n 33, at 110.

[494] Dagan, above n 33, at 98.

[495] At 98.

[496] At 110.

and prosperity by some economists.[497] This will be considered further in part 4.4.4 when productivity is considered.

Next, we consider neutrality, in the sense of both horizontal fairness and neutrality of investment decisions.

4.4.2 Neutrality

Usually neutrality, in the context of tax policy setting, refers to the objective that tax should not distort economic decision-making. This is one aspect of Adam Smith's canon of efficiency: it may "discourage them from applying to certain branches of business".[498] However, in this context, it is used to encompass horizontal equity as well. Neutrality is achieved when tax does not distort outcomes. This can be with regard to taxpayers or transactions.

Neutrality with respect to taxpayers is horizontal equity – treating those in the same position in the same way. This is an essential component of both fairness and prosperity. If taxpayers in the same position are treated differently under tax law, this will impact on both the perception of fairness and fair outcomes. More typically, horizontal inequity arises because transactions are treated differently for tax purposes – for example, if income from capital is favoured over income from labour, then taxpayers will have different tax outcomes depending on where their income is derived from. Horizontal equity and neutrality often arise from the same tax settings.

Neutrality of transactions means that tax should not distort economic decision-making. Keeping tax neutral ensures that decisions are made based on their own merits and will improve the likelihood of a closer approximation to optimal outcomes, assuming no other distortions are present. This will ideally lead to improved financial and physical capital.

Neutrality of taxpayers and transactions will improve perceptions of fairness, leading to improved social capital.

Where tax is neutral in its application, it will enhance both fairness and prosperity.

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[497] See the discussion on this point further in this chapter.

[498] Smith, above n 51, at book V, chapter II, part II.

4.4.2.1 Horizontal fairness

The principle of horizontal equity states that taxpayers that are similarly situated should be subject to the same taxation burden. Despite the prevalence of this equity goal in literature and policy settings, its theoretical foundations have been questioned. It has been argued that the goal of horizontal equity relies upon a presumption that the pre-tax income distribution is equitable.[499] While some theorists, such as Nozick, argue that the pre-tax market outcomes are fair,[500] others take a different view.

As discussed above, Nozick advances the view that provided property comes to a person through legitimate means, then the recipient has a natural right or entitlement to that property.[501] This represents a libertarian perspective that property rights are a natural right that must be protected. As the principle of horizontal equity presupposes that the pre-tax market distribution of income and wealth should be maintained post-tax, some commentators argue the principle is most consistent with a libertarian view of property rights.[502]

However, horizontal equity need not be concerned with dessert or moral entitlement – it is concerned with equity of outcomes. Horizontal fairness is not a tool for distributional outcomes – this is the objective of progressivity. Regardless of the moral validity of how a person's income has come about, they are enriched by that income. People who have been enriched in the same amounts, should be subject to taxation equally, unless another objective of tax is being met by a different outcome.[503] As we will see later in the thesis, non-residents are often given tax privileges not available to residents with the same income. This is clearly contrary to horizontal equity outcomes.

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[499] David Elkins "Horizontal Equity as a Principle of Tax Theory" (2006) 24 *Yale Law and Policy Review* 43 at 88.

[500] Nozick, above n 113, at 151.

[501] At 151.

[502] Elkins, above n 499, at 84; Murphy and Nagel, above n 132, at 38-39.

[503] Murphy and Nagel's criticism of horizontal equity is that other social justice objectives may be prioritised over horizontal equity.

Neutrality of tax treatment also enhances perceptions of fairness. Regardless of the fairness of pre-tax market outcomes, if tax is not perceived to be applied even-handedly, it will be detrimental to social capital objectives.

Sometimes one source of income is preferred over another and may be given preferential tax treatment. Alternatively, perhaps an activity or investment choice will be promoted using tax incentives or concessions. This has the effect of creating horizontal inequities but also results in market distortions because of tax settings. These are conscious decisions to override the principle of horizontal equity. Arguably this has occurred with respect to non-residents. However, there should be a justification for deviation from the principle of horizontal equity.

4.4.2.2 Non-distortionary economic decisions

When Adam Smith put forward his principle of *efficiency* to guide tax policy setting, one of the underlying reasons was a belief that tax should not distort ordinary business decisions.[504] If tax becomes a consideration when evaluating two or more investment options, a sub-optimal decision may occur. An effective and efficient decision is one that allows the market to operate free of distortions. While this is clear in a domestic context, it becomes muddied in cross border investment decisions.

If an Australian corporate investor is considering whether to invest in a coal mine in New Zealand or Australia, they will need to model the costs and projected revenues to determine the rate of return for the prospective investments. One of the costs will be the tax costs for each option. As New Zealand and Australia do not have the same tax rates and rules, the tax costs will be different for the two options. Also, depending upon where the shareholders are located and the location of the investment, their tax outcomes may be different. If the shareholders of the investing company are in Australia, the taxes paid in New Zealand will not be creditable against their dividend income from the investing company. If the shareholders are in another jurisdiction, the location of the investment may not have an impact on their personal tax position.

[504] Smith, above n 51, at book V, chapter II, part II.

Cross border investment is generally not neutral due to the differences in tax rates and rules in different jurisdictions.[505] Jurisdictions may take a position on whether they want to be neutral regarding investment into or out of the state. States who want their residents to be tax neutral regarding where they invest may employ policies that adhere to the concept of 'capital export neutrality'. States that want their tax policy to be neutral regarding domestic and inbound investment would adhere to 'capital import neutrality'.[506] New Zealand adopts a capital export neutrality approach but is not neutral with regard to capital importing, as we shall see in chapter seven.

Some theorists regard these two concepts as impossible to achieve concurrently, given the variation in tax rates across jurisdictions.[507] However, if a state ignores the perspective of the taxpayer and considers only the position of the state, neutrality is achieved when residents and non-residents are treated in the same way.

Like horizontal equity, if the concept of neutrality is not met with regard to economic choices, the rationale for diverging from this principle must be justified by more pressing objectives. Tax competition, the act of reducing the tax burden on inbound investors, distorts neutrality by treating non-residents more favourably than residents.

4.4.2.3 Perceptions of fairness

The tax system not only needs to be fair, but it should be perceived to be fair. The benefits to perceptions of fairness include greater willingness to comply with tax laws when taxpayers feel others are also complying. This improves generation of tax revenue and, in turn, provision of public goods and services. Perceptions of fairness also improves trust in institutions and the associated social capital. Simple experiential observation shows that when some members of the public see others paying little tax, the reaction is often: "they don't pay tax, so why should I?"

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[505] For an analysis of neutrality in an international tax context, see David Weisbach "The Use of Neutralities in International Tax Policy" (2015) 68(3) *National Tax Journal* 635.

[506] Brewer Richman coined these terms, above n 223.

[507] Thomas Horst "A Note on the Optimal Taxation of International Investment Income" (1980) 84 *Q.J. Econ*. 793.

Neutrality of tax treatment with respect to both taxpayers and transactions, alongside progressivity of the tax system are essential elements in perceptions of fairness. If members of society can see that some taxpayers are better off than others, or some industry types gain tax benefits, this can erode perceptions of fairness. Perceptions of fairness underly social capital.

Perceptions that the tax system is fair are linked with better compliance outcomes.[508] If an individual believes the tax system that he or she contributes to is fair, then he or she will be more willing to contribute to it. The sense or perception of fairness may arise from the "value" one receives from taxes paid, or from a sense of satisfaction with the way the tax burden is shared across taxpayers.[509] Given the wide acceptance of the redistributive aim of tax, linking taxes paid to benefits received seems too simplistic. Perceptions of fairness must therefore incorporate a sense of participation in decision making and endorsement of the redistributive aims.

Slemrod addresses the importance of social capital in contributing toward the willingness of taxpayers to comply.[510] Slemrod notes the high level of compliance despite the low probability of audit amounts to a "pathological honesty".[511] He attributes high levels of voluntary compliance with social capital and credits this with lowering the government's costs of enforcement.[512] Essentially, where social capital is high, taxation collection is more efficient due to a willingness to comply without force.

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[508] Torgler, Schneider, and Schaltegger "With or Against the People? The Impact of a Bottom-Up Approach on Tax Morale and the Shadow Economy" (University of California Berkeley, Berkeley Program in Law and Economics, Working Paper Series, 2007) at 30.

[509] Torgler, Schneider, and Schaltegger find the quality of the institutions and their accountability to their voting base have a positive impact upon tax morale and reduce the incidence of tax evasion.

[510] Joel Slemrod "On Voluntary Compliance, Voluntary Taxes, and Social Capital" (1998) 51(3) *National Tax Journal* 480.

[511] At 485.

[512] At 486.

Knack and Keefer undertook empirical work on trust and civic duty and their correlation with prosperity and growth.[513] One of the five aspects of trust that is measured is whether someone is willing to avoid meeting their tax obligations given the opportunity. The avoidance of tax liabilities goes largely undetected and may be viewed as a victimless crime. Voluntary compliance therefore relies upon taxpayer willingness to comply. Knack and Keefer find a strong correlation between trust and economic performance. More specifically, they find that high levels of trust correlate to higher income in later years, suggesting that trust leads to greater prosperity, rather than the other way around. Social capital is fundamentally a result of equity. If members of a state perceive the tax settings are fair and the procedures around collecting, paying, and challenging tax liabilities are fair, then social capital will be elevated. This, in turn, enhances prosperity. Social capital is a result of meeting one objective, but it serves to enhance the other as well.

Changes have taken place since the global financial crisis ("GFC"). With tax revenues under strain due to falling profits and increased unemployment, those taxpayers failing to support the tax base became the subject of unwanted attention. Enormous efforts have been made since 2008 to shine light on multinational tax avoidance practices by the G8, G20, the Organisation for Economic Cooperation and Development ("OECD"), and individual governments.[514] This public scrutiny is likely to be reignited with the economic impact of the COVID-19 pandemic.

The G8 and G20 organisations, formed from the largest and most powerful 8 and 20 countries around the globe, identified the problem of multinational tax avoidance.[515] The OECD and the G20 undertook two projects: one sought to set standards for global tax transparency[516] while the other dealt with the multi-faceted issues around base erosion and profit shifting

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[513] Knack and Keefer, above n 385; the link between social capital and economic growth is also established by Putnam, Leonardi, and Nanetti *Making Democracy Work: Civic traditions in Modern Italy* (Princeton University Press, New Jersey, 1993).

[514] See OECD "Base erosion and profit shifting" www.OECD.org <Base erosion and profit shifting - OECD BEPS>.

[515] Simon Bowers "G8 and tax avoidance: Q&A" *The Guardian* (online ed, London, 19 June 2013).

[516] See OECD "Global Forum on Transparency and Exchange of Information for Tax Purposes" www.OECD.org <Global Forum on Transparency and Exchange of Information for Tax Purposes (oecd.org)>.

(now referred to simply as 'BEPS').[517] These significant projects have gained widespread media attention – bringing multinational household names into public view. Certainly, media polls tend to suggest the public does not support tax avoidance practices.[518]

Prior to the OECD/G20 projects, the United States government formed a permanent subcommittee of the senate to investigate tax avoidance by multinationals. The subcommittee investigated Microsoft, Hewlett-Packard, Apple, and Caterpillar.[519] The focus of the investigations is on how these multinationals shift their profits to destinations with low or no tax, avoiding tax liabilities on global profits in the United States. These investigations brought the tax practices of multinationals into public view.

One of the most high-profile investigations undertaken by the permanent subcommittee examined the tax minimisation activities of Apple Inc. Located in Cupertino in the United States, Apple Inc. sold its valuable intellectual property to an Irish subsidiary in 1985 in order to alienate this potentially valuable asset from the United States tax base. While intellectual property development continued in the United States, the Irish subsidiary remunerated its United States parent with a "cost-sharing" agreement, paying only the costs of intellectual property development. Since that time, Apple's intellectual property has grown to create the most valuable brand in the world[520] and it is the first company to have reached a market capitalisation of more than USD 2 trillion.[521]

In 2013, John McCain, a former United States senator stated:[522]

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[517] OECD "BEPs", above n 458.

[518] Jon Stone "Most people think legal tax avoidance is just as wrong as illegal tax evasion, poll suggests" *The Independent* (online ed., UK, 1 March 2015).

[519] US Senate investigation into Apple Inc's tax avoidance activity, above n 4.

[520] According to Interbrand, www.Interbrand.com <Best Brands - Interbrand>, in 2020, the Apple brand is valued at almost USD 323 billion.

[521] Gurman and Vlastelica "Apple Makes Wall Street History by Breaking $2 Trillion Barrier" *Bloomburg* (online ed, New York, 20 August 2020).

[522] US Senate investigation into Apple Inc's tax avoidance activity, above n 4.

> Today, Apple has over $100 billion, more than two thirds of its total profits, stashed away in an offshore account. That's over $100 billion that are not currently subject to US corporate income taxes and, therefore, *cannot be used to ease the deficit or help invigorate the same American economy that fostered the creation of this large corporation in the first place*. As the shadow of sequestration encroaches on hard-working American families, it is unacceptable that corporations like Apple are able to exploit tax loopholes to avoid paying billions in taxes. (emphasis added)

More broadly, at the same time, commentary is found in the media such as that from Brian Levin:[523]

> Last week, I wrote a "Letter to Apple CEO Tim Cook from a Disgruntled Shareholder", expressing my grievances about Apple's tax avoidance. I wrote because I find it immoral that Apple, the wealthiest company in America, has not paid U.S. taxes on at least $74 billion over the past four years. Apple's practices, like those of Amazon, Google, GE and others, are not victimless. In fact, they contribute directly to our inability to close the budget deficit and help cause the painful sequester cuts that have stemmed from the government's inability to fund its operations. Furthermore, the rest of us--the American people and most companies--end up having a higher tax burden because the government has to collect more from us when the wealthiest companies do not pay their due.

Even the co-founder of Apple Inc., Steve Wozniak, had this to say about the tax avoidance arrangements:[524]

> Apple thinks it must have a strategy to maximise profits. That is ethically wrong. But for a corporation there is no such thing as corporate ethics. As a result, big companies including Apple pay only the tax that the system requires them to pay. That is because corporations make sure it works that way.

These quotes are reproduced here as they represent widely held views. United States senators, both republican and democrat, public commentators and even a co-founder of Apple Inc. all share a dim view of the company's tax avoidance activity. All refer to the loss suffered by other taxpayers and members of society as a result of Apple Inc.'s decision to minimise its tax liabilities. Where those who can afford to pay tax choose not to, this is accompanied by a sense of grievance by others who do not have that option. The balance of the population is

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[523] Brian Levin, "Apple's Tax Avoidance: 'Not Illegal' Does Not Mean Moral, Right or Acceptable" *Huffington Post* (online ed., New York, 28 May 2013).

[524] Apple Inc. "Business Conduct: The way we do business worldwide" *Belfast Telegraph* (online ed., Belfast, December 2012).

left to pick up the tax obligations not met by the wealthier, more mobile tax base, hence the incursion upon perceptions of fairness. Individuals become less satisfied with the tax system overall where they see their own contribution is more than what they perceive as fair. This results in deterioration of trust in institutions and therefore, social capital.

When the public becomes aware that many taxpayers who can afford to pay tax choose not to, perceptions of fairness are undermined. This, in turn, deteriorates social capital especially where multinationals' shareholders may have quietly benefitted from structuring their affairs to reduce their tax burden.

Tax competition involves providing preferential tax outcomes for inbound investors as a means of attracting 'scarce' and mobile capital. However, these preferential settings are not horizontally equitable, they are not neutral, and they deteriorate social capital through reducing perceptions of fairness in the tax system. Whether this can be justified based on another sub-aim of the framework will be considered in this thesis. However, favourable tax settings on non-residents does not meet the sub-aim of neutrality.

4.4.3 Participation and human capital

The next sub-aim of the normative framework as developed in chapter three is participation. This aim has multiple outcomes that support both the fairness and prosperity objectives. In an ideal state, every individual should have the opportunity to participate in civic life, education, and the workforce. Broad participation can improve prosperity, as will be discussed further below, by broadening the pool of talent available for achievement of economic goals.[525] However, it also improves fairness by ensuring each person *can* reach their potential. Participation is usually achieved by ensuring adequate provision of health and education.[526] However, a significant barrier to accessing health and education can often be distribution. Participation is negatively affected by inequality. Improved equality, through the tax system, is one way to improve participation and the result of that participation is increased stocks of human and social capital.

[525] Stiglitz, above n 420, at 140-142.

[526] Morrissey, above n 389.

Human capital is "an individual's skills, knowledge, mental and physical health that enable them to participate fully in work, study, recreation and in society more broadly".[527] The capital is measured through educational and health outcomes.[528] Although in the framework the sub-aim is called "participation", ultimately the act of participation and the stock of human capital are inextricably linked.

According to work undertaken by Treasury officials on human capital, the desired outcomes with regard to human capital are better labour market participation, improving an individuals' subjective and material wellbeing, and improved societal economic performance, cultural wellbeing and social capital outcomes.[529] Essentially, skilled and participating humans have better wellbeing outcomes and this contributes toward better societal outcomes.

The same piece of work by the Treasury identifies those inputs required to achieve improved human capital. The inputs are varied but include quality education and health services.[530] Education and health are typically the focus when measuring stocks of human capital. Human capital is measured in financial terms, so it is readily comparable with other capitals across time and geographic areas. Measurement of a concept as intangible as human capital is challenging and inevitably flawed. However, up to now, in New Zealand, human capital from education is measured by using an income-based approach. This is a measurement of projected lifetime earnings per qualification.[531] This is directly comparable across nations as other states calculate the same measurement. Health is more challenging to measure and there is no universal method. However, measures such as life expectancy and subjective wellbeing contribute to an overall assessment of health.[532]

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[527] At 3.

[528] The measures for each capital, including human capital, are found on the LSF dashboard, above n 360. The measures currently used to quantify human capital are cognitive skills at age 15; educational attainment of the adult population; life expectancy; and impact of non-communicable diseases.

[529] Morrissey, above n 389, at 2.

[530] At 3.

[531] Le, Gibson, and Oxley *Measures of Human Capital: A Review of the Literature* (NZ Treasury WP 05/10, November 2005) at 6.

[532] Morrissey, above n 389, at 15.

While human capital can be measured through observation of educational and health outcomes, the more vexing question is how to develop and utilise this capital. How can a state put the settings in place to ensure human capital is maximised?

In terms of enabling the development of human capital in the individual, aside from provision of access to health and education, several other determinants are required. This includes norms, attitudes and behaviours toward health and education, housing quality and material wealth, the quality of the physical environment, family wellbeing, pre-natal conditions, and social connections.[533] While health and education are influenced by state provision, the other determinants are usually in the private domain. They are the conditions relating to the individual and their environment.

Also identified by the Treasury paper are barriers to the utilisation of human capital – that is, the human capital may already be developed, but society is failing to utilise this.[534] The barriers identified include 'structural disadvantage', the 'dual burden', cultural and social norms, and management skills.[535] The structural disadvantage exists where the individual's condition presents a disadvantage, such as where progression in the workplace is advanced by playing golf with colleagues. This will be a barrier for someone unwilling or unable to play golf. The dual burden occurs where (typically) women find themselves working in both paid and unpaid work as a result of bearing the burden of domestic chores as well as paid work outside the home. Cultural and social norms are a subtle form of structural disadvantage, where expectations relating to a person's circumstances prevent them from participating in education or progressing their skills. Management skills can also create a barrier to development and utilisation where training and skill development is not promoted or valued, or where biases favour some races, genders, or ethnicities. In other words, managers may not fully utilise the staff they have available due to a lack of management skill or biases.

One of the key barriers to development and utilisation of human capital is that some individuals are inherently disadvantaged. There are many reasons for these disadvantages to arise, but the outcome is that human capital is not optimised. Research undertaken in 2001 by

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[533] At 3.

[534] At 3.

[535] At 3.

Paul David indicates one of the barriers to development and optimisation of human capital stems from poverty of ethnic minorities.[536] This poverty results in perceived limitations, both within and outside the affected group. Research in 2018 by Morrissey observes similar limitations regarding gender: perceptions that women with young children will be working part-time or that women are not the "breadwinner" of the family.[537]

To improve overall human capital, policies should prioritise the needs of those whose human capital is lowest. Raising the skill levels of the least skilled is the most effective way to reduce inequality and, in turn, improve human capital.[538]

David's study on human capital focuses on the objective of increasing economic growth. He too concludes that improvement of the human capital of the least well-off should be the primary focus.[539] Morrissey also highlights the problem of distributional issues regarding improving human capital in New Zealand.[540]

To this end, Acemoglu recommends increased progressivity of tax rates in New Zealand.[541]. However, this is prefaced with the necessity to assess the effect of increased taxes on labour market elasticity.

Consistent among all these researchers is a mutual concern that unequal distribution of wealth, education and health is a significant barrier to overall improvement of human capital. Individuals whose wealth, education and health are low are less likely or able to participate in the workforce. This leads to the conclusion that tax policy that is inconsistent with redistribution policies is counterproductive for development and utilisation of human capital. Until our less advantaged groups have the same opportunities availed to them as our most

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[536] David (with Goddard Lopez) *Knowledge, Capabilities and Human Capital Formation in Economic Growth* (The Treasury, WP 01/13, June 2001) at 123.

[537] At 14.

[538] Acemoglu *Human Capital Policies and the Distribution of Income: A Framework for Analysis and literature Review* (The Treasury, WP 01/03, 1 December 2001).

[539] David, above n 536.

[540] Morrissey, above n 389.

[541] Acemoglu, above n 538.

advantaged, our human capital will always be sub-optimal. In addition to this, the broader approach to encouraging participation using tax levers is to encourage labour. Ideally participation will be enhanced through tax incentives to participate. Participation is therefore encouraged through the tax system with progressive tax rates and incentivising labour participation, particularly for the least advantaged.

Tax can be used as a lever to promote social or economic goals. There may be active ways to use tax to incentivise development and utilisation of human capital.[542] However, this is outside the scope of this research. In this context, it is the overall tax settings that are relevant. Tax settings should be used to encourage the development of human skills and to encourage participation in the workforce, which leads to better participation in other areas of society. However, since the early 1990s, the dominant discourse in tax policy discussion has favoured income from capital over labour. Favourable tax treatment for non-resident investors has been one of the consequences of tax competition and this has placed a heavier tax burden upon labour. This is explored in chapters five to seven.

4.4.4 Productivity and financial and physical capital

The last aim of the tax policy framework developed in chapter three is productivity. Productivity refers to the production of goods and services, essential to the maintenance of humanity's standard of living. Improved productivity occurs when efficiencies result in less inputs being required to produce greater outputs.[543] For example, when less labour is required to produce the same amount of milk powder, we have improved productivity. Productivity relies upon not only labour but also financial and physical capitals. It also creates physical and financial capital for both current prosperity and for future prosperity. Productivity is key to our material standard of living.

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[542] For example, deductibility of education expenses is suggested by David, above n 536, at 119. Note that the OECD report on "Taxation and Skills: Financial Incentives to Invest in Education" (OECD Policy Studies, April 2017) shows New Zealand performs poorly in using the tax system to encourage improvement of skills.

[543] New Zealand Productivity commission definition of "productivity". Found at <Productivity Commission | Productivity>.

One of the main purposes for organisation is to cooperate for higher living standards.[544] By working together, humans have discovered they can progress toward improved material conditions. This is the basis for organisation, including the organisation of government and the state. Productivity is not therefore just an activity that is nice to have, it is the very reason for human organisation. We are all better off through cooperation. Tax settings need to encourage, and not inhibit, productivity – while remaining in balance with the other aims.

The inputs required for productivity include labour, intellectual property or know-how, and financial and physical capitals. Labour and intellectual property have been considered under the aim of participation and both lead to improved stocks of human capital. Productivity will focus more closely on the desired outcome to build stocks of financial and physical capitals. These stocks are both the result of productivity and an input of production.

The OECD use the term 'economic capital' and categorise this into produced capital and financial capital.[545] Produced capital is all tangible assets and knowledge assets. This includes buildings, machinery, and motor vehicles as well as computer software, prototypes, and artistic works. These might also be referred to as tangible and intangible capital, or physical and intellectual capital. Financial capital includes currency and deposits, and loans and debts, according to the OECD. Financial capital is money and money's worth. Any nuances of these definitions are not that relevant for the purpose of this thesis. Essentially, economic capital encompasses that which has been man-made and has value. The LSF uses the term financial and physical capital to describe this category of capital.

4.4.4.1 Relationship of taxation, productivity and financial/physical capital

Taxation is an essential component of a state's financial and physical capital. In New Zealand, around $85 billion in tax is collected annually and this amounts to almost 30 per cent of gross domestic product (GDP).[546] As discussed in chapter two, the primary purpose of taxation is to collect revenue for the government to fund the provision of public goods and

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[544] Rousseau, above n 432.

[545] OECD, above n 49, at 21.

[546] New Zealand Government "Financial Statements of the Government of New Zealand for the year ended 30 June 2020" www.treasury.govt.nz <Financial Statements of the Government of New Zealand for the year ended 30 June 2020 (treasury.govt.nz)>.

services. A secondary purpose is redistribution of wealth. Taxation is a transfer of money from the private sector to the public sector. Much of it is then transferred back to the private sector as goods, services, or redistributions. For this reason, taxation is integral to the development and production of financial and physical capital.

As shown in chapters five to seven, the main contention by business advocating for lower taxes is that the cost of taxation reduces profitability and therefore makes investment into business less attractive. The underlying assumption of these views is that financial and physical capital is best utilised in the private sector. Tax is regarded only as a cost of business that reduces an investor's return, and therefore their willingness to invest. An investor will seek out the best return they can find in the global market. Reduced investment results in a lower stock of capital and lower standards of living. Tax competition practices then stem from the fear of losing investors. States compete to attract business investment by reducing tax costs for inbound investors. This has resulted in some preferential tax regimes being granted to non-resident investors in order to attract this "scarce" capital.[547] Alternatively, if a state does not provide an attractive tax environment, it risks reduced capital investment and reduced production of goods and services.

Research is less clear as to how responsive investment is to tax settings. Mooij and Ederveen conducted a literature review and found most studies observe a negative relationship between increasing taxes and quantity of inbound foreign direct investment. [548] Note that this study considered direct foreign investment which is usually regarded as less mobile than portfolio investors. Overall, most studies show inbound foreign direct investment decreases as tax rates increase, indicating investors are sensitive to tax rates. However, the review also uncovered large variability in the elasticity of these two factors. The OECD suggests this is not surprising given the variation in corporate tax rates, host country environment and policies, types of industries and other factors.[549] The Inland Revenue Department's Policy and Strategy team and The Treasury point out that none of the studies observed by Mooij and

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[547] Avi-Yonah, above n 141.

[548] Mooij and Ederveen "Taxation and Foreign Direct Investment: A synthesis of Empirical Research" (2003) 14(4) *International Economic Journal* 77.

[549] OECD Tax Policy Studies *Tax effects on Foreign Direct Investment: Recent evidence and policy analysis* (OECD Tax Policy Studies No. 17, 2007).

Ederveen include New Zealand, and therefore it is difficult to draw any conclusions on tax settings and foreign investment in New Zealand.[550]

Research undertaken by the Productivity Commission[551] indicates one of the reasons for New Zealand's underperformance in productivity statistics is lack of capital investment.[552] Mason compares New Zealand and Australia's productivity performance and notes that Australia benefits from higher capital investment per labour hour employed. Mason also notes Australia benefits from higher levels of skill.[553] Conway also observes New Zealand has less capital per employee than other developed nations and this could be holding New Zealand back from greater productivity.[554] These researchers argue that higher capital investment in New Zealand will result in more efficient use of labour.

Capital investment is therefore desired but there is no certainty as to how responsive inbound investment is to tax settings.

Where inbound investors are given preferential tax treatment, the result is a shift in financial capital offshore. Whereas preferential treatment to domestic investors results in a shift from the public to the private sector, or perhaps from one part of the private sector to another, the wealth stays within the borders. This is not the case for foreign investors. A reduction in taxation on inbound investors is therefore a direct transfer of wealth offshore. In addition to this, because of the common practice of crediting foreign taxes paid against domestic taxes, reductions in host country tax tends to favour those investors from low or no tax jurisdictions.

Finding an appropriate taxation setting for inbound investors when considering an objective of maximising both private and public sector financial and physical capital requires balancing

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[550] New Zealand's taxation framework for inbound investment 2016, above n 491, at 8.

[551] The Productivity Commission was established in 2010 under the New Zealand Productivity Commission Act 2010 to investigate issues relating to New Zealand's productivity.

[552] Geoff Mason *Investigating New Zealand-Australia productivity differences: New comparisons at industry level* (New Zealand Productivity Commission, WP 2013/02, December 2013); Paul Conway "Can the Kiwi Fly: Achieving Productivity Lift-Off in New Zealand" (2018) 34 *Productivity Monitor* 40.

[553] Mason, above n 552.

[554] Conway, above n 552.

of multiple factors. First, the nation in which the production of goods and services takes place (the host country), does not want to see all the gains moved offshore. Some of the gains must be kept onshore as a reward and to fund the inputs provided by the nation in the form of human skills, public infrastructure, customer base and natural resources. On the other hand, some reward for capital investment can also be expected by inbound investors.

4.4.4.2 Other arguments against preferential tax settings on inbound investors

There are a number of economic arguments against tax competition. One of the recognised outcomes of tax competition is that it reduces productivity by providing competitive advantage for multinationals able to take advantage of reduced tax costs without having to improve their business efficiency. Tax competition can therefore result in reduced market competition and sub-optimal productivity.[555]

The 2016 joint Inland Revenue Department ("IRD") and Treasury statement on inbound investor policy recognise the multiple factors influencing policy setting. While accepting the cohesive argument put forward by corporate interests that reducing tax costs on inbound investors could lead to improved economic wellbeing,[556] the document also identifies competing factors. The authors observe that the two reductions in corporate tax rates in 2008 and 2011 were not accompanied by any increase in inbound foreign direct investment, at all.[557] While the commentary recognises the links between tax and economic growth are complex, there is no conclusive evidence to support the economic growth claims of many corporate interests in New Zealand.[558]

The IRD and Treasury identify offsetting factors that may reduce the elasticity of inbound investment and tax rates. First, they identify that location-specific rents mean that some

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[555] Angel Gurria, OECD Secretary-General "Taxation and Competition Policy" (Competition Forum, European Commission, Brussels, 11 February 2014).

[556] New Zealand's taxation framework for inbound investment 2016, above n 491, at 8.

[557] The first corporate tax rate reduction occurred on 1 April 2008 and reduced the rate from 33 per cent to 30 per cent. From 1 April 2011, the rate was further reduced to 28 per cent.

[558] At 8.

investors are less sensitive to New Zealand's tax rates.[559] This may arise where New Zealand offers higher than usual returns because of location-specific factors. For example, access to the New Zealand market may offer higher returns or access to a resource available in New Zealand. In these situations, the investor may make higher than usual returns due to New Zealand's unique factors. Reducing tax on these investors may simply reduce tax revenue without affecting the supply of investment.[560]

Another offsetting factor is that existing investment is already committed to New Zealand. Reductions in corporate tax rates will reduce tax revenue and provide a windfall gain to the investor. The IRD and Treasury refer to this as "sunk investment".[561] This is lost tax revenue without any increase in capital investment.

Another offsetting factor is the ability of investors to gain a tax credit for non-resident withholding taxes ("NRWT") paid in New Zealand.[562] Most states will allow a tax credit for NRWT on repatriated income. Reductions in tax on amounts being repatriated overseas can result in a direct transfer of tax from New Zealand to another jurisdiction, with no benefit to the investor. Where NRWT is not creditable, investors may be more sensitive to payments of NRWT. Of most significance here is that payments to low-or-no-tax jurisdictions will be the greatest beneficiaries of tax reductions on repatriations – essentially supporting the success of tax havens.

Other factors are identified, and the overall thrust of the document is that several factors may offset the presumption that lower corporate taxes will result in higher foreign investment. There is little evidence to support a position one way or another. While there are global studies showing a link between the amount of foreign direct investment and reduced corporate taxes, there are also many other conditions that may affect the elasticity of the two factors in New Zealand.

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[559] At 10.

[560] One of the beneficiaries is the "big 4" banks who are discussed in chapters seven and eight.

[561] At 11.

[562] At 11.

While doubts are raised with regard to the standard economic wellbeing arguments, there are also significant limitations to the economic wellbeing objective itself. First, the economic wellbeing objective is still entrenched in GDP maximisation dogma. This fails to account for the many other factors that contribute to overall wellbeing, such as deterioration of the environment or erosion of social capital. Also, while short term gains to GDP may (arguably) be obtained by reducing tax on inbound investors, the resulting loss of tax revenues, reduced investment into public goods and services, and growth in inequality may result in far worse economic and overall wellbeing outcomes further down the track.

The neo-liberal arguments for preferential tax rates for non-resident investors leading to improved prosperity are therefore fragile. Offsetting these claims are several counterclaims that lead to declining economic and overall wellbeing outcomes. In the next section, the risk factors associated with financial and physical capitals are considered.

4.4.4.3 Risks to wellbeing in relation to stocks of financial and physical capital

Janssen considers the importance of financial/physical capital in light of New Zealand's LSF.[563] He considers two perspectives of financial/physical capital. One is in terms of the accumulation of a stock of capital for the resilience of the economy. The second considers how financial and physical capital can contribute to production of goods and services and therefore, to higher living standards.

As discussed above, one of the reasons a state may want to keep a stock of capital is to manage the risk and resilience of New Zealand's economy. Frieling and Warren identify the risks New Zealand faces with respect to its stock of financial capital. These are climate change, high income inequality, price shocks, and cyber risks.[564] Climate change places a burden upon financial capital as New Zealand's economy is so dependent upon natural resources. The OECD's review of New Zealand's environmental performance indicates that if New Zealand's pollution is accounted for, New Zealand's economic growth would have

[563] John Janssen *The Start of a Conversation on the Value of New Zealand's Financial/Physical Capital* (The Treasury, DP 18/07, July 2018).

[564] Frieling and Warren *Resilience and Future Wellbeing* (The Treasury, DP 18/05, July 2018) at 14-15.

been negative between 2000-13.[565] This puts New Zealand in the bottom six in the OECD in terms of growth after adjusting for environmental impacts, quite in contrast with the growth statistics which place New Zealand well above the OECD average growth in GDP for the same period when not adjusted for pollution.[566] This demonstrates New Zealand is enjoying current economic growth at the expense of degrading its natural capital.

The framework developed in chapter three does not include an objective of maintenance and improvement of natural capital. This is because tax policies in relation to natural capital are usually targeted rather than being part of the broad framework. Tax policy in relation to natural capital falls within the purpose of tax to support government economic or social policy agendas. However, this is not intended to downplay the importance of natural capital and its impact upon New Zealand's future prosperity. Without a solid foundation of natural capital, New Zealand's future prosperity looks dismal. Tax policy must be targeted in this area in a similar vein to 'sin' taxes such as excise on alcohol, tobacco, petrol, and gambling. This falls outside the scope of this thesis.

Price shocks and cyber risk are both risks associated with exposure to the global economy.[567] A price shock may occur to a global commodity. Frieling and Warren point out that New Zealand is particularly susceptible to price shocks due to the under-diversified nature of our exports. Cyber risk is a result of the digital revolution and exposes the New Zealand economy to potential loss through cybercrime.[568] Both threats pose a risk for New Zealand's stock of financial capital. However, they have little connection with tax settings.

Frieling and Warren identify the final risk to New Zealand's stock of financial capital as excessive or high-income inequality.[569] They refer to the research undertaken by Joseph

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[565] OECD *New Zealand's Environmental Performance Reviews: New Zealand 2017* (OECD publishing, Paris, 2017), figure 3.1. These statistics are historic but are the most recent available in the OECD report.

[566] Above n 565, figure 1.1.

[567] Frieling and Warren, above n 564, at 15.

[568] This has been particularly topical during 2021 with numerous cyber-attacks crippling organisations. One New Zealand example is the attack on the Waikato District Health Board. See Andrew McRae "Waikato DHB cyberattack: Patient, staff data taken, says group claiming hack" *RNZ* (online ed, New Zealand, 25 May 2021).

[569] At 15.

Stiglitz, one of the four economists responsible for the Fitoussi Report.[570] Stiglitz is one of many economists who link inequality with reduced overall prosperity. Stiglitz is a Nobel Memorial Prize winner in Economic Sciences (2001) and has written extensively about income distribution and its impact upon overall prosperity.[571]

Stiglitz argues that inequality is mainly a result of rent-seeking behaviour.[572] By rent-seeking, Stiglitz means rewards that are not a result of creating wealth but are a result of taking a larger share of the wealth that would have been produced anyway. This may occur when taking a higher salary or when taking rent simply based upon ownership claims rather than the production of goods and services. Stiglitz focuses on executive pay as an example of rent-seeking. He observes that executive pay rose dramatically in the United States over the 50 years from 1965 without a corresponding change in productivity. He also identifies the "rent" enjoyed by large banks who effectively enjoy an implicit state guarantee, subsidised by the taxpayer, while taking all the gains into private hands.[573] Stiglitz points to institutional and political influences that underly the movement toward the rent seeker taking a greater share of the wealth than that which they contribute to. This is the outcome of adopting the argument that scarce and mobile factors of production must be rewarded handsomely for fear they will move to another jurisdiction.

However, Stiglitz argues these handsome rewards, and increased inequality, result in worsening economic outcomes for the whole nation. He identifies three effects of excessive inequality that contribute to a decline in overall prosperity.

The first effect is that where many people become poorer in real terms, this weakens demand for goods and services.[574] Stiglitz also points to the usual government response to weakened demand, to decrease interest rates which often leads to an asset bubble, further increasing

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[570] Fitoussi Commission report, above n 47.

[571] For example, Stiglitz *The Great Divide: Unequal Societies and What We Can Do About Them* (WW Norton & Co, New York, 2015).

[572] Stiglitz "Inequality and Economic Growth", above n 420, at 140-142.

[573] At 142.

[574] At 146.

inequality.[575] The second effect of excessive inequality is the accompanying inequality of opportunity.[576] Stiglitz argues that this results in the inability to gain from the potential talent of the poorer sector of the population. If only the wealthy have the opportunities for education and career development, then only this smaller sector of the population can contribute to the development of the nation. This is not only unfair but results in lost opportunities to develop talent amongst a wider pool of people. Finally, Stiglitz argues that more unequal nations invest less in public infrastructure such as transportation, education, and technology.[577] These three outcomes all contribute to the lowering of future economic growth of a nation.

Stiglitz makes a few suggestions for improving equality and one is to ensure full taxation of capital.[578] Currently, capital income is frequently favoured by tax regimes – either through lower taxes on income derived from capital, or reduced taxes on capital gains. The tax preferences granted to non-resident investors is just one example of this.

4.4.4.4 Conclusion on tax settings and productivity

There is little clarity in the literature on whether tax settings can make improvements to productivity and stocks of financial and physical capital. While the neo-liberal arguments for maintaining low tax rates for businesses to increase economic wellbeing are compelling, there is little conclusive evidence to support them – not necessarily because they are false. It is more likely a consequence of the multiplicity of factors contributing toward a decision to

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[575] This has been very evident lately in New Zealand where low interest rates, coupled with several other factors, have contributed to the exorbitant rise in house prices. According to REINZ, house prices rose almost 30% across New Zealand from June 2020 to June 2021, despite the COVID-19 global pandemic. See REINZ "REINZ June data: House prices continue to rise across the country, defying expectations" (press release, 13 July 2021). This trend is not only found in New Zealand. See Peter Martin "House prices in Australia are soaring, but not because there aren't enough homes" *The Conversation* (online ed, Australia, 24 May 2021); Kalyeena Makortoff "Nationwide predicts UK house prices will continue to rise" *The Guardian* (online ed, UK, 21 May 2021); Harry Robertson "US home prices are rising at their fastest in 15 years – and Goldman says they'll surge another 7% this year" *Insider* (online ed, US, 1 April 2021).

[576] At 146.

[577] At 146.

[578] At 148.

invest, the type of investment being made and the reasons for the investment. Equally, there are many arguments against providing tax preferences, where the benefits will not accrue to New Zealand. Counter to the neo-liberal narrative are the increasing calls for reduction in inequality. Inequality is linked with reduced prosperity due to reduced equality of opportunity and reduced investment in infrastructure.[579] What is clear is that provision of public infrastructure, funded by the government, reduces the cost of business and improves the quality of the inputs.[580] It is also clear that preferential tax treatment of non-resident investors shifts potential tax revenue offshore.

4.5 Conclusion

The question addressed in this chapter is how to achieve the objectives of fairness and prosperity through the tax system. The sub-aims of progressivity, neutrality, participation, and productivity have been developed to support the more aspirational objectives of fairness and prosperity. These sub-aims provide more tangible pathways for tax policy assessment.

A tax system that is fair not only benefits from those perceptions of fairness but also the positive outcomes associated with reduced inequalities. This can have a multitude of positive outcomes, including the enhancement of prosperity. Essentially, the two objectives and the sub-aims are inextricably linked. Rather than being competing forces, fairness and prosperity will usually be achieved in tandem, especially where the conception of prosperity is based on a premise of sharing and sustainability.

Progressivity promotes fairness through redistribution. Modern administrative states widely support tax distribution based upon an ability to pay concept. This is also perceived as fair – and perception of fairness is necessary for building trust in the state and its institutions. Progressivity also promotes prosperity through reducing inequality. Inequality is linked with a range of social ills that act to the detriment of the economy's performance.

Neutrality of the tax system with respect to both taxpayers and transactions is essential to both fairness and prosperity. There needs to be a good reason to diverge from treating people and alternative economic choices in a neutral way. A tax system that does not promote equality where the situations are the same will reduce the perceptions of fairness and

[579] Stiglitz, above n 571.

[580] Avi-Yonah, above n 141, at 1618.

undermine the integrity of the tax system. Neutrality is also necessary for optimal economic decisions. Ideally, tax should not distort these decisions, so choices are selected free of tax considerations.

Participation in society promotes prosperity but is derived from fairness. Addressing social ills such as inequality is essential to maximising an individual's participation in education, the workforce, and other aspects of communal life. Higher levels of inequality result in lower levels of participation. This is linked to reduced prosperity for many reasons discussed further in this chapter. Tax policy should focus upon encouraging individual participation.

Finally, productivity promotes prosperity through increased production of goods and services and the associated financial and physical capitals built as a result. It can also contribute to fairness provided the resulting prosperity is shared. Like participation, productivity is enhanced through greater fairness in the tax system.

So far, this study has focused on two sub-questions: can tax on inbound investors be justified and what principles should guide tax policy setting? The conclusion reached in chapter two justifies the inclusion of inbound investors in the tax base of a host state, on the basis they are participating in the economy of that state. The chapter argues the participation provides the justification for the state to legitimately include the non-resident within their tax base. Chapters three and four propose a framework upon which New Zealand might develop its tax settings in a way that promotes fairness and prosperity.

The thesis now takes a sharp deviation away from the theoretical side of tax policy setting and toward an empirical examination of what has happened with regard to taxation of inbound investors in New Zealand over the past six decades. Once complete, chapter eight will tie the theoretical work of the early chapters together with the empirical work of chapters five to seven, to assess whether and how New Zealand's tax settings on inbound investors are as they should be.

5 A tax system in disarray

5.1 Introduction

New Zealand is a large group of islands located in the South Pacific. While its geographical area exceeds that of Great Britain, its population has only recently surpassed 5 million.[581] It is regarded as a relatively "young" country, having been established in its current political form with the agreement of over 500 New Zealand Māori tribes and the British Crown in 1840.[582] Although Māori had inhabited the islands for over 1,000 years, the Treaty of Waitangi and colonisation changed the course of the country's development by uniting all treaty signatories under a single government.[583] In 1947, New Zealand became an independent nation – that is, it took full autonomy from the British Crown.[584]

Colonisation resulted in a rapid development of national infrastructure.[585] It also resulted in New Zealand participating in the first and second world wars, supporting Great Britain. Then, in the 1930s, the comprehensive social welfare system was introduced by the first Labour Government of New Zealand.[586] All this spending resulted in successive New Zealand governments requiring increased income. This came about through large increases in taxation,[587] but also through other tools such as borrowing from offshore.[588] New Zealand is

[581] According to Stats NZ, www.statsnz.com <Home | Stats NZ>.

[582] This agreement is the Te Tiriti o Waitangi (Treaty of Waitangi) 1840.

[583] This is a statement of how history occurred only. In fact, there was and still is significant disagreement over whether this was the intention of the treaty.

[584] Statute of Westminster Adoption Act 1947.

[585] Goldsmith, above n 141, at 33.

[586] Social Security Act 1938.

[587] Goldsmith, above n 141 in chapters 8 and 9, discusses Walter Nash's influence on increased taxes.

[588] Belich *Making Peoples: A History of New Zealanders from Polynesian Settlement to the End of the Nineteenth Century* (Allen Lane, Auckland, 1996) at 242.

not unusual in this regard. New colonies across history have required significant levels of investment.[589]

By the 1950s, New Zealand was a relatively wealthy country with sustained economic growth.[590] Its economy was built upon agriculture: supplying meat, wool, and dairy to the British market.[591] Since the 1960s, however, New Zealand's relative growth deteriorated compared with other developed nations.[592] This caused concern for successive governments.[593] One of the solutions was to encourage the import of foreign capital to New Zealand in the hope this would boost productivity and grow the economy.[594] Whether this goal was achieved is difficult to measure as we cannot know where New Zealand would be without this investment. We measure ourselves against the relative growth of other economies that have been on a similar journey toward increased openness to foreign trade and capital.

Despite the lack of firm evidence, inbound foreign investment is widely believed to be of benefit to New Zealand as it funds additional production of goods and services, necessary for economic growth. Like many other nations, New Zealand has used tax as a tool to entice foreign investment.[595] This practice has resulted in global tax competition – that is, nations compete against other nations using tax incentives and concessions to attract foreign

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[589] Bernard Attard "Making the Colonial State: Development, Debt, and Warfare in New Zealand, 1853-76" (2012) 52(2) *Australian Economic History Review* 101.

[590] GR Hawke *The Making of New Zealand: An Economic History* (Cambridge University Press, Cambridge, 1985) at 177; Brian Roper *Prosperity for All? Economic, Social and Political Change in New Zealand Since 1935* (Thomson Dunmore Press, Australia, 2005) at 4.

[591] Hawke, above n 590, at 58.

[592] Hawke, above n 590, at 329.

[593] The focus on economic growth is discussed above at 3.4.

[594] Examples such as Ruth Richardson's tax policies to attract foreign investment are discussed in more detail in part 6.3.1 further on in this thesis.

[595] See the discussion in chapters six and seven.

investment.[596] Globally, these practices have been referred to as a 'race to the bottom'.[597] While this claim is debatable, there has been a global trend toward reduced corporate tax rates[598] and many incentives introduced for wealthy investors and migrants.[599]

This chapter is the first of three that explores the development of international tax policy through three periods of New Zealand's recent history. This thesis argues that taxation of non-resident investors has shifted from being discriminatory, through a transitional, and then preferential period when compared with domestic investors. These are not three perfectly delineated moments of time. They represent a trend from a discriminatory tax treatment through to a preferential tax treatment. This trend has coincided with the growing attempts to attract foreign investment. Prior to the 1970s, foreign investment was considered by some commentators to be detrimental to a healthy domestic economy.[600] It was perceived, by some, as a way for foreign interests to strip New Zealand of its resources and wealth.[601] This belief changed as government realised the potential benefits of foreign investment in bridging the gap between available domestic capital and the capital required to maximise employment and production of goods and services. We will observe the discourse over the next three chapters that demonstrate the rise in tax competition in New Zealand. This is consistent with the global trend.

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[596] OECD "BEPS report", above n 12.

[597] For example, the Tax Justice Network refer to tax competition as triggering a race to the bottom: <Tax competition and the race to the bottom - Tax Justice Network>. It is noteworthy, however, that the OECD have been undertaking significant work to reverse this trend, perhaps best evidenced by the Pillar One and Two Blueprints, above n 19, where a unified approach to taxation is recommended with a minimum tax imposition for large multinationals recommended.

[598] OECD *Corporate Tax Statistics* (OECD, Paris, 2019).

[599] In New Zealand, new migrants are granted a four-year tax holiday from foreign-sourced investment income (Income Tax Act 2007, s HR 8).

[600] W.B. Sutch *Takeover New Zealand* (A.H.& A.W. Reed, Wellington, 1972); See speech by Bill Rowling at (5 August 1964) 339 NZPD 1092.

[601] As above.

The tax policy settings for inbound investors are assessed against the settings for domestic investors. Rather than assessing the level of taxation upon income from investment in isolation, the thesis considers the way an inbound investor may be discriminated against or preferred with lower or higher tax imposition compared to the base standard of a domestic investor. The phase examined in this chapter is referred to as the discriminatory phase.

It is important to note that in the context of this thesis, discrimination is used in the sense of the plain meaning of the word and should not be confused with the concept of 'non-discrimination' used in bilateral tax treaties. [602] Article 24 of the OECD model tax convention states that:

> …nationals of a contracting state shall not be subjected in the other contracting state to any taxation…which is other or more burdensome than the taxation...to which nationals of that other state… are subjected.

The treaty also disallows tax discrimination based upon the residence of the owners of capital.[603] These provisions were first introduced into the 1977 OECD Model Tax treaty which is late in the period discussed in this chapter. The intention of Article 24 is to prevent tax protectionism – that is, using the tax system to deter foreign investors.[604] However, the purpose of this thesis is to observe a trend in favour of inbound investors rather than to determine adherence to the OECD model treaty. For this reason, this is outside the scope of the overall study and will not be addressed in this chapter.

During the discriminatory phase, the New Zealand economy was very closed to foreign interests, and there was a culture of distrust toward non-resident investors. However, the tax policies of the time were not necessarily as discriminatory as the general tenor of the period in New Zealand politics. If any general statement can be made regarding tax policy in relation

[602] OECD Model Tax Convention, above n 117, Article 24(1).

[603] Article 24(3), (4) and (5).

[604] Elliffe "Thin Capitalisation Rules and Treaties: Does the ratio in the New Zealand thin capitalisation rules contravene New Zealand's tax treaty obligations?" (2012) 18(4) *NZBLQ* 307 at 310.

to inbound investors during this period, it was that the domestic tax law became so inequitable and incoherent at times that non-residents were given little attention.[605]

This chapter considers the general political, economic, and social background of the discriminatory period in part 5.2. Part 5.4 will then examine the various tax review groups during the 1960s through the 1980s. Finally, in part 5.5, the development of New Zealand's tax treaty network throughout the discriminatory period will be observed.

5.2 Domestic background during the discriminatory period

For the purpose of this research, the discriminatory phase is the time prior to the early 1990s. Investment in New Zealand businesses by non-residents became increasingly common from the 1960s onward. The tax treatment of non-residents during each period needs to be considered in light of the political environment. The following section gives some background of the political scene in New Zealand during the discriminatory phase.

While neo-liberal economics influenced political policy in the United States and the United Kingdom in the 1970s,[606] New Zealand did not adopt "free market" policies until the mid-1980s.[607] Up until then, the government continued to be highly interventionist.[608]

The political scene in New Zealand during the 1970s and early 1980s was dominated by the presence of the Rt Hon Sir Robert Muldoon. Muldoon was the Finance Minister from 1967 to 1972 and was both Finance Minister and Prime Minister from 1975 to 1984.[609] Muldoon was

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[605] The incoherence and inequity of the tax system during this period was highlighted by the McCaw Taskforce in their report, above n 292.

[606] Daniel Stedman Jones *Masters of the Universe: Hayek, Friedman, and the Birth of Neo-Liberal Politics* (Princeton University Press, United States, 2012) at 216-217.

[607] The revolution of neo-liberalism in New Zealand is discussed in Marcia Russell *Revolution: New Zealand from Fortress to Free Market* (Hodder Moa Beckett, Auckland, 1996).

[608] Geoff Bertram refers to this period as "insulation and industrialisation" in his chapter "The New Zealand Economy 1900-2000" in Giselle Byrnes (ed) *The New Oxford History of New Zealand* (Oxford University Press, UK, 2009) 537 at 540; Richard Osborne "Toward Prosperity? Some Aspects of Recent Economic Deregulation in New Zealand" (1990) 7(1-2) *Pacific Basin Law Journal* 158 at 163.

[609] See <https://www.parliament.nz/en/visit-and-learn/mps-and-parliaments-1854-onwards/prime-ministers-of-new-zealand-since-1856/> for a list of New Zealand prime ministers and their party affiliations since 1856.

a member of New Zealand's more conservative National Party, and one might describe the tenor of the period as heavily controlled by the state. New Zealand was one of the most closed economies in the world, with the state controlling almost all international financial transactions.[610] Economic policies were dominated by the drive to minimise imported goods and services and maximise exported goods and services with the Government sitting in the centre of these private transactions.[611] The key to a wealthier future was considered to be the maximisation of the balance of trade in New Zealand's favour.

New Zealand had been in a steady period of economic decline since the 1950s after enjoying relative prosperity.[612] For decades, New Zealand acted as Britain's farm, exporting agricultural products to Britain.[613] When Britain joined the European Economic Community in 1973, the effect on New Zealand was profound. New Zealand still relied on agriculture as its primary export industry, but its main market disappeared almost overnight.[614] Britain had formed a new political allegiance with Europe and could no longer favour its dominions from its colonial past.

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[610] Hawke, above n 590, at 163 for a discussion on the introduction of exchange controls and import licencing into New Zealand in 1938. Also see, Marcia Russell above n 607, at 80, for a statement from Roger Douglas regarding the deregulation of the financial markets.

[611] In an interview with Marcia Russell, above n 607, at 12, Alan Gibbs says "Every area of our economy was licenced and if you had a licence you were protected, and no one could break into your market... You couldn't import anything to start a new business without months of endeavour in Wellington to write permits and sign offs".

[612] Hawke, above n 590, at 329.

[613] Bertram, above n 608, at 554.

[614] Hawke, above n 590, at 335, although Hawke states there were probably other reasons for the decline in agricultural exports – namely, the trend toward manufactured goods. McAloon has the same reservations stating that the agreement between New Zealand and Britain to take all the meat New Zealand farmers could produce was drawing to a conclusion from 1954: Jim McAloon *Judgements of All Kinds: Economic Policy Making in New Zealand 1945 – 1984* (Victoria University Press, Wellington, 2013) at 98.

The economic mantra of minimising imports and maximising exports in order to improve the wealth of New Zealanders continued through the 1970s and early 1980s.[615] However, imported goods were becoming increasingly expensive.[616] Exports were falling.[617] The government's foreign borrowing was increasing.[618] Inflation was rampant.[619] New Zealand experienced unemployment for the first time since the great depression of the 1930s.[620] Exchange controls meant New Zealanders could not import or export money or goods without the permission of the state.[621] The New Zealand dollar was not allowed to fluctuate according to market forces but was pegged to the British pound and later the United States dollar.[622] Meanwhile, in the Middle East, two oil shocks occurred sending the price of oil to record levels.[623]

The impact on New Zealand's balance of trade prompted Muldoon and his supporters to initiate the "Think Big" projects: building energy-producing infrastructure to reduce the

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[615] Bertram, above n 608, at 548 where he describes the shift from the dominance of terms of trade statistics toward the "real exchange rate".

[616] Hawke, above n 590, at 327-328.

[617] At 327-328.

[618] At figure 15.3 at 314 shows the dramatic increase in budget deficit from 1974 to 1980.

[619] In the New Zealand government's budget of 1976, inflation, alongside growing unemployment, the budget deficits, and growing public debt were highlighted as the most significant problems the country was facing: Budget 1976 [1976] *AJHR* B-6 at 3.

[620] Budget 1976, above n 619.

[621] McAloon, above n 614, at 93.

[622] New Zealand followed Australia in December 1971 and unpegged the NZ dollar from the British pound to the US dollar. In 1973, this was changed to a bundle of 10 currencies: see McAloon, above n 615, at 146. Then, in 1985, the NZ dollar was "floated" by allowing the public to buy and sell the currency through a registered bank without having to go through the Reserve Bank of New Zealand (The Exchange Control Regulations 1985).

[623] James Hamilton "Historical oil shocks" in Parker and Whaples (eds) *Routledge Handbook of Major Events in Economic History* 239, figure 21.7 at 248

country's reliance on expensive, imported energy.[624] This required the government to borrow heavily from foreign banks, worsening New Zealand's balance of trade and placing the country in an increasingly precarious financial position.[625]

Despite the restrictions on importation of goods and services and foreign investment, there was substantial foreign ownership in the New Zealand manufacturing sector. Foreign investors were regarded as key suppliers of technology and skills.[626] Despite the focus on domestic manufacture and production, the reality was that even as early as the 1940s, foreign-owned firms were setting up subsidiaries in New Zealand to manufacture for the domestic market.[627] Cars were built in New Zealand, washing machines were manufactured and later, electronic goods were produced in New Zealand for the domestic market. New Zealand enjoyed the local employment opportunities associated with manufacturing domestically, while also benefitting from the skills and know-how provided by the foreign owner. While restrictions were placed upon foreign ownership, the government would approve those investments that could contribute skills and know-how that did not already exist domestically. Presumably, there was an understanding that New Zealand could not produce these goods without the capital and expertise of foreign investors. However, it was still politically unpalatable to admit to any reliance on foreign investment to sustain growth in the economy.

With this background in mind, the next section considers how tax law developed over this period.

5.3 Tax policy settings in the discriminatory phase

During the period up until the 1980s, Keynesian style economics drove policy making in New Zealand. Government policy was there to provide the levers to manage the economy. Free market economics had not risen to the fore. Tax, like other government policies, was

[624] McAloon, above n 614, at 180 – 185.

[625] Bertram, above n 608, in figure 22.10 at 551.

[626] A requirement for government approval for foreign investment of greater than 25 per cent was introduced by the Overseas Takeover Regulations Act (1964). Investors were required to establish they could contribute technology or knowledge to New Zealand.

[627] Sutch, above n 600.

used to encourage, incentivise, or discourage behaviour or activity. The "hands-on" approach resulted in incentives and concessions being used liberally to promote economic goals during the 1970s and early 1980s. The result was a two-tier tax system – a group that paid very little tax, and another group that paid a lot of tax.

Meanwhile, tax policy settings on foreign inbound investors received less attention. Despite the existence of cross-border trade and investment, it was not on the scale seen today.[628] The post-world-war II era has seen a surge in trade, from 5 per cent to half of global GDP.[629] Cross-border investment has seen similar trends. This may account for the lack of attention to how inbound investors were taxed until much later.

The following sections consider how various sources of inbound investment income were taxed under New Zealand's domestic law during this period.

5.3.1 Taxation of dividends prior to 1964

Prior to 1958, dividends paid by companies to their shareholders were not taxable to the recipient.[630] However, the corporate tax rate was very high, up to 57.5 per cent – in order to offset the shareholder exemption. Both residents and non-residents benefitted equally from the dividend exemption. Even though dividends became taxable in 1958, companies adopted techniques to ensure New Zealand resident shareholders continued to benefit from tax-free distributions.[631] Dividends paid out of 'share premium' or 'capital reserve' accounts were free of taxation at the shareholder level. While not articulated as tax policy to condone these practices, they were allowed to continue for a sustained period of time. As the McCaw Taskforce observed in 1982, the pressure for companies to adopt these artificial practices

[628] C. John McDermott and Rishab Sethi "Balance of payments - A brief history" Te Ara - the Encyclopedia of New Zealand <http://www.TeAra.govt.nz/en/graph/23963/exports-and-imports-1857-2003>.

[629] Peter Vanham "A Brief History of Globalization" (2019) World Economic Forum <A brief history of globalization | World Economic Forum (weforum.org)>.

[630] Land and Income Tax Assessment Act 1954, s 86(1)(i) repealed by Land and Income Tax Amendment (No.2) Act 1958, s6.

[631] McCaw report, above n 292, at 183.

gave some companies (and their shareholders) an advantage over others.[632] In addition, all taxpayers were exempt from income taxes on the first $200 of dividend and interest income. Domestic taxpayers were (and still are) able to deduct any borrowing costs associated with the investment.[633] Therefore, while the law applied equally to the dividend income of residents and non-residents, domestic investors had access to techniques to avoid tax on dividend income.

5.3.2 Taxation of interest prior to 1964

In contrast to dividends, up until 1964, interest derived from New Zealand sources was subject to full taxation in New Zealand, regardless of whether the recipient was resident or not. By 1964, New Zealand had entered into six double tax agreements[634] with other nations for the direct purpose of alleviating double taxation for taxpayers with interests in both states and with the intention of facilitating trade between the two contracting states. In these early agreements, any mention of interest was excluded. Taxation of interest was left up to domestic law, with the effect of maintaining source taxing rights. For a capital importing country like New Zealand, this is a significant advantage as interest paid by borrowers in New Zealand to lenders outside New Zealand falls within the New Zealand tax base.

5.3.3 Introduction of non-resident withholding tax in 1964

Non-resident withholding tax ("NRWT") was introduced into New Zealand legislation in 1964.[635] This is a tax imposed upon passive forms of income, including interest, royalties, and dividends, paid to non-residents. It was levied at the rate of 15 per cent on both interest and dividends.[636]

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[632] At 185.

[633] Income Tax Act 2007, ss DB 5-7.

[634] New Zealand entered into agreement with United Kingdom (1947), Canada (1948), United States of America (1952), Sweden (1956), Japan (1963), and Australia (1960).

[635] Land and Income Tax Amendment Act 1964.

[636] Section 203T.

In the case of interest and royalty income, NRWT was a minimum tax, with the income still being subject to full taxation in New Zealand.[637] This meant that if the recipient of the income had a higher tax liability than the NRWT deducted by the payer, further tax was payable in New Zealand on the income. In the case of dividends, NRWT was introduced as a final tax.[638] Being a final tax, a claim for deduction of expenditure relating to income is not available. Depending upon the costs associated with deriving the dividend income therefore, some taxpayers will be better off under the NRWT regime and some less well off. Taxpayers were subject to progressive tax rates between 25-55 per cent.[639] Depending on what tax rate was applicable to the non-resident investor, they would need to claim between 40 per cent and 73 per cent of expenditure incurred in deriving the dividend income to end up with a tax liability equivalent to the 15 per cent NRWT.[640]

The introduction of NRWT was announced in the government's financial statement of 1964.[641] Then Minister of Finance, the Hon Harry Lake, concludes the statement with the summary that the measures in the budget primarily aim to promote economic growth.[642]

The Minister's introduction of the Bill accompanied the statement that there are significant gaps in the taxation of income from overseas investment in New Zealand and "the present law tends to discriminate against New Zealanders".[643] The introduction of the new tax was accompanied with the explanation that New Zealanders were not getting a fair deal when

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[637] Section 203ZA.

[638] Section 203Z.

[639] Ross et al. *Taxation in New Zealand: Supplementary Report of the Taxation Review Committee* (RE Owen, Wellington, February 1968) at 12.

[640] At 13.

[641] (25 June 1964) 338 NZPD 344.

[642] At 357.

[643] At 350.

compared with non-resident investors.[644] The suggestion is that non-resident investors had lower tax liabilities than their domestic counterparts.

Regarding interest, the post-NRWT position was that provided the interest is sourced in New Zealand, interest is taxable in New Zealand even if paid to a non-resident. The source rules at the time were not as broad as they are today. Interest was sourced in New Zealand if it arose from a mortgage over land in New Zealand, or from debentures issued by a New Zealand company or the New Zealand Government.[645] Presumably, the Hon Mr Lake's comment on non-resident lenders having a lower tax liability in New Zealand, referred to those falling outside the source rules or, more likely, the inability to collect revenue from taxpayers absent from New Zealand. The NRWT mechanism would enforce a withholding obligation upon resident borrowers, ensuring better collection of tax.

Unfortunately, only the Hansard debates remain of the discussion surrounding the introduction of NRWT. No record of public submissions or technical analysis by officials exists.[646] At a time when foreign investment was still regarded with suspicion, it seemed timely that while foreign investment was growing,[647] they should make a greater contribution to the tax base of New Zealand.

In 1964, the New Zealand Government perceived economic growth as generated from within the country, by exporting the goods and services produced internally. The announcement to introduce NRWT was accompanied by concerns expressed by the incumbent government that foreign investment in New Zealand was too high.[648] The policy relating to overseas investment at the time was that it should be encouraged but only to the extent to which it meets three objectives: the investment should be worthwhile in that it should contribute skills, knowledge and technology to New Zealand industry; it should not undermine New Zealand's

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[644] At 350.

[645] Land and Income Tax Assessment Act 1954, s 167 (d), (e) and (f).

[646] Per personal correspondence with the New Zealand Parliamentary Library in an email dated 21 March 2019.

[647] According to debates in Parliament, above n 641, at 349, foreign investment growth trebled over the 10 years leading up to 1964.

[648] At 348-349.

balance of payments; and the freedom of New Zealand business to make decisions as they see fit should be protected.[649] The risks associated with foreign investment were broadly associated with exporting excessive profits to non-resident investors and failing to reinvest profits into the New Zealand business.[650] The opposition suggested the proposal to introduce NRWT was a "backdoor method" for dealing with the problem of takeovers and overseas investment in New Zealand.[651]

At this point in history, New Zealand appeared to have a 'love-hate' relationship with foreign investment. On the one hand, politicians acknowledged what had been achieved through foreign investment – investment in capital infrastructure, importation of new techniques of production and management, increasing competitiveness, and some increases in New Zealand tax revenue.[652] National Party Member of Parliament, the Hon JR Hanan, discussed two impending investors into New Zealand – the "Consolidated Zinc Rio Tinto Corporation" and "Broken Hill Proprietary". Both were considering investing into industrial projects with the potential to "give employment to our people, earn overseas exchange, and make the country wealthier."[653] However, other politicians were more cautious, stating that while foreign investment is not intrinsically bad, it is only good where it is serves the best interests of New Zealand, ideally with New Zealanders' maintaining ownership and control.[654]

One member of parliament at the time described overseas investment in New Zealand as "of the greatest public interest".[655] For an insight into the perspective of the time, the Hon Hanan (Minister of Justice) states:[656]

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[649] At 349.

[650] At 349.

[651] (5 August 1964) 339 NZPD 1107.

[652] At 1090, speech by National Party Member of Parliament, Hon JR Hanan.

[653] At 1091.

[654] At 1092, speech made by Labour Party Member of Parliament, Bill Rowling.

[655] At 1089.

[656] At 1089.

> It is rather a paradox that we in this country are giving earnest consideration to controlling in some manner further overseas investment, whereas in many other parts of the world people are thinking along the lines of cooperation.

Overall, although some members of parliament are in favour of foreign investment and others less so, the debate strikes a balance between the benefits that can be achieved from inbound investment and the potential to replace domestic productivity.

The initial budget announcement in the financial statement of 1964 was for a NRWT of 30 per cent on dividends and 15 per cent for interest and royalties.[657] As this might encourage inbound investors to operate through a New Zealand based branch of a foreign company, to avoid the NRWT on dividends sent abroad, the government also announced an additional tax on foreign companies operating in New Zealand of 7.5 per cent.[658] This additional tax would go some way to equalising the post-tax effect of investing through a branch or a subsidiary. Between the initial announcement of the government's intention to introduce these measures and the first draft of the Bill, the rate of NRWT was reduced to 15 per cent and the additional tax on non-resident companies was reduced to 5 per cent.[659]

In 1980, the rate of NRWT on dividends was increased from 15 per cent to 30 per cent,[660] where it remains today.[661] During the 1980s, a large number of treaties were entered into with other jurisdictions that reduced the NRWT on dividends to, usually, 15 per cent.[662] The imposition of New Zealand income tax upon dividends would therefore be either 15 per cent or 30 per cent, depending on whether the taxpayer resided in a country with which New Zealand had a treaty.

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[657] Above n 641, at 350.

[658] At 350.

[659] (20 October 1964) 340 NZPD 2737.

[660] Income Tax Amendment Act 1980 (No.28), s 44.

[661] Income Tax Act 2007, s RF 8(2).

[662] This follows the OECD model where article 10 recommends a maximum tax at source of 15 per cent.

NRWT on interest still applies to all interest payments made to non-resident lenders at the rate of 15 per cent[663] or a reduced amount if allowed under a double tax treaty. However, NRWT is reduced to 0 per cent where the payment is made to an approved issuer.[664] This will be explored further in the next chapter.

5.4 Tax Review Groups during the 'discriminatory' phase

5.4.1 Ross Review 1967

In 1966, not long after the enactment of NRWT, then Minister of Finance, the Hon Harry Lake, commissioned the 'Ross Review' committee to "carry out a comprehensive review of the rates, structure, and incidence of the whole field of central Government taxation…".[665] The committee was comprised of L.N. Ross (chair), C.A. Blyth, N.B. Fippard, L.M. Papps, and R.G. Stark.[666] They were asked to consider the future of the tax system in light of New Zealand's continuing revenue needs and the desire to promote economic growth and stability. The group use a traditional tax analysis framework based upon Adam Smith's original principles for a good tax – that is, equity, 'economy', convenience, and certainty.[667]

The overall tenor of the report was to achieve a balance between equitable outcomes and promoting economic objectives. The group identified the purposes of taxation as: to provide revenue to support government expenditure; as an instrument to achieve economic aims of government; and to redistribute income on a socially acceptable basis.[668] They stated the tax system needs to "achieve a politically acceptable balance between the search for efficiency and the desire for equality".[669] The group emphasised that taxation is recognised as an important tool for redistribution but should not be confused with attempting to achieve

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[663] Income Tax Act 2007, s RF 7.

[664] Income Tax Act 2007, s RF 12.

[665] Ross supplementary report, above n 639, at 8.

[666] At 8.

[667] At 12.

[668] At 13.

[669] At 13.

equality. They noted that equality may impact upon incentives to economic activity.[670] The inference is that a delicate balance is to be struck between redistribution without disincentivising enterprise.

The Ross Review focused on domestic tax issues, with considerable thought going into taxation of individuals based upon their personal situations. This is possibly a reflection of the time – the focus was the traditional nuclear family with a married working man and, usually, a dependent wife and children.

The group considered taxation of non-residents, but this is on the periphery of the report – and is not central to the group's findings. With respect to the discussion on taxation of non-residents, the focus was on equity rather than economic issues. The group sought to determine whether the settings were fair rather than whether they would attract more investment.[671]

The group supported NRWT – still a relatively new form of tax in New Zealand at that time. Their other recommendations mainly revolved around the impact of proposed changes to taxes on residents by combining the social security tax with the income tax to create a single tax.[672] With regard to double taxation agreements, the group recommended New Zealand continue to investigate new agreements to enhance future trade opportunities.[673] The group also suggested the government investigate the benefits of double taxation agreements for the benefit of trade.

During the following years, including the whole decade of the 1970s, there were no significant changes that had a direct impact on the taxation of inbound investors. However, with reducing imports and increasing exports in mind, many concessions and incentives were granted to various industries within New Zealand. This resulted in a narrowing of the tax base

[670] At 15.

[671] At 12.

[672] At 20.

[673] At 22.

which, in turn, necessitated higher tax rates. By the end of the 1970s and early 1980s, the tax system was widely regarded as inequitable.[674]

5.4.2 McCaw Taskforce Review 1982

The next substantial tax review, under the Prime Ministership of the Rt Hon Robert Muldoon, was the McCaw Taskforce Review. The group was formed in July 1981 and issued its report to the government in April 1982, less than a year later.[675] This was no mean feat given the state of the tax system at the time.[676] New Zealand's tax system had become distorted, with many taxpayers paying little or no tax and others paying very high tax rates.[677] Because of the many inequities in the domestic system, the report did not deal with taxation of non-residents, presumably due to the lack of time and resource identified in the report.

However, one of the Taskforce's areas of focus was company and dividend taxation and their work in this area was a step toward the introduction of imputation later in the 1980s by the subsequent government. While they did not make a recommendation to introduce imputation, they recommended all dividends should be taxable, eliminating the exemption for dividends paid out of capital reserves and share premium reserves, with a fixed rebate against this dividend income.[678]

The recommendations of the Taskforce included reducing the number of tax rates, introduction of a fringe benefit tax, introduction of a value added tax, reducing 'double taxation' of income derived by companies, reducing concessions, and indexing the company tax base to account for inflation.[679] Most of the recommendations of the group focused upon fairness as this was the need at this time.

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[674] McCaw Report, above n 292, at 1-2.

[675] At 1-2.

[676] At 8.

[677] At 1-2.

[678] At 188.

[679] A summary of the group's recommendations can be found at McCaw Report, above n 292, at 3–9.

The government that commissioned the McCaw Taskforce did not implement its recommendations. However, when neo-liberal economic policies found their way to New Zealand under the following Labour government, they were adopted quickly and comprehensively.[680] Despite the recommendations being mainly focused upon equity rather than economic growth, the McCaw Taskforce recommendations (and the spirit of them) were implemented during the transformative period of the subsequent government, perhaps recognising that the distortions in the tax system were not only unfair but also inefficient due to their lack of neutrality.

5.4.3 The Treasury's economic review 1984

The replacement of the Muldoon government with the new Labour government in 1984 heralded the beginning of a new era. The new government had a new economic agenda, more consistent with what was happening in the United Kingdom and the United States: that is, neo-liberalism had finally arrived. The neo-liberal agenda is discussed in full in the next chapter as its influence on tax policy is seen most clearly in the transitional and preferential phases.

Alongside the incoming members of parliament was a Treasury, keen for change. The Treasury recognised the fiscal imbalance that existed in New Zealand at the time – revenue failed to meet expenditure.[681] The Treasury, therefore, recommended tax reform.

The Treasury's main concern with the tax system in 1984 was much the same as that in the McCaw Taskforce Report. The tax base was far too narrow and the number of departures from the general principles decreased the breadth of the tax base.[682] They stated that the system failed to deliver sufficient revenue and many of its features did not meet the equity and efficiency criteria.[683] They made suggestions for comprehensive and transformative reform. They did not specifically address the issue of taxation of foreign investors, however.

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[680] See the discussion on 'Rogernomics' in chapter 6 at 6.3.

[681] The Treasury *Economic Management: Briefing to the Incoming Government 1984* (1 July 1984).

[682] At 213.

[683] At 210.

Some domestic changes did take place to introduce more equitable measures in the tax system with the overall goal of having a 'broad-base low-rate' system. Fringe benefit tax was introduced; [684] goods and services tax was introduced;[685] concessions were removed;[686] tax rates were simplified and lowered;[687] and a company imputation system was introduced.[688] The 1980s saw transformational changes to the domestic tax system of New Zealand.

While taxation of both outbound and inbound investment required reform, both the Treasury and the McCaw Taskforce focused upon the gross inadequacy of the domestic tax base. It was not until substantial domestic reform had taken place that the government had capacity to turn its mind to matters beyond the domestic tax base.

5.4.4 Consultative document on international tax reform 1987

A further group was formed in 1987 to consider how the New Zealand tax base could be broadened and how international tax avoidance could be reduced.[689] This group was known as the Valabh Committee as it was chaired by Arthur Valabh.[690]

The government tasked the Valabh Committee to consider some specific areas of taxation law – it was not a comprehensive review of the whole tax system. The group was asked to consider how New Zealand applied income taxes to outbound investment – that is, New Zealand residents investing overseas.[691] This review led to the introduction of the foreign investment fund ('FIF') and controlled foreign company ('CFC') regimes that impose taxation on New Zealand outbound investment by attributing income rather than taxing actual

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[684] Income Tax Amendment Act (No 2) 1985 (No 59), s 34.

[685] Goods and Services Tax Act 1985.

[686] For example, Income Tax Amendment Act (No 2) 1985 (No 59), ss19–26, schedule 3.

[687] Income Tax Amendment Act 1984, schedule 1.

[688] Income Tax Amendment Act (No 5) 1988, Part XIIIA.

[689] Valabh et al. *Consultative Document on International Tax Reform* (The Treasury, December 1987) at 1.

[690] Arthur Valabh was a partner of Deloitte Touche Tohmatsu at the time of the appointment.

[691] Valabh consultative document, above n 689, introduction by Roger Douglas at i.

income.[692] The group recognised that New Zealand residents were able to maintain income and assets abroad without incurring tax in New Zealand. The recommendation and subsequent implementation of the FIF and CFC regimes incorporated income from residents' foreign investments within the New Zealand tax net.

The Valabh Committee also recommended the implementation of an imputation credit regime into New Zealand taxation law.[693] This system grants a credit to New Zealand resident taxpayers against the tax liability on dividend income for tax paid by the company on its profits. Provided the dividend is paid out of a company's tax paid retained earnings, the shareholder's tax liability on the dividend is therefore reduced by (up to) the company tax rate.

The imputation credit system was introduced into law in 1988.[694] Prior to this, a New Zealand resident receiving a dividend would be subject to full taxation without credit for any underlying tax paid on the profits derived by the company.[695] Imputation effectively takes the view that a company is a conduit for its shareholders. The effect of imputation is to treat dividend income as company profit distributed to its domestic investors. A further tax burden is imposed at the shareholder level to the extent the tax credits do not meet the full tax obligation of the shareholder.

The introduction of imputation played a significant role in promoting business investment through the removal of 'double taxation'. Since the historic case of *Salomon v A Salomon & Co,*[696] there has been no doubt that a company is a separate legal person from its shareholders. Even in dealing with a small family company, creditors of the company are

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[692] Valabh et al. *Report on International Tax Reform Part I* (The Treasury, March 1988); these recommendations were enacted into law in the Income Tax Amendment (No.5) Act 1988.

[693] Valabh et al. *Full Imputation: Report of the Consultative Committee* (The Treasury, April 1988).

[694] Income Tax Amendment (No.5) Act 1988.

[695] New Zealand had adopted a classical system of taxing dividends up to that point. However, as noted in the McCaw Report, above n 292, at 188, some domestic shareholders benefitted from loopholes allowing untaxed distributions from companies.

[696] *Salomon v Salomon & Co* [1896] UKHL 1.

unable to access shareholder's personal assets.[697] This reinforces the fact that a dividend to a shareholder is not treated the same as income from profits derived by the company. During the history of New Zealand taxation, dividends have sometimes been treated as taxable in the hands of the shareholder and, at other times, exempt in the hands of the shareholder.[698] However, taxation of the dividend was not linked with taxation of company profits until imputation was introduced. Imputation is based on the theory that the income of the company and the dividend paid to the shareholder are economically the same income – even if they are the separate legal income of separate legal persons.

The imputation system introduced a perspective of a company based upon the aggregate theory of a corporation.[699] Effectively, in introducing imputation, the New Zealand government aligned itself with the aggregate theory and, indirectly, a shareholder primacy perspective. This would seem to be consistent with the rise in neo-liberal economic thinking during the 1980s.

Prior to the introduction of imputation, New Zealand had a classical system for taxing dividends. In discussing the adoption in 1958 of the classical system, Cunningham states:[700]

> …an incorporated company's assets are its own property and not the property of its shareholders. Any dividends paid to the shareholders are received by them as income from the shares, and not from the sources from which the company derives its income.

Cunningham describes the view of a company that subscribes to the entity theory – that is, the company has an existence entirely separate to its shareholders. Introduction of imputation

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[697] Companies Act 1993, s 15.

[698] Prior to 1958, dividends were exempt from taxation (Land and Income Assessment Act 1891, cl 3) and from 1958, dividends became taxable under the classical system of taxation (Land and Income Tax Amendment (No 2) Act 1958). For more on this, see Annie Cho "Five Phases of Company taxation in New Zealand: 1840-2008" (2008) 14 *Auckland University Law Review* 150.

[699] See discussion in chapter 6, part 6.2.2, that refers to David Millon "Theories of a Corporation" [1990] *Duke LJ* 201 at 222. He makes the argument that shareholder primacy theory can only be justified where a corporation is viewed in law as an aggregation of its actors, compared with the entity theory that views a corporation as separate to its members.

[700] Cunningham et al. *Taxation Laws of New Zealand* 4th ed. (Butterworth and co (New Zealand) Ltd, Wellington, 1960) at 455.

diverges from the entity view of a corporation and toward the aggregate view – one that was popularised alongside neo-liberal economics and which is discussed in more detail in the next chapter. The aggregate theory views the company as an aggregation of the sum of its contracts – placing the shareholders in the middle.[701]

When introducing imputation, New Zealand made the policy choice not to extend it to foreign shareholders, which had the result of foreign shareholders and domestic shareholders being treated differently under New Zealand law. The decision not to extend imputation credits to non-residents was because the extension "is unlikely to maximise national welfare" and would most likely result in a transfer of revenue from source country to residence country.[702] This is because the home country of the investor would likely tax the income of the investor and offer a tax credit for New Zealand taxes paid. By reducing the New Zealand tax liability, the return on the investment would not increase but the tax revenue would shift to the home country jurisdiction.

Non-residents remained subject to NRWT at 30 per cent on their dividends, reduced to 15 per cent under any applicable double tax agreement. Given double tax agreements existed with all New Zealand's main trading partners, most investors enjoyed the benefit of the reduced NRWT rate.

Foreign investors into New Zealand equities bore the burden of both company taxes and NRWT on dividends received. The company tax rate fluctuated during the 1980s from a high of 48 per cent in 1986-1987,[703] to a low of 28 per cent during 1988.[704] Prior to the introduction of imputation, both residents and non-residents suffered a double tax burden upon receipt of dividends – although often residents were able to alleviate or escape this tax burden. From 1989, New Zealand residents enjoyed imputation and top personal tax rates of

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[701] Adolf Berle "For Whom Corporate Managers are Trustees: A Note" (1932) 45 *Harvard Law Review* 1365.

[702] Matt Benge and Tim Robinson *How to Integrate Company and Shareholder Taxation: Why full imputation is the best answer* (Institute of Policy Studies, Victoria University Press, 1986) at 60.

[703] Income Tax Amendment (No 4) Act 1985, s 4(a).

[704] Income Tax Amendment Act (No 2) 1988, s 22(d).

only 33 per cent.[705] Meanwhile, non-resident investors were still subject to NRWT at the 30 per cent rate from 1980 to 1995, unless reduced by a double tax treaty. While residents' total tax burden on profits derived and paid out by New Zealand companies was just 33 per cent, non-residents might have a tax burden of 43 per cent or even 53 per cent if they resided in non-treaty countries.[706]

For the period from 1988 until 1994-96, non-residents were subject to a discriminatory tax treatment on their equity investments in New Zealand with respect to dividends paid due to their inability to benefit from the imputation system compared with domestic investors.

During the same period, interest paid to non-residents remained subject to tax at the NRWT rate of 15 per cent, as enacted in 1964.

5.5 Development of tax treaty network

In some instances, a non-resident will conduct business in New Zealand directly, rather than through a New Zealand registered company. In this case, New Zealand tax is levied on any income sourced in New Zealand.[707] The income of the non-resident is business income rather than income from capital.

The non-resident 'person' can be a non-resident company or a non-resident individual. A non-resident company is one that is not controlled from New Zealand and a non-resident individual is someone that does not have a home or a presence in New Zealand.[708] The business the non-resident does in New Zealand might be as substantial as manufacturing

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[705] Income Tax Amendment Act (No 3) 1988, ss 23-24 reduced the tax rates for individuals in two steps. The first step was from 1 April 1988 and the second step, which had only two tax rates, commenced from 1 April 1989.

[706] Say the company derives profit of $100 and this is all distributed, via dividend, to non-resident shareholders. Assuming a company tax rate of 33 percent, the tax burden in New Zealand will be: $100 profit x 33 percent = $33, plus 15/30 per cent NRWT on distribution of $67 = $10.05/$20.10, making the total NZ tax burden either $43.05 or $53.10.

[707] The only exclusion from "income" for the purpose of raising income taxes in New Zealand is "non-resident foreign-sourced income" in s BD 1(5) of the Income Tax Act 2007. Therefore, if income is sourced in New Zealand, it will always fall into the New Zealand tax net.

[708] Income Tax Act 2007, s YD 1 and 2.

goods or constructing new assets, or it could simply be making sales to people residing in New Zealand. At what point a non-resident becomes taxable in New Zealand depends when they are regarded, under New Zealand's domestic law, as 'carrying on a business in New Zealand'.[709]

Craig Elliffe considers the question of when income is sourced in New Zealand and, through analysis of case law, concludes the following activities are likely to constitute carrying on business in New Zealand where they take place in New Zealand: production and manufacture of goods; offering goods or services for sale through an agent or employee; habitually concluding contracts; and maintaining a store of goods for delivery.[710] These activities indicate a presence is required in New Zealand, either of goods or people in order to attract income tax. Sales made over the internet or through mail order catalogues are typically not enough to constitute 'doing business in New Zealand', especially where the goods need to be shipped from abroad to New Zealand.

During the discriminatory period, branches of foreign companies operating in New Zealand were required to be registered with the company registrar.[711] Registration was only available to companies incorporated in other Commonwealth countries. It has been suggested the resistance to foreign investment may have reflected a distrust toward US investment.[712] In any case, these branches of foreign companies were disadvantaged by a higher tax burden than domestic investors. The Land and Income Tax Assessment Act 1954 introduced a distinction in the income tax rate between resident and non-resident companies. The former was taxed at between 45-50 per cent and the latter, 50-55 per cent – always being exactly 5

[709] Source rules can be found in s YD 4 Income Tax Act 2007 and this rule has been in place since the Land and Income Tax Act 1954. Income is excluded from the New Zealand tax net where it is "non-resident foreign-sourced income" according to s BD(1)(d) Income Tax Act 2007. Therefore, determining the source of the income is essential to the determination of whether it is taxable in New Zealand or not at all.

[710] C. Elliffe *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, Wellington, 2015) at 328.

[711] Companies Act 1955, s 127.

[712] Goldsmith, above n 141, at 243.

per cent apart.[713] The rationale for this spread was to account for the NRWT deducted from dividends paid by New Zealand companies to foreign shareholders.

By the mid-1980s, however, New Zealand had established a substantial double tax treaty network[714] and this had a direct impact upon taxation of branches of foreign companies.

The treaties limit the ability of a contracting state to tax the income of an entity of the other state. In the case of business income derived by non-residents, only when a *permanent establishment* is present can a state tax the income that is sourced or derived in that state. Therefore, even if under domestic law, a non-resident has New Zealand sourced income, the treaty may exclude this income from the tax base where the presence in New Zealand is something less than a permanent establishment. For example, conducting sales in a state alone will not constitute a taxable presence. A permanent establishment has a long and complex definition in every treaty but essentially amounts to a permanent physical presence such as an office or manufacturing plant. How this applies to inbound investment into New Zealand is to limit New Zealand's 'source' taxing rights to the profits generated by a permanent establishment of a foreign enterprise.[715]

Prior to the early 1970s, New Zealand's main trading partner was the United Kingdom ("UK").[716] Instigated by the UK,[717] New Zealand entered into its first double tax agreement

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[713] This was introduced with NRWT in s 4 Land and Income Tax Amendment Act 1964 (no.122); Income Tax Act 1976, Schedule 1 (7) and (8).

[714] During the 1970s and 1980s, New Zealand entered into double tax agreements with the following *new* treaty partners: Belgium (1983); China (1986); Denmark (1981); Fiji (1977); Finland (1984); France (1981); Germany (1980); India (1986); Indonesia (1988); Ireland (1988); Italy (1983); Korea (1983); Malaysia (1976); Netherland (1981); Norway (1983); Philippines (1980); Singapore (1973); and Switzerland (1981). This took the total number of treaties from 6 in 1970, to 24 by the end of the 1980s.

[715] Note that at the time of writing, the OECD have released a blueprint for taxation of business profits generated in the digital economy as part of its wider BEPS project, above n 19. This has the potential to significantly reshape the way tax applies to business across borders by reducing the reliance on physical presence and operating based on allocation of profits between relevant jurisdictions.

[716] In 1955, over 65 per cent of New Zealand's exports were to the Britain. Around the turn of the 20th century, 80-90 per cent of New Zealand's dairy produce went to Britain.

[717] See Andrew Smith "A History of New Zealand's Double Tax Agreements" (2010) 16(1) *NZJTLP* 105.

with them in 1947.[718] This first agreement includes business profits of a UK resident within the New Zealand tax net to the extent they are attributable to a permanent establishment.[719] Under the 1947 agreement, a permanent establishment includes any "branch, management, factory, mine, farm, or other place of business".[720]

Following on from the UK agreement was an agreement with Canada in 1948.[721] This agreement follows the UK one but shortens the definition of a permanent establishment to a "branch or other fixed place of business" – a more succinct description of the same thing. The calculation of profits is described in the same way as the treaty with the UK.

The next double tax agreement entered by New Zealand was with the United States ("US") in 1952.[722] The taxation of business profits is very similar, with taxation being restricted to the existence of a permanent establishment of an enterprise in the other state. The agreement with the US, like the agreement with the UK, provides for calculation of profits as if the permanent establishment were an arm's length enterprise. However, the agreement with the US specifically allows for deduction of expenses relating to the permanent establishment of an "executive or general administrative" nature.[723] This may be a clarification or an extension but would usually favour the capital exporting country. In this agreement, the US is the net capital exporter.[724]

It wasn't until 1960 that New Zealand and Australia entered into their first double tax agreement.[725] This agreement included mines, oil wells, agricultural properties, and

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[718] Double Taxation Relief (United Kingdom) Order 1947.

[719] Article III (1).

[720] Article II(1)(k).

[721] Double Tax Relief (Canada) Order 1948.

[722] Double Tax Relief (United States of America) Order 1952.

[723] Article III (5).

[724] Malcolm McKinnon "International economic relations - The US and New Zealand" Te Ara - the Encyclopedia of New Zealand <http://www.TeAra.govt.nz/en/international-economic-relations/page-5>.

[725] Double Tax Relief (Australia) Order 1960.

construction projects within the definition of a permanent establishment – reflecting the industries relevant to the two contracting states. Although more specific in its list of inclusions within a permanent establishment, the agreement does not seek to broaden the scope of included activities. The calculation of profits of a permanent establishment followed a similar basis to the treaties with the UK and Canada.

By 1967, the time of the Ross Review, New Zealand had entered treaties with Japan and Sweden as well – bringing the total to six treaties. Although the later treaties were based upon the OECD model of 1960, New Zealand still negotiated to maintain more source taxing rights than the standard OECD model.[726] As a net capital importer, retaining the right to tax income sourced in New Zealand was necessary to protect the tax base. Treaties based on the OECD model, as New Zealand's are, favour residence-based taxation by reducing source taxing rights.[727] New Zealand sought to retain source-based taxing rights while also seeking to expand its treaty network, especially with its largest trading partners.

Despite New Zealand's attempts to retain source taxing rights, the definition of permanent establishment began to narrow – meaning that regardless of domestic laws, some business operations were simply not included in the New Zealand tax base at all due to exclusion under the treaty. For example, New Zealand's first treaty with Australia in 1960 included all construction projects in its definition of permanent establishment.[728] The 1972 agreement then excluded any construction projects lasting less than six months.[729] Other exclusions also appeared in the 1972 treaty that had not appeared in the 1960 treaty with Australia.[730] The treaty negotiated between New Zealand and the UK in 1966 had already started to reduce the applicability of source taxation on foreign businesses. This treaty excludes construction

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[726] Andrew Smith And Adrian Sawyer "The Impact of OECD Membership Upon New Zealand's International Tax Policy and DTA Negotiations – A Comparative Text Analysis" (2011) 6(1) *Journal of the Australasian Tax Teachers Association* 1 at 19.

[727] Tsilly Dagan "The Tax Treaties Myth" (2000) 32 *Journal of International Law and Politics* 939.

[728] Double Tax Relief (Australia) Order 1972, Article II (1)(m).

[729] Above n 728, Article 4 (2).

[730] Such as maintenance of stock for storage, display or delivery, and maintenance of a fixed place for preparatory or auxiliary purposes.

contracts lasting less than twelve months, places of business solely for the purposes of advertising, research or storing goods, amongst other exclusions.[731] While the early treaties mainly replicated New Zealand's domestic law, these bilateral agreements soon began to narrow the scope of domestic law. As New Zealand was and still is mainly a capital importer, the tax base was being eroded by taking foreign investors out of the tax net.

5.6 Conclusion

Foreign investment was a topic that attracted a lot of attention by politicians in the 1960s and 1970s. However, this attention was a mix of favourable and unfavourable perspectives. While some commentators felt foreign investment was a threat to New Zealand's economy, by displacing local businesses, others considered it an opportunity for progress. Some commentators took a middle ground by supporting foreign investment in New Zealand business to the extent its benefits could be proven to outweigh any costs.

Taxation of non-residents during this period is sometimes discriminatory when compared with taxation of domestic residents. At other times, it is preferential. The complexity of the New Zealand tax system during this period of history means it is difficult to articulate any particular strategy with respect to non-resident investors. By the early 1980s, the tax system was haphazard in its impact and demonstrated little coherence or consistency. It was, as stated in the title, a tax system in disarray. Hence, any comprehensive tax reviews focused mainly upon improving the fairness and coherence of the domestic system rather than international tax policy.

Overall, a non-resident investor would be expected to pay a substantial amount of income tax on New Zealand investments. Interest and dividends were subject to NRWT and branches of foreign companies were subject to a 5 per cent income tax premium compared with a domestic company. Domestic investors were also subject to further income taxes upon deriving interest and dividends – therefore, there is no evidence of overt discrimination. However, domestic and non-resident investors were treated differently.

From here, the research will now explore the transitional phase. The transitional phase developed from the early 1990s onward. However, the scene for this phase had been set over

[731] Double Tax Relief (United Kingdom) Order 1966.

several decades with the growth in the neo-liberal economic agenda. This will be considered in the next chapter.

6 Early stages of tax competition

6.1 Introduction

Mid-1980s New Zealand experienced the most comprehensive economic reforms in its history. The highly controlled and regulated economy was dismantled in favour of economic liberation.[732] This was followed by sweeping tax changes to simplify and improve the equity of the tax system.[733] The most significant tax changes in the 1980s were the introduction of imputation, the controlled foreign company and foreign investment fund regimes, fringe benefit tax, goods and services tax, and new taxation of trust rules. These changes took place under the Labour government and, predominantly, focused on base broadening, neutrality, and fairness. With a broader tax base, the rates could be reduced having, at one point, been as high as 66 per cent. This objective is known as BBLR for "broad base, low rate" and it is still a key objective of the tax system today.

Following this period of major reform of the economy is a period of relative calm. However, in the background, tax changes are made through the 1990s to adjust the New Zealand tax impact upon foreign investors. This period, referred to here as the "transitional period" involves a shift from, sometimes, discriminatory tax treatment of foreign investors toward a preferential treatment. This movement is examined in this chapter.

During the transitional phase, non-resident investors' New Zealand tax costs were reduced on every type of investment. This was consistent with the political drive to reduce tax on non-residents in order to encourage their investment into New Zealand business.[734] The tax rate on non-resident companies was reduced to meet the rate imposed upon resident companies doing business in New Zealand.[735] For most non-resident investors, the NRWT liability on dividends was effectively eliminated by the introduction of the Foreign Investor Tax Credit

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[732] This is discussed in 6.3 below.

[733] This is discussed in 6.4 below.

[734] Ruth Richardson *Making a Difference* (Shoal Bay Press, Christchurch, 1995) at 107.

[735] Income Tax Act 1994 Amendment (No 3) 1995, s 30.

("FITC") regime, meaning non-resident investors had a maximum tax rate on company profits of 33 per cent, equalling resident investors post imputation.[736] NRWT on interest remains in force, although the growing double tax treaty network means more investors will be subject to reduced rates. Further, a new option was introduced to apply NRWT on interest at 0 per cent and pay a 2 per cent approved issuer levy ("AIL") instead.[737]

This phase demonstrates a move toward global tax competition. The government takes a more aggressive view on attracting inbound investment by reducing New Zealand's tax costs for these mobile and sought-after foreign investors.

Chapter six examines the changes that took place in New Zealand during this period and their underlying influences. First, in part 6.2, the thesis looks at the development of the neo-liberal economic agenda. Examining the international context is important to the whole thesis. New Zealand may be described as a "cork bobbing in the ocean" given its relatively small size and influence in global terms. It is strongly affected by events in the United Kingdom, the United States and Australia. The wave of neo-liberalism that moved across the Anglo-American countries during the 20th century is, hence, an essential part of the narrative in tax policy setting in New Zealand. Closely following the neo-liberal movement was the rise in shareholder primacy. The effect of these movements upon tax policy cannot be overstated. After looking at the broader global economic trends, part 6.3 will sharpen the focus on the influence this had on New Zealand's tax policy agenda, especially during the 1990s. Part 6.4 looks at the specific tax law changes that took place in New Zealand, with reference back to the policy drivers influencing the change.

6.2 Development of the neo-liberal agenda

6.2.1 Economic and political background

Neo-liberal economics refers to the return of classical economic principles in the 20th century. The new agenda was led by economists such as Fredrich August von Hayek[738] and Lionel

[736] Income Tax Amendment Act (No 3) 1993, s 76 introduces FITC for portfolio investors and the regime is extended to direct investors in December 1995 (Income Tax Act 1994 Amendment Act (No 3) 1995, s 17).

[737] Income Tax Amendment Act (No 4) 1991.

[738] Hayek is linked with the tradition of the Austrian School of Economics.

Robbins from the London School of Economics, and Frank Knight, Jacob Viner and Henry Simons from the University of Chicago School of Economics, in the earlier part of the 20th century. However, the theories and ideas promoted by neo-liberal economists did not become popularised and politicised until around 1980.[739]

Fredrich von Hayek argues against socialism and for economic freedom.[740] As an Austrian born economist, Hayek had seen the totalitarian result of fascism in Nazi Germany and the subsequent rise of socialism - in part, as a response to fascism. Hayek argues that socialism results in big government and therefore, totalitarianism of a different sort.[741] Hayek's view was that a return to classical economics with greater reliance on the equilibrium of the free market would reduce the likelihood of concentrations of power. Hayek's 20th-century return to free-market economics has influenced Western democracies of the 20th and 21st centuries immeasurably – in part because of his influence upon other economists such as Milton Friedman. While Hayek's views had many influences,[742] the father of free-market economics is usually considered to be Adam Smith.[743]

Smith's work, published in the 18th century, advocated for allowing the free market to control economic relationships between individuals. He refers to the "invisible hand" that represents the market's ability to create equilibrium through balancing the interests of market players.[744] Smith's views have formed the basis for many of the neo-liberal ideas evolving in the 20th century. In particular, the rise of the term "laissez-faire", used prolifically by neo-liberalists is a direct reference to the term used by Adam Smith to describe the ability of the market to be free of government interference. Smith argues that despite self-interested actions, the free market ensures the best social outcomes are achieved.[745]

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[739] Angus Burgin *The Great Persuasion* (Harvard University Press, US, 2012) at 218.

[740] Fredrich August von Hayek *The Road to Serfdom* (The University of Chicago Press, Chicago, 1944).

[741] At 97-111.

[742] For example, Ludwig von Mises and Alexis de Tocqueville.

[743] Smith, above n 51.

[744] At Book IV, Chapter II, paragraph IX.

[745] At Book IV, Chapter II paragraph IX.

Contrary to the free-market economic views held by classical and neo-liberal economists, communist and socialist ideas were popularised during the 19th century as well. Karl Marx, the father of communism, advocated that all means of production should be held by the state, or perhaps more accurately, communally.[746] This position formed the basis for many countries adopting communist political systems in the 20th century.[747] The rise of socialism also meant the demise of free-market capitalism. Both Britain and the United States adopted a more interventionist approach to their economies after the great depression in the 1930s.[748] Often referred to as Keynesian economics, after John Maynard Keynes, Britain and the United States used interventionist tools to control the economy, including money and in particular, unemployment. Keynesian economics was popular through the 1930s and 1940s and was sustained throughout the Anglo-American world right up to the 1980s. During the same period, large parts of Europe and Asia adopted Marxist ideas of communist political and economic systems.

The influence of Keynes can be seen in New Zealand politics right up until the 1980s. In discussing the development of capital markets in New Zealand, the Hon Harry Lake states the government will "foster the orderly and balanced growth of such a market".[749] With regard to monetary policies he speaks of the government's role in managing private trading bank advances by requiring the banks to borrow from the Reserve Bank only.[750] In respect of takeovers of New Zealand enterprises by foreign owners, he discusses implementing a registration system so government grants consent before a takeover proceeds.[751]

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[746] Karl Marx and Fredrich Engels *The Communist Manifesto* (online ed., Socialist Labor Party of America, 2006) at 21.

[747] Most notably the USSR and China.

[748] As stated by Skidelsky and Backhouse, "Keynesianism dominated the political economy of the developed world from roughly the 1950s through to the middle of the 1970s." in Skidelsky and Backhouse "The Keynesian Revolution and the Theory of Countervailing Powers" in Skidelsky and Craig (eds) *Who Runs the Economy? The Role of Power in Economics* (Palgrave MacMillan, London 2016) 59 at 62.

[749] (25 June 1964) 338 NZPD 348.

[750] At 348.

[751] At 348.

In the background of the Keynesian era, Hayek and his peers formed a group advocating for neo-classical economics known as the *Mont Pèlerin Society*. In the United States and the United Kingdom, Keynesian economics was in favour and classical economics had fallen out of favour.[752] The Mont Pèlerin society was advocating alternative, minority views in the early years. Over the decades since its formation in 1947, the society has enjoyed a membership of notable names in economics scholarship including many that have won the Nobel Prize for Science in Economics.[753] Neo-classical economics grew in popularity during the second half of the 20th century to become the mainstream view of economics in most Western democracies, particularly in the United Kingdom and the United States in the 1980s.

Milton Friedman, a member of the Mont Pèlerin society, was influenced by Hayek and his peers. Friedman was an American economist who was part of a second generation of neo-classical economists in the Chicago School of Economics. Friedman became widely read amongst the mainstream and was influential within political domains. He was a close economic advisor to both Margaret Thatcher, the Prime Minister of Great Britain, and Ronald Reagan, the United States President, during the 1970s and 1980s.[754] While many academics over the course of time remain largely disconnected from political and media affairs, Friedman was adept at taking his views into the mainstream arena. He had a column in the New York Times,[755] and appeared on television[756] where he was able to popularise his ideas on the free market, reducing the size of government and government intervention, and loosening the control over money. In Friedman's book "Capitalism and Freedom", [757] that

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[752] Skidelsky and Backhouse, above n 748.

[753] Fredrich Hayek, Milton Friedman, George Stigler, Maurice Allais, James Buchanan, Ronald Coase, Gary Becker, and Vernon Smith.

[754] Alan Ebenstein *Milton Friedman: A Biography* (1st ed, Palgrave MacMillan, New York, 2007) at chapter 21.

[755] His most famous column is Milton Friedman "The Social Responsibility of Business is to Increase its Profits" *The New York Times Magazine* (New York, 13 September 1970).

[756] Milton Friedman "Free to Choose" (1980) Free to Choose Network <https://www.youtube.com/watch?v=D3N2sNnGwa4>.

[757] Friedman, above n 46.

sold over 500,000 copies, he advocated for political and economic freedom, commenting on how government intervention often created failure.[758]

Friedman's influence in the political arena contributed to revolutionary change in the United States and in the United Kingdom.[759] In the United Kingdom, Margaret Thatcher's government was responsible for deregulating large parts of the economy, including labour markets and money supply.[760] During the same era, Ronald Reagan sought to deregulate markets, reduce taxation, and cut public spending.[761] Both leaders followed the principles laid out by Milton Friedman to reduce the size of government and allow the economy more freedom to manage itself. This freedom would, according to the theories of neo-classical economists, lead to greater prosperity.

6.2.2 Corporate growth and shareholder primacy

Alongside the development of neo-classical economics was the growth in the corporation. This is also important to acknowledge in relation to the movement in tax policy changes. The dominance of the corporation led to a new influence in every sphere of the public and private sector.

While the origin of the corporation was a means of funding large infrastructural projects,[762] its proliferation and dominance in the world economy has increased its significance, power, and influence. One of the questions raised during the 20th century was in whose interests

[758] Friedman, above n 46, at 34-35.

[759] Ebenstein, above n 754, at 213. According to Ebenstein, Friedman was also very influential upon communist Chinese politicians during the 1980s.

[760] John Blundell *Margaret Thatcher: A Portrait of an Iron Lady* (Algora Publishing, New York, 2008) at chapter 11. Blundell states at 94: "Flanked by Geoffrey Howe and Keith Joseph, her entry into 10 Downing Street marked the repudiation of Keynes and the post-war Butskellite consensus. All three had read Hayek and Friedman and knew their brief backward and forward".

[761] Michael Schaller *Ronald Reagan* (Oxford University Press, New York, 2011) at 42-50.

[762] The Joint Stock Companies Act (UK) 1844.

should a corporation act?[763] Once again, Milton Friedman's voice gave weight to what became the mainstream view that corporations must act solely in the interests of their shareholders.[764] However, this was not the only view.

To understand in whose interests a corporation should act, one needs to examine what a corporation is. There are two dominant theories describing the form of the corporation: the *aggregate theory* and the *entity theory*.[765] The form of the corporation informs its purpose.

David Millon describes the aggregate theory as "an aggregation composed of shareholders and management, the latter confined to labour for the interests of shareholders by standard principles of property and trust law".[766]

The entity theory, on the other hand, takes the view of a corporation as an entity separate from its shareholders and other stakeholders. The entity theory gives the corporation a separate personality. Under this view, the corporation will have its own objectives, not necessarily that of any one of its actors.[767]

It is difficult to justify shareholder primacy on any basis other than an aggregate view of the corporation. The aggregate theory views the corporation as the aggregation of the shareholders and the managers, with managers serving the interests of the shareholders. There are many detractors from the shareholder primacy model. Many argue there is no legal

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[763] Most famous is the debate between Professors Adolf Berle and Merrick Dodd. See A Berle "Corporate Powers as Powers in Trust" (1930-1931) 44 *Harv. L. Rev*. 1049; then E Merrick Dodd "For Whom are Corporate Managers trustees?" (1932) 45(7) *Harv. L. Rev* 1163; and then Berle's response in A Berle "For Whom Corporate Managers are Trustees: A Note" (1931-1932) 45 *Harv. L. Rev*. 1368.

[764] Friedman, above n 755.

[765] There are others such as the "nexus of contracts theory" and "director primacy theory" but for the purpose of this chapter, we will consider these two significant theories.

[766] Millon, above n 699, at 222-223.

[767] At 218.

foundation for the shareholder primacy model and that it produces suboptimal outcomes for society.[768] Despite this, shareholder primacy undoubtedly dominates modern discourse.[769]

The rise of the corporation and the evolution that the corporation should act in shareholders' interests should be seen alongside the rise in neo-liberalism. Neo-liberalism provided the grounds for governments to reduce regulation to free business and corporations from constraints. These conditions have allowed corporations to thrive and increase their dominance in modern Western societies. Increasingly, over the past several decades, we rely on the corporation to produce the economic growth required to sustain and improve upon our human endeavours. Our perception of the importance of the corporation has given large business interests an unencumbered and unopposed power.

The purpose of this thesis is not to establish whether shareholder primacy and neo-liberalism are justified. This thesis recognises the ideas that have been popularised and normalised over the middle decades of the 20th century and observes how these ideas have influenced tax policy in New Zealand. The normalisation of these concepts has formed the basis for the narrative that has influenced tax policy on inbound investors, especially from the early 1990s onward in New Zealand. This will be considered further below.

The next section moves away from the global political and economic movements of the 1970s and 1980s and focusses on what was happening in the New Zealand context.

6.3 Domestic background in the transitional phase

The fourth Labour Government was voted in after the Rt Hon Robert Muldoon called a "snap election" in 1984, late in the evening in a "tired and emotional" state.[770] After nine years of a National government led by Muldoon, the incoming Labour government found the country was ripe for change. Not only was the economic situation bleak, but certain political events had stirred up an almost revolutionary fervour.

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[768] Lynn Stout *The Shareholder Value Myth* (Berrett-Koehler Publishers, Inc., San Francisco, 2012); Jane Gleeson-White *Six Capitals* (Allen & Unwin, Sydney, 2014).

[769] Kenneth David "Discretion of Corporate Management to do Good at the Expense of Shareholder Gain – A Survey of, and Commentary on, the US Corporate Law" (1988) 13 *Canadian US Law Journal* 7 at 8.

[770] Russell, above n 607, at 9.

In 1981, the government allowed the South African rugby team to tour New Zealand, despite global boycotts against South Africa's persistent continuation of apartheid policies.[771] This provoked a striking division within New Zealand society, resulting in protests against the tour and, in turn, retaliation against the protestors. New Zealand had not seen civil unrest like this since the Waterfront strike in 1951. Only a few years earlier, in 1978, there was the 506-day protest against the proposed sale of Crown land at Bastion Point, gifted to the government by Māori for defence purposes.[772] Also rumbling away during this period was the discontent felt by many New Zealanders with the nuclear testing undertaken by the French government in the South Pacific.[773] The previously peaceful, stoic, and complacent population of New Zealand demonstrated an increasing tendency towards unrest.

Against this background came Roger Douglas, the new Minister of Finance, with a radical agenda that would transform New Zealand within a year. In the United Kingdom, the reforms were named "Thatcherism",[774] in the United States they had "Reaganism"[775] and in New Zealand, "Rogernomics" had arrived.[776] The New Zealand dollar was floated, exchange controls were relaxed, deregulation of the financial sector took place, interest rate restrictions were removed, and control over foreign ownership was reduced.[777] The underpinning philosophy of Roger Douglas and others in the Labour party cabinet[778] was to reduce the size of government and allow the free market to prevail. New Zealand went from being "the most

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[771] Charlotte MacDonald "Ways of Belonging: Sporting Spaces in New Zealand History" in Giselle Byrnes *The New Oxford History of New Zealand* (Oxford University Press, Melbourne, 2009) 269 at 290-291.

[772] Richard Hill "Māori and State Policy" in Giselle Byrnes *The New Oxford History of New Zealand* (Oxford University Press, Melbourne, 2009) 513 at 533-534.

[773] David Capie "New Zealand and the World: Imperial, International and Global Relations" in Giselle Byrnes *The New Oxford History of New Zealand* (Oxford University Press, Melbourne, 2009) 573 at 589-590.

[774] Named after The Rt Hon Baroness Thatcher, the Prime Minister of the United Kingdom from 1979 to 1990.

[775] Named after Ronald Reagan, the President of the United States from 1981 to 1989.

[776] "Rogernomics" is the New Zealand colloquialism for the introduction of neo-liberal economic policies, led by The Rt Hon Roger Douglas, Minister of Finance in New Zealand from 1984 to 1988.

[777] Marcia Russell and John Carlaw *Revolution (part three)* (TVNZ series, Auckland, 1996).

[778] Supported by senior Treasury officials as evidenced in The Treasury Economic Management, above n 681.

regulated [economy] in the world to the least regulated" in the short time between July 1984 and March 1985. [779] New Zealand had joined the movement toward neo-liberal economic reforms. With these reforms came greater cross border investment.

Roger Douglas was a powerful and influential figure in 1980s politics given his impact upon deregulation of the economy. The Prime Minister from 1984–1989, the Rt Hon David Lange was a more traditional Labour party member who supported and promoted social issues.[780] Initially Lange supported the economic reforms. Inevitably, however, when Lange realised the extent and impact of Rogernomics, he withdrew his support. This happened in 1988 when Douglas proposed a universal basic income and a flat-tax rate. This signalled the breakdown of the Lange government and, eventually, the Prime Minister resigned.[781]

At the next general election held in 1990, a National government was voted into power. This government was led by Prime Minister, the Rt Hon Jim Bolger. The Minister of Finance was the Hon Ruth Richardson. Richardson largely supported the work already done by the previous government and continued its reforms. Richardson moved toward reducing the size and regulation of government.[782] She was known for her 1991 "mother of all budgets" where spending on welfare was cut back severely. She also had a large role to play in the government's reformation of employment relationships with the introduction of the Employment Contracts Act 1991, which reduced the power of trade unions and elevated the individual contract.[783] This move alone may have reduced the organised challenge to neo-liberal ideas. Trade union movements have a long tradition of contributing a strong voice for

[779] Marcia Russell and John Carlaw *Revolution (part two)* (TVNZ series, Auckland, 1996), per Roger Douglas.

[780] Russell and Carlaw, above n 779.

[781] Russell and Carlaw, above n 779; Also see Barry Gustafson *David Lange* (Manatū Taonga, Wellington, 2013).

[782] Richardson, above n 734.

[783] Richardson, above n 734.

workers' rights. In diminishing the effectiveness of trade unions, this opposition was suppressed.[784]

The radical changes that took place during the 1980s and 1990s formed part of what became known as the "New Right".[785]

Also occurring during this period was the 'Commission of Inquiry into Certain Matters Relating to Taxation', known as the 'Winebox Inquiry', named after the box of documents presented to parliament by the Hon Winston Peters.[786] Allegations were made by Peters that the Inland Revenue Department and the Serious Fraud Office had been fraudulent and negligent in their handling of information regarding large scale corporate fraud, involving New Zealand corporations. The Winebox Inquiry found a number of New Zealand companies had been involved in transactions that sought to avoid New Zealand tax obligations.[787] However, the Commission didn't accept that the Inland Revenue Department and the Serious Fraud Office had behaved either negligently or fraudulently.[788] While the results of the inquiry were somewhat inconclusive, the transactions possibly brought the practice of tax avoidance to the awareness of the New Zealand public for the first time. The possibility that corporations, especially New Zealand corporations, might put into place arrangements to defeat the objectives of the tax provisions, in the name of creating shareholder value, had not reached the mainstream view until this time.

With this political and social background in mind, the development of tax policy during this period will be examined next.

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[784] Gregor Gall, Richard Hurd, and Adrian Wilkinson *The International Handbook of Labour Unions* (Edward Elgar Publishing, Cheltenham, 2011) at 82.

[785] Chris Brickell "Sexuality, Morality and Society" in Giselle Byrnes *The New Oxford History of New Zealand* (Oxford University Press, Melbourne, 2009) 465 at 485.

[786] Ronald Davison *New Zealand Commission of Inquiry into Certain Matter Relating to Taxation* (Government Printing Publications, Wellington, 1997), usually known as the "Winebox Inquiry".

[787] At Vol I, at Part 12 for details on the many corporations investigated for potential tax avoidance and fraudulent activities relating to the Cook Islands transactions.

[788] The findings of the Commission are set out in Vol 2, Part 7 of the report.

6.3.1 Tax policy aims of the 1990s

With the growth in the neo-liberal movement in New Zealand, came developments in tax policy with respect to foreign investors. These took places during the 1990s.

The Minister of Finance after the 1990 election, the Hon Ruth Richardson, explained that her intention was to reduce the burden of taxation on non-resident investors in order to encourage foreign investment into New Zealand. As she states in her policy framework document, the government's objective is to "shift the New Zealand economy from a slow-growth to a high-growth track".[789] She explained that to achieve this growth, New Zealand required more investment and much of this would come from overseas. To attract high quality investment, New Zealand needed to be an attractive place to invest. Richardson's policy statement clarified that "low taxes on non-residents are important to the Government's employment and growth objectives".[790]

The fourth National government issued an international tax policy framework discussion document in July 1991. This was published in the year following the election of the new government. In this document, the Ministers of Finance and Revenue announce their "Directions for reform":[791]

> The New Zealand government has decided in principle that it will move to limit the taxes on income from capital it imposes on non-residents, while maintaining a comprehensive system for taxing residents on their world-wide income.

The international tax agenda was to impose more tax on residents and less tax on non-residents, with the objective of encouraging investment from abroad. The rationale for attracting foreign investment was to bridge the perceived shortfall in financial capital to invest in domestic business. While domestic labour and land are immobile, foreign financial capital is highly mobile and can choose to invest anywhere. The objective the Ministers had

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[789] New Zealand Government *Taxing Income Across International Borders: A Policy Framework* (30 July 1991) at 4.

[790] At 10.

[791] At 12.

in mind was to make New Zealand attractive as an investment destination to boost domestic business investment.[792]

Only a few years later in 1995, another discussion document was issued by the Inland Revenue Department and the Treasury on the subject of international taxation.[793] This document placed significant weight on the matter of how tax policy might have an impact on New Zealand's economic growth.[794] The rationale for seeking economic growth is the consequent improvement in "living standards of all New Zealanders." [795] The document describes the "broad aim of international tax policy" as including *efficient* use of New Zealand's resources to ensure optimal economic growth and consequential living standards of New Zealanders.[796] The discussion document placed significant emphasis on economic measurements such as maximising the return on capital on investments.

The 1995 policy document observed the fairness of taxing on a source basis as opposed to a residence basis – although it does not elaborate on the reasons for this.[797] By taxing on a source basis, whether an investor is resident or non-resident, they would be subject to taxation on their New Zealand sourced income on the same basis. The problem outlined in the document is that the international capital markets respond by transferring investments elsewhere. This will mean New Zealand companies looking for capital investment will have to offer a higher rate of return to attract that investment to New Zealand – the effect being the cost of the tax burden is borne by New Zealand companies. The policy discussion theorises that the company will respond by reducing costs in order to increase return to shareholders, in particular labour costs are identified.[798] The deductive outcome is that taxing non-residents reduces the price of labour costs, therefore reducing the welfare of ordinary New Zealanders.

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[792] At 4.

[793] New Zealand Government *International Tax: A discussion document* (discussion document, 1995).

[794] At preface.

[795] At 8.

[796] At 7-8.

[797] At 13.

[798] At 14.

The conclusion reached is that reducing tax on non-residents improves the welfare of New Zealanders.

Other factors that influence a non-resident's decision to invest were acknowledged, such as political stability and the fact New Zealand is a price taker – not being able to dictate market rates of return on investment.[799] Also, the impact of New Zealand's domestic law could not be viewed in isolation for two reasons: first, investors may have had tax liabilities elsewhere such as in their country of residence; and second, New Zealand had entered into a number of bilateral double tax agreements that alter the application of domestic law.[800]

Despite the acknowledgement of other counteracting influences, the recommendations in the discussion document generally supported reducing the tax burden upon non-resident investors in the drive toward increased economic growth.[801] Factors relating to equity are largely ignored. This is consistent with the modern thinking of the day because of the dominant neo-liberal discourse. Provided owners of capital are doing well, the benefits will trickle-down and be enjoyed by all New Zealanders.

With this policy framework in mind, the National government from 1991 to 1999 introduced amendments into tax law to improve the tax position in New Zealand for non-resident investors. First, the introduction of the approved issuer levy ("AIL") for inbound lenders.[802] Second, the introduction of the FITC regime that had the effect of eliminating NRWT,[803] and finally, the further expansion of the double tax treaty network meant more inbound investment fell outside the scope of New Zealand's tax base.

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[799] At 9.

[800] At 15.

[801] Recommendations include the extension of the FITC regime to direct non-resident investors and tightening thin capitalisation and transfer pricing rules. Reducing the ability of non-residents to shift profits was also a strong influencer.

[802] Income Tax Amendment Act (No 4) 1991.

[803] Income Tax Amendment (No 3) Act 1993, s 76; Income Tax Act 1994 Amendment (No 3) 1995, s 17.

6.4 Tax changes during the transitional phase

6.4.1 Introduction of Approved Issuer Levy in 1991

In 1990, the new Minister of Finance, the Rt Hon Ruth Richardson, announced in her first budget that new measures would be introduced to reduce the tax burden on New Zealand borrowers, essentially continuing the work of the previous government. Then Minister of Revenue, Wyatt Creech, introduced the bill into parliament on the evening of 31 July 1991, stating that parliament would work through the night until the bill was passed. The bill enacting the AIL was introduced and passed under "extraordinary urgency" and did not receive any public input or select committee scrutiny.

The Minister of Revenue introduced the measure "to promote economic growth by removing barriers to more and better investment in New Zealand".[804] This is reflected in the policy document published by the government the previous day stating the government's intention to "shift the New Zealand economy from a slow-growth to a high-growth track".[805] In order to achieve high growth, according to the Minister of Revenue, New Zealand must attract investment from overseas. According to the policy document, taxes should be designed to both raise revenue from non-residents while also not creating barriers to foreign funding.[806]

The issue the new government identified in attracting investment from overseas is that New Zealand is a price-taker in the capital markets due to its relative power imbalance. The incumbent government argued a NRWT is shifted onto resident borrowers and businesses, increasing the cost of capital. Their rationale is as follows. The lender requires a set rate of return based upon what they can demand or achieve in the global market. If New Zealand imposes a tax on this return, such as a NRWT on interest, the lender will factor this tax cost into their required rate of return, effectively passing the cost onto the New Zealand borrower. The result of this rationale is that NRWT on interest results in higher interest rates for New Zealand borrowers.[807] This has been supported by one research study that provides empirical

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[804] (31 July 1991) 317 NZPD 277.

[805] 1991 international tax policy framework, above n 789.

[806] At 4.

[807] At 5-7.

evidence that the cost of capital for New Zealand businesses is lowered with the exemption from NRWT.[808]

Offsetting this rationale is the fact that many other countries (including treaty partners), have a system of tax credits to allow source-based taxes, such as NRWT, to be offset against domestic tax liabilities.[809] However, this is only useful to the extent the lender is a taxpayer who can utilise a tax credit. To the extent the lender is not such a taxpayer, tax paid in New Zealand is an additional cost. The government's policy document specifically refers to intermediaries and pension funds. The nature of the intermediary is not elaborated upon. The government's policy document also acknowledges the benefits to New Zealand borrowers of "well-known techniques" for avoiding NRWT.[810]

The result of the introduction of AIL is to exempt non-resident lenders from NRWT altogether while imposing a tax deductible 2 per cent levy upon the borrower in New Zealand. The 2 per cent levy is known as the AIL, as the issuer of the debt must have the debt instrument approved by the Inland Revenue before NRWT can be exempted. The 2 per cent levy is tax deductible to the payer (the New Zealand based borrower) and therefore, the net cost, after deduction, is only 1.44 per cent of the interest paid.

The weakness in this policy is that it undermines a domestic lender's competitiveness by giving the foreign lender a tax advantage. Where the tax advantage does not exist, because the foreign lender must pay tax revenue in another jurisdiction instead of New Zealand, the cost of capital should be the same for the domestic borrower while the tax revenues are shifted to a foreign jurisdiction – leaving no benefit to New Zealand at all.

The benefit of the exemption from NRWT is enjoyed by those lenders located in low tax jurisdictions. Effectively, New Zealand is willing to promote the use of lenders in low tax

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[808] Craig Elliffe, Alaister Marsden, and Russell Poskitt "The Impact of the Approved Issuer Levy on the New Zealand Dollar Domestic Interest Rates" (2008) 14(4) *NZJTLP* 483.

[809] In Australia, a foreign tax credit is allowed under Division 770 of the Income Tax Assessment Act 1997 (Aust.); in the United States, a foreign tax credit is allowed under the Internal Revenue Code 26 USC § 27; in the United Kingdom, double tax relief is granted in the Taxation (International and Other Provisions) Act 2010, Part 2, Chapter 2.

[810] At 14.

jurisdictions to provide cheaper debt to New Zealand businesses. This depletes the New Zealand tax base and makes domestic lending uncompetitive. While this change took place in the transitional period, the effect is clearly to provide a preferential tax regime for non-resident investors.

Ruth Richardson later describes the rationale for the introduction of the AIL:[811]

> The proposal was designed to maximise the positive impact on domestic interest rates, while minimising its negative impact on the New Zealand tax base. It was targeted at those fixed interest investors who received no tax credit in their own country for NRWT paid in New Zealand. These investors would now be largely able to escape paying NRWT, with positive implications for New Zealand interest rates. Investors who did receive a tax credit, and who were thus not being deterred by NRWT from investing here, would be deterred by the 2 per cent levy from claiming an exemption. Accordingly, these investors would not be a loss to the New Zealand tax base. The policy was a shrewdly targeted measure.

Richardson points out that this was mainly for the benefit of those investors who were not able to obtain a tax credit for the NRWT imposed in New Zealand. However, New Zealand's main trading partners, the United States, the United Kingdom and Australia all operated a foreign tax credit system at the time.[812] In fact, most nations that New Zealand relies upon for borrowing have provision for foreign tax credits and this was also built into New Zealand's 24 double tax treaties in existence at the time. It is, therefore, likely the beneficiaries of this would be finance companies located in low-or-no-tax jurisdictions like tax havens. Introduction of the AIL may have reduced the cost of borrowing for New Zealand businesses, but it also produced a significant taxpayer funded windfall to lenders located in tax free jurisdictions.[813]

Funding investment in New Zealand with foreign debt is expensive from the perspective of the New Zealand taxpayer. Interest expenses are generally tax deductible for the borrower, reducing their tax liability on their taxable income. Meanwhile, the only revenue generated is often the 2 per cent levy paid by the New Zealand borrower. The foreign lender contributes

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[811] Richardson, above n 734, at 106.

[812] See above n 809.

[813] Note that research supports the view that non-resident lenders pass the cost of New Zealand tax onto their borrowers which does increase the cost of capital: Elliffe, Marsden and Poskitt, above n 808.

nothing to the New Zealand tax base where the AIL is paid. Overall, New Zealand's tax base is eroded.

Despite this, the AIL remains in force today.

6.4.2 Portfolio investment in equities

When NRWT was initially enacted in 1964, it was at the rate of 15 per cent on all dividends paid to non-residents. In 1980, the rate was increased to 30 per cent[814] where it remains today.[815] During the 1980s, a large number of treaties were entered into with other jurisdictions that reduced the NRWT on dividends to, usually, 15 per cent.[816] The imposition of New Zealand income tax upon dividends was either 15 per cent or 30 per cent, depending on whether the taxpayer resided in a country with which New Zealand had a treaty. New Zealand had treaties with its main trading nations at that time so generally we can assume the NRWT rate on dividends was 15 percent.

This meant non-resident investors were subject to tax on company profits (indirectly) and on dividends as well. For some investors, this meant an effective tax rate in New Zealand of as much as 53 per cent.[817] In an economy committed to welcoming foreign investors to boost available capital, a tax disincentive seemed inconsistent.

However, the decision on how much to tax foreign investors is not as simple as trying to minimise the New Zealand tax burden. Other factors have an impact on the effect of taxation on the investor. Many home jurisdictions impose income tax upon dividends received and allow a tax credit for New Zealand tax paid – meaning the foreign investor will be less sensitive to the New Zealand tax burden on the dividend income as it is creditable against their tax liability in their home territory. If New Zealand chooses to remove all tax on

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[814] Income Tax Amendment Act 1980 (No.28), s 44.

[815] Income Tax Act 2007, s RF 8(2).

[816] New Zealand entered into double tax agreements for the first time with Belgium (1983), China (1986), Denmark (1981), Finland (1984), France (1981), Germany (1980), India (1986), Indonesia (1988), Ireland (1988), Italy (1983), Korea (1983), Netherlands (1981), Norway (1983), Philippines (1980), and Switzerland (1981). This increased the treaty network from 9 to 24 countries.

[817] The corporate tax rate was 33%, then a further 30% of NRWT could be paid on the net dividend.

dividends paid to foreign investors, the same amount of tax may be collected by the residence country. Even if the foreign investor is not taxed on the dividend in their home country, they have already made the investment so subsequent removal of the tax will not have an impact on their choice to invest – it is a windfall to the investor. Also, foreign investors are not voters, and the imposition or removal of tax has no direct political impact. For these reasons, the choice to impose a tax on dividends paid to non-residents is more complex than it might initially seem.

In 1993, the government altered the tax burden on foreign investors with portfolio equity investments to be the same as the tax burden on domestic investors.[818] They decided, given the perceived desirability of foreign investors, to treat the two groups equally.[819] The company tax rate at that time was 33 per cent, equivalent to the highest marginal tax rate on personal income. The imputation regime capped the tax on both company and dividend income at a total of 33 per cent for domestic shareholders. The Foreign Investor Tax Credit Regime ("FITC") was implemented to achieve the same tax outcome for foreign investors as domestic investors.

FITC was chosen rather than the much simpler alternative to eliminate NRWT on dividends. FITC involves the company paying the foreign shareholder the regular dividend plus a supplementary dividend. NRWT was applied to the total of the two dividends, resulting in the foreign investor receiving a net amount equal to the total dividend they would have received without FITC. As an example, let us say the company has $100 of retained earnings to pay its foreign shareholder. They will pay this $100 to the shareholder, along with a supplementary dividend of $17.65. The total dividend received by the shareholder is $117.65, from which 15 per cent NRWT is deducted and returned to the New Zealand government. The shareholder will receive cash of $100 and have a tax credit of $17.65 available to use against their tax liability in their home jurisdiction. Meanwhile, by operation of the FITC legislation, the company is granted a credit in their imputation credit account of $17.65 – meaning they are not out of pocket for the supplementary dividend. This scenario assumes the dividend is fully

[818] Non-resident portfolio investors are those whose voting interests are less than 10 per cent of the New Zealand company and, if a 'market value circumstance' exists, this is also less than 10 per cent. A market value circumstance essentially refers to alternative means of controlling a company.

[819] NZ International tax discussion document 1995, above n 793, at 2.

imputed and the foreign investor resides in a country with which New Zealand has a double tax treaty.

The question of why such a convoluted regime was implemented must be asked. The explanation given is that FITC allows investors the opportunity to gain a tax credit against their home country tax liability where an exemption regime does not. This means the tax burden on the investor is reduced which, in turn, should reduce the cost of capital to the New Zealand borrower. This regime was put in place for portfolio investment in 1993 and extended to direct investment in 1995. At the time the regime was first introduced, the ministerial press statement stated the rules are to "put foreign and local investors on a more equal footing and so help to lower the costs faced by New Zealand businesses in financing new investment".[820] Removal of NRWT would simply result in transfer of revenue from New Zealand to the country of residence (assuming a classical tax credit system). The FITC regime provides a genuine reduction in the tax cost of investing in New Zealand.[821]

Although the NRWT was not altered in domestic legislation during the transitional period, the introduction of the FITC on portfolio dividends eliminated the effect of it.

Like the rationale for the introduction of the AIL, Richardson believes the cost of taxation of non-resident investors will fall onto the New Zealand economy.[822] She refers to double taxation of non-residents as ill-considered policy that is worn by New Zealanders.

The bill introducing FITC[823] was first read in parliament in August 1993. The Hon Wyatt Creech, then Minister of Revenue, explained that the bill had been drafted after extensive consultation with the taxpayer groups "most affected" and with experts in taxation.[824] He explains the purpose of the new FITC regime is to reduce the current double taxation on non-

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[820] The Rt Hon Ruth Richardson, Minister of Finance and the Hon Wyatt Creech, Minister of Revenue "New Zealand Government Tax Measures Improve Climate for Growth" (press release, August 1993).

[821] Michael Rigby "New Zealand Taxation of Interest and Dividend Income of Non-Residents" (1995) 1:3 *NZJTLP* 160.

[822] (3 August 1993) 537 NZPD 494.

[823] The Taxation Reform Bill (No.7) 1993.

[824] (3 August 1993) 537 NZPD 486.

resident investors, which can be as high as 53 per cent for those in countries with which New Zealand does not have a treaty.

The FITC bill went through the standard legislative process including consideration by the select committee. Submissions were sought from the public and 20 were received.[825] All submissions were in favour of the changes and commentary on the proposed FITC was limited to discussion on the mechanism itself rather than the overall policy intent. All the submissions represented business interests, including the New Zealand Society of Accountants, the New Zealand Business Roundtable, and the New Zealand Law Society.

The government opposition also supported the bill despite some concerns that the FITC regime as proposed is unduly complex.[826] There was little (or no) opposition to the reduction of tax imposition upon non-resident investors by opposition politicians or submitters to the bill.

The New Zealand Law Society, the New Zealand Society of Accountants and the New Zealand Chamber of Commerce all submitted that an alternative mechanism be implemented, such as a simple exemption from NRWT.[827] Certainly, from a mechanistic perspective, this would have been far simpler than the complex regime introduced. However, policy advisers were reluctant to lose the tax revenue gained from NRWT without the additional benefit of the tax credit provided to investors. As NRWT is still payable by investors, although not borne economically, the home jurisdiction will still grant a foreign tax credit.

The risk for New Zealand in adopting this regime was that the scheme engendered a level of artificiality that could elicit a response from a home jurisdiction to deny the NRWT as a tax credit. However, this has not occurred and FITC continues to be used today although it has reduced in its importance due to the reduction of NRWT rates, discussed in the next chapter.

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[825] House of Representatives *Taxation Reform Bill (No. 7): List of Submissions* (undated) obtained from the New Zealand Parliamentary library.

[826] At 492.

[827] Inland Revenue Department and Treasury *Taxation Reform Bill (No.7): Second Report to the Finance and Expenditure Select Committee on Submissions* (September 1993) at 4.

6.4.2.1 Winebox Inquiry

It is impossible to discuss New Zealand's introduction of FITC without addressing the winebox controversy that arose in the same period.

Then MP and member of the National Party, Winston Peters, made claims in 1992 of tax fraud and criminal activity amongst some of New Zealand's largest corporations and most well-known business personalities.[828] A winebox full of documents was presented by the Hon Winston Peters[829] as evidence of large-scale tax fraud. The documents were given to Peters by deceased tax lawyer Paul Darvell who worked on the transactions. The allegations involved many activities but central among them was known as the 'Magnum' transaction.[830]

The Magnum transaction involved a loan from a New Zealand company to a company registered in the Cook Islands. Interest was paid on the loan with NRWT deducted in the Cook Islands at the rate of 35 per cent. This NRWT became creditable against the New Zealand tax liability of the New Zealand lender. At the same time, in the Cooks Islands, the NRWT was effectively refunded to another group company, after deduction of a fee retained by the Cook Islands government.[831] Many observers at the time regarded the essence of the transaction as large business interests paying a fee to the Cook Islands government in exchange for a tax credit certificate.[832]

The ensuing Commission of Inquiry set up by the government had terms of reference to investigate corruption allegations made by Mr Peters against the Commissioner of Inland Revenue and the head of the Serious Fraud Office.[833] The outcome of the inquiry was

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[828] Particularly notable are Sir Michael Fay and David Richwhite.

[829] The Hon Winston Peters was a Member of Parliament with the National Party at the time of the initial allegations. In 1993, he formed the New Zealand First Party and has remained the leader of that political party since that time.

[830] Winebox Inquiry, above n 786, at 2:1:40.

[831] At 2:1:40.

[832] At 2:1:52.

[833] At 1:3:1.

mixed.[834] However, for the purpose of this thesis, what is important is that these tax arrangements were carried on by large business interests in New Zealand, with the knowledge of government officials.[835]

During the winebox period, quietly, in the background, the FITC regime was being developed and implemented into law. The initial winebox allegations began in 1992 and the Commission's report was issued in 1997. The FITC proposals were initiated through the legislative process in 1993 and legislated, in full, in 1995.

The similarities between the FITC and the Magnum transaction are striking. Both arrangements seek to provide tax credits for use in a foreign jurisdiction while, in reality, the NRWT has not really been borne by the investor. In the case of the Magnum transaction, the NRWT is refunded through related party mechanisms. With FITC, the New Zealand company is credited with the amount of the supplementary dividend paid to their foreign investor, through the imputation credit account. Both transactions involve an element of deception in order to achieve their goal. FITC is more transparent, but it is unlikely the foreign jurisdiction granting the tax credit will be aware of the relatively complex regime.

The obvious question is why there would be such a public outcry at the transactions subject to the winebox inquiry and yet little interest in the FITC regime. The answer to this is unclear. However, one might assume the FITC regime did not capture the public interest due to its complexity and the disinterest which the public display toward tax policy matters. This is highlighted with many of the tax changes discussed in this chapter and the next. The public have little input or interest in tax matters that they do not perceive to affect them directly. However, the revenue forgone with the introduction to FITC[836] must have an impact upon all members of the public, either through reduced public goods and services or through increased taxation imposed upon the domestic tax base. Only self-interested parties submitted on the FITC proposals and unsurprisingly, none of them objected to them on the grounds of protecting the domestic tax base.

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[834] At 2:7:6 – 10.

[835] At 1:3:1.

[836] International Tax discussion document 1995, above n 793, at 41.

6.4.3 Direct investment into equities

The extension of the FITC regime to direct investors was tabled in the 1995 discussion document on international tax, issued by the government of the day.[837] Continuing with the work of the Hon Ruth Richardson,[838] the Rt Hon Bill Birch and the Rt Hon Wyatt Creech wanted to further international taxation reform for sustained economic growth. They attribute the economic growth New Zealand experienced during the 1990s to "extensive structural reform of the economy, including major reforms of taxation".[839]

The policy document recommended that the FITC regime, currently being utilised for inbound portfolio equity investors be extended to 'direct' investors – those with an interest of 10 percent or greater.[840] The benefits of this extension were reducing the pre-tax rate of return required to be paid by New Zealand companies, reducing the differential between the tax rates on residents and non-residents, and the provision of the benefit only where the company was paying tax in New Zealand. Of the benefits listed, the policy document said the extension of the FITC regime to direct investors would increase investment and employment.[841]

The fiscal cost of the extension of the FITC regime was estimated at $60-70 million.[842] This was in the context of annual tax revenues of around $30-35 billion in the mid-1990s.[843]

The bill proposing the extension of the regime to direct investors went through the consultation and select committee process. The consultation attracted submissions from 24

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[837] International Tax Discussion Document 1995, above n 793.

[838] Richardson resigned from Parliament in 1994 after having been dismissed as Minister of Finance after the 1993 election.

[839] International Tax Discussion Document 1995, above n 793, at preface.

[840] At 41.

[841] At 41.

[842] At 41.

[843] These statistics are found at <https://stats.oecd.org/Index.aspx?DataSetCode=REVNZL> and are collated and published by OECD.

parties – all representing business interests.[844] Once again, a number of submissions were made regarding the mechanism employed.[845] However, all submitters agreed with the extension of the regime with only a few preferring an exemption from NRWT as an alternative. Given there are no submissions from parties without the interests of non-resident investors in mind, it is predictable that submitters would be content with a reduction in the tax burden for non-resident shareholders.

The FITC regime remains in place today although subsequent changes to tax law have reduced the importance of the regime.

The effect of the introduction of FITC in the 1990s is to treat non-resident equity investors and domestic equity investors in the same way for tax purposes. The maximum income tax imposition for a non-resident investor was the company tax rate. At the time, this was the same as the top marginal tax rate for an individual. The extension of FITC to direct investors therefore had the effect of equalising the tax treatment of all domestic and non-resident equity investors.

6.4.4 Tax changes for direct investors

Direct investment into assets, as opposed to investment into debt or equity instruments, has not been subject to major changes under domestic law. New Zealand taxes business income of non-residents on a source basis - that is, income tax applies where a non-resident is 'carrying on business in New Zealand'.[846] Like New Zealand businesses, the same rules apply to determine what income is taxed and what deductions are allowed to foreign businesses operating in New Zealand. Up until the FITC regime was introduced, New Zealand branches of non-resident companies were subject to a higher income tax rate than New Zealand resident companies. This was an attempt to equalise the treatment of non-resident investors operating through a company and those who invested directly into assets,

[844] Inland Revenue Department *Taxation (International Tax) Bill: Official's Report to the Finance and Expenditure Select Committee on Submissions Received on the Bill* (1995) at 104.

[845] At 6.

[846] Income Tax Act 2007, s YD 4(2).

by including a premium as a substitute for NRWT.[847] Along with the extension of the FITC regime to direct investors, the branch profits tax was reduced from 38 per cent to 33 per cent, to match that of domestic companies.[848] The estimated loss of tax revenue was in the order of $5 million annually.[849]

The underlying reasons for the change echoed those for extending FITC. New Zealand needed economic growth to improve economic wellbeing.[850] This required greater investment and New Zealand does not have sufficient financial capital. To attract capital from elsewhere, New Zealand needed to become more competitive – in other words, offer better returns on that investment. This could be enhanced by reducing cost burdens such as source-based taxation.

Once the effect of the NRWT was removed by the FITC regime, the tax rate premium was no longer justified.

Today, the domestic law remains the same – non-residents investing into assets in New Zealand are taxed in the same way as a local investor; that is, a direct investor will be subject to income tax on the income they derive in New Zealand based upon their marginal tax rates.

Other tax changes on direct investment into New Zealand have been a result of the negotiation of new treaties between New Zealand and other jurisdictions. Although the treaties do not necessarily have a significant impact upon how much direct investors are taxed, they do affect who comes within the tax base and who is excluded. Before overlaying the effect of any treaty, New Zealand takes a comprehensive approach and taxes any business income that is carried on in New Zealand – even if only in part.[851] Where New Zealand has a double tax treaty with another jurisdiction, taxation of that New Zealand sourced income will

[847] This was introduced with NRWT in s 4 Land and Income Tax Amendment Act 1964 (no.122); Income Tax Act 1976, Schedule 1 (7) and (8).

[848] Income Tax Act 1994 Amendment Act (No.3) 1995, s 30.

[849] International Tax discussion document 1995, above n 793, at 42.

[850] At 1.

[851] Income Tax Act 2007, s YD 4(2).

only be allowed where the New Zealand investment meets the test of a *permanent establishment*. This is discussed in more detail in chapter seven.

New Zealand has actively maintained some source taxing rights in its treaty negotiations.[852] However, as it is frequently the weaker partner in treaty negotiations and the net capital importer,[853] the erosion of source-based taxation has inevitably occurred. The OECD model favours residence-based taxation, and every treaty New Zealand enters erodes domestic source-based taxing rights.[854] The increase in the number of treaties has therefore necessarily resulted in some activities falling outside the scope of the New Zealand tax base. This will be considered further in chapter seven.

6.5 Conclusion

The 'transitional' phase took place in the 1980s and 1990s. The phase saw the influence of neo-liberal thinking upon tax policy. The neo-liberal narrative is part of a global movement toward economic liberalisation and smaller governments. This was popularised by figures such as Milton Friedman from the 1980s onward.[855] While New Zealand was a laggard in adopting these policies when compared with the United States and the United Kingdom, when they did arrive, a hard and fast approach was taken. Significant changes to the economy were made in the mid-1980s but it wasn't until the 1990s that changes were made to the taxation of non-residents.

In the early 1990s, the new National party led government declared their policy was to minimise the tax impost on non-residents to attract foreign investment into New Zealand. An increase in foreign investment would (it was hoped) lead New Zealand toward economic

[852] This is analysed below in chapter 7.

[853] This is because New Zealand has a relatively small population (currently $5m) and is generally the net capital importer. In its treaty negotiations with other OECD countries, it is inevitably the weaker party. It is only in its negotiations with small, developing states such as the Pacific Island nations, that New Zealand becomes the dominant negotiator – and in these cases, New Zealand will often take a humanitarian and patriarchal view of the relationship.

[854] Dagan, above n 727.

[855] See the analysis in 6.2.1 above.

growth and greater prosperity. This theoretical position underpinned the introduction of the AIL and the FITC.

The AIL eliminates the NRWT on interest paid to a foreign lender provided they are not associated with the borrower. The borrower had to pay a levy to the New Zealand government, but the lender was not subject to taxation at all. The introduction of the AIL created a preferential treatment for non-resident lenders. While the rationale was to reduce the cost of capital for New Zealand businesses, the effect was to eliminate New Zealand taxation from foreign lenders entirely. This provides the greatest benefit to those lenders in low or no tax jurisdictions.

The FITC also had the effect of eliminating NRWT on dividends paid to non-resident investors. However, the mechanism used to affect the elimination of NRWT potentially provided the investor with the benefit of a tax credit against their home country tax liability. While the investor may have been better off than under the previous regime, the New Zealand tax revenue collected was the same for a non-resident investor and a domestic investor – treating them both in the same way. Effectively the change reduced the imposition of New Zealand income tax on non-resident equity investors to equalise it with that of domestic investors.

The tax changes that took place during the transitional phase responded to the neo-liberal discourse that became the dominant narrative for economic wellbeing from the 1970s onward. Governments during the transitional phase were setting tax policy to attract foreign investment and other mobile factors of production. This meant reducing the tax burden on these taxpayers and either increasing the tax burden on immobile factors of production or reducing the supply of public goods and services. The transitional phase in New Zealand involved significant discourse around reducing or even eliminating the tax burden on non-residents. This policy was pursued further during the preferential phase, which is the subject of the next chapter.

7 Favouring inbound investors

7.1 Introduction

This chapter addresses the development of the preferential phase of tax settings on inbound investors. The preferential phase is the period where New Zealand has adjusted its tax settings to provide a reduced tax imposition upon inbound investors when compared with their equivalent domestic investor. This shift mainly occurred during the 2000s onward. However, the beginning of the preferential phase started in the early 1990s. The Hon Ruth Richardson, Minister of Finance from 1990 to 1994, favoured an international tax policy based on taxing non-residents more leniently in the hope of improved economic performance.[856] Steps were taken to reduce the tax burden on non-residents.

The objective of this chapter is to examine the development of the preferential phase. First, the political background of the period is examined in part 7.2. Next, part 7.3 analyses the discussions, public consultation, and recommendations of the many tax and business review groups during this period. The changes in tax law affecting the way non-resident investors are taxed in New Zealand are analysed in part 7.4. This part also includes a detailed analysis of the double tax treaty network as it currently stands in relation to whether the agreements favour residence or source-based taxation.

The conclusions reached in the chapter are intended to demonstrate the shift toward preferential tax treatment of inbound investors and to gain insight into the economic theory and popular discourse supporting these settings.

7.2 Domestic background in preferential phase

The 1999 election was the first in a new mixed member proportional ("MMP") environment.[857] This resulted in a coalition being formed between the Labour Party and a relatively new party, the Alliance. The new Prime Minister, the Rt Hon Helen Clark, led the government for the following nine years. Despite being led by a left-of-centre coalition, the government did not significantly reverse the direction of economic reform initiated in the

[856] Richardson, above n 737734, at 107.

[857] Mixed Member Proportional voting involves a government being formed on the basis of the proportion of 'party' votes received.

1980s. They renationalised the rail network that had been sold into private hands in the 1980s and repealed the Employment Contracts Act 1991. They undertook a number of measures over the nine years in power to address social issues, perhaps most significantly, the introduction of the Working for Families tax credits package.[858] However, the free-market policies introduced by the Labour government of the 1980s and continued by the National government of the 1990s remained largely intact.

In 2008, the Labour party lost its hold on power to the more conservative National party who formed a coalition with ACT and United Future. The new government was led by the Rt Hon Sir John Key, a 'rich-lister'[859] and former money market trader with investment bank, Merrill Lynch.[860] ACT is a "new right", libertarian party, initially formed by Roger Douglas (formerly Labour) and Derek Quigley (formerly National). United Future was more centrist and only ever had a single MP, Peter Dunne, who had formed part of the previous Labour party's coalition as well. This new government was a swing to the right for New Zealand politics.

Two significant events took place during this period. First, 29 men lost their lives in an explosion at the Pike River Mine in November 2010;[861] Second, there were two large earthquakes that resulted in significant loss of life and the destruction of Christchurch city in 2010 and 2011.[862] The earthquakes, in particular, had long term economic consequences in terms of rebuilding the third most populated city in New Zealand. Over the following years, 1,500 buildings were demolished, requiring a massive reconstruction effort.

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[858] Still in force under part M of the Income Tax Act 2007.

[859] A New Zealand term for someone who makes it onto the National Business Review annual "rich list" – a list of the richest people in New Zealand.

[860] Gavin McLean "John Key: Biography" (Ministry for Culture and Heritage, 27 October 2017) <John Key | NZHistory, New Zealand history online>.

[861] Glass, Brown, and Vance "Rescuers wait on final all-clear to enter mine" *The Press* (online ed, Christchurch, 20 November 2010).

[862] Quinn and Tran "New Zealand earthquake strikes Christchurch, killing at least 65 people" *The Guardian* (online ed, London, 22 February 2011).

Despite relatively little major policy development, the economy thrived in New Zealand from 2010 onward. This is attributed partially to the rebuild of Christchurch city but also due to strong commodity prices for logs and dairy products and an increase in demand from China.[863] The significant immigration and buoyant growth in house prices also contributed toward a period of economic growth.[864]

This period included strong rhetoric from leadership around economic growth and small government – the focus of neo-liberal economics. John Key continued to send the message that only economic growth could "provide greater prosperity, security and opportunities to all New Zealanders".[865]

One of the more immediate changes implemented by the new government was to cap the number of government employees.[866] The objective of smaller government is consistent with neo-liberal theories that the private sector should be free to operate without public sector interference or excessive regulation. This continued through the National-led government's nine-year term under the refrain of building better public services within a tight budget.[867] The government of the day also cut taxes[868] and sold state assets,[869] consistent with the desire to reduce the size of the state.

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[863] The Treasury "New Zealand Economic and Financial Overview 2012" (8 June 2012) at 10.

[864] OECD "OECD Economic Surveys: New Zealand 2019" (OECD Publishing, Paris, 2019) at 10.

[865] Rt Hon John Key, Prime Minister of New Zealand "Speech to the Act Party National Conference" (press release, 15 March 2009).

[866] Hon Tony Ryall, Minister of State Services "Government caps core government administration and pledges better performance" (press release, 27 March 2009).

[867] Rt Hon John Key, Prime Minister "PM outlines key priorities for 2nd term in Govt" (press release, 27 January 2012); Rt Hon John Key, Prime Minister "Prime Minister's Statement to Parliament" (press release, 11 February 2015).

[868] Taxation (Budget Measures) Act 2010, s 31.

[869] Rt Hon John Key, Prime Minister "Next steps in Govt plan to build faster growth" (press release, 27 January 2011); Hon Tony Ryall, Minister of State -Owned Enterprises and Bill English, Minister of Finance "Next steps in mixed ownership programme" (press release, 16 December 2011).

Other first term objectives of the 'new' government were reducing compliance and regulation, improving educational outcomes, strong law and order, and looking for new ideas to stimulate growth in the economy.

"Cutting red tape" was a project led by Rodney Hide, leader of the Coalition partner, ACT, and Minister of Regulatory Reform.[870] The objective of the review was to identify areas where regulation is holding back productivity and growth.[871] The review focused upon regulation in the areas of climate change response, building, resource management, employment relations, and overseas investment.

A "Jobs and Growth Plan" was unveiled in the first term that involved minor measures to improve small business performance, upgrade roads, build cycle paths, and new schools.[872] Although there were no revolutionary changes while this government served its three terms in office, there was a consistent message around the importance of economic growth as a way to improve living outcomes for New Zealanders.

This government was popular, and the economy thrived after the immediate effects of the global financial crisis passed. Key was very popular in his role as Prime Minister.[873] He resigned at the end of 2016 in the year leading up to the next election. The Rt Hon Bill English took over as Prime Minister leading into the next election.

The 2017 election votes were well spread across the National Party, Labour Party, and other minor parties – meaning no single party could govern alone, nor with their traditional allies. The Labour Party managed to form a coalition with New Zealand First. This signalled a possible change in focus from economic growth to social issues. This new government was

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[870] Hon Rodney Hide, Minister of Regulatory Reform, "Red tape review begins" (press release, 27 February 2009).

[871] Rt Hon John Key, Prime Minister "Speech to the ACT Party National Conference" (press release, 15 March 2009).

[872] Rt Hon John Key, Prime Minister "National focuses on jobs and growth with package" (press release, 5 February 2009); Rt Hon John Key, Prime Minister and Rt Hon Bill English, Minister of Infrastructure "Fast-tracked public projects give $500m boost" (press release, 11 February 2009).

[873] NZ Herald "National climbs closer to record high in latest poll" (online ed., 18 April 2011), shows John Key was voted preferred Prime Minister by over 50 per cent of pollsters.

led by Labour leader the Rt Hon Jacinda Ardern. Like Key, Ardern is popular with the public.[874]

At the end of 2018, the Minister of Finance, the Rt Hon Grant Robertson announced that the 2019 government budget would be based upon The Treasury's LSF – a multi-dimensional wellbeing framework.[875] The budgets of 2019, 2020 and 2021 are touted as "wellbeing budgets" to symbolise their focus on wider concepts of wellbeing, beyond economic growth alone.

The 2020 election was a success for Ardern's labour party with the party becoming the first, since MMP was introduced in 1996, to gain enough seats to govern alone.[876] While the government has continued to support the wellbeing objectives of the LSF, this has been overshadowed in 2020 by the response to the COVID-19 pandemic and the resulting economic recovery.

This chapter will now consider the tax and business reviews that influenced political decision-making and give an indication of the narrative of the time.

7.3 Tax and business reviews

During the 2000s, multiple tax and business reviews took place in order to find innovative ways to stimulate economic growth.[877] These reviews spanned the Labour-led and National-led coalition governments, and the focus of the groups reflect the concerns of the time. Economic growth was a big focus for the successive governments who were dissatisfied with

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[874] Colmar Brunton "1 NEWS Colmar Brunton Poll 9 – 13 March 2021" (15 March 2021) shows Jacinda Ardern voted as preferred Prime Minister by 43 percent of pollsters, having dropped from 58 per cent in December 2020.

[875] See discussion in 3.2.4 on this framework. Robertson press release, above n 332.

[876] The official election results show Labour has 65 of 120 seats. See the official results at <2020 General Election official results | Elections>.

[877] McLeod report, above n 302; The Hon Michael Cullen, Minister of Finance and Hon Peter Dunne, Minister of Revenue *Business Tax Review*, above n 889;*: A discussion document* (Inland Revenue Department, July 2006); VUW report, above n 52.

how New Zealand growth tracked compared with other developed nations.[878] This may have been the vector for the proliferation of reviews which were aimed at improving economic growth and increasing foreign investment into New Zealand. However, the dominant focus upon economic growth wains over time, with later tax review groups openly questioning the wisdom of such a narrow focus and whether the right tax settings have been adopted for overall wellbeing.[879]

7.3.1 McLeod Tax Review

Prior to the 1999 general election, the Labour Party announced that, should they be elected as Government, they would form a tax review group to assess the tax system. The Terms of Reference for the review group were to consider four questions: Can the tax system be fairer in its role of redistributing income?; How the tax system can be designed to encourage desirable conduct such as work and saving and to discourage such undesirable behaviour as the wasteful use of non-renewable resources?; How can the level of tax that is reasonably required by the Government for the provision of essential social services be achieved reliably in the medium and long term?; and Do the tax system and tax rates need to be modified in light of new technology and international competition?[880]

After a successful election campaign, the McLeod Review group was formed, comprising three tax practitioners, an economist, and an academic.[881] The McLeod Review group reported back to the Minister of Revenue a year later in October 2001. The group acknowledge the changes to the tax system since the McCaw tax review. The tax system had moved from being "narrow-base high-rate" toward "broad-base, low-rate".[882] They came up with a number of recommendations for further improvements including: taxing gains from

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[878] Although New Zealand has experienced growth, it has been at a lower rate than most OECD nations. See the data at <https://data.oecd.org/gdp/gross-domestic-product-gdp.htm>.

[879] TWG Report, above n 112, placed greater emphasis on broader wellbeing objectives.

[880] The Hon Dr Michael Cullen, Minister of Revenue "Terms of Tax Inquiry" (press release, 31 July 2000).

[881] The Hon Dr Michael Cullen, Minister of Revenue "Tax Review Panel – the right team for the job" (press release, 5 October 2000).

[882] McLeod report, above n 302, at II.

capital using the risk-free return method; a reduction in the top personal tax rate (that had recently been increased to 39 per cent); a reduction in the corporate tax rate for non-resident shareholders; and tax breaks for new migrants.[883]

The McLeod Report of 2001 was underpinned by an objective to improve New Zealand's economic wellbeing. The issues paper that preceded the report, states:[884]

> The key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes – or making the tax system more efficient – while promoting fairness and continuing to raise sufficient revenue.

Delving further into the McLeod report, the supporting policy framework that underpins the recommendations of the report are explicitly articulated.

The analysis follows the rationale that foreign investors are sensitive to tax costs and reducing or eliminating taxation on income derived in the host jurisdiction will increase the volume of foreign investment.[885] This theory assumes foreign investors are highly mobile and have a required rate of return on their capital investment, set by global markets.[886] Setting the tax imposition at low or zero rates for these mobile investors reduces the cost of capital for New Zealand businesses trying to attract foreign investment – increasing the level of foreign investment in New Zealand.[887] An increase in foreign investment will increase GDP per capita as greater investment will increase the production of goods and services in New Zealand, create more employment and increase tax revenue to fund Government expenditure.[888]

The McLeod Review group granted considerable attention to matters of international business taxation – that is, taxation of non-resident investors and taxation of resident's

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[883] At III to XII.

[884] McLeod issues paper, above n 106, at 5.

[885] McLeod report, above n 302, at X and 78.

[886] McLeod issues Paper, above n 106, at 129.

[887] At 130.

[888] At 129.

investing abroad. With respect to inbound investment, the group recommended two policy options, both incorporating a corporate tax rate reduction from 33 per cent, to 18 per cent, to the extent the company is owned by non-residents. A 2 per cent NRWT was also recommended for these equity investors. The difference between the two policy options was simply whether this would apply to new investment only, or to existing investment as well.[889] Neither of these options were taken up by the Government. However, unpicking the process that led the group to reach these conclusions highlights popular economic theory of the time.

The McLeod Review group's reasoning was that economic integration with the rest of the world brought "important benefits and lifts incomes" of New Zealanders.[890] The group based their proposals on the premise that the introduction of new technologies, management, expertise, and product distribution systems, would enhance New Zealand's economic performance.[891]

The group also argued that international mobility and competition for foreign capital was increasing, and the economic costs of taxing this capital also increase.[892] The group referred to the increased mobility of young, skilled workers and financial capital, and the risk that taxes imposed upon these groups would be borne by others who are less skilled and capital that is less mobile, such as landholding. This effect was also described as shifting the economic incidence of the tax from one party and onto another.[893] They also alluded to the possibility that the mobile groups may be increasingly difficult to tax in the future.[894]

All of this analysis led the group to the conclusion that it is best not to tax non-residents at all, except for two qualifications. The first is that investors may not be driven by tax considerations because of the opportunity to earn 'economic rents' in New Zealand. The

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[889] At Chapter 8, 82-83.

[890] McLeod issues paper, above n 106, at 17.

[891] At 129.

[892] At 18.

[893] At 130.

[894] At 17.

second is that if the country from which the investment is derived allows for foreign tax credits, any reduction in New Zealand tax will simply shift the revenue to the other jurisdiction.[895]

In the case of economic rents, the theory proposed by the McLeod Review group is that provided an investor into New Zealand would earn above normal required rates of return, due to the unique opportunity available in New Zealand, they would be less sensitive to income taxes and would bear at least some of the taxation without passing this onto immobile New Zealand based factors of production. The group also pointed out that foreign direct investment was likely to be less elastic than portfolio investment. In addition, the nature of the investment, whether to service the local market or to produce goods or services for export, would have an effect on the investor's responsiveness to New Zealand taxes.[896]

The group also recognised the reduced impact of New Zealand tax on inbound investment where the investor was able to gain a foreign tax credit in their home jurisdiction. However, this may be complicated by the investor's inability to gain an equivalent of imputation credits for foreign taxes paid, or the home jurisdiction's deferral of taxation until the profits are repatriated.[897]

With regard to foreign tax credits, it should also be noted that the group referred to New Zealand's most significant sources of inbound investment being Australia, the United States, and the United Kingdom. All three of these countries, at the time, had a system of foreign tax credits.[898] In 2017, the United States introduced the Tax Cuts and Job Act of 2017, that introduced a territorial system for taxing corporate income, meaning income derived from foreign subsidiaries would not be taxed under the United States equivalent of New Zealand's controlled foreign company regime. Dividends paid to a United States investor are (in effect)

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[895] At 130.

[896] At 137.

[897] At 131.

[898] See above n 809.

not taxed. However, at the time the McLeod Review group was considering the tax system, the United States operated a tax credit system for income from foreign investments.

Based on the analysis described above, the McLeod Review group advocated for a substantial reduction in the tax rate on inbound equity investment.[899] The essence of this argument is that New Zealand should participate in the international tax competition to attract foreign investors. While the government of the day did not act on the recommendations of the group, the group's views were indicative of the thinking of the time; that is, many commentators agreed that tax costs on foreign investors should be reduced considerably to attract much-wanted capital into New Zealand.

However, perhaps the government's lack of action also indicates reservations around this narrative. Certainly, not all commentators agreed with the conclusions reached by the McLeod Report.[900] Dabner reports that the Treasury and the Inland Revenue Department both advised the Minister of Finance and Revenue, the Rt Hon Dr Michael Cullen, that they had significant doubts about the desirability of the proposed tax measures.[901]

7.3.2 Business Tax Review 2006

A company tax cut from 33 per cent to 30 per cent came out of the 2007 budget and followed the 2006 Business Tax Review. Then Minister of Revenue, the Hon Peter Dunne, described the tax cut as helping to increase New Zealand's competitiveness, particularly with Australia.[902] The government policy objectives at the time included the desire to enhance productivity and improve international competitiveness. The Business Tax Review was conducted with the purpose of ensuring tax policy settings did not create obstacles to

[899] McLeod report, above n 302, at X.

[900] Justin Dabner "New Zealand's Proposals for the Taxation of Foreign Investment: A view from across the Tasman" (2003) 9(3) *NZJTLP* 261.

[901] At 265.

[902] (17 May 2007) 639 NZPD 9379.

achieving these goals.[903] The Business Tax Review still retained a strong neo-liberal perspective. This is despite being overseen by the more progressive Labour Party-led government. Hence, the narrative remained the same. Look after business and economic wellbeing will improve for everyone.

During this period, politicians placed great weight on New Zealand's competitiveness with Australia. It was observed that New Zealander's incomes were lower than their Australian counterparts and productivity was lower. This is evident in the many references to better productivity and income levels in Australia in the discussions around the business tax review but also by the next government.[904] In particular, concern is expressed that the Australian company tax rate was 30 per cent at the time, compared with New Zealand's 33 per cent tax rate.[905]

The Business Tax Review links tax to competitiveness and productivity. It states competitiveness and productivity come about from investment in depreciable assets, investment in intangibles and innovation, investment in staff, also risk-taking and entrepreneurship.[906] The tax rates, the tax base and tax compliance all have an impact on these activities. The document states that tax rates have an impact on return on investment, the tax base also affects returns but may be more targeted to some investment over others, and the cost of complying with taxation has an impact on the use of business resources.[907]

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[903] The Hon Michael Cullen, Minister of Finance and Hon Peter Dunne, Minister of Revenue "Business Tax Review" (press release, 25 July 2006).

[904] The Hon Bill English, Minister of Finance "Address to Centre for Accounting, Governance and Taxation Research Forum" (Centre for Accounting, Governance and Taxation Research Forum, Victoria University of Wellington, 12 February 2009).

[905] The Hon Michael Cullen, Minister of Finance and Hon Peter Dunne, Minister of Revenue *Business Tax Review: A discussion document* (Inland Revenue Department, July 2006) at 2. This was part of a broader interest in New Zealand's economic performance in comparison with Australia in the public and political domain at the time.

[906] Figure 1, at 2.

[907] At 2.

Reduction of the company tax rate from 33 per cent to 30 per cent was estimated to cost $540 million per year in lost revenue.[908] On the other hand, however, productivity and growth was expected to increase along with the competitiveness of New Zealand based companies. According to the authors of the discussion document, a reduction in the company tax rate "would encourage increased inbound investment by firms that have decided to locate in New Zealand. As a result, it would tend to increase New Zealand's stock of plant, equipment and buildings which would, in turn, boost labour productivity and wage rates."[909]

The discussion document also lists as an advantage of the decreased company tax rate the reduced incentive for foreign owners to strip profits out of New Zealand.[910] However, the discussion also recognised the potential disadvantages where tax cuts simply result in greater profit-shifting offshore without the corresponding greater investment.[911] It also recognised that this would do little to boost the productivity and competitiveness of New Zealand companies.

Submissions were requested from the public on the desirability of a company tax rate reduction. Although the eventual tax rate reduction was only 3 per cent, the review considered a more substantial tax cut but dismissed the idea as the loss of revenue would need to be found elsewhere. Also, substantial cuts would increase the gap between company rates and personal tax rates and the accompanying undesirable income diversion behaviour.[912] The report also acknowledged that company tax rate cuts to non-resident shareholders may not be desirable if they increased returns to foreign shareholders without increasing the level of investment.[913]

The reduction in the company tax rate was based upon the belief that corporate tax cuts would result in economic growth, increased productivity, and improved competitiveness of

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[908] At 9.

[909] At 9.

[910] At 9.

[911] At 9.

[912] At 23-25.

[913] At 25.

New Zealand businesses (for capital).[914] Presumably, the overall objective is not corporate welfare but a faith that better business outcomes will result in better overall wellbeing of New Zealanders, that is, the 'trickle-down' effect. This aligns to the neo-liberal view of how economic wellbeing is improved.

The Business Tax Review attracted 163 submissions from the public.[915] Many of the responses did not consider corporate tax rate cuts as they focused on other issues such as the proposed increase in the tax rate upon trustees and research and development tax credits. However, 79 responses offered a view on the proposed corporate tax cuts from 33 per cent to 30 per cent. Of these 79 opinions, 72 were in favour of tax cuts for companies. All except one represented business interests.

Almost all the responses from business interests support the proposal for corporate tax rate changes for the reasons set out in the consultative document – that is, improved competitiveness and productivity, particularly in relation to Australia. The Business Roundtable advocated for both corporate and personal tax cuts to "boost productivity and economic growth, and …. competitiveness, especially with Australia"[916]. In a similar vein, the Corporate Taxpayers Group ("CTG") stated the review should "…seek to increase the presence of substantial businesses in New Zealand thus increasing spending, skills, employment and wealth to the New Zealand economy".[917] The CTG recommended the review address tax issues around attracting foreign capital and labour to New Zealand and the need for New Zealand to "compete aggressively".[918] The New Zealand Bankers Association, in their submission, stated "tax is a cost of doing business".[919] This assumes tax is much like other business inputs that are an expense relating to producing income. Some submitters

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[914] At 9.

[915] Submissions obtained under the Official Information Act 1985 in correspondence with David Carrigan, Inland Revenue Department to Alison Pavlovich on 29 October 2019.

[916] New Zealand Business Roundtable "Submission on the Business Tax Review" (September 2006) at 1.2.

[917] Corporate Taxpayers Group "CTG submission – Business Tax Review" (8 September 2006) at 2.

[918] At 2.

[919] New Zealand Bankers Association "Submission to the Inland Revenue Department on the Business Tax Review" (8 September 2006) at 3.

suggest corporate tax cuts should be "deep" with associated cuts in public spending.[920] Many submitters recommended the corporate tax cuts should be accompanied with cuts in personal taxes.[921] Other submitters suggested reducing corporate tax rates while maintaining higher personal tax rates would encourage companies to reinvest rather than pay dividends.[922] Many of the submitters recommended lowering the tax burden on foreign investors in order to encourage further inbound investment.[923] Many of the submitters argued for corporate tax cuts to follow the general global trend downward.[924] None of the submitters who supported corporate tax rate cuts referred to the loss of public goods or services as a result of reduced tax revenue.

Seven submitters stated they did not support tax cuts. Three were unions of workers, including the PSA, Finsec, and the Council of Trade Unions. The other four submitters were individuals, although one was a small business owner who supported further investment in research and development tax credits and did not support corporate tax cuts. Finsec represents workers in the financial sector. They stated banks are competitive enough and tax cuts would simply make the directors and non-resident shareholders wealthier while having no benefit to New Zealand.[925] They argued that decreasing the tax burden on banks was inequitable as it would shift the tax burden onto others less able to pay. They described the decrease in tax rate, stated to benefit banks substantially, as ironic given the stated aim is to increase competitiveness with Australia.[926] As the main trading banks are Australian owned, Finsec argued tax cuts simply shift wealth to Australia.

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[920] Examples include Employers and Manufacturers Association at 8; The Business Roundtable Association at 8; Federated Farmers; Business New Zealand at 12.

[921] Example: Corporate Taxpayers Group "CTG submission – Business Tax Review" (8 September 2006) at 5.

[922] KPMG "Business Tax Review Submission" (September 2006) at 3.2.2.

[923] Examples include OneSteel, Origin Energy.

[924] Examples include Sealord, Business New Zealand.

[925] Finsec "Submission" (September 2006) at [13].

[926] At [14].

The PSA argued against corporate tax cuts on the basis that the government cannot afford to forego that revenue.[927] They focused particularly on the government's ability to continue to support the public sector.

The Council of Trade Unions also argued against a corporate tax rate cut, stating it would not increase productivity as it does nothing to "encourage investment in plant, machinery, technology, research or industry training".[928] They also stated that none of the discussion on corporate tax rate cuts has included the likely impact upon public services.[929]

It is an accurate observation that there was a lack of discussion on the impact of tax cuts on public services. The Business Tax Review does not mention the reliance upon government provision of goods and services for improved business performance. Any connection between economic performance and the infrastructure of the economy, dependent upon tax revenue, is missing from the discussion altogether. Many of the submissions that supported corporate tax cuts took the view that reducing corporate taxes would increase tax revenues.[930] Once again, this is consistent with the 'trickle-down' narrative that putting money into the hands of businesses would result in improved economic wellbeing overall. However, this theory has not been supported by subsequent evidence as is discussed at 7.3.8 below.

7.3.3 Further corporate tax cuts in the preferential phase

Like the Labour-led government's corporate tax cut in 2007, the National-led government cut the rate further from 30 per cent to 28 per cent 'under urgency'.[931] Once again, no consultation or select committee process ensued. The Minister of Revenue, the Hon Peter

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[927] New Zealand Public Service Association "Submission to the Government's Business Tax Review" (September 2006) at [3].

[928] New Zealand Council of Trade Unions "Submission on the Business Tax Review" (8 September 2006) at [4.13].

[929] At [3.4].

[930] The submission from Business New Zealand states that "experience and economic modelling" show us that corporate tax cuts are more likely to increase tax revenues and decrease demand for public expenditures.

[931] Taxation (Budget Measures) Act 2010, s 97.

Dunne,[932] introduced the bill into parliament on 20 May 2010 and the bill went through its three readings on that day.[933] Like the previous tax rate cut, it was an enactment of a measure already announced in the budget. The tax bill came with the promise it would result in an increase in productivity and wages – still a concern for New Zealand governments.[934] The company tax rate cut was accompanied by income tax cuts for individuals and an increase in the rate of goods and services tax (GST) from 12.5 per cent to 15 per cent.

In all the documentation explaining the tax changes, the purpose of the package of tax changes was to achieve a step up in economic growth.[935] The changes were intended to "boost economic growth by improving incentives to work, save and invest" and to support "New Zealand's international competitiveness".[936] However, subsequent analysis has indicated that the tax cuts did not result in any increase in inbound investment.[937]

7.3.4 Capital Markets Taskforce

Also operating in the background during this time is the Capital Markets Taskforce. This private sector advisory group was established by the 2007 government with the objective to "improve New Zealand's financial system" for improved economic growth.[938] They were tasked with setting out a plan for future development and strengthening New Zealand's market for capital.

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[932] The same Minister of Revenue under the previous Labour Party-led government.

[933] (20 May 2010) 663 NZPD 11066.

[934] (20 May 2010) 663 NZPD 11067.

[935] Taxation (Budget Measures) Bill 2010, explanatory note at 155-1.

[936] At 155-1.

[937] New Zealand's taxation framework for inbound investment 2016, above n 491, at 8.

[938] The Hon Lianne Dalziel, Minister of Commerce "Launch of Capital Market Development Taskforce" (press release, 21 July 2008).

One of the recommendations of the taskforce is that New Zealand might operate as a "niche player" in the financial services market.[939] The recommendation suggested New Zealand could operate as a high-value middle and back-office service provider for global fund management providers. The new National-led government of 2009 further commissioned another private sector advisory group to investigate how New Zealand could position itself as an international funds domicile.[940]

OECD statistics on economic growth show that countries operating as financial services centres experienced higher growth in their gross domestic product – such as Ireland, Luxembourg, and Switzerland.[941] Some financial services centres such as Ireland, Switzerland, and Singapore, have comparatively low levels of taxation in relation to average incomes, bucking the trend that the level of taxation is indicative of the level of average income.[942]

Becoming a financial services hub requires a tax friendly environment to attract foreign investment funds.[943] In April 2011, a supplementary order paper ("SOP") was added to an existing bill, proposing the introduction of a new foreign investor investment vehicle.[944] This New Zealand administered vehicle enables non-residents to invest offshore without incurring any New Zealand tax. The SOP was early enough in the process to go through a consultation and select committee process. There were 14 submissions on the bill, and all supported the new non-resident foreign investment vehicle. All submitters represented the interests of the funds industry, including the New Zealand Institute of Chartered Accountants and the New

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[939] Cameron et al. *Capital Markets Matter: Report of the Capital Markets Development Taskforce* (CMD Taskforce, Wellington, December 2009) at 12.

[940] Hon Gerry Brownlee "Fund Services Development Group formed" (press release, 7 April 2010).

[941] See the statistics at www.OECD.org <https://data.oecd.org/gdp/gross-domestic-product-gdp.htm>.

[942] Matt Grudnoff "Tax and Wellbeing: The impact of taxation on economic wellbeing" (The Australia Institute, Discussion Paper, October 2020) at 20.

[943] Hon Simon Power "Govt responds to capital market recommendations" (Press release, 19 February 2010).

[944] Hon Peter Dunne, Minister of Revenue "New rules for non-resident PIE investment" (press release, 5 April 2011).

Zealand Law Society.[945] All submissions recommended more favourable tax treatment for investors. The introduction of this vehicle did not receive any opposition or public debate. It quietly slipped into law with input only from those submissions that supported the bill.

In this way, the 0 per cent rate for foreign investors into New Zealand investment funds with foreign sourced income was introduced.[946] The reasons stated for allowing the 0 per cent rate were the reduction in the cost of running New Zealand-based funds, and enhancement of the financial services sector.[947]

There is no discussion in any of the commentary of why a non-resident would want to invest through a New Zealand funds vehicle in any case where domestic investment is not the purpose; in other words, why would a foreign investor choose to place funds in the care of a New Zealand fund manager when all investments are held abroad? Up until the more recent introduction of the common reporting standard ("CRS") for international exchange of taxpayer information, the potential use of these vehicles to hide funds from other tax jurisdictions presented a risk. There is still substantial risk, although the CRS does reduce this somewhat for participating jurisdictions.[948]

This does not have an impact on the taxation of non-resident investment into New Zealand companies but indicates New Zealand's willingness to provide low or no tax options for non-resident investors into offshore investments. Effectively, this is a tax advantaged mechanism for non-resident investors to invest outside New Zealand, with the only beneficiaries being

[945] Policy Advice Division of Inland Revenue and Treasury "Supplementary Order Paper 220: Taxation (Tax Administration and Remedial Matters) Bill: Officials' report to the Finance and Expenditure Committee on submissions on the bill" (May 2011).

[946] Inland Revenue Policy Advice Division and The Treasury "Allowing a zero percent tax rate for non-residents investing in a PIE" (issues paper, 14 April 2010).

[947] At 3-4.

[948] The Common Reporting Standard was developed by the OECD. Participating countries, such as New Zealand, will report information to other tax authorities on the financial activities of residents of that other state in New Zealand. The Common Reporting Standard and the exchange of information regulations were introduced into legislation in The Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017.

the funds and advisory industries and the potential losers being foreign tax jurisdictions missing out on tax revenue.

7.3.5 Victoria University of Wellington Tax Working Group

The VUW Group recommendations, published in 2010, were based upon the primary objective of increasing growth in GDP, particularly by stimulating foreign direct investment.[949] While it is difficult to find explicit mention of this, the selected tax policy settings rely mainly upon their impact on economic growth.[950] There is little discussion around objectives such as equality, education standards, or other wellbeing indicators.

The VUW group chose to focus upon four features of the New Zealand tax system that acted as an impediment to economic growth. They found that taxes on capital were too high in New Zealand, which is most harmful to growth as it has an impact on savings, investment, and productivity;[951] New Zealand's tax rates were considered uncompetitive internationally;[952] Working for Families produced high effective marginal tax rates;[953] and the lack of capital gains tax produced a hole in the tax base.[954]

Specifically, among the recommendations of the VUW Group, is reducing the company tax rate to improve competitiveness with other jurisdictions, especially Australia. In making these recommendations, the group were concerned with the impact upon taxes and growth. They state:

> Seventy percent of New Zealand's tax revenue is from personal and company taxes and our reliance on these more mobile tax bases – business, capital and people can all move across national boundaries –

[949] VUW report, above n 52.

[950] For example, see The Treasury *Medium Term Tax Challenges and Opportunities* (The New Zealand Treasury, 2009).

[951] VUW report, above n 52, at 16 and 18.

[952] At 18.

[953] At 17.

[954] At 15.

> makes us increasingly vulnerable to international competition, and may threaten New Zealand's productive potential and future living standards…
>
> Numerous recent studies suggest that, while almost all taxes impact adversely on growth to some degree, some taxes have larger impacts than others... personal income and corporate taxes tend to be the most growth-reducing while consumption and property taxes tend to be the least growth-reducing taxes.

The VUW Group emphasised the impact of taxes upon attracting foreign investors to invest in New Zealand.[955] They also emphasised altering the tax system to encourage savings behaviour rather than spending.[956] This goal is driven by the aim of increasing economic growth. In the final report they stated:[957]

> In a global economy, company tax can discourage inbound investment. For a small open economy that can import as much capital as it wishes at a fixed after-tax return, the tax will not be borne by foreign residents. Instead, it will reduce capital invested in the economy and adversely impact on labour productivity and real wages.

They made several recommendations including: ensuring alignment of the corporate, personal and trustee tax rates; ensuring competitiveness of the corporate tax rate (particularly with Australia); reduction in top personal tax rates; and introduction of a land tax.[958]

The VUW Group recommendations were, once again, consistent with the narrative of reducing tax on business and investors to boost economic growth. The government of the day implemented some of the recommendations including tax cuts for companies and individuals on higher incomes and increasing the rate of GST.[959] These measures are regressive and indicate support for the narrative that lower taxes support growth.

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[955] At 27.

[956] At 41-42.

[957] VUW report, above n 52, at 27.

[958] At 10-11.

[959] Taxation (Budget Measures) Act 2010, ss 31, 45, and 97(1).

7.3.6 Mirrlees Review 2011 (UK)

The Mirrlees Review, published in 2011,[960] considered tax reform in the United Kingdom. This was a report commissioned by the Institute of Fiscal Studies ("IFS") to provide a coherent re-think of the UK tax system. This report is included here because it provides an insight into tax policy drivers beyond New Zealand.

As the report says about tax systems in respect of international taxation:[961]

> They are developed at a time when cross-border flows of goods, services, and capital were much less important than they are today. Arrangements to deal with international trade and capital flows have been added to national tax systems on a needs-must basis. Inevitably, these arrangements tend to be complex and problematic, requiring a degree of cooperation between governments and having to reconcile different approaches to taxation in different countries, as well as differences in tax rates.

The Mirrlees Review looked at the prevalence of source taxation and suggested this was an approach that had evolved but was not necessarily optimal. The review identified two main areas where problems arose with source-based taxation of non-residents: they are, implementation issues[962] and where the economic incidence of the taxation falls.[963]

Implementation issues include the high compliance costs for both taxpayers and tax administrators and the difficulties with taxpayers using debt and transfer pricing to manipulate source-based tax liabilities.

Regarding the incidence of tax, the Mirrlees review essentially restated the position highlighted in the McLeod Report and by other commentators; that is, the tax cost will fall back on the immobile domestic factors such as labour and land, ultimately failing to improve domestic wellbeing.[964]

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[960] Mirrlees et al., above n 262.

[961] At 429.

[962] At 434.

[963] At 436.

[964] At 436-438.

This section of the Mirrlees report is underpinned by the work undertaken by Auerbach, Devereux, and Simpson.[965] Because of the problems with source-based taxation identified above, Auerbach et al. recommended a destination-based cashflow tax. Essentially, this is like a VAT on imports.[966]

However, the Mirrlees Review, while accepting the issues raised in the work by Auerbach et al., recommended a less radical approach. They suggested source-based corporation tax remain but only upon economic rents.[967] This would operate by granting a tax-free allowance for a risk-free return. This recommendation is designed to overcome the distortion of the incidence of taxation as mentioned above. However, these suggestions, once again, are premised on capital being highly mobile and likely to move should the tax outcomes in the source country suddenly become unappealing as a "better option" arises elsewhere.[968] This narrative is present in tax policy discussion beyond New Zealand.

Incidentally, these recommendations were not taken up by the UK government.

7.3.7 International Tax Review 2016

Up until this point, the New Zealand reviews during the preferential period all recommended lower taxes on inbound investors to promote economic growth objectives. While the governments throughout this period implemented some of the recommendations, as discussed below, they did not go as far as the groups suggested. This may be an indication of New Zealand's inability to forego the tax revenue, or it could demonstrate that policy makers had reservations about the narratives of the time.

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[965] Auerbach, Devereux, and Simpson "Taxing Corporate Income" in Adam, Besley, Blundell et al. (eds) *Dimensions of Tax Design* (Oxford University Press, Oxford, 2010). Note that Professor Auerbach was also an adviser to the New Zealand McLeod Committee Review in 2001.

[966] This is also supported by other tax academics such as Avi-Yonah "The Case for a Destination-Based Corporate Tax" (2015) 41(5) *International Tax Journal* 11.

[967] Mirrlees et al. above n 262, at 446-450.

[968] At 437-438.

The Inland Revenue Department and Treasury revisited their tax policy in relation to inbound investment in 2016.[969] In the view of the writer, this review reflected a more moderated and balanced approach than previous reviews.

The review acknowledged the theory that reducing the tax imposition on inbound investors encourages further investment leading to improved economic growth. However, it also criticised this theory for its reliance on simplified assumptions.[970] In particular, the model failed to recognise the impact of "economic rents" and that mobile capital may not be perfectly mobile.[971]

In the case of inbound capital investment, the following factors were recognised as reducing the shift of the New Zealand tax cost onto local immobile factors. First, New Zealand's geography (or isolation) and size of our market, may be a more significant factor in its ability to attract mobile FDI.[972] Second, any tax cut would be a windfall to existing investors who have already chosen to invest in New Zealand under the current tax regime - referred to as a sunk investment.[973] Third, inbound investment may be driven by economic rents; that is, the opportunity to derive above normal returns due to specific conditions available in New Zealand. The presence of economic rents makes investors less sensitive to tax.[974] And finally, the presence of foreign tax credits in the investor's home country may render the investor less tax sensitive – and a reduction in New Zealand tax will simply result in a shift of that tax

[969] New Zealand's taxation framework for inbound investment 2016, above n 491.

[970] At 5.

[971] At 10.

[972] McLeod issues paper, above n 106, at [E.10].

[973] New Zealand's taxation framework for inbound investment 2016, above n 491, at 11.

[974] McLeod issues paper, above n 106, at Annex E: International Taxation: Inbound investment by non-residents, [E.13]; VUW report, above n 52, at 27; New Zealand's taxation framework for inbound investment 2016, above n 491, at 10.

revenue to the home country.[975] This will serve as a windfall to the foreign Government at New Zealand's expense.

It is also recognised in the 2016 report, that perhaps the assumptions underlying the dominant model may be less than perfect; that is, perhaps 'mobile' capital and labour are not perfectly mobile. Also, it is recognised that 'immobile' labour in New Zealand may be more mobile than assumed.[976]

The 2016 International Tax Review identifies that the neo-liberal narrative that has dominated the tax policy discourse since the early 1990s is simplistic. There are many other factors to consider in relation to tax settings. This statement by policymakers demonstrates a balanced approach to taxation on inbound investors. While recognising the desirability of foreign investment, there are several reasons why low taxes may not be the most effective setting for inbound investors.

Another significant finding in the 2016 report is that, with the benefit of hindsight, it was possible to observe that the corporate tax cuts in 2007 and 2010 did not result in the much hoped for surge in foreign direct investment ("FDI").[977] New Zealand reduced its corporate tax rate while Australia did not. However, New Zealand did not experience an increase in its FDI relative to Australia. In the same vein, a 2020 study at the London School of Economics found that tax cuts for "the rich", have resulted in a growth of inequality and have not achieved the much hoped for economic growth.[978] These findings support the view in the 2016 report that the relationship between tax and investment is more complex than the neo-liberal narrative might suggest.

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[975] McLeod issues paper, above n 106, at [E.14]; VUW report, above n 52, at 28; New Zealand's taxation framework for inbound investment 2016, above n 491, at 11.

[976] New Zealand's taxation framework for inbound investment 2016, above n 491, at 12.

[977] New Zealand's taxation framework for inbound investment 2016, above n 491, at 8.

[978] David Hope and Julian Limberg "The Economic Consequences of Major Tax Cuts for the Rich" (London School of Economics and Political Science, Working Paper 55, December 2020).

7.4 Tax changes during the preferential phase

The preferential phase included tax changes that increased the gap between domestic and non-resident investors. These changes included the reduction of tax rates that had the impact of reducing the tax imposition on inbound equity investors.[979] Further reductions on NRWT for some dividends paid to non-residents were introduced.[980] A reduction in the approved issuer levy ("AIL") on payments to some non-resident lenders reduced the cost of borrowing from overseas even further.[981] The growing network of double tax agreements further encroached upon New Zealand's ability to tax income sourced in New Zealand.[982]

These changes are discussed in more detail below.

7.4.1 Tax on non-resident investors into equities

During the 1990s, the New Zealand government's tax initiatives were mainly focused on neutralising the tax position of equity investors using the FITC mechanisms for both portfolio and direct investors.[983] The NRWT rate on dividends was 15 per cent for those dividends carrying full imputation, although up until 1995 it was 30 per cent.[984] New Zealand's double tax treaties generally defaulted to a 15 per cent rate on dividends.[985] FITC applied to fully imputed dividends by paying a supplementary dividend to the investor to compensate them for the NRWT paid. This supplementary dividend was then refunded to the company. The

[979] Taxation (Budget Measures) Act 2010.

[980] Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009, s 115.

[981] Taxation (International Investment and Remedial Matters) Act 2012, s 149.

[982] New treaty partners since 2000 are: Austria (2007); Chile (2004); Czech Republic (2007); Hong Kong (2010); Mexico (2007); Papua New Guinea (2012); Poland (2006); Russian Federation (2001); Samoa (2015); South Africa (2004); Spain (2006); Turkey (2010); United Arab Emirates (2004); and Vietnam (2013).

[983] See discussion above at 6.4.1-2.

[984] Income Tax Act 1994, s NG 2. This was altered to 15 per cent for fully imputed dividends in the Income Tax Act 1994 Amendment (No 3) Act 1995, s 23.

[985] This follows the OECD model treaty, above n 117.

effect of the NRWT and FITC regimes was to cap the tax imposition upon non-resident investors at the corporate tax rate.

In 2010, an NRWT exemption was introduced for equity investors holding greater than a 10 per cent interest in a New Zealand company dispensing with the need for FITC for direct investors.[986] This will be discussed further below after the impact of reduced tax rates is observed.

Increases in domestic resident's personal tax rates and the reduction in corporate tax rates resulted in non-resident investors having more preferential tax obligations than residents. In 2000, the top marginal tax rate for individuals was increased from 33 per cent up to 39 per cent.[987] Even after imputation, domestic investors were typically paying tax on distributed company profits at 39 per cent. Non-resident investors continued to be subject to the company tax rate at the maximum tax impost – this remained at 33 per cent.

Then in 2008, a small decrease in the top tax rate to 38 per cent was enacted 'under urgency'.[988] Because it was under urgency, no select committee or consultative process took place. However, in the following couple of years, some more significant tax cuts were introduced. The top personal tax rate was reduced to 33 per cent[989] and the company tax rate dropped twice – once from 33 per cent to 30 per cent,[990] and again down to 28 per cent.[991]

The company tax rate cuts were also passed 'under urgency' so no public consultation took place.[992] Equally, there was no select committee scrutiny or official advice. However, we can observe the policy drivers behind the changes in the debates held in Parliament and the

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[986] Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009, s 115.

[987] Taxation (Tax Rate Increase) Act 1999, s 11.

[988] Taxation (Urgent Measures and Annual Rates) Act 2008.

[989] Taxation (Budget Measures) Act 2010, s 31.

[990] Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007, s50(1)(c).

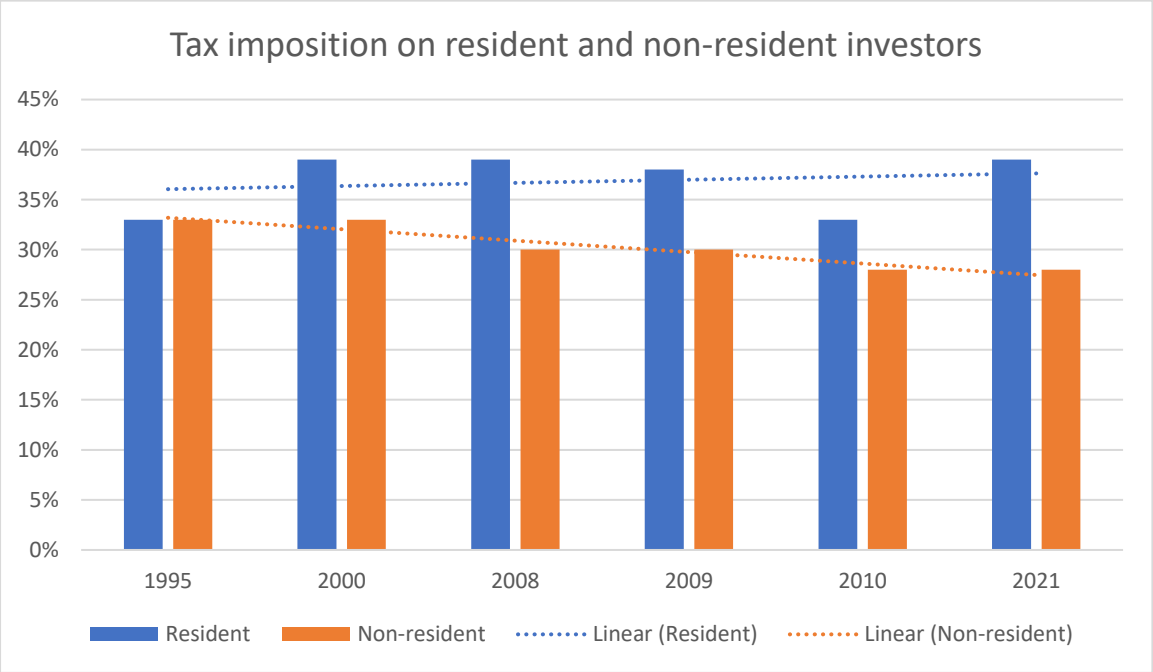
[991] Taxation (Budget Measures) Act 2010, s 97(1).

[992] (17 May 2007) 639 NZPD 9379.

extensive Business Tax Review that was undertaken in 2006 that led to the tax rate cuts.[993] The impact of these rate reductions was to leave domestic investors paying tax at their marginal tax rates while foreign investors' tax liabilities declined.

In 2021, an increase in the highest marginal tax rate for individuals was introduced to 39 per cent.[994] This rate change is included in the table below although it should be observed that it only applies to income above $180,000 per annum.

The effect of these changes in tax rates is shown in the chart below:



The chart shows that changes in tax rates from 2000 onward had the effect of reducing tax rates on non-resident investors in equities. This occurred at the same time as domestic investors rates either increased or remained the same.

As mentioned above, in 2010, NRWT was reduced to 0 per cent for fully imputed dividends paid to non-resident investors with an equity interest of 10 per cent or more, provided they were resident in a country with which New Zealand had an existing double tax treaty.[995] This amendment came about as a result of negotiations with Australia, Singapore and the United

[993] See the discussion above at 7.3.2 and 7.3.3.

[994] Taxation (Income Tax Rate and Other Amendments) Act 2020, s 16.

[995] Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009, s 115.

States.[996] New Zealand's new treaties with Australia and Singapore were about to come into force and the parties to each agreement committed to eliminate NRWT from dividends paid to direct investors. The same agreement had been made in a protocol to the treaty with the United States. To avoid the complexity of treaty partners invoking the 'most favoured nation' articles,[997] an amendment would be made to the domestic legislation to extend the exemption from NRWT to all residents of treaty partner nations.[998]

This change to law was required because of agreements that had already been made during treaty negotiations. The effect of the legislative change is negligible as FITC was a complex mechanism for achieving the same tax revenue outcome for New Zealand.

Requests for correspondence surrounding the legislative change supported the pattern that only a small group of "interested parties" were invited to review draft legislation and comment on any proposed amendment. These parties include the largest accounting firms,[999] the Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants ("NZICA"), and the New Zealand Law Society.[1000] While there are no tax revenue consequences in relation to inbound investment, the lack of consultation with the wider public has typified many of these tax changes. In this instance, perhaps as a result of lack of public interest in previous consultations, the IRD only sought the views of large corporate interest groups.

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[996] See Double Taxation Relief (United States of America) Amendment Order 2009, Schedule 2, Article VI, Double Tax Relief (Australia) Order 2010, Article 10(2), Double Tax Relief (Singapore) Order 2010, Article 10(2).

[997] Many treaties have a "most favoured nation" article that allows a treaty partner to request the other contracting state to apply any more favourable tax arrangements made with other states, to their own arrangement.

[998] Carmel Peters (Inland Revenue Department) *Taxation (International Investment and Remedial Matters) Bill 2010: A briefing note prepared for the Finance and Expenditure Committee* (1 December 2010) at 4.

[999] KPMG, PwC, Deloitte, and Ernst and Young.

[1000] Letter from Carmel Peters to Alison Pavlovich regarding the Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009 (24 January 2019).

7.4.2 Tax on non-resident lenders

The first substantial legislative change granting non-resident investors preferential tax treatment was for the benefit of non-resident lenders. This came about in 1991 with the introduction of the approved issuer levy ("AIL").[1001] Usually where interest is paid by a resident of New Zealand to a non-resident, an NRWT of 15 per cent is required to be deducted from the interest payment and returned to the Crown. While the legal obligation falls upon the payer to deduct and return the amount to the Crown, the tax is supposed to be borne by the recipient of the interest. The AIL is a 2 per cent charge that is paid instead of the NRWT. The charge is to be borne by the payer rather than the recipient of the income.[1002]

Further to the movement toward preferential tax treatment, in 2012 another change was made to the AIL. Bonds issued on the New Zealand exchange and offered to the public have a reduced AIL of 0 per cent. [1003] This reduces the cost of borrowing to the interest cost only – no tax liability or levy is required to be paid in New Zealand.

The proposal to introduce this change came from the Reserve Bank.[1004] The motivation for the request to remove the AIL altogether was that it was thought to be contributing to the "shallowness of our bond market" in New Zealand and discouraging bond issues.[1005]

Alongside this, Inland Revenue policy advisers indicated continuing support for maintaining an AIL in other situations as it encourages domestic lending over foreign lending, and this means an interest margin is maintained in New Zealand.[1006] Maintaining the AIL encourages

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[1001] Income Tax Amendment Act (No.4) 1991 (No.75) and Stamp and Cheque Duties Amendment Act (No.2) 1991.

[1002] Stamp and Cheque Duties Act 1971, s 86K.

[1003] Taxation (International Investment and Remedial Matters) Act 2012, s 149.

[1004] Turner & Associates *Taxation (International Investment and Remedial Matter) Bill 2010: Report of the Specialist Tax Adviser to the Finance and Expenditure Committee* (March 2011) at 15.

[1005] Inland Revenue Policy and Strategy *Taxation (International Investment and Remedial Matter) Bill 2010: A briefing note prepared for the Finance and Expenditure Committee* (16 November 2010) at 3.

[1006] Letter from Tony Booth (Acting Policy Manager Inland Revenue Policy Advice Division) to Craig Foss (Chair of the Finance and Expenditure Committee) (11 March 2011) at 2.

international banks to maintain a presence in New Zealand for domestic lending rather than lending directly from abroad. This is seen as beneficial for New Zealand as the banking sector is a "key contributor" to the tax base.[1007]

The proposal to reduce the AIL to 0 per cent for exchange traded bonds was met with approval from all nine submitters, with no opponents to the proposal.[1008] However, several submitters suggested the exemption from AIL should apply to a wider range of debt issues.[1009] In particular, many submitters suggested the exemption from AIL should apply to foreign denominated issues and to less widely held issues. These submissions were not accepted, and the exemption applies, as originally intended, to corporate bond issues denominated in New Zealand dollars and issued to a minimum of 100 unrelated holders.[1010]

In 2017, further changes were made to the AIL to improve its integrity.[1011] One of the main changes was to align the deduction of interest payments by the borrower in New Zealand with the due date for NRWT or AIL.[1012] Previously, some structures allowed the borrower to deduct interest on an accrual basis while the NRWT or AIL was not due until the actual interest payment was due which could be decades in the future. This had the effect that, for those taxpayers with enough resource available, NRWT became a voluntary tax.[1013]

The other changes that took place closed loopholes that appeared to have existed since the 1964 implementation of the NRWT regime. These loopholes allowed some borrowers to

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[1007] Peters, above n 998, at 4.

[1008] Submissions were made by NZICA, NZLS, KiwiBank, NZ Post, NZ Bankers' Association, Corporate Taxpayers Group, Russell McVeagh, Ernst & Young, and KPMG to the Finance and Expenditure Select Committee.

[1009] Submissions from Russell McVeagh, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants, New Zealand Bankers' Association, KPMG, KiwiBank, and Corporate Taxpayers Group.

[1010] Stamp and Cheque Duties Act 1971, s 86IB.

[1011] Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017, s 278.

[1012] Income Tax Act 2007, s FG 3.

[1013] Inland Revenue Department and The Treasury *NRWT: related party and branch lending* (Officials' Issues Paper, Wellington, May 2015) at [2.18].

avoid any NRWT and AIL obligations using on-shore and off-shore branches.[1014] These structured arrangements were used by participants in the financial services sector. Another loophole that existed was the use of "back-to-back" loans – allowing the New Zealand borrower to pay interest to a non-associated lender, who had received a deposit from a non-resident associated with the borrower.[1015]

For decades, the banking sector had employed mechanisms to avoid New Zealand tax on interest paid to their related party overseas lenders. Although the loophole is not available after 2022, they have been granted the benefit of paying the AIL as an alternative to NRWT on related party borrowing where no other sector has been granted this privilege. This tax preference for banks continues unfettered.

The 2017 bill received a total of 35 submissions from interested parties, of which 15 concerned the proposed changes to NRWT and AIL.[1016] All of the relevant submissions represented corporate interests and none of the submitters were supportive of the proposed changes, although some appear neutral on the policy intent.

The strongest opponents were the foreign owned banks (who stood to lose under the proposals) and their advisors (the largest accountants and law firms). The essence of their opposition was that the proposals would be detrimental to the New Zealand economy. The submission from the ANZ, one of New Zealand's largest foreign-owned banks, is indicative of the opposition to the proposal. They state:[1017]

> The proposed onshore and offshore branch rules in the Bill will increase the cost of debt for New Zealand borrowers creating a drag on the New Zealand economy at a time of limited growth. These

[1014] At [6.6].

[1015] At [4.5] – [4.9]; Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017, s 279.

[1016] Submissions are all available on the New Zealand Parliamentary website www.parliament.nz <Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill - New Zealand Parliament (www.parliament.nz)>.

[1017] ANZ "Submission to the Finance and Expenditure Committee on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill" at 1.

> proposals are contrary to the tax policy approach adopted by other key developed countries, placing New Zealand's economy at a disadvantage compared to such countries which are key competitors.

Other submissions reiterate the same concerns about low growth and scarce supply of capital.[1018]

These objections are consistent with the neo-liberal narrative discussed in more detail in chapter six. However, there are two assumptions in the arguments put forward by the submitters that are controversial. First, is the assumption that the current levels of economic growth are inadequate. While economic analysis is outside the scope of this paper, economists are by no means in agreement that a 1 or 2 per cent growth rate is inadequate, with some arguing this level of growth may be too high.[1019]

Secondly, there appears to be no evidence of scarcity of capital. This assumption is used by many advocates for lower taxes on inbound investors. As discussed in more detail in chapter six, growth relies upon attracting 'scarce' and mobile capital to New Zealand, and low taxes help to achieve this objective. However, the assumption that capital is scarce is unsubstantiated. Others argue that the world is awash with cheap capital, that it has never been easier to find investors.[1020] Therefore, the foundations of the arguments put forward by the banks and their advisors are insecure.

The loopholes were removed from the tax code, with some exceptions. Where the back-to-back loan arrangement is already in place and between unrelated parties, the new rules did not take effect for five years – giving the parties until 2023 to enjoy the benefits.[1021] The new

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[1018] KPMG "Submission to the Finance and Expenditure Committee on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill" at 1-2; Russell McVeagh "Submission to the Finance and Expenditure Committee on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill" at [2.9]; Westpac "Submission to the Finance and Expenditure Committee on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill" at 2.

[1019] Piketty, above n 418, at 121.

[1020] Noah Smith "The World is Awash in Financial Capital" *Bloomberg* (online ed., New York, 14 November 2019).

[1021] Inland Revenue Department *NRWT: Related party and branch lending* (Special Report, April 2017) at 29.

provisions ensure branch lending is now subject to NRWT.[1022] However, a major concession is granted to the banks allowing them to substitute the 2 per cent AIL for NRWT.[1023] The justification for this concession is because banks act as margin lenders only – that is, the foreign parent lends to the New Zealand subsidiary (using a branch structure to avoid NRWT), and they borrow these funds from non-associated lenders.[1024] Officials state that banks are unlikely to be substituting debt for equity. Presumably, this is because the banking sector tends to operate within the capital adequacy parameters set by the Reserve Bank.

Officials also distinguish banks from other businesses as they make their money on interest margins; therefore, if they are subject to NRWT, they may not have enough profit in their home territory to offset the foreign tax credit for the NRWT paid.[1025]

It is difficult to distinguish banks from other multinational subsidiaries receiving debt funding from a group company. Any multinational may prefer to fund its subsidiaries at a head office level because they will have better negotiation power to obtain better borrowing rates. Being a "margin lender" is not unique to banks. Equally, there is no reason why banks cannot fund their subsidiaries with higher levels of equity. The Reserve Bank requirements set minimum levels of equity funding – not maximums.[1026] There is no barrier to higher equity levels in banking subsidiaries other than the desire to maximise leveraging opportunities and, therefore, profits.

The major commercial banks operating in New Zealand have managed to secure preferential tax treatment on non-resident borrowing, using similar arguments to those supporting introduction of the AIL; that is, where New Zealand imposes taxation upon non-resident

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[1022] Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017, s 279.

[1023] Income Tax Act 2007, s RF 12(1)(a)(ii).

[1024] Inland Revenue Department *NRWT: Related party and branch lending* (Special Report, April 2017) at 24.

[1025] Inland Revenue Department *Regulatory Impact Statements for the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill* (3 May 2016) at 116.

[1026] The Reserve Bank of New Zealand sets minimum capital requirements, amongst other requirements, as a condition of granting a banking licence in New Zealand under section 73 of The Reserve Bank Act 1989.

lenders, this increases the cost of capital for New Zealand borrowers, resulting in the cost being borne domestically and leading to decreased wellbeing.

What is notable concerning the concessions granted to the foreign owned banking sector is that a Reserve Bank of New Zealand profitability report shows that the New Zealand banking sector is the fourth most profitable in the world – meaning they enjoy the benefit of substantial economic rents.[1027] Despite this, they have still been extended preferential tax treatment for their foreign owners on even more generous terms than other foreign investors.

7.4.3 Tax treatment of foreign companies doing business in New Zealand

The domestic provisions of New Zealand tax law have not changed with respect to non-resident companies doing business in New Zealand during the preferential phase. Where a non-resident carries on business in New Zealand, they will be subject to the same income tax rates as a domestic investor. A branch of a foreign company operating in New Zealand will be subject to tax at 28 per cent, the same rate as a New Zealand resident company.[1028] An individual will be subject to tax at the New Zealand marginal tax rates.[1029] Equally, under domestic law, the rules around items included within the definition of income and deductions are the same for resident and non-resident investors.

The bilateral tax treaty network has continued to grow so most investors into New Zealand will be subject to the clauses found in the relevant agreement which may override or supplement New Zealand's domestic legislation. This means, for most non-resident investors, they will only be subject to income tax where their presence constitutes a permanent establishment in New Zealand.[1030] This is a higher bar than the domestic test of carrying on a business in New Zealand.[1031] An expanding treaty network means more taxpayers will fall out of the New Zealand tax net by falling between the crack between

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[1027] Reserve Bank of New Zealand *Financial Stability Report* (Wellington, May 2019) at 24.

[1028] Income Tax Act 2007, schedule 1.

[1029] Income Tax Act 2007, schedule 1.

[1030] OECD model, above n 117, Article 7 at M-27.

[1031] Income Tax Act 2007, s YD 4(2).

‘carrying on a business’ and having a ‘permanent establishment’. Since 2000, an additional 14 double tax treaties have been entered into by the New Zealand government with new treaty partners – adding over 50 per cent to the existing network. [1032] This must result in more non-residents falling outside New Zealand’s tax net. However, this research is cognisant of the fact that New Zealand has had double tax treaties with most of its main sources of capital investment for many decades, excluding Hong Kong.[1033] These new treaties are mainly with minor trading partners.[1034]

It is difficult to reach firm conclusions on the effect of a treaty on the New Zealand tax base given the multiplicity of affected taxpayers. However, New Zealand imports more capital than it exports.[1035] Also, tax treaties favour residence-based taxation over source-based taxation when compared to New Zealand’s domestic rules.[1036] The overriding effect must be a reduction of tax revenue to New Zealand. The increase of tax treaties results in more non-residents carrying on business in New Zealand, without the presence of a permanent establishment.

Within the most recently negotiated treaties are some more targeted provisions favouring non-resident investors. This includes the agreements with Australia and the United States to reduce the NRWT rate on payment of some dividends to 0 per cent and the reduction of

[1032] New treaty partners since 2000 are: Austria (2007); Chile (2004); Czech Republic (2007); Hong Kong (2010); Mexico (2007); Papua New Guinea (2012); Poland (2006); Russian Federation (2001); Samoa (2015); South Africa (2004); Spain (2006); Turkey (2010); United Arab Emirates (2004); and Vietnam (2013).

[1033] New Zealand entered into a tax treaty with Hong Kong on 1 December 2010.

[1034] Statistics around New Zealand’s trade with other countries can be found at www.nzstats.govt.nz <New Zealand Trade Dashboard (shinyapps.io)>.

[1035] These statistics can be found, updated quarterly, on the NZ Stats website at <Balance of payments and international investment position: March 2020 quarter | Stats NZ>.

[1036] This is analysed below in the next section.

NRWT on royalties.[1037] It also includes entering a tax treaty with Hong Kong, a financial services centre with many tax benefits extended to some of its residents.[1038]

The following analysis looks at specific areas of New Zealand's tax treaty network to determine New Zealand's position on taxation of income derived by non-residents in New Zealand. The treaties are observed with reference to the United Nations (UN) and OECD models. The UN model favours more source-based taxation than its OECD counterpart. This is because the UN model is drafted to favour developing nations ,which will usually be net importers of capital.[1039] However, this does not overcome the fact that tax treaties reduce source taxation. The question is, then, how much revenue has New Zealand negotiated away to gain tax treaties with these 40 nations?

As discussed in the introduction, this research recognises that treaty negotiations are just that – negotiations. New Zealand will start from a preferred position and may have to compromise in order to reach an agreement with its treaty partner.[1040] New Zealand is also bound by its obligations as a member of the OECD.[1041] However, this study is an examination of the current tax settings, as they stand, against the normative framework developed in chapters three and four. International obligations and political expedience do not form part of the

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[1037] Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion, Australia-New Zealand 2723 UNTS 3 (signed 26 June 2009, entered into force 19 March 2010); Protocol Amending the Convention between New Zealand and the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, New Zealand-United States of America 2728 UNTS 167 (signed 1 December 2008, entered into force 12 November 2010).

[1038] Agreement between the Government of New Zealand and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2824 UNTS 115 (signed 1 December 2010, entered into force 9 November 2011).

[1039] United Nations *Model Double Taxation Convention between Developed and Developing Countries 2017* (United Nations, New York, 2017), at iii.

[1040] Per Robin Oliver, advisor for the Crown in *Lin v Commissioner of Inland Revenue* [2017] NZHC 969 at [33-38].

[1041] OECD convention, above n 115, Articles 1 and 2.

analysis. While it is recognised that political considerations form part of tax setting, this study would be immediately undermined if this was factored in.

7.4.3.1 Taxation of business profits in New Zealand's treaty network

New Zealand's treaty network demonstrates a desire on New Zealand's part to maintain source taxing rights for business undertaken in New Zealand wherever it can, while still expanding the treaty network. In addition to adherence with the UN model deviations in some instances, there are provisions in many of New Zealand's tax treaties that offer further expansion upon the permanent establishment definition. New Zealand's treaties expand the definition of a permanent establishment by including the following activities: exploration and exploitation of natural resources; operation of substantial equipment; the aggregation of activities of associated enterprises; and manufacturing or processing goods.[1042]

The inclusion of these additional activities reflects the importance of New Zealand's oil and gas industry, agriculture, and horticulture and, the mining industry. In all New Zealand's treaties, at least some of these activities are included within the scope of a permanent establishment. Within New Zealand's domestic legislation ("Schedule 23"), the definition of 'permanent establishment' includes activities that consist of or relate to "the exploration for or exploitation of natural resources, including standing timber, situated in that state".[1043] Schedule 23 also includes the operation of substantial equipment within the definition of permanent establishment. These clauses all indicate a preference for New Zealand to ensure the inclusion of activities such as mining, oil and gas exploration, construction, etc. However, it is also notable that New Zealand's domestic legislation provides non-resident investors in the oil and gas industry with significant tax concessions.[1044]

[1042] Thirty-two of New Zealand's 40 treaties include exploration and exploitation of natural resources within the definition of permanent establishment. Twenty-four treaties include operation of substantial equipment. Sixteen treaties include the aggregation of activities of associated enterprises. Fourteen treaties include the manufacturing or processing of goods.

[1043] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018, s 54 inserts new Schedule 23(4) into the Income Tax Act 2007.

[1044] Although not quantified, this industry is identified as having concessional tax treatment in New Zealand's 2020 Tax Expenditure Statement found at www.treasury.govt.nz <2020 Tax Expenditure Statement

This indicates New Zealand would prefer to retain more sourced based taxation than the OECD model includes within business profits. However, the nature of being a small and open economy is that New Zealand will frequently find itself in a weaker bargaining position.

The effect of entering double tax treaties, whether by choice or compromise, is that New Zealand has given away the right to tax the business profits of some non-residents doing business in New Zealand. However, in some cases, New Zealand has managed to retain greater source taxing rights than the OECD model recommends.

Calculating business profits

Determining which activities are included within the source-based taxing rights is the first step toward determining a tax liability. The methodology around calculation of business profits is also an area subject to variation. For example, the UN model includes the 'force of attraction rule' where business profits of an enterprise operating in another state include not only the business profits from the permanent establishment but also any sales or other business activities related to that permanent establishment.[1045] New Zealand's adoption of this provision is limited with only a handful of treaties including this wording.[1046] Neither has New Zealand entered a reservation to the OECD model on this point. We can conclude this is not a deviation supported by New Zealand negotiators.

In 2010, the OECD model changed fundamentally with respect to the attribution of profits to a permanent establishment.[1047] This approach, known as the authorised OECD approach ("AOA"), is underpinned by the objective to attribute profits to a permanent establishment as if it is a "functionally separate entity". This involves some notable differences with the previous approach. AOA factors in the assumed risks of the enterprise by considering where the economic ownership of assets and risks lie. This, in turn, leads to a permanent

(treasury.govt.nz)>. There are tax exemptions for non-resident oil rig and seismic vessel operators and accelerated deductions for petroleum mining expenditures (at 12).

[1045] UN Model, above n 1039, Article 7(1). Also see the commentary on this paragraph at 215-216.

[1046] Only eight of New Zealand's forty tax treaties include the 'force of attraction' rule, of which seven are developing nations.

[1047] See OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, 22 July 2010.

establishment being charged for use of these assets or risks – although not real external costs, they impact the attribution of profit between the permanent establishment or head office (or other branch) of the enterprise. This allows notional interest payments or royalties or rental charges to be considered when calculating the taxable profits of the permanent establishment. This is a significant divergence from the UN model and clearly favours the capital exporting state, of which New Zealand generally is not.[1048]

The UN model disallows all deductions of payments made to head office such as royalties, technical fees, or interest unless they are a reimbursement of actual expenses.[1049] These actual expenses also need to reflect arm's length prices for real services. The restriction upon deductions applies in respect of payments of the same nature from head office to a permanent establishment. In this respect, the UN model does not treat a permanent establishment as a separate and distinct entity but rather tries to attribute only the "real" or external income and costs to the permanent establishment. Given charges for royalties, technical fees or notional interest will usually flow from a permanent establishment to a head office, the UN rule favours source-based taxation and favours the capital importing country.

New Zealand rejects the AOA approach. In its reservation to the 2010 (and subsequent) OECD model treaties, it states it reserves the right to apply the 2008 model with respect to business profits.[1050]

Schedule 23 is silent on the calculation of the attributable profits of a permanent establishment other than stating they will be determined as if it is a "distinct and separate enterprise".[1051] This is the wording found in both the OECD and UN models, although both go on to elaborate on their approach to the attribution. However, New Zealand's tax treaty

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[1048] This approach appears to support Tsilly Dagan's thesis that double tax treaties favour the already wealthy OECD countries by reducing the host countries opportunity to tax locally sourced profits. See Dagan, above n 33, at 79-119.

[1049] UN Model, above n 1039, at 225-226.

[1050] OECD, *Model Tax Convention on Income and on Capital, condensed version, 2010*, commentary on Article 7, para.95 at 197.

[1051] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 (2018/16), s 54 inserts new Schedule 23 into the Income Tax Act 2007.

network reflects an overwhelming support for the UN model, as one might expect given the reservation entered into the OECD model. Although New Zealand's treaties usually do not set out the full clauses found in the UN model regarding the attribution of expenses, they do refer to deduction of actual expenses rather than notional expenses. This deviation from the OECD model would tend to indicate that despite New Zealand often being the weaker negotiating partner, adherence to the UN model (or the old OECD model) is a bottom line for New Zealand negotiators.

Building sites and construction projects – 6 months or 12 months?

One of the areas where a business presence in a host country can be excluded from the tax net is construction and building sites. The double taxation treaties generally place a minimum time limit upon the presence of a construction site before a permanent establishment exists – until the time limit is exceeded, no taxation right exists in the host country.[1052] This clause is a standard clause in most taxation treaties. However, there are some differences in the time limit. The UN model defines a building or construction site as a permanent establishment when it has been present in a state for a minimum of 183 days.[1053] This compares with the OECD model, which does not create a permanent establishment until its presence in another state is for a minimum of 12 months.[1054] Despite the dominance of the OECD model, exactly half of the current double tax treaties that New Zealand is a party to determine a permanent establishment exists for an enterprise where they have a building site or construction project present in that state for a minimum of six months.[1055] This is 20 treaties out of a total of 40.[1056] Of the 20 treaties following the UN model's time period in respect of building sites

[1052] Found in article 5(3) of both the OECD Model, above n 117, and UN Model, above n 1039.

[1053] UN Model, above n 1039, article 5(3).

[1054] OECD Model, above n 117, article 5(3).

[1055] These are the treaties with Australia, Chile, China, Czech Republic, Fiji, Hong Kong, India, Indonesia, Ireland, Malaysia, Mexico, Norway, Papua New Guinea (90 days), Philippines, Samoa, South Africa, Sweden, Thailand, Turkey, United Arab Emirates, and Viet Nam.

[1056] Papua New Guinea is included in this list as the treaty between New Zealand and Papua New Guinea state that construction projects exceeding 90 days will constitute a permanent establishment.

and construction projects, 14 of these treaties are with 'developing nations'.[1057] The shorter period of time follows the reservation New Zealand has lodged on the OECD model stating that they "consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment".[1058] However, there are still 20 treaties that follow the OECD model time period and only create a permanent establishment for an enterprise when the building site or construction project has been present in the other state for a minimum of 12 months. These treaties are mainly with developed economies. Presumably, given New Zealand's reservation, this reflects the impact of negotiations between the two contracting parties; that is, the developed nations are typically more influential treaty partners given they are more likely to have the desired capital New Zealand wants to attract.

In addition to the analysis of the treaties, support for the premise that New Zealand would prefer to follow the UN model can be found in Schedule 23, that includes a building site or construction project within the ambit of a permanent establishment where it has been present in a state for a minimum of six months.[1059] Schedule 23 is probably New Zealand's preferred model and it indicates a preference for retaining sourced-based taxation by favouring a shorter time period for presence of building sites and construction projects.

The conclusion to be drawn from this analysis is that New Zealand, recognising it is a capital importer, would prefer to retain source taxing rights in respect of construction projects. However, the result of having large and dominant treaty partners is that New Zealand has negotiated away some of its taxing rights.

Can delivery of goods constitute a permanent establishment?

Generally, New Zealand does not tax foreign enterprises whose only business in New Zealand is the delivery of goods. Under New Zealand's domestic legislation, delivery of

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[1057] This is determined according to the findings in the UN *World Economic and Situations Report* (2018) and includes Chile, China, Fiji, Hong Kong, India, Indonesia, Malaysia, Mexico, Papua New Guinea, Philippines, Samoa, South Africa, Thailand, and Turkey.

[1058] OECD model, above n 117, commentary on article 5, para 201, at 168.

[1059] Introduced in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 (2018/16).

goods in New Zealand could result in New Zealand sourced income[1060] but would not be included where the business income is derived by a person from a country with whom New Zealand has a double tax treaty. While the UN model treaty includes delivery of goods within its definition of a permanent establishment, New Zealand's treaty network follows the OECD model in this case. Schedule 23 follows the OECD model as well. The exclusion of delivery of goods from the definition narrows the tax base on source-based business profits in New Zealand.

Maintenance of a stock of goods for delivery

Under New Zealand's domestic law, maintaining a stock of goods could potentially be regarded as doing business in New Zealand.[1061] The UN model treaty, in preserving source-based taxing rights, creates a permanent establishment of an enterprise where the enterprise maintains a stock of goods in a state for the purpose of delivery.[1062] On the whole, the New Zealand treaties have not followed the UN model. There are nine treaties that include this activity within the definition of a permanent establishment, and they are all, except Sweden, with developing nations.[1063] Other treaties follow the OECD model that does not include maintenance of a stock of goods within its permanent establishment definition. Also, Schedule 23 does not include this activity within its definition of permanent establishment. Generally, maintenance of a stock of goods in New Zealand does not create a permanent establishment in isolation. This favours nations that are net exporters of goods. New Zealand, however, is a net importer of goods. [1064]

[1060] Elliffe *International and Cross Border Issues*, above n 710, at 328.

[1061] Elliffe *International and Cross Border Issues*, above n 710, at 325, discussion on *Watson v Sandie & Hull* (1897) 3 TC 611 (QB).

[1062] UN model, above n 1039.

[1063] These are the treaties with Fiji, India, Indonesia, Malaysia, Papua New Guinea, Sweden, Thailand, Turkey, and Viet Nam.

[1064] See statistics at www.StatsNZ.govt.nz <Overseas merchandise trade: September 2020 | Stats NZ>.

7.4.3.2 Services

The UN model states that an enterprise has a permanent establishment in another state if it furnishes services through its employees in that other state and they are present there for 183 days or more in any 12-month period.[1065] This extends the application of the permanent establishment definition to service providers who do not otherwise meet the definition of a permanent establishment. This clause is not found in the OECD model.

The effect of the UN clause is to grant taxing rights to the state where employees are present to undertake service work on behalf of an enterprise of another state. To some extent there is an overlap with Article 14, which specifies that services can be taxed in the state in which they are performed where the individual's presence exceeds 183 days in a 12-month period. Article 14 appears in the UN model but not the OECD model. For a permanent establishment to exist, the OECD model concentrates on the presence of a fixed physical site in the other contracting state.[1066] In the UN model, the presence of services is dependent upon the presence of individuals for a sustained period.

New Zealand includes a service clause in 19 of its 40 treaties, marginally less than half.[1067] However, it also has an Article 14 in 22 of its treaties, and 15 of these are in addition to the treaties including the clause within their definition of permanent establishment.[1068] New Zealand's tax treaty network therefore brings the presence of service providers into the source-based tax net in 34 of its 40 treaties. The most notable exception is the treaty between New Zealand and the United States. This treaty does not include services within the definition of permanent establishment and nor does it include an article 14. As well as the

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[1065] The requirement for the services to on a single or connected projects has been removed in the 2017 UN model treaty, above n 1039.

[1066] This may change in the future because of the work undertaken on taxation of the digital economy, above n 19.

[1067] These are the treaties with Australia, Austria, Canada, Chile, China, Czech Republic, Hong Kong, Indonesia, Japan, Mexico, Papua New Guinea, Philippines, Poland, Samoa, Singapore, South Africa, Thailand, Turkey, and Viet Nam.

[1068] These are the treaties with Belgium, China, Denmark, Finland, France, Germany, India, Indonesia, Ireland, Italy, Norway, Papua New Guinea, Philippines, Russian Federation, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Arab Emirates, United Kingdom, and Viet Nam.

significant number of treaties with ‘service’ clauses, Schedule 23 includes a ‘service’ provision.

The Schedule 23 service provision has two limbs. The first is that a permanent establishment will be created if an individual is undertaking services within a state for 183 days or more in a 12-month period and the revenues generated by these services are more than 50 per cent of the gross active revenues of the enterprise. The second limb is where a permanent establishment is created because an employee or employees are present in that state for 183 days or more in any 12-month period and they work on single or connected projects. The treaties with Australia and Canada include the same service clause as Schedule 23. The treaty with Austria includes an enterprise carrying on services in the other state for 183 days or more in a 12-month period and is silent on whether it must be the same or connected projects. There are significant variations in service articles within the existing treaty network.

From the prevalence of service articles in the existing network of treaties New Zealand has entered into and Schedule 23, it can be seen that New Zealand has a preference to gain source taxation rights where there is a sustained presence of service provision in a state. Once again, New Zealand favours retention of source-based taxing rights.

It is worth noting at this point that the latest UN model convention has included a new article granting source taxing rights to those enterprises providing “technical services” in another state.[1069] This includes charges such as management fees and other service fees, although these do not require a permanent establishment be present in the state from where the payments derive. There may be some overlap between this new article and the “service” clause in the definition of permanent establishment.

7.4.3.3 Royalties

New Zealand’s domestic law imposes a 15 per cent withholding tax upon payment of a royalty to an overseas recipient.[1070] The definition of royalty in New Zealand tax law is wide and includes the right to use any intellectual property and the right to exploit natural

[1069] UN model, above n 1039, Article 12A at 23.

[1070] Income Tax Act 2007, s RF 7.

resources.[1071] A non-resident receiving a royalty that is sourced in New Zealand will be subject to the NRWT under domestic law. A royalty is sourced in New Zealand if it is paid by a New Zealand resident (and not used for a fixed establishment located outside New Zealand) or it is paid by a non-resident who receives a tax deduction for the payment in calculating the New Zealand taxable income.[1072] A royalty paid to a non-resident could be subject to the NRWT where a New Zealand enterprise pays it to an unrelated non-resident. It could also arise where a New Zealand resident pays a royalty to an associated foreign resident. It could even arise where a non-resident, doing business in New Zealand, bears a share or all of a royalty paid to another non-resident.

The double tax treaty network in New Zealand has maintained this source taxing right in its treaties,[1073] despite the OECD model recommendation that royalties are only taxed in the country of the recipient's residence.[1074] New Zealand's maintenance of source taxing rights operates to the benefit of the New Zealand tax base due to the dominance of capital importing over exporting. With the increase in technical and knowledge-based industries, it is inevitable that payment for the use of intellectual property has become more prevalent.

New Zealand's treaties have typically reduced the NRWT rate from the domestic statutory rate of 15 per cent[1075] to 10 per cent, and sometimes down to 5 per cent.[1076] Merely entering a treaty with another territory is likely to result in a reduction of tax revenue for the capital importing nation due to the implicit favouring of residence-based taxation in the OECD model.[1077]

[1071] Income Tax Act 2007, s CC 9(2).

[1072] Income Tax Act 2007, s YD 4(9).

[1073] All New Zealand treaties retain the right to withhold an NRWT on payments of royalties.

[1074] OECD Model, above n 117, Article 12(1).

[1075] Income Tax Act 2007, s RF 7.

[1076] The more recent treaties entered into with Australia, Hong Kong, Singapore, and the protocol with the United States reduce the withholding rate down to 5 per cent.

[1077] Dagan "Tax Treaties Myth", above n 727.

The treaties entered into since 2008 erode this right further by reducing the NRWT rate on royalties to 5 per cent. These new treaties include the protocol to the United States treaty,[1078] the new treaty with Australia,[1079] and treaties with Singapore and Hong Kong.[1080] The estimated reduction in tax revenue to New Zealand as a result of the recent protocol to the United States treaty is estimated to be $20,000,000, largely due to the reduction in NRWT on royalties paid from New Zealand to US residents.[1081] The same NRWT rate was introduced in the treaty with Australia. This is significant as investment from Australia is a third of our total inbound investment.[1082] Another change to both agreements was the exclusion of leasing of equipment from the definition of royalty. This provision has long been held by New Zealand negotiators and resulted in NRWT being collected on payments to non-residents for the lease of substantial equipment located in New Zealand, even where a permanent establishment did not exist.[1083]

[1078] Protocol Amending the Convention between New Zealand and the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, New Zealand-United States of America 2728 UNTS 167 (signed 1 December 2008, entered into force 12 November 2010).

[1079] Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion, Australia-New Zealand 2723 UNTS 3 (signed 26 June 2009, entered into force 19 March 2010).

[1080] Agreement between the Government of New Zealand and the Government of Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2722 UNTS 319 (signed 21 August 2009, entered into force 12 August 2010); Agreement between the Government of New Zealand and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2824 UNTS 115 (signed 1 December 2010, entered into force 9 November 2011).

[1081] Finance and Expenditure Committee *International treaty examination of the Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (24 November 2008) at 3.

[1082] Finance and Expenditure Committee *International treaty examination of the Convention between New Zealand and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion* (15 May 2009) at 5

[1083] The right to use equipment is included within the definition of royalty in 34 of New Zealand's 40 tax treaties.

The treaties entered into with Singapore and Hong Kong have also adopted the lower 5 per cent NRWT rate on royalties.[1084] Significant global investment flows through these two countries that provide an accommodating environment for financial investment in a low tax environment. The National Interest Analyses for both treaties recognised a loss in tax revenue as a result of these treaties.[1085]

Although the most recent treaties include significant reductions in NRWT rates on royalties, the New Zealand treaties still maintain higher source-based deductions than the OECD model recommends.[1086] Once again, New Zealand indicates a preference for retaining source-based taxing rights.

7.4.3.4 Insurance activities

New Zealand deviates from the OECD model treaty with respect to the activities of non-resident insurers. In 37 out of 40 treaties, New Zealand retains the right to tax non-resident insurers deriving premiums from New Zealand under its domestic law.[1087] Like the OECD model, New Zealand's treaties generally exclude this activity from taxation through its

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[1084] Agreement between the Government of New Zealand and the Government of Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2722 UNTS 319 (signed 21 August 2009, entered into force 12 August 2010) at Article 12(2); Agreement between the Government of New Zealand and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2824 UNTS 115 (signed 1 December 2010, entered into force 9 November 2011) at Article 12(2).

[1085] Finance and Expenditure Committee *International treaty examination of the Convention between New Zealand and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (undated) at 7; Finance and Expenditure Committee *International treaty examination of the Protocol amending the Convention between the Government of Hong Kong and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (undated) at 6.

[1086] OECD model, above n 117, Article 12.

[1087] Income Tax Act 2007, s CR 3.

business profits article. However, New Zealand also reserves the right to tax this activity under domestic law – and it activates this right. [1088]

The UN model treaty states that any insurer collecting insurance premiums in a state will have a permanent establishment in that state.[1089] The OECD model is silent on insurers, meaning a fixed presence in a state would be required to create a permanent establishment under this model. So once again, the UN model increases the incidence of source-based taxation in this respect and the OECD model does not.

New Zealand follows a different model again. New Zealand does not follow the UN model by specifically including certain activities within the definition of permanent establishment. Rather it carves out insurance business from the business profits article, allowing domestic law to prevail. This allows New Zealand's non-resident insurer tax regime to operate regardless of whether the insurer is resident in a country with which New Zealand has a treaty. Effectively this has a similar outcome to the UN model in that it gives the source country (New Zealand) taxation rights over income earned by non-resident insurers from premiums sourced in New Zealand. New Zealand's domestic regime imposes a tax of 10 per cent on the gross premiums derived in New Zealand by non-resident insurers.[1090]

7.4.3.5 International airline and shipping operators

The UN model provides two options for taxing profits derived by international airlines and shipping operators. The first aligns with the OECD model by granting taxing rights to the country where the place of effective management of the enterprise is located. This should usually be the same place as the country of residence, which is the test in the OECD model. The UN model provides a second alternative provision that includes source-based taxing rights. Other than a few exceptions in relation to shipping, New Zealand applies either the OECD or UN's first option, granting sole taxing rights for these international transport operators to the country where their place of effective management or residence is located.

[1088] OECD model, above n 117, para.75, at 137.

[1089] UN Model, above n 1039, Article 5(6).

[1090] Income Tax Act 2007, s CR 3(2).

7.4.3.6 The Hong Kong treaty

The treaty between New Zealand and Hong Kong is an anomaly in itself.[1091] It is worthy of special note because it highlights what New Zealand has been prepared to negotiate away in the pursuit of economic growth.

Hong Kong taxes its residents on income sourced in Hong Kong only.[1092] It does not tax its residents on their worldwide income as most countries do. Given that tax treaties are primarily designed for the avoidance of double taxation, it is difficult to see the tax benefit for New Zealand taxpayers of entering into a treaty with Hong Kong.[1093] Even if a New Zealand resident is found to be a resident in Hong Kong as well (dual residency), the taxpayer will not be subject to double taxation as Hong Kong does not tax residents on foreign sourced income. The effect of this treaty breaches the single tax principle that says income from cross-border transactions should be taxed at least once and only once.[1094] This treaty provides opportunities for income to escape any taxation.

Another anomaly of this treaty is the tax benefit and loss of tax revenue afforded to employees of Hong Kong based airlines or shipping enterprises living in New Zealand. It is not unusual for a treaty to allocate the right to tax employees of international airlines or shipping enterprises in the state in which the enterprise is resident.[1095] Employees of Air New

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[1091] Agreement between the Government of New Zealand and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2824 UNTS 115 (signed 1 December 2010, entered into force 9 November 2011).

[1092] See details of Hong Kong's territorial basis for taxation at www.ird.gov.hk <IRD: A Simple Guide on The Territorial Source Principle of Taxation>.

[1093] Kyle Rainsford "Tax Treaties with Tax Havens: The Hidden Tax Break" 17 *UALR* 60.

[1094] Reuven Avi-Yonah, Nicola Sartori, and Omri Marian *Global Perspectives on Income Taxation Law* (Oxford Scholarship Online, 2011) at 156.

[1095] Both the UN and OECD models have articles dealing with these persons.

Zealand who reside in another part of the world may have the taxing rights on their income allocated to New Zealand, being the place where Air New Zealand is resident.[1096]

However, the operation of this provision with a jurisdiction that does not tax income sourced abroad means employees of Hong Kong based airlines and shipping enterprises can reside in New Zealand tax free. This is a direct subsidisation of a non-resident business as it reduces the cost of employing staff. The outcome of this provision in the treaty incentivises Hong Kong based airlines and shipping enterprises to locate their employees in New Zealand where the post-tax cost of staff will be reduced.

The Hong Kong treaty is an unusual agreement with the inevitable loss of tax revenue to New Zealand going to the taxpayer as a windfall, rather than a transfer to the Hong Kong tax authority. The inevitable conclusion is that the treaty with Hong Kong represents another shift in favour of providing incentivised preferential treatment to non-residents.

7.5 Conclusion

The treaty analysis above has demonstrated the impact of the tax treaty network upon New Zealand's tax base. As a net capital importer, taxing rights have been negotiated away on some of the income generated or sourced in New Zealand. While New Zealand may start from a preferred position or a "model treaty" that favours source-based taxation, the process of negotiation involves concessions being made in the interests of broader political, commercial and trade considerations.[1097] Put more directly, New Zealand forgoes taxing rights with the aim of encouraging trade and enterprise with its treaty partners.

New Zealand has experienced a movement in the policy of taxing non-resident investors from a discriminatory treatment to a preferential treatment. This movement is consistent with other similar economies around the world. The shift in tax treatment followed the underlying changes in the political landscape and global economic trends, particularly the rise of neo-liberal theories relating to free markets, smaller government, and the drive for economic growth. The drive for economic growth led to states competing for 'scarce' capital. A

[1096] New Zealand has 14 double tax treaties that operate in this way.

[1097] Per Robin Oliver, advisor for the Crown in *Lin v Commissioner of Inland Revenue*, above n 1040, at [33-38].

common way a state sought to attract capital was through tax incentives. New Zealand, like many other states, has travelled this path.

The preferential phase has followed on from the transitional phase where tax settings acted to neutralise the tax treatment of residents and non-residents, except in relation to non-resident lenders where preferential tax settings have existed since the early 1990s. Changing tax rates, the introduction of specific beneficial regimes and the expansion of the tax treaty network have provided non-residents with a lower New Zealand tax burden than domestic investors.

Changing tax rates have widened the gap of the headline tax rate between resident and non-resident investors. While personal tax rates have increased or remained stable, corporate tax rates have declined. Since the introduction of FITC, non-resident investors will not suffer a tax burden greater than the corporate tax rate which has been lower than individual tax rates over the past couple of decades.

The introduction of foreign PIEs and preferential tax treatment for banks indicates a willingness on New Zealand's part to provide an attractive environment for foreign financial capital. Although the changes to the AIL were, in part, to close loopholes that had existed for decades, the banks still managed to negotiate favourable terms in the final legislation.

The growing tax treaty network, alongside international trends that reduced source-based taxation, meant with each treaty New Zealand negotiated, further erosion to New Zealand's tax base was taking place. These treaties tend to favour residence-based taxes and for net capital importing nations such as New Zealand, tax revenue losses are to be expected. While New Zealand has made many efforts to maintain its source taxing rights, a lot is negotiated away as a necessary outcome of contracting with larger and more influential nations. Withholding taxes on dividends and royalties have been reduced substantially in recent treaties. New Zealand's rejection of the AOA approach to calculation of business profits has been forgone in many of its treaties. Entering a treaty with a state known best for its status as an international financial services hub with a territorial based tax system further serves to give up tax revenues in favour of pursuing economic growth.

Like many other nations, New Zealand finds itself competing for foreign capital using its tax system. This has developed over a period of several decades to what is now, in every area, a favourable tax system for non-resident investors. The next chapter will examine whether

these settings are consistent with New Zealand's broader economic objectives, in light of the framework developed in chapter three of this thesis.

8 Conclusion

8.1 Overview

The overall research question being asked in this thesis is "how should New Zealand tax its inbound investors? the development of a tax policy framework and an analysis of current settings against the framework." In reaching a conclusion on this question, three sub-questions arose which have been addressed in chapters two to seven. These sub-questions are:

1. Can tax on inbound investors be justified?
2. What principles should guide tax policy setting?
3. How does New Zealand tax its inbound investors?

The sub-questions have been addressed in earlier chapters and will be summarised in parts 8.2, 8.3 and 8.4. The aim of this final chapter is to consolidate the previous chapters and answer, as best as possible, the overall research question.

The overall research question relies upon applying the findings of how New Zealand taxes its inbound investors to how New Zealand *should* tax its inbound investors. More specifically, this involves the application of the framework developed in chapter three to the findings in chapter seven.

This chapter concludes that the current favourable tax settings for inbound investors do not meet optimal tax settings. While the neo-liberal narrative has argued that taxing mobile factors of production (financial capital and highly skilled international labour) will result in negative consequences to the overall economy, there is little research to support this position. However, there is evidence that growing inequality, exacerbated by preferential tax regimes for the wealthy, have a range of negative outcomes across a range of areas. Not only is it unfair to shift the tax burden onto the immobile domestic tax base, but there is increasing evidence that the current settings are not producing the economic benefits promised. For these reasons, it is detrimental to overall wellbeing to 'undertax' mobile factors of production, including income of inbound investors. The conclusion reached in this chapter is that inbound investors should face the same tax burden as domestic investors. The tax settings should focus upon reducing inequalities and ensuring host countries receive their fair share of tax revenue.

8.2 Can tax on inbound investors be justified?

Chapter two put forward the argument that taxing rights should be determined based on the presence of an economic participation. In the past, the benefit and sacrifice theories have been used to justify imposing taxation on participants in a state's economy. However, neither of these theories have been satisfactory in justifying the tax imposition by a state in all cases. While the sacrifice theory rose in popularity and provided justification for the redistributive aims of governments, this wasn't seen as adequate to justify imposing tax on non-residents. In many cases, international tax theorists fell back onto the principles of the benefit theory to justify source-based taxation of non-residents. The benefit and sacrifice theories are used to answer a range of questions relating to the tax base of the state. The only question that is required to be addressed in this thesis is the matter of legitimation of taxing rights

Chapter two addresses this question and argues that a state is justified in imposing tax upon all those who participate in the economy of that state. This justification does not rely upon benefits being received by the investors, although they almost always will be. Neither does it depend upon a non-resident being a member or having any solidarity with the state. Under the economic participation theory, the right attaches to the state, rather than to the investor.

The economic participation theory is based on the view that tax is a necessary part of the modern state, and therefore, the justification for tax should follow the justification for the state. Chapter two finds that one of the main purposes of a state is to build a communal economy, allowing its participants to flourish. Given this purpose, it follows that participation in this communal economy justifies requiring its participants to contribute toward it.

The theory legitimising taxation based upon economic participation is a contribution of this study to the existing body of research in this field.

8.3 What principles should guide tax policy setting?

In chapters three and four a framework was developed to determine the tax principles that should guide tax policy. Chapter three has argued that tax setting should be based upon two principles: fairness and prosperity. While fairness is generally accepted as a tax policy objective, prosperity is new and is a contribution to the existing body of research.

Traditionally, fairness (or equity) and efficiency have been the two primary tax policy making principles. However, this research identifies some weaknesses in the use of the

objective ‘efficiency’, particularly with its expansion to include economic growth within its ambit. This research proposes that prosperity is a better objective that more closely aligns with modern policy making objectives. Prosperity aims toward higher material standards of living, a key reason for the existence of a state. Prosperity also relies upon factors such as higher levels of education and wellness to support human progress. However, it also focusses on the resulting prosperity being shared across the population and across time – meaning any growth needs to be sustainable. Prosperity also recognises that ongoing wellbeing relies upon keeping inequalities in check. While some inequality is acceptable, excessive inequality results in poor outcomes, including potentially reducing future material wellbeing.

Supporting the twin principles of fairness and prosperity are four sub-aims: progressivity, neutrality, participation, and productivity. These sub-aims arise from analysis of research into how the aspirational objectives of fairness and prosperity are best achieved. All of these sub-aims support the need to reduce excessive inequality.

The framework developed in chapters three and four is also an original contribution of this thesis.

8.4 How does New Zealand tax its inbound investors?

Chapters five to seven examine the development of New Zealand’s tax policy in relation to its inbound investors. A clear narrative is established that mobile capital, particularly financial capital provided by non-residents, should not be encumbered by taxation as this will drive that capital to other jurisdictions. In the author’s view, tax policy settings have developed over decades based upon a narrative of fear of the potentially negative economic consequences should these non-residents be subjected to tax at the same levels as residents. It is notable, however, that policymakers have indicated some resistance to these arguments and have retained more source taxing rights than other comparable states.[1098] Overall, there has been a trend toward the reduction of taxation upon non-resident investors. This reduced tax

[1098] While interest and dividends are not subject to further income tax at the investor level in New Zealand, the analysis of New Zealand’s double tax treaty network indicates some retention of source taxing rights in respect of a more inclusive definition of permanent establishment and the inclusion of services performed in New Zealand. This analysis is written up in chapter seven. This is also evidenced in the most recent policy statement by the IRD and Treasury on taxation of inbound investors, above n 491.

burden must either be offset by increasing taxes on immobile factors of production or cutting spending resulting in reduced public provision of goods and services.

By the time we get to the present day in our analysis of taxation on non-resident investors, we observe that interest derived in New Zealand by non-residents is often wholly untaxed, dividends are capped at the corporate tax rate (which is lower than personal marginal tax rates), royalties are taxed at as little as 5 per cent, and direct investments often enjoy profit shifting mechanisms to minimise tax liability in New Zealand. While profit shifting behaviour is not the subject of this thesis, it does have the same outcome – reduction of the tax contribution of non-residents investing into New Zealand business. Much of this last problem is the subject of the OECD work on BEPS.[1099]

The analysis in chapters five to seven, including observations relating to consultation and submissions on draft tax laws, is another contribution to the existing body of research.

8.5 How should New Zealand tax its inbound investors?

The next section applies the model developed in chapters three and four to the findings in chapter seven to determine whether current tax settings meet the objectives of the framework. Each sub-aim is considered separately.

8.5.1 Progressivity

Progressivity is the tool used to achieve vertical equity – a concept of fairness largely accepted in modern administrative states.[1100] Progressivity in a tax system relies upon higher taxes applying to those wealthier participants in the economy. This acts as a redistribution tool, effectively countering the inequalities produced by pre-tax market outcomes.

Investors are those participants in an economy who can save – and the volume of savings will reflect their ability to pay. Therefore, under a progressive system of taxation, we would expect those who have investments to pay a higher proportion of their income in tax.

[1099] The OECD have issued 15 Action Plans to deal with the problem of BEPS. Perhaps the most significant of which is Action 1, taxing the digital economy. This Action is now supported by a two-pillar solution to share the profits of multinational digital business across participating jurisdictions and ensure a minimum level of taxation on those profits: see above n 19.

[1100] See chapter 4 for a full discussion on progressivity.

However, we find this is not the case with respect to those investors from outside New Zealand. The tax concessions provided to inbound investors quite clearly do not meet progressivity aims. The following sections consider each type of investment with progressivity in mind.

8.5.1.1 Debt and equity investors and progressivity

New Zealand's preferential treatment of debt and equity investors does not accord with vertical equity.

Under current settings, inbound debt investors can pay as little as 0 per cent New Zealand tax on their New Zealand participation and inbound equity investors may contribute up to 28 per cent on their New Zealand participation. Domestic investors, by contrast, pay tax at their marginal tax rates on all interest and dividend income from investments – typically 33 per cent or 39 per cent.[1101] The position of these investors is clear – they are required to pay lower levels of tax in New Zealand than their domestic counterparts.

The argument for lowering the tax costs on inbound investors is that the rate of return is increased, and the cost of capital is, in theory, lowered for domestic businesses seeking investment.[1102] This is only the case where the inbound investor's tax savings in the host country are not absorbed by increased tax costs in the home country. For example, if an Australian investor receives dividend income from an investment in a company located in New Zealand, that income would be taxed at their marginal tax rate, with a credit for any tax paid on the dividend in New Zealand.[1103] What New Zealand doesn't tax, will be taxed in Australia. Therefore, reductions in a host country's taxation on inbound investors will often only shift tax revenues back to the home country's jurisdiction. This will almost always be the case unless the home country exempts foreign sourced income, as many 'tax havens' do.

New Zealand's tax settings that favour inbound investors therefore best serve those investors who do not have a tax liability elsewhere in the world. This setting provides investors from

[1101] Unless the domestic investor is a PIE investor, in which case they enjoy the same preferential treatment that non-resident investors do. However, this is at the expense of labour, business, and rental income.

[1102] This narrative is explored more fully in chapter 6.

[1103] Income Tax Assessment Act 1997 (Aust), Division 770.

low or no tax jurisdictions (including tax havens) with a competitive advantage.[1104] This is contrary to all aspects of fairness, including progressivity. Wealthy investors with the resources to arrange their affairs in such a way to take advantage of low tax jurisdictions have a lower overall tax burden. For a tax system to be progressive, those investors with means should face a higher tax burden.

8.5.1.2 Direct investors and progressivity

Regarding those who invest directly into assets located in New Zealand, such as branches of foreign companies, the application of New Zealand's double tax treaty network determines the allocation of taxing rights between residence and source states. As New Zealand has treaties with all its major trading partners, and many more states, most investors will be affected by a treaty.

One of the findings in chapters five to seven is that the definition of permanent establishment has narrowed, driven by changes to the OECD model. This means capital importing states will have a reduced tax base as less direct investment constitutes a permanent establishment. Unless the presence is a permanent establishment, it is likely to fall outside the tax base of the investee state.

As a net capital importer, when New Zealand enters into double taxation agreements, it gives away some of its taxing rights (except in the case of a few developing nations where New Zealand may be a net exporter). The justification for giving away taxing rights is that double taxation agreements "reduce tax impediments to cross-border trade and investment".[1105] Another way to construe this is that New Zealand is willing to give away some of its tax revenue to facilitate trade and investment.[1106] This is evidenced in most of the national interest analyses for individual treaty negotiations that identify that the agreement being entered into will result in reduced tax revenue for New Zealand, mainly due to reductions in

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[1104] If the OECD's work in pillar two, above n 19, comes to fruition, this will reduce the ability of multinationals to escape a minimum level of tax on profits.

[1105] IRD "The role of double tax agreements" www.taxpolicy.IRD.govt.nz <http://taxpolicy.ird.govt.nz/tax-treaties/role-double-tax-agreements>.

[1106] *Lin v Commissioner of Inland Revenue*, above n 1040, at [33-38].

NRWT rates on dividends, royalties and interest.[1107] This ties into the economic wellbeing argument that reduced taxation on mobile factors of production will increase economic wellbeing.[1108] However, this also perpetuates the shift of the tax burden onto domestic immobile factors of production, effectively operating against progressivity.

As New Zealand has established a double tax treaty network of 40 treaties since 1958, including all its main trading partners, New Zealand has negotiated away its source taxing rights, at least in part, in favour of economic growth objectives.

When New Zealand enters into double tax agreements with large trading partners, when NRWT on interest, dividends and royalties are reduced, and when New Zealand introduces regimes such as FITC to reduce the tax burden of international investors, it acts against progressivity and vertical equity. It shifts the cost of New Zealand's public goods and services away from foreign owners of capital, and onto domestic taxpayers, including labour. This shift is regressive.

8.5.2 Neutrality

As discussed more fully in chapter four, neutrality refers to both neutrality in the tax treatment between taxpayers and neutrality with respect to alternative transactions. Neutrality between taxpayers is referred to as horizontal equity while neutrality between alternative transactions is what we usually refer to as, simply, neutrality. These two objectives are considered together as while one relates to fairness across taxpayers in the same situation, and the other to economic choices, they both require the tax system to provide a neutral

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[1107] For example, the second protocol to the treaty between New Zealand and the United States indicates the reduction in NRWT on royalties will result in tax lost of around $20 million per annum: Finance and Expenditure Committee *International treaty examination of the Protocol amending the Convention between New Zealand and The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income: Report of the Finance and Expenditure Committee* (24 November 2008) at 9. The national interest analysis for the treaty between New Zealand and Hong Kong estimates a tax loss of $0.5 million per annum: Finance and Expenditure Committee *International treaty examination of the Protocol amending the Convention between the Government of Hong Kong and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income: Report of the Finance and Expenditure Committee* (undated) at 17.

[1108] See chapter 6, part 6.2 above for a discussion on the development of the neo-liberal school of thought.

setting – it shouldn't provide discriminatory settings favouring some taxpayers or transactions. As it happens, horizontal inequity often arises due to alternative economic choices not being treated equally for tax purposes.[1109] It is quite clear that providing tax concessions to a single group of taxpayers, such as non-residents, is not a neutral tax setting. This favours one group of taxpayers over another, and also can result in the distortion of economic consequences.

When it comes to assessing neutrality across different taxpayers, in this context, we may consider the differences between how inbound investors are taxed compared with domestic investors. We may also consider how investors are taxed compared to other suppliers of capital to business – such as labour. The comparison of domestic investors and inbound investors is central to the question in this study. However, the comparison of financial capital and labour is still relevant in that the observations further reinforce the findings that New Zealand has followed a neo-liberal framework by favouring those mobile forms of capital with respect to tax policy setting.

The motivation for shifting the tax burden onto domestic factors of production is discussed in detail in chapters six and seven. It is not unique to New Zealand as this forms the basis for the tax competition rationale. As Avi-Yonah states:[1110]

> …the public finance literature's standard recommendation for small, open economics is to refrain from levying any taxes on capital because its mobility may result in the tax burden being shifted to domestic labor and land, which can be taxed directly with great ease.

This tax preference for capital over labour has the potential to result in distorting economic decisions regarding choices between labour and capital. For example, where capital gains on property are preferred over labour, it would be beneficial from a tax perspective to invest and manage a portfolio of properties rather than investing in an education and taking on employment income.

However, more visible distortions occur when looking at neutrality across taxpayers. Chapter seven found that inbound investors and domestic investors are not treated in the same way

[1109] For example, if income from investment in residential property is untaxed and income from investment in a manufacturing business is taxed, both neutrality of investment and horizontal inequity are breached.

[1110] Avi-Yonah, above n 141, at 1618.

under New Zealand tax law. Tax resident investors are subject to a higher tax impost in New Zealand than an inbound investor.[1111] While both resident and non-resident investors derive income in New Zealand in the same way and will receive dividends, interest and capital gains in the same amounts, the tax imposition will not be the same. Essentially inbound capital is favoured through concessionary treatment over domestic suppliers of capital.

New Zealand does not adopt the capital import neutrality concept. Inbound investors almost always pay less tax in New Zealand than domestic investors. However, inbound investors may have tax obligations in their home jurisdictions on the income they derive from investing abroad. This means lower tax imposition in New Zealand favours inbound investors from low or no tax jurisdictions.

New Zealand does not have a neutral approach to taxing inbound investors from the perspective of the state or the taxpayers. Inbound investors pay less tax in New Zealand than domestic investors and the tax settings favour those investors whose affairs enable them to pay less tax on a global basis. This does not accord with horizontal equity and distorts commercial decisions by providing a competitive advantage for inbound capital.

8.5.3 Participation

The third sub-aim of the tax policy setting framework developed in chapter three is participation. Research has established that those who participate in the workforce and in civic life, are more likely to be healthy, happy, and housed.[1112] Tax policy should support broad participation in the workforce and civic life, developing both human and social capital. This can be encouraged by putting settings in place that aim to reduce inequality and encourage skill development and labour participation.[1113] Perceptions of fairness and trust

[1111] See findings in chapter 7.

[1112] Stiglitz, above n 420, at 140-142; Morrissey, above n 389.

[1113] See the discussion in chapter 4, especially 4.4.3.

also contribute to members of a state have a willingness to participate in society's institutions[1114] and, following from that, a willingness to contribute to the tax base.[1115]

The technical detail of tax settings on non-resident investors generally escapes public scrutiny.[1116] Policymakers and those who have an interest in international business are the main contributors to discussion regarding taxation of inbound investment.[1117] The nature of the subject fails to spark the interest of the balance of the population. As a result, policy can be set with little public intervention. This is evidenced by the contributions to public debate on law changes in this field. The submissions to public consultation are almost exclusively from corporate interests with little to no interest shown by other members of the public. This is not to suggest that policy is set to appease corporate interests alone. However, this sector can (and does) put pressure on lawmakers to act in their interests with little opposition from the balance of the population.

Despite the lack of public interest in the detail, the broader issue of multinational tax avoidance has become very visible, particularly since the GFC. Even beyond structuring and profit shifting activity, multinationals have benefitted from states welcoming them in with preferential tax regimes. One result of this is the erosion of willingness of those upon whom the burden of taxation falls more heavily to top up the lost tax revenue from those more able to pay.

As New Zealand's approach to taxation of non-residents is not progressive and does not support redistributive policies, it is inconsistent with development and utilisation of human capital and broader participation. As the reduced taxation burden upon non-resident investors results in an increased taxation burden on residents, or a decrease in provision of public goods and services, opportunities to improve human capital are reduced. As established already, the current policies regarding non-resident investors are regressive in nature.

[1114] Knack and Keefer, above n 385.

[1115] Slemrod, above n 510.

[1116] Evidence of this can be found in chapters four to six that look at influences and contributions to the development of tax policy on inbound investors over the past few decades in New Zealand.

[1117] Avi-Yonah, above n 141.

Counter to this conclusion is that foreign investment can result in improvement of skills in New Zealand. Know-how and other skills may be improved with the importation of international ideas and practices. However, not all foreign investment will come with an improvement in skills and New Zealand's tax policy does not distinguish between good investment and not-so-good investment. Equally, it is not clear whether reduced tax rates have a significant impact upon the quantity of foreign investment in any case, and even less on quality.[1118]

8.5.4 Productivity

The aim of productivity is to improve material standards of living. This is an essential reason for human cooperation.[1119] Material wealth must therefore be one of the aims of tax policy setting. Tax settings should support optimal prosperity in two ways. They may determine how much financial capital is allocated to the public and private sector. Also, tax settings determine how the tax burden is allocated between members of the private sector. The narrative of corporate interests is that minimising the tax burden on income from capital is better for overall prosperity. However, this research challenges that narrative as prosperity and productivity rely on a far greater multiplicity of factors than just increasing the supply of financial capital.

The aim of productivity and the overall objective of prosperity are at the heart of the question raised in this thesis. It is clear that providing preferential tax settings for inbound investors runs contrary to fairness as it is not progressive and is horizontally inequitable. However, the neo-liberal narrative argues that overall wellbeing improves when these factors of production are favoured. The question at the centre of this thesis is whether these tax concessions produce benefits to overall prosperity that outweigh the regressivity of the settings.

Productivity, in this context, may result in both the efficient production of goods and services and the subsequent accumulation of financial and physical capital. Economists typically use the term productivity to refer to a measure of efficiency. However, productivity, in this

[1118] New Zealand's taxation framework for inbound investment 2016, above n 491.

[1119] Rousseau describes the ends of political association as being "the preservation and prosperity of its members" in Rousseau, above n 432, at 69.

context, is meant in the plain sense of the word, meaning the act of producing goods and services.[1120]

One of the strongest drivers for preferential treatment of non-residents is to attract capital that New Zealand businesses can use to increase production of goods and services. Economic growth is measured as increases in GDP per capita. Therefore, we would expect to see improvements in economic growth as a result of the preferential tax settings extended to non-resident investors. Since the inception of AIL and FITC, however, New Zealand's GDP per capita has consistently remained lower than the OECD average.[1121]

In addition to this, there is no conclusive research linking tax settings with economic growth.[1122] Recent international research indicates that the regressive tax policies of the past several decades have exacerbated inequality while producing no economic gains.[1123] This undermines the arguments that have been made by corporate interest groups that the economy will benefit from tax cuts. There is also no conclusive research indicating capital is scarce or that it is always applied to productive activity.[1124] Further, economic growth, in itself, is not always an accurate indicator of economic wellbeing. Economic growth only measures growth in GDP which encompasses increases in housing prices but fails to include other less measurable factors.[1125]

As well as increased production, prosperity relies upon tax settings that encourage the development and preservation of the four capitals: particularly financial and physical capital.

[1120] The term 'productiveness' could be used here.

[1121] OECD "Gross Domestic Product (GDP) indicator" (2020) www.OECD.org <https://data.oecd.org/gdp/gross-domestic-product-gdp.htm>.

[1122] New Zealand's taxation framework for inbound investment 2016, above n 491.

[1123] Hope and Limburg, above n 978.

[1124] Michael Howell "Capital Wars: The Rise of Global Liquidity" (Palgrave Macmillan, London, 2020) discusses the large influxes of financial capital into some nations and the consequent misapplication of those funds into unproductive activity.

[1125] Fitoussi Commission report, above n 47, at 12.

The objective of the preferential tax settings for non-resident investors is to improve the accumulation of physical and financial capital. As discussed above, one of the main drivers for preferential tax settings is to provide New Zealand businesses with cheaper debt and equity. Potentially this can lead to greater investment in physical assets that can improve current and future economic wellbeing. A business may borrow more to invest in capital assets that can be used to produce goods and services.

The downside of preferential tax treatment is reduced tax revenue which means the New Zealand government has less to invest in infrastructural public assets. In the same way that it is uncertain how preferential tax treatment impacts prosperity, there is uncertainty about the flow-on effects of this concession. It is impossible to determine if the tax concessions granted to the private sector result in improvements to physical and financial capital in New Zealand. However, we do know that unless tax revenue increases elsewhere, there will be a reduction in investment in public services and assets.

Exempting non-resident lenders from New Zealand income tax has the intention, and probably the effect, of making borrowing cheaper for New Zealand businesses. Reducing costs for New Zealand businesses allows them to borrow more to invest in productive goods and services – although we cannot measure this effect. Offsetting this benefit is the reduction of the New Zealand tax base, resulting in lower provision of public goods and services. We make a transfer from the public sector to the private sector, with the uncertainty of whether the tax savings produce any benefits to the broader economy. The best outcome is that New Zealand businesses can benefit from the full amount and translate this benefit into productive activity. However, the New Zealand business may take the savings and apply it to an unproductive activity. Equally, the tax savings may end up, in whole or in part, offshore in a tax haven or within the tax revenues of another tax jurisdiction.

If the OECD proposals under pillar two are implemented, this will further undermine the value of preferential tax settings for foreign lenders. Where New Zealand does not tax interest derived domestically, pillar two will ensure that the income is taxed at the home country level through operation of the 'income inclusion rule'.[1126] This will render any tax savings in New Zealand as a shift in tax revenue to the home country and not a tax reduction to the lender.

[1126] OECD Pillar two, above n 19, at 14.

For the same reasons that underpin the AIL, dividends paid to foreign investors are not subject to any New Zealand tax over and above the underlying corporate tax paid by the company. Where investors reside in states with a tax credit system, this concession is unlikely to provide tax savings to the investor. In this case, there would not be any reason to expect increased investment. For some investors, NRWT may be a permanent cost that is unable to be offset against home country tax. Whether this results in reduced investment is uncertain. There is international evidence that there are weak links between tax costs and quantity of investment,[1127] but there is no New Zealand-based evidence so it is difficult to estimate the value of tax concessions against offsetting factors such as economic rents.[1128] However, in all cases, the loss of NRWT is a reduction to the domestic tax base and the cost of this will be borne elsewhere.

On balance, New Zealand foregoes the certainty of tax revenue for the uncertainty of increased inbound investment. With no firm evidence that tax concessions for inbound investors produce improved economic performance and improved financial and physical capital, the tax benefits are not justifiable based on production of goods and services.

8.5.5 Should New Zealand favour non-residents for economic reasons?

There simply is not enough evidence that inbound investors are so tax sensitive that they would withdraw investment or fail to provide investment if the tax impact was the same as domestic investors. Banks make extremely high profits in New Zealand and it seems unlikely the big four Australian owned banks would withdraw from New Zealand because their investors had to pay the same tax as a resident of New Zealand. Arguably, the location-specific rents outweigh tax considerations. A similar observation can be made in some of New Zealand's agricultural and horticultural industries. New Zealand's environment is unique and investors gain location-specific advantages. In the manufacturing, wholesale, and retail sectors, due to New Zealand's geographical isolation, investment is made to service the

[1127] Mooij and Ederveen, above n 548.

[1128] New Zealand's taxation framework for inbound investment 2016, above n 491.

domestic market, rather than acting as a base for international markets.[1129] For these reasons, New Zealand may not be as sensitive to tax concessions as other nations.

One of the omissions by corporate interest groups arguing for tax concessions is acknowledgement of the benefits to businesses operating in a nation with better provision of public goods and services. As Avi-Yonah points out, being able to rely upon the skills and resources available in the state reduce the cost of the inbound investment.[1130] For a multinational operating in a country with a high standard of public goods and services, many of the business costs are met by the host nation. There will be skilled staff available, a high level of infrastructure such as roading, rail, electricity etc. and potentially a wealthier domestic customer base. For banks, New Zealand's regulatory environment is a significant advantage for their own success.

Slemrod observes that GDP per capita increases with general government tax revenue as a proportion of GDP.[1131] The reason for this is unclear. However, the explanations offered include that as wealth increases, the demand for government involvement increases and, on the flip side, as government activity increases, the public services that feed affluence increase. Whatever the explanation, states with higher tax revenue are also the more affluent states overall. Slemrod's study is not isolated. Matt Grudnoff has produced a report with an international analysis of levels of taxation compared with annual GDP.[1132] There is a clear nexus between the two indicating higher level of taxes arise in wealthier nations.

While the neo-liberal economic wellbeing theory has some merit, it is unsupported by evidence. While some links have been found in international evidence between tax costs and FDI,[1133] tax concessions for inbound investors are not proven to support other indicators of

[1129] New Zealand's taxation framework for inbound investment 2016, above n 491, at 8.

[1130] Avi-Yonah, above n 141, at 1618.

[1131] Slemrod, above n 510.

[1132] Grudnoff, above n 942, at 8.

[1133] Mooij and Ederveen, above n 548.

economic wellbeing.[1134] What is certain is that these tax concessions produce regressive outcomes and a reduction in the tax base of the host nation.

8.5.6 Inequality and the preferential regime

Running through many of the objectives of the tax policy setting framework is the desire to minimise inequalities in wealth and other wellbeing outcomes such as health and education. Modern conceptions of fairness include the aim of redistribution to minimise inequalities.[1135] This underpins the inclusion of progressivity in the sub-aims of the tax policy framework. Equally, participation relies upon minimising inequality.[1136] Encouraging participation in the workforce and other areas of communal life depends upon members having the opportunity to participate – this means certain barriers need to be eliminated. Barriers usually arise through poverty, ill health, and lack of education. Redistribution and reduction of inequality can be alleviated through tax settings. Productivity may also be improved by reducing inequality.[1137] By achieving high participation rates, improving human capital and social capital, by investing in public infrastructure, the private economy has better opportunities to thrive.

Taxation as a tool for redistribution, therefore, becomes a key setting for the improvement of overall welfare and greater shared prosperity.

8.6 How should New Zealand tax its inbound investors?

Using economic participation as the basis for taxing rights, New Zealand has a right to impose taxation on inbound investors regardless of where they normally reside. This basis draws a circle around the potential tax base and includes all inbound investors.

[1134] Slemrod, above n 510; Grudnoff, above n 942; Hope and Limburg, above n 978; New Zealand's taxation framework for inbound investment 2016, above n 491.

[1135] This is discussed above at parts 3.3 and 4.2.

[1136] See discussion above at part 4.4.3.

[1137] Stiglitz, above n 572; Frieling and Warren, above n 564, at 15; See discussion above at 4.4.4.

The framework developed in chapters three and four determines how the tax burden should be allocated amongst the tax base. This framework has twin objectives of fairness and prosperity.

Contrary to the neo-liberal arguments that tax concessions will produce economic wellbeing, this thesis has highlighted the importance of minimising inequalities to improve fairness and prosperity. A lack of evidence that the neo-liberal approach leads to improved economic performance undermines the arguments for tax concessions on inbound investors. However, evidence does support the view that prosperity can be improved through tax settings that are progressive, redistribute wealth, promote equality of opportunities and develop a large and high-quality talent pool. With these objectives in mind, financial capital and knowledge developed outside New Zealand are still required. However, this does not justify preferential tax treatment of those who have that capital and knowledge that New Zealand desires. Preferential taxes, sometimes to the rate of nil, only serve to counteract the redistributive aims of government.

The principles established in the tax policy framework support neutrality and horizontal equity – all taxpayers and transactions should be treated in the same way unless pressing social or economic reasons mean another mix should be preferred. This has not been established with respect to non-residents investing into New Zealand. Neutral tax settings should therefore apply – treating inbound investors in the same way as domestic investors.

8.7 New Zealand as a case study

Chapter one describes this study as a case study of the broader issue of international tax competition and whether it benefits overall wellbeing. New Zealand is not an aggressive nation with respect to tax competition. Yet it has succumbed to this pressure and from the early 1990s onward, has established tax policy settings that provide a favourable tax environment for inbound investors. Other jurisdictions have gone much further.

This research argues that preferential tax settings for non-residents reduces fairness and prosperity, and this creates a deterioration in overall wellbeing. This is particularly so where the investor is granted tax relief in host jurisdictions and finds a home country that also provides a low or no tax environment. This deteriorates not only the welfare of the host country but also global welfare by allowing income to escape any tax imposition.

The framework developed in chapters three and four is unique to New Zealand conditions, being heavily influenced by the LSF. However, the use of multi-dimensional wellbeing frameworks is a global phenomenon and is being utilised by the OECD.[1138] For this reason, the findings of this study can be applied more widely than New Zealand alone.

Over the past several decades, the neo-liberal narrative has dominated all aspects of economic life, including tax policy. Despite the tax concessions offered in New Zealand to inbound investors, stated tax policy indicates policymakers recognise there are many factors that may operate to counteract the argument that lower taxes promote growth.[1139]

The development of multi-dimensional wellbeing frameworks, partly because of some discontent with neo-liberal economic theories, may change the direction of a state's economic and tax policies. Evidence to date does not support the neo-liberal theories that have become mainstream ideas. While we have enjoyed the prosperity of global trade and cross border investment, the point at which we provide preferential tax settings to some of our wealthiest global citizens has tipped the balance away from growth in shared prosperity and toward growth in inequality. Global trade and investment should be enabled. However, using the tax system to exacerbate market inequalities has a detrimental effect on overall wellbeing. Tax policy should be reset to treat all markets participants in the same way – regardless of their place of residence.

With the introduction of the OECD's Pillar two on the horizon, and with the changing needs of global economies as a result of the COVID-19 pandemic, the time for a change in narrative may be near. If the Pillar two proposals are acted upon, tax concessions on source-based taxation are no longer beneficial. Where taxing rights are justified based on where the economic participation takes place, then host state taxation may become more prevalent. The unsubstantiated arguments that tax concessions increase economic wellbeing will no longer be valid in a Pillar two world. These changes may serve to ensure host countries impose taxation on inbound investors to reduce inequalities and assist with the challenges nations are currently facing.

[1138] OECD "How's Life?", above n 49.

[1139] New Zealand's taxation framework for inbound investment 2016, above n 491.

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