



5 November 2009

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Dear Dr Brash

2025 TASKFORCE: INVITATION TO HAVE YOUR SAY

Thank you for your letter dated 28 September 2009 to the New Zealand Institute of Chartered Accountants (NZICA) inviting comment on what needs to be done to close the income gap with Australia.

This project is timely. Now more than ever New Zealand needs to improve its performance, as we respond to key challenges including supporting an aging population, managing the challenges of climate change, competing with other countries for a greater market share of declining international markets and managing the risks of major structural imbalances in the domestic and international economies.

NZICA has limited its comments to what the government can do to close the income gap with Australia, through its functions of regulating, taxing and spending. In essence, this means improving economic efficiency, or facilitating the supply of goods and services of most value at least cost over time.

The first section of our response will touch on a number of the orthodox but well debated initiatives the government can take to promote a relative increase in incomes. The main obstacles to these initiatives are political. The second section of our paper outlines in more detail an issue we believe is not being given adequate weight in the current debate: New Zealand losing its regulatory comparative advantage through converging to international regulatory norms.

The orthodox

There are many things the government can do to improve average living standards, including:

Stable macro-economic environment

It is well established that business needs a stable macro-economic environment within which to plan and to keep down the cost of transacting business. This will be particularly challenging in the years ahead as the government comes to grips with newly emerged fiscal pressures and an environment within which monetary transmission mechanisms appear to have altered. For the

sake of long term stability it is imperative that government comes to grips with this new environment quickly, and resist the inevitable pressure for inappropriate short term relief at the expense of New Zealand's long term interests.

Micro-economic reforms

Low hanging fruit from an economic (if not political perspective) include:

- A low, flat, and simple tax structure, properly integrated with the benefit system. Key objectives are to fund government spending in a non-distortionary way and promote incentives for greater labour force participation. NZICA is currently promoting a major initiative in this area, which we would be pleased to brief the Taskforce on;
- Effective disciplines on government to produce regulation of the highest quality. A Regulatory Responsibility Act is a good place to start. Key objectives include regulation that imposes few unnecessary costs on economic growth;
- Simplifying employment law and reducing the cost of employing (and dismissing) people. The key objectives are to reduce existing barriers to employing more staff, and reduce the harm (lost productivity/legal risk) that can be done to, in particular, small firms that have employed the wrong person;
- Reducing unnecessary barriers to research, for example, bio-technology, which has great potential to add value to New Zealand's primary sector. This is preferable to tax breaks/subsidies;
- Driving better value from government spending, for example:
 - Incentivising, developing and employing capability in the public sector better equipped to deliver on efficiency objectives. Sweden is a model worth considering;
 - Government exiting from commercial activities, through privatisation, for example;
 - Injecting greater choice and innovation into the education and health sectors, and stronger disciplines to perform, for example, allowing tertiary institutions to fail (with appropriate transitional arrangements in place) and better performance management in schools;
 - Developing more creative ways of investing, managing and funding infrastructure, for example, public private partnerships and reviewing the "Better Roads" proposals developed in the late 1990s; and
 - Co-ordinating and improving government procurement.

Caution needed in adopting international regulatory standards

New Zealand can do little about its distance from markets, the small size of its population and its endowment of natural resources. We do, however, have control of our regulatory settings and the quality of our supporting institutions. The quality of our regulations and institutions are critical to determining our economic prospects, as evidenced by numerous studies (IMF, OECD, World Bank).

Since the mid 1980s New Zealand has enjoyed a comparative advantage in the quality of its laws and institutions. This is recognised by, for example, the World Competitiveness Forum's 2009-10 Global Competitiveness Report (20th out of 133 economies), the IMD World Competitiveness Yearbook 2009 (15th out of 57 economies), the 2010 World Bank Doing Business survey (2nd out of 183 economies), and Transparency International 2008 (1st equal).

NZICA is concerned that New Zealand is at risk of surrendering this advantage, to the long term detriment of our growth relative to other countries. To a point this is inevitable. The growth of worldwide economic and other interdependencies has seen an international convergence of regulatory standards, driven by a need to, for example:

- More effectively deal with negative externalities that spill across national borders;
- Ease the cost of transacting between countries, thereby aiding the efficient flow of resources;
- Boost the regulatory standards of countries with little capacity to develop their own; and
- Achieve administrative cost savings, for example, in the cost of developing and administering policy standards.

In New Zealand it is frequently argued that departing from international regulatory norms will see overseas investors lose confidence in the quality of our regulatory environment, or simply not put in the effort to learn about our different regulatory regime. The heavier weighting being given to this pro-convergence argument can be seen in the many public comments from government in policy documents across securities and companies law, occupational regulation and even money laundering and terrorist financing regulation¹. The Joint Prime Ministerial Single Economic Market Statement (20 August 2009) signals a potentially dangerous extension of this approach². Yet the benefit, greater investment into New Zealand, is likely to be illusory:

- *Investor confidence*: In terms of the quality of its regulation and institutions, New Zealand keeps company with countries such as Australia, Canada the United Kingdom and the Scandinavian countries, not Zimbabwe or Laos, which must pay investors a significant premium for investment. And we are not seeing overseas investors asking for more regulation as a pre-requisite to investing here. Investment sites listing New Zealand as a destination for investment are more likely to identify the absence of excessive bureaucracy and red tape as a comparative advantage.
- *Learning about New Zealand*: It is reasonable to ask why overseas investors should spend time and money learning about the law in a small distant country that will never make up a significant part of a global investment portfolio. But beyond law that impacts investors directly, overseas investors will also want to know about the quality of our courts, liquidity of our markets, exchange rate risk and what drives that risk, the quality of our labour markets, the state of our infrastructure and its ability to accommodate future economic growth, for example. And then there is the quality of investment targets, ie, opportunities for expansion, quality of management, nature of competition and so on. Within this context, it is difficult to believe the marginal cost of learning about New Zealand's key regulatory settings would be significant.
- *Materiality*: Similarly, implicit within the government pro-convergence argument is the assumption that specific regulation is material to the investment decision of overseas investors. Yet within the wider context outlined above, NZICA does not view it as credible to suggest New Zealand must align, for example, its money laundering/terrorist financing regime with overseas regimes to remain attractive to

¹ NZICA would be please to furnish specific examples if the Taskforce would find this useful.

² Harmonisation is given prominence in the joint statement. The political reality is New Zealand will in most cases have to harmonise with Australia, even where their standards are inferior. While this may benefit our trans-Tasman entities (lower compliance costs), it will be harmful for the much larger population of New Zealand entities that do not operate across the Tasman. Further, harmonising to inferior standards would strip all New Zealand entities of a comparative advantage they currently enjoy over Australian entities. This, coupled with a net trans-Tasman benefit test rather than the more conventional mutual (New Zealand and Australian) net benefit tests, means harmonisation could become very detrimental to New Zealand, and more precisely, **worsen** the income gap between New Zealand and Australia.

foreign investment. If government believes specific regulatory setting might be driving investment decisions, this position should be supported by empirical evidence, ie, to broadly inform government on what regulatory settings really matter for investors. This is preferable to allowing New Zealand to surrender an existing comparative advantage on the basis of incorrect assumptions.

On the cost side, NZICA believes the “overseas investor” argument has too often been used to cloak the adoption of high cost and inefficient regulation, regulation not only inappropriate for the New Zealand market, but often for overseas markets as well. Government failure is not peculiar to New Zealand, and it is a mistake to import those failures into New Zealand.

Also, in NZICA’s view, the failures and risks of international standards setting bodies (from which an increasing proportion of New Zealand’s regulation originates) are not sufficiently recognised, let alone managed. Too often these standards setting bodies are associated with significant regulatory failure because:

- Some standards setting bodies are unrepresentative, follow poor process and lack effective accountability in the development of their standards;
- The one size fits all nature of centralised standards setting means some standards will not be optimal for some countries. This is particularly relevant for New Zealand;
- International standards are more difficult to change and can quickly become dated.³

NZICA believes there would be tremendous value in the Taskforce addressing this issue in its report to government. To protect New Zealand’s regulatory comparative advantage, we would like to see a strong statement to the effect that:

- a. New Zealand should aim for regulatory settings that as a minimum are as good as those found in comparable countries, but ideally are better, thereby securing New Zealand a comparative advantage;
- b. New Zealand regulatory reform should never be driven by regulatory convergence as an ends in itself, better regulation is instead the key;
- c. The best way to attract overseas investment is to target regulation to problems that exist in New Zealand and provide solutions that are appropriate and proportionate to New Zealand circumstances;
- d. These messages be incorporated into guidance material for policy advisors; and
- e. The government undertake research as a matter of urgency on both:
 - i. what broad regulatory settings attract investment to New Zealand; and
 - ii. what regulatory settings (including absence of regulation) is discouraging investment.

³ NZICA, with its Global Alliance Partners, is working on a major project to address the problem of sub-standard performance by international standard setting bodies. Examples of international standards setting bodies include the FATF, IOSCO, IAIS etc – although no comment is offered on the quality of these bodies at this stage.

NZICA would be pleased to elaborate on any of the points raised above.

Yours sincerely

A handwritten signature in black ink, appearing to read "David Pickens", followed by a comma.

David Pickens
DIRECTOR – GOVERNMENT AND INTERNATIONAL RELATIONS