

**Unclassified**

**ECO/WKP(2011)49**

Organisation de Coopération et de Développement Économiques  
Organisation for Economic Co-operation and Development

**13-Jul-2011**

**English - Or. English**

**ECONOMICS DEPARTMENT**

ECO/WKP(2011)49  
Unclassified

**HOW TO MOVE PRODUCT MARKET REGULATION IN NEW ZEALAND BACK TOWARDS THE FRONTIER**

**ECONOMICS DEPARTMENT WORKING PAPER No. 880**

**By Paul Conway**

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**JT03305194**

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## ABSTRACT/RÉSUMÉ

### **How to move product market regulation in New Zealand back towards the frontier**

From the mid-1980s, New Zealand was widely considered to be a leader in liberalising product market regulation (PMR). However, the reform of PMR has lost momentum over recent years. Many areas of PMR are still consistent with best practice, but New Zealand is no longer assessed to be at the forefront of regulatory policy making. Although economic geography clearly offers a partial explanation for the relative underperformance of the NZ economy, restrictive policies in some areas are also likely to be constraining growth in GDP per capita. Indeed, it is likely that being small and distant exacerbates the negative impact of restrictive product market policies on New Zealand's economic performance. This implies a genuine need to shift the regulatory framework back towards the OECD frontier. Ongoing improvements in regulatory governance, minimising the government's influence in competitive markets and lowering barriers to trade and FDI, including ongoing policy harmonisation and mutual recognition with trading partners where appropriate, would all help in this regard. This Working Paper relates to the *2011 Economic Survey of New Zealand* ([www.oecd.org/eco/surveys/NewZealand](http://www.oecd.org/eco/surveys/NewZealand)).

*JEL classification codes:* D04, D24, K20, K23, L11, L22, L25, L43, L5

*Keywords:* New Zealand; Product market regulation; indicators; reforms; institutions; productivity

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### **Replacer la réglementation des marchés de produits en Nouvelle-Zélande à la pointe des pays de l'OCDE**

Depuis le milieu des années 80, la Nouvelle-Zélande a été considérée comme le leader dans la libéralisation de la réglementation des marchés de produits (RMP). Cependant, la réforme des RMP s'est essouffée au cours de ces dernières années. Dans nombre de domaines, les PMR sont encore en phase avec les meilleures pratiques mais la Nouvelle-Zélande n'est plus considérée comme étant à l'avant-garde de la politique de réglementation. Certes, la géographie économique explique en partie la relative sous-performance de l'économie néo-zélandaise, mais des politiques restrictives dans certains domaines sont susceptibles de brider la croissance du PIB par habitant. Le fait d'être un petit pays excentré aggrave probablement l'impact négatif d'une réglementation restrictive des marchés de produits sur la performance économique néo-zélandaise. La Nouvelle-Zélande a donc le plus grand besoin de ramener son cadre réglementaire vers la frontière des pays de l'OCDE. Continuer d'améliorer la gouvernance de la réglementation, réduire autant que possible l'influence de l'État sur les marchés concurrentiels et abaisser les obstacles aux échanges et à l'IDE, notamment par une plus grande harmonisation des politiques et, le cas échéant, par des accords de reconnaissance mutuelle avec les partenaires commerciaux sont autant d'actions qui seraient utiles à cet égard. Ce document se rapporte à l'*Étude économique de l'OCDE de la Nouvelle-Zélande 2011* ([www.oecd.org/eco/etudes/Nouvelle-Zélande](http://www.oecd.org/eco/etudes/Nouvelle-Zélande)).

*Classification JEL:* D04, D24, K20, K23, L11, L22, L25, L43, L5

*Mots-clés:* Nouvelle-Zélande ; réglementation des marchés de produits ; indicateurs ; réformes ; institutions ; productivité

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## How to move Product Market Regulation in New Zealand back towards the frontier

Paul Conway<sup>1</sup>

### 1. Introduction

This paper asks whether New Zealand's regulatory framework is making the best possible contribution to economic growth. Over the last 25 years, GDP per capita growth rates have been insufficient to close the gap with other OECD countries, particularly Australia. Real business investment has been relatively modest in international comparison, and the efficiency with which productive resources are combined to produce output has underperformed. Although many regulatory areas are consistent with OECD best practice, persistently low productivity and GDP per capita suggest that policy and institutional settings could be doing more to enhance New Zealand's economic performance.

Having the most unhelpful economic geography of any OECD country is one important reason for New Zealand's poor long-run economic performance. Although empirical work on New Zealand's industrial structure is sparse, it is likely that its product markets are relatively concentrated and that a large proportion of firms produce at less than minimum efficient scale. These twin disadvantages arise largely as a result of a relatively small domestic economy and geographic isolation that reduces the effective size of international markets. In an age when scale economies are increasingly important and agglomeration is a key driver of productivity growth, these features of the NZ economy entail significant economic cost.

But economic geography is by no means the whole story. The OECD Indicators of Product Market Regulation (PMR), which are used as a basis for discussion throughout this paper, show that product market reform has lost momentum in New Zealand, while most other OECD countries have continued improving their regulatory environments.<sup>2</sup> As a result, New Zealand is no longer at the forefront of regulatory policymaking but is about average in the OECD. Its regulatory regime also suffers from a

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1. Paul Conway is currently Director of Research & Analysis at the New Zealand Productivity Commission. Email: Paul.CONWAY@productivity.govt.nz. He has previously worked in the Economics Department of the OECD. Peter Jarrett, Head of Division, supervised this work. Invaluable comments from the New Zealand Desk at the OECD – Alexandra Bibbee and Calista Cheung – are gratefully acknowledged. Francoise Correia provided statistical support, while Mee-Lan Frank provided editorial assistance. Suggestions from Andrew Dean and Robert Ford were especially helpful. Comments from officials at the New Zealand Treasury are also gratefully acknowledged.
  2. The OECD's PMR indicators have been used to illustrate broad differences in product market policies in both member and non-member countries since the late 1990s. The indicators summarise a large set of formal rules and regulations that have the potential to reduce the intensity of competition in areas of the product market where technology and market conditions make competition viable. Key papers outlining the development of the PMR indicators are: Nicoletti *et al.* (1999), Conway *et al.* (2005), Conway and Nicoletti (2006) and Wölfl *et al.* (2009).

certain degree of uncertainty and inconsistency in the extent to which competitive forces are able to operate across different policy domains. The regulatory framework has also diverged to some extent from those of major trading partners, implying mounting fixed costs for domestic firms wishing to expand into offshore markets and for multinationals wishing to operate in New Zealand. These types of regulatory barriers to competition exacerbate the impact of geographic isolation on New Zealand's "smallness" and are consequently more harmful than they might be in larger and better connected economies.

Given New Zealand's exogenous disadvantages, the regulatory environment needs to be highly conducive to new entry and competition to help mitigate the impact of economic geography on performance. If the threat of competition is credible, incumbent firms will perceive that pricing above competitive levels will attract entry and therefore refrain from anti-competitive behaviour and work to improve productivity so as to minimise costs and enhance profitability. The number of competitors is only one determinant of market performance, and the regulatory environment needs to ensure that other determinants – such as barriers to entry – are highly supportive of productivity growth. In addition, with large companies necessarily dependent on exports, the regulatory framework also needs to emphasise the minimisation of barriers to international trade and investment.

Ongoing improvements in regulatory governance to enhance the government's capacity to consistently produce high-quality regulation and an accelerated programme of reforms are needed if New Zealand is to begin the process of closing the productivity and income gaps with more advanced OECD economies. Regulatory improvements that stimulate competition and thereby improve economic efficiency can hasten catch up towards the world production possibilities frontier. As such, the government's current focus on "better regulation" as one of its six drivers of an enhanced economic performance is welcome and needs to be deepened and broadened.

As well as highlighting the need for an exceptionally good regulatory environment, New Zealand's economic geography also implies a number of nuances in regulatory enforcement. All else equal, effectively regulating a small and remote economy is relatively difficult and requires more subjective judgements than in larger economies where competition is likely to be more robust for a given regulatory stance. As such, New Zealand's regulatory institutions must be well resourced and staffed by highly skilled individuals with detailed industry knowledge. Also, given the goal of a trans-Tasman Single Economic Market, on-going improvements in regulatory harmonisation, mutual recognition and institutional co-operation between New Zealand and Australia would improve competitiveness by lowering spatial transactions costs as well as allowing for greater economies of scale in carrying out increasingly complex regulatory functions.

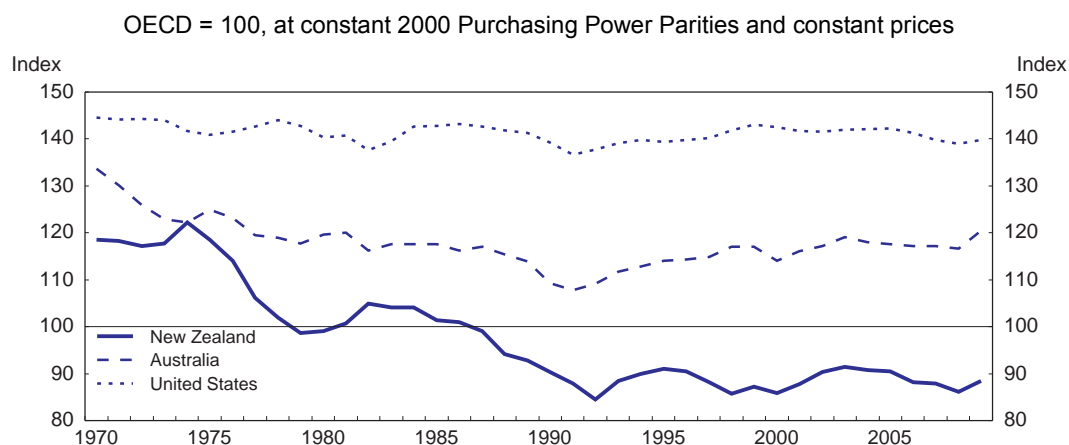
Against this background, Section 2 goes on to outline broad long-run trends in New Zealand's productivity performance. In Section 3, the implications of economic geography for scale economies and competition in New Zealand markets are briefly outlined, along with the broad policy challenges inherent in mitigating the disadvantages of small size and large distance. Section 4 uses the PMR indicators to briefly outline New Zealand's regulatory history and some of the distinctive features of the current framework. Finally, Section 5 takes a detailed look at current policy settings and makes a number of suggestions that would help move New Zealand's regulatory framework back towards the OECD frontier.

## **2. New Zealand's long-run productivity performance continues to disappoint**

Living standards in New Zealand, as measured by GDP per capita, have been well below the OECD average since the late 1980s (Figure 1). In 2008, New Zealand's GDP per capita ranked 23<sup>rd</sup> in the OECD and about 50% below that of the United States, 30% below that of Australia and 13% below the OECD average. This has not always been the case – in the first half of the 1970s, New Zealand's real GDP per

capita was only 18% lower than in the United States, approximately equal to Australia's and about 15% above the OECD average.

Figure 1. Real GDP per person<sup>1</sup>



1. GDP per capita has been calculated in USD at constant prices and constant PPPs.

Source: OECD National Accounts database.

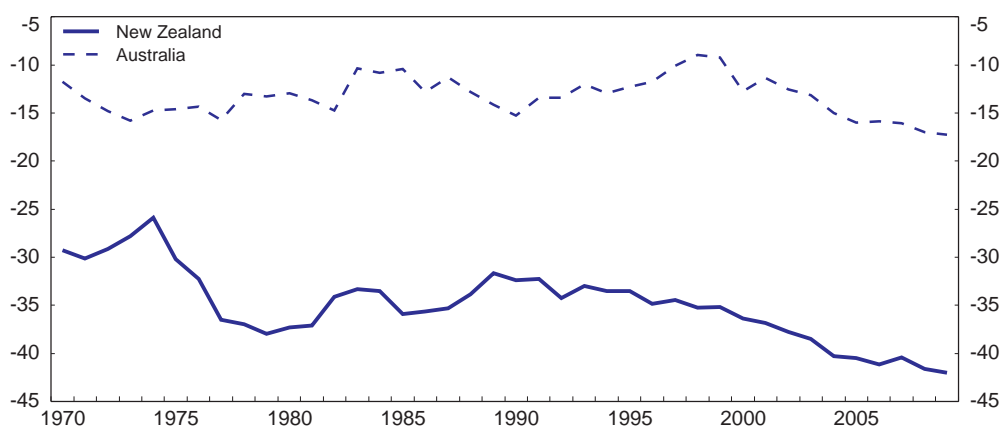
Virtually the entire decline in New Zealand's GDP per capita relative to the OECD average occurred from the mid-1970s to the late 1980s. In large part, this reflected the negative impact of extremely restrictive regulatory settings that reduced New Zealand's economic resilience in the face of changing circumstances. In particular, dramatic terms-of-trade shocks over this period, coupled with generally unsustainable monetary and fiscal policies, had a severe negative impact on New Zealand's economic performance. From the early 1990s, reflecting the beneficial effects of economic reforms in the late 1980s to early 1990s, New Zealand's economic performance improved and GDP per capita has since broadly stabilised *vis-à-vis* the OECD average. However, the gap in living standards relative to Australia has continued to widen, reflecting an above-average growth performance in New Zealand's trans-Tasman neighbour.

Comparatively low GDP per capita in New Zealand overwhelmingly reflects poor performance in labour productivity, which has suffered a long slow decline *vis-à-vis* the United States and the OECD average for a number of decades (Figure 2). In 2008, hourly labour productivity is estimated to have been in the lower third of OECD countries and broadly comparable to that in Greece (prior to the sovereign debt crisis) and the Slovak Republic (Figure 3). This equates to a labour productivity level that is 45% below that in the United States, 30% lower than in Australia and over 25% lower than in the average OECD country. In comparison, with relatively high employment and low unemployment, labour utilisation makes a positive contribution to New Zealand's gap in GDP per capita *vis-à-vis* other OECD countries.

Given data limitations, it is not entirely clear whether this persistently poor labour productivity performance predominantly reflects weak growth in investment or in multifactor productivity (MFP). At first glance, total investment as a share of GDP has tracked near or above the OECD median since 1990 (Figure 4, Panel A). Moreover, the share of ICT in total investment, a key driver of recent growth in a number of OECD countries, has been strong in international comparison (Figure 5). However, housing investment has been relatively robust over this period, and thus the GDP share of non-residential investment has typically been in the lower half of OECD countries (Figure 4, Panels C and D), consistent with a low level of capital intensity per worker (OECD, 2009a). A range of indicators – such as a

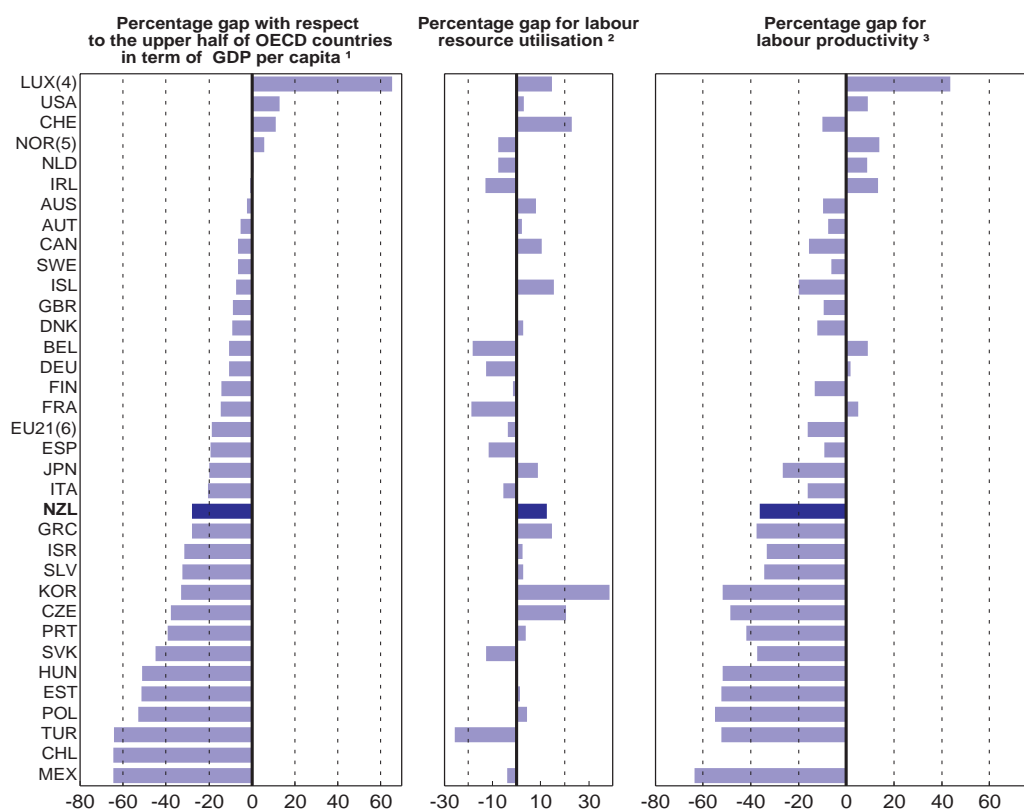
Figure 2. **Gap in labour productivity vis-à-vis the United States**

At constant 2000 purchasing power parities; USA = 100



Source: OECD National Accounts database and OECD.stat, productivity database.

Figure 3. **The source of real income differences, 2009**



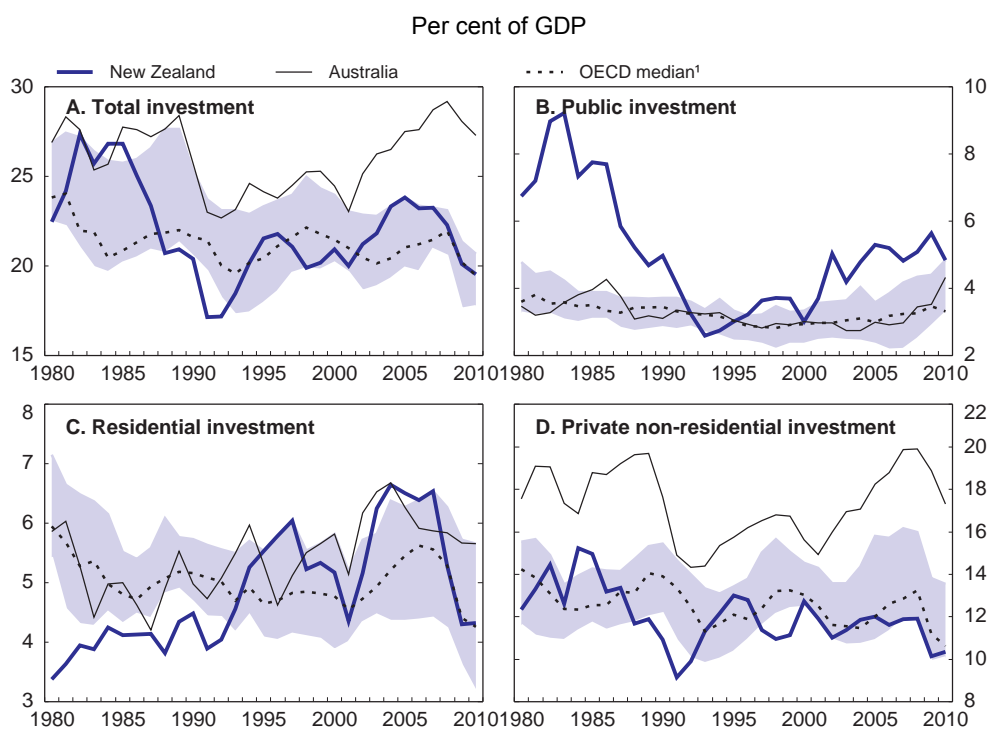
Note: The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

1. Relative to the simple average of the 17 highest OECD countries in terms of GDP per capita, based on 2009 PPPs.
2. Labour resource utilisation is measured as total number of hours worked divided by population.
3. Labour productivity is measured as GDP per hour worked.
4. For Luxembourg, the population is augmented by the number of cross-border workers.
5. Data refer to GDP mainland Norway which excludes petroleum production and shipping.
6. EU21 is EU15 plus Czech Republic, Estonia, Hungary, Poland, the Slovak Republic and Slovenia.

Source: OECD (2011).



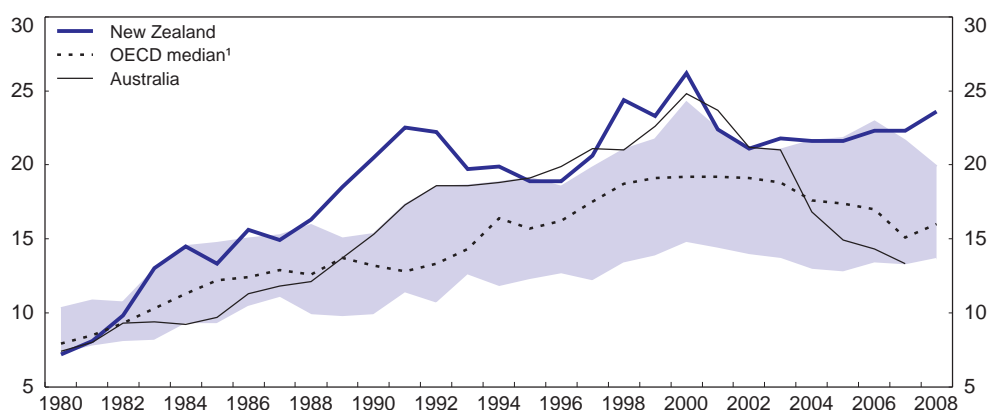
Figure 4. Investment rate



1. The shaded area is the OECD range of 25th to 75th percentile. Half of the countries lie inside this range.

Source: OECD Economic Outlook 88 database.

Figure 5. ICT investment as a share of total economy non-residential investment



1. The shaded area is the 25<sup>th</sup> to 75<sup>th</sup> percentile range (covering half the countries) of 21 available OECD countries.

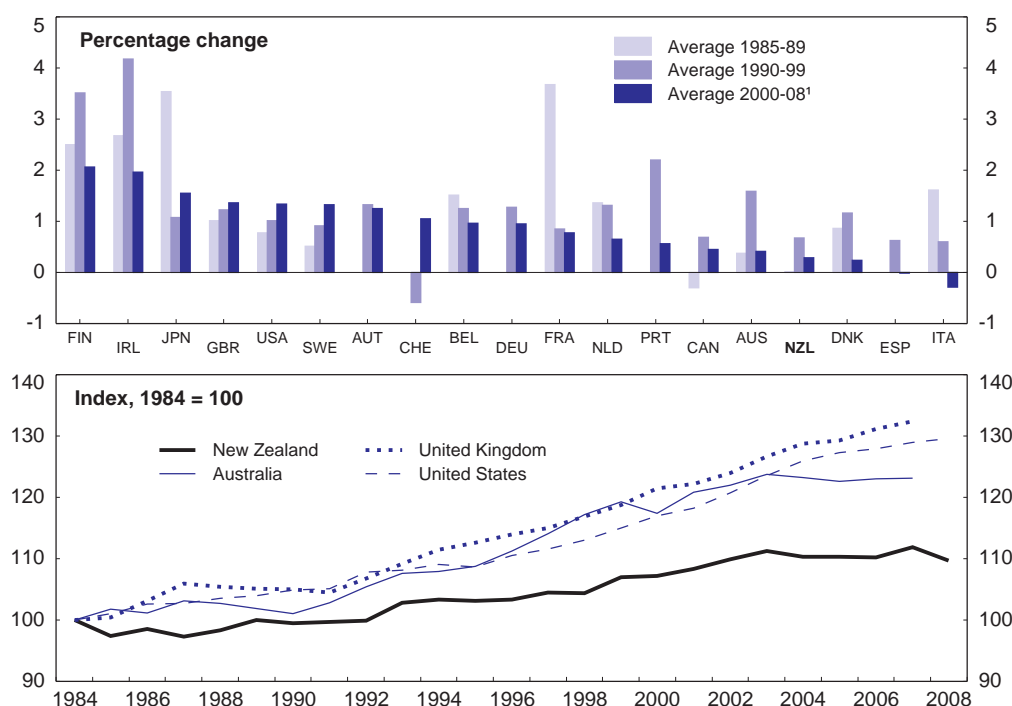
Source: OECD Factbook 2010.

pronounced slowdown in government investment around the beginning of the 1990s – suggest that infrastructure investment, often found to have a disproportionately positive impact on economic

performance, has also been low in New Zealand.<sup>3</sup> In addition, some older survey evidence suggests that the quality of New Zealand’s infrastructure was generally considered to be relatively poor (Grimes, 2003). In recent years, however, the government and local authorities have significantly increased infrastructure expenditure (Figure 4, Panel B) (New Zealand Government, 2010).

As well as a questionable contribution from capital deepening, New Zealand’s poor labour productivity performance also reflects slow growth in MFP. Although there is evidence of a structural improvement around 1993 (Black, Guy and McLellan, 2003), MFP growth has consistently been at the lower end of the range of outcomes of countries for which data are available (Figure 6). In particular, MFP growth in New Zealand did not experience the strong surge seen in Australia over the 1990s and in the United States more recently.

Figure 6. Multifactor productivity outcomes



1. Or latest available year.

Source: OECD.stat, productivity database.

Other than communications and finance and insurance – two sectors that are likely to have benefited from high rates of ICT investment – and agriculture, forestry and fishing, this poor MFP growth performance is reasonably broadly based. Rapid labour productivity growth in the electricity, gas and water sector over the 1990s reflected high investment levels, while MFP growth was more subdued before turning negative after 2000 (Table 1). In the transport and storage sector, MFP growth also collapsed in the 2000s after a solid performance in the previous two decades. In the manufacturing sector, which makes

3. For instance, Romp and de Haan (2005) report that 32 out of 39 studies of OECD countries find a positive effect of infrastructure investment on some combination of output, efficiency, productivity, private investment and employment.

the largest contribution to GDP growth (Warmke *et al.*, 2010), relatively mediocre labour productivity growth up until 2000 was driven by both MFP growth and capital deepening.

Table 1. **Labour productivity, MFP and capital deepening by sector**

	Average labour productivity growth			Average MFP growth			Average rate of capital deepening		
	1980-89	1990-99	2000-08	1980-89	1990-99	2000-08	1980-89	1990-99	2000-08
<b>Aggregate (measured sector)</b>	<b>2.32</b>	<b>2.44</b>	<b>1.58</b>	<b>0.81</b>	<b>1.59</b>	<b>0.90</b>	<b>1.49</b>	<b>0.80</b>	<b>0.72</b>
Agriculture, forestry and fishing	6.44	4.15	1.58	5.60	2.79	1.70	0.81	1.31	0.88
Mining	4.10	6.41	-3.83	-0.28	3.11	-2.49	4.41	3.20	-1.36
Manufacturing	2.42	1.46	1.32	0.64	0.51	0.66	1.78	0.94	0.65
Electricity, gas and water supply	3.76	8.30	0.80	2.09	1.19	-1.73	1.64	7.01	2.57
Construction	1.91	-0.22	0.12	1.72	-1.15	-0.33	0.20	0.93	0.46
Wholesale trade	0.02	0.20	2.24	-1.40	0.55	1.75	1.45	0.93	0.46
Retail trade	1.08	1.10	3.04	-1.89	0.76	1.98	0.85	0.33	1.02
Accommodation, cafes and restaurants	-2.65	-1.34	-0.16	-2.94	-1.06	-0.96	0.29	-0.26	0.81
Transport and storage	3.96	5.80	0.77	4.20	5.76	0.13	-0.23	0.03	0.65
Communications services	7.28	13.45	7.79	2.85	6.95	6.10	4.32	6.07	1.77
Finance and insurance	1.18	4.93	3.98	-1.74	3.31	2.01	2.97	1.56	1.94

Source: Statistics New Zealand and OECD.

### 3. The regulatory framework needs to be top notch

#### *New Zealand faces inherent disadvantages*

New Zealand's small domestic market, coupled with its geographic remoteness, reduces the potential for exploiting scale economies and specialisation. This is apparent in some aspects of its firm demography. Although the proportion of small firms operating in New Zealand is not too far out of line with some other OECD countries, its largest firms are relatively small in international comparison (Mills and Timmins, 2004).<sup>4</sup> For example, only around one quarter of employment is in firms with 500+ employees, whereas over half of employment in the United States and the United Kingdom is in firms in this size class.

Notwithstanding difficulties inherent in identifying the impact of scale on productivity growth, New Zealand's firm demographics have been linked to significant diseconomies of scale (Arnold *et al.*, 2003). For example, the ratio of total economic cost to total revenue and the amount of capital per unit of output are both found to be markedly higher in New Zealand than in several other OECD countries.<sup>5</sup> This is particularly the case in the network sectors, given that New Zealand's small population limits the scope for network externalities, thereby increasing required capital intensity compared to larger countries. Using an index-number approach, Fox (2005) finds that returns to scale play a much larger role than technical progress in explaining New Zealand's productivity performance, also suggesting that a lack of scale may be restraining productivity growth.

As well as reducing the potential for scale effects, the small size of the NZ economy may also reduce the potential for competition to encourage improvements in firm performance. Very little work has been done on New Zealand's industrial structure. However, available evidence suggests that although

4. In contrast to the results of Mills and Timmins (2004), Simmons (2004) finds that New Zealand does have an unusually large number of small firms compared to some other OECD countries.

5. As pointed out in Arnold *et al.* (2003), these results reflect some combination of scale diseconomies and low productivity.

competition may have increased as a result of economic reform, product markets still tend to be more concentrated than in some other OECD countries, despite the relative lack of large domestic firms (Ratnayake, 1999; Arnold *et al.*, 2003). There is also evidence that, as measured by value added, large firms do not perform particularly well in international comparison (Treasury, 2008b). Among other things, this suggests that competitive pressures may be limited in the markets in which they operate.

These key economic characteristics imply a tension between market concentration and firms' ability to produce at an optimum scale. International trade is the most obvious means of resolving this tension – imports increase effective competition in concentrated domestic markets, while exports allow national firms to exploit increasing returns to scale and specialisation without adversely affecting competition. However, in the case of New Zealand, which is the most remote economy in the OECD, relatively high spatial transaction costs act as a barrier and reduce the potential for trade to overcome the disadvantages of smallness. In addition, it is more difficult for potential exporters to develop an understanding of destination markets, given that they tend to be relatively small firms at an earlier stage of development than exporting firms based in larger economies.

The estimated economic impact of remoteness on the New Zealand economy is far from negligible. In a recent comprehensive study the OECD found that reduced market access relative to the OECD average cost as much as 10% of GDP per capita (Boulhol *et al.*, 2008). As has been found to be the case in Australia (Dolman *et al.*, 2007; Davis and Rahman, 2006), aspects of New Zealand's internal geography may also hamper economic performance. For example, its sparse population, small cities and long distances between urban centres may also constrain productivity growth by limiting competitive pressures and the opportunities for specialisation and scale (McCann, 2009).

### ***Good policy can help New Zealand overcome its exogenous disadvantages***

Although economic geography clearly plays a key role, it is by no means the only cause of New Zealand's mediocre long-run productivity performance. Australia provides a useful counter-example. Australia's economic geography also implies reduced access to world markets that is estimated to cost as much as in New Zealand – around 10% of GDP per capita (Boulhol *et al.*, 2008). Yet Australia has the eighth highest level of GDP per capita in the OECD, has been the OECD country least affected by the global recession and is one of the fastest growing developed economies in the world. Australia's larger domestic markets and cities imply greater scope for scale economies than in New Zealand, and it has benefited from a recent boom in natural resource exports. Yet, good policies and institutional settings are widely credited as being of key importance in driving its exceptional economic performance (*e.g.* OECD, 2010a). Conversely, Mexico sits on the doorstep of the largest market in the OECD but performs poorly, reflecting regulatory settings that stifle competition, among other things (OECD, 2009b).

Although the synthesis of economic geography and regulatory economics is currently too little studied, it is apparent that good policies can mitigate some of the impact of unfavourable economic geography. The beneficial impact of liberal product market policies works through a number of different channels (Box 1). In general, regulatory settings that encourage competition have been found to spur technological diffusion and hasten catch up towards the productivity frontier (Conway *et al.*, 2006). From this perspective, New Zealand's large productivity gap suggests considerable "bang for the buck" from reforms *via* more rapid convergence. From an economic-geography perspective, regulatory improvements that foster competition have been found to increase trade and foreign direct investment (Nicoletti *et al.*, 2003), implying that good policy can counter-balance the negative impact of size and distance. In a direct test of the interaction between product market policies and the forces of economic geography, Nordås and Kox (2009) estimate a gravity model across 25 OECD countries (including New Zealand) and find that liberal regulatory settings and greater policy harmonisation across countries mitigate the impact of distance on trade and FDI. Conversely, these authors also find that overly strict

regulation in some sectors amplifies the disadvantages of remoteness. With scale economies and agglomeration effects becoming increasingly important in the current era of globalisation, it is likely that poor regulatory settings have a more harmful impact on the economic performance of small and distant countries such as New Zealand.

The NZ government is well aware of the need for an outstanding regulatory system to overcome the economic costs of size and distance and has made improving the quality of regulation a priority. Although it is unlikely that potential regulatory improvements will be able to fully offset the impact of New Zealand's economic geography, economic theory and experience suggest that they can make a considerable difference. As well as emphasising the importance of ongoing improvements in regulatory institutions and governance, New Zealand's economic geography also implies a number of important nuances in the design and enforcement of product market policies, discussed in more detail below.

#### Box 1. The cost of regulatory impediments to competition

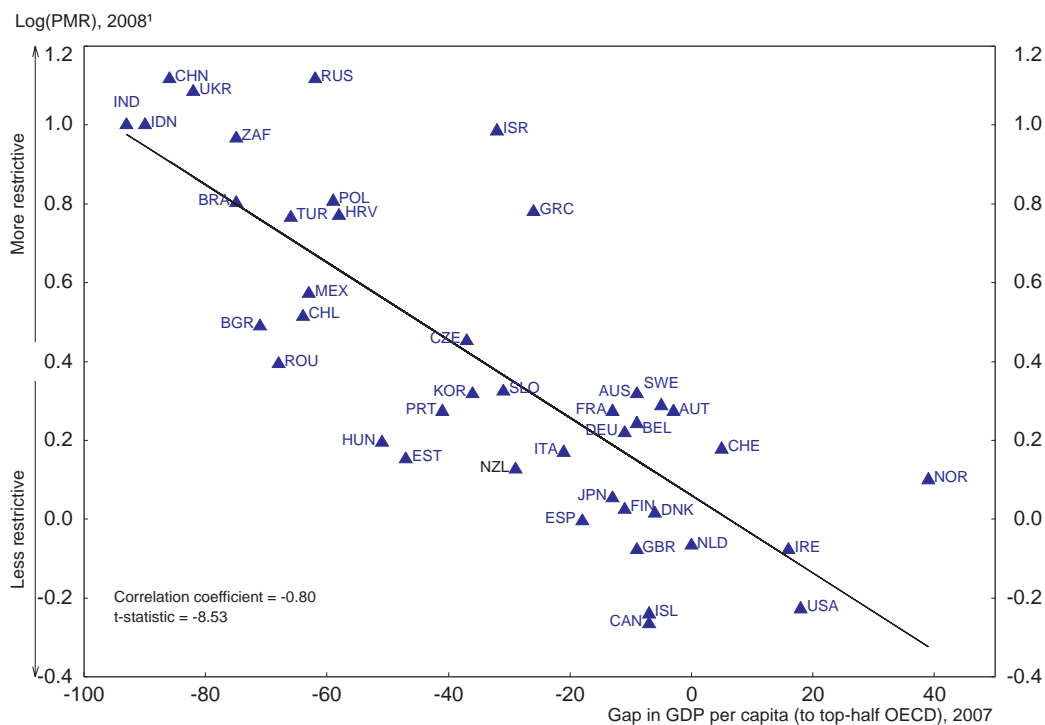
It is now well established that the extent to which regulation is conducive to competition has an important impact on economic performance. *Prima facie* evidence suggests that regulations that encourage competition are consistent with higher average income across a range of developed and developing countries (Figure 7). A large number of recent theoretical and empirical papers generally confirm that the extent to which PMR supports competition has a significant impact on GDP per capita across countries.

This significant link between PMR and economic performance may reflect a number of potential mechanisms. Broadly speaking, promoting competition by lowering (domestic and border) barriers to entry and levelling the playing field for different firm types encourages capital to move from low to high productivity firms and sectors, thereby improving resource allocation. The beneficial impact of reform may depend on the distance of given firms or sectors from the world technological frontier. For firms operating at the frontier, a competitive regulatory environment has been found to foster innovation-based productivity growth (Acemoglu *et al.*, 2005). For firms some distance behind the frontier, an increased entry threat from more productive firms may result in a "discouragement effect" that *reduces* innovation. At the sectoral and economy levels, however, the impact of increased competition on innovation and aggregate productivity is unambiguously positive as weaker incumbents shrink or close and more productive incumbents and new firms innovate (Aghion and Bessonova, 2006). This is particularly relevant to New Zealand where the sizable productivity gap *vis-à-vis* high-income OECD countries implies considerable scope for technological catch up.

Enhanced product market competition can also contribute to GDP per capita growth by increasing employment (Blanchard and Giavazzi, 2003; Haefke and Edell, 2004; Nicoletti and Scarpetta, 2005). This can occur through a number of different mechanisms including new firm entry and changes in real wages (Blanchard and Giavazzi, 2003; Nicoletti and Scarpetta, 2005; Bassanini and Duval, 2006). However, employment in some large firms, particularly in the network sectors, where previous regulations were conducive to over-manning, may be adversely affected by deregulation. In addition, although the effects of product market reform on capital formation are ambiguous in theory, empirical studies have found that regulatory reforms, especially those that liberalise entry, are likely to spur fixed investment in some industries (Alesina *et al.*, 2005).

Box 1. The cost of regulatory impediments to competition (cont'd)

Figure 7. Product market regulation and GDP per capita<sup>1</sup>



1. Based on a "simplified" PMR indicator. PMR measured in 1998 for OECD countries; 2008 for Brazil and China; 2007 for Croatia, Indonesia, South Africa and Ukraine; 2006 for Bulgaria, India and Romania.

Source: OECD.stat, Market regulation database and World Bank, World Development Indicators.

#### 4. New Zealand's regulatory advantage has been eroded away

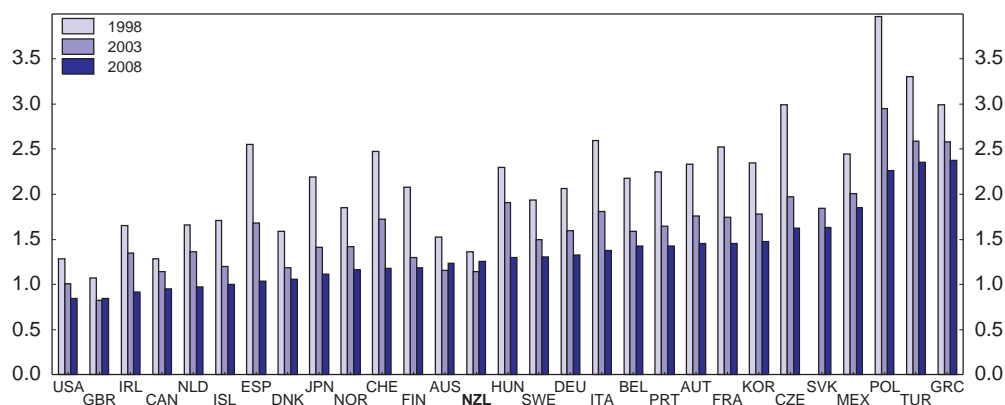
Up until the mid-1980s, the New Zealand economy was characterised by extensive regulatory controls and heavy involvement of local and central government enterprises across a broad range of sectors. The government controlled a large portion of economic activity through regulation and state ownership, often under the protection of statutory monopolies. That all changed from the mid-1980s when dissatisfaction with the systematic underperformance of the economy prompted the government of the time to embark on a period of comprehensive economic reform.<sup>6</sup> A raft of changes was introduced to reduce the government's influence in the business sector and strengthen the role of market competition in resource allocation and price determination.

By the end of the 1990s, New Zealand was considered to be a leader in implementing far reaching liberalisation across the economy. According to the PMR indicators, New Zealand at this time was one of a small group of countries in which regulatory restrictions on competition were significantly lower than average across OECD countries (Figure 8). From the late 1990s to 2003, the regulatory environment was

6. This period in New Zealand's economic history has been extensively documented. Among others, see: Silverstone *et al.* (1996), Evans *et al.* (1996) and Dalziel and Lattimore (1999).

further improved at a rate slightly below that in other well regulated OECD countries, but New Zealand broadly maintained its high ranking.

Figure 8. **Economy-wide product market regulation, 1998-2008<sup>1</sup>**



1. Index scale of 0-6 from least to most restrictive.

Source: OECD, OECD.stat – Market regulation database.

In more recent years, the intensity of New Zealand's reform effort has fallen and, as detailed below, some policy changes have made the regulatory environment slightly *less* conducive to competition. This may reflect a surprisingly prolonged period of "reform fatigue" after the sometimes tumultuous reforms of the late 1980s and early 1990s and a view that those reforms should have been sufficient to move New Zealand's regulatory structure to some ideal state. However, the OECD experience over the last couple of decades has been that effective regulatory management is a dynamic process, as opposed to a one-off set of interventions, implying an ongoing need for reform (Malyshev, 2006). At the same time, most other OECD countries have continued reforming, with the net effect that New Zealand is no longer at the forefront of product market regulation but, instead, around average (Figure 9).<sup>7</sup>

### ***New Zealand's approach to competition lacks consistency***

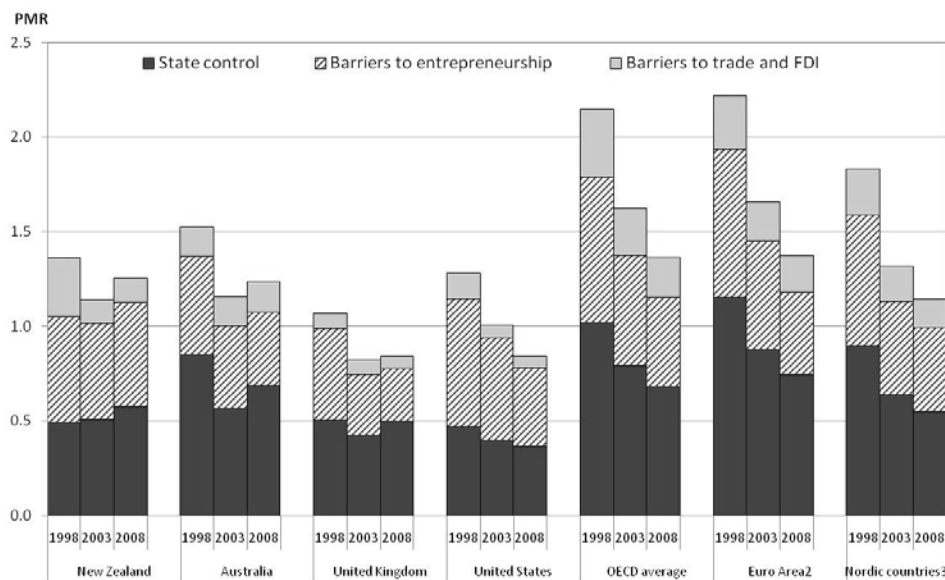
As well as having a regulatory environment around average in the OECD in terms of fostering competition, New Zealand's regime is also characterised by a significant degree of inconsistency in the extent to which policy settings are supportive of competition. By way of example, although tariffs are among the lowest in the world, barriers to FDI are assessed to be relatively restrictive in international comparison. As a general measure of policy inconsistency economy wide, the variance of New Zealand's low-level PMR indicators has recently moved up from 1.35 to 2.25, fourth highest in the OECD and well above the mean value of 1.72 (Table 2). Across the network sectors, differences in the extent to which policy settings encourage competition in New Zealand are the highest in the OECD, and much higher than would be expected given the overall stance of regulation (Figure 10, Panel A).<sup>8</sup> This implies that New Zealand's regulatory framework does not "hang together" as well as it could in that there are marked differences in the extent to which policies in different areas support competition. Although many aspects of

7. In an analysis of changes in PMR indicator values, Wölfel *et al.* (2009) confirm that New Zealand is one of a few OECD countries in which the change in product market regulation in the ten years to 2008 is statistically insignificant.

8. Conway *et al.* (2005) find that policy inconsistency tends to increase as the regulatory environment becomes more restrictive across countries.

the regulatory framework are conducive to competition, barriers exist across a range of other areas, including accident insurance, the dairy industry, kiwifruit exporting and pharmacy ownership.

Figure 9. The overall PMR indicator and main sub-indicators



1. Index scale of 0-6 from least to most restrictive.
2. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovakia, Spain.
3. Denmark, Norway, Sweden, Finland, Iceland.

Source: OECD, OECD.stat – Market regulation database.

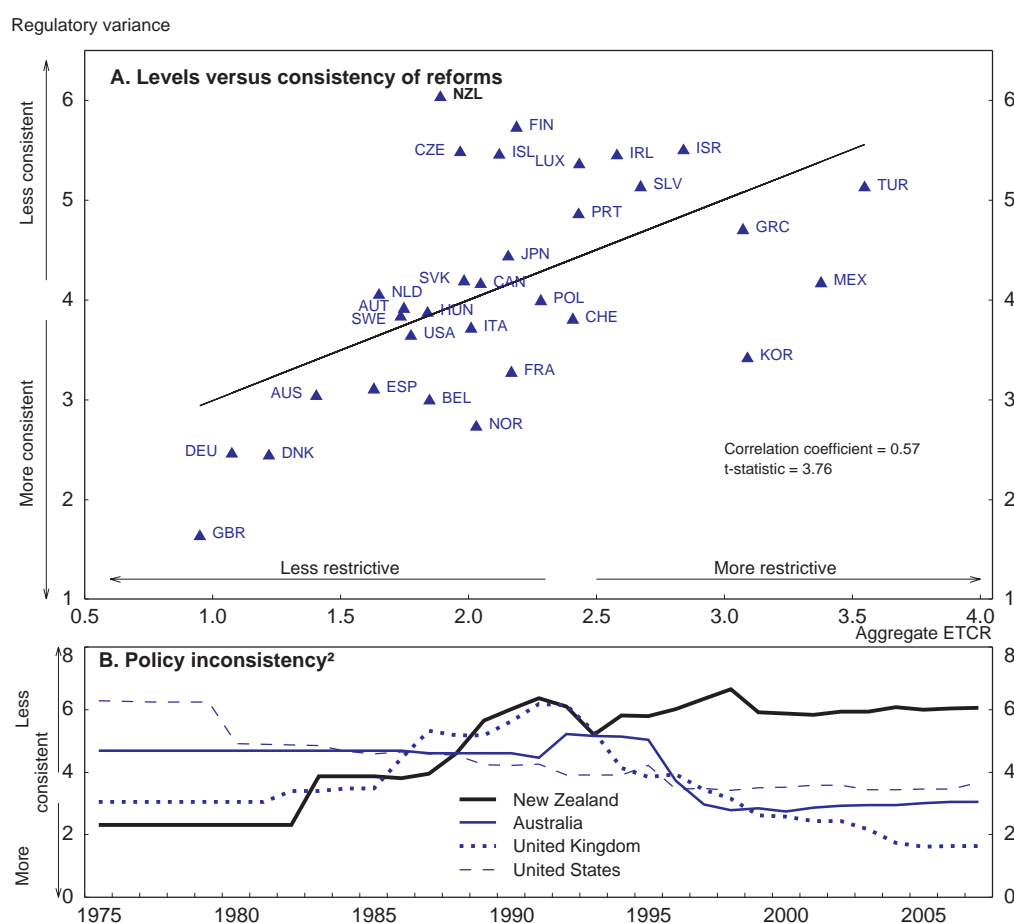
While most other OECD countries have been focusing reform efforts on problem areas and thereby improving the coherence of their regulatory frameworks with respect to encouraging competition, policy inconsistency has been escalating in New Zealand. For example, while barriers to entry in network sectors have been reduced in virtually all OECD countries, New Zealand has concurrently increased the extent of public ownership in some of its network sectors. Although policy inconsistency typically increases at the beginning of reform programmes, this should subsequently reverse as reforms become entrenched and applied more uniformly across the board. In contrast to a number of comparator countries, this period of regulatory consolidation has yet to occur in New Zealand, indicating an unfinished reform agenda (Figure 10, Panel B). Given complementarities across different policy domains, this implies a danger that the potential benefits of product market reforms in some areas may be reduced in view of ongoing and increasing restrictions in others.



Table 2. Within-country variance of low-level PMR indicators, 1998 to 2008

	Australia	Austria	Belgium	Canada	Czech Republic	Denmark	Finland	France	Germany	Greece
1998	1.15	2.90	2.87	0.78	2.29	2.17	1.83	2.83	1.69	3.20
2003	1.30	2.51	1.80	1.00	1.70	1.37	1.46	2.05	1.29	2.35
2008	1.45	1.80	1.55	1.21	1.46	1.06	1.36	2.02	1.61	2.16
	Hungary	Iceland	Ireland	Italy	Japan	Korea	Luxembourg	Mexico	Netherlands	New Zealand
1998	2.84	1.88	2.94	4.01	2.78	2.49	--	1.87	1.40	<b>1.40</b>
2003	2.22	2.12	2.26	2.03	1.86	1.22	1.92	2.69	1.19	<b>1.35</b>
2008	1.43	2.02	1.54	1.85	1.35	1.37	1.59	3.32	0.88	<b>2.25</b>
	Norway	Poland	Portugal	Slovak Republic	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
1998	2.17	2.70	1.95	n.a.	1.98	2.67	2.78	2.38	1.26	1.79
2003	1.86	3.51	1.70	1.57	2.06	1.77	2.68	3.65	0.67	1.19
2008	1.59	3.94	1.92	1.06	1.42	1.87	1.52	2.95	0.88	1.12

Source: OECD PMR Database and OECD calculations.

Figure 10. The regulation of network sectors<sup>1</sup>

1. Regulation on Energy, transport and communication.

2. Policy inconsistency is measured as the standard deviation of the low-level indicators used in the OECD's indicators of regulation in the energy, transport and communications sectors. See Conway and Nicoletti (2006) for details on this indicator.

Source: OECD.stat – Market regulation database.

## 5. Policies to improve product market regulation

This section takes a more detailed look at product market regulation in New Zealand. It begins with the network sectors before moving on to discuss regulatory settings under the three broad categories captured by the PMR indicators – that is, *barriers to entrepreneurship*, *state control* and *barriers to trade and investment*. Each of these four sub-sections first outlines New Zealand’s relative performance in that regulatory domain and then examines problem areas in more detail and proposes regulatory refinements that would improve the business environment by enhancing the role of competition with the aim of increasing economic efficiency.

### *The network sectors*

The network sectors (*i.e.* electricity, gas, water, transport and communications) account for a significant and increasingly important share of New Zealand’s economic activity, around 13% of GDP (Warmke, 2010). Although an up-to-date input-output table does not currently exist, network sectors also presumably account for a large share of intermediate inputs, as in other OECD countries. As such, network-sector regulation not only impacts the performance of these sectors but also has a less visible effect on firms that use the output of network sectors as intermediate inputs in the production process (Conway *et al.*, 2006; Bourlès *et al.*, 2010).<sup>9</sup>

Reflecting their economic significance and challenges around natural monopolies, the network sectors have undergone significant reform in New Zealand. Prior to the start of reforms in the mid-1980s, the network sectors were typically operated by vertically integrated state-owned monopolies. However, New Zealand was very much an early mover in network-sector reform and by the late 1990s was at the forefront of network regulation in the OECD. The broad thrust of reform over this period focused on separating potentially competitive functions from natural monopolies and removing legal barriers to entry. Pricing and other terms of network access were determined under a light-handed regulatory framework that rested on generic competition law, information disclosure and the threat of government intervention – in the form of price controls – in the event of anti-competitive behaviour.

Over the 1990s, the ability of New Zealand’s light-handed regulatory framework to exert sufficient pressure on incumbents to offer network access to new entrants on reasonable terms was increasingly called into question. At the same time, the courts generally refused to assume the role of sector regulator and resolve access and pricing disputes, undermining the suitability of the Commerce Act as a quasi-regulatory system. In addition, as the reform of network sectors gathered pace in other OECD countries, New Zealand’s light-handed approach began to look increasingly atypical.

These concerns prompted policymakers to embark on a period of re-regulation in some of the network sectors from the late 1990s. Independent regulators were introduced in a number of sectors in an effort to shield market participants from interference by political and private interests and improve regulatory efficiency. Although some of the changes introduced during this period of re-regulation are consistent with OECD best practice, other aspects of network-sector regulation, particularly state involvement and the reacquisition of significant ownership interests in the case of rail and airline networks, have been discouraging of competition. At the same time, other OECD countries have made significant progress in this domain, and New Zealand’s regulatory framework in network sectors is currently assessed to be around average and significantly less conducive to competition than in comparator countries such as Australia and the United Kingdom (Figure 10).

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9. The knock-on effects of regulation in the non-manufacturing sector will also propagate through the economy via a number of other channels such as the effect on the price of investment goods and Baumol-disease effects that act through wages.

*Network sector regulation needs to settle in and continue improving at the margin*

In some of New Zealand's network sectors – for example, telecommunications and energy markets – aspects of the regulatory framework are still relatively new. As such, their ability to mimic the impact of competition on the efficiency and pricing of network-sector firms will develop over time as both regulators and firms gain experience.<sup>10</sup> For example, in 2008 provisions were introduced into the Commerce Act to promote outcomes consistent with competitive markets in network sectors in which there was little competition. Effectively implementing these provisions calls for the use of international benchmarks as well as a top-down approach in which indicators of competition and market efficiency are used to assess performance. These new provisions of the Commerce Act also require the Commerce Commission to specify “input methodologies” outlining the rules, processes, requirements and evaluation criteria that are applied in implementing various regulatory instruments in the airport services, electricity transmission and distribution, and gas pipeline sectors. Successfully implementing these input methodologies would promote regulatory certainty, which is needed in some of New Zealand's network sectors.

Regulatory certainty, and network sector performance more generally, could also be improved by clarifying the respective roles and responsibilities of the departments and ministries that set policies and the regulators that implement and enforce them. In the interests of clarity, it is imperative that regulators maintain political neutrality and that the executive branch of government does not get involved in regulatory operations. These lines of responsibilities can be blurred in New Zealand, which can undermine the authority of regulators and increase market uncertainty, instability and investor risk premiums. For example, in the electricity sector, changes in institutional responsibilities have recently been made to strengthen regulatory independence and discourage market participants, particularly state owned enterprises, from seeking ministerial intervention to achieve particular market outcomes (Electricity Technical Advisory Group, 2009).

This same exercise needs to be broadened across some of the other network sectors. In transport, a provision in the Civil Aviation Act means that the Minister of Transport, on the advice of the Ministry of Transport, decides on any international aviation alliances that fall short of a merger under the Commerce Act.<sup>11</sup> However, the Ministry of Transport does not have the necessary expertise and is not authorised to share information with competition regulators in other jurisdictions, unlike the Commerce Commission, which will soon have the power to share information and co-operate with foreign regulators. In addition, with the NZ government a majority shareholder in Air New Zealand, the current arrangement reduces the distinction between the government's roles as policymaker, regulator and owner. As such, the Minister of Transport's special powers over restraints on competition in international air carriage and international ocean shipping need to be revoked. By way of another example, in the telecoms sector, the respective roles of the Minister and regulator in making decisions under the Telecommunications Act and Part IV of the Commerce Act is often criticised as being unclear.

Of course, independent regulators should be accountable. Their performance should be evaluated periodically to assess their impact on the markets they regulate, their capacity to strike a balance between multiple and possibly conflicting goals, the quality of their regulatory output and their respect of established accountability standards. Regulatory decisions should also be more consistently open to merits

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10. By way of an example, the United Kingdom was an early starter in opening up network sectors to competition and in implementing many regulatory reforms and best practices that have subsequently been followed by a number of other countries (e.g. RPIX price regulation). However, it took over a decade for effective competition to emerge in the telecommunications and energy sectors.

11. This arose recently in the context of collaboration between Air New Zealand and Virgin on the trans-Tasman route. For this to proceed, approval was required from the Australian Competition and Consumer Commission (ACCC) and the New Zealand Ministry of Transport.

reviews, which would also help ensure robust processes and high-quality decision making, though they should not be allowed to stifle pro-competitive initiatives. In contrast to merits review, judicial review is widely available in New Zealand.

*Government interventions in network sectors need to be more transparent*

In the telecoms sector, the government has committed up to NZD 1.5 billion to provide ultra-fast broadband via fibre optic cable accessible to 75% of New Zealanders within the next 10 years (New Zealand Government, 2010). While the private sector is expected to at least match NZ government contributions to the ultra-fast broadband initiative (UFB), such a large public investment should be made on the basis of a rigorous business plan. Instead, the UFB has effectively circumvented the regulatory governance process and has not been subject to a Regulatory Impact Assessment. Hence, the economic justification for the government's investment remains unexplored. In addition, in an effort to promote retail competition, Telecom's participation in the UFB is contingent on full ownership separation of its network division. However, much of the regulatory regime for telecoms is designed around a vertically integrated incumbent provider, implying significant regulatory uncertainty going forward. While regulatory safeguards will continue to be necessary for wholesale UFB operators, who are likely to have significant monopoly power, the separation of retail services should enable a considerable lightening or removal of retail regulation.

The "Kiwi Share", which is a single "golden share" retained in Telecom by the government, is a long-running issue in the telecoms sector that has an important influence on firm behaviour and market outcomes. It is used to impose foreign-ownership restrictions, coverage obligations, price caps for certain residential services and a "free local calling" rental option. It therefore imposes significant constraints on Telecom and distorts competition in the telecoms market (Howell, 2008). Coverage obligations, which have been subsumed into the Telecommunications Service Obligation, should be made contestable by other potential entrants and open to a range of technologies. Concerns about price increases for some residential services should be dealt with by industry-specific regulation enforced by the regulator, while concerns about foreign ownership should be dealt with under New Zealand's foreign direct investment regime. Finally, "free local calling" simply distorts residential fixed-line pricing by pushing up the price of rentals in calling packages that do not suit many households. Overall, the Kiwi Share should be abolished.

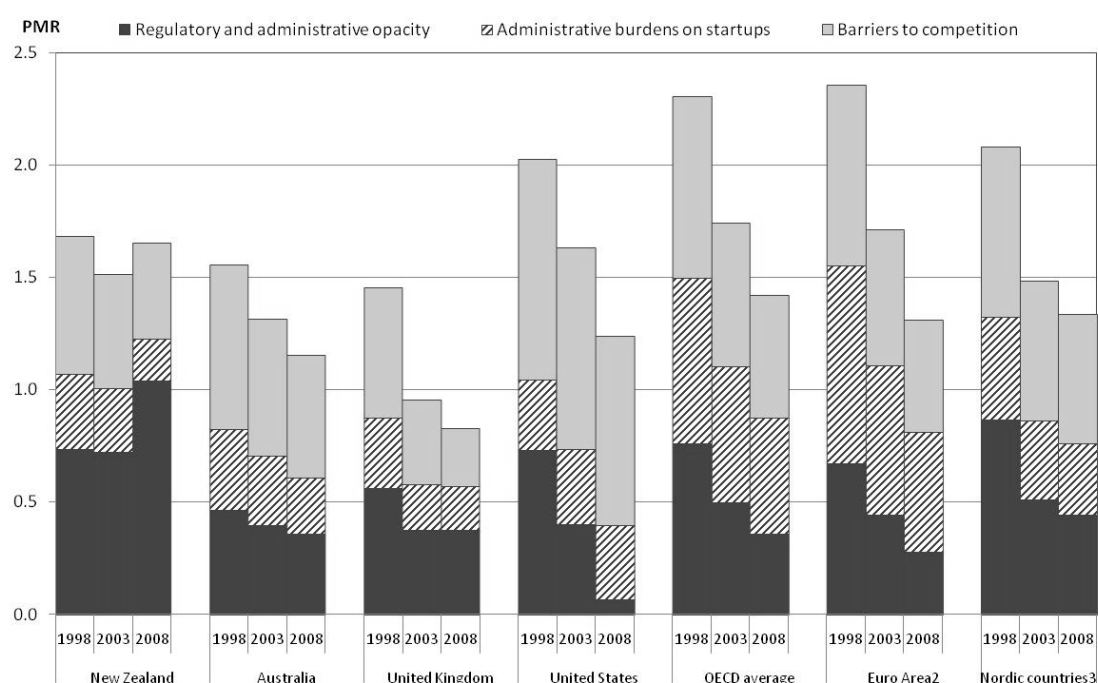
An efficient telecommunications market would help mitigate the impact of economic geography on New Zealand's economic performance. However, the international mobile roaming market segment, which is currently unregulated, suffers from insufficient competition and displays symptoms of market failure. Of particular importance, the pricing of international roaming in Australia appears to be relatively high and pricing transparency and consumer awareness relatively low in comparison to what might prevail in a competitive market (MED/DBCDE, 2010). As such, effective regulation is required in this area to improve transparency and lower prices to competitive levels, thereby allowing mobile telecommunications to play a significant role in facilitating a single trans-Tasman economic market.

In the electricity sector, current investment plans in generation and the transmission grid have recently been assessed to be sufficient in the context of rising energy consumption and long-term supply contracts (Electricity Technical Advisory Group, 2009). However, a necessary condition for fostering investment in a small and isolated energy sector is to ensure sufficient information on firms' investment plans is available to market participants. This highlights the importance of a high level of transparency in network-sector firms. However, this is not always the case in New Zealand, given that some network sectors (electricity in particular) are dominated by state-owned enterprises (discussed in detail below).

### Barriers to entrepreneurship

The administrative burden associated with starting a business, which is often used as a headline measure of red tape, has remained low in New Zealand. In addition, the World Bank ranks New Zealand as the third least restrictive country for the “ease of doing business”, highlighting generally low barriers and efficient enforcement of regulations on starting, operating and closing a business (World Bank, 2010). This is reflected in a healthy rate of “creative destruction” among NZ firms, with firm turnover making a positive contribution to aggregate productivity growth (Mills and Timmins, 2004; Law and McLellan, 2005). However, the broader estimate of barriers to entrepreneurship in the PMR indicators has increased slightly in New Zealand since the early 2000s, whereas virtually all other OECD countries have made solid progress in this regulatory domain (Figure 11).<sup>12</sup> As a result, New Zealand was recently assessed to be in the lower third of OECD countries in terms of barriers to entrepreneurship, suggesting that its regulatory and administrative systems are more onerous and less transparent than elsewhere.

Figure 11. The barrier to entrepreneurship indicator and main sub-indicators<sup>1</sup>



1. Index scale of 0-6 from least to most restrictive.
2. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovakia, Spain.
3. Denmark, Norway, Sweden, Finland, Iceland

Source: OECD, OECD.stat – Market regulation database.

### Regulatory uncertainty is a barrier to entrepreneurship

A range of regulatory settings and policy actions indicate that product market regulation in New Zealand is prone to a degree of uncertainty, which has the potential to repress entrepreneurship and investment. Evans *et al.* (2009) recently cited a number of regulatory interventions that are indicative of a lack of protection from state takings of property rights without compensation including: changes to the

12. By way of confirmation, according to survey data, overall compliance costs per full-time equivalent worker for the 50-99 and 100+ sized enterprises have increased slightly since 2004 (KPMG, 2008).

government's valuation policy on Crown pastoral leases and the treatment of pre-1990s forests under the Kyoto protocol. These authors also argue that policymakers and administrators have excessive discretionary power and that special interest groups wield considerable influence. For example, a recent review concluded that the Resource Management Act is considered to have hindered development by giving too much discretionary power to the local councils that administer it resulting in reduced growth without improved environmental outcomes (The 2025 Taskforce, 2010; OECD, 2011).

Regulatory uncertainty is exacerbated by occasional *ad hoc* policy changes that can occur without any formal analysis of the associated costs and benefits. One of the most egregious recent examples is the 2008 amendment to the regulations under the Overseas Investment Act that was made to prevent foreign investment in Auckland International Airport, but imposed considerable private costs on some in the domestic economy. Despite laudable intentions and the obvious urgency of the situation, the *Canterbury Earthquake Response and Recovery Bill*, which was rushed through the House in one day and gives government the power to alter the effect of almost any piece of legislation on the statute books, also reflects an approach to policymaking that puts little weight on consistency.<sup>13</sup>

Policy uncertainty suggests that New Zealand's system of regulatory governance suffers from a lack of checks and balances to encourage stability and ensure that the basic rules regulating markets are not easily changed. This is exacerbated by a very "hands on" approach from some government ministers, who are often involved in regulatory decisions and enforcement at a very detailed level. Further, a recent survey suggests that the policy advice emanating from some parts of the civil service is focused on gaining consensus rather than high-quality analysis based on sound evidence-based reasoning (Scott *et al.*, 2010).

#### *Regulatory governance needs to continue improving*

Increased barriers to entrepreneurship, excessive policy inconsistency and regulatory uncertainty raise questions about the ability of New Zealand's system of regulatory governance to consistently deliver high-quality regulation. Regulations need to be both adaptable and predictable so that market participants can be confident that past regulatory decisions will be respected and that future decisions will be made in a way that is consistent with precedent, unless it is clear that the previous approach was flawed in some important way. This is a difficult challenge in all OECD countries and calls for an explicit policy that sets out the principles and broad objectives of the regulatory system.

With this in mind, the government issued a statement on "Better Regulation, Less Regulation" in August 2009 vowing to introduce new regulation only when it is "required, reasonable and robust" and to review the stock of existing regulation to identify and remove requirements that are "unnecessary, ineffective or excessively costly".<sup>14</sup> Although this is clearly a welcome development, a more specific statement outlining the importance of competition and the government's approach to promoting it would help ensure consistency in the regulatory reform process and in setting a regulatory reform agenda. This was the approach taken in Australia's National Competition Policy (NCP) legislative programme, which was implemented in the mid-1990s to embed a guiding principle in the regulatory framework that there should be no regulatory restrictions on competition unless they are in the public interest (Box 2).

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13. Although outside the ambit of product market regulation, recent changes to labour law made to secure the filming of the Hobbit movies in New Zealand were also passed under urgency and indicate that policy is sometimes made on the run.

14. See <http://www.treasury.govt.nz/economy/regulation/statement>.

### Box 2. Regulatory governance in Australia

In many respects, the Australian experience provides a good framework for the application of regulatory reform strategies and regulatory governance. Australia has a well-established precedent in using regulatory management systems and was a very early adopter of Regulatory Impact Analysis (RIA) and institutions for overseeing and improving regulatory quality. The Productivity Commission, which is the government's independent research and advisory body on a broad range of issues, has played a key role in helping successive governments improve the regulatory framework in the nation's long-term interests.

Australia's framework for regulatory governance arose out of a series of institutional and regulatory reforms enacted under the National Competition Policy (NCP) over the period 1995-2005. The NCP reforms consisted of a range of strategies including:

- the establishment of the National Competition Council as an independent assessor of the performance of all governments (including state governments);
- the introduction of regulatory gate-keeping measures to scrutinise new regulatory proposals and ensure that any restrictions on competition are explicitly justified; that is, that the benefits of the restriction to the community as a whole must outweigh the costs, and that the objectives of the legislation can be achieved only by restricting competition; and
- the introduction of measures to ensure legislatively backed third-party access to essential infrastructure services.

In conjunction with increased exposure to international trade during the 1980s, product market liberalisation conducted under the framework of the NCP has reduced barriers to market entry and exit, improved anti-competitive regulation and exposed government-owned businesses to market forces in a competitively neutral manner. As a result, Australia has experienced strong economic performance, with high and steady growth that has raised its per capita income to among the highest in the OECD. The Productivity Commission (2005) reports that the NCP "has delivered substantial benefits to the Australian community which, overall, have greatly outweighed the costs".

Building on the success of the NCP, Australia has recently embarked on a National Reform Agenda (NRA) to continue improving regulation that impacts on competition and human capital. The aim of the competition and regulation stream is to facilitate a "National Seamless Economy" by eliminating internal regulatory barriers. This includes further measures to broaden the structural reform process, enhance competition in the energy and transport sectors, implement a simpler and more consistent national approach to the economic regulation of significant infrastructure and reduce the regulatory burden imposed by all three levels of government as well as others to ensure best-practice regulation making and review.

Some of the key elements emphasised in Australia's regulatory governance experience include the goal of continuous improvement in regulation, as opposed to one-off reviews and target-driven reform programmes; an emphasis on removing outdated regulation that is excessively burdensome on business or unfair to consumers; and, a commitment of no net increase in the regulatory burden arising from new Commonwealth regulation (Tanner, 2008).

As well as setting broad framework parameters, the government has also improved other aspects of regulatory governance. A ministerial portfolio for regulatory reform has been created to increase the political profile of the issue. Responsibility for assessing the adequacy of economically significant regulatory proposals and helping the government set a programme for reviewing existing regulation has moved to a Regulatory Quality Team within the Treasury. Regulatory Impact Statements (RISs) have been mandatory for regulatory proposals going before Cabinet for many years but are receiving increased attention and visibility. The government has also set up a Productivity Commission that works along the same lines as its Australian counterpart.

The government is also considering implementing a Regulatory Responsibility Act to improve accountability and transparency by establishing quality benchmarks for regulation based on "principles of

responsible regulation” that cover a range of areas.<sup>15</sup> The proposed Act would compel policymakers to consider the full costs and impacts of new legislation at an early stage in the development process. If implemented, it would give the courts a discretionary declaratory role limited to assessing the compatibility of legislation in light of the principles it lays down. This would represent a major, quasi-constitutional change in the role of the courts that could be challenging to implement.<sup>16</sup> However, by introducing quality benchmarks and increasing the level of scrutiny of new regulation, this relatively novel approach may offer a pragmatic solution to instilling a degree of discipline and promoting consistency in regulation across the whole of government. The challenge is to define the “principles of reasonable regulation” in a way that is broadly acceptable and requires minimal interpretation by the courts. Should this difficult task prove impossible, the government should consider introducing more targeted select committee scrutiny to improve the quality of legislation.

More broadly, with many of the elements of a good system of regulatory governance already in place, the ongoing challenge is to continue improving the implementation of better regulatory policies. This amounts to cultural change within the public bureaucracy, which takes time and political will. Continued work is required to advance the regulatory reform agenda under which ministers and their departments are more clearly accountable for the quality of regulation in their portfolios and instigate a culture of continuous improvement supported by evidence-based decision-making. The use of regulatory tools, including the systematic use of sunset clauses and a commitment from government that there will be no net increase in regulatory burden arising from new regulation, could also improve the regulatory management system. The current system of regulatory screening, which includes annual Regulatory Reform Bills that repeal redundant Acts and Regulations, needs to be strengthened and given more Ministerial attention. Building on past achievements, the RIA process needs to become more rigorous and an integral part of policy development and the culture of government departments (NZIER, 2009).

Although consultation on new regulatory proposals generally occurs, it is rare for legislation to be reviewed on the basis of feedback, implying that consultation processes could also be improved. In addition, although parliament’s Regulatory Review Committee is empowered to disallow regulations on the basis of *ex post* evaluations, it has not often done so and therefore does not inject a great deal of discipline into regulatory policymaking. Advocacy for increasing regulatory quality could also be increased, and the establishment of the Productivity Commission is a welcome development in this regard.

#### *The competition policy framework needs updating*

The aim of New Zealand’s basic competition law – the Commerce Act (1986) – is to promote economic efficiency by safeguarding competition in NZ markets. Mergers and acquisitions, restrictive trade practices and price controls that conflict with this aim can be authorised by the Commerce Commission, the principal enforcer of competition law, if they “will result, or will be likely to result, in such a benefit to the public that it should be permitted”. This implies that agreements or mergers that lead to greater economic efficiency or other public benefits can be authorised if the benefits are considered to outweigh any anti-competitive effects. In essence, this entails authorisations for mergers and practices that increase the sum of consumer and producer surpluses and admits the acceptability of consumers paying prices above competitive levels (Bertram, 2004).

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15. Specifically, the principles of good regulation recommended by the Taskforce established to review the Regulatory Responsibility Bill fall within six broad categories: rule of law, liberties, taking of property, taxes and charges, role of the Courts, and good law making (Regulatory Responsibility Taskforce, 2009).

16. Currently, the NZ courts do not have responsibility for reviewing regulations but are able to overturn regulatory implementation decisions and may also hold regulations invalid if they do not fall within the statutory power under which they were made.



This total surplus or efficiency criterion is predicated on New Zealand's economic geography, which, as discussed above, implies that domestic firms are more likely to produce at less than minimum efficient scale (Evans and Hughes, 2003; Evans, 2004). Thus, the presumptions, rules of thumb and “*per se*” rules used in much larger economies, where firms are more likely to benefit from scale economies without compromising competition, may not be appropriate for New Zealand. Even though efficiency concerns are by no means unique to New Zealand, this implies that enforcing competition law is a difficult balancing act that often calls for a relatively subjective case-by-case approach that is complex and resource intensive.<sup>17</sup> Accordingly, it is important that the Commerce Commission be well resourced with highly skilled professionals to ensure that the Commerce Act is implemented to the highest possible standard.

Perhaps reflecting the intricacies of enforcing competition law in a small and distant economy, the time required for Commission decisions has sometimes been lengthy. As such, the Commission's recent efficiency drive – which has involved restructuring its activities into two branches from six and streamlining the process for authorisations that have obvious public benefits – is welcome. The Commission could also benefit from using a wider range of interventions, such as remedial orders, the payment of damages and/or compensation and public warnings, to resolve cases more quickly and free up resources for new investigations.

Consideration also needs to be given to introducing criminal sanctions for cartel formation, which has recently been a growth area for the Commission, reflecting the introduction of a leniency and cooperation programme (King, 2010). The issue of prohibiting tacit price collusion may also warrant consideration, as is currently being done in Australia. *Ex post* evaluative studies of the market impact of mergers and acquisitions and other Commission decisions, which are currently done on a trial basis, would also be useful in assessing the net benefits of Commission decisions.

New Zealand's prohibition of abuse of dominance – taking advantage of a substantial degree of market power – has proven particularly difficult to implement. In the 25 years since the Commerce Act came into force, the Commerce Commission has had only very limited success in proceedings under this section of the Act. In addition, the recent Supreme Court loss against *Telecom* also raises questions about New Zealand's approach to unilateral conduct. While monopolisation law is a perennial challenge in all countries, this suggests that New Zealand's law on unilateral conduct is impractical and needs to evolve further (Ahdar, 2009).

In particular, New Zealand and Australia are unique among OECD countries in assessing dominance cases using a “purpose test” (that the conduct had an anti-competitive purpose) and a “counterfactual test” (that the conduct could not have occurred in the absence of market power). International best practice does not involve either of these tests but, instead, focuses primarily on whether behaviour by a dominant firm is likely to create demonstrable consumer harm (OECD, 2005). The NZ experience demonstrates that proving anti-competitive purpose and assessing the nexus between market power, purpose and the counterfactual test are extremely difficult. Indeed, recent amendments to Australia's Trade Practices Act have clarified the term “taking advantage of” in a more flexible way that is not limited to the counterfactual test (Meech, 2010). To allow greater flexibility in the application of New Zealand's monopolisation law and ongoing harmonisation with Australian competition law, the Commerce Act needs to be amended along the same lines as Australia's legislation. In addition, the competition law in Mauritius, which was drafted with the assistance of the OECD, represents best practice for a small economy and may also provide a useful benchmark against which New Zealand's framework could be assessed.

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17. For instance, a range of factors that could impact on concentration and efficient scale need to be considered, including the extent of import competition and countervailing powers, the likelihood of higher prices or margins, the extent of substitutes and product differentiation and the likely path of innovation and other drivers of dynamic efficiencies.

More broadly, the advocacy role of the Commerce Commission in promoting competition and the Commerce Act as means to an end – the enhancement of economic efficiency and welfare – could be improved. The Commission should also be able to conduct market studies without reference to a merger application or other investigation, as is the case in Australia. These changes would help strengthen the competition culture among policymakers and the public and reduce the inconsistencies in New Zealand’s policy approach to competition. In addition, more background work on assessing New Zealand’s industrial structure needs to be done to help minimise subjectivity in enforcement decisions involving competition-efficiency tradeoffs.<sup>18</sup>

With economic activity increasingly integrated across countries, international co-operation and information sharing is a pre-requisite for effective competition law enforcement. As such, the recent establishment of cross-appointments between the Commerce Commission and the Australian Competition and Consumer Commission (ACCC) is a welcome development that should facilitate convergence in the approaches of the two regulators. This should improve the ability of businesses to conduct seamless operations across the Tasman without regulatory overlap and reduce spatial transaction costs and the relatively high cost of competition law enforcement in New Zealand. Indeed, as the aspiration of a genuine Single Economic Market across New Zealand and Australia comes to fruition, the Commerce Commission and the ACCC need to become increasingly integrated. As part of this process, the *International Co-operation and Fees Bill*, which allows greater cooperation and information sharing between the Commission and other competition regulators, particularly the ACCC, should be passed.

### ***State control***

From 1998 to 2008, the extent of state control in the New Zealand economy increased slightly, reflecting increased scope of the public enterprise sector and greater government involvement in network industries (Figure 12). With the exception of Luxembourg, all other OECD countries reduced state control over this period, and New Zealand has thus slipped down the rankings.

### *Government influence in product markets has increased*

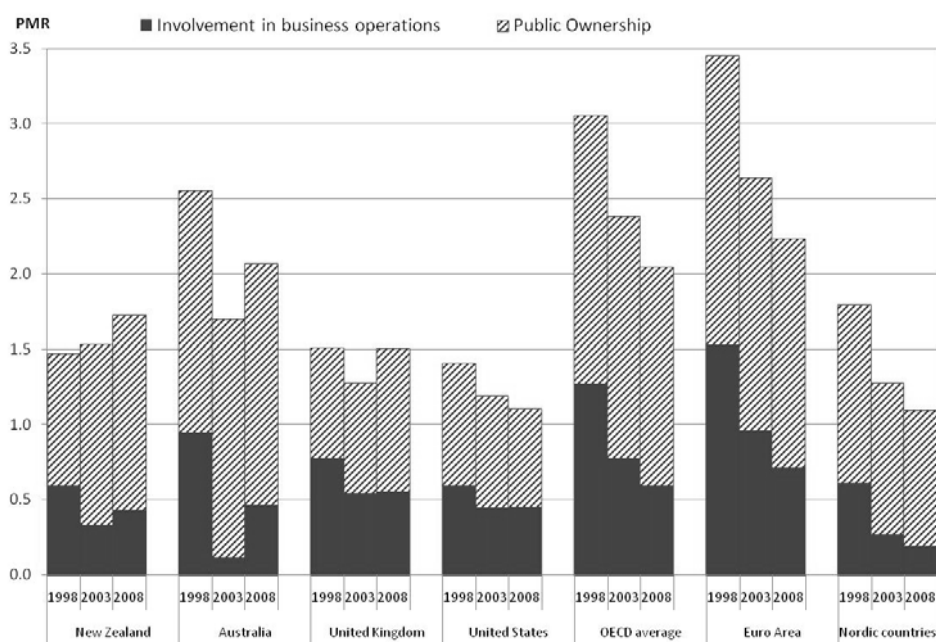
The NZ government owns around 45 different companies and commercial entities – including 17 state-owned enterprises (SOEs) – that collectively employ around 26 600 people (about 1.5% of total employment) and have a total capitalisation of around NZD 28 billion (COMU, 2010).<sup>19</sup> Over the last ten years, the government has increased its portfolio of SOEs by buying an 80% stake in Air New Zealand and establishing Kiwibank, both in 2001, and buying back KiwiRail (formerly Toll) in 2008. SOEs dominate electricity generation and transmission and include the country’s largest farming business and coal mining operator. SOEs are also active in the land and environment, services, infrastructure and communications sectors. The Accident Compensation Corporation, a Crown agent, has a statutory monopoly in the provision of workplace accident insurance.

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18. A credible dataset of NZ firms has recently become available that opens up a wealth of information that could be used to reduce subjectivity and improve the enforcement of competition law. For details, see Fabling *et al.* (2008).

19. Specifically, the government’s portfolio includes: 17 SOEs, 8 Crown research institutes, 4 Crown financial institutions, Air New Zealand Ltd, some statutory entities and a shareholding in a shipping line and four airports. See <http://www.comu.govt.nz/index.html>.

Figure 12. The state control indicator and main sub-indicators



1. Index scale of 0-6 from least to most restrictive.
2. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovakia, Spain.
3. Denmark, Norway, Sweden, Finland, Iceland

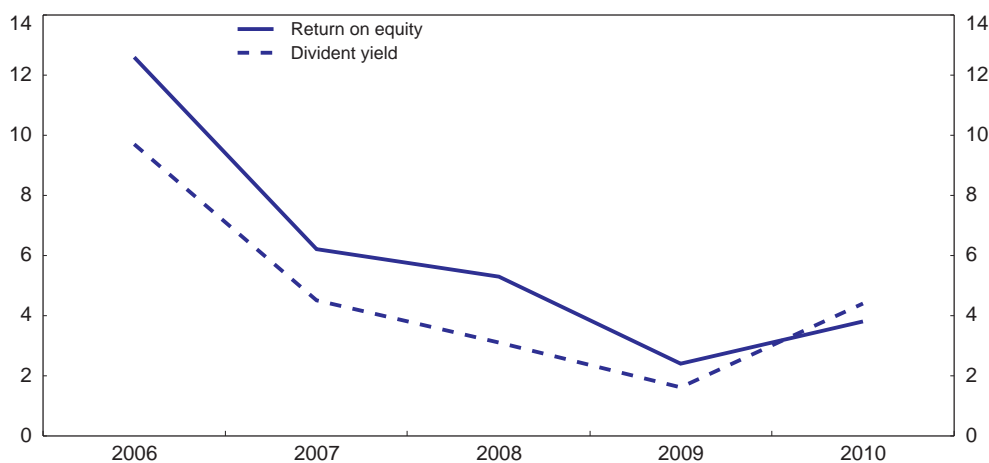
Source: OECD, OECD.stat – Market regulation database.

The operating context of New Zealand's SOEs is governed by the *State-Owned Enterprise Act* (1986). This Act aims to align SOE management with that of the private sector by establishing commercial freedom and responsibility and requiring that they be as profitable and efficient as comparable private-sector businesses. Competitive neutrality is maintained between SOEs and the private sector, and any non-commercial activities that SOEs are required to perform must be transparently funded by government. Ownership monitoring of the SOEs is done by the Crown Ownership Monitoring Unit (COMU) within the Treasury, and each SOE has two shareholding ministers – the responsible Minister (in most cases the Minister for SOEs) and the Minister of Finance, each of whom holds 50% of the company's shares. The shareholding Ministers appoint a Board of Directors to oversee the management of each SOE.

#### *The financial performance of the SOEs is mixed*

Despite the requirements of the SOE Act, the financial performance of New Zealand's SOEs has been mixed. Although a few have been highly profitable, the (weighted) average return on government equity invested in the SOEs was a mediocre 6½ per cent over the four years to 2009 (Figure 13), compared to nearly 9% for all companies. At the firm level, dividend yields have been volatile and, on average, lower than for comparable companies listed on the New Zealand stock exchange (COMU, 2010). Generally speaking over this period, the SOEs have invested heavily in new plant and other assets in New Zealand, but the government has yet to see a commensurate increase in profits and returns.

Figure 13. Return on equity and dividend yield of the state-owned enterprises



Source: COMU (2010), 2010 Annual Portfolio Report, Wellington.

This mixed financial performance reflects a number of factors. Despite the good intentions of the State Owned Enterprise Act, it is difficult to fully insulate SOE management from a sense of political accountability that can cloud commercial objectivity. For example, a number of SOE senior executives report that they are unduly influenced by changes in the political climate and are relatively risk averse, given a fear of the political ramifications of commercial failure (Luke, 2010). Also, although SOE boards now typically have a high level of control over strategic and investment decisions (Cameron and Beattie, 2007), there are still anecdotal reports of ministers wielding influence in SOE management decisions, such as senior appointments.

As well as imposing a low risk appetite on some of New Zealand's largest firms, government ownership also results in relatively poor transparency and disclosure standards. By way of illustration, the quality and quantity of information supplied to taxpayers after KiwiRail moved back into state ownership was much lower than the level of disclosure for other listed transport companies under private ownership (Heatley, 2010).<sup>20</sup> In an attempt to mimic the disclosure requirements of listed private-sector companies, the government has recently instigated a number of changes to improve transparency and accountability (House of Representatives, 2010). In particular, the larger SOEs are now required to maintain a continuous disclosure regime and expected to hold annual public meetings. A suite of financial performance measures has also been developed and must be included in each company's Statement of Corporate Intent from 2010/11. In addition, COMU recently began publishing an Annual Portfolio Report that includes up-to-date analysis of SOE performance.

#### *A partial float of the SOEs has some advantages*

These characteristics of the framework – a mixed financial performance, risk aversion and poor but improving transparency requirements – indicate that the commercial disciplines applied to New Zealand's SOEs are less consistent than what the market would provide. This impacts on results and could be an important reason why New Zealand's large firms are relatively poor performers in international comparison (Treasury, 2008b). From a broader perspective, although the SOE Act provides a very good

20. For example, the public version of the government's "turn around plan" for KiwiRail is a mere two pages long and has none of the detail shareholders would expect in evaluating a NZD 750 million investment.

framework, it is likely that SOEs are a relatively unpredictable and intimidating market presence, thereby restricting competition and discouraging FDI, with negative implications for aggregate productivity.

The rationale for privatisation is well known in New Zealand. Although the international experience suggests that privatising SOEs in competitive markets is economically beneficial (Megginson and Netter, 2001), the domestic debate remains clouded by lingering concerns stemming from the experience of the late 1980s and early 1990s. In particular, privatisation carries negative connotations given past privatisation failures (such as the recent buyback of KiwiRail) as well as perceptions that some former SOEs were sold too cheaply and that privatisation merely replaced public monopolies with private ones during the era of light-handed regulation. Privatisation also raises concerns over economic sovereignty, reflecting foreign investment in former SOEs (in part a function of low private domestic saving and a lower cost of capital abroad).

The government is currently considering the merits and viability of selling minority stakes in some of the SOEs.<sup>21</sup> If pursued, this would be an important innovation in New Zealand's model of SOE governance that would help push SOEs' performance towards that of private-sector companies. To begin with, partial floats would subject SOEs to the corporate governance disciplines of stock market listing requirements, thereby enabling and encouraging increased transparency, direct monitoring and independent analysis of SOE performance. Partial privatisations would also improve SOE access to capital, which would facilitate their expansion into offshore markets and help mitigate the impact of New Zealand's economic geography on scale economies.<sup>22</sup> In addition, with a number of SOEs operating in regulated industries, a competitive market for ownership shares would also be an important source of information for regulators and enhance the separation of the ownership and regulatory functions within government. In conjunction with the minority shareholder protections imposed through exchanges and securities regulation, this would minimise the potential for political interference in the strategic decisions of the SOEs. Finally, partial floats would also improve the depth of New Zealand's capital market, which is extremely shallow in international comparison (Hubbard and Evans, 2009), and increase the savings options available to New Zealanders.

Although the likely benefits from partial privatisations are clearly welcome, the government's intention to maintain controlling stakes in SOEs will limit the extent of improvements in firm performance. In particular, by retaining controlling stakes, the government will preclude the possibility of a market for corporate control and thereby curb the potential for restructuring and other management changes to further improve firm productivity (Mulherin *et al.*, 2001; Manne, 1965). In the same way, the government will also forfeit a price premium for control. However, this will arise only if the government chooses to keep its controlling stakes in perpetuity. Indeed, some OECD governments have maximised privatisation proceeds by initially floating small stakes in SOEs and using the resultant improvements in corporate governance as a basis for increasing revenues from later tranches. Accordingly, partial privatisation should be seen as a politically feasible short-run step on the way to full privatisation. In addition, any privatisations should be carried out following the good practises espoused in OECD (2010c).

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21. In particular, the government has requested Treasury advice on the merits and viability of selling up to 49% of coal miner and exporter Solid Energy, along with up to 49% of its three electricity generators/retailers – Meridian Energy, Genesis Energy and Mighty River Power. It has also requested advice on reducing its 75% stake in Air New Zealand while retaining a majority stake.
  22. For example, the Chairman of Solid Energy has recently commented that the company needs up to NZD 10 billion in additional capital over the next five years to fund a number of major projects.

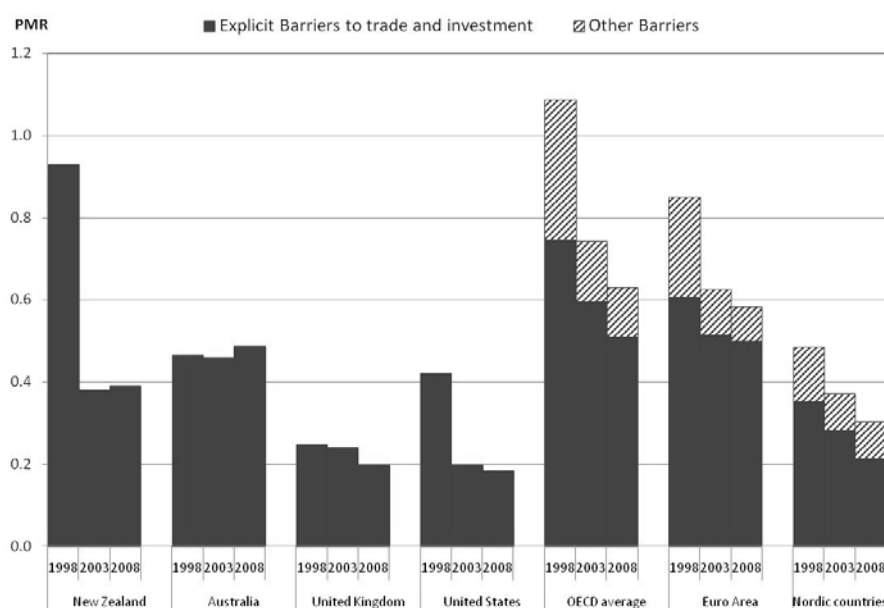
## Barriers to trade and investment

*New Zealand has an open policy framework but performs poorly*

Because distance from markets is a natural barrier to foreign trade and investment, policies that encourage the integration of domestic and global markets are critically important in increasing competition and scale economies. Not surprisingly, a growing body of literature finds that policies that influence international openness can have a relatively more important impact on economic performance in small countries (Evans and Hughes, 2003). Equally, foreign affiliates tend to be more capital- and skill-intensive and invest more in research and development than domestic firms (Keller and Yeaple, 2009). As such, foreign affiliates in New Zealand and the OECD in general are more productive than domestic firms and an important channel for technological diffusion (Fabling *et al.*, 2008; Criscuolo, 2005).

As part of its reform programme from the late 1980s, New Zealand instigated relatively low barriers to trade and investment that have been broadly preserved over the intervening years. More recently, New Zealand has also negotiated bilateral free-trade agreements with a number of countries, including China, and is a founding member of the Trans-Pacific Strategic Economic Partnership. Given limited progress in reducing barriers to trade and investment in most other OECD countries, New Zealand continues to be one of the more open countries in a relatively flat distribution of indicators (Figure 14). Remaining direct regulatory barriers to trade and investment predominantly reflect New Zealand's FDI screening regime, which, as discussed below, is assessed to be relatively onerous.

Figure 14. **The barriers to trade and investment indicator and its sub-components**<sup>1</sup>



1. Index scale of 0-6 from least to most restrictive.
2. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovakia, Spain.
3. Denmark, Norway, Sweden, Finland, Iceland

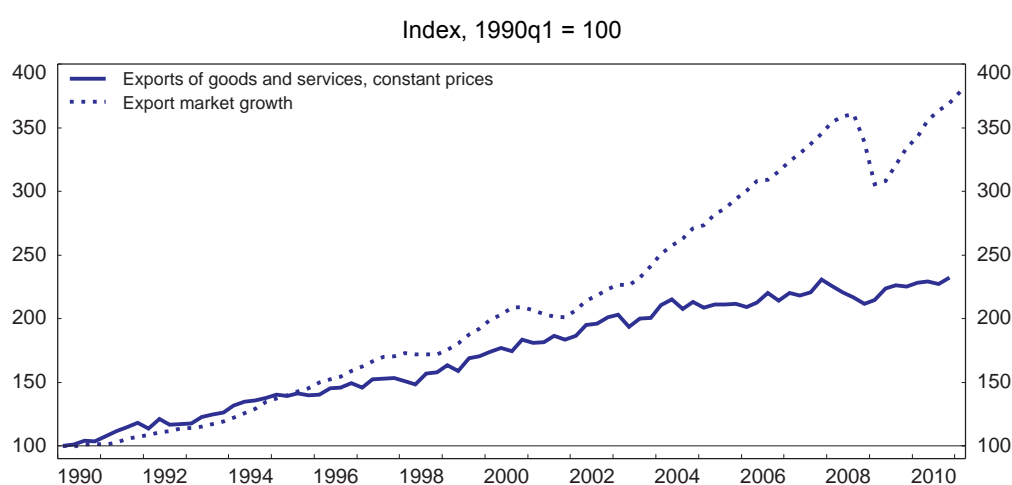
Source: OECD, OECD.stat – Market regulation database.

Despite having only moderate policy barriers, New Zealand's trade performance has been decidedly mediocre. Although import penetration is higher than in the United States and Australia, it is considerably lower than in a number of the smaller OECD countries, suggesting that imports provide only modest

competitive pressure. On the export side, Asia's emergence has moved the world's centre of economic gravity eastwards and greatly benefited some sectors of the NZ economy. However, the overall intensity and diversity of its exports is still comparatively low, and exporters have been unable to capitalise on generally strong growth in export markets since around 2003 (Figure 15). Services exports have been especially weak (see Figure 17 below). Moreover, the bulk of export growth is accounted for by a small number of firms with a relatively small contribution from new exporters, implying that relatively few firms attain efficient scale through exporting (Treasury, 2008b). Overall, the tradables sector has found it difficult to compensate for a high exchange rate *via* productivity improvements.

In contrast to trade, New Zealand's performance in attracting FDI is reasonable, with the GDP share of FDI inflows in the upper third of the range occupied by OECD countries. However, outward FDI is very low in international comparison, perhaps reflecting weak private saving.

Figure 15. Exports and export market growth



Source: OECD Economic Outlook 89 database.

### *Overcoming distance requires greater policy transparency*

FDI into New Zealand is governed by the Overseas Investment Act (2005), which lays out the legislative requirements for inward investment and is enforced by the Overseas Investment Office (OIO). This Act requires that foreigners get consent before investing in sensitive land (which is defined according to type of land and area thresholds), significant business assets or fishing quotas. Applications involving sensitive land are assessed on a large number of criteria that are used to determine if the proposed investment will benefit New Zealand. Notoriously, in 2008, in response to an offer from the Canada Pension Plan Investment Board to buy 40% of Auckland International Airport, a new and somewhat contradictory criterion of whether an investment will “assist New Zealand to maintain New Zealand control of strategically important infrastructure on sensitive land” was retrospectively introduced.<sup>23</sup>

In 2009 the government reviewed the Overseas Investment Act with the aim of reducing the administrative burden and cost and increasing transparency and predictability for foreign investors. As a result, some changes were made to speed up the screening process and reduce the number of applications

23. Ultimately, this “strategic asset test” was not used and the application to invest was declined by Ministers on the basis that they were not convinced that benefits existed under the Act (Heatley and Howell, 2010).

requiring ministerial approval.<sup>24</sup> In contrast to these changes and the aim of the review, in 2010 the government introduced a new “economic interests” test and a “mitigating factor” test to give ministers more discretion in deciding if a proposed foreign investment involving sensitive land would be in New Zealand’s economic interests. On the grounds of safeguarding ministerial discretion, the government also opted to retain the strategic asset test for investment applications involving sensitive land. More encouragingly, in February 2011 an Investment Protocol that lifts the screening threshold for trans-Tasman FDI was signed with Australia, which is New Zealand’s largest source of FDI.

The criteria for acceptable foreign investment into sensitive land in New Zealand have thus become increasingly opaque and need to be simplified to increase certainty, clarity and consistency. As in other regulatory areas, increasing the scope for ministerial discretion adds uncertainty and cost to an already complex and non-transparent regime. For example, any genuine concerns about foreign ownership of “strategic assets” should be specified and dealt with under separate explicit ownership controls. Another difficulty with the FDI screening regime is that, in practice, it does not take the private benefits of FDI involving sensitive land into consideration (Heatley and Howell, 2010). Although only a small number of FDI applications are rejected (notwithstanding the possibility that applicants are a self-selected group), this runs the risk of refusing potentially beneficial transactions, negatively impacting on local vendors of sensitive land and restricting both foreign and domestic investment.

*Ongoing harmonisation and mutual recognition will reduce ‘behind the border’ barriers*

Border barriers are not the only potential constraints on trade and FDI. Domestic regulations that restrict competition and differ significantly from those of major potential trading partners can also shelter local incumbents from market entry by foreign firms. Because the services sector has been regulated in idiosyncratic ways across countries, policy heterogeneity across borders can impose considerable costs on firms wishing to establish a footing in offshore markets (Nordås and Kox, 2009). Indeed, it is likely that the border effects found in most studies of international trade occur because a national boundary represents a frontier between two legal and regulatory systems. Given ongoing internationalisation of the services sector, cross-country differences in regulation are most likely becoming increasingly onerous and a binding constraint on the development of many types of services exports.

Differences in product market regulation across pairs of countries can be quantified using the underlying data used to construct the PMR indicators. These indicative indicators of policy heterogeneity show that regulatory differences between New Zealand and Australia are the second lowest of all of New Zealand’s OECD country pairings. In no small part, this reflects the impact of the Single Economic Market agenda under which a range of activities and initiatives designed to reduce regulatory barriers to doing business across the Tasman are being progressed. However, differences in product market regulation across New Zealand and Australia are larger than in a number of other close trading partnerships in the OECD, such as the United States and Canada, Germany and Austria, and Germany and France. In addition, these indicators of heterogeneity in PMR suggest that, after falling between 1998 and 2003, regulatory differences across New Zealand and Australia have been broadly unchanged in more recent years (Figure 16).

With the New Zealand economy relatively concentrated in services, cross-country regulatory differences could be an important reason why services exports have been so weak over recent years (Figure 17). New Zealand’s long-run economic trends are not too far out of line with those of Australia’s

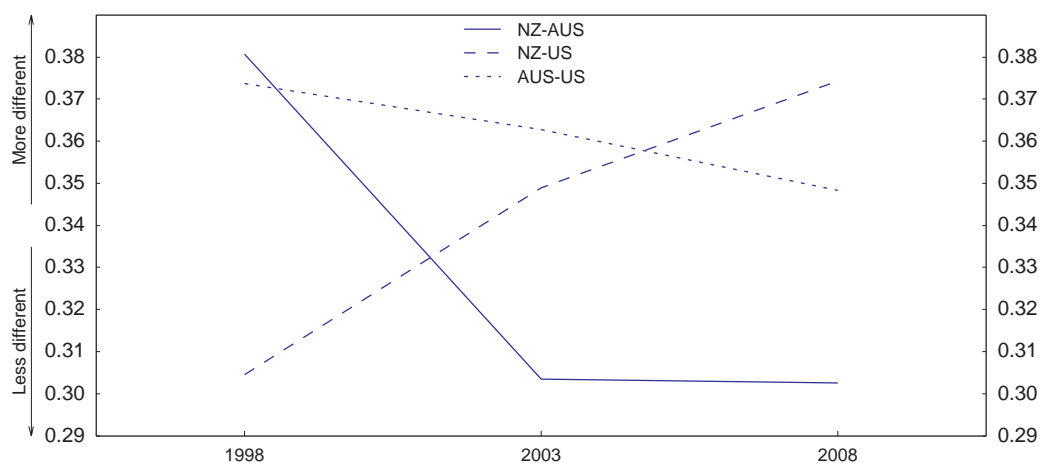
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24. Although there is no mandatory processing time, the OIO aims to turn around 90% of investment applications within 50 working days, but currently only 70% are decided within this deadline. A “creep provision” was also introduced to exempt small incremental increases in foreign ownership from requiring a new application process.



six states and two territories (Grimes, 2004), which, as well as being supportive of a currency union, implies that there are no structural issues standing in the way of a single trans-Tasman market. This underscores the importance of regulatory harmonisation and mutual recognition of standards, such as the trans-Tasman Mutual Recognition Arrangement (TTMRA) and the Closer Economic Relations project.<sup>25</sup>

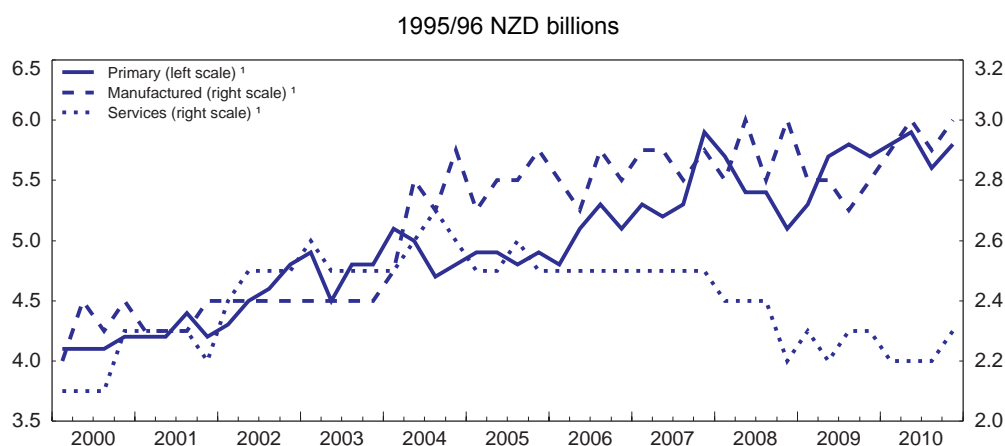
Figure 16. Policy heterogeneity *vis-à-vis* key trading partners<sup>1</sup>



1. Bilateral Indicators of policy heterogeneity are calculated using the regulatory data contained in the OECD's Regulation Database. These indicators measure the extent to which specific policies differ between country pairs. Full details can be found in Nordås and Kox (2009).

Source: OECD, OECD.stat – Market regulation database and OECD calculations.

Figure 17. Export volumes



1. The third and fourth quarters of 2010 have been estimated by the Reserve Bank of New Zealand.

Source: Reserve Bank of New Zealand (2010), Monetary Policy Statement, December.

25. The TTMRA allows that any good that may be legally sold in Australia may be legally sold in New Zealand and *vice versa*, and that a person registered in Australia to practice an occupation is entitled to practice an equivalent occupation in New Zealand and *vice versa*.

An ongoing push for greater regulatory harmonisation, mutual recognition and integrated institutions, where appropriate, would continue to reduce spatial transaction costs between New Zealand and Australia and mitigate the negative impact of economic geography. As such, the recent Memorandum of Understanding between the New Zealand and Australian governments, which encourages more cooperation between regulators and policymakers and sets out a range of co-ordination initiatives to deepen business integration, is most welcome. The principles underlying these arrangements need to be broadened and extended to other potential trading partners, particularly in Asia, to reduce the additional compliance costs for firms doing business in offshore markets. However, as with all significant regulatory changes, it is important that harmonisation initiatives be consistent with New Zealand's own objectives and circumstances.

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