Lost in the Regulatory Maze

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Address to the New Zealand Initiative

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www.independenteconomics.com

Government’s view of the economy

- In summary:
- If it moves, tax it
- If it keeps moving, regulate it
- If it stops moving, subsidize it
- With acknowledgement to Ronald Reagan

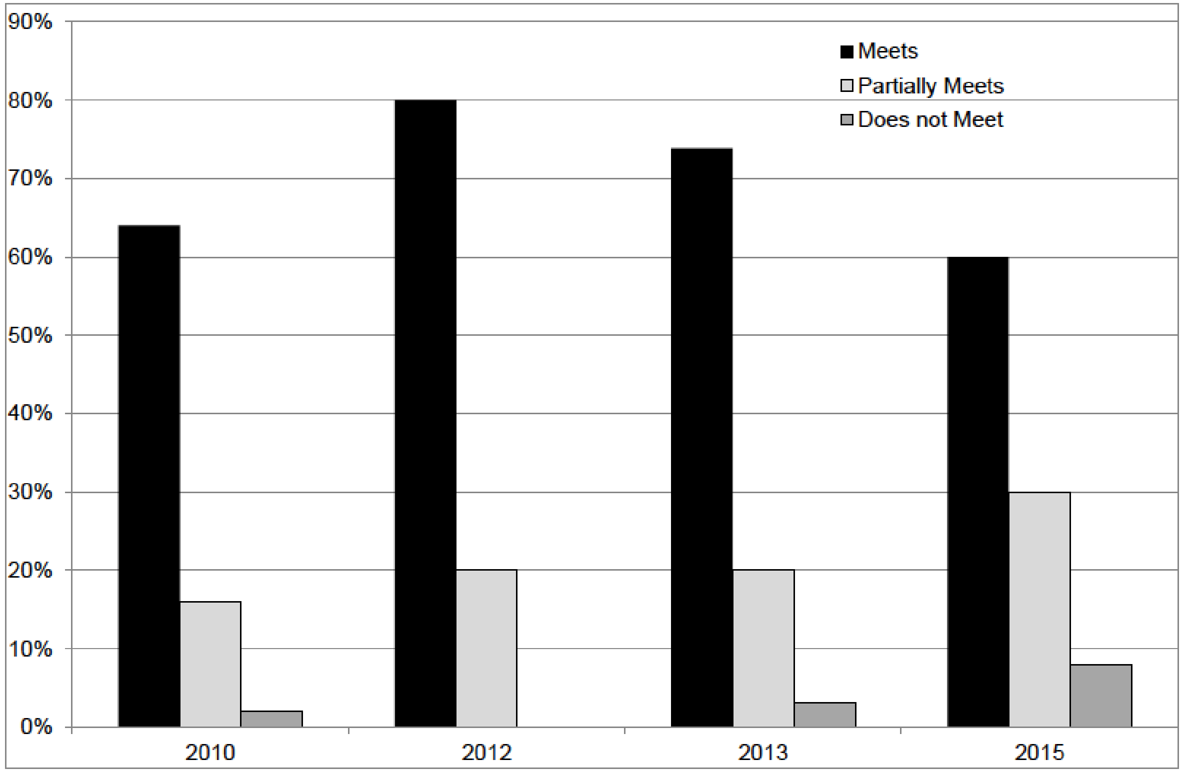
There is no shortage of activity on regulation

- NZ Parliament Select Committee on Regulation Review
- NZ Productivity Commission major 500 page report 2014
- New Zealand Initiative reports to the PM & special economic zones
- NZ Treasury Regulation Section
- Regulatory Impact Analysis Evaluation 2015
- Rules Reduction Taskforce report 2015
- Statutes Repeal Bill 2015
- And then there is the RIA Handbook (and the CBA Guide)
- Yet most regulators have never worked in the private sector

Regulatory Impact Statements – Internal Quality Assessments (extract from Sapere Research Report to Treasury 31-7-15)

Figure 4 Comparison of agency IQAs with previous years

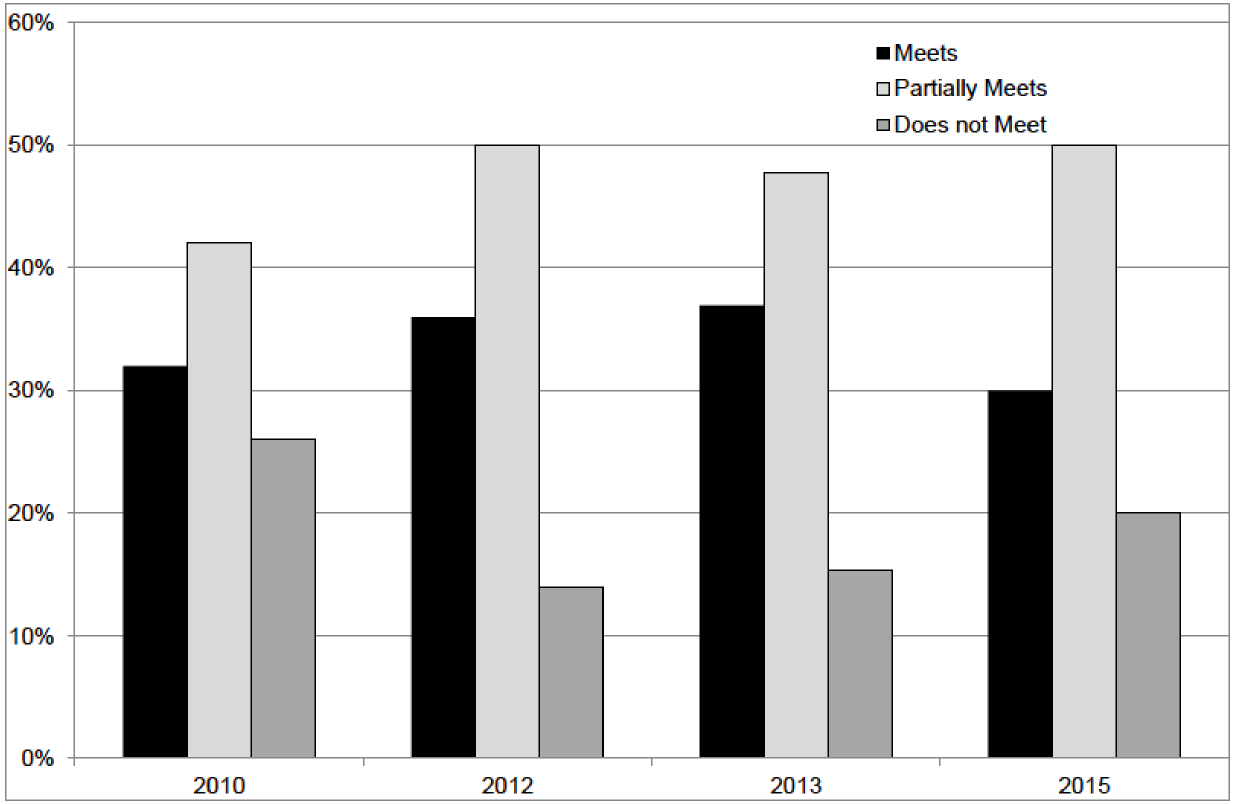
Proportion of RIS sample



Regulatory Impact Statements – External Quality Assessments (extract from Sapere Research Report to Treasury 31-7-15)

Figure 5 Comparison of external assessments with previous years

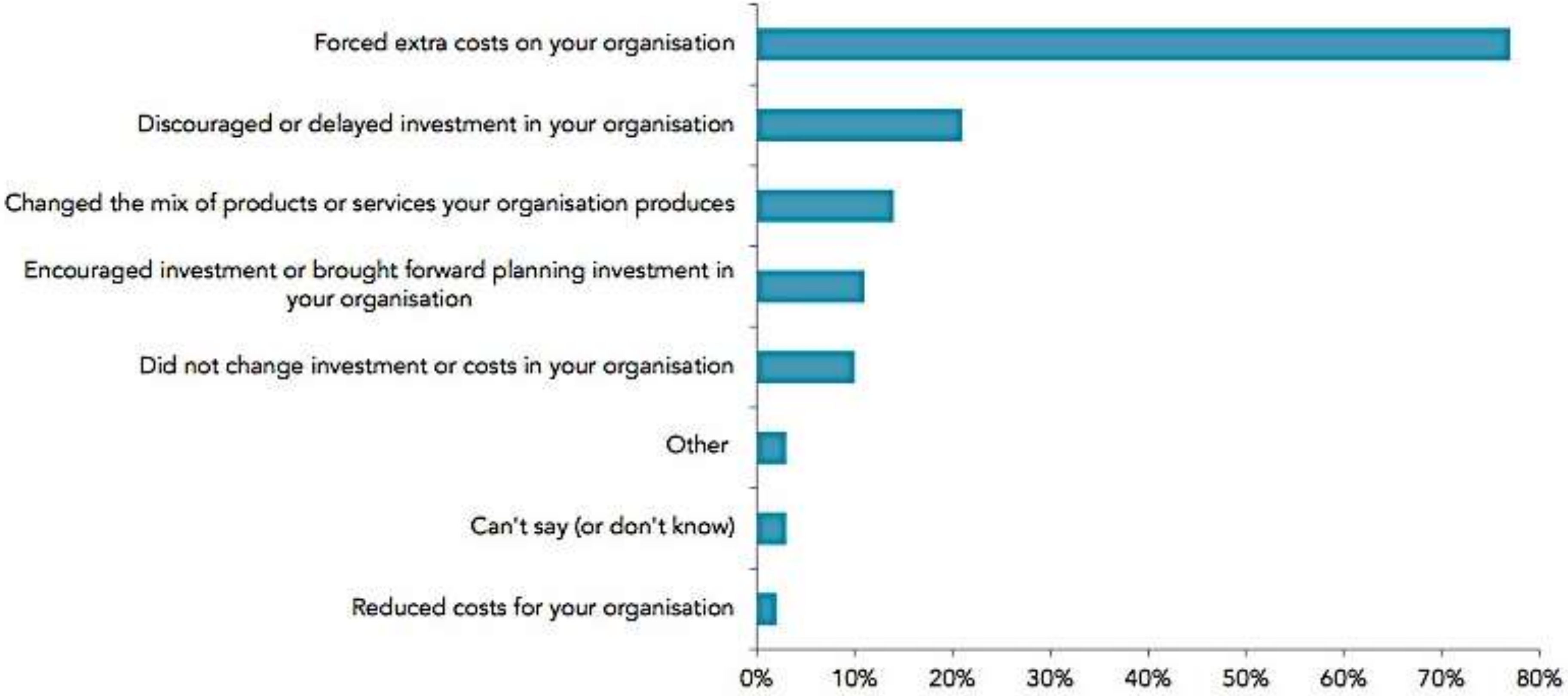
Proportion of RIS sample



Some disturbing survey facts

- 90% of firms say regulations contradictory or incompatible
- 77% of firms say regulations impose additional costs
- 74% of agencies say legislation is outdated or not fit for purpose
- More than 1 in 5 firms say regulation discourages/delays investment
- Half of CEOs say agencies too risk averse in enforcing regulations
- Only 1 in 4 firms say regulators understand the issues
- Less than 1 in 4 firms say regulators are skilled and knowledgeable
- Source: NZ Productivity Commission “Regulatory Institutions and Practices” June 2014666

Impacts of changes to regulations on business

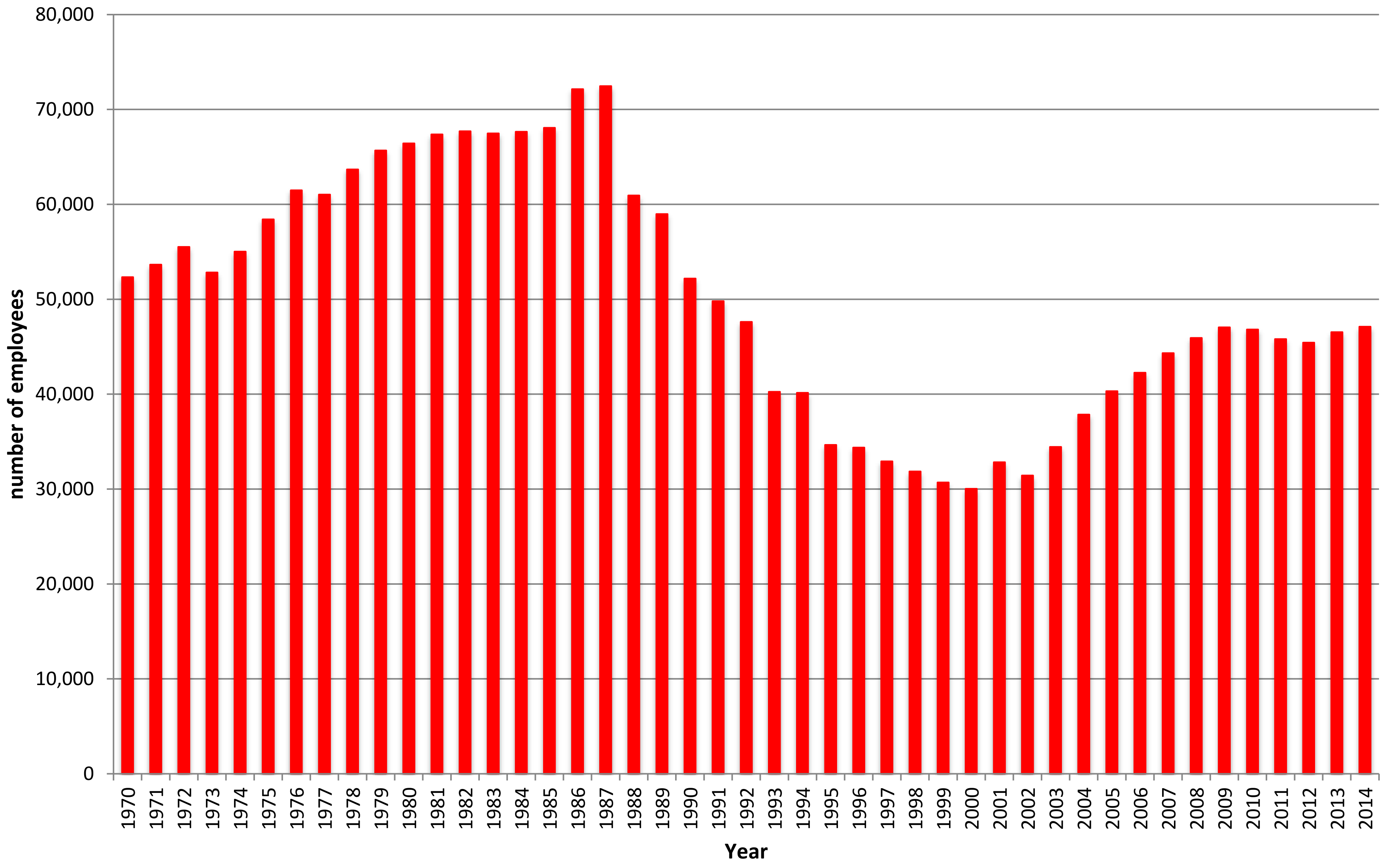


Source: Productivity Commission; Colmar Brunton.

The Productivity Commission on regulation

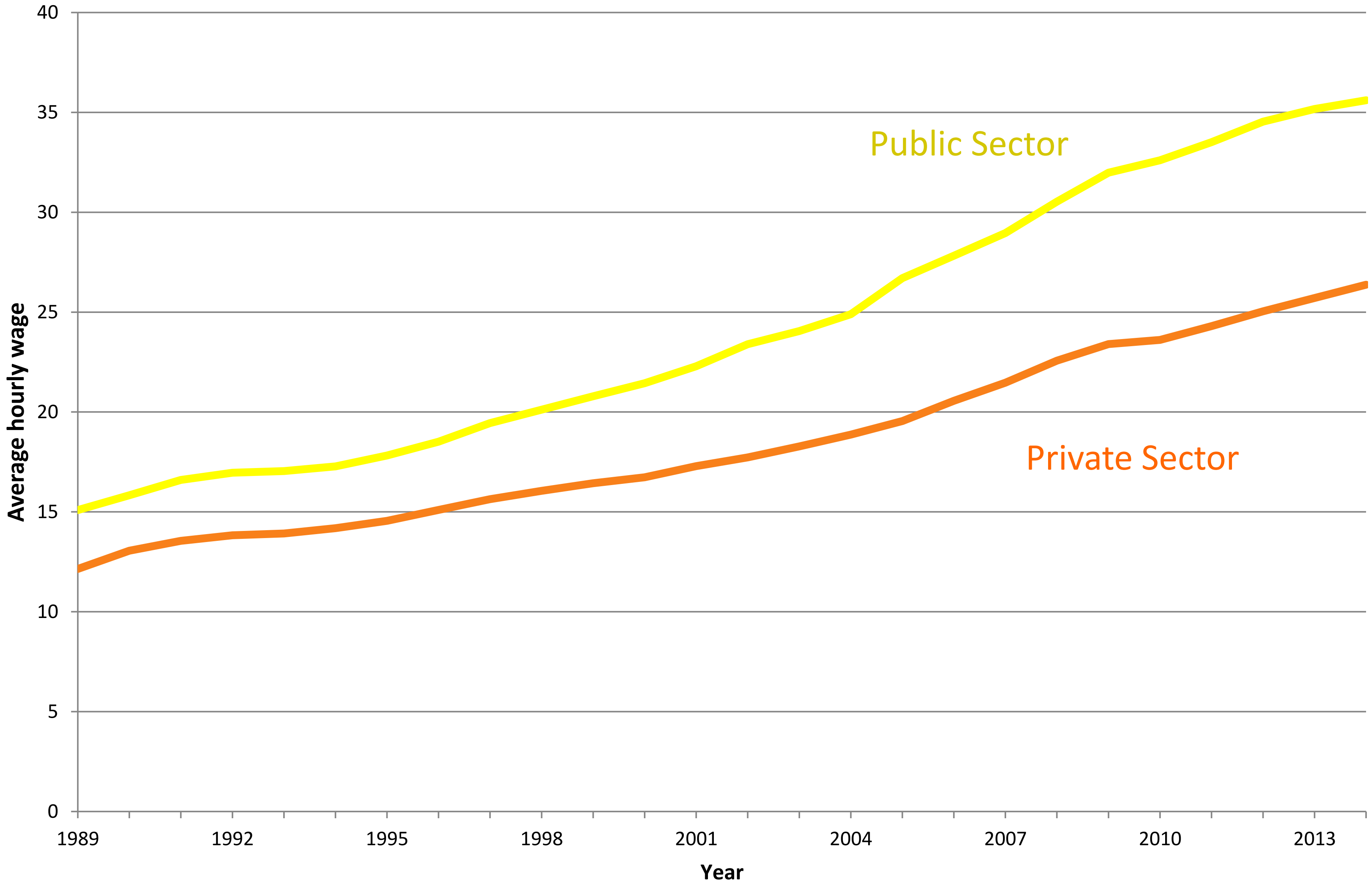
- “We can do much better”
- Aim “to improve design and operation of regulatory regimes & outcomes”
- 200 regulatory regimes plus 10,000 to 14,000 people
- 100-150 Acts and 350 legislative instruments each year since the mid 1990s
- Acts in force 2,871; legislative instruments in force 4,950
- “Surprisingly little information about regulation effects and performance”
- “Bad regulation impedes productivity and growth”
- “Poor regulation imposes significant costs”
- “The regulatory system is in need of improvement”
- “Surprising complacency”

Core Public Servants



Source: State Service Commission

Public vs. Private sector hourly earnings



Source: Statistics NZ

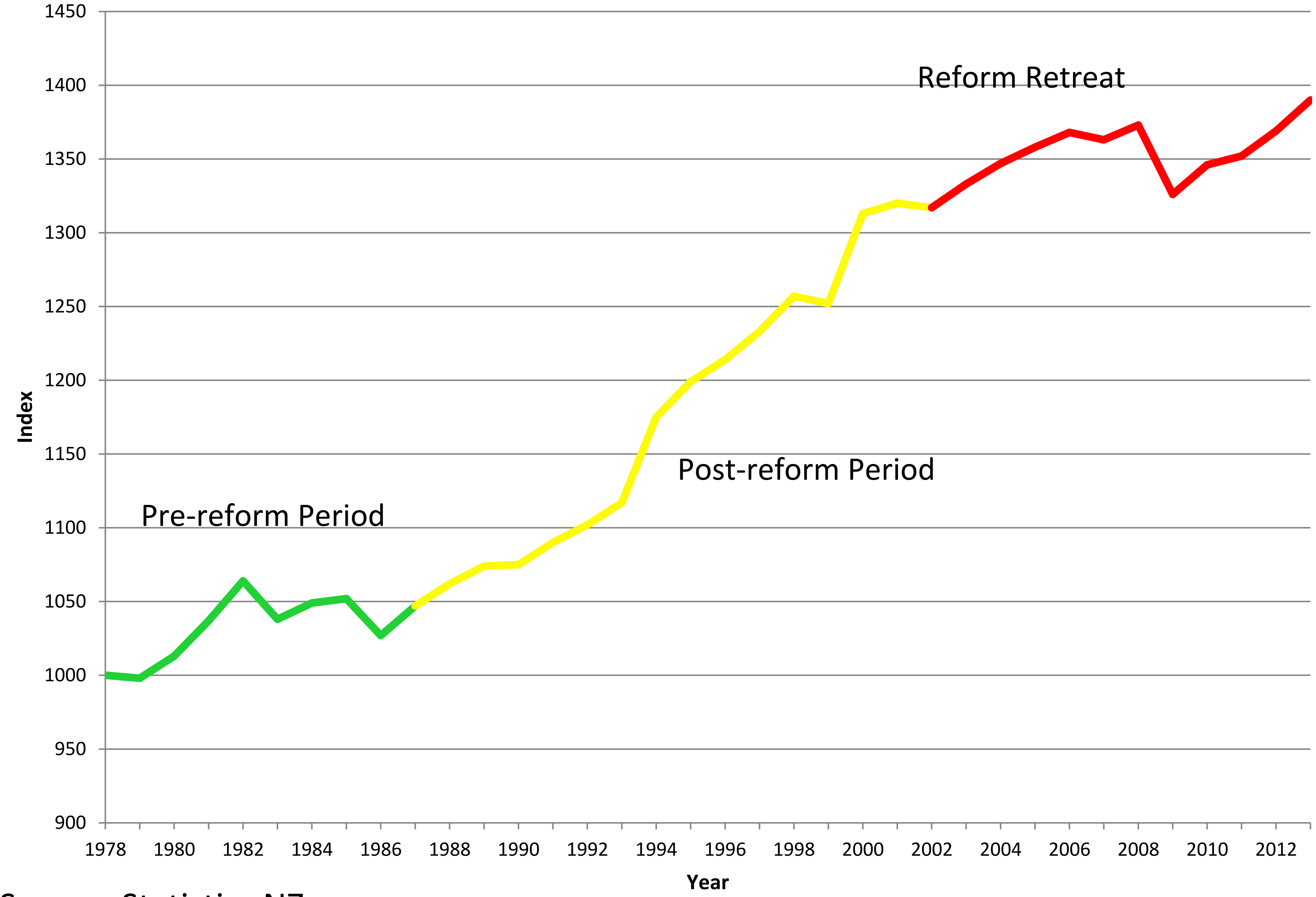
What makes successful regulation ?

- According to the Productivity Commission, better regulation needs:
- sophisticated understanding and strong leadership
- good cultures and professional workforce
- good communications and engagement processes
- role clarity and independence
- good governance and review mechanisms
- adequate funding and strong monitoring
- much on process and operations and institutions and structure
- even a “Head of the Regulatory Profession” … help !

But what was excluded ?

- exclusions from the Government's terms of reference:
- no assessment of:
  1. individual regulators
  2. regime objectives
  3. or the policymaking process
- these are huge missing elements … the underlying economics
- reviews of process … but not the fundamentals

Multi-factor Productivity Growth



Source: Statistics NZ

Where does the regulatory burden lie ?

- Resource management
- Health and safety
- Prudential supervision
- Financial markets
- Commerce Commission
- Housing and construction
- Environmental
- Electricity & Telecommunications
- Local authorities
- The list is actually a long one

An illustration
Commerce Commission interventions

- Complaints about anti-competitive behaviour and predatory pricing
- Some illustrative dilemmas
- Progressive Enterprises/Countdown v Shane Jones & suppliers
- Fletcher Building/Winstone Wallboards v Knauf
- Fletcher Building & Stevenson concrete - 5 years for clearance
- Spark v Chorus - more later

Another illustration
Financial Markets Conduct Act

- wonderfully commendable stated objectives :
- avoid unnecessary compliance costs
- reduce governance risks
- promote innovation and flexibility
- provide understandable information
- facilitate transparent markets
- promote informed participation in markets
- Despite this, the FMA oversees or monitors 32 items of legislation

Unintended consequences in financial markets

- All this simplification needed 597 clauses
- Complex, lengthy, detailed, high risks for directors
- Prospectuses now replaced by overnight placements
- IPO's often now avoided – trade sales preferred to market listing
- On market takeovers replaced by off market transactions
- Relatively few significant takeovers today
- Yet takeovers used to be a major form of corporate restructuring
- Remuneration disclosure simply stimulated increased executive pay
- Major financial advisers have departed the NZ market
- Protection for small shareholders an irrelevant myth

More unintended consequences
Banks and regulation - Case I

- Housing rated low risk, so 50% of normal capital requirements
- Incentive for banks to accelerate growth in house lending
- Then the GFC and sub-prime mortgages arrived
- The same officials redesigned the Basle agreements
- They decided housing had become higher risk
- Aggravated in NZ by a price boom especially in Auckland
- So loan to value ratio (LVR) controls introduced
- But the fundamental issues remain unresolved

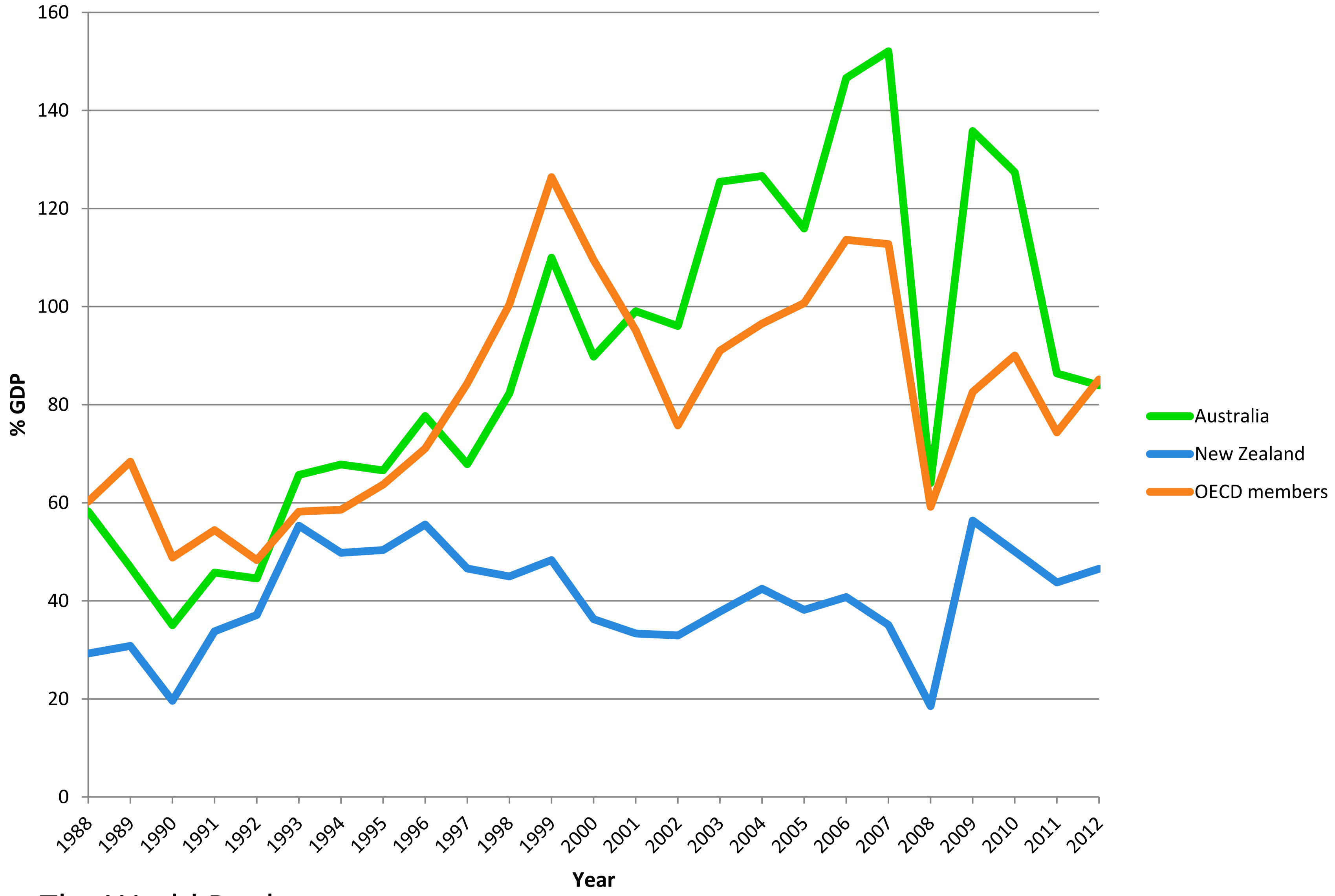
More unintended consequences
Banks and regulation - Case II

- ANZ bid for National Bank so RBNZ sought new legislation
- NZ’s largest ever takeover/merger
- Prudential controls extended by overnight legislation
- Policy design then took over a year to develop
- Cost ANZ $250m NPV
- NZ banks forced to reproduce worldwide systems just for NZ
- Offset much of the cost savings from the merger

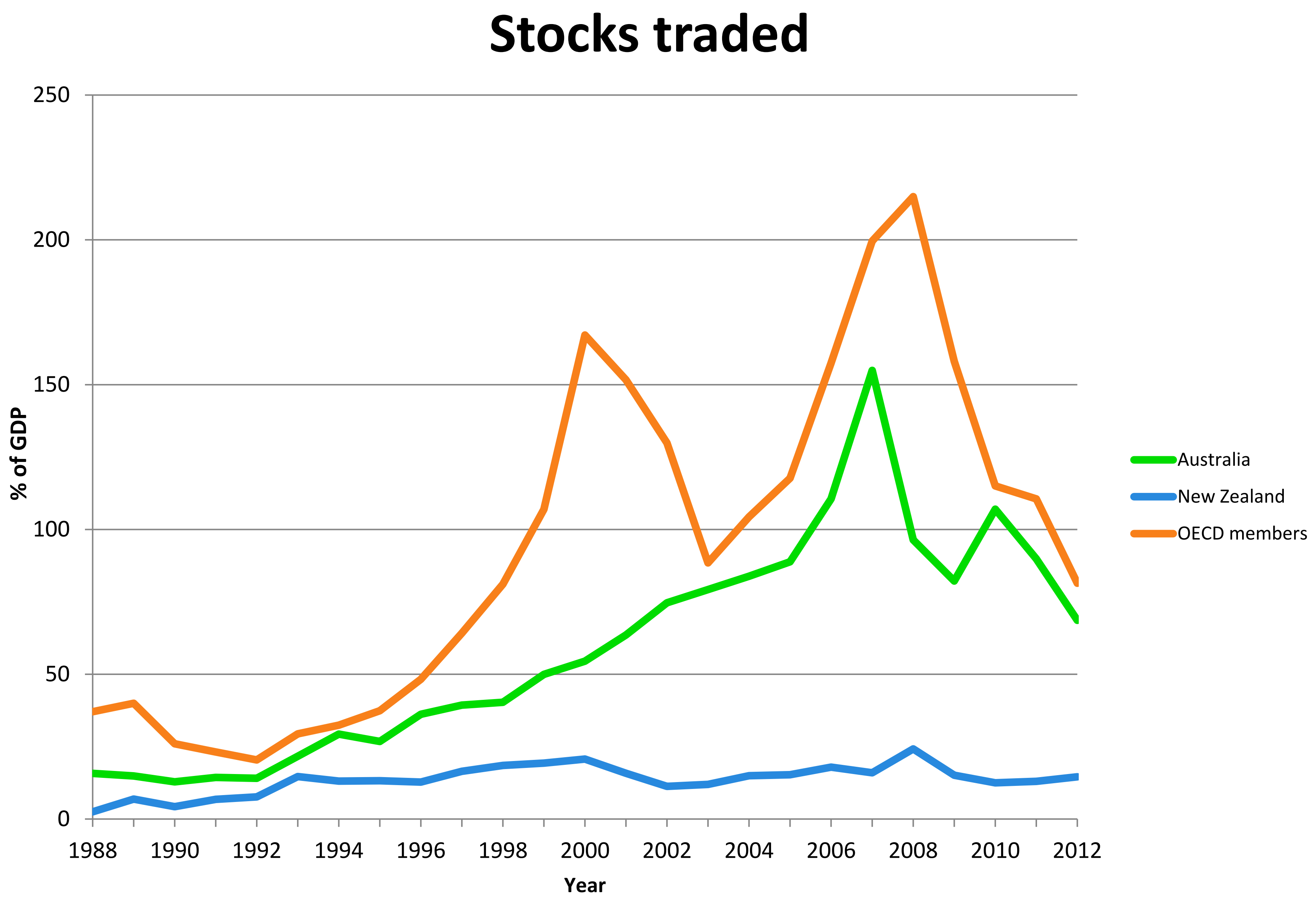
Regulatory risks often high and uncertain

- Many major NZ companies face regulatory risks
- These can be explicit or implicit
- Meridian, Mighty River, Contact, Genesis, Spark, Vodafone, Chorus, Sky City, Sky TV, Auckland International Airport, Fletcher Building
- That is, most top NZ companies face uncertain regulatory situations
- Compliance for directors carries substantial risks
- Courts perceive matters ex post not ex ante
- Courts perceived as often unsympathetic to the corporate world
- NZ sharemarket capitalization still small by international standards
- And it has declined over time

Market capitalization of listed companies



Source: The World Bank



Source: The World Bank

Governance and performance

- The essence of good governance is not about regulations
- Strong commercial performance does not arise from the regulations
- What matters is strong leadership
- Good strategies and clear objectives
- Individual accountabilities and quality people
- Sound commercial judgement and quality execution
- Much commonsense and high integrity

Governance and performance II

- We cannot simply regulate for these elements
- The myth is that we can do so
- A problem emerges, we regulate to solve it
- So we end up overburdened by masses of regulation
- This imposes long delays and substantial costs
- To say nothing of heaps of unintended consequences
- And thus we lose the plot

Another case study
The telecommunications industry

- 12% of households use internet streaming for TV
- Doubled in past year cf. Netflix, Lightbox, Neon
- About 100 service providers in NZ but 3 account for 95% of market
- Network traffic up 77% in FY 2015
- Fibre network 15% uptake so far
- Fibre is so far just 5% of Chorus total connections
- NZ 1st in OECD for fibre growth
- Chorus invested $2 billion in fibre networks since 2011 demerger
- Government spending $2 billion, with NO COST BENEFIT ANALYSIS

The disconcerting case of Chorus

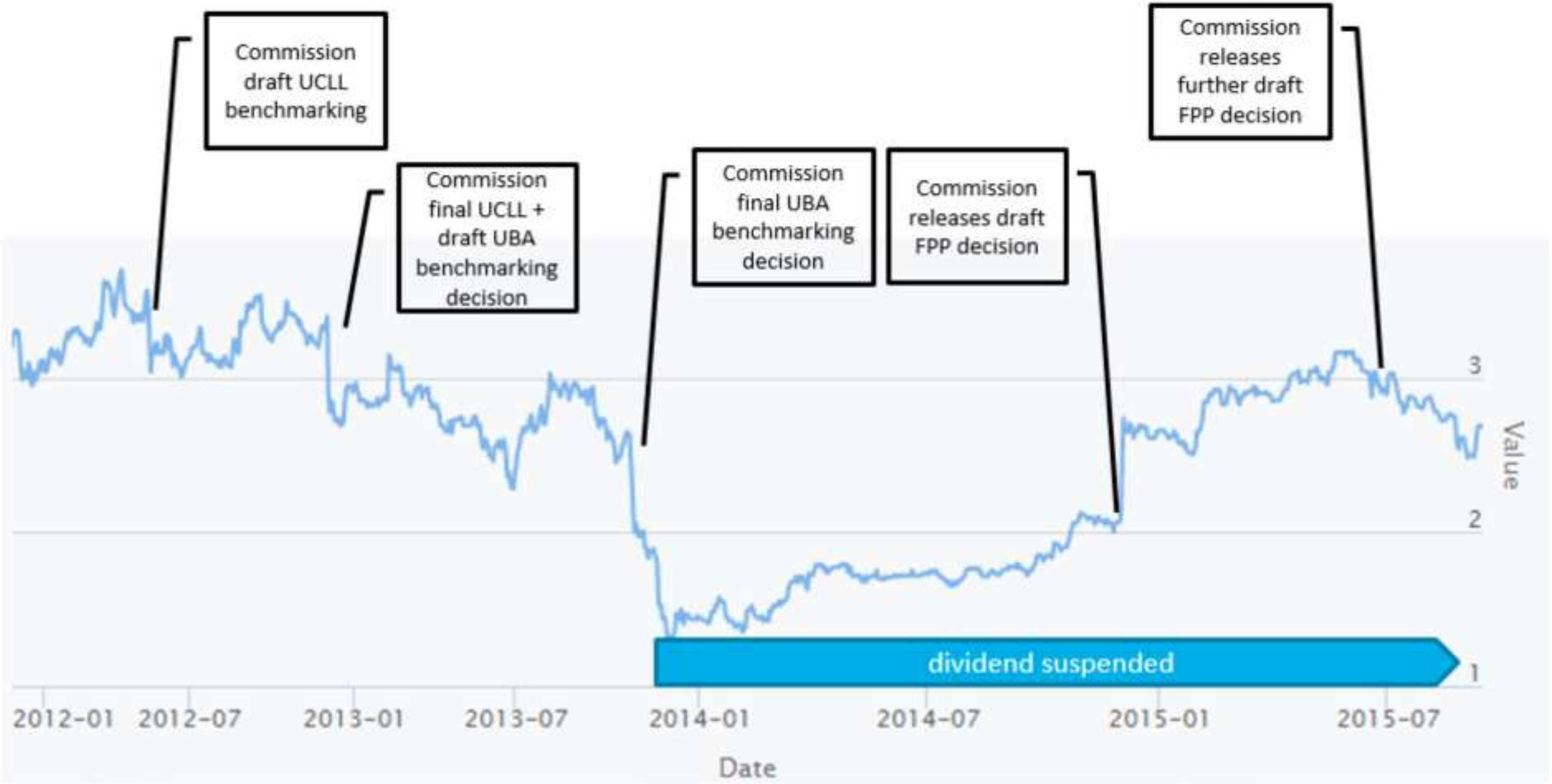
- Yet 80% of Chorus revenue regulated by Commerce Commission
- Benchmarking copper line price reduced earnings by $20 million
- Benchmarking broadband reduced earnings by $140 million
- Chorus had a $1 billion funding gap for its network
- Review requested Feb 2013, delayed 4 times, still not finalized
- Price dropped $45.92 to $34.44, draft suggests $38.40
- CC modelled on a hypothetical network, not actual NZ costs
- CC network valuation $6.6 b. v Chorus analysis $13 b.
- CC desktop costings 50% below Chorus actuals

Debilitating regulatory effects

- Strong connections growth
- Powerful broadband expansion
- Despite this growth, costs declined 1%
- But poor regulatory induced financials
- Chorus revenues down 5%, profit down 39%
- No dividends for two years
- Huge uncertainty for companies and investors
- Regulatory and official irresponsibility

Regulatory history vs share price

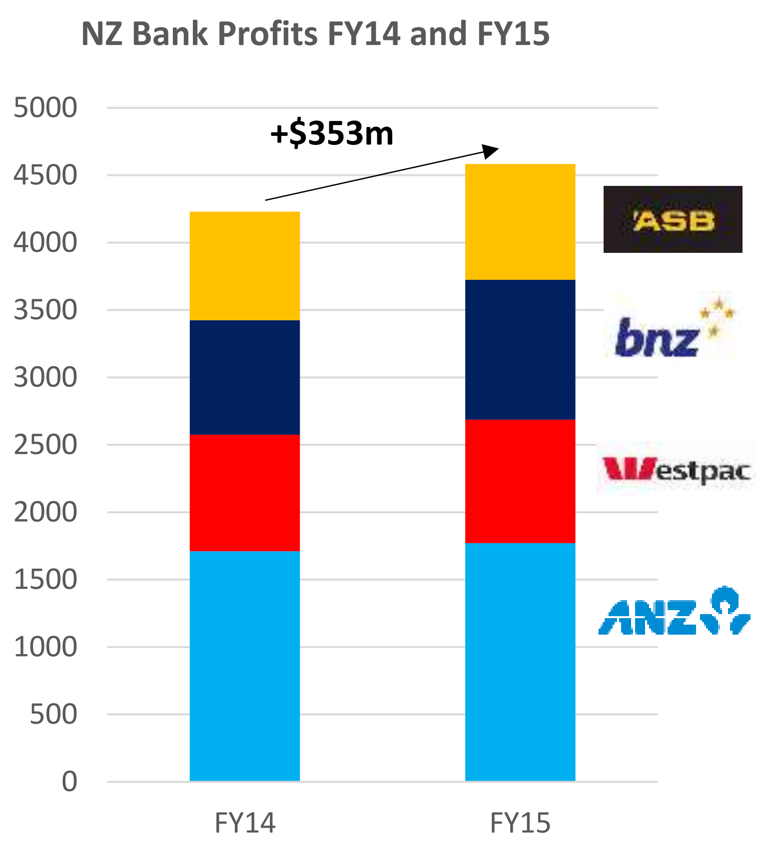
> Chorus' share price performance since demerger in 2011 has been dominated by regulatory decisions and processes

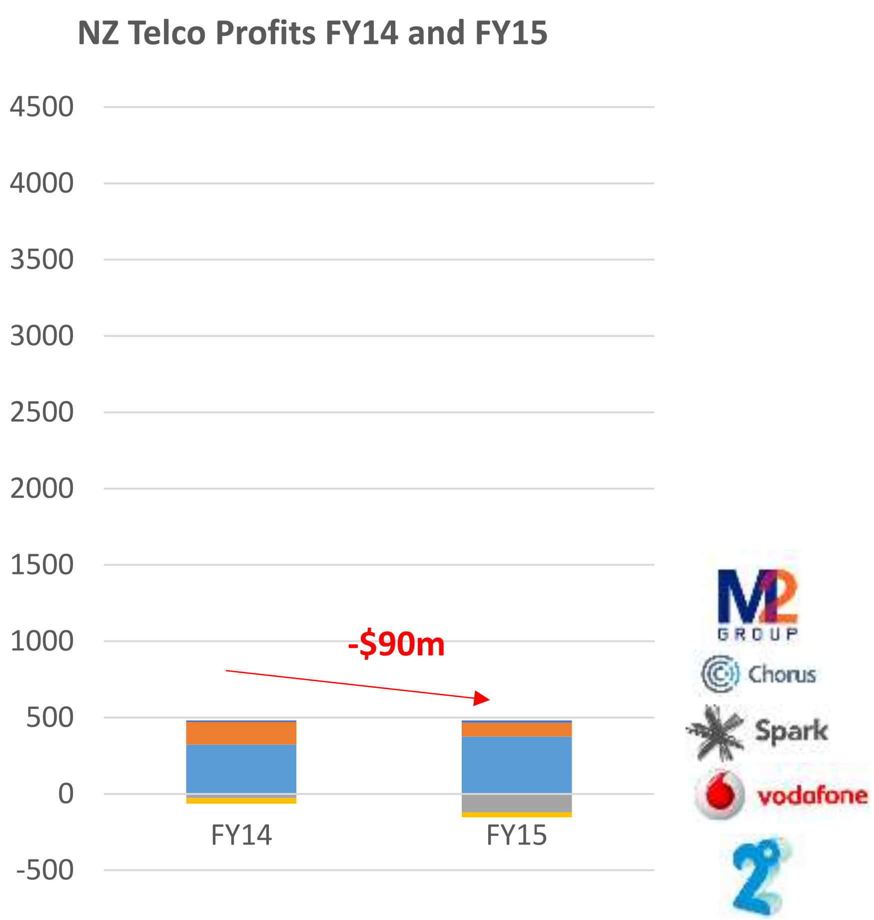


And what of Spark/Telecom ?

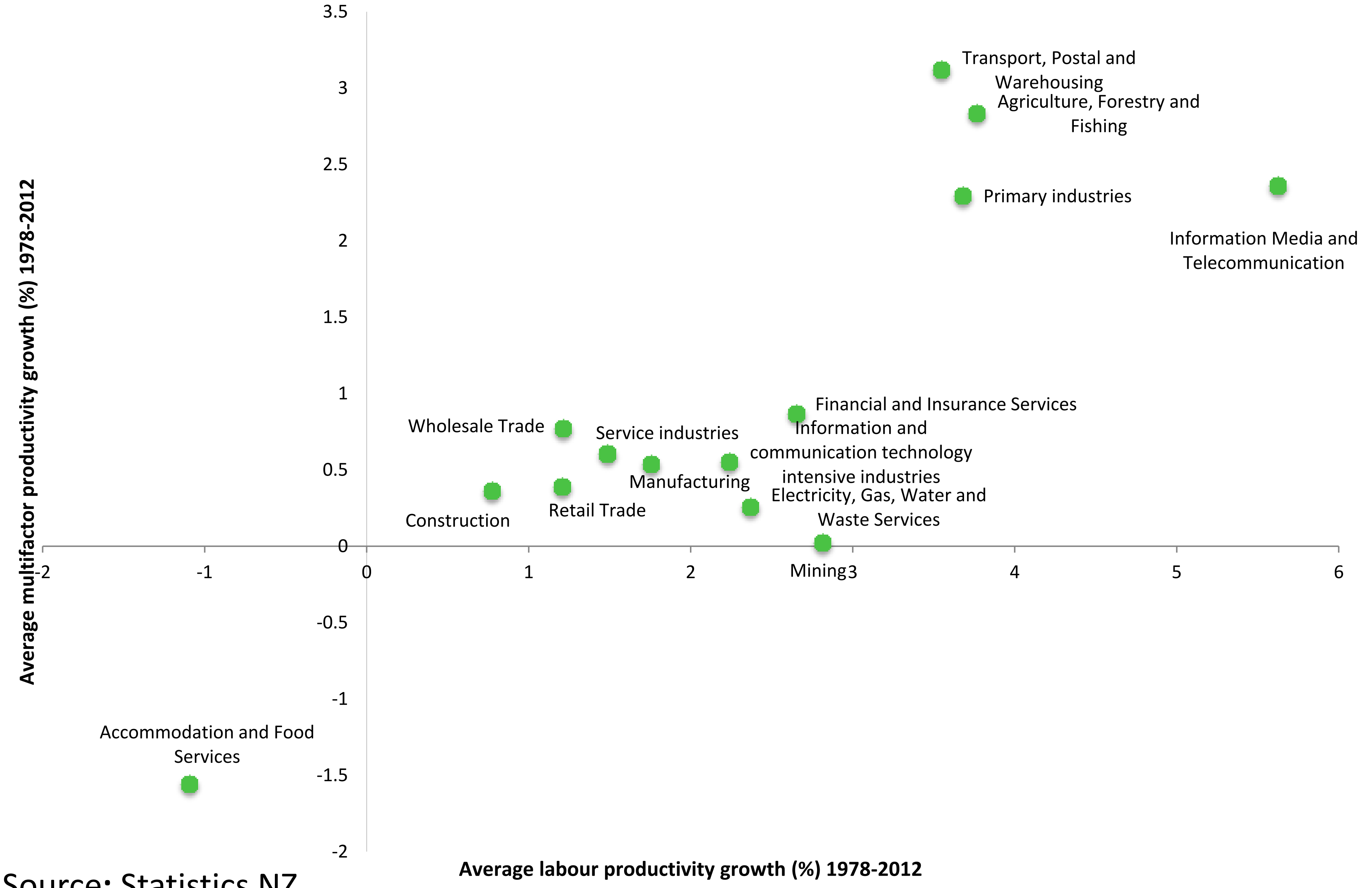
- In 2003 the CC recommended against unbundling
- Telecom offered a market led solution
- In 2004 Government agreed with CC
- In 2006 Government introduced unbundling without notice
- Overnight $3b. written off Telecom’s market value
- Over 2005-2015, TSR for NZX50 84%, for Spark 34%

Telco industry profits less than smallest of Big 4 banks





Labour and multifactor productivity by Industry



Source: Statistics NZ

Productivity growth is the key

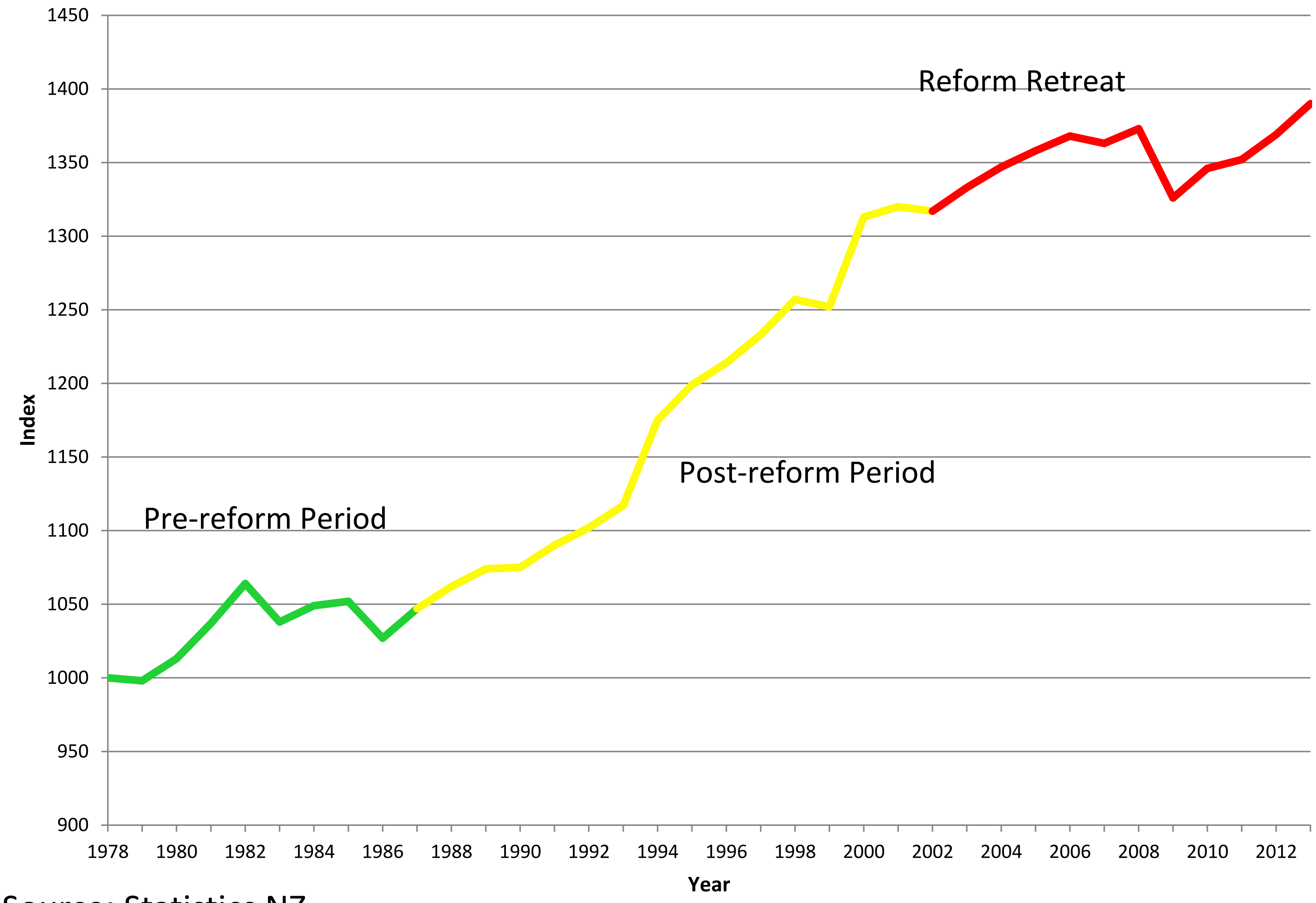
- Productivity growth should drive economic growth
- The major economic reforms took place 84 to 91
- NZ's strongest productivity growth post reforms 92-00
- The 2000's benefitted from strong terms of trade growth
- But productivity growth slowed as regulation re-emerged
- Example: telecommunications heavily re-regulated
- Yet it had recorded the fastest productivity growth
- And the government sector generally got larger again
- So once again productivity growth is slow
- MBIE target now 2 % pa, up from 1 % pa, not a great target

Business adaptability severely eroded

Regulatory Dilemmas

- Regulation begets regulation
- Regulation overrides commercial solutions
- Regulation and changes induce uncertainty
- It imposes high transactions costs
- Diverts energy into rent seeking behaviour
- And away from focussing on winning in the market
- Regulation always has unintended consequences
- It concentrates on past issues rather than future growth
- Success ironically attracts regulation
- Regulation reduces flexibility
- It ultimately impedes the competition it pretends to promote
- Reduces attractiveness of New Zealand for foreign direct investment

Multi-factor Productivity Growth



Source: Statistics NZ

In Summary I

- We regulate takeovers and few take place
- A major corporate adjustment mechanism is thus lobotomized
- We regulate prospectuses and few people read them
- IPO’s become high risk and fall out of favour
- Boards bypass the market by going off-market
- We regulate remuneration disclosure and simply put more pressure on increases in remuneration
- We regulate the stockmarket and it languishes
- Moreover, we stimulate off-market transactions

In summary II

- We favour housing by lower capital requirements and fret when it grows so strongly
- So we regulate it in new ways that promote other downsides
- We regulate building activity and regulatory approvals take longer than the construction time
- To say nothing of the dollar cost of regulatory approvals
- We regulate land use and urban boundary land costs 9 times more than rural boundary land

In summary III

- Regulators rarely have to work under their own regulations
- They have seldom worked in the industries they regulate
- Remarkably little understanding of unintended consequences
- And minimal attention to addressing them
- Even the PC is ruled out from addressing underlying economics
- Solutions are available
- But it is really all about understanding the issues
- And how the incentives and sanctions operate
- And then it is leadership and commitment

Some solutions in principle

- More secure property rights
- Greater certainty in the application of the law
- Enforceability of contracts
- Reduce judicial activism
- Less intrusive regulation and fewer changes
- Cost/benefit analysis for new & old regulations
- Ex post reviews of regulations
- Sunset clauses
- Revisit the economics of regulation
- Strong leadership of deregulation

The solutions framework

- Property rights really matter
- Open and competitive markets
- Smaller government
- Reduce public service bureaucracy
- Tighten up on government expenditure
- Abolish corporate welfare
- Reduce taxes
- Develop clearer price signals in public sector
- But it is really all about leadership

Sir Roderick Deane

Sir Roderick Deane KNZM, PhD, BCom (Hons), FACA, FCIS, FNZIM, Hon. LLD, has had an extensive career at the top levels in the public sector, both policymaking and management; in the corporate world, both in NZ and overseas; in the charitable and arts arenas; and as a professional and academic economist. He is currently Chairman and Patron of the IHC Foundation, Chairman of the Pataka Foundation and a Trustee of the Deane Endowment Trust.

He was previously Chairman of Fletcher Building, ANZ NZ Bank, Telecom NZ, the NZ Seed Fund, TransPower NZ, PowerDesignBuild, Pacific Road Group in Sydney, Te Papa Tongarewa (the Museum of NZ), City Gallery Wellington Foundation, a Director of the ANZ Banking Group in Melbourne and Woolworths Ltd in Sydney, a Director of TransAlta Corporation in Canada, and a Director of AMP in NZ. The NZ Seed Fund underpinned the creation of Pacific Edge in NZ and Neuren Pharmaceuticals in Australia.

At an earlier stage he was CEO and MD of Telecom Corporation of NZ, CEO of the Electricity Corporation of NZ, Chairman of the State Services Commission, and Deputy Governor & Chief Economist of the Reserve Bank of NZ, and President of IHC NZ Inc. He was also Professor of Economics and Management at Victoria University of Wellington, and Alternate Executive Director of the International Monetary Fund in Washington DC.

Sir Roderick is a Distinguished Fellow of both the Centre for Independent Studies in Sydney and the New Zealand Association of Economists. He was the inaugural NZIER Economist of the Year in NZ, and has been CEO of the Year, Chairman of the Year, and Executive of the Decade in the NZ Management Awards. As part of these awards, he was also given a Special Leadership Award. He was the inaugural recipient of the NZ Shareholders Association Beacon Award for corporate governance and leadership and he also received the USA based Stern Stewart Award for the creation of EVA (Economic Value Added) while he was CEO of Telecom NZ.

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