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Dear Sir

Report On the Paper "Modelling the Effects of Mutual Recognition of Imputation Credits"

This constitutes my report on the paper "Modelling the Effects of Mutual Recognition of Imputation Credits" ("the paper").

The paper puts forward a model for estimating the economic and fiscal impact of trans-Tasman mutual recognition of imputation credits ("TMRIC"). This is the Small MRIC model. This provides a useful guide to thinking about the impact of TMRIC and supplements the model outlined in the August 2012 NZIER and CIE paper "the costs and benefits of mutual recognition of imputation and franking credits". Both models agree that TMRIC would be to the economic and welfare benefit of Australasia overall. This is not surprising. The lack of TMRIC hinders the free-flow of capital between Australia and New Zealand and it is not unreasonable to conclude that barriers to the free movement of capital have economic and welfare costs. The models agree that the trade diversion argument, which holds that bilateral arrangements may not benefit countries covered by such arrangements, are not relevant in this case.

Where the models diverge is in their conclusions as to the distribution of the overall benefits of TMRIC between the two countries. The NZIER/CIE model concludes that the benefits flow to both countries albeit weighted to New Zealand's advantage. The Small MRIC model, on the other hand, concludes that the benefits of TMRIC would be more than fully captured by New Zealand. The fact that New Zealand would benefit more than Australia from TMRIC seems unsurprising. This, it seems, follows first from the relative sizes of the two economies. Secondly, New Zealand investment in Australia is predominately of a portfolio nature, any increase of which could be expected to be

offset, to a significant extent, by a reduction in portfolio investment from the rest of the world. By contrast, Australian investment in New Zealand is more heavily of a direct nature which is unlikely to be so easily substituted by outside investment.

Any asymmetries in specific country benefits should not, however, divert attention from the clear overall benefits of TMRIC for the Australasian economy. Such asymmetries are likely to be inherent in any bilateral agreement as indeed they were from the beginning of Closer Economic Relations. To the extent considered appropriate they can be the subject of government to government discussion within the overall CER/SEM framework that has proved to be so beneficial to both Australia and New Zealand.

That said, the degree of country asymmetries in benefits shown in the Small MRIC model seems difficult to take at face value. This seems to be driven by assumptions made as to investment and savings responses. In particular, that a lower required rate of return for Australian investment in New Zealand would significantly drive down capital investment in Australia. Given the openness of Australia to rest of the world capital and the likely country specific returns from direct investment into New Zealand, the degree to which the model leads to reduced capital investment in Australia seems implausible. It is noted that the sensitivity analysis on the model shows that a more realistic assumption around capital responses (where capital from New Zealand to Australia is likely to be more substitutable than capital flows from Australia to New Zealand) will reduce the asymmetry in benefits between the two countries.

Most importantly, it should be acknowledged that models such as the Small MRIC model and the NZIER/CIE model do not of necessity capture the dynamic welfare and economic gains that one would expect from TMRIC. As with CER/SEM these are likely to be far more important in the overall picture than any gains able to be measured, however inaccurately, in a model. My experience is that lack of TMRIC makes tax a core factor in considering any trans-Tasman business arrangements. Whenever tax is a core factor in business arrangements, high economic costs are incurred. When dealing with trans-Tasman operations the lack of TMRIC requires businesses to choose between:

- Reallocate expenses and revenue to have taxable profit where the can produce useable tax credits;
- Avoid using the corporate form in holding investments and thus forgo the benefits of this efficient form of managing a business; or
- Cease operating as a trans-Taman business.

Small and medium enterprises have more limited opportunities than larger enterprises in terms of the first option and are thus especially impacted by lack of TMRIC.

Practical examples of the impact of the lack of TMRIC are provided at pages 7 and 8 of the NZIER/CIE report of August 2012.

Finally, and in conclusion, both the Small MRIC model and the NZIER/CIR model seem useful background for considering the policy issues with TMRIC but all models are only useful to the extent

to which we can relate their findings back to the real world on an intuitive basis. The underlying economic logic behind TMRIC seems strong with long term benefits to both economies.

Yours faithfully

Robin Oliver MNZM