AUSTRALIA NEW ZEALAND LEADERSHIP FORUM

6 November 2012

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Chair
New Zealand Productivity Commission
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Mr Gary Banks AO
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Dear Chairmen

Thank you for creating the opportunity in Melbourne on 31 October for a discussion about the technical details of the ANZLF's research on mutual recognition of franking and imputation credits. Lee Davis and Dr Tingsong Jiang from CIE and Dr John Yeabsley from NZIER attended that meeting on behalf of the Australia New Zealand Leadership Forum.

We have received the accompanying report on the meeting from Lee Davis. The report points out some important points of difference in the economic modelling approaches taken by the APC and our own research, which we submitted to the Commissions on 27th August 2012. We found these insights very interesting and therefore wish to share them with you for consideration.

We would be happy to make this letter and report available as a formal submission whenever you deem appropriate once the workshop proceedings are made more widely available. If you would like us to submit these as a submission now via the website, please let us know and we will action accordingly.

Thank you again for the time and effort the Commissions are investing in fully exploring the franking and imputation credit issue.

Yours sincerely

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Dear Rod and Jonathan

MRIC TECHNICAL MODELLING WORKSHOP

The CIE (Lee Davis and Dr Tingsong Jiang) attended the Technical Modelling Workshop on mutual recognition of (company tax) imputation credits, held at the Australian Productivity Commission offices in Melbourne on 31 October 2012. Below we report our findings from the workshop.

The CIE would firstly like to congratulate the Australian and New Zealand Productivity Commissions for holding the MRIC Technical Modelling Workshop. We thought it was a good initiative and was well attended by informed participants. We would like to think that the discussions will be of some assistance to both the Commissions going forward.

Of particular interest to the CIE was the discussion around the economic modelling, and particularly how the Australian Productivity Commission's results differed from our own analysis of how MRIC implementation would impact the Australian and New Zealand economies.

The flavour of (some of) the discussions appeared to be along the lines of 'the CIE modelling said this, the APC modelling said the opposite'. We don't believe such comparisons were particularly helpful, and probably only served to add to the level of confusion. In our view, it is not a question of one model versus another, but rather using each model appropriately to gain insights about the likely outcomes of a particular policy change.

Further —while we did not explicitly raise this topic with the APC personnel who developed the model — it does seem to us that the APC model developers never intended for their modelling results to be painted as a definitive 'this is the impact of MRIC' result. Rather, we think the model was developed to investigate some basic relationships only.

The CIE

However, if the APC modelling is to be portrayed/reported as a 'this is the impact of MRIC' result, we consider it may be useful to all parties to set out where we think the core differences arise.

The APC presentation made it very clear as to what drives the apparent difference between the CIE and APC modelling results, and why the APC modelling suggests that MRIC would impose a net cost on Australian economic activity.

There are two broad areas to comment on:

- an assumed fixed capital stock
- the model not distinguishing between the government and household sectors.

An important point to note with the APC modelling is its treatment of the capital stock. The APC approach uses, in effect, an extremely short-run closure — one which does not allow changes to the size of the capital stock owned by each economy (p5 of the *Mutual recognition of imputation credits* paper). Implementation of MRIC would lower taxes on Australian capital in New Zealand, leading to a higher post tax rate of return for that capital. The higher returns then encourage greater Australian investment in New Zealand.

Higher returns, and the fixed capital stock, mean investment in Australia is shifted to New Zealand, which sees New Zealand having a higher capital stock with a correspondingly lower capital stock in Australia. Quite simply, a quantum of investment is shifted from Australia to New Zealand. As this 'shifted' investment is not replaced, the capital stock closure as implemented could only ever see MRIC being detrimental for economic activity in Australia.

It is perhaps helpful to consider the process by which investment would move from Australia to New Zealand. As the APC model does not include savings, the capital that is moved to New Zealand must already be in place in Australia as investment (such as plant and machinery etc). For the invested capital to be freed up, it would need to be sold, with the raised money then invested in New Zealand. The APC modelling suggests that over US$500 million of investment in Australia would be liquidated and then invested in New Zealand under MRIC. However, the APC assumption of a fixed capital stock necessitates that whoever bought the Australian assets for US$500 million then retires them from use. We are not sure this is a plausible assumption.

An alternative specification in the APC model would be to allow the capital stock to change over time. One option is to assume a perfectly elastic supply of capital by setting an exogenous world capital cost. Although this represents another extreme, it does not depart from reality too much given both Australia and New Zealand are both small open economies.

Another option would to be to use the savings/investment results from the CIE-GCubed simulations (which do allow for changes in capital stocks) to represent changes to the quantum of available capital over time.

A further issue concerns the fact that the APC model does not appear to distinguish the consequences of government spending versus household consumption (p32–33 in the APC paper). As a result, there will be no costs or benefits associated with a transfer from government to households even if the capital cannot move across borders (slides 23–24 of the APC presentation).

As with all models, the initial results from the APC analysis should be treated with some caution, and we trust that it would be instructive for the Commissions to directly address the issues we have raised above.

Finally, various workshop participants suggested a range of alternative/additional modelling simulations. We agree that investigation of these alternative simulations could prove to be helpful in the Commissions' work, particularly using an extended framework that is able to relax some of the more restrictive assumptions.

The CIE would welcome the opportunity to discuss these issues further with both the Australian and New Zealand Productivity Commissions.

Yours sincerely

Lee Davis
Director