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The Economics of Harmonisation: Implications for Reform of Commercial Law and Regulation in New Zealand*

by

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1. INTRODUCTION

From the mid-1980s until the mid-1990s New Zealand actively pursued a policy of deregulation and economic reform that in many instances resulted in commercial laws and regulations different from those of its major trading partners. More recently, New Zealand's policy independence has been questioned on the grounds that:

(i) It is unlikely that such a small country can consistently produce or bear the cost of producing "better" laws and regulations than larger countries.

(ii) Policy independence comes at high cost. In particular, regulatory and legal independence may reduce investment in New Zealand and slow the international expansion of New Zealand firms.

(iii) The retention of laws and regulations that are distinctive from those in Australia may provide a barrier to New Zealand firms obtaining the full benefits of CER and unimpeded access to Australian markets.

Proponents of harmonisation suggest that it is likely to result in more firms locating in New Zealand and in New Zealand firms expanding more rapidly. Superior growth prospects for New Zealand firms flow from the fact that their cost of capital will be lower because investors will be more willing to invest in them when they operate within a familiar framework of commercial regulation and overseas expansion will be easier because they will already comply with international standards of commercial regulation. Following the signing of a Memorandum of Understanding between the New Zealand and Australian governments, harmonisation of New Zealand's commercial law and regulation with that in Australia has become a primary rationale for the revision of commercial legislation.

This paper provides an economic assessment of the costs and benefits of harmonising New Zealand's commercial laws and regulations with those in Australia or with an OECD norm.[1] It argues that unless the definition of harmonisation is limited to mutual recognition the economics literature surveyed does not support a general presumption in favour of harmonisation of commercial laws.

The absence of any presumption in favour of harmonisation is based on the infeasibility of full harmonisation while New Zealand maintains political independence, and on the overall requirement for an assessment of the efficiency of any law in the context of the New Zealand economy.

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[1] Commercial regulation is interpreted as meaning all legislation and regulations bearing directly on the creation of commercial entities including their ability to raise new capital or transfer existing ownership rights, operate in markets, enter into transactions, enforce contracts relating to transactions, protect physical and intellectual property rights, and be wound up in the event of insolvency.

So long as New Zealand has independent courts and regulators the adoption of identical laws will not guarantee that the same words in legislation or the same regulatory structure will result in identical interpretations of decisions. Thus, harmonisation of laws and regulations cannot remove from investors many of the costs of understanding unique features of the commercial environment in New Zealand.

The design of commercial law and regulation should focus first and foremost on ensuring that the legal and regulatory framework is conducive to maximising the long-term growth of all commercial entities in New Zealand. In this framework, the benefits that would arise from harmonisation represent only one of the factors that would be considered in the reform of legislation. Thus, whether the optimal legislation for New Zealand is unique, incorporates elements of regimes from other countries, or is exactly the framework of other countries, is at best a secondary issue.

The paper concludes that the focus of debate about commercial regulation in New Zealand should be on the efficiency of legal and regulatory frameworks in promoting commercial activity in New Zealand. There should be no presumption that the benefits from harmonisation *per se* will be large enough to drive the adoption of legal and regulatory frameworks from overseas. Any case for the adoption of legal and regulatory frameworks from overseas must therefore be made on the basis of the superior efficiency of the foreign approach when it is applied to firms operating in New Zealand.

2 THE BENEFITS AND COSTS OF REGULATORY HARMONISATION

2.1 WHAT IS REGULATORY HARMONISATION?

The literature defines harmonisation as either "making the regulatory requirements or government policies of different jurisdictions identical, or at least similar" (Leebron 1996) or as a broader spectrum of possible co-ordination between regulators in different countries. In our view, the essence of harmonisation is that it involves some degree of regulatory co-ordination between two or more regulatory jurisdictions, which allows the laws of those countries to work together to some degree. Thus, our definition of harmonisation does not necessarily entail two or more countries adopting identical or even similar laws.

There is a spectrum of regulatory co-ordination ranging from co-operation between legislators and regulators designed to ensure clarity of jurisdiction and plug loopholes relating for firms operating in both jurisdictions to the adoption of identical laws and a single multi-state enforcement mechanism (regulator and courts) so that complete uniformity is achieved. In the latter case harmonisation effectively provides for the integration of the markets of two or more economies. In the middle of the spectrum are approaches designed to provide for reciprocity or mutual recognition, sometimes based on minimum standards.

Spectrum of regulatory harmonisation

The degree or level of harmonisation pursued between regulatory jurisdictions will be dependent upon a number of factors including, the particular laws under consideration, the strength of economic connection between the jurisdictions, the likeness of current regulatory policy and objectives, the desired degree of local flexibility, the similarities and differences in the scale and institutional structures of the two economies, and the perceived benefits from harmonisation.

The literature on harmonization often focuses on aspects of reciprocity (in the New Zealand context see Goddard 1999 for example). Reciprocity can provide for mutual recognition regimes (where firms complying with the legal and regulatory regimes in one country are deemed to comply with those in the second country) and for jurisdictional agreements that allow firms to operate with one regulator and one set of rules for their activities whatever jurisdiction they operate in. It is readily apparent, however, that mutual recognition and single jurisdiction agreements are most easily negotiated where the laws and regulations of the different jurisdictions are very similar, where the countries have a substantial economic interaction and where there is already some similarity in legal regimes, for example, both meeting some minimum standard (Geiger 1998). Thus,

reciprocity often leads to consideration of common minimum standards and may require stronger forms of harmonization such as the adoption of identical legislation or regulatory frameworks.

2.2 POTENTIAL BENEFITS FROM REGULATORY HARMONISATION

The key benefits of harmonisation are normally claimed to arise from its ability to reduce transaction and compliance costs for firms operating or selling in multiple jurisdictions as well as providing benefits associated with joint production of regulatory products.

Regulatory harmonisation across countries (whether through reciprocal arrangements, minimum standards or commonality) reduces the transactions/compliance costs associated with doing business across multiple jurisdictions. For businesses, having to comply with multiple sets of regulation across jurisdictions adds to the cost of conducting business across borders. This may discourage multiple market participation, reducing competition and social welfare. For other market participants, harmonised standards reduce the need to gather and analyse information about different regulatory standards across jurisdictions. Overall, harmonisation efforts act to reduce regulatory barriers to cross-country commerce. Where New Zealand's laws and regulations are harmonised with those of its major trading partners this may encourage the location of multinational firms in New Zealand and the retention of New Zealand firms that develop multinational operations.

Where regulatory policy is independently determined within each jurisdiction, there is the potential for negative and/or positive external effects to be imposed on other regulatory jurisdictions. Under these circumstances, some form of cooperation may be desirable to ensure that regulation is produced at the efficient level, not only within, but, across jurisdictions. A commonly used example is intellectual property protection in one jurisdiction conferring positive benefits on other regulatory jurisdictions, through increasing the returns from research and development activity. In the absence of coordination, the level of regulation may be set at sub-optimal levels.

Economies of scale and scope may be derived from joint production of regulatory policy such that it is more efficient for a single (coordinated) regulator to produce regulatory policy across multiple jurisdictions. That is, subsets of the market for regulatory policy may be characterised as a 'natural monopoly' where, given the level of demand, the market is more efficiently supplied by a single producer. In areas where regulatory policy making is characterised by high fixed costs, for example, the cost of setting up a market regulator, there may be significant benefits from coordination as the fixed costs of regulatory policy making are spread across a wider market, reducing regulatory cost per head of population. Shah and Thomas (2001) find that there are significant increasing returns to scale in securities regulation and market infrastructure. This issue is particularly relevant for smaller economies/markets where regulatory costs must be absorbed by a relatively small number of market participants.

Even for the aspects of regulatory policy making that are not characterised by economies of scale, sharing otherwise duplicated efforts can result in regulatory cost savings. Goddard (1999) identifies significant 'network effects' from harmonisation of substantive legal rules across jurisdictions. Where two or more jurisdictions apply the same substantive law, each jurisdiction benefits from the interpretation and application of those rules to cases in the other jurisdiction. As more jurisdictions adopt the same substantive laws, the potential for cross-border learning and knowledge sharing increases commensurately.

2.3 How Widely Spread Are The Benefits of Harmonisation?

Any case for regulatory harmonisation must rest on an analysis that demonstrates that the costs of harmonisation are clearly outweighed by the benefits. The costs associated with regulatory harmonisation (associated with both the introduction of new legislation and the requirement for ongoing changes to maintain the desired degree of harmonisation) will be dependent to a large extent on the degree of harmonisation/co-ordination pursued (in market and regulatory structures, laws and law enforcement). For example, mutual recognition, due to the absence of need to actually change domestic laws, is relatively simple and less costly to implement.[2] Moving further along the harmonisation spectrum, establishing minimum standards, or identical laws will impose progressively higher coordination costs. Importantly, these costs are imposed on all firms in the economy, because all firms will be required to comply with the harmonised legislation or regulations. In weighing up the net costs and benefits it is therefore necessary to consider whether the benefits of harmonisation will be as widely spread.

In any economy, the proportion of firms who operate in more than one jurisdiction will be small. In OECD countries such as New Zealand, Australia and the UK, at any time 80 - 85 percent of the commercial enterprises are small business whose operations are confined to the country of origin (though they may of course export goods and services without establishing a presence in other countries). Broad harmonisation initiatives may require these firms to bear substantial costs associated with higher legislative and regulatory requirements even though their present operations do not allow them to obtain any of the benefits of the resulting ability to operate in other jurisdictions.

Firms who do wish to operate in more than one jurisdiction will have to bear the costs of complying with whatever regulations and statues are relevant, but there may be substantial savings for these firms if they can operate in a regime that has lower compliance costs until such time as they wish to expand beyond their home jurisdiction. In this sense there may be a trade-off between short-term and long-term gains from harmonisation. Harmonisation may provide short-term gains associated with the reduction in transaction and compliance costs for firms who operate in more than one jurisdiction. However, there may be long-term costs for the economy resulting from the imposition of higher transaction and compliance costs on all firms in the economy. Higher transaction and compliance costs may slow the growth of those firms who are yet

[2] Some change in domestic laws is often required in order for participating jurisdictions to be a party to mutual recognition arrangements.

to achieve the level of competitive advantage necessary to consider operating in another country, and thus slow the long-term rate of growth of the economy as a whole.

Mutual recognition or reciprocity is the minimum degree of harmonisation required to facilitate lower cost access to Australian markets. Overall, the costs associated with a system of mutual recognition are much lower than for those forms of harmonisation where law changes are necessary (e.g. adoption of common minimum standards or identical laws).

A system of mutual recognition will, however, only be achievable where the laws of the participating jurisdictions fall with the tolerance limits for differences in regulatory standards in each jurisdiction. In practice the process of harmonisation is likely to involve considerable real resource costs in agreeing to and effecting minimum standards, and in the imposition of those standards on firms that are not in a position to take advantage of the benefits that the common standards claim to provide. Thus, regulatory harmonisation to attract firms with substantial operations in Australia comes at considerable cost and may not provide net benefits to the New Zealand economy.

2.4 Does 'One Size Fit' All In Regulation?

A common criticism of harmonisation is that it will never lead to efficient outcomes as each country has different endowments and preferences (Goddard 1999) as reflected in each countries unique mix of domestic institutions, political circumstances, and position in the global economy (Guillen 1999).[3] This high degree of diversity is evident across countries and is reflected in a wide breadth of factors including firm financing, ownership, and production decisions. According to this view, efforts to harmonise regulation across jurisdictions may result in harmonised, but inefficient standards, reducing social welfare. A non-harmonised, but efficient standard should be preferred to a harmonised inefficient standard (Geiger 1998). There is therefore considerable doubt that a 'one size fits all' approach to regulatory policy across countries is appropriate.

Harmonisation may have costs for New Zealand if the optimal form of regulation depends on institutional features of the economy. Arnold, Evans and Boles de Boer (2003) utilize Standard and Poors and ANZ data to compare markets and firms in New Zealand with those in Australia, the US, Sweden, the UK and the rest of the world. They conclude that New Zealand's

1. Domestic markets are relatively concentrated;
2. Industries and firms are capital intensive (relative to output);
3. Firms have a higher real and nominal cost of capital; and
4. Firms produce a relatively high operating margin but have significantly higher costs associated with relatively poor productivity and the absence of economies of scale.

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[3] This argument is most frequently raised in the specific literature on harmonisation of corporate governance laws across countries.

They conclude that regulatory approaches and laws from the larger OECD countries cannot be applied to New Zealand without significant risk of setting standards or imposing industry structures that are inefficient in the context of the small and isolated markets of New Zealand.

Recognising this principle, international bodies (e.g. World Bank, OECD, IOSCO) have generally taken the approach of developing key regulatory principles or 'minimum regulatory standards' which recognise the value of divergent laws between countries. For example, in the 1999 *OECD Principles of Corporate Governance (at pages 8 and 13)*, it is noted in the preamble that "[t]here is no single model of good corporate governance. Different legal systems, institutional frameworks and traditions mean that a range of different approaches have developed around the world." The objective of these Principles is to form a foundation for the development of legal and regulatory frameworks "…that reflect their [the country's] own economic, social, legal and cultural circumstances…".

2.5 THE FEASIBILITY OF HARMONISATION

Lloyd (1997) has argued that the feasibility of achieving harmonisation, defined as law and regulation which provides common outcomes in different jurisdictions, depends on the balance between quantitative and qualitative harmonisation. Where there is only one object to be harmonized, for example, tariff levels or an acceptable level of polluting activity, harmonisation can be termed 'quantitative'. In contrast, where regulatory policies have multiple dimensions or elements, harmonisation will be qualitatively-based. Harmonisation of corporate laws is predominantly a qualitative process that cannot be portrayed on a line or continuum (Lloyd 1997: 10). Where this is the case even slight differences in qualitative substance may lead to very different regulatory outcomes. Because so many elements of the law and institutional structure of society bear on the commercial sector, Lloyd argues that harmonisation will almost always be partial and minimum standards are the most achievable and most likely form of harmonisation. The adoption of minimum standards in corporate law, which may be based on the current laws in either jurisdiction, or on model laws produced by international bodies such as the OECD or IOSCO, ensure that like principles and objectives are adopted, while giving individual regulators discretion with respect to legislative detail.

The different functional levels of regulatory policy and law making – ranging from the formulation of regulatory objectives, drafting of legislative substance, administration, and enforcement – mean that harmonisation of substantive law will not necessarily produce identical regulatory outcomes across jurisdictions. Even where harmonisation takes the form of adopting identical substantive laws, different approaches to interpretation by regulatory and legal institutions across countries may defeat the objectives of harmonisation.

An example is provided by harmonisation of competition law. It is commonly said that the adoption by New Zealand of a substantially lessening of competition test for merger assessment in 2001 'brings New Zealand merger assessment in line with that of Australia'. However, substantive law is only one input into the regulatory process and there is still considerable scope for different regulatory outcomes. For example, the Commerce Commission's *Practice Notes* that provide guidance to market participants on how the law will be interpreted and applied have not been harmonised with the Australian Competition and Consumer Commission (ACCC) equivalent guidelines (*Merger Guidelines)*. Similarly, actual enforcement by courts in each jurisdiction is expected to diverge based on differing market conditions. Such differences in interpretation and application across jurisdictions can lead to very different regulatory outcomes despite the adoption of identical substantive laws.

Evans and Hughes (2003) provide an example that illustrates why divergence in the interpretation of the same statutory terminology in Australia and New Zealand should be expected. In a small economy, it is much more difficult for firms to achieve economies of scale in the domestic market. This means that where economies of scale exist, mergers between relatively large domestic firms in the New Zealand market will have a stronger efficiency rationale than would an equivalent merger in a large economy where economies of scale had already been achieved.

Harmonisation may be viewed as diluting the rights and influence of citizens to shape domestic policy. Where the preferences of two or more countries must be accommodated in developing regulatory policy, the relative influence of domestic stakeholders may be lessened. Coordination of regulatory policy and laws across countries will necessarily result in some degree of reduction in regulatory flexibility. The need to coordinate policy responses to market changes across multiple jurisdictions may result in reduced policy responsiveness and less flexibility where some jurisdictions are relatively more affected or affected in different ways by market changes.

The loss of flexibility is most obvious where differences in administration and enforcement are overcome by integrating regulatory and legal institutions across countries. However, the loss of political autonomy associated with this approach and political sensitivities mean that it is a rarely pursued option, and is often viewed as being a radical policy proposal in comparison with substantive law harmonisation.

Harmonisation may also dilute the accountability of local regulators and politicians for the laws that they pass and for their enforcement of them. The ability of legislators and politicians to avoid accountability for unnecessarily costly legislation or regulation on the grounds that it is was required to maintain harmonisation represents a potentially very significant cost.

2.6 CORPORATE LAW HARMONISATION: SECURITIES REGULATION

This section of the paper considers the relative magnitude of the potential benefits and costs of regulatory harmonisation of corporate laws between New Zealand and Australia, examining the specific case of securities regulation.[4]

One of the key economic benefits of regulatory harmonisation is a reduction in the costs of regulatory compliance for business when operating across multiple regulatory jurisdictions. In relation to securities and disclosure regulation, harmonisation significantly reduces the costs to business associated with cross-listing on a foreign exchange.

The costs associated with multinational offerings/cross-listing (including initial fundraising costs and ongoing disclosure obligations) can be substantial. Geiger (1998) notes the results of various studies which find that disclosure costs are a key and often determining factor for management in pursuing cross-border listing. The sensitivity of domestic companies to the compliance costs of cross-listing on a foreign exchange is demonstrated by the reaction of domestic companies to the recent tightening of foreign listing exemption thresholds on the ASX. Box 1 provides an overview of the current ASX foreign listing exemption arrangements and the recent impact of increases in the thresholds on the cross-listing decision of New Zealand firms.

Box 1: Moves away from regulatory harmonisation of securities law?

Recent changes to foreign listing exemption on ASX – moves away from harmonisation?

Cross-listing of New Zealand companies on the ASX has so far only been undertaken by some of the largest publicly listed companies (e.g. Telecom Corp, Carter Holt Harvey, and Sky Network Television). This is largely due to the foreign exempt threshold which allows foreign companies having over $50m of assets and $200m in net profit being allowed to list on the ASX while being exempted from most of the ASX listing/disclosure rules provided they comply with home country laws. Companies falling below this threshold must undertake a full listing, incurring significant compliance costs in addition to those incurred in their home country.

In a recent move away from harmonisation, the ASX lifted the exemption threshold affecting a number of New Zealand companies that have since de-listed from the ASX, in preference to applying for full listing. These companies either considered ASX full listing to be too costly, or did not meet the requirements for admission. The decision to de-list in many cases demonstrates the importance of compliance costs in the decision to cross-list on foreign exchanges.

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[4] There are many areas of law which make up business law, including: contract law, sale of goods, property law, negotiable instruments, company law, competition law, intellectual property law, insolvency laws, and jurisdiction and administrative law (Goddard 1999).

The ASX stated that the motivation for increasing the threshold was to improve disclosure, with the exemption still applying for larger foreign companies which are generally subject to more scrutiny than smaller companies.

Where securities laws are harmonised (whether through reciprocity or commonality), issuers of capital no longer need to incur the cost of complying with multiple sets of disclosure standards across countries. Other things being equal, harmonisation is expected to lead to an increase in multijurisdictional offerings of securities.

The potential benefits for domestic firms of cross-listing on larger, more liquid foreign exchanges are well documented in the literature, and include access to a larger investor base, a reduction in information asymmetries, enhanced stock liquidity, and lower cost of capital. Table 1 compares the size of liquidity of the New Zealand (NZSE) and Australian stock market (ASX) at the end of 2001.

Table 1: The size and liquidity of NZSE and ASX (end 2001)

	NZSE	ASX
Market Size		
Total no. Co.s listed	195	1410
Market capitalisation of domestic Co.s	$42.5m	$732.8m
Market capitalisation to GDP	35%	106%
Market Liquidity		
Total Value Traded (local $)	$20,435m	$469,953m
Value traded to GDP	17%	68%
Value traded to market capitalisation	48%	64%

Source: World Federation of Exchanges (2001)

The ASX is significantly larger than the NZSE, not only in the absolute sense, but also relative to the size of the economy. The ASX also experiences higher liquidity in listed stocks, having a larger aggregate value-traded and turnover ratio.[5]

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[5] The value-traded ratio is equal to the total value of shares traded over the year divided by total GDP for the period. The turnover ratio is equal to the total value of shares traded divided by market capitalisation at year end.

Theoretical and empirical studies highlight stock market liquidity (as measured by the level of activity) as being an important driver of firm cost of capital and growth.[6] The economic literature finds that a more active stock market is associated with lower firm cost of capital and from a macroeconomic perspective, higher current and future economic growth.

Further, large capital markets (like that of Australia) provide economies of scale in monitoring and encouragement to active portfolio management that may not be feasible in a smaller and less diversified market, encouraging foreign investor participation. A recent report on New Zealand's stock market noted that "to some large overseas investors, the New Zealand market has become too small and illiquid to invest in with any great conviction…"[7] Given the declining size of New Zealand's stock market over the past decade, there is the real possibility that foreign demand for domestic equity securities will significantly decline as the fixed costs of information acquisition and market monitoring are spread over a relatively small portfolio. Cross-listing on the ASX provides a vehicle for domestic companies to increase foreign participation in their capital issues, increasing stock liquidity, and lowering the cost of capital.

Reducing the transactions costs of cross-listing on the larger and more liquid ASX through harmonisation would provide clear benefits to the largest New Zealand firms and could potentially lower their cost of capital. Overall, harmonisation measures that facilitate lower cost listing on larger and more liquid foreign exchanges help to retain large New Zealand companies in New Zealand. However, this analysis does not consider the costs that are imposed on all firms by the requirement to adopt harmonised regulations or laws. There can certainly be no presumption that the net effect of adopting regulations or laws that facilitate cross-listing will promote the growth of New Zealand firms or the New Zealand economy as a whole.[8]

Encouraging capital inflow

It is often claimed that harmonising New Zealand's securities laws with those of Australia will reduce the barriers to foreign participation in the New Zealand market, encouraging capital inflow and benefiting New Zealand's capital markets. The argument is that harmonisation of New Zealand's securities laws with those of Australia creates a familiar regulatory regime which may see foreign investors 'bundle' the two markets together for the purposes of portfolio monitoring and assessment, thereby increasing participation in New Zealand's equity market. Where securities laws are harmonised, foreign investors do not have to incur the costs of learning and assessing a separate New Zealand regulatory environment, for what is a relatively small part of their global portfolio (Goddard 2001).

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[6] See Amihud and Mendelson (1988), Bernstein (1987), Demirguc-Kunt and Maksimovic (1998) and Eleswarapu and Krishnamurti (1995).

[7] Euromoney (2002).

[8] For a critical analysis see Wilkinson (2003) .

Although some degree of regulatory harmonisation will contribute to reducing monitoring and transactions costs for foreign investors, the net impact on New Zealand capital markets is likely to be small. Differences in regulation and the associated transactions costs of learning are unlikely to be a key determinant of foreign investor participation in New Zealand's capital markets. Other non-regulatory factors such as market efficiency, relative returns, agency problems, and ownership structures are much more influential than the extent of regulatory harmonisation with Australia. So while regulatory harmonisation may reduce transactions costs for foreign investors, the actual impact on New Zealand's capital markets is likely to be very small.

More important for foreign investors is that regulations relating to New Zealand's capital markets are consistent with and efficient in the context of the particular institutional features of capital markets in New Zealand. This suggests that short of full integration of the New Zealand capital market into that of Australia, New Zealand may benefit from regulatory competition designed to create a regulatory environment that is efficient in the context of New Zealand capital markets rather than one that is efficient in the context of Australian capital markets.

2.7 INTERNATIONAL EXPERIENCE

The most notable efforts to harmonise corporate laws across countries has occurred in the European Union where most economic commentators consider that the experience raises doubts about both the feasibility and efficiency of harmonisation. Other examples have occurred in North America between the US and Canada, two countries that, like New Zealand and Australia, have a very close economic connection.

Callaghan (2000) summarises the difficulties encountered in the EU corporate law harmonisation process over several decades:

> *The first formal legislative draft for a European Company Statute, presented by the European Commission after ten years of preparatory work, was rejected by the Council of Ministers in 1970. Amended versions in 1975, 1989 and 1991 met with a similar fate. A highly diluted fifth draft was finally passed at the Nice summit last December; EU merger policy was deadlocked for almost fifteen years; the hostile takeover directive has been under debate for more than a decade with no compromise in sight; the prospectus directive has recently inspired calls for another sixty amendments. In all cases, the harmonisation process was held up because national representatives in the Council of Ministers and/or the European Parliament refused to endorse legislative drafts presented by the European Commission.*

The European Shadow Financial Regulatory Committee, a group of academics and independent experts formed to analyse policy issues in financial regulation, released a statement in February 2002, emphasising the desirability of harmonising capital markets regulation across the EU. In relation to corporate law harmonisation, however, they considered that "the determination of corporate law…should be left largely to the Member States, pursuant to the subsidiarity principle."[9]

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[9] European Shadow Financial Regulatory Committee (2002).

The subsidiarity principle which has gained considerable momentum in the EU in recent years[10], is "…intended to ensure that decisions are taken as closely as possible to the citizen and that constant checks are made as to whether action at Community level is justified in the light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the Union does not take action (except in the areas which fall within its exclusive competence) unless it is more effective than action taken at national, regional or local level. It is closely bound up with the principles of proportionality and necessity, which require that any action by the Union should not go beyond what is necessary to achieve the objectives of the Treaty."[11]

The Committee went on to state that, "[w]henever the EU has departed from this [the subsidiarity] principle in the area of corporate law, the results have either been inconsequential or harmful (for example, the imposition of a rigid and expensive regime of mandated capital in the Second Corporate Law Directive). *By now there is considerable evidence that it is preferable to allow corporate law to retain a fair amount of flexibility by leaving its structures to competition among Member States*." (emphasis added)[12]

Despite the recommendations of the Shadow Committee, further efforts towards corporate law harmonisation continue in the EU. The *Lamfalussy Report* released in February 2001 contains a number of priorities for harmonisation of securities regulation in the EU. Among the key priorities are: a single prospectus for issuers in the EU, adoption of international accounting standards, and a single passport for EU stock markets. Further, the High Level Group of Company Law Experts recently released a report on Company Law Harmonisation in Europe highlighting key areas for harmonisation priority including corporate governance laws, capital formation, and company restructuring laws.[13]

In respect of Canada and the US, the Multijurisdictional Disclosure System (MJDS) adopted in 1991 is based on reciprocity, rather than harmonisation, allowing Canadian and US issuers of securities to list in each other's jurisdiction based on compliance with home country laws. The rationale for the agreement was that "…filing standards in Canadian jurisdictions and the US were so similar that to file in both countries would have been a waste of time and money."[14] The MJDS has been described as a hybrid between commonality and reciprocity, with reciprocal agreement being dependent upon some degree of commonality or minimum standards.

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[10] The subsidiarity principle is incorporated into the EU Treaty.

[11] Europarl.

[12] European Shadow Financial Regulatory Committee (2002).

[13] High Level Group of Company Law Experts (2002).

[14] CIBC Mellon (2000).

The MJDS has reduced the costs of access of Canadian firms to US capital by reducing the need for compliance with detailed documentation through the SEC. Similar to the case of New Zealand and Australia, the agreement provides most benefit to Canadian firms that can access the larger and more liquid US capital markets at lower regulatory cost.

In 2000 the SEC proposed to remove the MJDS exemption for Canadian issuers, claiming that it offered preferential treatment to Canadian issuers, over other foreign issuers.[15] However, many commentators suggested that the SEC may have been unsatisfied with the level of Canadian disclosure regulations.[16]

2.8 CO-OPETITION

An intermediate position between regulatory competition and harmonization, termed 'regulatory co-opetition', has been suggested by some authors. They argue that some combination of regulatory competition and cooperation is almost always optimal regardless of the subject matter of regulation.

According to Esty and Geradin (2000: 248) the co-opetition model recognizes that the regulatory process may benefit from some degree of coordination working in parallel with competitive forces. Coordination may range from formal harmonisation on some matters through to simple exchanges of information and data and policy experience between regulators. They cite varying justifications for cooperation including the benefits of resource sharing and expertise to the need for coordination on issues such as antitrust assessment of cross-border mergers. They conclude that "it is very much the exceptional case…where cooperation should proceed to the point of complete harmonisation or 'homogenization' of regulatory policies across all jurisdictions".

2.9 SUMMARY

Contrary to views commonly expressed in the policy literature, there is no general presumption in the wider economics literature in favour of or against harmonisation (Lloyd et al 2001).[17] This is particularly true in respect of harmonisation of commercial laws; here harmonisation has intellectual appeal but may also impose substantial costs (Duffy 2002).

Even where there are market imperfections that justify government intervention, or where the costs of some firms can be reduced by harmonization, it must be demonstrated that the long-run benefits of harmonisation outweigh the long-run costs for all commercial enterprises in the economy. Any form of government intervention is costly in terms of

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[15] Ibid.

[16] Ibid.

[17] It is very common to see broad statements in policy papers that assume that the argument for harmonisation is so straightforward and intuitive that it need not be made out. For example, "It seems generally accepted that CER reforms, including the removal of regulatory inconsistencies between Australia and New Zealand is beneficial." (Speir Consulting (2002)). Similarly, in the 2001 *Lamfalussy Report*, significant economic benefits are claimed on one hand, while, on the other hand, it is recommended that a quantitative study be carried out to assess the economic impact of legal harmonisation and market integration.

initial costs of effecting coordination, potential transition costs, and any ongoing costs of harmonisation. Further, harmonisation is just one form of intervention where there are barriers to effective regulatory competition. Other forms of welfare-enhancing intervention may include specifically targeting the sources of market imperfections, for example, by reducing barriers to mobility, or increasing the availability of information.

In many cases there will be a tradeoff between the benefits of regulatory competition and harmonisation. Where this is the case, the short-term advantages of harmonisation should be weighed against the long-term benefits of sustained regulatory competition (Niemeyer (2001)). In particular, it would not be efficient for New Zealand to impose on all its commercial enterprises costs that need be borne only by firms who wish to operate in multiple jurisdictions because such a policy is likely to produce short-term gains for the most successful firms but long-run net costs for the vast majority of firms in the economy.

Regulatory harmonisation of securities laws between Australia and New Zealand would provide benefits to the largest New Zealand companies through a reduction in the costs of participating in the larger, more liquid, Australian capital markets. Participation in Australian markets can deliver increased stock liquidity and potentially lower the cost of capital for domestic firms.

In terms of the impact on New Zealand's capital markets, harmonisation would result in some reduction in transactions costs faced by foreign investors. However:

1. Small differences in law and regulation across countries are unlikely to be a key determinant of foreign investor participation in New Zealand's capital markets. Other non-regulatory factors such as market efficiency, relative returns, agency problems, and ownership structures are likely to be more important determinants of foreign participation; and
2. Small differences in the interpretation of law and regulation are likely to impose substantial transactions costs associated with understanding local markets thus mitigating any benefits from the harmonisation of laws.

Our analysis suggests that there is substantial scope for effective competition in securities regulation between Australia and New Zealand. There is a high degree of mobility for business and citizens between the two jurisdictions, both countries compete for foreign investment in the development of the local economy, and recent efforts at unilateral coordination suggest that some competitive process is currently at work. The regulatory environment does have an impact on the expected returns available to investors and can thus have a significant impact on new investment in an economy. In respect of attracting foreign investment and retaining the investment capital of New Zealand residents, regulatory competition aimed at providing in New Zealand the most efficient regime of capital market regulation is likely to provide the greatest benefit to New Zealand.

3 REGULATORY COMPETITION

3.1 THE THEORY OF REGULATORY COMPETITION

The theory of regulatory competition views regulation (including policy design, legislation, administration, and enforcement) as a 'product' best produced in a competitive global market. That is, in the same way that it is accepted that competition promotes welfare-maximising outcomes in conventional product markets, competition in regulatory policy and law making produces efficient and superior regulatory regimes (Romano 2001). Esty and Geradin (2000) summarise the argument for regulatory competition as follows:

> *Competitive pressures…force governments to produce their regulatory products at competitive 'prices' (so that the benefits of government intervention exceed the costs) on the pain of losing their customers, in this case citizens or businesses. The normative strength of the theory lies in the hope that competition will stimulate experimentation, innovation, and product differentiation in regulation, as in markets for products. The process of refining the product (regulatory requirements and approaches) to meet consumer (societal) desires thus leads to the adoption of more efficient laws and enhances social welfare…*
>
> *…For regulatory competition theorists, centralized systems of standard setting [harmonisation] should be seen as regulatory cartels which, like any form of collusion between competitors, inhibit the operation of the market, raise prices, and reduce economic efficiency.*

Further, the theory predicts that regulatory competition can act to eliminate inefficient rent-seeking behaviour and make regulators less susceptible to capture.

The proponents of regulatory competition therefore argue that governments should operate autonomously in developing regulatory policy. Just as in other product markets, in the absence of market failure, competition among the different regulatory jurisdictions will stimulate regulatory innovation, economic efficiency and convergence to the 'competitive equilibrium'. Thus, regulatory competition does not rule out convergence in the legal and regulatory regimes implemented in different jurisdictions, but it does imply that the process driving convergence is different from that associated with a policy of harmonisation. Regulatory competition leads to convergence because the competitive process drives the identification of the most efficient laws and regulations, and provides each jurisdiction with incentives to adopt them. The competitive process actually determines the substance and form of optimal regulatory policy and in the absence of regulatory competition, the optimal policy will be unknown (Sykes 2000).

Ongoing heterogeneity would only be observed where differences in the commercial environments made different laws and regulations efficient in each jurisdiction.

3.2 RELEVANCE TO NEW ZEALAND

The literature on regulatory competition focuses on the situation in which states operating within a framework of mutual recognition (such as that established within a federal system) compete to attract capital on the basis of the efficiency of the regulatory environment that they create. The most frequently-discussed example relates to the requirements for incorporation within the US: the costs of incorporation vary across states but incorporation confers the right to operate throughout the US. Similar examples may now be cited in relation to the European Union.

This approach to regulatory competition has limited applicability to New Zealand. New Zealand's high degree of political independence from even its closest trading partner (Australia) and its geographical isolation mean that the scope for competition is limited. Even if New Zealand had a comprehensive mutual recognition regime covering all aspects of commercial regulation in place with Australia, there is limited scope for New Zealand to compete with Sydney and Melbourne for the location of head offices (just as, within New Zealand, Dunedin is no longer a feasible location for the head office of firms whose primary market is in Auckland). This is because the costs of being at a distance from the largest markets and from the managers of the operating divisions of the firm outweigh any of the benefits associated with more efficient regulation. New Zealand is not in competition with Australia to attract firms wanting to supply the Australian market: they will certainly find the costs and risks of operating from New Zealand to be too high, no-matter how efficient is New Zealand's commercial regulation.

The concept of regulatory competition has greater relevance to New Zealand when the competition is viewed as being that required to attract and retain the investment and labour that is required to maximize economic growth in New Zealand. New Zealand competes for internationally mobile capital and labour that will be applied to activities based in New Zealand and may attract more of both factors of production the more efficient is its commercial regulation. While commercial regulation may not be the pre-eminent factor in a business investment decision it may have a significant impact on the expected return from the investment and thus on the aggregate amount of investment in the economy. Thus, the closer are New Zealand's commercial laws and regulations to those that are optimal in the context of the New Zealand economy, the faster will be the growth of firms located in New Zealand. This approach suggests that in the consideration of the adoption of Australian laws, the efficiency of those laws in the context of the New Zealand economy should take precedence over any views about the merits of harmonisation *per se*.

3.3 LIMITATIONS ON THE SCOPE FOR REGULATORY COMPETITION

The scope for regulatory competition to produce efficient outcomes may be limited by a range of costs or market imperfections.[18] The principal costs and imperfections considered in the literature are discussed below.

[18] Some of the literature refers to these costs and market imperfections as "market failure", but this terminology is inconsistent with the usual definition of market failure found in the public economics literature.

Externalities

The regulatory standards of one country may impose negative (or positive) externalities on another economy leading to over-production (or under-production) of regulatory standards relative to the social optimum. A commonly noted example of a negative externality is the argument that weak intellectual property laws may also impose external costs by reducing the level of innovation and dynamic efficiency in other jurisdictions (Esty and Geradin 2000). However, the literature suggests that competition in corporate charter rules does not have significant spillovers and is likely to be welfare-enhancing (Esty and Geradin 2000). A positive externality arises from the fact that regulators in different jurisdictions may adopt in part or as a whole the legislation or regulations of other countries where they consider it advantageous to do this. This of course implies that unless developments are left up to international regulatory bodies, all legal jurisdictions benefit from the willingness and ability of individual countries to develop and adopt law and regulation that differs from that in their trading partners.

Information

The efficient allocation of resources in a competitive market requires that market participants possess full and perfect information, allowing them to choose between competing suppliers. It follows that for regulatory competition to produce efficient outcomes, businesses and citizens need to be fully informed about the costs and benefits of alternative regulatory regimes across multiple jurisdictions.

There are significant costs associated with acquiring and analysing this type of information across multiple countries. Further, such costs need to be incurred on an ongoing basis as laws change and evolve in response to market pressures. There may also be some degree of uncertainty as to the actual operation and application of laws in foreign jurisdictions. These factors potentially inhibit the efficient operation of regulatory competition.

Lack of information and comparability of regulatory jurisdictions may lead to a market for lemons (Geiger 1998). Where market participants are unable to fully distinguish between efficient and inefficient jurisdictions, they may end up choosing the jurisdiction imposing lowest compliance costs, regardless of the efficiency or effectiveness of regulation. In the extreme it is frequently argues that information problems may generate a 'race to the bottom'. The argument is that as jurisdictions compete for business as part of the competitive process, competing regulators will be tempted to reduce standards to attract more business. Under this view, rather than producing welfare-maximising competition, regulatory competition may lead to inefficient standards, reducing social welfare.

Arguments relating to information primarily have force where there are negative externalities for other jurisdictions so that the home jurisdiction does not bear all of the costs of the low standards. Absent these externalities we would expect the cost of low-quality regulation to be fully internalized in the decisions made in each jurisdiction. In addition, the arguments have little force where the type of regulatory competition being considered is that associated with policy-makers selecting the optimal environment for the growth of local business, since policy-makers have the resources and the incentives to

invest in acquisition of information about the long-term costs and benefits of alternative legal and regulatory regimes.

Mobility of Resources

The theory of regulatory competition within federal systems is dependent upon the free movement of market participants between regulatory jurisdictions in order to exert competitive discipline on regulators – that is, businesses and citizens being able to "vote with their feet" (Esty and Geradin 2000). This characterization of regulatory competition relies very much on the example of competition for state-level incorporation where the location of the incorporation has no important implications for the location of the firm's activities within the different states that make up the federal system. The example is of limited relevance to regulatory competition between New Zealand and Australia because, short of comprehensive mutual recognition regimes, incorporation in New Zealand would not allow avoidance of Australian regulations. Moreover, even if incorporation in New Zealand did provide full powers to operate in Australia, New Zealand incorporation brings with it the requirement to maintain head office functions in New Zealand and thus separate from the primary operational activities of the firm.

Market Power

Some regulatory jurisdictions may possess market power derived from some non-regulatory advantage over competing jurisdictions (Geiger 1998). For example, in relation to securities regulation, countries with larger and more liquid capital markets may be able to impose more costly, less efficient regulation while still attracting firms from competing jurisdictions with more efficient regulation but smaller and less liquid capital markets.

3.4 SUMMARY

There is a substantial body of academic thinking on regulatory structure which suggests that the presumption should be in favour of regulatory competition and that harmonization should be considered only where market imperfections "…prevent the creation of the competitive equilibrium" (Geiger 1998). The theory of regulatory competition and critiques of it have, however, developed in relation to environments where political integration provides for mutual recognition, and economic integration is so complete as to ensure that regulatory competition can be effective in influencing the geographical investment and resource allocation decisions of firms. This clearly is not the case for New Zealand.

For New Zealand the key lesson from the regulatory competition literature lies in the view that cross-country heterogeneity in law and regulation may be efficient. This is because it provides New Zealand with the scope to implement the most efficient environment within which to operate and promote the growth of firms in New Zealand. From this perspective, regulatory competition focuses attention on the need to ensure first and foremost that the legal and regulatory framework is conducive to maximizing the long-term growth of all commercial entities in New Zealand. Whether this is a framework that is unique, incorporates elements of regimes from other countries, or is exactly the framework of other countries, is at best a secondary issue.

4 CONCLUSIONS

Our analysis suggests that while the costs and benefits of harmonisation of commercial regulation vary with the specific approach that is adopted, the costs of harmonisation will often outweigh the benefits. Specifically:

(i) All harmonisation initiatives impose some costs on society.

(ii) Where mutual recognition agreements can be negotiated, these will lower the transactions costs associated with trade and multinational investment. The costs of mutual recognition *per se* are not high (if legislative change is not required and no additional compliance costs are imposed). However, there will only be clear net benefits from mutual recognition if that regime leaves New Zealand free to adopt laws and regulatory frameworks that maximize the long-term growth of all firms in New Zealand. The freedom to adopt regulation and law that is optimal in the context of New Zealand firms and markets - "regulatory competition" - is likely to provide substantial benefits to the New Zealand economy.

(iii) Harmonisation of laws may provide benefits to those firms who operate in more than one jurisdiction, but may impose higher transaction and compliance costs on the vast majority of firms who operate only in the domestic market. Harmonisation may also make New Zealand investment opportunities less attractive to foreign and domestic investors by creating a regulatory or legal regime that is inefficient given the unique features of New Zealand's economy. Thus, harmonization may provide short-term gains but may, in the long-term, slow the growth of domestic firms and of the economy as a whole.

(iv) Harmonisation of laws may provide the benefits of a wider body of precedent and interpretation from multiple jurisdictions. If, however, local interpretation of laws and regulations is required precedents and interpretations from other jurisdictions will be of more limited value, and the transactions costs imposed by the need to understand unique elements of the legal and regulatory regime in each country are unlikely to be reduced to any significant extent. Our view is therefore that unless the adoption of harmonised laws is accompanied by the adoption of a single legal and regulatory framework for enforcement, net social benefits from harmonisation are unlikely even in the most optimistic scenarios.

Mutual recognition is consistent with regulatory competition in that it provides the scope for New Zealand and Australia to compete through improvements to their commercial laws within the tolerance limits set by the minimum requirements for mutual recognition. However, the literature on competition within a framework provided by mutual recognition has been developed in political contexts unlike that applying to New Zealand. For New Zealand mutual recognition may require substantial harmonization and rule out significant independence in law and regulation, which means that the costs and benefits of the adoption of laws from other jurisdictions will usually need to be considered.

In the context of securities markets, there is evidence that harmonisation of laws and enforcement at the level of the creation of a single market does provide benefits in terms of lower costs for investors and a lower cost of capital for firms. There is, however, no clear evidence that would lead us to expect that harmonisation of laws with Australia will reduce the cost of capital in New Zealand. So long as commercial laws are interpreted by New Zealand regulators, enforced by New Zealand courts and subject to change through political processes in New Zealand, then investors in firms domiciled in New Zealand will still have to invest in understanding the local environment rather than simply utilizing their knowledge of Australia.

New Zealand's current policy on harmonisation appears to place too little weight on the importance of regulatory competition for the attraction and retention of investment in New Zealand. New Zealand will benefit most from regulatory competition designed to create a regulatory and legal environment that is efficient in the context of New Zealand markets and this may not always be identical to that adopted in Australian markets.

Overall this analysis suggests that the focus of debate about commercial regulation in New Zealand should continue to be on the long-run efficiency of legal and regulatory frameworks in promoting commercial activity in New Zealand. In many cases the benefits from harmonisation *per se* will not be large enough to drive the adoption of legal and regulatory frameworks from overseas. New Zealand may wish to adopt Australian laws where they are considered to be superior to those in New Zealand. However, this should primarily be a matter of superiority, not a matter of harmonisation. Any case for the adoption of legal and regulatory frameworks from overseas should therefore be made on the basis of the superior efficiency of the foreign approach when it is applied to firms operating in New Zealand.

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