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# Developing Kiwi global champions:

## Growing successful New Zealand multinational companies

DAVID SKILLING | DANIELLE BOVEN

AUGUST 2006

**The New Zealand Institute**

The New Zealand Institute is a privately funded think-tank that aims to introduce new and creative thinking into the economic and social policy debate in New Zealand. We are committed to the generation of debate, ideas, and solutions that creatively address New Zealand's economic and social priorities in order to build a better and more prosperous New Zealand for all New Zealanders.

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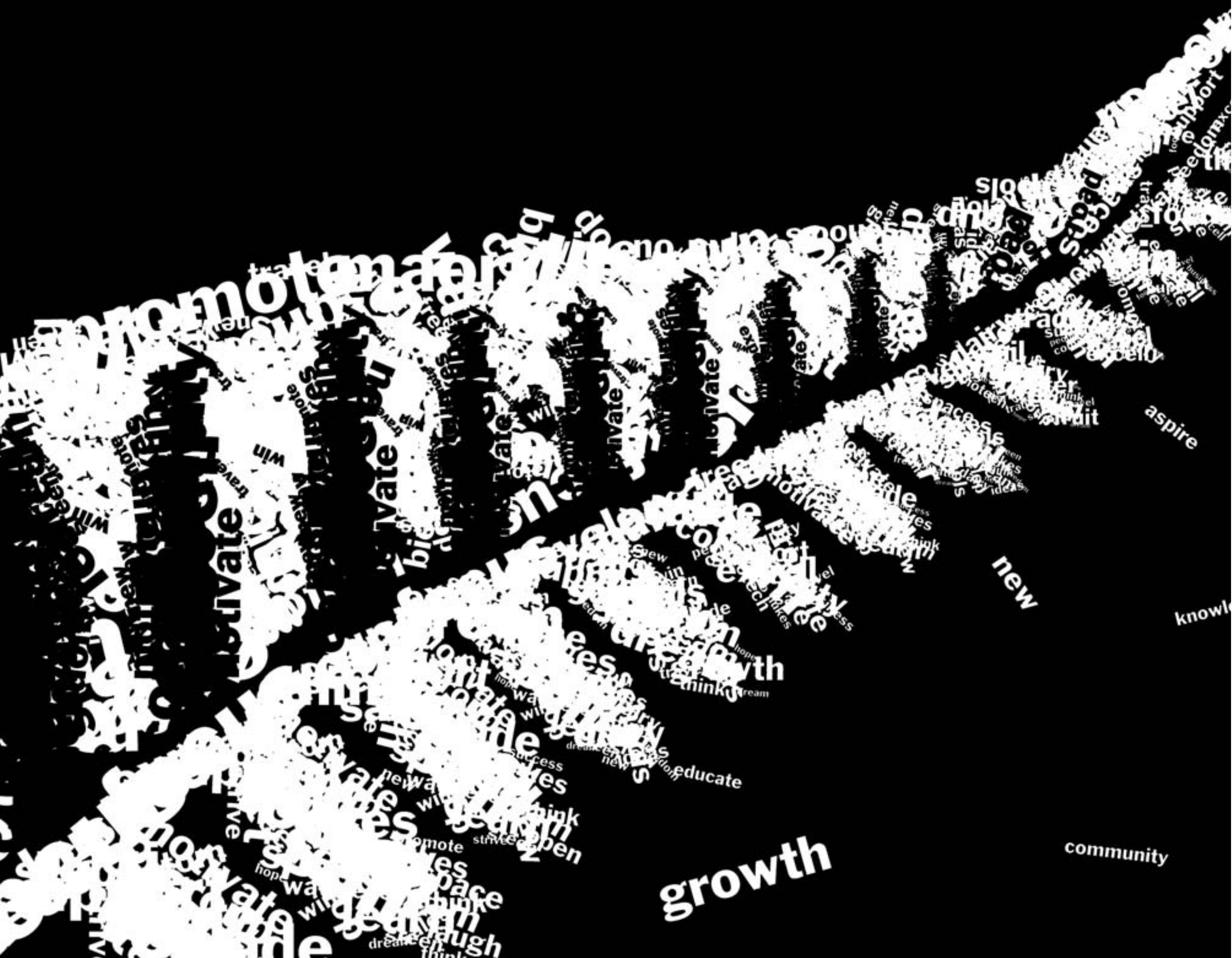
‘Developing Kiwi global champions’ is the fourth paper in a series that forms part of the New Zealand Institute’s research project on ‘Creating a global New Zealand economy’. This paper follows on from our first three papers ‘No country is an island’, ‘Dancing with the stars?’, and ‘The flight of the Kiwi’.



## FOREWORD: CREATING A GLOBAL NEW ZEALAND ECONOMY

The New Zealand economy has performed well over the past 15 years, with economic growth rates that exceed those generated in previous decades and that compare well against the US and Australia.

The challenge now is to build on this good performance, so that New Zealand's income levels converge to those of other developed countries. Sustaining high rates of economic growth into the future will necessarily involve a substantial increase in labour productivity growth.

New Zealand is a small economy, and substantially raising New Zealand's labour productivity will require much greater levels of exporting and foreign investment by New Zealand firms. Exporting and investing offshore provides scale, growth opportunities for New Zealand's most productive firms, and great learning opportunities for New Zealand firms. New Zealand cannot achieve and sustain high rates of productivity growth without making much greater use of larger markets through international activity.

However, New Zealand's international performance does not compare well against many other developed countries, and only a small number of New Zealand companies are substantially engaged in international markets in terms of either exporting or investing. New Zealand is not participating in increased international economic activity to the extent that many other countries are.

Of course, New Zealand firms do face particular difficulties in terms of moving into international markets because of the small size and remoteness of the New Zealand market. It is this combination of the importance of international engagement, and the difficulties that some New Zealand firms face in going global, that provides the motivation for this project.

This project is being undertaken to identify the actions and policies that will move New Zealand towards becoming a genuinely global economy, in which much more of New Zealand's national income is generated offshore and where New Zealand firms win systematically abroad.

Over the next several months, we will be releasing a series of reports examining different aspects of this issue. Initial reports will describe why taking the New Zealand economy to the world is vitally important, will examine New Zealand's current exporting and international investment outcomes, and will identify some of the key reasons that New Zealand's international outcomes do not compare well against other small, developed countries.

An important part of this project will be conversations with a wide range of business and political leaders about the key issues and the actions that can be taken to increase exporting and international investment by New Zealand firms.

This will provide the basis for reports that focus on a range of solutions. The aim of the project is to identify the actions of government, business, and others, which are required in order to take the New Zealand economy to the world in a material and successful way. Creating a global New Zealand economy is an important but demanding challenge, and will require sustained leadership from both the private and public sectors.

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## EXECUTIVE SUMMARY

Increasing the level of New Zealand's exporting and outward foreign direct investment (FDI) in a substantial way is a vitally important part of strengthening New Zealand's economic prospects. Achieving this goal will require developing many more global champion New Zealand firms with the capacity and aspiration to expand successfully into global markets.

Of course, New Zealand's small scale and isolation can make international expansion by New Zealand firms a daunting challenge. This goes some way to explaining why there are relatively few medium and large-sized New Zealand firms operating successfully in international markets.

Overcoming these challenges, and achieving a substantial increase in New Zealand's participation in the global economy, will require a deliberate, aggressive response by both business and government. Indeed, it is New Zealand's failure to respond with sufficient intensity that is the primary cause of New Zealand's relatively low level of international economic engagement rather than its geographic isolation.

Much improved performance is possible. New Zealand's international sporting success demonstrates that New Zealand has what it takes to create Kiwi global champions. The priority should be to apply the same standards to international business success as New Zealand does to achieving sporting success.

Developing many more Kiwi global champions will require meaningful action from business and government. New Zealand's policy settings need to be configured to be as supportive as possible of international expansion by New Zealand firms. And there is a need for New Zealand firms to take advantage of global opportunities and be willing and able to move successfully into international markets.

The Institute's previous report identified four significant factors that needed to be addressed in order to assist many more New Zealand firms to expand into international markets. In particular, actions need to be taken to enhance financial incentives for firms to go global, to strengthen firm-level capacity with respect to international expansion, to increase New Zealand ownership of these expanding firms by increasing the domestic pool of capital, and to raise the level of aspiration around international success.

Four high potential areas for business and government action have been identified in order to respond to these issues, and develop more Kiwi global champion companies. These solutions are to reform the tax regime, to implement a bold savings policy, to encourage international expansion by State-Owned Enterprises (SOEs), and to improve corporate strategy around international expansion.

**Reform the tax regime**

New Zealand's tax system can be changed in two ways to improve the financial incentives around international expansion by New Zealand firms. First, we propose the introduction of an international market development

rebate that will provide financial assistance to firms as they establish a presence in offshore markets. Second, we propose that income earned from the active operations of New Zealand firms in international markets not be taxed in New Zealand. This will make New Zealand a much more attractive place to locate multinational activity.

**Implement a bold savings policy**

Increasing the size of New Zealand's domestic pool of capital will help to develop more Kiwi global champions in a few ways. First, increased savings will strengthen New Zealand's capital markets, enhance the supply of capital, and reduce New Zealand's high cost of capital. Second, a larger pool of domestic capital will raise the New Zealand ownership share of these companies as they go global, which will increase the likelihood that firms retain a New Zealand presence. And third, increased savings will moderate New Zealand's exchange rate cycle, making international activity more attractive to New Zealand firms. To achieve such an increase in savings, we propose an expanded version of the government's KiwiSaver scheme.

**Encourage international expansion by SOEs**

New Zealand has a relatively small number of large companies that are well placed to undertake substantial international investments. However, some of the government's remaining SOEs have the potential to make a material contribution to New Zealand's level of international economic engagement through their investment activity. Historically the government's policy approach has been to discourage SOE expansion. We propose that this be changed to encourage some SOEs to explore the potential for international expansion, and that shareholding Ministers support proposals for international expansion where the business case stacks up. Issues around strengthening SOE governance and considering the ownership of SOEs should also be addressed in this context.

**Improve corporate strategy around international expansion**

The way in which New Zealand firms undertake international expansion is critical to creating a global New Zealand economy. There are particular challenges associated with going global from a New Zealand base, and this report identifies four features of corporate strategy as being important to successful international expansion from New Zealand: sustaining a long-term commitment to international success, developing world-class competitive advantage, moving into international markets in steps, and placing experienced people on the ground in foreign markets.

Improved corporate strategy is likely the most significant of the four areas identified. Public policy can and should be made more supportive of international expansion by New Zealand firms, but achieving much higher levels of exporting and outward FDI ultimately rests on whether sufficient New Zealand firms have the capacity and aspiration to become global champions.

What this report begins to show is that there are concrete actions that business and government can take to improve New Zealand's level of international economic activity. There is no reason that New Zealand cannot generate global champion companies, just as New Zealand has over-produced sporting and cultural talent. But this will not happen spontaneously. It requires substantial and sustained investments by both business and government.

The actions identified in this report should generate a material increase in New Zealand's level of international economic engagement. These actions need to be supplemented with a series of other actions that were identified in the Institute's previous report; enhancing international market access for New Zealand firms; connecting New Zealand to the world through enhanced transport, communication, and people-to-people links; and developing substantial new strengths in the New Zealand economy. These actions will be detailed in three further reports.

New Zealand needs to be much more ambitious about its international engagement. New Zealand's poor performance in terms of its international economic engagement reflects in large measure that these issues have not been taken sufficiently seriously. The policy environment has not been as supportive of international expansion by New Zealand firms as it could have been, and there have been issues around the capacity and aspirations of firms to undertake international expansion. Developing many more Kiwi global champions is possible but will require a sustained commitment from business and government in terms of taking meaningful action to create a supportive environment around international expansion.

CREATING A GLOBAL NEW ZEALAND ECONOMY:
PROJECT STRUCTURE

**No Country is an Island**
The importance of international
economic engagement for
New Zealand's economic future

**Dancing with the Stars?**
New Zealand's level of exports and outward FDI
does not compare well to other countries

**The Flight of the Kiwi**
Identifies four classes of solutions
to create a global New Zealand economy

**Detailed Analysis and Recommendations**
(To be contained in four reports)

1. Developing Kiwi global champions
2. Achieving real market access
3. Connecting to the world
4. The New Zealand economy 2.0

# 1 INTRODUCTION

Increasing the level of New Zealand's exporting and outward foreign direct investment (FDI) in a substantial way is a vitally important part of strengthening New Zealand's economic prospects. Achieving this goal will require developing many more global champion New Zealand firms with the capacity and aspiration to expand successfully into global markets.

Of course, New Zealand's small scale and isolation makes international expansion by New Zealand firms a daunting challenge. This goes some way to explaining why there are relatively few medium and large-sized New Zealand firms operating successfully in international markets.

Overcoming these challenges, and achieving a substantial increase in New Zealand's participation in the global economy, will require a deliberate, aggressive response by both business and government. Indeed, it is New Zealand's failure to respond with sufficient intensity that is the primary cause of New Zealand's relatively low level of international economic engagement rather than its geographic isolation.

Much improved performance is possible. New Zealand's international sporting success demonstrates that New Zealand has what it takes to create Kiwi global champions. The objective should be to apply the same standards to international business success as New Zealand does to achieving sporting success.

A substantial increase in seriousness of purpose is required from both business and government to develop many more Kiwi global champions. New Zealand's policy settings need to be configured to be as supportive as possible of international expansion by New Zealand firms. And there is a need for New Zealand firms to take advantage of global opportunities and be willing and able to move successfully into international markets.

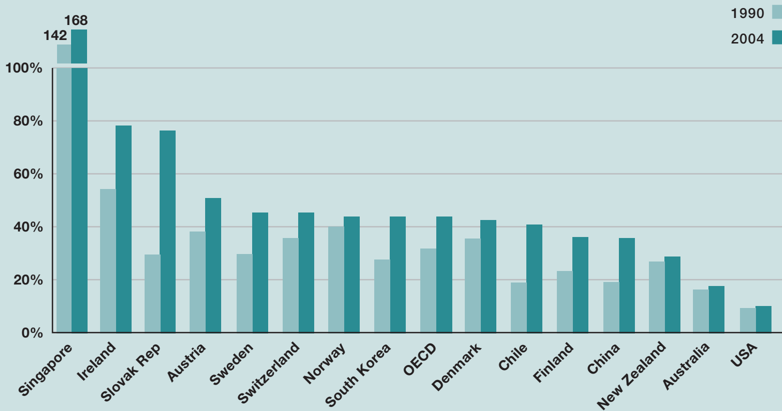
This report aims to describe the actions that can be taken in New Zealand by business and government in order to strengthen the international engagement and performance of New Zealand firms. In particular, four high potential areas for action have been identified. These are to reform the tax regime, to implement a bold savings policy, to encourage international expansion by SOEs, and to improve corporate strategy around international expansion. This report provides more detailed analysis on these four areas and outlines some specific recommendations on the way forward.

This report should be read in the context of the other three types of solutions that were identified in the Institute's previous report: actions to enhance international market access for New Zealand firms, connecting New Zealand to the world, and developing substantial new areas of economic strength in the New Zealand economy (Skilling & Boven (2006)). These issues will be discussed in more detail in three further reports.

New Zealand's exporting and outward FDI performance over the past few decades has been relatively poor, as can be seen in Figures 1 and 2. Benchmarked against other developed countries, and particularly against other small developed countries, the New Zealand economy is not well integrated into the global economy.

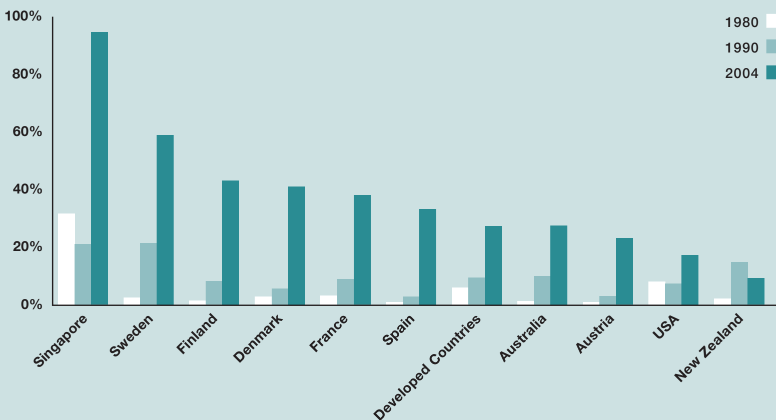
These differences are becoming larger over time as the intense process of globalisation continues, with strong worldwide growth in exports and outward FDI.

FIGURE 1: EXPORTS AS A % OF GDP




Note: OECD average for 1990 and 2003.
Source: OECD; National government statistics for Chile, China, and Singapore.

FIGURE 2: LEVEL OF OUTWARD FDI AS A % OF GDP




Source: UNCTAD.

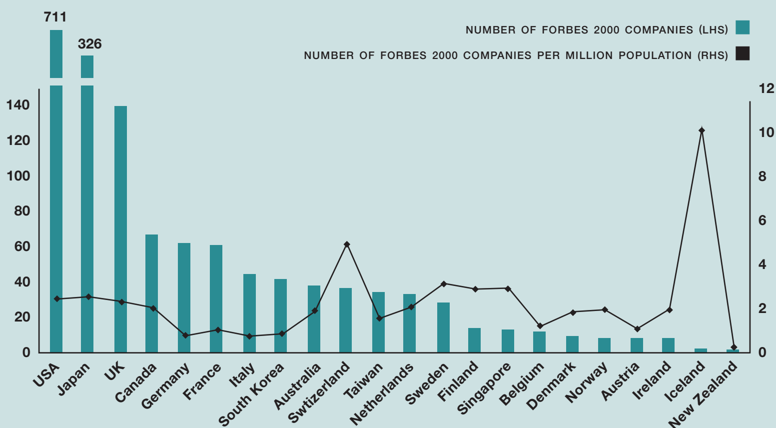
New Zealand's lack of international engagement can also be seen at firm level. Only a small number of New Zealand firms are involved in exporting or outward FDI. New Zealand Trade & Enterprise (NZTE) estimate that only 361 New Zealand firms exported more than $10 million in the year to September 2005, and only 50 firms exported more than $75 million. And of those firms that are engaged in international activity, the income from these activities often comprises only a small proportion of their total activity. Knuckey & Johnson (2002), for example, report that about half of New Zealand's exporting firms in 2002 derived less than 10% of their income from exports. That is, most New Zealand exporters regard international activity as a useful adjunct to the domestic market rather than being truly global in orientation.

New Zealand has only a small number of medium and large-sized firms participating actively in international markets. One measure of this is the Forbes Global 2000, an index of the world's largest 2000 listed companies. As shown in Figure 3, New Zealand has just one company on this list (Telecom) whereas Australia has 38 companies and countries of similar population size – such as Singapore and the Nordic countries – tend to have ten or more companies on the list. There are few examples of New Zealand companies outside the primary sector growing into large multinational companies.

This record contrasts sharply with New Zealand's international achievements in many other areas of endeavour, where New Zealand punches well above its weight. James Belich notes New Zealand's consistent over-production of talent in areas ranging from arts and literature to academia and science.

And, of course, New Zealand has always been proud of its international

FIGURE 3: FORBES GLOBAL 2000 COMPANIES




Source: Forbes Magazine; The New Zealand Institute calculations.

sporting prowess particularly given its small size. This success has been achieved not just because of New Zealand's intrinsic ability, but because of high aspiration, drive, and a supportive domestic environment. The way in which New Zealand operates its domestic competitions, the training and preparation, the benchmarking against global best practice, are all undertaken with a view to international success.[1] In sports like rugby, netball, and yachting, the teams and the public expect and demand New Zealand teams to be global champions. There is an understanding that while good teams win at home, it is the great teams that win abroad.

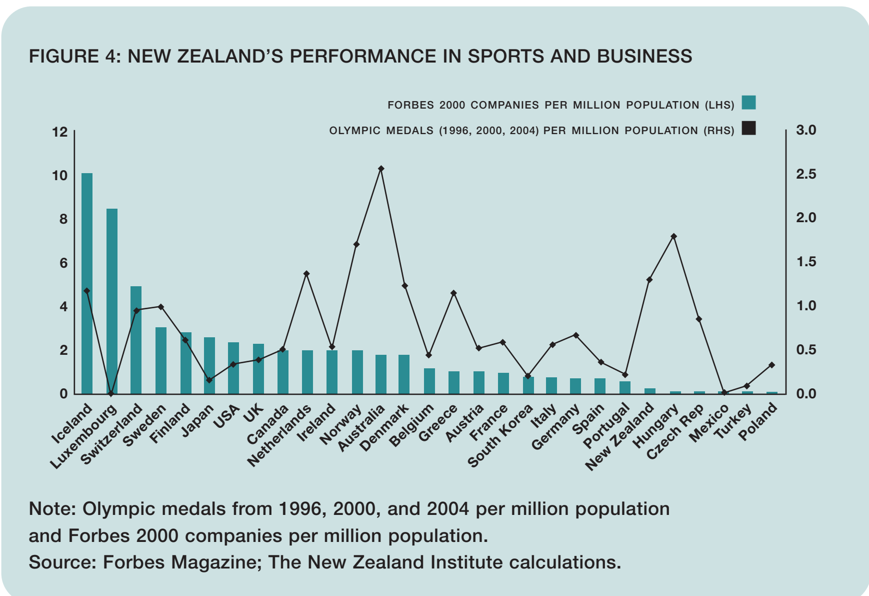
Figure 4 compares the performance of the 30 OECD countries in terms of international business performance, as measured by the number of Forbes Global 2000 companies per million population, and international sporting performance, measured by the average medal count at the last three Olympic Games per million population.

New Zealand is ranked in the top 5 of the OECD by Olympic medal count but is close to the bottom of the rankings in terms of the number of large companies. The challenge for New Zealand is to develop global champions in international business in the way that New Zealand has done in sport. There is nothing about being a small country that should prevent New Zealand from thinking big in this regard, as many other small countries have done.

## KIWI GLOBAL CHAMPIONS

Creating a global New Zealand economy necessarily involves developing many more Kiwi global champions – New Zealand companies that are winning substantially in

**FIGURE 4: NEW ZEALAND'S PERFORMANCE IN SPORTS AND BUSINESS**




**Note: Olympic medals from 1996, 2000, and 2004 per million population and Forbes 2000 companies per million population.**
**Source: Forbes Magazine; The New Zealand Institute calculations.**

*[1] Porter et al. (1991), for example, note that rugby in New Zealand has been organised for international success.*

## Iceland: Small country, big ambitions

**"He may be the head of state for only 300,000 people, but [President of Iceland] Dr Olafur Grimsson is also the figurehead for one of the most powerful investment machines in the world. In the year to June, £1.8 billion was invested in Britain alone. That's £6,000 per head. It all seems rather unlikely, but Grimsson [notes that] "It is an important lesson of history that small creative communities can do extraordinary things".**

**Sigurjon Arnason, of Landisbanki, explains the boom, partly, by the youth and therefore energy of the business community. Among the big three Icelandic banks, he is the oldest chief executive at 39. He says there would not have been the chance to make so much money without access to the European markets.**

**A reduction in corporate taxes from 30 to 18 percent helped, too. And the pension system has created a pot of money worth 110% of the country's GDP with which the banks can invest. At least 11% of earnings must be put into pensions, by law."**

**Source: The Observer, 20 November 2005; Economist, 17 February 2005.**

international markets, that are profitable, and that are growing substantially.

Achieving the export and outward FDI targets specified in the Institute's previous report – exports over 35% of GDP and outward FDI over 15% of GDP by 2020 – will require significant contributions from New Zealand firms across the size spectrum. It is not possible to rely only on New Zealand's existing large firms to drive growth in New Zealand's international economic engagement, because there are only a relatively small number of such firms with substantial international growth aspirations.

But neither is it possible to rely only on New Zealand's small and medium-sized firms to achieve these targets because this would require very substantial growth rates as well as many more of these firms. In our last report, we calculated that achieving the proposed export target of 35% of GDP by 2020 would require an additional $35 billion of exports a year. Achieving this export target would require an additional 500 firms the size of Rakon (current exports of about $70 million) or about 150 firms the size of Pumpkin Patch (current exports of over $200 million). These calculations show that New Zealand will need a major contribution from its large firms as well.

So New Zealand will need to grow a wide range of global champion companies. New Zealand needs more large companies, such as those on the Forbes Global 2000, as well as many more internationally successful medium-sized companies.

Germany provides a good example of this broad-based approach. Most of Germany's large companies are actively engaged in international markets. For example, 75% of the revenue of the DAX 30 – Germany's largest 30 listed companies – is derived from outside Germany. In addition, as the accompanying Box suggests, it is the medium-sized

companies in Germany that have gone global in a particularly meaningful way.

There are many international examples of global firms growing out of small domestic economies, and there is no reason that New Zealand should not expect to do likewise. Over the past couple of decades, large, global companies have grown out of countries like Finland, Ireland, and Israel, which have roughly the same population size as New Zealand. And many companies from Spain, a country with roughly the same per capita income as New Zealand, have expanded aggressively into global markets.

## FRAMEWORK FOR ACTION

So what can be done by business and by government to develop many more Kiwi global champions and better integrate New Zealand into the global economy?

On the basis of a series of in-depth interviews with New Zealand business leaders, as well as our own analysis, we have identified four factors that are currently constraining international expansion by New Zealand firms. These are:[2]

- The perceived lack of compelling financial incentives to go global
- Concerns about the capacity of New Zealand firms to compete successfully abroad
- The low level of ownership of New Zealand companies, and weak capital markets
- The perceived low level of aspiration in New Zealand firms to go global

## Exportweltmeister – export world champions

**"In spite of Germany's unexceptional macro-economic data, no other industrial nation has so successfully harnessed the opportunities offered by an interconnected global economy. [Germany] has been the world's largest exporters of goods every year since it overtook the US in 2003. Exports have become the main driver of German growth… and they generate 40% of GDP.**

**The main German winners of globalisation have been small and mid-sized industrial players – the so-called Mittelstand. Though tiny, the most successful of them are highly specialised and often command overwhelming shares of niche markets.**

**Decades of accumulated know-how have made such companies, often referred to as hidden champions, into formidable opponents for new entrants. Because they are so specialised, the only way for them to generate economies of scale is to act globally. [A recent survey] shows that 98% of small and mid-sized German companies now have exposure to international markets."**

**Source: Financial Times, 19 May 2006.**

[2] *The Institute's previous report contains a more detailed discussion of these issues (Skilling & Boven (2006)).*

## Spanish conquistadores

**"Since the return of democracy, the Spanish have rediscovered the outside world. None more so than the country's businessmen, whose exuberant expansionism has led to them being dubbed, the 'new conquistadores'…**

**The purchase of the British Airport Authority may, admittedly, not rank quite as high in the annals of history as the conquest of Mexico. But a planned bid by Ferrovial… is just the latest evidence of the emergence of Spanish firms as a global force. Buoyed by healthy profits, a rising stock market, and a purring economy, Spanish firms are increasingly using audacious – and expensive – deals to expand abroad. Their acquisition spree means that Spain is already home to the biggest bank in Continental Europe – Santander; to five of the top seven European construction companies, and to Telefonica, the third biggest telecoms company in the world".**

**Source: Economist, 16 February 2006.**

Actions that address these specific constraints are likely to have a substantial effect on developing more Kiwi global champions. We have identified four business and government actions with the potential to respond to these constraints. The four areas are:

- Reform New Zealand's tax regime
- Implement a bold savings scheme
- Encourage international expansion by SOEs
- Improve corporate strategy around international expansion

The discussion in the next four sections will provide detailed analysis on these areas and make specific recommendations on the actions required by business and government.

These recommended actions will lead to many more Kiwi global champions, both through removing self-imposed constraints and also through creating a more supportive environment around international expansion. However, the initiatives detailed here provide just one dimension of the solution and need to be supplemented by the broader set of solutions that will be detailed in a series of three future reports.

The solution areas discussed in this report are those that are directly aimed at ensuring that New Zealand

| | Action Proposed | | | |
|---|---|---|---|---|
| Issues Identified | Reform tax regime | Bold savings policy | International expansion by SOEs | Improve corporate strategy |
| Incentives | ✓ | ✓ | – | ✓ |
| Capacity | – | – | – | ✓ |
| Ownership | – | ✓ | ✓ | – |
| Aspiration | – | ✓ | ✓ | ✓ |

firms can compete and win in international markets. In a more general sense, of course, the New Zealand business environment needs to be made as supportive as possible of business success. New Zealand cannot expect to generate global champion firms if the lights are going out because of energy infrastructure issues or if the education system is not producing people with an adequate level of skills and training.

But these broader set of issues are outside the scope of this report.

And although more still needs to be done in this regard, it seems unlikely that New Zealand's economic policy settings are a significant source of competitive disadvantage for New Zealand firms in global markets. New Zealand has made substantial improvements to the quality of its policy settings over the past few decades. The priority now is to leverage an efficient, flexible New Zealand economy across international markets.

## 3 REFORM THE TAX REGIME

A key deterrent to international expansion by New Zealand firms is the frequent absence of a compelling commercial motivation to expand beyond the domestic market.  There is a common view that the returns available in the domestic market exceed those that can be earned in offshore markets.  Actions to improve the financial incentives around international expansion may therefore have a powerful effect on the level of international economic activity undertaken by New Zealand firms.

Some of the factors that contribute to expected domestic returns being higher than those available in international markets are not amenable to action.  For example, the relative absence of intense competition in New Zealand is likely to lead to higher returns being available domestically, at least for some firms.  But this is largely a function of the small size of the New Zealand market, and there is nothing obvious that can be done in terms of changing New Zealand's competition policy that would lead to a significant change in the intensity of competition.

One of the most direct ways in which to enhance the financial incentives around international expansion is through the tax code.  In particular, two changes to the tax code are proposed.  The first is the introduction of an international market development rebate to encourage New Zealand firms to establish a presence in international markets.  The second is a change to the way in which New Zealand firms are taxed on the income from their international investments.

### INTERNATIONAL MARKET DEVELOPMENT REBATE

An important barrier to New Zealand firms breaking into international markets is the cost and risk profile of making investments to establish themselves in an offshore market.  It is expensive to develop an understanding of the new market, to employ local staff, and to set up a physical presence.  For many New Zealand firms, a large number of which will be small by international standards, these costs may deter or delay substantial movements into international markets.

Providing financial assistance to firms as they develop an international presence is very likely to increase the speed and scale at which New Zealand firms move beyond the domestic market.  The tax system can make a direct contribution to providing such financial assistance.

Of course, many of the costs involved in establishing a presence in international markets, such as visits to these markets, hiring additional staff, and purchasing market research, are tax deductible in the standard way.  But given the importance of increased international economic activity, it is appropriate to be more supportive in terms of providing financial incentives and helping firms to overcome these initial barriers to going global.

To respond to these issues, we propose the introduction of an international market development tax rebate.  This rebate would allow firms to claim a credit for qualifying international market development

expenses, such as those described above, at a rate of 33 cents on the dollar. This is effectively the same as a 200% tax deduction for these expenses, but half of this would be in the form of a rebate.

Providing the assistance in the form of a tax rebate, rather than in the form of enhanced deductibility, is important because some New Zealand firms making an initial move into international markets will not have taxable income against which to offset these expenses. In addition, some firms are likely to be cash-constrained, particularly those that are going global at an early stage in their life. A tax rebate, payable in cash, will be of more benefit to firms than enhanced deductibility.

To ensure that the scheme is focused on firms that are making a significant commitment to developing a presence in international markets, we propose that the annual spending on market development will need to exceed $50,000 in a year before the firm can apply for the rebate. A cap on the qualifying expenditure will be placed at $350,000 a year, so a firm can only claim a maximum of $300,000 of expenses a year for the rebate (a maximum rebate value of $99,000). The accompanying Box contains a worked example of how this rebate would benefit a firm.

The scheme would be time-limited so that firms could only claim the rebate for a maximum of five years after their first claim. This period should be sufficient for firms to establish an initial presence offshore.

This proposal will reduce the costs and risks of international expansion relative to domestic economic activity, and make establishing an international presence seem more feasible and attractive for New Zealand firms. This will help all New Zealand firms that are interested in exploring greater international engagement, whether through exporting, outward FDI, or other means.

The evaluations of similar schemes in other countries have been positive, particularly in terms of increasing the number of small and medium-sized firms that are engaged in international activity in a meaningful way (e.g. Austrade (2005)).

## Worked example

**A New Zealand firm spends $500,000 to develop a presence in an offshore market by undertaking some market research and establishing a small local office. These expenses can be deducted against the firm's taxable income in the standard way, for a benefit of $165,000.**

**In addition, the introduction of the international market development rebate would mean that the firm could make a claim on $300,000 of this expenditure. This would generate a lump sum payment of $99,000.**

**So of the $500,000 spent by the firm, $264,000 can be claimed back from the IRD. This means that over 50% of the expense of establishing a presence in an offshore market is covered, which substantially lowers the cost and risk profile of international expansion.**

Over time, this may generate a substantial increase in exporting activity as firms become established in new international markets.

Schemes that are aimed at assisting firms establish a presence in international markets are often run through export promotion agencies, in the form of export market development grants. These grants provide some form of matching payment for the expenses incurred in developing an international presence. Indeed, the government's 2006 Budget contained an expansion of its Export Market Development Assistance Scheme, which provides financial contributions to firms that have incurred these types of expenses.

However, operating this scheme through the tax system has multiple advantages. In particular, it reduces compliance costs as firms file the claims with their tax return, it is likely to be simpler to administer, the payment of the rebate is guaranteed, and there is less chance of manipulating the system because of the additional safeguards built into the tax system.

Perhaps more importantly, using the tax system to administer this rebate will likely increase the awareness of the scheme among the target group. Instead of relying largely on NZTE to market the scheme, using the tax system will mean that accountants and lawyers will also be making their clients aware of this scheme.

The fiscal cost of this proposed scheme depends very much on the take-up by firms. But to give a sense of the possible cost, if 2000 firms claimed the maximum rebate this would generate an annual cost of about $200 million a year for the next five years.[3] After the first five years the cost would reduce sharply as only firms beginning to enter international markets would be eligible for the rebate. This cost estimate is likely to be on the high side given that only about 1400 firms currently export more than $1 million a year.

## INTERNATIONAL TAX REFORM

Another factor that has a significant impact on the incentives on firms to go global through outward FDI is the nature of New Zealand's international tax regime, particularly the CFC (controlled foreign company) regime. This regime determines the amount of tax that New Zealand firms need to pay on the income generated by their international investments.

Under the existing CFC regime, New Zealand firms are taxed on their worldwide income with a credit for foreign tax paid. This means that New Zealand firms are subject to a 33% company tax rate around the world, regardless of the local tax rate. As a result, whenever the foreign company tax rate is lower than 33%, New Zealand firms are at a competitive disadvantage in that foreign market as they pay a higher tax rate than their competitors and cannot take effective advantage of various tax concessions.[4]

21 OECD countries currently apply a lower company tax rate than New Zealand, and the average company tax rate in these countries is about 26%. Tax rates in many Asian countries, which are frequently the high growth markets, are often lower than this. The tax liability for a New Zealand company operating in Singapore, for example, with a headline company tax rate of 20% is about 65% higher than for most other companies operating in that market.

This competitive disadvantage is exacerbated by the fact that New Zealand firms must restate their income under New Zealand tax rules each year and pay tax on income as it is earned regardless of when the funds are distributed. This adds a level of compliance costs to New Zealand firms operating abroad.

In general, OECD countries operate a territorial system in which the income generated from the productive

*[3] The government currently spends around $6 million a year on its Export Market Development Assistance Scheme. The 2006 Budget increased this by about $20 million a year.*

*[4] Income earned in 'Grey List' countries is currently exempted from New Zealand tax. These countries are Australia, Canada, Germany, Japan, Norway, Spain, the UK, and the US.*

operations of domestic firms in foreign markets is taxed only in the foreign jurisdiction with no additional domestic tax obligation. Australia is an example of a country that uses this approach.

This tax treatment has a significant impact on the attractiveness of New Zealand as a base for international activity. PricewaterhouseCoopers (2001) note that the current regime "penalises the activities of multinational companies based in New Zealand, putting them at a competitive disadvantage" and "is arguably the most severe application of taxation to international economic activities in the world".

Despite the fact that the current New Zealand approach is unusual, it is nevertheless a deliberate approach. The 2001 McLeod Tax Review argued that "New Zealand does not wish to adopt a built-in tax incentive that causes… a tax advantage in investing offshore rather than in New Zealand". It reached this view despite noting that "it is precisely this type of system that produces a tax incentive to invest offshore that is the international standard".

New Zealand's current approach attempts to ensure that firms are neutral from a New Zealand tax standpoint between making domestic and foreign investments. However, because most other developed countries tax companies only on their domestic income, New Zealand's current approach makes New Zealand a relatively unattractive base from which to go global. The OECD (2000) notes that "New Zealand has thus chosen to put more weight on equity considerations (between investing domestically and abroad) and less emphasis on the competitiveness of domestic firms operating in foreign markets".

New Zealand's current approach does not recognise that New Zealand firms already face substantial financial disincentives to invest offshore. This is because of the additional costs and risks that are associated with international expansion by New Zealand firms relative to operating in the domestic market. A tax system that exacerbates this disincentive will likely act as a significant deterrent to international expansion from a New Zealand base.

The New Zealand approach also does not adequately recognise that companies are increasingly internationally mobile, and can locate their activities where it is most financially advantageous to do so. Because of this, New Zealand's current approach of tax neutrality between domestic and foreign investment is likely to lead to companies that want to invest offshore to relocate to other countries where foreign investment income is not taxed. There is considerable anecdotal evidence of this occurring over the past decade. Tax is seldom the only issue driving these location decisions, but it acts to strengthen the existing pressure for firms to locate in larger markets.

In sum, the current CFC regime generates real economic costs in terms of aspirational companies choosing not to go global from a New

Zealand base, and either staying in the domestic market or relocating their company offshore. It also makes it more difficult to attract some types of FDI into New Zealand. Ultimately this poses a significant fiscal risk to the government, as the tax revenue paid by these companies may be lost.

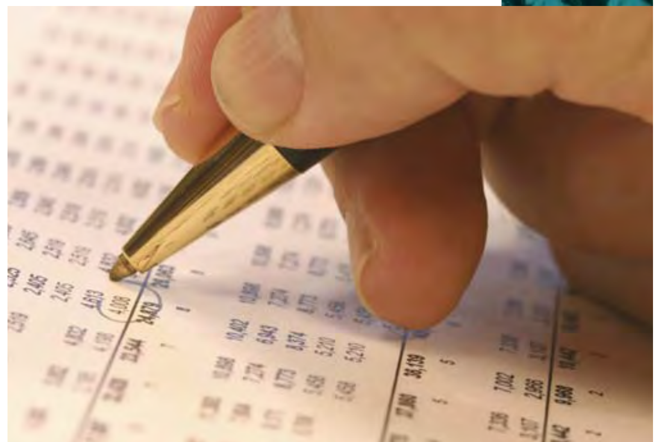
Given the importance of international economic engagement to the New Zealand economy, a system aimed at tax neutrality between domestic and foreign investment is not appropriate. Rather, New Zealand's international tax system should be deliberately directed towards encouraging international engagement by New Zealand firms.

## Recommendations

To achieve this, we recommend that the CFC regime be changed so that New Zealand-based companies not be taxed in New Zealand on income from their active, productive operations in offshore markets. Income from the foreign operations would be taxed in the foreign country with no additional New Zealand tax liability. New Zealand tax will be levied either on the company when earnings are repatriated from the foreign subsidiary or on the ultimate shareholders when these funds are eventually distributed as dividends.

This change will significantly improve the financial incentives for New Zealand companies to undertake international investment by increasing the post-tax returns to international investment. It will also make New Zealand firms more competitive in foreign markets by placing them in the same position with respect to company taxation as the companies they are competing with in international markets. Further, this proposed approach will enable New Zealand firms to take advantage of tax concessions that are offered by foreign countries (currently any concession is clawed back by the IRD, because of a reduced foreign tax credit).[5]

The income earned from passive investments in foreign countries, such as investments in financial assets, would continue to be taxed in New Zealand as they accrue at the New Zealand company tax rate. Policing the distinction between active and passive investments can be difficult, but countries all over the world have been doing so for many years and have worked out practical ways of making this distinction. This recommendation is no more than a proposal that New Zealand adopt the international mainstream policy approach.



*[5] The 'Grey List' would be abolished as part of these proposals, and all countries would be treated in the same way (except for countries that are effectively tax havens).*

We also propose that the minimum shareholding level for participation in the changed CFC regime be lowered to 10%. The CFC regime currently applies to companies in which the New Zealand firm has a controlling stake, defined as 40% or more ownership (or where ownership is held by more than one New Zealand firm and collective ownership exceeds 50%, the CFC regime applies to each firm holding at least 10%). If the New Zealand firm's investment in an offshore entity is less than this, it is effectively treated as portfolio investment and the income is covered under the FIF (foreign investment fund) regime.

But there will be many active investments where the ownership stake does not meet these current CFC criteria. For example, where a young New Zealand firm is expanding offshore

with substantial venture capital funding coming from overseas, the New Zealand ownership stake may be much less than 40%. A 10% minimum shareholding stake for participation in the CFC regime will ensure that such firms also receive the benefit from the proposed tax changes.

These proposed changes are likely to have a substantial effect in terms of international investment by New Zealand firms into non-Grey List countries, such as the Asian countries, which is where a considerable portion of the future growth can be expected to come. The proposed changes may have less impact with respect to investments into the existing Grey List countries, because income earned in these countries is effectively treated as exempt at the moment. Overall, however, our conversations with tax advisors and others in the industry suggest to us that this could have a substantial impact in terms of improving the economics of outward FDI by New Zealand firms.

These changes may also help to make New Zealand a more attractive destination for inward FDI. If firms know that they can expand from New Zealand in much the same way as from other potential investment destinations, they may be more likely to locate a presence in New Zealand.

This proposal is unlikely to be fiscally costly in terms of current revenue foregone, because only a small amount of outward FDI activity occurs at the moment and the majority goes into Grey List countries. However, if income earned by New Zealand companies from outward FDI increases in the future, as is the goal of this policy proposal, the tax revenue foregone will increase.

One objection to this proposal is that it will lead to the 'hollowing out' of the New Zealand economy, as it encourages New Zealand firms to invest abroad. It is certainly the case that the proposed changes will encourage New Zealand firms to make greater investments offshore. But this is unlikely to come at the expense of domestic investment.

The international evidence suggests that domestic investment and foreign investment are complements not substitutes at both firm and country level (Desai et al. (2005)). In a New Zealand context, those firms that have gone abroad successfully have not obviously reduced their domestic investments. And often the FDI activity will complement New Zealand's exporting activity; for example, setting up distribution chains or a retail presence to promote exports from New Zealand. New Zealand benefits most by having strong, profitable, internationally competitive firms, and this will be assisted by encouraging international investment.

The reform of the CFC regime has been raised in the context of the government's business tax review, and we understand that work is currently underway to examine the introduction of an active/passive distinction. We recommend that this work be fast-tracked, with a view to introducing legislation to effect such changes as rapidly as possible.

## 4 IMPLEMENT A BOLD SAVINGS PLAN

Increased household savings, and the creation of a much larger pool of domestic capital, will make a significant contribution to the task of developing many more Kiwi global champions. Increased savings will strengthen the financial incentives to go global, create a more supportive domestic platform from which to expand, and also ensure that New Zealand retains a larger ownership stake in these companies.

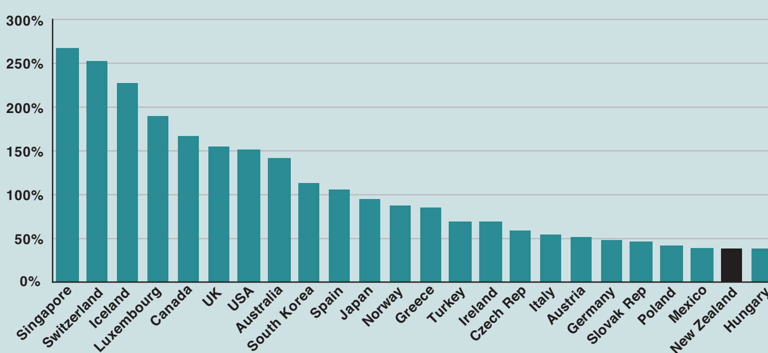
### STRONGER CAPITAL MARKETS & REDUCED COST OF CAPITAL

A larger pool of domestic capital will strengthen New Zealand's capital markets, reduce the cost of capital in New Zealand, and make it easier for New Zealand firms to access the capital they need to expand internationally from New Zealand. As a consequence, expanding the domestic pool of capital will enhance the incentives for New Zealand firms to go global and make New Zealand much more attractive as a base from which to take on the world.

Capital market strength and firm growth are strongly related, particularly for firms that have a heavy reliance on external financing (Rajan & Zingales (1998)). This will be the case for many New Zealand firms that are seeking to expand into international markets, given that they will frequently be small and will need to scale up their activities substantially to operate in much larger offshore markets.

The Australian experience suggests that savings policy can have a strongly positive effect in this regard. The weight of capital in Australia, and the fact that it is growing every year, means that there is capital readily available to fund international expansion and growth stocks are sought out. The increased pool of capital has also had a positive effect

FIGURE 5: MARKET CAPITALISATION AS A % OF GDP, 2006




Note: In most instances only the major domestic exchange considered to avoid double counting.
Source: IMF; relevant national exchange for Iceland, Canada, Slovak Republic, and Czech Republic.

on the level of aspiration around international expansion, because there are many more firms who are looking at growing into offshore markets.

But as it currently stands, New Zealand has small, illiquid capital markets by international standards, as noted in Figure 5. And New Zealand ranked 21st out of 22 OECD countries in terms of IPO (initial public offering) funds raised in 2005, according to an Ernst and Young study. This means that New Zealand firms may not be able to raise capital as easily or cheaply as firms that operate in countries with deeper, more liquid capital markets. In turn, this may have a negative effect on the level of New Zealand's international engagement.

Increasing the level of personal savings will also reduce New Zealand's high cost of capital. On average over the 1990-2005 period, New Zealand's 90-day interest rates have been about a percentage point higher than in Australia and three percentage points higher than in the US. New Zealand companies need to earn a higher rate of return than their international competitors to compensate for the higher cost of capital. This places New Zealand companies at a competitive disadvantage relative to companies who can raise capital more cheaply in other markets.

New Zealand's high cost of capital is partly due to New Zealand's high level of external indebtedness. Reserve Bank analysis estimates that a 10 percentage point reduction in New Zealand's external liabilities to GDP ratio would reduce its long-term real interest rate by 25 basis points. Other New Zealand research estimates that a percentage point reduction in the current account deficit to GDP ratio would reduce the real interest rate by 19 basis points (Plantier (2003), Conway & Orr (2002)). These estimates are consistent with international research (Obstfeld & Rogoff (2000)).

Over time, increasing household savings will act to reduce New Zealand's cost of capital. This will assist New Zealand firms as they seek to grow into global champions, by allowing them to access capital at rates more similar to their competitors in other markets.

Increasing household savings is therefore an important element in creating a supportive environment for New Zealand companies as they expand into international markets. Generating a domestic pool of capital will grow and strengthen New Zealand's capital markets, lead to more aggressive pricing of companies, provide expansion capital for large and small New Zealand companies, and reduce New Zealand's cost of capital. By making New Zealand a more attractive base for international activity, these factors will help to anchor companies in New Zealand as they expand their operations internationally.

## INCREASED NEW ZEALAND OWNERSHIP

Increased household savings will also likely increase the share of the returns that flow to New Zealand investors as New Zealand companies expand offshore. It may be that many New Zealand companies are able to obtain capital for international expansion from foreign investors, but in this case the returns flow offshore to reward the investors who have put up the capital. In order for New Zealand to obtain real benefits from the process of international investment by New Zealand firms, there needs to be a significant New Zealand ownership stake.

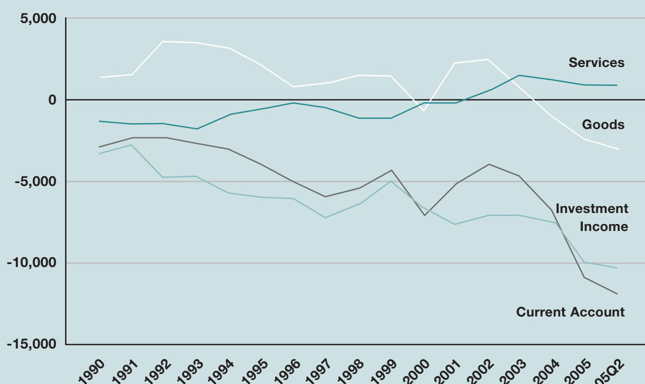
New Zealand's heavy reliance on foreign capital can be seen in its substantial investment income deficit. New Zealand exported about $13 billion, or 8% of GDP, to foreign investors in 2005 as the returns on their New Zealand investments.

This is not an argument against New Zealand firms accessing foreign capital. Often the sources of foreign capital will also provide New Zealand firms with access to international networks and expertise, in addition to the capital itself. But it is desirable for there to be an increased pool of domestic capital to complement this foreign capital.

Having a substantial ownership share is particularly important to the extent that New Zealand companies increasingly go global through outward FDI, which may involve less reliance on domestic production. In this case, the primary benefit from international engagement by New Zealand firms will be delivered through a share of the ongoing profit stream.

Increased household savings will help to reduce the number of New Zealand companies being sold into foreign ownership as they expand. There is likely to be a negative relationship between foreign ownership and New Zealand's international engagement.

FIGURE 6: BALANCE OF PAYMENTS FOR NEW ZEALAND ($M)




Source: Statistics New Zealand.

For one thing, New Zealand subsidiaries of foreign companies tend to have lower levels of international engagement. Foreign-owned companies in New Zealand rarely undertake international investments, and the foreign shareholders of these firms often do not have the same focus on undertaking major international expansion from New Zealand.

Further, foreign ownership often strengthens the tendency for New Zealand companies to relocate offshore. The arguments for remaining in New Zealand may weaken with foreign ownership, and this will have a negative effect on the international engagement of the New Zealand economy. For example, one of the reasons for this pressure to relocate comes from Australian investors being unable to access New Zealand imputation credits and the consequent desire by Australian shareholders for companies to be treated as Australian tax residents. A larger New Zealand shareholder base will reduce this pressure.

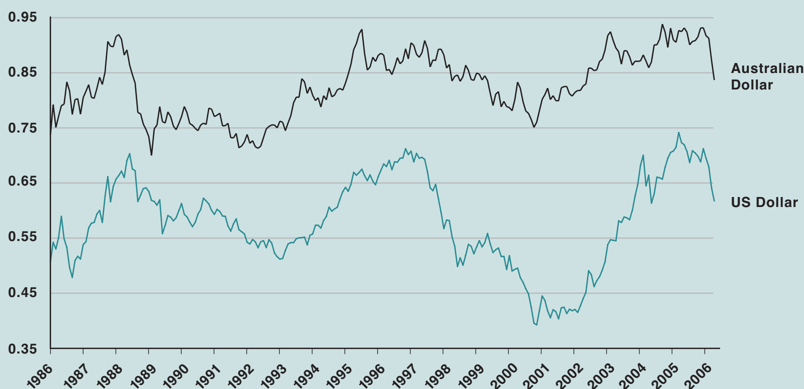
## MODERATING THE EXCHANGE RATE CYCLE

The New Zealand dollar experiences a pronounced periodic cycle against currencies like the Australian and US dollars, as described in Figure 7.

This exchange rate volatility acts as a deterrent to international expansion from New Zealand. The negative effects of these exchange rate movements are frequently cited by New Zealand firms as a significant impediment to international expansion (Grimes & Holmes (2000)). This is likely to be particularly the case for relatively small firms, who may find it more difficult to absorb the major swings in cashflows due to the exchange rate cycle (Baldwin (1988), Baldwin & Krugman (1989)).

This exchange rate cycle reflects the cycle of high domestic interest rates that are raised in response to

**FIGURE 7: NEW ZEALAND EXCHANGE RATE TO AUSTRALIAN AND US DOLLARS, 1986-2006**




Source: Datastream.

inflationary pressures. This has the effect of placing pressure on the export sector in order to get inflation out of the domestic economy. This is not desirable given the vital importance of international engagement for New Zealand's economic prospects. It is like sacking the All Blacks' coach for poor Black Caps' performance.

The implementation of a bold savings plan is likely to moderate the exchange rate cycle, and thereby promote greater international economic activity by New Zealand firms. One of the key drivers of the tight monetary policy response has been the strong growth in private consumption, fuelled by the substantial increase in household debt. However, increased savings would take some of the heat out of domestic spending, and so interest rates would not need to be raised as aggressively. In turn, this would reduce the pressure on the exchange rate.[6]

Another suggestion sometimes made in this regard is for New Zealand to form a currency union, most likely with Australia or the US. There is evidence that currency union will lead to increased trade and investment flows and reduce the cost of capital (Frankel & Rose (2002), Coleman (2002)). But the loss of independent control over domestic interest rates is likely to impose some economic costs (Hunt (2005)). At this stage, there is not a sufficient consensus on where the balance lies to justify New Zealand adopting another currency.

But over the next few decades, it is likely that the number of independent currencies will decline as consolidation occurs and, for this reason, there is likely to be ongoing pressure for New Zealand to adopt another currency. As a consequence, currency union will likely remain a live issue in New Zealand for some time to come (Farrell & Lund (2000)). In the meantime, increasing personal savings in a significant way is the most promising option in terms of moderating New Zealand's exchange rate cycle.

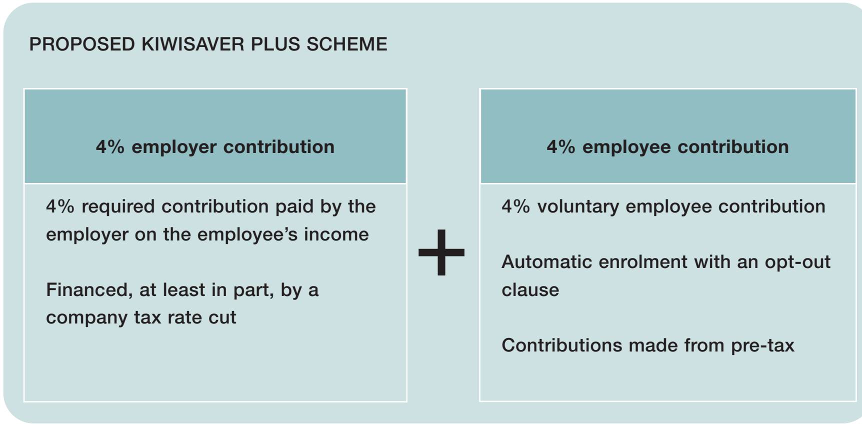
## KIWISAVER PLUS

The government is currently moving to introduce the KiwiSaver scheme in an effort to increase household savings. But KiwiSaver needs to be made more ambitious in order for it to have a meaningful impact on New Zealand's overall level of savings. In the Institute's recent submission on the KiwiSaver Bill, we proposed an expanded version of the KiwiSaver scheme to ensure that it generates a material increase in household savings.[7]

The major elements of the Institute's proposed KiwiSaver Plus scheme are a required employer contribution of 4% of employee income, partly financed by a company tax rate cut, and a voluntary contribution by individuals of an additional 4% of income with the

[6] *Increased household savings are likely to have a more significant effect on moderating the exchange rate cycle than the measures examined by the Treasury and Reserve Bank in their recent Supplementary Stabilisation Instrument report.*

[7] *The Institute's submission on the KiwiSaver Bill is available on our website www.nzinstitute.org*




ability to make contributions to the account out of pre-tax income.

KiwiSaver Plus would deliver a significant increase in private and national savings. The required 4% employer contributions would amount to about $2.5 billion a year, or 1.7% of GDP. Because of the tax advantage on voluntary contributions, a participation rate of 50% in this part of the scheme seems reasonable. This would generate additional annual savings of $1.25 billion, or 0.8% of GDP. Taken together, KiwiSaver Plus could generate an increase in savings of slightly under $4 billion a year, or 2.5% of GDP, over six times the likely effect of KiwiSaver.

After a decade in operation, KiwiSaver Plus would have generated accumulated personal savings of over $40 billion in real terms, much of which will be new savings.

KiwiSaver Plus would make a substantial contribution to improving New Zealand's savings performance. In turn, this would have a material impact on outcomes such as the current account deficit, the cost of capital, and the size and strength of New Zealand's capital markets. This proposed policy is likely to lead to significantly more capital raising on the domestic market, and to a much higher level of New Zealand ownership of New Zealand companies as they go global.

Although some of this increased savings will be invested offshore, the international evidence suggests that a disproportionate amount will be invested locally. Even a 10-15% allocation to domestic equities – an average allocation by New Zealand funds – would lead to a flow of about $400-600 million a year into New Zealand markets, which is a more significant investment than the New Zealand Superannuation Fund currently makes.

And over time, the development of New Zealand's capital markets will increase the likelihood that domestic savings will be channelled into domestic investment, as the industry scales up and develops its ability to allocate funds to domestic opportunities.

In addition to encouraging household savings, we also recommend that the government direct the New Zealand Superannuation Fund to give greater consideration to domestic equity markets and other domestic asset classes in making their portfolio allocation decisions. Currently the Fund's allocation to New Zealand equities is 7.5%, which is lower than the domestic weighting of government funds in most other countries. Care obviously has to be taken to avoid flooding the New Zealand market, but there is scope for consideration of how a greater portion of these funds might be directed into the domestic market. This will assist in adding liquidity and depth to the New Zealand market, and assist in funding the international expansion of New Zealand companies.

## 5 ENCOURAGE INTERNATIONAL EXPANSION BY SOEs

As noted above, New Zealand has relatively few large companies that are well placed to undertake substantial international investments or other forms of international engagement. However, the government's remaining portfolio of State-Owned Enterprises (SOEs) contains several large, and 100% New Zealand-owned, companies. The three largest SOEs – Meridian Energy, Genesis Energy, and New Zealand Post – have annual revenues in excess of $1 billion, and would be in the Top 20 listed firms by market capitalisation if they were listed on the New Zealand Stock Exchange.

Because of the size of many of these SOEs, international expansion by SOEs has the potential to make a material contribution to New Zealand's overall level of international engagement. By way of example, the sale price of Meridian's investments in Australia in 2005 accounted for about 8% of New Zealand's total stock of outward FDI at the time.

There is also a track record of success in terms of international investments by SOEs. The most recent example of this is Meridian's Southern Hydro investments in Australia. The New Zealand ownership of these companies also means that the returns from these investments flow back to New Zealand. Indeed, the $800 million special dividend that Meridian recently paid to the government on the profitable sale of its Australian investment is now playing a significant role in financing infrastructure spending.

Some of the large SOEs are in a good position to undertake significant international expansion. There are companies that have substantial assets and experience, that have developed real competitive advantage in some areas, and that currently have debt levels that are below private sector benchmarks.

While the SOEs remain in government ownership, SOEs should be allowed and encouraged to act in the same

**TABLE 1: TOP 10 STATE-OWNED ENTERPRISES**

| | | 2004/5 NZ$m | | |
|---|---|---|---|---|
| | **Company Name** | **Revenue** | **Profit** | **Assets** |
| 1 | Meridian Energy | 1,656 | 218 | 4,349 |
| 2 | Genesis Energy | 1,494 | 70 | 1,867 |
| 3 | New Zealand Post | 1,209 | 137 | 2,506 |
| 4 | Mighty River Power | 684 | 121 | 2,668 |
| 5 | Transpower | 636 | 141 | 2,077 |
| 6 | Solid Energy | 401 | 6 | 316 |
| 7 | ONTRACK | 157 | 92 | 174 |
| 8 | Airways Corporation of New Zealand | 132 | 3 | 106 |
| 9 | THL Group | 130 | 15 | 180 |
| 10 | Landcorp Farming Limited | 116 | 10 | 1,027 |

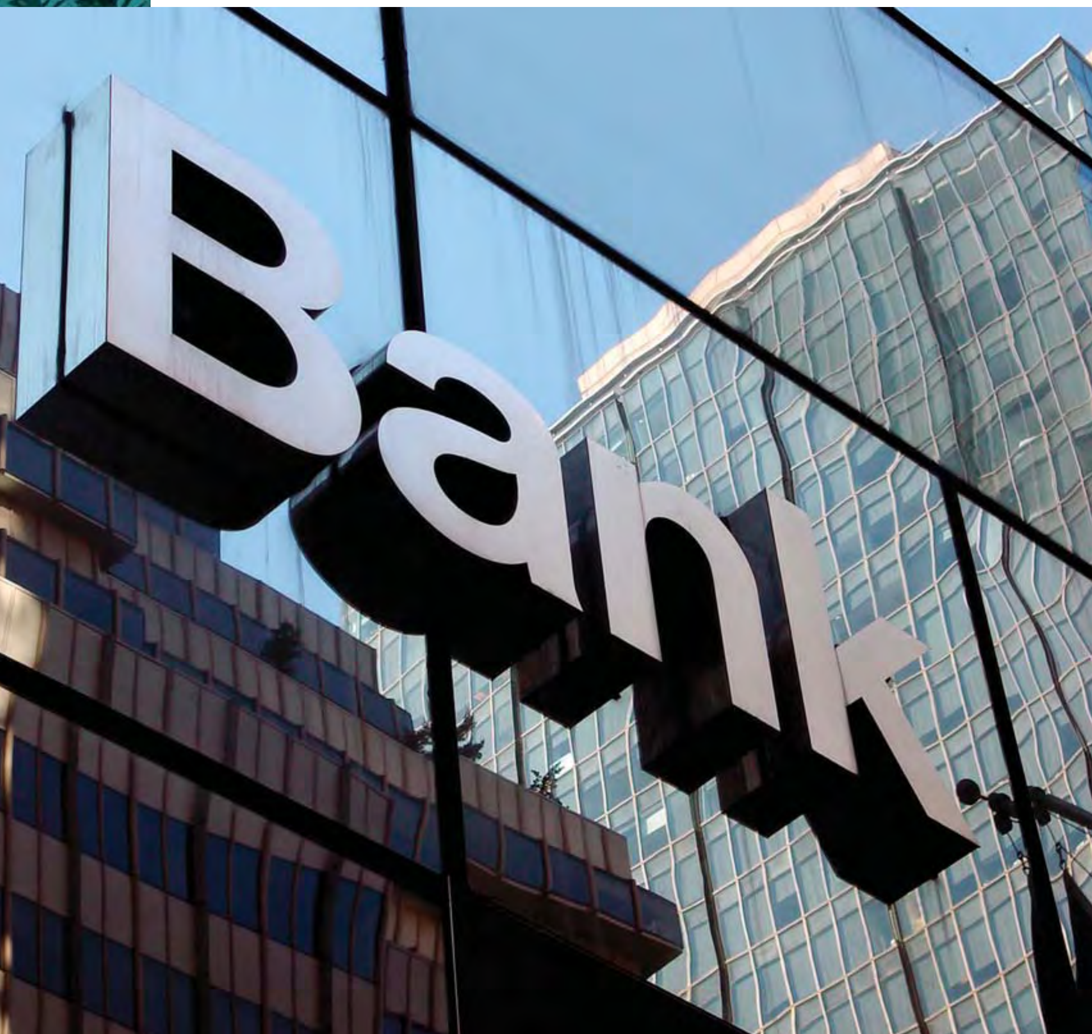
**Note: Ranked by revenue.**
**Source: CCMAU website.**

way as their private sector counterparts. Such encouragement to consider international expansion is an important part of SOEs operating as a "successful business" as required in the SOE legislation. In addition to the direct commercial benefits from this approach, there is also a broader public policy rationale with respect to encouraging international engagement by New Zealand firms.

## PROPOSED POLICY CHANGE

However, as a practical matter, SOEs have been constrained in terms of making international investments. Although international expansion is not prohibited, the policy guidance around international expansion by SOEs is quite restrictive.[8] There has been little or no explicit encouragement by shareholding Ministers to consider international expansion.

This approach is in place because of a fairly risk averse approach by successive governments to managing the portfolio of SOEs. For the most part, there has been a preference to put the SOEs in a holding pattern. As a




[8] *Owners Expectations Manual, published by the Crown Company Monitoring & Advisory Unit and Treasury.*

consequence, few international assets are owned and operated by SOEs. Although some SOEs have international operations, these are generally in areas like consultancy services rather than in activities that require substantial investments of capital.

Encouraging international engagement by New Zealand firms, including those firms owned by the government, ought to be a policy priority given the importance of international engagement to the New Zealand economy. Shareholding Ministers should be aspirational around international expansion, and be prepared to take some calculated risks, in the same way as it is important for private sector shareholders to do so.

The proposed focus on international expansion avoids the standard concern about SOE expansion, which is that SOE expansion will crowd out private sector activity in New Zealand. With this proposed change, the expansion by SOEs will take place offshore and so will not act to crowd out private companies.

We recommend that a signal be sent to encourage the consideration of international investment by SOEs. Letters should be written by shareholding Ministers to at least some of the SOE Boards advising that proposals requesting approval for international expansion will be treated favourably, as long as the business case stacks up.

These investments will obviously need to meet rigorous commercial criteria, and Ministers will need to have confidence that the Boards and management of the SOEs are capable of managing such international investments in a successful way. The Boards and management required to operate a domestic business, with limited expansion opportunities, will very likely be different to that required to successfully manage international operations. Careful consideration should therefore be given to the composition of the Board and management team when evaluating investment proposals by SOEs.

For these reasons, a cautious approach may be warranted initially. The encouragement to consider international expansion might be restricted to a handful of SOEs in the first instance, perhaps Meridian Energy, Genesis Energy, New Zealand Post, Mighty River Power, and Solid Energy, with a view to expanding this policy if it delivers good results.

The impact of this proposed change on New Zealand's international economic engagement will rest largely on the investment opportunities that arise, and so it is difficult to estimate the expected economic benefits. But it makes sense to relax the self-imposed constraint on international expansion by some large New Zealand firms. There is not a compelling rationale for adopting a negative attitude in principle towards international activities by SOEs.

The major benefit from the proposed change is likely to accrue to SOEs, in terms of strengthened profitability from a larger market in which to operate. In turn, this will benefit the government as the shareholder and the broader economy in terms of a positive contribution to productivity. This approach is also likely to strengthen the capacity of SOEs, as they develop expertise, obtain exposure to industry developments abroad, and increase career options to develop and attract talent.

## SOE policy change

**On June 2, the government announced a change in SOE policy in which SOEs would be encouraged to consider expansion opportunities, where this was expected to generate broader spillover benefits to other parts of the New Zealand economy. The stated aim of this policy was to encourage SOEs to contribute more directly to the process of economic transformation.**

**There are a couple of differences between the government's announcement and our proposals. First, the announced change has a far broader focus on expansion relative to our emphasis on international expansion. Second, the government argues that SOEs can be a vehicle for economic transformation through their investing and research activities, whereas in our view the existence of spillover benefits is of secondary importance. The test for supporting international expansion should be simply whether it is a good commercial opportunity and whether there is confidence that the SOE will be able to execute well and not whether there are significant economic spillovers.**

In terms of financing these investments, some SOEs may be able to finance the investments off their own balance sheets. Shareholding Ministers should also be prepared to make capital injections into these companies where appropriate and/or accept a lower level of dividend payment from the SOE. There is some precedent for such injections by shareholding Ministers – the government invested about $80 million to help establish KiwiBank in 2001, because it viewed this as a policy priority. The debt position of the government means that it is well placed to finance these investments.

Another funding option is for the SOE to invest together with other parties in a joint venture that owns the international investment. In addition to reducing the size of the investment by the SOE, this would introduce a degree of market discipline into the investment process. More broadly, there is scope to consider a partial sale of equity in SOEs to finance such international expansions. Proposals to sell a 20% or a 40% stake in SOEs have been publicly raised before, and should be considered further in this context.

In sum, there is real potential to change SOE policy in a creative way so as to encourage SOEs to explore the potential of greater international engagement. Such a policy will likely have benefits for the individual SOEs, the government's balance sheet, and for the New Zealand economy.

## 6 IMPROVE CORPORATE STRATEGY AROUND INTERNATIONAL EXPANSION

Developing many more Kiwi global champions ultimately rests on the behaviour and performance of the firms themselves. The success or failure of international operations can generally be traced back to what happens within firms. While it is important that New Zealand's policy settings support international expansion by New Zealand firms, such actions will have a limited effect without a pipeline of New Zealand firms with the capacity and aspiration to go global. Exporting and outward FDI cannot be raised by government directive.

New Zealand firms face particular challenges in terms of expanding into international markets from a New Zealand base. Understanding the factors that contribute to international success by New Zealand firms in this context will be an important part of raising New Zealand's overall level of international engagement. So what do New Zealand firms need to focus on in order to generate a substantial improvement in their international success?

## GLOBAL CHAMPIONS RESEARCH

To make progress in answering this question, the New Zealand Institute undertook a joint research project with McKinsey & Company. This project drew on a major international research project that McKinsey had undertaken to identify success criteria associated with 'global champion' companies. We were particularly interested in those global champion companies that had grown from small domestic markets, such as Ireland, Finland, and Israel, as these experiences are likely to be particularly instructive for New Zealand. Some of these company examples are described in Table 2.

Because of the distinctive nature of the challenge of going global from New Zealand, we supplemented this international research with a series of interviews with New Zealand business leaders that have experience in international expansion. We also spoke with senior figures in the capital markets and others in the professional advisory community.[9]

**TABLE 2: GLOBAL CHAMPIONS**

| | Expansion Path | Financial Impact |
|---|---|---|
| Nokia, Finland | Diversified, nearly bankrupt, European conglomerate in 1991 with mobile phones contributing 7% of revenue. Grew to the world's number one mobile phone company by 2000. | Revenue increased from US$3.7b in 1990 to US$36.4b by 2004 through organic growth. |
| CRH, Ireland | CRH first began acquiring small, regional players in 1985. This activity accelerated and CRH spent more than €1b on major projects and deals in each year from 2000 to 2004 (including about 40 acquisitions per annum). | Annual sales grew from €325m to €12.5b between 1980 and 2005, despite recessions and downturns. |
| Teva, Israel | Used business connections in the USA along with strategic alliances, acquisitions and partnerships to expand outside Israel. Share of revenue from North America and Europe increased from 33% in 1992 to 88% in 2002. | 500% revenue growth over ten years to $5.3b in 2005, along with moves into higher margin IP products. |
| Macquarie Bank, Australia | Operations started in the 1970s and now a significant player in the Australian market. Organic growth has built international operations which now contribute 37% of income. | One of Australia's best performing companies in the last 10 years, with market capitalisation growing at 28% per annum from 1996, reaching $US11.1b in 2006. |
| Norske Skog, Norway | Went from domestic focus in 1995 to a global leader in 5 years by purchasing global paper assets, and shifted focus to higher margin newsprint products. | Sales grew from $US1b to US$3.8b in 10 years and now achieves higher margins than the troubled global paper industry. |

**Source: McKinsey & Company.**

*[9] These interviews were conducted in confidence so as to ensure a frank conversation.*

This process has highlighted the nature of the challenges associated with going global from New Zealand, and the need for New Zealand firms to be particularly attentive to the importance of operating in this context. In particular, we have identified four key factors that New Zealand firms should focus on in order to enhance the prospects of international success.

## 1. Commitment to international success

International success does not tend to happen spontaneously, but is generally the result of a long-term commitment to go global. It is instructive that many of the iconic global champion firms that grew out of small countries, such as Nokia from Finland, were characterised by high aspiration and a long-term commitment to international success. Successful international expansion can be a decades-long task, involving substantial costs and risks. Accordingly, companies need to have a long-term focus and be prepared to sustain a commitment to international expansion over a long period of time, rather than simply be hoping for a short-term payback.

The focus needs to be on becoming a global company rather than simply having some modest international activities that supplement the company's domestic operations. This commitment may be driven by a recognition of the limited growth opportunities in the small New Zealand market, the need to diversify exposure to New Zealand's economic cycle, or a sense that the only long-term sustainable strategy for many New Zealand firms is an international growth strategy. More positively, the commitment to international success may stem from an aspiration to build a successful, genuinely global New Zealand firm.

This long-term commitment is particularly important because of some of the issues around the reaction of New Zealand capital markets to international expansion. Firms need to have a clear focus on the long-term benefits of international expansion in order to overcome potential initial market scepticism.

In addition to developing a long-term commitment to international success within the firm, there is also a need to undertake active efforts to align stakeholders around this commitment. Firms need to bring shareholders, capital markets, employees, and others along rather than assuming that people will automatically understand and support the firm's vision. Such an education process will create an environment that makes it easier for the firm to sustain its commitment to international success over a long period of time.

## 2. Investing in competitive advantage

New Zealand firms will succeed in international markets to the extent that they have truly distinctive assets and capabilities that generate economic value relative to their competitors. New Zealand firms need to be very clear about how they will create economic value in international markets, and the nature of their competitive advantage. Which specific capabilities are globally distinctive? What does the firm bring that is of relevance to the international market?

This is not the same as assuming that strong financial performance in New Zealand is proof of competitive advantage, and that the New Zealand business model can be replicated successfully offshore. Although good financial performance in New Zealand may be a sign of underlying competitive strength, it may also reflect the absence of intense competition in parts of the New Zealand economy. Winning in competitive international markets requires strong intrinsic capability.

This is not just an academic exercise, but one that requires follow-through in critical budgeting and planning processes. Firms need to make genuine choices as to how they are going to compete, translate that choice into specific assets and capabilities, benchmark those assets and capabilities to ensure they know the standard required to win in international markets and that they can continuously improve, and then invest behind the relevant assets and capabilities. The key is to ensure that the firm's allocation of scarce resources, particularly capital expenditure and talent, reflects some decision as to how the firm is going to compete and win. It is not sufficient to simply identify some advantage, it requires sustained investment.

This focus on competitive advantage also has implications for which offshore markets the firm chooses to expand into. An analysis of the market structure and the competitive environment in those markets should be a key focus in addition to standard metrics like the size and growth of the market. It is important to map the firm's distinctive advantages onto the market conditions, rather than assuming that because, say, the Australian market is five times as large that the firm will automatically be able to sell five times as much as in New Zealand.

Although Australia may be the right choice, this should be a considered decision rather than simply be the default choice. Markets should be selected on the basis of the firm's ability to compete successfully in that particular market.

### 3. International growth in steps

One of the characteristics of successful international expansion by firms in other countries has been the development of a secure financial base before moving offshore, so that the firm's international expansion can be supported by a strong domestic position. For many New Zealand firms, however, this will not be a possibility.

New Zealand firms will generally be at an early stage on the learning curve as they go global, and will also tend to be a lot smaller and have weaker balance sheets than many of their international competitors. As a consequence, the investments that they make in international markets tend to be relatively large for the firm and higher risk. This suggests that the profile of international expansion for New Zealand firms will have to be different than the standard profile for firms in many other countries.

In general, international expansion in an organic manner or through small acquisitions has proven to be more successful for New Zealand firms. Big bang, 'bet the company', movements into international markets have tended to be less successful. And if these substantial investments do not work out, the negative consequences can be very serious in terms of firm viability.

So the strategy for the long-term development of a competitive position in international markets position by New Zealand firms is likely to include some initial low-risk moves to test competitive advantage overseas, followed by more aggressive scaling up once international competitiveness is proven. This growth process also needs to involve a deliberate, systematic approach to learning as you go.

This approach reflects an understanding that the New Zealand firm will be on a learning curve, and that a measured approach ought to be taken as the firm ventures out. For example, Pumpkin Patch has moved in an incremental way into new international markets, but has expanded rapidly as it has developed an understanding of the market.

Another way of managing the risks associated with scaling up into international markets is through international outsourcing. Rather than making large investments in production capacity to service large markets, it may be possible to route production through a contract supplier that can provide low cost scale production at lower risk to the New Zealand firm. There may also be potential for New Zealand firms to work together as they move abroad, sharing costs and knowledge, which may also lower the risk profile.

It is important to note that expanding offshore in steps should not be interpreted as a reason to purchase a lower quality, but cheaper, asset or to expand offshore in a sub-scale way. It turns out that New Zealand firms that have profited from their international investments tend to have purchased the #1 or #2 firm in the market rather than buying the #4 or #5 firm and attempting to improve the asset. The experience has been that it is often hard to do a turn around in an established market in another country.

Indeed, in terms of outward FDI, firms that have made smaller purchases are doing better. Recent Deutsche Bank analysis provides an indication that New Zealand firms are getting better at going abroad, with acquisitions made over the past few years generating higher rates of return than previously.[10] This is associated with these acquisitions being smaller relative to the size of the New Zealand firm. This signals that some learning has taken place.

There may be some tension between the imperatives to expand offshore in steps and to expand with scale appropriate to the market. The first step in managing this tension is to understand that it exists and identify the competing priorities. In addition, the firm should select markets to expand into that allow for incremental expansion without compromising the quality of the firm's expansion profile. This may mean, for example, that the firm should move into smaller markets as a step into larger markets subsequently.

## 4. Put experienced people on the ground

Successful entry by New Zealand firms into international markets requires developing a good understanding of the market environment. In particular, New Zealand firms need to invest in understanding issues like customer demographics, customer tastes, market structure and the nature of the competitive environment, channels to market, and the regulatory environment.

Obtaining real insights about international markets requires people

[10] *Presentation by Dean Hamilton to the INFINZ Industry Conference, 21 October 2005.*

on the ground. Desk research from New Zealand, supplemented with occasional market visits, is helpful but is unlikely to be sufficient. This may require the deployment of senior executives into the foreign market well before entry, the development of a network of relationships with potential suppliers and customers, and the recruitment of local executives with deep market knowledge. It is also vital to have a process for integrating this knowledge of foreign markets into the firm.

This can be an expensive process, particularly for small New Zealand firms. But these investments are particularly important for New Zealand firms because there are fewer ways in which to obtain knowledge about markets that will frequently be distant from New Zealand. The initiatives outlined in a previous section, such as the international market development tax rebate, are likely to assist in this regard by making these investments more affordable.

## Specific actions

Successful international expansion from New Zealand is difficult, but it is feasible. The analysis summarised above provides some guidance as to the key factors that ought to be top of mind for New Zealand firms as they think about going global. In addition, there are some broader factors that also need to be addressed in order to develop more Kiwi global champions.

• **Business education**

At the university level, there needs to be a much greater focus on teaching and research on how to successfully take New Zealand firms global. Investments need to be made in New Zealand case studies that describe the challenges of taking New Zealand firms global, so that there is a much deeper knowledge base of what has worked and what has not in terms of approaches to international expansion.

Developing a deep understanding of these issues in a way that can be communicated to current and future business leaders is a vitally important role for business schools. This will likely include a much enhanced focus on international business at undergraduate, graduate, and executive education levels.

To this end, business schools should also be actively investigating the potential for developing relationships with top international business schools, running programmes with Asian universities, embedding student exchanges at undergraduate level, and bringing out visiting experts in international business. New Zealand business schools should aim to put themselves at the centre of the task of taking the New Zealand economy global.

• **Knowledge sharing**

A key priority in creating a global New Zealand economy is developing New Zealand business leaders who have the right set of skills to take firms global from New Zealand. However, we have been told frequently that there is a relative absence of learning from the experiences of other New Zealand firms. As a consequence, New Zealand firms tend to go through the same learning process and make the same mistakes repeatedly. There

is a need to make the learning much more systematic.

There are some reasonably straightforward things that can be done in New Zealand to facilitate greater sharing of knowledge between New Zealand firms, such as arranging seminars and conferences focused on international expansion where chief executives talk with other business leaders about what they have learned along the way.

NZTE and organisations like Export New Zealand undertake some of these activities at the moment, but there is a need for much more. Industry groups and professional advisors should also become more involved in sharing knowledge across the community of internationally engaged firms.

In addition, providing shared physical facilities in offshore markets for New Zealand firms, for example through NZTE, will also assist firms to share knowledge and learn from each other in terms of how to successfully enter international markets.

There is also a need for New Zealand firms to operate in a more collaborative way, and be prepared to share lessons and work together. The scale of opportunities in global markets is enormous, and New Zealand firms ought not see each other as competition in these markets.

• **Changing the conversation**

A key part of enhancing the level of aspiration around international expansion is to change the public conversation. The first step is to make the notion of international expansion more of a mainstream conversation in the business community, and to create some peer pressure around international expansion.

As part of this process, there is a need to start talking about the success stories more and examining the features underlying their success, rather than talking about the high profile failures. New Zealand has tended to focus on discussing corporate failures rather than celebrating the corporate success stories. Highlighting success is an important way of beginning to change national attitudes.

If people see the success of other firms, their expectations are also likely to begin to change. People and firms tend to assess their behaviour and performance relative to that of those around them. It has been said that New Zealanders will always clear the bar as long as they know where the bar is set. If more attention is given to firms that are successfully moving into international markets, they are more likely to do so as well.

Leadership from business and government is important in terms of changing the public conversations that we have. And there is a clear responsibility for the New Zealand media to highlight business success more systematically.

# 7 CONCLUDING REMARKS

The task of creating a global New Zealand economy, with much increased levels of exporting and outward FDI, necessarily involves developing many more Kiwi global champions. Achieving the exporting and outward FDI targets proposed in the Institute's previous report requires major contributions from New Zealand's existing large firms as well as growing many more small New Zealand firms into Kiwi global champions.

This is a big challenge for New Zealand. It is difficult going global from the end of the world, and many New Zealand firms have struggled over the years to achieve this. But despite these challenges, it is possible to do substantially better.

The aspiration should be to become as accomplished in terms of international business success as New Zealand has been in terms of international sporting achievement. New Zealand expects many of its sports teams to be global champions, and its teams act accordingly. There is nothing in principle to prevent New Zealand from achieving this type of success in international business.

However, to generate a material improvement in New Zealand's international engagement, and to achieve the exporting and outward FDI targets that were specified, will require meaningful change. Modest moves in the recommended direction will simply lead to more of the same type of outcomes as have been generated over the past decades. Ambitious, determined action is required given the challenges facing New Zealand firms in growing into global champions.

This report has identified a series of actions that can be taken by business and government that, taken together, have the potential to develop many more Kiwi global champions.
In particular:

- Changing New Zealand's tax regime to enhance the financial incentives for firms that are undertaking international expansion
- Implementing a bold personal savings scheme to strengthen capital markets, reduce the cost of capital, increase New Zealand's ownership stake in its international companies, and moderate the exchange rate cycle
- Encouraging international expansion by SOEs
- Improving corporate strategy around international expansion

These proposed actions would be supported by actions to achieve enhanced market access for New Zealand firms in offshore markets, to strengthen the links that connect New Zealand to the world, and to develop new strengths in the New Zealand economy. These additional areas will be discussed in detail in three reports that will follow.

A major reason for New Zealand's poor international performance has been the absence of a sufficiently aggressive response to the challenge of going global from New Zealand. New Zealand can do much better than it is currently doing, but real seriousness of purpose will be

required from business and government leaders. New Zealand needs to remove the constraints on international engagement, provide a more supportive environment, and be more outwardly-focused.

In short, New Zealand needs to approach international business with more of the mindset used by New Zealand teams in achieving international sporting success. New Zealand needs to have a clear focus on winning in global markets, to expect and demand international business success, and to back this up with the hard work and preparation required to become genuinely world-class. If this is done, New Zealand's business global champions can be admired and feared across the world in the same way that many of New Zealand's sporting champions are.

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