THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Why do foreign-owned firms perform better than New Zealand-owned firms?

Date:	18 December 2009	**Report No:**	

Action Sought

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Minister of Finance (Hon Bill English)	**Note** the contents of this report.	30 January 2010.

Contact for Telephone Discussion (if required)

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Minister of Finance's Office Actions (if required)

Refer a copy of this report to the Minister of Revenue.

Enclosure: **No**

Treasury Report: Why do foreign-owned firms perform better than New Zealand-owned firms?

Executive Summary

At your briefing with Treasury staff on 3 December, you noted that foreign-owned firms earned higher returns on equity than New Zealand-owned firms. This report provides you with more details on the difference between the performance of foreign-owned and domestic firms, and some reasons for this difference.

A higher return on equity is just one difference between the performance of foreign and domestic-owned firms. There is also evidence to show that foreign-owned firms have higher productivity and better management practices. This is a trend that is common in a number of countries and is not specific to just New Zealand. For example one study found that the labour productivity of US firms operating in the UK was 26% higher than their UK counterparts.

There are a number of possible reasons for these differences in performance, as outlined below.

- *Foreign firms invest in high performing local firms.* Foreign firms may invest in the best performing local firms if they have greater resources to finance takeover activity, and/or are better at spotting the best firms in the local market.

- *Foreign firms bring new techniques and skills to improve productivity.* Multinational firms may bring new knowledge, technology or ways of operating to the recipient firm that increases productivity and returns.

- *Foreign firms invest in firms that earn location specific rents.* Foreign investment could be driven by a specific 'advantage' in the recipient country that allows higher returns to be earned, such as access to rare resources or specialised skills unavailable elsewhere.

Our initial view is that the most plausible explanations are the ability of foreign investors to invest into the best performing local firms and the productivity improving techniques they bring as multinational firms. There is international evidence to show that multinational investors tend to target firms at the top of the productivity spectrum. A further contributing factor is that these investors may have access to lower cost capital to allow them to out-bid local investors and purchase the firm.

Also important are the techniques and skills 'imported' by the foreign investor. For a firm to be a multinational they must excel at what they do, particularly given that they must compete in local markets against firms which have advantages such as local knowledge. It is therefore likely that a multinational firm would perform near the top end of firms in a particular local industry.

We think the argument that higher returns are explained by location specific rents is weak. If there are location specific rents, local firms should equally be able to earn them. Any additional returns earned by the foreign firm could instead be explained by better productivity and management techniques.

The weight given to each possible explanation can have important implications for government policy. For example, the productivity benefits from new techniques and skills and better management is one argument for reducing barriers to foreign investment.

Recommended Action

We recommend that you:

a **indicate** if you would like to discuss this report with officials; and

Agree/disagree

b **refer** a copy of this report to the Minister of Revenue.

Agree/disagree

Nic Blakeley
Acting Manager, International
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Purpose of Report

1. At your briefing with Treasury staff on 3 December, you noted that foreign-owned firms earn higher returns on equity than New Zealand-owned firms. This report provides you with more detailed information on the difference in productivity and performance between New Zealand and foreign-owned firms, and some possible explanations for the difference.

Data and evidence

2. An initial data scan has revealed three main 'stylised facts' relating to the differences in performance between foreign-owned and locally-owned firms:

- foreign-owned firms earn higher returns on equity and capital than local firms;
- foreign-owned firms have higher productivity than local firms; and
- foreign-owned firms have better management practices than local firms.

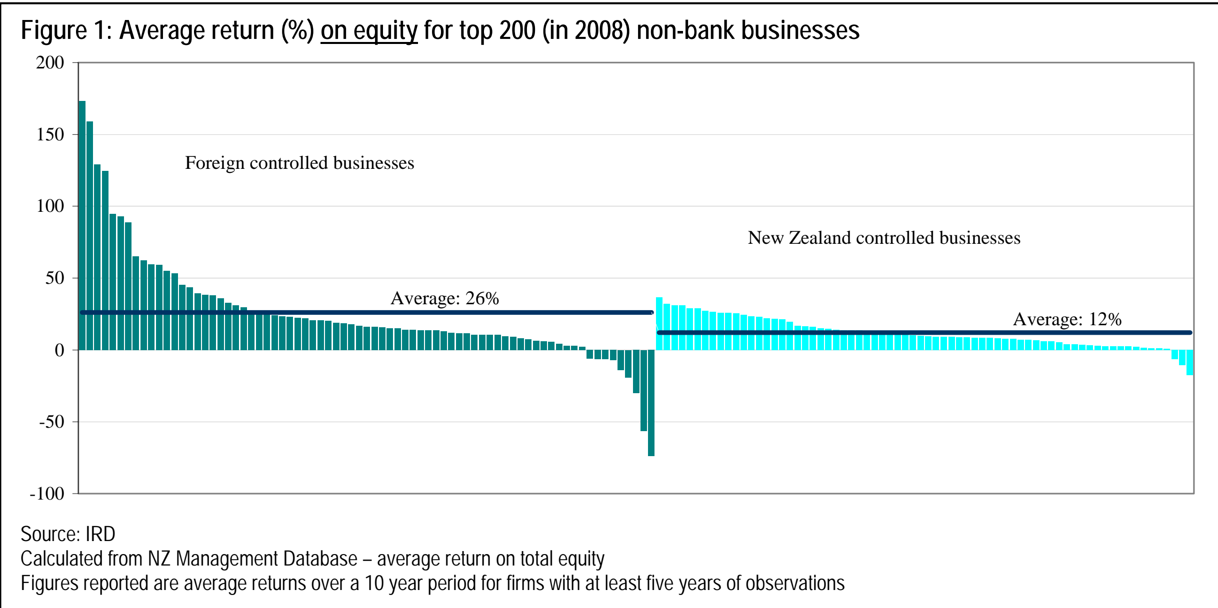
3. These are discussed in turn below.

Returns on equity and capital

4. Foreign-owned firms earn higher rates of return than their domestic counterparts. Figures 1 and 2 below show that both the return on equity and the return on capital are higher for foreign-controlled firms compared to New Zealand firms, although the difference is much lower when looking only at returns on capital.

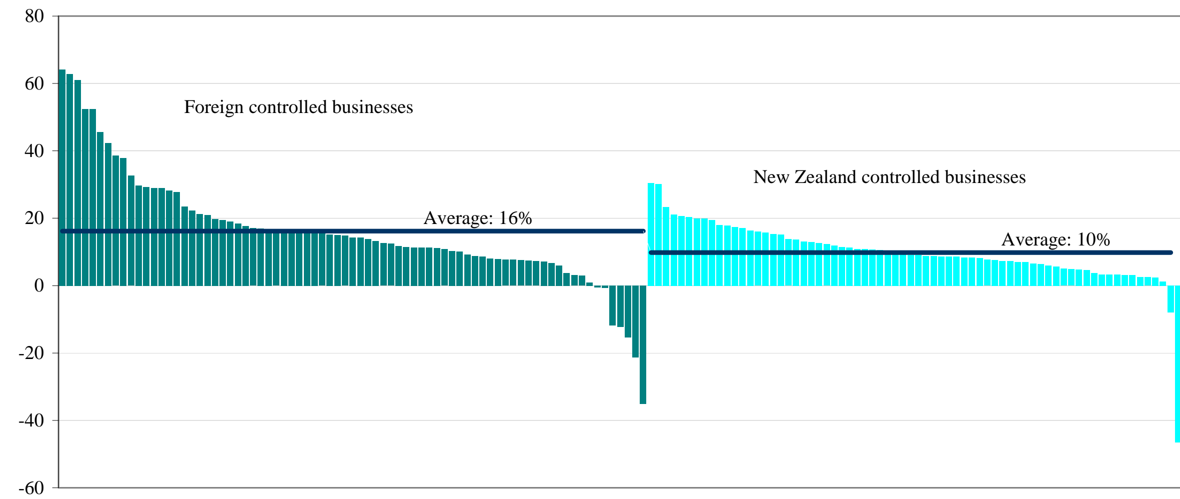
5. Also of note is that the variance of returns by foreign-owned businesses is significantly greater than that for New Zealand firms.

Figure 1: Average return (%) on equity for top 200 (in 2008) non-bank businesses



Source: IRD
Calculated from NZ Management Database – average return on total equity
Figures reported are average returns over a 10 year period for firms with at least five years of observations

Figure 2: Average estimated return (%) on capital for top 200 (in 2008) non-bank businesses

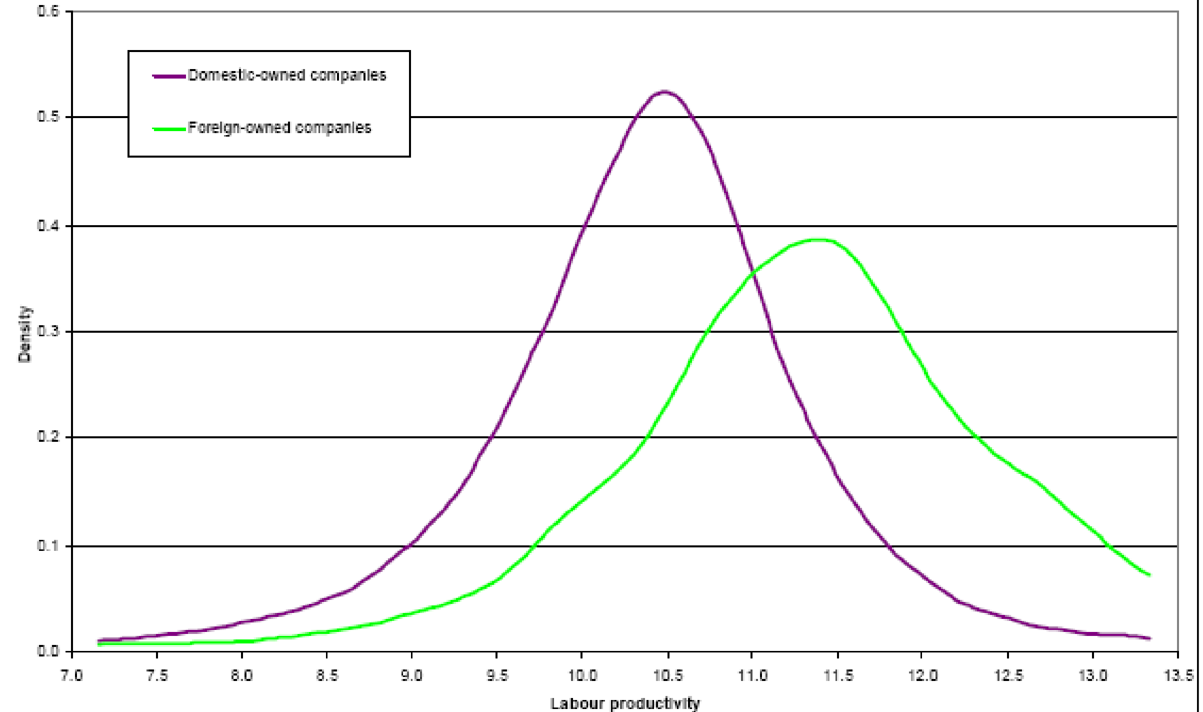


Source: IRD
Calculated as after-tax profit before interest divided by the sum of equity and debt
Figures reported are average returns over a 10 year period for firms with at least five years of observations

Higher productivity

6. Figure 3 below shows that labour productivity in foreign-owned firms operating in New Zealand is on average higher than that of New Zealand firms. Similar results have been found overseas. For example, a 2007 study found that labour productivity in US-owned firms in the UK was on average 26% higher than UK-owned firms.

Figure 3: Labour productivity of foreign-owned firms and NZ-owned companies



Source: Fabling, Grimes, Sanderson and Stevens (2008), *Some rise by sin, and some by virtue fall: Firm dynamics, market structure and performance*

7. Figure 4 below shows that on average foreign-owned firms have higher productivity than domestic firms, regardless of whether the firm exports or not. This distinction is important as it means the productivity difference cannot be entirely explained by suggesting that foreign firms are more likely to export and that exporting firms are more

productive. Also of note is that the productivity of domestic-owned exporting firms is closer to that of foreign-owned firms.

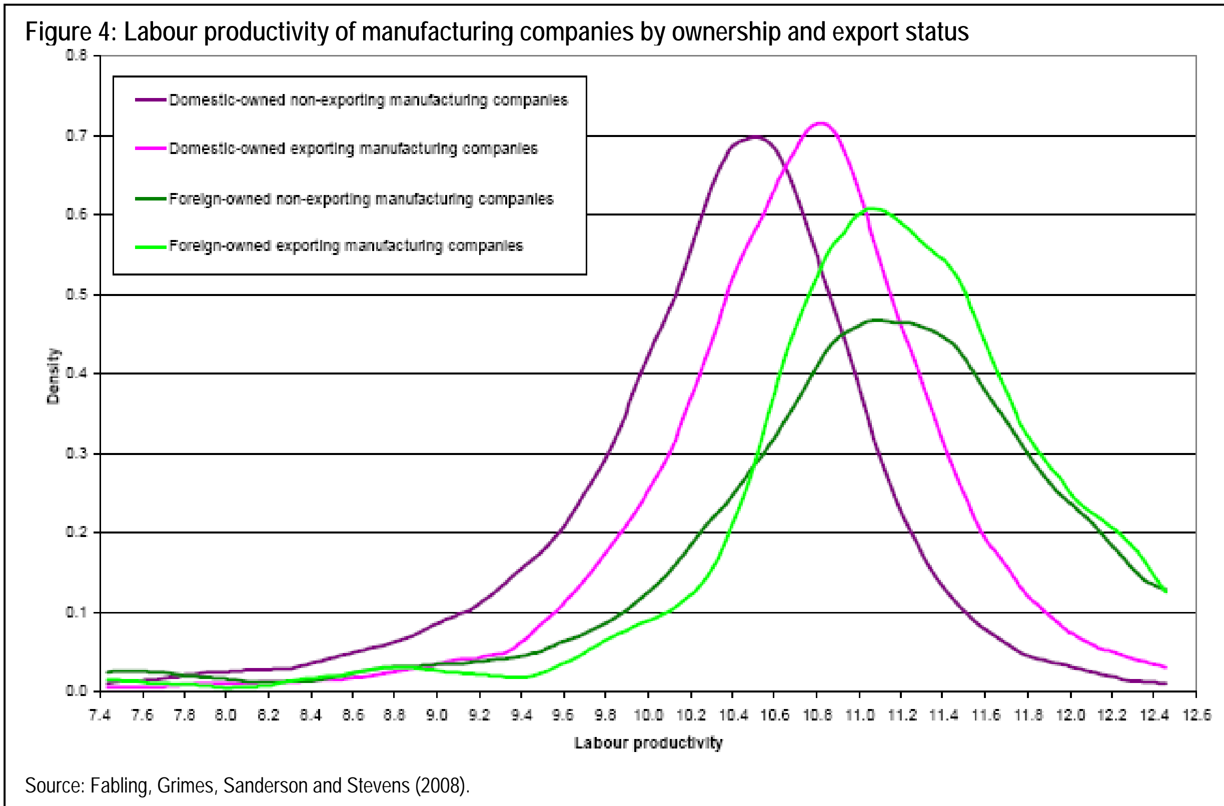


Figure 4: Labour productivity of manufacturing companies by ownership and export status

Source: Fabling, Grimes, Sanderson and Stevens (2008).

Better management practices

8. Foreign-owned firms tend to have better management practices than domestic firms. A 2002 survey-based study of New Zealand business practices and performance found that foreign-owned businesses outperformed New Zealand firms in most areas of the survey.

9. These results also hold for international comparisons. Figure 5 below shows the results of a management practice study comparing domestic firms to multinationals in a range of countries. In all cases multinationals scored more highly than domestic firms.

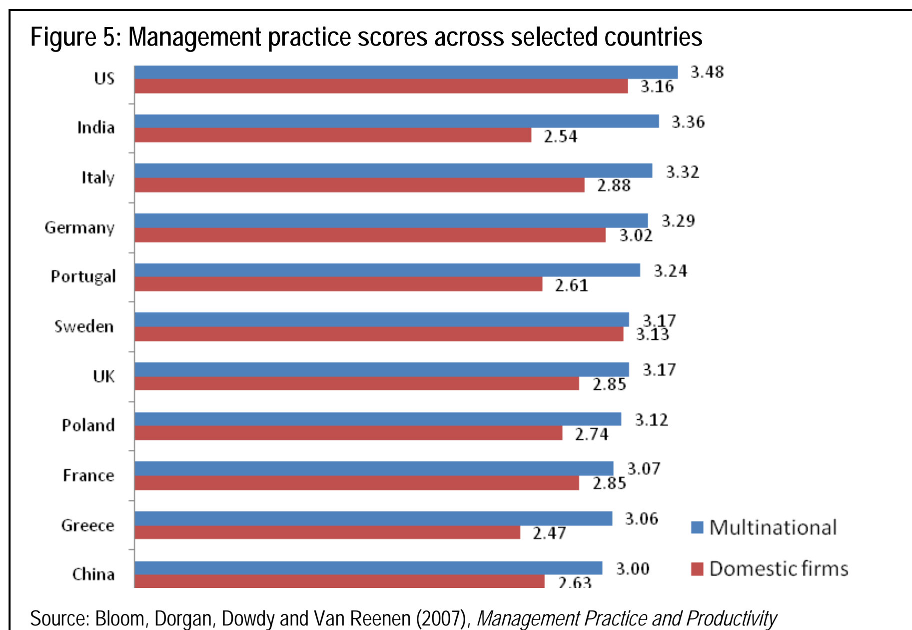


Figure 5: Management practice scores across selected countries

Source: Bloom, Dorgan, Dowdy and Van Reenen (2007), *Management Practice and Productivity*

What explains the difference?

10. We have identified the following three possible reasons for the difference in returns and productivity between foreign and domestic firms:

    - **Foreign firms invest into high performing local firms**. If foreign firms invest into the most productive local firms, they will be at an advantage in terms of returns and productivity relative to other domestic firms in the same sector. It is possible that foreign firms are able to invest in the best performing local firms if they have greater resources to finance takeover activity, or are simply better at spotting the best firms. A UK empirical study found evidence to suggest that this was a major reason why US-owned firms in the UK had higher productivity than domestically owned firms.

    - **Foreign firms bring new techniques and skills to improve productivity.** Foreign investors, particularly multinational firms, may bring economies of scale, new knowledge or technology to the recipient firm that improves productivity and returns. For example, a foreign firm may have better access to international networks, have improved management techniques or new production techniques. It is likely that a multinational firm will be more productive as they are unlikely to become a global business without being efficient in what they do.

    - **Foreign firms invest in firms that earn location-specific rents**. It is possible that foreign firms invest in local firms that have certain location-specific advantages that allow higher profits to be earned. For example, the recipient country may have certain relatively rare natural resources that can be extracted or manufactured into high value products. In these cases the foreign investment is largely driven by the location of the 'advantage' in the recipient country and the likelihood of the investor relocating to another country is low.

11. It is also possible that higher returns on equity are driven by foreign firms being more highly geared to reduce their tax liability. Figure 2 shows that the difference in returns is still apparent when looking at just returns on capital, but there is a much smaller gap which suggests that differences in gearing do play a role.

Conclusion

12. We know foreign-owned firms have higher returns, productivity, and better management practices than domestic firms but it is difficult to conclusively determine which of the above factors drives this difference.

13. While there is likely to be a mix of reasons behind the difference, we don't consider that the existence of location-specific rents is likely to be the most significant. One of the most important reasons is likely to be the ability of foreign firms to pick the best performing local firms to invest into. It is plausible that a foreign investor with access to significant investment capital is able to pay a high price for such a firm. In addition, given that the US is one of New Zealand's most significant sources of foreign direct investment (FDI), the UK findings that US investors tend to target the most productive firms could equally apply here.

14. The introduction of new techniques and skills is also likely to be an important factor that drives improved profitability. We consider that at least part of the difference in productivity and returns is caused by better production and management techniques that are 'imported' by foreign firms. As noted above, it would be unlikely that a firm could become a multinational if they did these things badly.

15. We do not discount the possibility that foreign firms are seeking location-specific rents. However this may be less important than the other two explanations of differences in

firm performance. If there are location-specific rents, there is no reason to think that foreign firms would be more likely to secure these rents than local firms. In addition, any location-specific rents should be captured in asset prices or resource rentals, so there is little reason to expect foreign firms to be able to capture ongoing super-normal returns. If foreign and domestic firms have equal access to the market, any additional returns earned by the foreign firm could instead be explained by better productivity and management techniques. EDS could be an example of a firm in this category.

16. A key argument for location-specific rents that has been put forward relates to our distance from major markets. The question is whether our distance from potential competitors allows firms operating here to extract rents that would not be possible if alternative suppliers were 'just across the border'? However arguably we do have a large neighbour (Australia) and distance in itself does not necessarily imply economic rents. It may simply indicate that firms located in New Zealand have higher marginal costs and can levy higher prices than they otherwise could.

Policy implications and further work

17. Depending on how much weight is attached to the possible reasons for the difference between foreign and local firm performance, there are implications for areas of government policy. Three examples are:

- **Investment policy**. To the extent that foreign investors bring new techniques and skills to a domestic firm, this supports the case for reducing barriers to FDI. Greater dispersion of these techniques and skills could be one way of improving productivity for firms and across the economy.

- **Taxation**. The existence of location-specific rents might be used as an argument against reducing corporate tax rates on the grounds that reducing taxes would simply mean higher returns for those foreign owners. However, even if location-specific rents are being earned, this is only one factor that could influence the setting of corporate tax rates. In addition, location-specific rents that may occur in certain sectors such as mining, can be addressed with targeted interventions such as royalty regimes.

- **Cost of capital.** As noted above, access to lower cost capital may be a factor that assists foreign investors to purchase the best performing local firms. Ensuring New Zealand's capital markets are operating efficiently and reducing New Zealand's large external liabilities could remove any advantage held by foreign investors in this area.

18. Further work could usefully be undertaken to examine in more detail the reasons for the difference in the performance of foreign-owned and domestic firms. In particular it would be useful to further examine to what extent location-specific rents are being earned by foreign firms operating in New Zealand. Some questions to consider include:

- *In what sectors are firms earning higher returns or experiencing higher productivity?*

- *Are investors making 'greenfields' investment or taking over existing businesses?*

- *Can we determine if higher productivity of foreign firms is due to higher value of output or higher volumes of output?*

- *Is there evidence of location- specific rents being earned in Australia?*