NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION TO THE FOREIGN AFFAIRS, DEFENCE AND TRADE COMMITTEE

INQUIRY INTO NEW ZEALAND'S ECONOMIC AND TRADE RELATIONSHIP WITH AUSTRALIA

JUNE 2000

Summary

- This submission to the Foreign Affairs, Defence and Trade Committee is made by the New Zealand Business Roundtable (NZBR), an organisation consisting primarily of chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

- CER has, without doubt, been of significant benefit to New Zealand.

- There are, however, a number of outstanding areas for reform. Priorities include removing the restrictions on the free flow of capital and the remaining exemptions for goods and services.

- More broadly, New Zealand should actively explore developing similar relationships with other countries, either on a bilateral or, preferably, a multilateral basis.

- New Zealand should resist the temptation to extend subsidies and protection to its industries just because Australia or any other country does. At the end of the day, such assistance is likely to penalise rather than benefit the economy as a whole.

- Harmonisation of New Zealand's domestic policies with Australia's policies should be considered on a case-by-case basis. Our aim should be to have the best possible public policies, rather than necessarily replicating the policies of another country.

- We welcome research and debate on the merits of adopting another country's currency. For a common currency to work effectively – eg without leading to additional volatility in unemployment – New Zealand would need flexible labour markets. The direction of current policy, however, is to reduce rather than increase the flexibility of New Zealand's labour markets.

- Consideration should be given to removing passport restrictions on trans-Tasman travel. There are likely to be more cost-effective ways of restricting drug trafficking.

- Local content quotas are likely to stifle rather encourage innovation and vitality in our media, advertising and broadcasting industries.

- Political union with Australia is not a matter on which the NZBR has a view. However, it would be a mistake to expect significant economic benefits from any such move. As the case of Tasmania amply demonstrates, political union is no 'silver bullet'.

- At the end of the day, New Zealand's economic success is in our own hands. The economic performance of countries like Switzerland, Singapore and Hong Kong shows that size is no handicap. How well we do depends mainly on how well we manage our own affairs.

Strategic overview

Around the world, countries' economies have become more closely integrated in the last half-century. The volume of world merchandise trade today is more than 16 times the volume in 1950, a rate of growth three times faster than the growth of global output.[1]

This growth in trade has brought huge economic gains. A recent paper in the *American Economic Review* estimates that every one percentage point increase in the ratio of trade to Gross Domestic Product (GDP) raises income per person by between one-half and two percent.[2] Similarly, the OECD estimates that nations that are relatively open to trade grow about twice as fast as those that are relatively closed.[3]

Both New Zealand and Australia were relative latecomers amongst OECD countries to the phenomenon of economic integration. The two governments took little part in the regional and multilateral agreements through which other OECD countries became more closely integrated with each other and the rest of the world in the four decades following the end of the Second World War.

In the past two decades, however, both countries have moved a long way towards more liberal trade and investment regimes. The initial CER agreement provided a platform on which both countries have built.

The NZBR strongly supports more outward looking policies. We welcome the steps that have been taken to expose New Zealand industries to competition from the rest of the world. This competition has provided a necessary spur for New Zealand businesses to innovate, to reduce costs and to make products that the customer wants.

The decision of the new government to halt the phasing out of tariffs is of major concern and marks a significant policy reversal.

Rather than slowing down the process of liberalisation, we consider there are a number of further initiatives the government should be taking. Priorities include:

- removing all remaining tariffs by a fixed and early date;
- treating anti-dumping actions as part of normal competition law;
- reducing rather than increasing official assistance for exports;
- removing the remaining monopsony rights of the three marketing producer boards;
- increasing the scope for private foreign direct investment in New Zealand, including in state owned enterprises; and

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1 OECD, "Open Markets Matter: The Benefits of Trade and Investment Liberalisation", Paris, 1998, p 25.

2 Frankel, Jeffrey A and Romer, David, "Does Trade Cause Growth", *American Economic Review*, 89/3 (1999), pp 379-399.

3 OECD, *op cit*, p 10.

•	seeking opportunities for regional and multilateral liberalisation.[4]

Immigration policy raises further important issues. There is no sound reason for thinking that higher inflows would increase economy-wide unemployment rates.[5] While immigrants produce, they also consume ("every pair of hands comes with a mouth") and their additional demand leads to additional jobs. There are good reasons to believe a more open immigration policy would make for somewhat greater national prosperity and would have wider positive rather than negative social effects.

The impact of CER

The benefits of CER are indisputable and do not need to be extensively documented here.[6] Since CER was signed in 1983, bilateral trade has grown from NZ$2.6bn to $NZ9.8bn in June 1998 in current dollars. Australia has become New Zealand's largest export market and New Zealand has become Australia's third largest export market. We are each other's largest market for manufactured goods.

Amongst other things, CER has:

- facilitated trade and economic links between New Zealand and Australia;
- improved resource allocation, providing better signals for investment decisions in both economies, to our mutual advantage; and
- provided a platform for wider liberalisation.

Fifteen years ago, manufacturing industry in New Zealand could not contemplate the idea of dismantling import licensing against Australia by 1995. Now, New Zealand companies are able to compete internationally without assistance.

There is no question that CER has helped lift New Zealand's economic performance. Competition forces industries to become more efficient. Through CER, New Zealand companies learned to compete with Australian ones first. As a former chairman of the NZBR noted, "The whole purpose of CER was to help each country break out of its cocoon and tackle the wider world."[7]

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4 Henderson, David (1997), "New Zealand's External Economic Policies, Current Issues in an International and Trans-Tasman Perspective", New Zealand Business Roundtable, Wellington.

5 As Henderson (*op cit*) notes, the best evidence in recent decades that increased immigration does not increase unemployment is that the United States, with a much faster rate of growth of its labour force, largely as a result of higher immigration, has experienced and maintained significantly lower rates of unemployment than the countries of continental Europe.

6 For an overview, see "Impact of CER", (Australian) Bureau of Industry Economics, 1995 and "CER: Economic Trends and Linkages" by Sir Frank Holmes and Stephen Edwards, Institute of Policy Studies and National Bank of New Zealand, 1994.

7 Myers, Douglas, "Australia and New Zealand – A New Economic Partnership?", *The Economist*'s Fifth Roundtable with the Government of Australia, Canberra, October 1996.

It is worth reflecting on the condition the New Zealand economy would be in now if we had not headed down the path of integration with the rest of the world that was begun with those first cautious steps. The experiences in the mid-20th century of Argentina and Uruguay – two once rich countries that stagnated after adopting populist and closed economic strategies – illustrate well the implications for New Zealand if we had continued with 'fortress New Zealand' policies.

Further development of CER

The CER agreement of 1981 covered trade in goods only. This initial agreement was extended, in 1988, to cover services. The Trans-Tasman Mutual Recognition Agreement (TTMRA), which was signed in June 1996, covers mutual recognition of goods and occupations across the state and national jurisdictions. Also, in 1996, the Australian New Zealand Food Authority was established to develop common food standards.

Remaining tasks within the New Zealand / Australia relationship include:

- removing New Zealand's two remaining exceptions for goods and services (coastal shipping and air traffic control services). There is no reason to treat these sub-sectors differently and shelter them from international competition. Such special protection raises the costs for other parts of the New Zealand economy;

- encouraging Australia to remove its remaining exceptions, including its exemptions for intrastate air travel, postal services and third party motor vehicle insurance;

- progressing mutual recognition of business and other laws as quickly as possible (including laws governing product labels and standards that may hinder free trade). Five goods (including motor vehicles, hazardous substances and industrial chemicals) remain outside the TTMRA, while West Australia still has not ratified the Treaty; and

- extending the agreements covering movement of goods, services and labour to a counterpart agreement covering movements in capital also (see Investment Relationship below).

The aim should be full integration of the New Zealand and Australian economies into a single market.

At the same time we should be sure to protect the gains already made. Trans-Tasman shipping is one area where the benefits of liberalisation are under threat from potential changes to New Zealand's policies.[8]

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8 See New Zealand Business Roundtable and Federated Farmers, "Ports and Shipping Reform in New Zealand, Current Development and Future Requirements", September 1989 and Swan Consultants, "Reforming Trans-Tasman Shipping", A study commissioned by Australian and New Zealand business organisations, June 1992.

Future directions and role of CER as a platform for other free trade agreements

Multilateral liberalisation is the first-best policy and the desired policy goal.

Bilateral or regional trade agreements that are open, outward and not a barrier to wider liberalisation are to be welcomed, both in their own right and as stepping stones towards the desired wider goal.

The establishment of a study group to look at a free trade agreement between AFTA and CER was an encouraging step. Similar initiatives with NAFTA and Mercosur would also be welcome where the aim remains to achieve agreement without significant sectoral carve-outs.

New Zealand should continue to explore all avenues for bilateral, regional and multilateral liberalisation. Preferably this should be done in tandem with Australia but, if necessary, New Zealand should be prepared to go it alone.

The impact of the federal system on bilateral trade and economic relations

The Federal system in Australia is sometimes criticised for encouraging a range of special assistance measures (such as bounties, subsidies and 'active' industrial policies) at the state level.

As discussed in a recent paper, such 'assistance' policies are more likely to harm rather than help Australian industry overall.[9] They harm the economy by encouraging resources into subsidised sectors at the expense of unsubsidised sectors; by raising the overall tax burden on the economy; and by encouraging business people to spend time lobbying the government rather than focusing on their businesses.

Australia, like many other countries, is becoming increasingly aware of the cost of such 'active' industrial policies and is moving to lower industry assistance. With the exception of some highly protected sectors (motor vehicles, textiles, clothing and footwear), industry assistance in Australia is now at a level where it is unlikely to be a major factor in investment decision making.

World Trade Organisation obligations are also helping keep Australia 'honest', as evidenced by the recent case of Howe Leather where the WTO found that financial assistance from the Australian government was an illegal export subsidy.

Regardless of the level of subsidies the Australian government provides its industries, however, the bottom line from New Zealand's point of view is that if Australia wishes to penalise its own overall economic competitiveness through such policies, that is Australia's folly. It certainly does not mean that New Zealand should follow suit.

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9 Kerr, R L, "Hands-On, Hands-Off or Hand-Outs?", address to the Auckland Regional Chamber of Commerce and Industry World Trade Club Breakfast, 15 September, 1999.

We can try, through diplomatic and other means, to persuade Australia to reduce or eliminate subsidies to its domestic industries. Otherwise, we are better to get on with ensuring that our own domestic policies are sound.

Harmonisation of business, customs and tax laws

The NZBR supports *mutual recognition* of business and other laws between Australia and New Zealand.

Harmonisation of business and other laws should be considered on a case-by-case basis and should not be implemented for its own sake. New Zealand should strive to achieve the best possible public policies. Where Australia has the best policies we should be happy to adopt them. However, it does not make sense to adopt policies just because they are Australian. Where Australian laws impede trade and are in our view deficient, New Zealand could try to negotiate improved laws for both countries.

Getting our tax levels and tax structure right is vitally important. The first step is to control government expenditure so that only expenditures that add economic value or – in the case of social policies – are well targeted are undertaken. In terms of the tax structure, the key ingredients are to:

- achieve a low and flat income tax structure so that disincentives to work, save and invest are minimised; and

- get the general international tax regime 'right', as this impacts on the cost of capital for all New Zealand companies and their ability to compete internationally.

In respect of the international tax regime, one aim should be to reduce the tax burden on non-resident investors. New Zealand is a small economy. A tax on foreign capital just increases the cost of capital for New Zealand companies (as foreign investors require the same after-tax return achievable elsewhere in the world).

While the direction of reform in the international tax regime in recent years has been positive, we would urge the government to hasten the speed of reform.

Investment relationship

Unlike goods, services and labour, investment is not covered by CER or any other formal agreement between the two countries. As a leading Australian academic noted, the absence of a bilateral provision guaranteeing the free movement of capital is "the most glaring omission from CER."[10]

In contrast, the Treaty of Rome guarantees the "four freedoms" of movements of goods, services, capital and labour. NAFTA also has a chapter relating to foreign investment.

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10 Lloyd, P, "Foreign Investment, Competition Policy and Labour Issues", CEDA / APEC Studies Centres of Australia, and New Zealand Roundtable Discussion of the CERTA, Melbourne, 30 April 1997.

There have been some moves to lower effective restrictions on trans-Tasman investment flows in recent years (eg the raising in December 1999 of the threshold where approval is required for cross-border investment). However, regulatory approval is still required for investments above $NZ50m in New Zealand and $A50m in Australia.[11] These approval processes inevitably involve costs, delays and political risk.

Attempts to negotiate investment agreements at the multilateral level have had little success in recent years. The breakdown of the negotiations at the OECD on a Multilateral Agreement on Investment is a prime example.[12] It may be that a bilateral agreement on investment with Australia would be more fruitful, if only to provide certainty that the current restrictions will not be increased over time.

The aim should be the free flow of investment between the two countries, just as we largely have a common labour market in the two countries.

Single trans-Tasman currency

The idea of New Zealand adopting another country's currency is not as radical as it may first appear. New Zealand once used the pound sterling and many countries now use the US dollar or Euro as their principal currency.
Several factors make the idea of currency blocs more plausible than it was 20 years ago, including low inflation rates and increasing trade in goods and services.

However, if a convincing case is to be made for changing the status quo, real advantages must be demonstrated. Areas of potential benefit include:

- reducing transactions costs (including the costs and risks of foreign exchange management);[13] and

- reducing firms' cost of capital.

These potential benefits must be weighed up against the possible costs including:

- the loss of one means of adjustment to adverse shocks that hit the economy. Fixing the exchange rate to the US (or Australian) dollar means other prices (especially wages) must carry more of the adjustment burden; and

- removing the exchange rate as one indicator of good or bad policy.

For there to be sustained ongoing benefits for New Zealand, we must meet the standard conditions for a currency union established by Mundell almost 40 years ago.[14] New

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[11] Both countries also have several sectors where special, more restrictive provisions apply.

[12] See Henderson, David, "The Multilateral Agreement on Investment, A Story and Its Lessons", New Zealand Business Roundtable, 1999, for the reasons why the MAI foundered.

[13] One recent study suggests that currency unions have a sizeable impact on trade. See Rose, Andrew K, "Does a Currency Union Boost International Trade?", *California Management Review*, vol 42 no 2, Winter 2000.

Zealand and the region whose currency we adopt should have a common or compatible fiscal policy and New Zealand would need to have flexible labour markets.

There is relatively free mobility of labour between New Zealand and Australia. However, if government policy makes our domestic labour markets less flexible, and we adopted a currency union with Australia, New Zealand would experience even greater migration to Australia at times of local economic downturns. Such migration would be unnecessary in a fundamental sense, since the expenses incurred would merely reflect the reduced labour market flexibility, not a rational response to basic economic conditions. If New Zealand were to adopt a currency union with a country with which we do not have open migration flows we would see increased volatility in unemployment in New Zealand.

Freedom of trans-Tasman travel

Residents of Australia and New Zealand are free to live and work in either country. Given the level of integration of the two economies, we question the need for passport controls between the two countries. Continental European countries no longer maintain passport controls for travel within the European Union. Removing the controls would reduce transaction costs for business travelers and tourists and allow border control resources to be directed to other areas.

While there are legitimate concerns about ensuring drug trafficking is restricted, there may well be better ways of achieving this objective.

Removing passport controls would require harmonisation between Australia and New Zealand of visa requirements with third countries. From New Zealand's perspective, removing passport controls would be more attractive if Australia relaxed its current policy of requiring visas from almost all other countries.

Cultural relationships

Maintaining a sense of national identity is important for all countries. Unfortunately, such a goal can be used as an excuse for protectionist measures in industries such as advertising, the news media and broadcasting.

It would not be sensible for New Zealand to go down a path of local content quotas. As well as being in conflict with our international obligations, imposing such quotas would lower rather than raise standards of quality, promote insularity and discourage a vibrant and innovative culture.

It is interesting to note that New Zealand's sport is becoming more rather than less integrated with Australia and the rest of the world. Recognising the importance of international competition, several of our sporting codes, like rugby league and soccer, have chosen to participate in Australia's domestic competitions as a means of bolstering local standards.

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[14] Mundell, Robert A, "A Theory of Optimum Currency Areas", *American Economic Review*, 51 (1961), pp 509-517.

Conclusions

New Zealand has benefited considerably from CER and the liberalisation measures that followed it.

There are further steps that need to be taken, especially removing the restrictions on the free flow of capital and the remaining barriers to the free flow of goods, services and people.

Whether New Zealand should go further and consider political union with Australia is a political matter on which the NZBR has no view.

However, it would be wrong to believe that economic benefits would necessarily follow from any such political union. The 'poor-cousin' status of regions like Tasmania, the 'deep south' of the United States and southern Italy is more than ample evidence that political union does not automatically mean economic equality or success.

The economic performance of countries like Switzerland, Singapore and Hong Kong shows that size is no handicap in the economic success league. There are no silver bullets, however. How well we do depends on how well we manage our own affairs.