# Introduction

Australia and New Zealand have distinct national identities and physical environments. They are also former British colonies, sharing much history and common endeavour. In the late 19th century they contemplated political union. While this did not eventuate, the two countries continue to have much in common, including in culture, institutions and values. And they are close geographically — Sydney being closer to Auckland than Perth. These factors have enabled them to develop a closer relationship than could be expected with any other country.

The Australian and New Zealand Governments have helped foster closer economic relations over a long period by reducing barriers to trade and investment, and facilitating free movement of people. The inaugural Closer Economic Relations (CER) agreement was signed in 1983 — the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). The economic integration agenda has continued to evolve over the past three decades.

Key features of the Australian and New Zealand economies are outlined in table 1.1.

## 1. What have the Commissions been asked to do?

At their annual leaders’ meeting in January 2012, the Prime Ministers of Australia and New Zealand agreed that the Productivity Commissions of each country would jointly conduct a scoping study on strengthening trans-Tasman economic relations. The study is to identify reforms that would boost productivity, increase competitiveness and drive deeper economic integration between the two countries. The Commissions were asked to provide analysis on:

* potential areas of further economic reform and integration, including identifying those where benefits are likely to be most significant, with particular focus on critical issues for business, such as investment and productivity
* the economic impacts and benefits of reform
* any significant transition and adjustment costs that could be incurred

Table 1.1 Country profiles — Australia and New Zealanda

|  |  |
| --- | --- |
| Australia | New Zealand |
| **Land area** | |
| 7 692 000 km2 | 268 000 km2 |
| **Population & 3 largest cities** | |
| Australia 22 324 000 | New Zealand 4 405 000 |
| Sydney 4 610 000 | Auckland 1 377 000 |
| Melbourne 4 170 000 | Wellington 393 000 |
| Brisbane 2 150 000 | Christchurch 381 000 |
| **Political system** | |
| Federation of states (6 states and 2 mainland territories) with the Parliament of Australia and most state parliaments being bicameral. | Unitary state with a unicameral parliament. |
| **Economic structure** | |
| GDP (US$ billion) 1 486 | 162 |
| GDP PPP (US$ billion): 914 | 122 |
| GDP per person PPP (US$) 40 234 | 27 668 |
| *Contribution to GDP (%)* | |
| Services 80 | 79 |
| Manufacturing 9 | 14 |
| Mining 8 | 1 |
| Agriculture, forestry & fishing 3 | 6 |
| **Exports** | |
| Goods & services exports (US$ billions) 324.8 | 46.5 |
| Goods & services exports (% GDP) 22 | 29 |
| Key goods exports (US$ billions) |  |
| Iron ore & concentrates 66.8 | Milk powder, butter & cheese 9.0 |
| Coal 48.7 | Meat 4.3 |
| Gold 15.7 | Logs, wood & wood articles 2.5 |
| Services exports (US$ billions) 52.1 | 10.1 |
| **Trans-Tasman goods trade** | |
| Trans-Tasman trade (% total trade) 3 | 23 |
| **Foreign direct investment (FDI)** | |
| FDI stock in country (US$ billions) 528.0 | 76.2 |
| FDI stock abroad (US$ billions) 352.7 | 19.5 |
| **Government sector** | |
| Government expenditure (% GDP) 37 | 42 |

a Data are for 2011 (population data are for June 2011; FDI data are for December 2011), except for government expenditure as a proportion of GDP and trans‑Tasman trade data, which are for 2009. **GDP**: gross domestic product. **PPP**: purchasing power parity.

*Sources*: IMF (2012); OECD (2011c); RBA (2012); RBNZ (2012a); UN Comtrade database (2012); various Australian Bureau of Statistics and Statistics New Zealand publications.

* identification of reform where joint net benefits are highest
* the means by which reforms might be best actioned
* the likely time paths over which benefits are expected to accrue.

This report is to inform the next meeting of Prime Ministers, scheduled for early 2013. The terms of reference are included in the preface to this report.

The timing of this scoping study is noteworthy in at least two respects. First, it occurs in the lead up to the 30th anniversary of the ANZCERTA. This anniversary provides an opportunity to take stock of what has been achieved and what remains to be done, and to consider how developments in our region should influence further trans‑Tasman integration. In particular, it is important to ensure that CER acts as a ‘building block’ to broader integration in what is becoming known as the ‘Asian century’ (Henry 2012).

Second, much of Europe is now going through an economic crisis. This crisis has complex causes, with one strand relating to the failure of economic integration to fully deliver on its promise (despite its evident successes). The European experience with economic integration, both positive and negative, can provide valuable lessons for Australia and New Zealand.

## Strengthening economic relations

Government efforts to strengthen economic relations with other countries are commonly referred to as economic integration initiatives. A higher degree of integration could be expected to increase trade, and flows of capital and labour. Prices for goods, services and factors of production will tend to converge in two countries that are highly integrated, as the costs of exchange (or ‘transaction costs’) are lowered.

### What should the policy objective be?

Increased economic integration expands the extent of markets, enabling countries to capture greater scale advantages and specialise in those things they do relatively efficiently. Resources ultimately shift to these activities and lower priced imports take the place of more costly domestically‑produced goods and services. This is a dynamic process that encourages competition and innovation. Consumers benefit from lower prices and greater choice. The integration of labour markets — a prominent feature of the trans‑Tasman relationship — opens up opportunities for people to develop and apply their skills and earn higher wages.

Government efforts to promote economic integration can achieve these types of benefits, but there are potential costs. Aligning regulations can be complicated, administratively costly and politically difficult, and sometimes produces results that are not a good fit for local circumstances. Achieving greater specialisation can bring significant benefits, but can also involve adjustment costs. Moreover, where integration is pursued bilaterally — the focus of this scoping study — there is a risk that it will be at the expense of productive exchanges with other countries. Higher levels of integration, such as through a monetary union, also carry their own risks, as demonstrated by the recent European experience.

Accordingly, rather than promoting economic integration to the maximum extent possible, the policy objective should be to maximise the net benefits from integration, as implied by the terms of reference for this study.

### What role for governments?

In market-based economies such as Australia and New Zealand, firms make their own decisions about whether to export to, or purchase inputs from, other countries. Likewise, individuals make independent purchasing decisions, often between domestic and imported goods and services. Individuals also decide whether to move to another country to work.

Accordingly, the main way that governments can promote integration with other economies is by making it easier and less costly to exchange goods, services and capital, and for labour to move internationally in response to economic opportunities. Governments have a more direct role in pursuing worthwhile opportunities to integrate government functions.

Examples of ways that governments promote economic integration include:

* lowering or removing tariffs and other measures that deliberately favour domestic production over imports
* removing regulatory barriers to competition, thereby encouraging greater market participation by both foreign and domestic firms
* aligning so-called ‘behind-the-border’ regulations more closely with those of other countries (for example, aligning product safety regulations), saving exporters the expense of tailoring production to comply with country‑specific regulations
* pursuing higher levels of integration, by adopting common monetary or fiscal policies.

Governments directly influence the environment in which firms and individuals operate; however they are not the sole driver of economic integration. Geography, institutional and social/cultural factors, and the everyday operation of markets are also important. Markets can reduce transaction costs in many ways, including through innovation in communications, transport and logistics. For example, market‑driven processes saw the costs of ocean freight fall by 80 percent (in real terms) between 1930 and 2000. This contributed to an uplift in trade and greater economic integration around the world. The costs of air passenger transport and international communications fell even further (OECD 2007).

Accordingly, economic integration should be seen as something that governments can choose to promote or inhibit, through actions that reduce or increase transaction costs for firms and individuals.

## The Commissions’ approach

The Commissions have been guided by the terms of reference and the ‘scoping’ nature of the study, while meeting the requirements of their enabling legislation (*Productivity Commission Act 1998 (Cwlth)*; *New Zealand Productivity Commission Act 2010*).

The Commissions’ approach has centred on identifying opportunities for the Australian and New Zealand Governments to lower the costs of exchange in ways that generate net benefits. Often these opportunities involve modifying existing policies that either deliberately or inadvertently make transaction costs higher than they need to be.

Doing this has involved four main tasks:

* First, gleaning insights from the 30 year experience with CER to help guide the future integration agenda — being cognisant of the economic challenges and opportunities that lie ahead for Australia and New Zealand.
* Second, addressing unfinished business — CER initiatives to which both Governments have committed, but not yet completed. Issues include how to overcome delays to worthwhile reforms and identifying measures that should not proceed.
* Third, identifying new integration initiatives with the potential to generate net benefits across the two countries. There are many potential initiatives, spanning the traditional four economic freedoms (as set out in the Treaty of Rome 1957) — freedom of exchange of goods, services, capital and labour — together with the free exchange of knowledge. To make this task tractable within the context of a scoping study, filtering criteria have been used to identify those options with the most potential. In some cases, sufficient evidence was obtained to make specific recommendations. In others, areas were identified that potentially offer net benefits, but further work is needed to identify the best way forward. ‘Directions of travel’ were identified for the economic relationship over the longer term.
* Fourth, as with all areas of public policy, implementation is important. The Commissions considered institutional and governance arrangements for managing the trans-Tasman economic relationship and what changes are warranted to advance the future agenda.

The terms of reference request the Commissions to identify reforms where joint net benefits are highest. While the coverage of the scoping study and the time available has made addressing all the issues raised in submissions infeasible, the Commissions have identified the most promising areas for reform on the basis of the available evidence on the breadth and depth of particular impediments to integration. However, comparing the joint net benefits of potential reforms in those areas is challenging in the context of a broad-ranging scoping study. The discussion draft trialled an indicative, two grade ranking of the relative importance of potential reforms, but feedback suggests that it would be of limited value for determining priorities for a future integration agenda. It has also become clearer in preparing this final report that no reforms are ‘stand outs’ in terms of likely net benefits. Given the resultant risk that formal rankings of joint net benefits would be of little value and may even be misleading, such rankings have not been included in this final report.

In any case, the packaging of initiatives into a coherent forward agenda that benefits both countries is primarily a matter for political judgment. Information on potential benefits and costs in each country that would arise from the different reforms, which can assist in such judgments, is included in the Commissions’ assessments, in chapters 4 and 5, and in the associated supplementary papers.

## Conduct of the scoping study

The scoping study was announced at a meeting of the Prime Ministers of Australia and New Zealand, with the terms of reference being received on 14 March 2012. The two Chairmen and Commissioners from each organisation led the study, supported by a cross‑Commission team.

The study was advertised in national and metropolitan newspapers in both countries, and promoted on the Commissions’ websites as well as on a joint study website. The Commissions engaged widely with stakeholders, drawing on input from participants through visits, roundtable discussions and written submissions. A technical modelling workshop on mutual recognition of company tax imputation credits was also held (appendix A).

Sixty submissions were received in response to the issues paper released in April 2012. A further 71 submissions were received in response to the discussion draft released in September 2012.

Quantitative modelling has been undertaken to provide insights relevant to various parts of the study. Economy-wide modelling has been used to illustrate the wider effects of economic integration.

Much of the detailed work undertaken for the study can be found in supplementary papers published on the study website.

The Commissions are grateful to participants in this study for meeting with Commissioners and staff, participating in roundtables and making written submissions.