Submission to the Joint Study by the Australian Productivity Commission and the New Zealand Productivity Commission on Strengthening Economic Relations between Australia and New Zealand – Comment on the Discussion Draft, *Strengthening Trans-Tasman Economic Relations*

Peter Lloyd

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Overall Comment

The Discussion Draft released in September 2012 provides an excellent overview of the issues and possibilities of pursuing greater economic integration of the national economies of Australia and New Zealand. I have a disagreement with only two of the specific proposals, namely DR4.14 relating to the third freedom movement of capital between the two countries, and the associated issues concerning the second freedom, trade in services, as set out in DR4.8..

First, I wish to comment on the "policy objective" or "end point" of the proposals for greater integration. Next, the issues relating to trade in capital and services are addressed in the section on Completing the Four Freedoms. In the last section I make brief comments on two textual matters.

The End Point of Greater Integration

In the Overview and in Chapter 1, the Commissions set down their approach to policies designed to promote greater integration of the two national economies. The Commissions eschew the adoption of an end point, arguing that it cannot be specified in advance. Instead they follow the "direction of travel" laid out in the Single Economic Market Principles adopted by the Prime Ministers of the two countries in 2009. To make this operational, they adopt the framework of "Four Freedoms" put forward by the European Union (originally by the European Economic Community). They then proceed to examine the possibilities of greater integration in the markets for goods, services, capital and labour.

The difficulty with this approach is that the "direction of travel" is not clear in the absence of an end objective. There is no vision to guide the policy options that may be considered. One may note that the Treaty of Rome saw the Four Freedoms adopted by the EEC as a part of the broader concept of the Common Market. The Common Market consisted of the Four Freedoms plus the four areas of common policy. Later the EEC and then the EU realised that the achievement of no discrimination in cross-country transactions in these four market areas required supplementary policies to prevent beyond-the-border regulations from restricting cross-border movements. Later still they realised that the Common Market was not sufficient and adopted the broader goal of a Single Market

This difficulty applies to the discussion of the discussion of the "third freedom", capital flows, and the associated issues relating to "second freedom", trade in services.

Completing the Four Freedoms

In examining prospects of greater integration in the third freedom area, the Commissions recognise that the CER Investment Protocol is limited in scope. The Protocol, when implemented, will seek only to "liberalise barriers to trade in investments". In DR4.14, the Commissions recommend that the Governments "… should consider expanding the scope of the Investment Protocol by lessening the remaining restrictions on bilateral foreign direct investment." (Discussion Draft, p. 119). That is, there should be further liberalisation. There is no suggestion of the direction or extent of weakening restrictions, except that the policy rationale and the costs and benefits of the restrictions left in place should be made clear.

The issues relating to the third freedom need to be investigated further. This also provides me an opportunity to explain more fully the reason why I recommended the removal of remaining trans-Tasman restrictions on FDI entry in my original submission, Submission No. 5.

In my view, there is no underlying economic reason or rationale why restrictions on the bilateral entry of capital flows, sometimes known as rights of establishment, should not be reduced to zero, as they are in the parallel area of people movements.

There is one apparent exception to the ending of restrictions on rights of establishment, namely, FDI capital flows in the "sensitive areas" which are listed in both the Australian and the New Zealand FDI regulations. These areas include all of the areas of service trade which are negative-listed by New Zealand and most of those negative-listed by Australia under the CER Services Protocol, plus other areas such as media, non-residential commercial real estate and banking in the case of Australia and the land, farm land and fishing rights in the case of New Zealand. They are all service or land –based industries (including fishing in the definition of endowed resources). In relation to the service industries, ending the remaining restrictions on FDI capital movements also involves ending the remaining exemptions to freedom of movement of services supply in the negative list of the Services Protocol.

These areas are areas which are heavily regulated by the respective governments except for a few areas such as land farming in New Zealand and non-residential commercial estate in Australia. These national regulatory regimes exist presumably because of some perceived market failure; examples are the problems of competition in the natural monopoly areas of telecommunications and the problems of coordination in air transport services with a network of air services agreements. But the appropriate action in relation to bilateral CER policy is not a restriction on trans-Tasman rights of establishment because the problems do not arise from a failure directly associated with trans-Tasman trade in capital. (This argument parallels the familiar argument by international trade economists that border restrictions are not welfare-improving because international trade is not the cause of market failure [ignoring the terms-of trade argument for tariffs because it is a beggar-thy-neighbour policy which invites retaliation and losses to all countries]. If there is a market failure because of, say, a shortage of risk capital or learning-by-doing in some manufacturing operation, the appropriate government intervention is in the relevant factor or product market.)

However, the ending of restrictions on rights of establishment would not be sufficient in these cases of domestic regulation. The relevant regulations of both the Australia and New Zealand Governments would need to be harmonised to ensure efficient Tasman-wide delivery of services and products. This does not imply a single or common set of regulations, merely that regulations are what might be termed "compatible" in the sense that they do not prevent or distort Tasman area investments and trade.

Each sensitive area would need to be investigated individually as each has a unique set of regulatory problems. The two Governments should take a hard look at why these areas are sensitive for trans-Tasman FDI investment alone. This might be done by sending a follow-up joint reference to the two Productivity Commissions.

This policy would, in addition, require a careful specification of eligible "Trans-Tasman" investments, as noted in my original submission to the Productivity Commissions Joint Study, and it would not apply to those restrictions relating to the regional level of government and other areas specified in the Australian and New Zealand Annexes to the Protocol.

The possibility of ending bilateral restrictions on FDI rights of establishment raises the question that there may be further and perhaps greater gains from the multilateral relaxation of FDI entry restrictions in both Australia and New Zealand with respect to all foreign parties. This would require, however, a total overhaul of the FDI regulation regimes and is clearly outside the scope of the present Joint Study.

Finally, we need to ask whether bilateral preferential ending of FDI entry regulations could have negative effects. This does not seem likely. Bilateral preferential ending of FDI entry regulations would increase competition in the relevant markets, broaden the range of services available to service customers, stimulate innovation and realise economies of scale.

Mutual recognition of imputation credits can then be viewed as one area of regulation where existing non-common beyond-the-border regulations are not "seamless", that is, they result in national governments discriminating against investors from the

Trans-Taman partner country. These matters do require careful supplementary examination, as they Commissions recognise, but this should be done on the economic principle of no-discrimination rather than as a response to business complaints that they restrict business.

These views have been put forward on the understanding, as expressed in the Joint Study Draft Supplementary Paper C, page 25, that existing bilateral trade agreements with other countries which have an MFN Clause, as in the Australia-US Free Trade Agreement, chapter 11, exempt existing agreements such as CER from the effect of this clause.

Similar issues apply to measures adopted by the two Governments which do not conform to the National Treatment obligation of the Protocol but these are not investigated here.

In conclusion, it is my view that the wording of DR.8 and DR.14 are too weak in scope. They should be replaced by a recommendation which states

> "That the governments should work progressively to eliminate all border and beyond-the-border restrictions or regulations which prevent Australian and New Zealand service suppliers and direct investors from competing on equal terms throughout the trans-Tasman area."

Or other words to the same effect. This would in most cases require some harmonisation of regulations on both sides of the Tasman, but not necessarily common regulations.

Comments on the Text

- Page 2 of the Overview states that "Tariffs and quantitative restrictions have been eliminated on virtually all goods traded between the two countries." One can put this more strongly in terms of a statement such as "Tariffs, quantitative restrictions and other border restrictions on trade have been eliminated on all goods trade (except for trade in prohibited goods and goods subject to quarantine restrictions which apply conditionally)".

- The section in Chapter 2 on trade diversion as a potential cost is, in my opinion, very outdated and gives the wrong impression. Even when it occurs, trade diversion is not necessarily harmful to the importing country. This has been well recognised in trade theory since the work of Gehrels, Meade, Michaely and others more than 50 years ago, and this point was noted in my original submission. Moreover, the possibilities of trade diversion occurring have been substantially reduced in recent years by each of the Trans-Tasman countries signing bilateral trade agreements with several third countries or country groups, as well as by the reductions in MFN tariff rates in both countries. China is now the main supplier of manufactures to both Australia and New Zealand and it is so competitive that minor tariff discrimination does not deter trade into Australia. It is difficult to see where trade diversion can occur in Australian and New Zealand import trade. This section should be revised along these lines.

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