NZIER INSIGHT

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Trans-Tasman relationship close, but could be closer

Sharing is caring

New Zealand and Australia share many things: a tariff-free border, a free labour market, joint institutions, hosting rights to the Cricket World Cup 2015 (go the Black Caps!) and a mutual distaste for English rugby. Ahead of the 10th Australia-New Zealand Leadership Forum in Auckland this week, we briefly examine the state of the trans-Tasman economic relationship and identify some likely topics for the leaders' discussion.

Overall, the New Zealand and Australian economies remain very closely linked, with few remaining bilateral policy irritants. Australia remains New Zealand's largest trade partner for goods and services combined, as it has been since the late 1980s as the CER has encouraged progressively deeper integration.

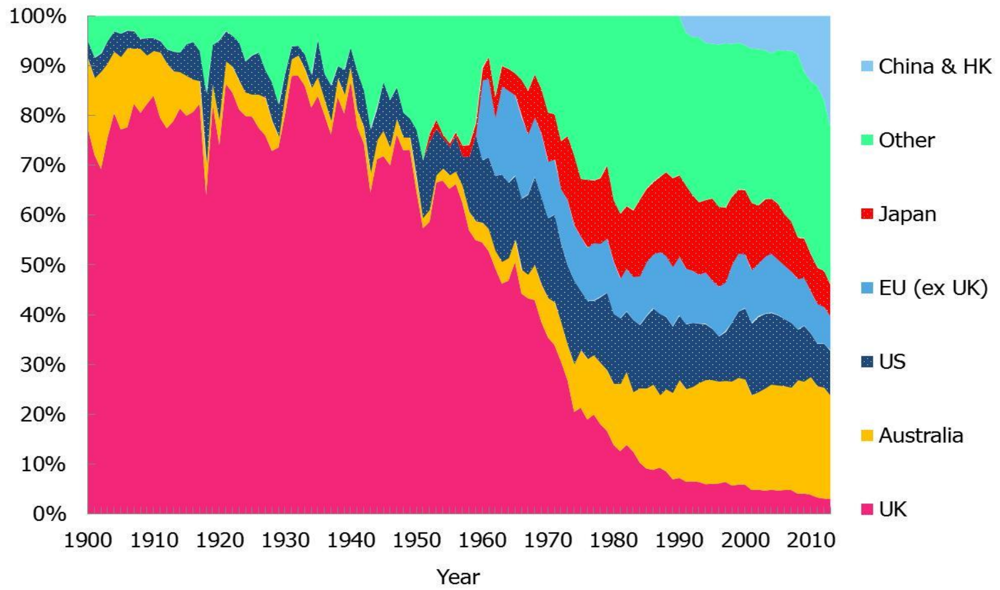
People are free – as they have been for decades – to move between the economies, based on the strength of job opportunities across the ditch. Over 50,000 Kiwis flooded to Australia in 2012 but changing economic fortunes slashed those outflows in half last year.

Some clear opportunities for further economic integration relate to the mutual recognition of imputation and franking credits, narrowing down the extent of exemptions from the Trade in Services Protocol and trimming the real costs of trans-Tasman travel. These are tough areas – analytically and politically – but they need to remain on the table for further discussions. Short term fiscal or operational concerns should take a back seat to longer term efficiency objectives.

Further collaboration on regional integration initiatives such as the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP) where we share similar objectives and levels of ambition will also be helpful to New Zealand and Australian businesses and households.

Figure 1 New Zealand's goods export markets

Shares of nominal merchandise exports, calendar years



Source: NZIER's long term data set

Australia is still a very important trading partner for goods…

Despite the understandable recent attention paid to China, Australia remains a critical destination for Kiwi primary producers and manufacturers, and has been for a very long time (see Figure 1). We have now enjoyed almost 25 years of tariff free[1] access on goods trade since CER commitments were achieved ahead of schedule in 1990, and the Trans-Tasman Mutual Recognition Arrangement allows most goods sold in one country to be sold easily in the other.

A booming Australia is good for New Zealand: a ten percent expansion in Australia's economy boosts New Zealand's exports by 2 percent, boosting New Zealand GDP by 1 percent.[2] Australian part-ownership of Kiwi firms (e.g. supermarkets) has also led to export increases through intra-firm trade.

Last year New Zealand exported almost $9 billion of goods to Australia, creating 18 cents of every dollar of export revenue New Zealand receives.[3] New Zealand's largest bilateral exports are oil, gold, wine and cheese (which make for a pretty good Ocker party).

On the imports side of things, Australia is New Zealand's third largest source of goods, after the EU and China. Australia accounts for $6.2 billion or 12.5% of New Zealand's total goods imports, with the key items being vehicles, aluminium oxide, wheat, medicines and chocolate (which would make for an unusual but possibly effective combination to cure a hangover).

…and tourism and commercial services are big business too

The trans-Tasman trading relationship is much broader than just agricultural and manufactured goods, however. Total bilateral services trade is well over $9 billion, which adds another 60% to the size of the goods-only relationship. This trade is assisted by the CER Services Protocol which achieved bilateral free trade in services in 1989 for most sectors.

Australia is by far New Zealand's largest source of services export revenue, generating $4.1 billion in the year to June 2014, some 65% more than the next largest source of services revenue (the US, at $2.5 billion). Around half of this is tourism exports, but commercial services exports also feature strongly.[4] Both markets benefit from strong trans-Tasman tourism flows. Australians spend more than any other market in New Zealand – well over $2 billion a year (see Figure 2).

New Zealand imported $5.1 billion of services from Australia in the year to June 2014. Again, most of this was Kiwis holidaying in Australia – each year Kiwis make more visits to Australia than any other country and spend about as much in total as US visitors (see Figure 3).

When services trade is brought into the equation, Australia becomes New Zealand's largest trading partner (see Table 1).

Table 1 Total exports to Australia and China

New Zealand dollar billions, year ended June 2014

Country	Goods exports	Goods imports	Services exports	Services imports	Total trade
Australia	8.9	5.9	4.1	5.1	24.0
China	11.6	8.1	1.7	0.5	21.8
World	**51.2**	**47.5**	**16.9**	**15.5**	**131.1**

Source: Statistics New Zealand

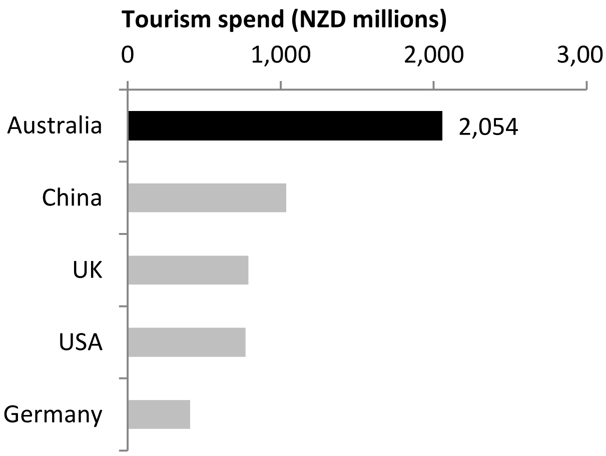
1 Some small exemptions apply.

2 Based on p.7, Australian Productivity Commission and New Zealand Productivity Commission. (2012). *Strengthening trans-Tasman economic relations, Joint Study*, Final Report. Available at http://transtasman-review.productivity.govt.nz

3 The comparable figures for China in CY2014 were $10.0 billion and 19.9%. Given the recent sharp drop in dairy prices, which will see exports to China ease, we might expect Australia to regain its top spot in 2015.

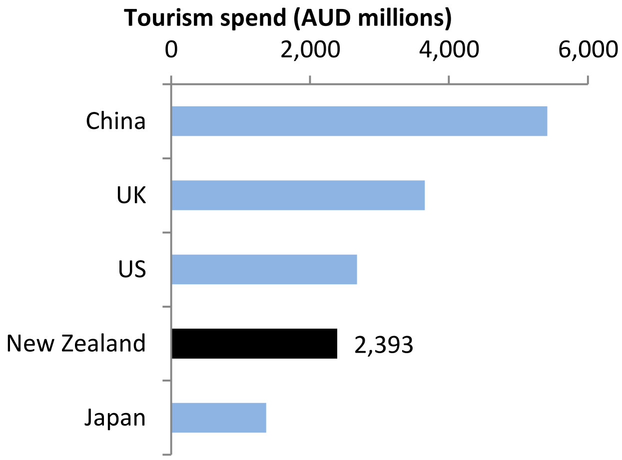
4 For example, $202 million of Computer and information services; $128 million of Legal, accounting, management and consultancy services; $95 million of Architectural, engineering, and other technical services; $66 million of Audiovisual and related services (year ended June 2013).

Figure 2 Australia tops NZ tourism



Source: International Visitor Survey, 2014, MBIE

Figure 3 Kiwis make Australia's top 4



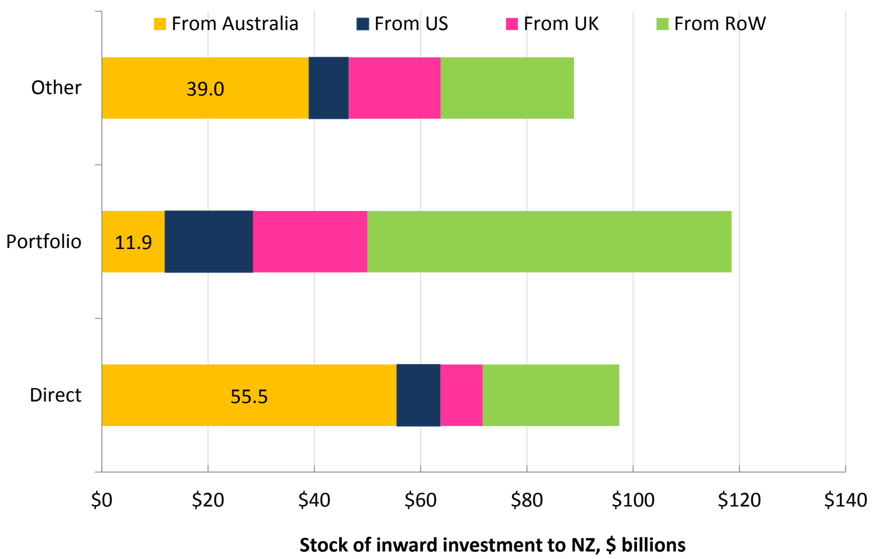
Source: International Visitor Survey, Sep 2014, TRA

Australia is our largest investment source

The large stock of Australian investment in New Zealand – some $114 billion or 36% of the total – is a positive indicator of how well the two economies are integrated (see Figure 4). Under the CER Investment Protocol that came into force in 2013, most bilateral investments are subject to higher screening thresholds than investment from other countries before requiring regulatory approval. This reduces investment costs and improves investor certainty.

Figure 4 Stock of investment in New Zealand

$ billions, year to March 2014[5]



Source: Statistics New Zealand BOP data

5 'Other' refers to "borrowing and lending using loans, trade finance and deposits, where the transactors are unrelated or have less than 10 percent ownership interest in each other" (Statistics New Zealand Balance of Payments definitions). Financial derivative products (available in total, but not on a bilateral basis) account for the difference between the total stock of investment and the subtotals in Figure 4.

Australia accounts for 57% of New Zealand's foreign direct investment, and this is largely directed to the financial services and retail sectors rather than in agricultural land. Australian-owned firms operating in New Zealand employ some 138,000 workers.[6]

Australia is also New Zealand's largest destination for outward direct investment: it takes over $12.6 billion of New Zealand's total outwards investment stock of $23.1 billion, although this is but a drop (0.8%) in the total Australian FDI bucket.

Our labour markets are very well integrated

Workers are already free to migrate across the Tasman via the Trans-Tasman Travel Arrangement (TTTA) and the Trans-Tasman Mutual Recognition Act (TTMRA). These pieces of legislation help ensure training and skills developed in each country are recognised in each country, improving labour market flexibility. They also allow Kiwis and Aussies to move freely to be with their families and to express their curiosity about living and working overseas.

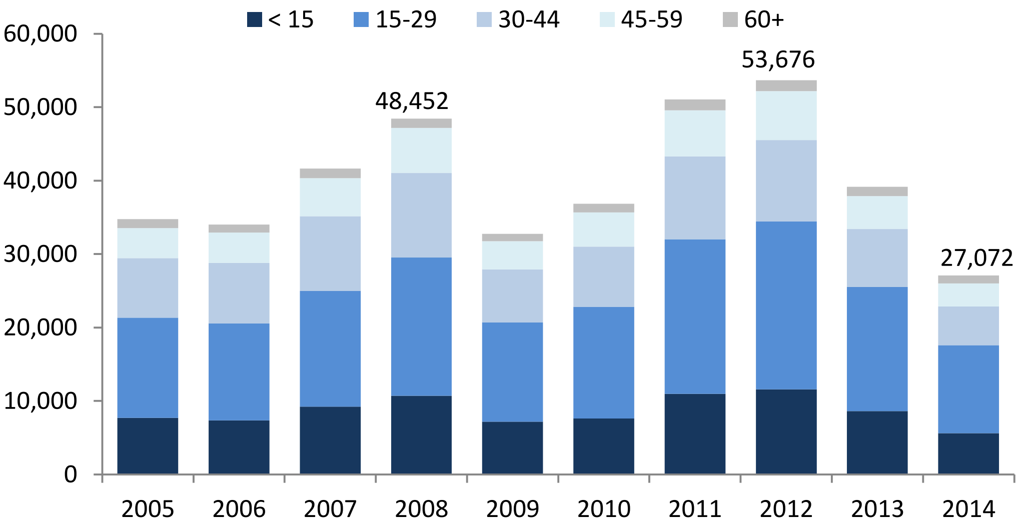
There are already some 330,000 Kiwi-born workers in the Australian labour force.[7] In 2011 and 2012, opportunities were abundant in Australia for New Zealand workers. This saw large outflows of Kiwis heading to the lucky country for work, which helped ease skills shortages in key Australian sectors (e.g. mining).

But with the slowdown in the Australian economy, Kiwis have preferred to stay home rather than fly the coop while Aussies migrating to New Zealand have soared – up 50 percent since 2012. That suggests, at a high level, that our shared labour market appears to work effectively as a combined shock absorber, quickly adjusting to economic conditions and allowing Kiwis and Aussies to identify opportunities for employment and wage growth.

Kiwis' propensity to migrate to Australia is age dependant (see Figure 5) – only the young tend to make the move. So as New Zealand starts to age expect fewer Kiwis to be taking up the slack from Australia's ageing workforce. Fuel for Australia's labour market might need to be found elsewhere.

Figure 5 Kiwis left in droves in 2012 but not in 2014

Out-migration by age, New Zealand residents to Australia (calendar years)



Source: Statistics New Zealand

6 See data on foreign affiliate trade statistics at http://www.stats.govt.nz/~/media/Statistics/browse-categories/economic-indicators/balance-of-payments/fats-2014/foreign-affilates-stats.pdf A foreign affiliate is a firm with over 50% foreign ownership. Data is for the year ended March 2012, the latest available in this series.

7 Based on 2011 Census data from the Australian Bureau of Statistics.

Further integration will be a challenge, but will likely benefit both economies

The overall picture is that the trans-Tasman economic relationship is in excellent health. Goods, services and labour are, in general, able to move easily between the economies with minimal transaction costs.

We agree with the 2012 joint report by the countries' Productivity Commissions[8] that most of the low-hanging fruit has been picked in terms of moving towards a genuine Single Economic Market, and that further integration will require addressing some more challenging economic and political issues.

The decision in late 2014 to cease efforts to develop the Australia New Zealand Therapeutic Products Agency is just one example of how difficult further integration might be, especially when New Zealand is generally the demander with more to gain, proportionately speaking, than Australia. Some analysis of the lessons learnt from this process may be insightful for informing future joint decision-making processes.

Much depends on the degree of political will that leaders are able to show. History tells us that it is not until political agreement is reached that further economic integration can occur.

Taking a long term perspective will help

The extent to which policy advice is prepared and decisions are made with the long term competitiveness of the two economies in mind is also important. Bold choices are required in some areas that see through current fiscal challenges and political difficulties towards a vision of a seamless trans-Tasman economy in which New Zealand and Australian businesses can compete on a level footing. This competition will lift efficiency, drive productivity gains and place firms in a stronger position to compete internationally in third countries.

A good example of where Australia and New Zealand usually work closely together in dealing with third parties is in trade policy. As commodity exporters, both economies have traditionally coordinated on matters of multilateral trade liberalisation and regional economic integration (e.g. AANZFTA). Ongoing efforts for further regional integration via mega-agreements such as the TPP and RCEP provide additional opportunities for trans-Tasman policy coordination. There may also be value in investigating shared opportunities for joint export promotion in certain products in selected large markets such as China, where the benefits of economies of scale to spread high set-up costs could usefully be exploited.

There are many areas for further investigation…

A key concern for New Zealand and Australian businesses is the **lack of recognition of franking and imputation credits**. Currently trans-Tasman equity investment dividends can potentially be taxed twice; first via company tax in the destination country and secondly via personal tax regimes in the investor's economy.

As a result, the cost of capital is increased (and hence return reduced) for Kiwi firms operating in Australia, and vice versa. This effectively acts as a tariff on trans-Tasman investment flows.

As the Productivity Commissions' joint report (p.141) noted, "Mutual recognition of imputation credits (MRIC) would be expected to result in a more integrated capital market and improve trans-Tasman economic efficiency".

Economic modelling by NZIER and CIE has shown that a mutual recognition scheme would deliver welfare gains to both economies, even after taking into account the initial drop in tax revenue that Australian officials remain concerned about.[9] The trans-Tasman economy would be better off by $7 billion by 2025 via lower costs of capital and higher household incomes. Dynamic gains from enhanced competition and innovation, and reduced management time spent on tax avoidance, would boost these modelled gains.

8 Australian Productivity Commission and New Zealand Productivity Commission. (2012). *Strengthening trans-Tasman economic relations, Joint Study*, Final Report. Available at http://transtasman-review.productivity.govt.nz

9 NZIER and CIE. (2012). *The costs & benefits of mutual recognition of imputation & franking credits*. Available at https://nzier.org.nz/static/media/filer_public/ca/8c/ca8ca43d-703e-4f6a-b12a-59e17a8808e9/120831_report_on_costs_and_benefits_of_mutual_recognition_of_imputation_and_franking_credits.pdf

The main concern from the Australian side about mutual recognition is that the transfers involved would be highly asymmetric – it would cost Australia more than New Zealand.[10] The challenge posed by the Productivity Commissions was to explore whether a compensation mechanism could be designed that might better distribute the costs and benefits from mutual recognition. This issue will be considered further in the Australian Tax Reform White Paper, due to be published in late 2015.

The extent of **exemptions from the CER Services Protocol** is also an area that warrants further analysis. Australia's main exemptions relate to aspects of broadcasting, insurance, interstate air services, coastal shipping and postal services; New Zealand's centre on air services and coastal shipping.[11] While there may be – or may have been historically – valid political economy reasons for imposing these exemptions, ongoing reviews of the public policy rationale, and associated costs and benefits, should ensure these restrictions remain effective and efficient.[12]

Further attention could usefully be paid to **cutting the costs of travelling** to our neighbours, including:

- Reducing the Australian Passenger Movement Charge used to recoup the cost of processing New Zealand (and other) travellers through customs, immigration and quarantine – this charge is disproportionately high for trans-Tasman flights, relative to flights to and from other longer haul destinations. Cutting it would likely better reflect the costs of servicing Kiwi travellers, potentially lowering ticket prices and incentivising more Kiwis to fly to Australia rather than elsewhere.[13]
- Lowering time spent in transit – speeding up travel times via further efficiency gains like e-Passport and SmartGate would reduce the real time cost of travel and support more trans-Tasman visits.
- Continuing to work hard where practical to deliver a single visa experience for visitors – initiatives such as allowing international fans to use a single visa for the Cricket World Cup in 2015 reduce the transaction costs of travel and simplifies the overall visitor experience.

The thorny issue of **Kiwis' social security entitlements** in Australia is unlikely to go away, and there are few signals that any significant change might be considered, at least in the short term. However, this may be more politically feasible as the Australian economy improves, or if Australian policy settings start to be more accommodating of migrants more generally.

…all of which require rigorous analysis and political drive

These remaining trans-Tasman issues are analytically difficult and politically delicate. Politics matters immensely – it's easy for politicians to find reasons *not* to do things. But that is not an excuse to keep kicking for touch.

Given that the relatively larger gains are likely to accrue to firms and households on this side of the Tasman, the onus is on New Zealand politicians, officials, firms and researchers to tackle these tough problems in the first instance.

There is a need to provide compelling analytical evidence that proposed changes would benefit Australia too, or that costs could be offset by gains in other parts of the integration agenda, or that any net costs would not disadvantage Australia to any significant degree in the broader context of the bilateral relationship.

After all, the intention of, and spirit behind, deepening the trans-Tasman relationship over the decades has always been about cooperation rather than contest, no matter what happens on the cricket field in coming weeks.

[10] We note that the potential direct fiscal costs are very small as a proportion of Australia's total tax revenue – almost certainly less than 0.5%, and possibly much lower than that – and could be replaced with revenue from different, less distortive sources.

[11] See p.114 of the Productivity Commissions' joint report.

[12] Another – more ambitious – version of this approach might be to jointly legislate that both Australia and New Zealand should remove or reduce barriers to trade in services (and investment) unless a convincing rationale for the barrier could be generated. See Hawke, G. (2013). 'ERIA Perspectives on the WTO Ministerial and Asian Integration', in Fukunaga, Y., J. Riady, and P. Sauvé (eds.), *The Road to Bali: ERIA Perspectives on the WTO Ministerial and Asian Integration*. ERIA Research Project Report 2012-31, Jakarta: ERIA, UPH and WTI. pp.75-89.

[13] Addressing the Passenger Movement Charge has been raised by various parties on both sides of the Tasman. See for example: Productivity Commissions' joint report; Tourism and Travel Forum (2014) *Bringing our neighbour closer*; GHD (2012) *Trans-Tasman Project Final Report.* A study for the Department of Resources, Energy and Tourism.

This Insight was written by John Ballingall (Deputy Chief Executive) and Dr Kirdan Lees (Principal Economist), 24 February 2015.

For further information please contact John Ballingall at 04 472 1880 or 021 606 477.

NZIER | (04) 472 1880 | econ@nzier.org.nz | PO Box 3479 Wellington

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