TREASURY WORKING PAPER

00/22

Economic Integration, Sovereignty and Identity: New Zealand in the Global Economy

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Abstract

Markets are becoming more integrated. Whilst governments have limited influence over this process, they can hasten or hinder the pace of integration and will need to respond to the implications of integration. This paper provides a framework for thinking about the benefits and costs of market integration. It analyses how cross border flows of goods, services, capital and labour affect the living standards of New Zealanders in terms of both productivity and incomes as well as other, broader, aspects of living standards. Particular attention is paid to the areas of spatial economic analysis and national sovereignty and identity.

Governments must consider a number of factors when thinking about their stance on integration. Further economic integration promises economic benefits for New Zealanders in terms of greater productivity and higher incomes. One risk, however, is that with increasingly free factor flows, government pursuit of integration may increase the risk of activity relocating offshore. The evidence on the overall effect of integration on income distribution is unclear, however we do know that there will be winners and losers. Decision-making power and feelings of identity seem to be important components of well-being – integration brings with it both risks and opportunities in these areas, as pressure is put on traditional forms of governance and identity, and new forms develop. Deciding how the costs and benefits of integration stack up ultimately involves a number of value judgements – the paper provides a framework and a summary of empirical evidence to help inform those judgements.

** The authors would like to thank John Carran, Benedikte Jensen, Lesley Haines, Struan Little, Mario di Maio, Peter Martin, Jim Rose, Grant Scobie and Andrew Sweet for assistance in writing this paper.*

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2. Integration

Market Integration occurs when two or more economies function as a single market. It is likely to be evidenced by high flows of goods, services, capital and labour and convergence of prices.

Policy Openness and Integration are means governments might use to encourage, impede or direct market integration. Openness involves goods, services, capital and labour being free to move across borders and is a necessary condition for market integration. It is evidenced by lack of barriers to cross border flows. Policy integration is evidenced by similarity or compatibility of policy settings between countries.

Even with high policy integration, market integration may not occur because of lack of *social integration*. Differences in culture, language and values make it unlikely that two economies will function completely as a single market.

3. Analytical Framework

We adopt two conceptual windows for analysis. The first is the traditional ‘New Zealand as a nation’ view, where the world is divided into sovereign nations with borders that clearly differentiate each from the rest of the world. The second is a newer ‘New Zealand as a region’ perspective, where the world can be viewed as a series of concentric groupings, starting with the individual and moving out to international groupings including all of humanity. We find that removing the focus from the nation state, as in the ‘New Zealand as a region’ analysis, reveals the implications of spatial location to a much greater degree and provides a new view of the effects of openness and integration.

4. Integration, Incomes and Productivity

The key to higher incomes is productivity. Higher productivity means that more goods and services can be produced from the same amount of resources and effort. As output increases, so too do incomes and employment. Productivity is therefore central to living standards.

What improves productivity?

Productivity results from high quality decision-making about the use of valuable assets. We identify seven mechanisms through which openness and integration may affect productivity: resource allocation; scale, scope and specialisation; technological advance; accumulation of human capital; accumulation of physical capital; firm organization, management practices and work arrangements; and plant/firm turnover.

Importantly, there is also a spatial dimension to productivity. The agglomeration of resources and production in a particular location can improve productivity as greater density leads to lower transport costs, greater specialisation of production and labour, labour market pooling effects and knowledge spillovers.

While domestic policy has an influence over the productivity-improving mechanisms, and the spread of activity across space, openness is also important. For smaller countries, such as New Zealand, openness may assume greater significance than it would for a larger country that suffers less from market-size and resource constraints.

What effect do cross border flows have?

Looking at the theory on cross border flows of goods, services, capital and labour through the 'New Zealand as a nation' lens, we find integration generally yields productivity improving effects. However, looking at New Zealand with a spatial perspective highlights some additional risks as well as benefits of integration. In particular, capital and labour could move out of New Zealand to more agglomerated places, in search of the higher productivity and wages associated with density. While these firms and workers may be more productive offshore, the benefits of their productivity improvements are lost to New Zealand.

From the literature we identify four factors that are key in estimating the size of the 'spatial' risks of integration. The factors are technology, critical mass/agglomeration, absolute advantage and border effects.

1. Will technology reduce the need to be in an agglomeration to tap into productivity benefits, and so make it easier for firms to locate in the periphery?

2. Are firms able to find suitable levels of density for their needs in New Zealand cities and towns, or do they have to go offshore to access that density and its benefits?

3. Integration will push countries' pattern of specialisation towards those activities where they have an absolute advantage – what are the implications for the level and type of activity that New Zealand might sustain in the future?

4. ‘Border effects’ can be thought of as less explicit barriers to integration which place an upper limit on the amount of activity that flows out of a country – how will these operate in New Zealand?

More empirical work around the mobility of firms and people would shed valuable light on these issues.

Empirical evidence

At a broad level, the empirical evidence on the effect of openness and integration on growth and productivity is mixed. Cross-country regressions tend to find positive relationships but there are concerns over the robustness of the methodology. More specific case studies of countries or industries tend to support openness.

5. Integration and Income Distribution

A classic critique of openness and globalisation is that they cause the distribution of income to become more unequal. Income distribution in New Zealand has widened over the past two decades. Part of this may be due to increased economic integration, although it is very difficult to disentangle from the many other factors influencing income distribution. International evidence has attributed perhaps 5 to 20 percent of the change in the distribution of earnings to trade.

Although the effect of integration on the overall distribution of income is unclear, trade liberalisation is likely to change the position of individuals and groups *within* the distribution, and result in winners and losers. Consumers will benefit, through access to lower priced goods. Costs are likely to be concentrated on relatively small groups of workers in sectors that are no longer competitive.

A key question is: are the losers permanently disadvantaged, or is the dislocation a relatively temporary one? If labour markets adjust rapidly, through people moving or retraining or both, the effect of the shock will be temporary. Government may still want to consider temporary assistance to help people cope with the effects of integration. For some the shock may be permanent and they may not be able to recover. We need to study more closely mechanisms of labour market adjustment in order to know what sort of policy response is appropriate.

6. Integration and Decision Making

Sovereignty

There is a concern that national sovereignty – the decision-making power of nation states – is diminished in an increasingly integrated and global world.

One facet of the concern is that increasing cross border flows of capital and labour generate economic pressures that place limits on domestic policies. To some degree global capital markets do limit choices. This may not be a bad thing if it supports domestic policy and binds commitment from successive governments. More fundamentally, sovereignty does not require limitless choices. Nations have always operated within the parameters of the options actually open to them and the pressures upon them. In a changing world these options and pressures have changed, but the effect on sovereignty is unclear.

Another focus for concern is that the increasing trend toward international decision-making represents a transfer of power from nation states to international organisations, and therefore harms national sovereignty. Again, use of the concept sovereignty is problematically imprecise. Signing up to international norms sets parameters on domestic policy. It will therefore only be undertaken for a greater expected benefit. This may amount to a loss of sovereignty (in the same sense that signing a contract limits an individual) but the real question is whether the benefits to New Zealand outweigh the costs of signing. Developing a framework or taxonomy for how we think about the costs and benefits of international cooperation is an important area for further work.

Levels of governance

If we change our perspective to 'New Zealand as a region' we see that there are a number of different possible levels of decision-making, and the nation state is only one. Rather than trying to decide when New Zealand should give up some of its sovereignty to international fora, the question can then be recast as an issue about subsidiarity: at what level of governance should decision-making be carried out.

It may then be possible to apply the principles that guide decisions of devolution to lower levels of government, to decisions of 'devolution up', to international cooperation. The paper discusses how the principles of balanced, informed and cost effective decision-making might be applied in the international context.

7. Integration and Identity

Identity, a sense of who we are, seems to be important to us. There is a multitude of ways that we define ourselves; national identity is one that has been particularly powerful. To the extent that we value it, national identity represents a limiting parameter for policy. Policy integration can only occur to the degree that people feel comfortable with it.

Nevertheless, there are a number of points to keep in mind. Firstly, identity is dynamic. Identity and culture have always evolved over time. It may be the rapid speed of evolution in culture and identity that causes us particular dislocation and concern. Secondly, change can be beneficial in terms of opening New Zealand to new ideas and different perspectives, which may make us more tolerant as well as innovative. Finally, national identity can also be a powerful negative force when directed against those identified as not belonging.

The challenge for the future is: how do we foster an evolving sense of identity in a world of increasing mobility and merging of cultural influence?

8. Conclusions and Policy Implications

We have identified costs and benefits of integration across goods, services, capital and labour markets in terms of both material, and less tangible, aspects of living standards. A simple calculus of the relative weights of various considerations is not possible because it involves empirical uncertainties and political judgements.

Integration is good for productivity. However, much of the analysis about the productivity advantages of integration hinges on how seriously we view the risk that economic activity will locate offshore as factor markets free up, and how much we can influence this. A particular development priority is work aimed at understanding the nature of capital and labour mobility between New Zealand and other countries.

Concerns about income distribution centre on the fact that some will suffer as a result of a changed environment. How much of a problem this is may depend, to a large degree, on the speed and nature of labour market adjustment. Research on labour market adjustment in New Zealand is another area for further work.

At the centre of the analysis lie matters of value, which cannot be resolved by applying economic, or other, arguments. Are we aiming to maximise the welfare of residents or citizens? Do we value places as well as people? What does it mean to be a New Zealander? These sorts of questions concern the preferences and attitudes of New Zealanders and should be vigorously debated in the public sphere.

This work provides new perspectives to apply to policy problems. It reminds us of the importance of clearly identifying goals and objectives and making linkages across policy areas. It highlights the need to distinguish between what we can't control and must simply respond to, and where we do have choices. It raises questions such as: how do we think more clearly about the benefits and costs of being different?; and how do we think more clearly about the benefits and costs of signing up to international agreements?

Objectives canvassed in the paper now need to be combined with practical considerations to determine what might be desirable and achievable in policy terms.

1. Introduction

1.1 Context

Integration is occurring. Every day individuals and businesses are making decisions and taking actions that cross national borders. In this environment the government has some degree of influence over the pace and nature of integration, but by no means total control. Policy can oil the wheels of integration, or put sand in the wheels; it cannot drive the machine.

Government roles include:

- setting the environment for openness unilaterally, eg setting tariff levels, immigration rules, statements on the desirability or otherwise of foreign investment, and exchange rate policy;
- engagements with other countries – this involves choices about how much and where policy resources and discretionary powers are to be deployed, eg deciding who to pursue integration with, whether bilaterally, regionally or multilaterally; what agreements should cover; and what sectors should be prioritised;
- domestic policies to manage the consequences of integration, eg assisting with adjustment for workers and regions affected by changes.

The policy areas pertaining to these three roles are numerous. External economic strategy can, most broadly, be understood as encompassing all topics relevant to the cross border flows of goods, services, capital and people. Thinking about external economic goals at a broad level will help us to identify linkages between various areas of external economic policy as well as provide a systematic basis for allocating limited resources, making trade offs and prioritising policy initiatives.

It should also assist us in determining the relative importance of integration in achieving higher living standards compared to domestic policy, and ensure that domestic and external policy settings are aligned.

There are costs and benefits of any course of action, including changing nothing. However the costs of the status quo often become starker in an environment of crisis. How likely we are to change our external economic strategy depends on how well we think we are doing with our current policy settings. We live in a dynamic environment and things can quickly move on and off the agenda.

1.2 What the paper does

The paper provides an analytical structure for clarifying external economic goals, by discussing the benefits and costs of market integration. It analyses how cross border flows of goods, services, capital and labour affect the living standards of New Zealanders in terms of both monetary aspects of living standards (productivity and incomes) as well as other, broader, values.

Many of the arguments about the benefits and costs of integration will be familiar to economists and others. Nevertheless it is worth drawing them together in a simple and clear way. Other aspects of the analysis will be less familiar: particular attention is paid to the perspectives of spatial economic analysis and national sovereignty and identity.

Most of the discussion in this paper centres on the effects of market integration. It aims to inform the question of how much integration is desirable for New Zealand; in other words, what the goals and objectives of external economic strategy should be. Issues about the mix of policy instruments that will best help us achieve our objectives are secondary, and contingent upon being clear about what we are aiming for. An in-depth treatment of policy is outside the scope of this paper. However, in order to remind the reader of the way in which thinking about objectives matters for policy, we have peppered the discussion with boxes containing illustrations and examples of relevant policy questions. The next step is to apply the insights in the paper to policy areas.

The paper was written in conjunction with another: *Facts about Economic Integration: How Integrated is New Zealand with the Rest of the World?*, by Vicki Plater and Megan Claridge (2000). Plater and Claridge is an empirical paper, which provides comparative data about New Zealand's current level of market and policy integration with the rest of the world. The paper concludes that New Zealand has a relatively high level of integration with the global economy. The widespread perception, however, that New Zealand is a great deal *more* open and integrated than the rest of the world is not supported. We are broadly similar to other advanced economies in both openness of policies and integration of markets, and significantly less integrated than other small economies. New Zealand started opening comparatively recently. The perception that we are 'leading the bunch' may have arisen due to the rapid liberalisation required to catch up with other advanced economies and overcome the burden of distance. It is hoped that both these papers will inform a discussion about the objectives and future directions of New Zealand's external economic strategy and provide a platform for further work.

1.3 Structure of the paper

The paper is structured as follows.

- Section Two introduces the notion of integration and distinguishes market, policy and social integration.
- Section Three provides a framework for thinking about the benefits and costs of further integration in terms of how it contributes to raising the living standards of New Zealanders. We also introduce a new perspective on the nation state.
- Section Four analyses how cross border flows of goods, services, capital and labour affect productivity and incomes.
- Section Five discusses how integration might affect income distribution.

- Section Six looks at the relationship between integration and national sovereignty.

- Section Seven discusses integration and identity.

We draw the threads of the preceding discussions together into conclusions and identify questions for further work in Section Eight. This section also discusses how the ideas in the paper influence the way we think about policy.

We begin by clarifying what is meant by integration.

2. Integration

The choice of 'integration' as an organising concept reflects the view that external economic strategy covers a wide range of policy areas. Discussion in terms of 'trade policy', 'competition policy', 'immigration policy' and so on risks becoming immersed in detail and missing broader perspectives and insights. Since we are interested in informing external economic objectives at the most fundamental level we will adopt this broad perspective.

Integration is a relational term: it lacks meaning separate from discussion of *what* is being integrated. As in Plater and Claridge (2000) we distinguish three dimensions of integration: market integration, policy openness and integration and social integration.

2.1 Market integration

In this paper we are primarily interested in *market integration*.

Market integration between two economies occurs when they function as a single market. Integrated markets will not sustain price differences for very long; any difference will be arbitraged away through quantity and price movements. Goods markets, for instance, are integrated if people in different regions have access to the same goods at similar prices and trade in these goods occurs between regions.[1] If markets are integrated we would expect to see mobility (labour moving between countries, goods trade, capital flows etc) and relatively quick price convergence (wages equalising, similar goods prices in different areas). For two countries with integrated markets, a shock in one country will quickly flow through into the other by price movements and flows. If markets are not integrated we would expect to see little or no mobility, and no, or very slow, price convergence.

We focus on the goods, services, capital and labour markets. These markets are not independent of each other. If all markets between two countries were integrated then we would observe rapid adjustment through both product and factor markets. However, it is often the case that some markets are more integrated than others because of restrictions on flows in certain areas (eg, capital controls, immigration restrictions). In this situation adjustment follows the path of least resistance: flows and prices respond quickly in the market that is the most integrated, leaving the other less integrated markets heading toward price convergence gradually over time.

One complication is that while the presence of flows is evidence for integration, the absence of flows is not conclusive proof of lack of integration. Lack of mobility *may* indicate lack of market integration, or it may indicate an integrated market that is in equilibrium. We can only tell which of these scenarios is true by studying price behaviour and flows after a shock to one location – if we still do not observe mobility after a differential shock we can infer that the markets are not integrated. To fully test market integration we would need to undertake

1 Coleman (1999)

more targeted work looking at price behaviour over time, particularly in response to shocks.

It is worth noting, however, that even within a country markets may not be fully integrated. It is important to keep this in mind when considering how integrated we might aim for our markets to be in an international context.

2.2 Policy openness and integration

Government policy may affect the degree and nature of market integration.

Policy openness allows cross border flows to occur. It implies a lack of barriers to market integration. That goods, services, capital and labour are free to move across borders is a necessary condition for market integration. However it is not sufficient: even if policies are extremely open, flows may not occur for other reasons. Openness implies the potential for market integration to be achieved.

Policy integration refers to the level of similarity or compatibility between policy settings in two countries. Policy integration will be one means by which governments might encourage market integration and lack of policy integration one explanation for lack of market integration. If, say, systems of health regulations and standards are similar between two countries this is likely to facilitate trade in the goods market to which these standards relate. If countries recognise each other's occupational regulations then integration in the service and labour markets is likely to be higher.

These two terms overlap and blur together to some degree. Difference in policy settings, for instance, is often referred to as a 'behind the border' barrier impeding openness. The aim is not to attempt a scientific taxonomy of classes of government policy but rather to distinguish clearly between events in the market (flows, price movements) and policy instruments designed to affect those events.

Dimensions of policy openness and integration include:

- Tariffs and non-tariff barriers;
- Regulations and common institutions regarding, for example:
  - trade in services
  - standards (eg on health and safety, environment, occupational licensing)
  - competition policy and legal systems
  - transport and communication (aviation, shipping, telecommunications, postal)
- Trade agreements and membership of international organisations;
- Monetary policy;
- Fiscal policy;
- Investment rules;
- Immigration policy;
- Political arrangements.

Policy integration is a particularly difficult area because many policy settings will have several objectives. Competition policy, for example, rests on a separate body of analysis about what is good for New Zealand domestically and this may not sit comfortably with the objective of increasing market integration internationally, if it turns out that this is also good for New Zealand. Monetary union with another country may promote market integration but will reduce an individual country's control over monetary policy as a tool to guide the macro-economy. In cases such as these our best policies from a purely domestic standpoint may conflict with policies that will best capture the benefits of integration. A key question is when do we sacrifice our first best domestic policies in order to attain better policy integration internationally?

The objectives of policy openness and integration hinge on what our objectives are with regard to market integration. The bulk of this paper informs the debate on the optimal level of market integration. It will be a further question which policy instruments and what level of policy openness and integration will best achieve our optimal level of market integration. Policy is discussed briefly in the final section of the paper; it is hoped that follow-on work will address these issues in more detail.

2.3 Social integration

Policy integration will not be the sole determinant of market integration between two countries. The level of social integration is also likely to be important. For example, labour flows are more likely to occur between countries that share similar languages, cultures and value systems. There is evidence that this may also be true of trade flows. These less explicit 'social' barriers to trade limit the amount of market integration that can be achieved even with perfect policy integration. Policy integration may be able to increase the level of social integration between two countries to a degree, but the timeframes tend to be very long.

Summary: Integration

Market integration occurs when two economies function as a single market. It is likely to be evidenced by high flows of goods, services, capital and labour and convergence of prices.

Policy openness and integration are means governments might use to encourage market integration. Openness involves goods, services, capital and labour being free to move across borders and is a necessary condition for market integration. It is evidenced by lack of barriers to cross border flows. Policy integration is evidenced by similarity or compatibility of policy settings between countries.

Even with high policy integration, market integration may not occur because of lack of social integration. Differences in culture, language and values make it unlikely that two economies will function completely as a single market.

3. Analytical Framework

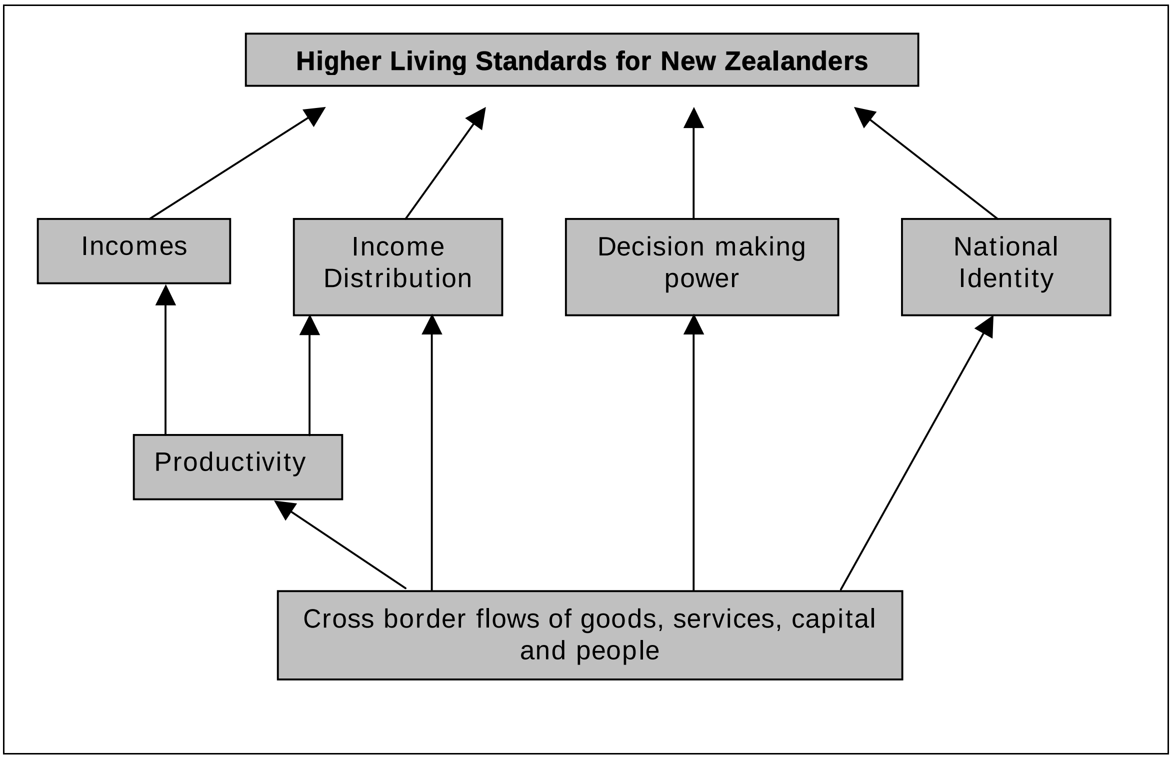
3.1 Higher living standards for New Zealanders

We base our analysis on the premise that the ultimate objective of policy is the promotion of higher living standards for New Zealanders. Our question is: what degree of integration with other countries will best achieve higher living standards for New Zealanders?

The concept of living standards is rich and complex, making it difficult to define or pin down. It is likely to mean different things to different people, and to change over time, making the idea of aggregation into a concept of 'New Zealanders' living standards' particularly problematic. 'Living standards', or well-being, encompasses many elements, both tangible and intangible. It is likely to include physical elements (eg health and security), material elements (eg employment and income), social elements (eg personal relationships, a welfare system), political elements (eg freedom of choice and action), environmental elements (eg clean air, leisure time) and elements that bring a sense of meaning (eg religious beliefs, cultural or national identity). This list is by no means exhaustive! Many of these components of living standards can be affected by government policies; some cannot.

In this discussion we have chosen to focus on four elements from among the large bundle of qualities that comprise living standards: incomes, income distribution, decision making power – particularly at the nation state level, and identity.

Figure 1: What contributes to higher living standards?



Whatever view one takes about living standards, income is important. A large proportion of what matters to individuals and families has to be paid for. Income brings choices; it allows greater levels of consumption, more leisure, greater capacity for individuals to help those less fortunate than themselves, and greater means for the economy as a whole to provide education, health and other social services. The key to higher incomes is productivity. Higher productivity means that more goods and services can be produced for the same amount of resources and effort. Whatever mix of outcomes New Zealanders choose, long-term growth in production and incomes is the foundation upon which higher living standards are built.

Economic theory has taught us that integration and openness are likely to have positive effects on productivity and growth. Section 4 below reviews the evidence on the links between cross border flows of goods, services, capital and labour, and productivity.

Other, broader, aspects of living standards, however, often fuel concerns about trade, integration and globalisation. Some argue that openness has contributed to growing income disparities. Many are worried that globalisation has compromised, and will continue to compromise, our control over our lives and erode both our personal and national sovereignty. This fear is linked to a vaguely defined, but deeply felt, concern about who we are as New Zealanders.

In Section 5 to 7 we discuss the effects of integration on income distribution, decision-making/sovereignty and identity. These three issues have been selected because they seem to be particularly high profile concerns associated with integration and globalisation.[2] Sovereignty and identity in particular are new areas for us: the paper offers some initial thinking and ideas on these topics, but we are by no means experts!

3.2 A new perspective

In our analysis we employ two conceptual windows.

View One: New Zealand as a Nation State

We can think of the world as comprising sovereign nations with borders that clearly differentiate each from the rest of the world. Traditional trade literature puts the focus on New Zealand as a nation, experiencing flows across its borders but not experiencing any effects from the particular spatial patterns of the flows. Traditional political thinking takes the nation state as its base unit of analysis and concerns itself with what the appropriate role and powers of this state should be.

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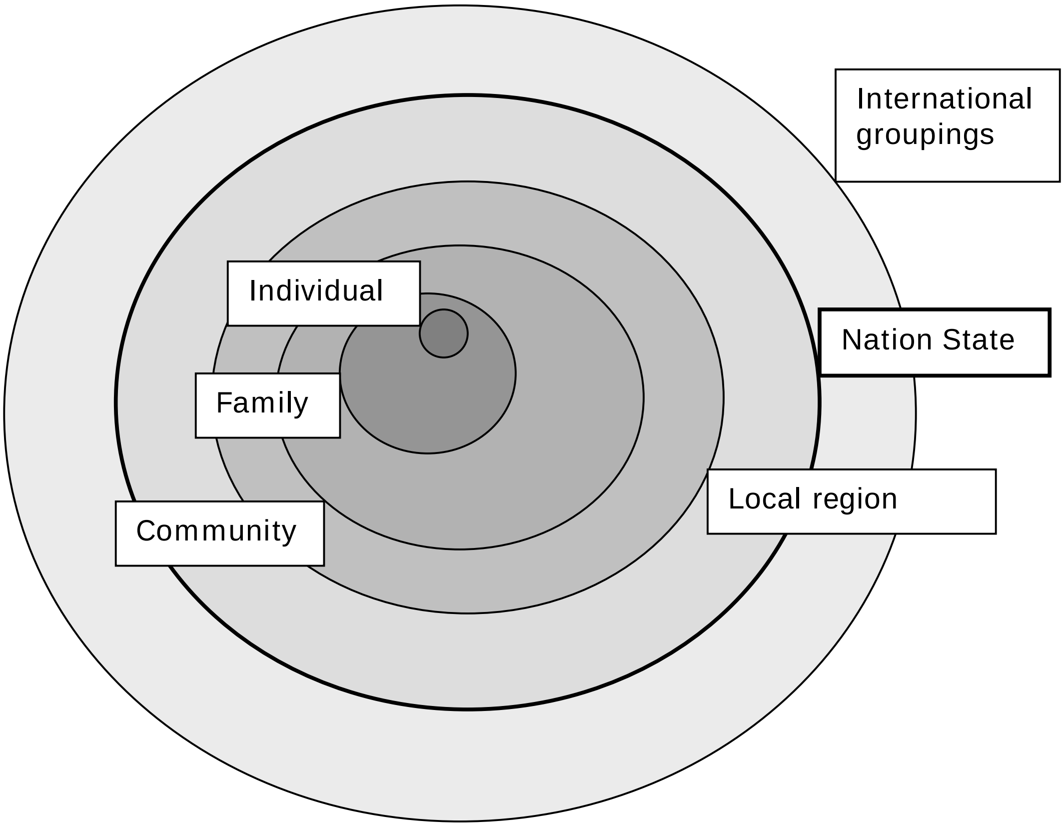
2 Concern about globalisation is also associated with environmental issues. Choosing to discuss decision-making and identity rather than environmental issues in this paper reflects our view that these issues have been less well canvassed elsewhere.

View Two: New Zealand as a Region

Alternatively we can think of the world as a series of concentric groupings. At the most basic level is the individual, or the family. Beyond that there are local groupings at various levels, such as community, city or region. Nations with a federal system include government at province or state level. Beyond state government is national (or federal, or central) government. Beyond nation states there are international groupings, bilateral and regional. Finally, at the widest level, there are international groupings including all of humanity. New Zealand the nation state is but one level of social organization – we are a region within larger regions, and we contain smaller regions within our borders. View Two takes the focus off the nation state and views New Zealand as a sub-region within larger, and smaller, areas.

Figure 2: Conceptual framework – taking the emphasis off the nation state



More recent literature in economic geography takes this view. It puts the focus on New Zealand as a region of a larger space, say, the Australasian region or the Asia-Pacific, or the world. This reveals the implications of spatial location for cross border flows to a much greater degree and provides a different view of the effects of openness and integration. If we apply this perspective to issues of political governance we also gain new insights. Questions about the role of the state broaden to include questions about the level of governance at which decision-making is best carried out.

View One is the more traditional way of looking at the world. We are accustomed to thinking of our planet in terms of political, nation state shaped, chunks. This is to be expected; over the last 200 years, nation states have been the dominant political unit of social organisation.

However, it is important to keep in mind that nation states are a modern phenomenon. Prior to the nineteenth century, social organisation was based on agrarian social structures that were both smaller than nation state units (city states, feudal principalities) and larger (empires, both secular and religious). What View Two helps us keep in mind, is that nation states are not 'naturally' privileged. They are one level of social organization – a particularly important one in the modern world – but there are others. Furthermore, in an increasingly global world, nation states may be losing their primacy. There has been a trend in recent years toward both devolution to lower levels of government and cooperation with higher levels. What these developments have in common is a de-emphasising of the nation state.[3]

Looking at issues of integration from the perspective of View Two sheds a different light on many of the issues. In particular, there are implications for the location of economic activity, governance and identity. Let's keep these two conceptual windows in mind as we proceed with the analysis.

[3] There may be debate about the degree to which nation states are actually losing their primacy. This is a matter for historians and political analysts and, in any case, is secondary to this discussion, since what is being advanced is an analytic tool rather than a statement of empirical fact.

4. Integration, Incomes and Productivity

As discussed in Section 3, living standards have many elements, tangible and intangible. This section focuses on two tangible elements of living standards – higher incomes and employment opportunities – and the role openness and integration play in relation to these elements. It also looks at the ability to purchase a greater variety of goods and services, though in less depth.

This section is structured as follows.

- To set the scene, section 4.1 briefly looks at the link between productivity and higher living standards and argues that productivity is the key to higher incomes.
- Section 4.2 discusses what general effects might improve productivity, introduces some spatial economic ideas and weighs up the importance of domestic policy versus openness in achieving productivity improvements.
- Section 4.3 looks at whether cross border flows of goods and factors can lead to these productivity-improving effects. The discussion is split in two: first we look at New Zealand as a nation, secondly at New Zealand as a region.
- Section 4.4 surveys some recent empirical literature on the relationship between openness and growth.
- Section 4.5 concludes.

4.1 Productivity and living standards

Higher incomes are an important component of rising living standards. They allow:

- greater levels of consumption for individuals;
- more leisure, for example taking more holidays or working fewer hours;
- greater capacity for individuals to help those less fortunate than themselves, through donations of either time or money; and
- greater means for the economy as a whole to provide education, health and other social services, as well as support for cultural activities[4].

The key to higher incomes is productivity. Productivity is a measure of the rate at which outputs of goods and services are produced from given amounts of inputs. Higher productivity means that more goods and services can be produced from the same amount of resources and effort. As output increases so too do incomes, as more wages are paid and profits rise.

Using more inputs can also increase output. However, this implies a cost – that of using the input. It is also possible that increasing inputs may raise overall activity but not increase per capita incomes[5]. Galt (2000) says that productivity is particularly relevant as a contributor to raising GDP per capita or other welfare

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4 Industry Commission (1997), pg 79

5 For a discussion of growth and the contribution of increased inputs see Appendix 1.

related measures of performance, as it does not necessarily require additional inputs to achieve gains. He notes that total factor productivity (TFP) has historically been the single largest contributor to GDP growth in New Zealand[6]. For Australia, productivity growth has accounted for around half the growth in output between 1964-65 and 1995-96[7]. It has also accounted for around two-thirds of the increase in Australian living standards over the same period.

Productivity also affects employment. In general, productivity growth over the long term creates the opportunity for new demands to be created and realised, leading to changes in the pattern of employment, but not necessarily long-term reductions in employment. For OECD countries as a whole, since the early 1970s declining rates of productivity growth have coincided with increasing rates of unemployment, and the period of highest productivity for most OECD countries coincided with the period of lowest unemployment[8]. It appears that there is a positive relationship between productivity and employment.

4.2 What improves productivity?

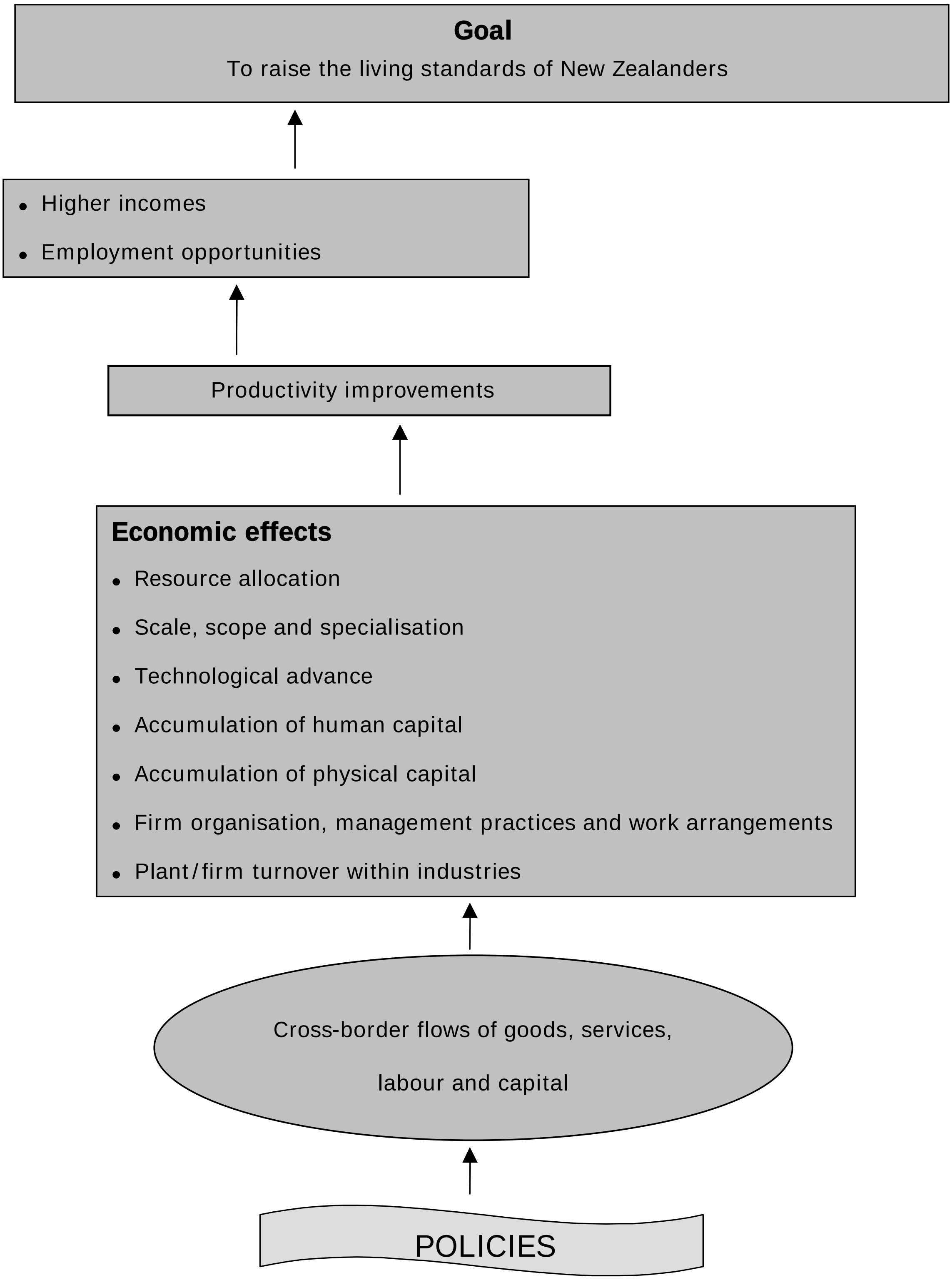
What are the linkages between openness, integration and productivity? Figure 3 lays out the framework we have chosen to use in this section – it shows how cross border flows affect productivity and ultimately the goal of higher living standards for New Zealanders.

6 For a discussion of productivity performance in New Zealand see Diewert and Lawrence (1999)

7 Industry Commission (1997), chapter 3.

8 Industry Commission (1997) pg 104

Figure 3: Linkages between higher living standards and cross border flows of goods, services, labour and capital



Adapted from Productivity Commission 1999, pg 155.

Cross border flows are defined as those flows of goods, services, labour and capital that move across New Zealand's internationally recognised boundary. These cross border flows set off various reactions in the economy. We are interested in knowing whether these reactions are productivity-improving effects. As discussed in section 4.1, if there are productivity improvements then it is possible to raise living standards. Affecting this is the policy environment relating to cross border flows – policies will alter the effects of cross border flows and hence affect productivity.

There are a number of ways that one can classify the various mechanisms for improving productivity. We chose to consider them under the following headings: resource allocation; scale, scope and specialisation; technological advance; firm organisation, management practices and work arrangements; and plant/firm turnover within industries, as outlined in Figure 3. However, in using these headings, we should not lose sight of the fact that all of these ways of improving productivity share a fundamental common component: the importance of high quality decision-making by the firms, individuals and institutions involved. Ultimately, improved productivity stems from better decisions about the use of valuable assets.

Of course, Figure 3 is simplified. We have chosen to focus on the productivity linkages as this provides a dynamic analysis. It is likely that the dynamic story surrounding cross border flows may be more interesting than the static story, with the dynamic benefits of cross border flows outweighing the static benefits due to their ongoing nature. There are other aspects that could be included in Figure 3, for example, the presence of welfare effects. Trade in goods and services allows consumers to enlarge their consumption possibilities, thus improving living standards. This is an important benefit of openness beyond productivity improvements and is mentioned briefly later in the chapter. However, given the static nature of the benefits we chose not to make it a central element of our framework.

The central question is how is productivity affected by openness and integration in the goods, services, capital and labour markets? We approach the answer in two stages. First, in this section, we take a closer look at the 'economic effects' box in Figure 3 – how do we get productivity improvements? Secondly, in section 4.3, we look at how cross border flows affect productivity via our 'economic effects'. Through both of these stages we attempt to distil some key messages. The impact of policy on cross border flows will be addressed briefly in Section 9 later in the paper – this is certainly an area for further reflection and work.

It is important to note that a country's level of integration is only one factor affecting productivity. Domestic policy is also important. At the end of this section we attempt to weigh up the relative value of openness against the value of domestic policy, in order to provide a balanced view of the merits of openness.

4.2.1 Resource allocation

The importance of allocating resources well for ensuring high levels of productivity is intuitively obvious. Essentially, it can be summed up in the statement that "you've got to make the most of what you've got".

Economists have a number of concepts for thinking about resource allocation. The first is simply that resources should not be used wastefully; that one should use the minimum amount of resources to produce a given output, in accordance with technology. This is referred to as *technical or productive efficiency*. The second is that resources should be used in the areas where they can be of most value, given the skills and preferences of the population. This is known as *allocative efficiency*. Note that this idea of allocative efficiency is pertinent both within firms (eg are our productive processes geared in the right way?) and between firms (eg are resources flowing to the right parts of the economy?).

The third concept is that, as time passes, external factors change, for example other countries become more competitive or relative prices for exports change. The economy should be flexible enough to allow changes in resource allocation (structural change) at low cost. This is known as *dynamic efficiency*.

Improvements in all these types of efficiency can lift the productivity performance of a country. While the importance of good resource allocation may seem obvious, it is important not to underestimate its value. Getting resource allocation right over the long-term is crucial to ensuring maximum growth, incomes and employment.

4.2.2 Scale, scope and specialisation

Scale, scope and specialisation offer significant abilities for individuals and firms, and therefore nations, to improve productivity.

Specialisation is probably the most fundamental. The concept holds at the level of the individual, firm and country. For an individual or firm, specialisation suggests focusing on performing a specific task, becoming expert in a particular field, or producing just a few products or services. This allows the individual or firm to become skilled at their chosen task and more productive at carrying it out, particularly as they learn better ways to operate.

For a country, specialisation suggests producing a limited number of products or services but producing more than is required to satisfy domestic demand, and then trading this surplus for other things not produced domestically. The payoff of this ability to specialise is particularly important for such a small nation as New Zealand. By way of illustration, when New Zealand continued to assemble (not actually make) cars in the mid 1990s, it was calculated that car buyers had to pay many thousands of dollars in tariff revenue per car over and above the price other countries could produce and ship the car for. Specialisation at the country level has traditionally been thought of as being driven by comparative advantage, that is, focussing on what we are good at making and importing what we are less good at. However, the rapid growth of intra-firm trade and the observable patterns of countries selling similar products to each other have led to other models of the drivers of specialisation and trade being considered important.

Scale is also an important contributor to productivity. Economies of scale exist when the expansion of activity within a firm allows it to enjoy reduced average costs of production. Higher productivity results as fewer inputs are used per unit of output. The level of output where this effect stops will vary from industry to industry, however, there is no doubt, for example, that the New Zealand dairy industry would not be able to produce milk and dairy products as cheaply as it does if it only produced, say one-tenth, of the current amount. Economies of scale can also encourage further specialisation, unleashing another round of productivity-improving forces.

Finally, *scope* can have a positive effect on productivity. Economies of scope exist when a firm's cost of producing a unit of output can be reduced due to the range of activities carried out by that firm, or other firms in the region. Such effects are the key drivers behind the clustering of firms in a region.

4.2.3 Technological advance

Technological advance is widely recognised as being a central driver of productivity improvements and economic growth. It encompasses the ideas of invention, innovation and diffusion. By definition it helps to improve productivity, as technological advance improves processes for making existing goods and services and creates new goods and services that better satisfy consumers. This improves the efficiency of resource use and helps to make more from resources over time.

Technological advance comes through many avenues. Science based innovation can be very risky and may account for only about 20% of all technical progress[9]. Non-science innovation generally happens within firms and is less risky than science generated innovation.

4.2.4 Accumulation of human capital

The accumulation of human capital is vital for increasing productivity. It is not enough simply to have more workers – those workers also need to be highly skilled and better educated[10]. More educated workers are better at making, using and improving new knowledge, which stimulates technological advance and thus productivity. They are also better at adapting foreign technologies to local conditions – an important factor for a small country such as New Zealand. Skilled workers tend to be more flexible to changes in tasks and processes.

More skilled people also tend to be more discerning consumers. This is also beneficial to productivity as it puts additional pressure on producers to make

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9 Salter & Martin (1999)

10 See Appendix 1 for a discussion of input accumulation and growth.

quality products, use resources efficiently, and come up with innovative new ideas.

4.2.5 Accumulation of physical capital

As discussed in Appendix 1, higher inputs of capital can contribute to economic growth by increasing productive capacity. However, higher levels of capital can also directly help to improve productivity. Firstly, labour productivity is increased as workers each have more capital to work with. This is known as *capital deepening*. Secondly, investment in capital equipment may create *knowledge spillovers* as skilled workers seek to understand and improve on technologies embodied in capital equipment[11]. This 'spillover' effect can help to increase total factor productivity (TFP).

4.2.6 Firm organisation, management practices and work arrangements

The way in which New Zealand firms are organised and managed will affect their profitability, and ultimately the nation's productivity. There is a great deal of evidence internationally that attests to the importance of firm organisation, management practices and work arrangements. Firm organisation refers to organisational structure – a good structure will allow and encourage flexibility and cross-fertilisation of ideas so as to enhance innovation and creativity. Management practices refer to such things as Total Quality Management, strategic planning and human resource management. Practices should support long-term planning and innovation and the ongoing improvement of processes and workers. Finally, work arrangements refer mainly to industrial relations. Workplace and individual bargaining give more scope for flexibility, enables firms to better reward productivity improvements and allows the scope to introduce bonuses and other performance related measures.

In New Zealand, studies suggest that management practices and work arrangements have steadily improved over the last decade, but still fall some way behind international best practice[12].

4.2.7 Plant/firm turnover

Many of the firms that now dominate certain sectors of the economy did not exist 20 years ago, particularly in the "new" technology sectors. It is relatively widely agreed that new firms are the key providers of innovation, and hence that a healthy supply of new firms is essential for a flourishing economy[13]. The flipside is that older, less productive firms need to be able to decline so that resources are released to new firms.

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11 Productivity Commission (1999) pg 151

12 Healy (1999). Also see, for example, Campbell-Hunt, Harper & Hamilton (1993) "Islands of Excellence? A study of management in New Zealand." Also, Campbell-Hunt & Corbett (1996) "A season of excellence?" An overview of New Zealand enterprise in the nineties."

13 Levehsohn & Petrin (1999)

The process through which new firms arrive is important. Statistics suggest that far more firm start-ups occur in any one year than the economy could ultimately sustain[14]. New start-ups literally have to compete to survive against each other as well as the incumbents. This process naturally advantages those with new skills, ideas or technologies that will make them more competitive. This process is nicely captured in the Schumpeterean concept of "creative destruction" where the failure of old firms can be a positive for the economy as a whole.

4.2.8 The spatial element to productivity

There is a spatial element to several of the ‘productivity improving effects’ that we have described so far. By this we mean that *where* something takes place is very important – activity does not exist in a vacuum and the actual layout of activity across space can noticeably affect productivity.

The key issue is resource allocation across space. Agglomeration of resources and production in a particular location can improve productivity, as greater density leads to lower transport costs, greater specialisation of production and labour, labour market pooling effects and knowledge spillovers[15].

Lower transport costs arise due to the smaller distances to suppliers and final consumers. Agglomerations are also often the hubs of transport networks, again making transportation cheaper and easier and lowering overall costs for businesses.

A higher degree of specialisation can be achieved in denser areas by both firms and workers due to the larger market. As scale increases, firms and workers become more efficient at producing or delivering their particular good, service or skill, and productivity can rise. Specialisation also leads to greater variety and diversity of products and services within the agglomeration, benefiting both producers and consumers. Low transport costs help to encourage specialisation as it becomes possible to serve a larger market more cheaply.

The thick labour market in an agglomeration enables workers to be ‘insured’ against firm or industry specific shocks, to better match their skills with jobs, and to have more bargaining power with employers. One US study suggested that doubling employment density in a particular location might increase that location’s labour productivity by 6% and TFP by 4%[16].

Knowledge spillovers are greater in dense areas as the easy movement of workers between proximate firms and the formal and informal contact between people allows ideas and expertise to disperse. Such dispersion of ideas encourages and enables the creation of new ideas, new processes and new products – in other words, encouraging the innovation process. The unplanned idea combinations that are facilitated by proximity are vital for innovation and growth. Knowledge spillovers and greater interaction also spur faster human

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14 Pinfold (1999)
15 See Box (2000) for more detail on this section
16 Ciccone & Hall (1996)

capital accumulation. This is supported by evidence from the US showing nominal wages to be 20% higher in urban areas, even after accounting for differences in worker experience, education, ethnicity and ability[17].

4.2.9 Domestic policy vs openness in achieving productivity improvements

There is an important question to be answered now: is openness of overriding importance to achieving productivity improvements or can domestic policy do the same job? In other words, how important is it for New Zealand to be open and integrated with the rest of the world if we wish to achieve our goal of higher living standards?

For a small economy such as New Zealand, trade may assume greater significance than it would for a larger economy. Small countries face tighter resource and market size constraints and openness may provide valuable access to the means needed for growth. Openness can help to:

- ensure relative prices are undistorted, leading to better resource allocation;
- reduce monopolistic behaviour in the marketplace by allowing new competition;
- give greater opportunities to achieve economies of scale and improve signals for choosing areas of specialisation;
- enable the transfer of technology from other countries to take place;
- provide additional sources of capital;
- introduce quality management practices from overseas; and
- stimulate innovation by widening the scope for applying and selling new products and processes.

Openness and domestic policy are also not unrelated. Closed economies are insulated from pressures to reform and low quality policy settings may be able to persist. Openness can help to stimulate reform and push for higher quality policy. For example, inefficient regulatory systems will hamper domestic producers. An open market will see these producers lose market share unless domestic regulations are improved. Another example is provided by the recent Asian crisis, where countries with weak institutional structures felt the full force of disapproving capital markets.

Empirically, small countries do trade more than large countries, as reflected by trade as a percentage of GDP[18]. This supports the idea that openness is more important to small countries. New Zealand is currently behind many small countries in its trade openness, suggesting there may be further scope for gains from openness.

However, once a country has moved from a ‘fortress economy’ to reasonably low levels of protection, the marginal gains from further integration are not clear. The idea of diminishing returns to openness is raised in Helliwell (1998).

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17 Audretsch (1998), Glaeser & Maré (1999 forthcoming)

18 See Plater & Claridge (2000)

Helliwell suggests that there may come a point where a reduction in border effects yields few additional gains from trade. He says that if there is a critical degree of openness necessary to receive knowledge transfers of the sort required to achieve convergence to higher growth and productivity, then further integration beyond that may not be important for growth. There may be decreasing returns to additional trade and investment, and continuing home preferences may simply reflect an equilibrium where the lower costs of operating with known norms and institutions are enough to offset any growth gains from further increases in the density of international linkages. Helliwell says that for the industrial countries already tightly bound into the global trading system, there are likely to be fewer gains from further globalisation, and that border effects may remain at levels similar to those among the OECD currently without causing any material loss of welfare.

It is unclear what the optimal degree of openness is for New Zealand, or whether we could ever develop an appropriately sophisticated framework for analysis, but the next section will make a start by setting out the effects of free flows of products and factors. We believe this is an important area for further thinking.

Summary: What Improves Productivity?

The economics literature identifies seven major determinants of productivity: resource allocation; scale, scope and specialisation; technological advance; accumulation of human capital; accumulation of physical capital; firm organisation, management practises and work arrangements; and plant/firm turnover. The common component of these determinants is the importance of quality decision-making by individuals, firms and institutions.

The layout of activity across space can noticeably affect productivity. Agglomeration of resources and production in a particular location can improve productivity, as greater density leads to lower transport costs, greater specialisation of production and labour, labour market pooling effects and knowledge spillovers.

Both domestic policy and openness contribute to raising productivity. But for a small country, openness assumes greater importance than it would for a large country because of tighter resource and market size constraints. Openness can also support and encourage domestic policy reform.

There may be diminishing returns to openness but it is unclear where exactly these would set in. The next section helps to inform the debate by discussing the effects of cross border flows of products and factors.

4.3 What effects do cross border flows have?

As discussed earlier, when we talk about cross border flows we mean flows of goods, services, capital and labour across internationally recognised national boundaries. Nations are considered economic units and are analysed as such. This is how traditional trade theories have generally been interpreted.

However, political units and economic units do not necessarily share the same boundaries. Nations become economic units via barriers to trade – explicit tariff-type barriers, red tape and regulations, limited mobility of people, different tastes and diverse cultures. With countries increasingly choosing to integrate with their neighbours or trading partners, the distinction between international trade and interregional trade is blurring. Countries begin to look more like regions, with high levels of trade, specialisation and factor flows.

This section looks at the implications of openness and integration for New Zealand's productivity. We use two conceptual windows to do this – New Zealand as both a nation and as a region of a larger economic area. This gives us new insights and shows that the case for increased integration is not as clear-cut as might be thought. Within each 'window' we take an incremental approach to the analysis – commencing from a completely closed economy, we first examine a world where only goods and services move, then expand the story to include capital and finally labour movements.

4.3.1 New Zealand as a nation

Goods and services

We start the analysis by assuming a world where factors of production remain immobile between countries. Both inward and outward flows of goods and services are free.

Looking first at goods trade, at the simplest level, when goods trade between countries is freed up, the impetus for actual trade between countries is based on having different labour productivities[19] or different resource bases[20]. This introduces the idea that one country can produce some good(s) relatively more cheaply than another country, that is, each country has a *comparative advantage* in the production of something. When trade begins, each country will reallocate resources to, and specialise in, its area of comparative advantage – resources are therefore moved to the area where they have the highest productivity within each country. Each country will then export its surplus production, with resulting gains from trade of enlarged consumption possibilities and cheaper access to goods. With transport costs there may also be some non-traded goods.

This simple story about goods trade leads to some important income distribution implications. These will be discussed in more depth in Section 5,

19 Ricardian model (see Caves, Frankel & Jones (1993) Chapter 5)
20 Heckscher-Ohlin model (see Caves, Frankel & Jones (1993) Chapter 7)

but briefly, labour and capital that is specific to the production of the export good, or that is used intensively in the production of the export good will tend to benefit. Factors specific to, or used intensively in, the import-competing sectors tend to lose. However, if ‘loser’ factors can shift their specificity (for example, retrain) there will be scope for them to benefit from trade. There is also scope for redistribution of the gains from trade.

When we incorporate second-round gains from changing resource allocation and specialisation a more dynamic story emerges. The first situation is where firms have internal economies of scale. There is an immediate productivity gain from trade and specialisation as the larger market allows a bigger scale of production and leads to a falling cost per unit. There will also be more variety for consumers as the number of firms and types of good increase with trade[21]. Individual countries can be constrained by the size of their domestic market in industries with economies of scale – trade overcomes this and offers opportunities for mutual gain even if countries do not differ in their resources or technology. There can also be productivity benefits from increased competition in the marketplace – firms will have greater impetus to make good decisions about their resources, to keep up with technological advances and innovations, and to keep their workplaces flexible and responsive to change[22].

The pattern of trade becomes less predictable in this type of world – while comparative advantage will drive inter-industry trade, for example trading cars for butter, it does not fully explain intra-industry trade, where different varieties of the same good are traded. One country will be a net exporter of the differentiated product and this will reflect their underlying comparative advantage, but it is unclear which country will export which variety of the good – history and accident will play a part. The relative importance of inter- and intra-industry trade depends on how similar countries are – more similar countries, in terms of capital/labour ratios, skill levels and incomes, have higher proportions of intra-industry trade. Intra-industry trade makes up a large part of world trade, especially in manufacturing trade between advanced industrial countries, and gives great scope for welfare gains in terms of variety and productivity gains.

When intra-industry trade dominates, the income distribution effects are small. This is because intra-industry trade does not lead to large changes in relative prices between industries. Rather it stimulates resource allocation within an industry, between different varieties of a particular item. Intra-industry trade does not tend to lead to whole industries declining. An example is provided by the European Union – trade grew rapidly in the first few years of integration but this did not cause drastic economic dislocation. The reason was that much of the increase was in intra-industry trade where each country was gaining from the increased efficiency of a larger market[23].

The second ‘dynamic’ situation is where there are external economies of scale: here the gains from trade stem from scale economies from increased output at

21 Krugman & Obstfeld (1994)
22 See for example Brander & Krugman (1983)
23 See Krugman & Obstfeld (1993) pg 132

the industry level. As before, the increased scale leads to greater specialisation and productivity gains. However, history and path dependence play a role in the case of external economies of scale. A country that has a high level of production in a certain industry, for whatever reason, will tend to have lower costs in that industry. Since a country that has lower costs in the production of a good tends to produce more and export that good, this leads to a positive feedback loop. Countries that start out as large producers may remain large producers, even if some other country could potentially produce the goods more cheaply. This gives a role to historical accident and raises the possibility that a country may be left worse off as a result of trade if it could produce the good more cheaply than its trading partner but is unable to break into the established market due to its later start. This is also true in cases where external economies are based on the accumulation of knowledge or experience[24]. Both these cases are commonly used as arguments for industry protection (see boxed discussion below).

However, path dependence may be overcome – tastes and technology change and new opportunities can present themselves most unexpectedly. Perhaps the lesson is that history matters, but you never know what is around the next corner.

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[24] ibid pg 142, also Krugman (1991).

Industry Policy – A Discussion

Theory suggests that, under certain circumstances, government support of a domestic industry against foreign competition can reap net benefits for the country. The benefits stem from the increased scale and market share of the industry.

There are several considerations that undermine this direction for government policy[25]. Firstly, the policy recommendations are sensitive to the industry's market structure – competition based on price suggests a tax on the home firm, whereas competition based on output suggests a subsidy. Government would have to hold extremely accurate information about firm behaviour in order to determine the policy intervention. Secondly, government subsidies can induce excessive entry into the industry, leading to resource misallocation and failure to achieve economies of scale at the firm level. Thirdly, there is a risk of foreign retaliation. Fourthly, there is a risk that special interest groups, whose lobbying can compromise the effectiveness of policy and whose 'noise' makes it difficult to collect accurate data and information, will capture policy. Finally there is the fiscal cost of paying for industrial support.

At a practical level, there are difficulties in selecting the right industry to support. There are also costs if chosen industries fail to reach independence, or if supported industries fail to advance. In short, the theoretical ideas about economies of scale and trade do not lend themselves to clear and simple policy implications when we look through the traditional 'New Zealand as a nation' lens.

Nonetheless, many countries choose to undertake industry policy. Some have had more success than others. The interesting point to note is that many developing countries choose to use trade policy as their industry policy lever to encourage manufacturing over agriculture in order to 'catch-up' to developed countries.

Some countries use tariffs and other protective policies to encourage the replacement of imported manufactures by domestic products. These policies have been successful in encouraging manufacturing in some countries but in others there has been stagnation in per capita income growth and lack of catch-up to advanced countries. The policies can also give rise to a dual economy where one section of the economy and population is doing well while the other struggles. The policies can lead to a widening distribution of incomes. Often the export sector suffers. Other countries follow a more export-oriented policy. This is not strictly free trade, but rates of protection are lower and less variable across sectors. Countries that fall into this category would include Korea, Taiwan and Singapore. All these countries have had quite successful economic growth stories.

In general though, using trade policy tools for industry policy purposes is costly. There are other policies that aim more directly at industry policy goals and these will be more efficient and effective. It may be that for a developing country, the tax base is too unstable to sustain subsidies to industry, and so trade policy is used instead. But for a developed country, direct tools should be used. Industry policy and trade policy should not be confused.

Should industry policy be used at all? From these arguments, the answer seems to be 'no'. But when we look through our 'New Zealand as a region' lens? Read on...

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[25] See Cheng (1999)

Analytically the story about services trade is similar to that for goods trade. There are gains from specialisation, the reallocation of resources, economies of scale and innovativeness stemming from competitive pressures. Competition in the service sector can also reduce costs for other businesses that use services as an intermediate input into their own production.

However, the movement of services across borders additionally implies the movement of people and/or extensive use of telecommunications networks. The movement of people would usually be only temporary, for example, an engineering consultant from New Zealand going to Asia for a few months, or an American tourist coming to New Zealand for a holiday. Temporary foreign workers can be an important source of new ideas and New Zealanders who work temporarily overseas can also pick up new ideas and contacts that can later benefit activity in New Zealand. The movement of labour will be discussed in more depth later in this section.

Unilateral Liberalisation – What are the Gains?

The discussion in this section has implicitly assumed that New Zealand is liberalising goods and services trade in concert with its trading partners. But unilateral liberalisation can also allow us to tap into some of the gains from trade, even if our partners keep their barriers up.

New Zealand's high rate of protection in the 1960s and 1970s led many commentators to call for liberalisation. Carpinter (1979) concluded that the method of protection in New Zealand, specifically quantitative import controls, was detrimental to economic performance. Local price signals were distorted and international competition stifled, leading to unprofitable enterprise, distorted investment, stunted exports, inefficient use of resources, poor productivity growth and continued Balance of Payments problems.

Lloyd et al (1980) agreed, saying that major structural change was a necessary condition for acceleration in the rate of growth of real output. Government assistance to industries in the form of restrictions on import and export trade distorted the allocation of resources between and within the export and import-competing and non-tradeable sector. This reduced the level of international trade and the size of the tradeable sector and slowed the rate of growth of productivity by restricting competition and hindering adaptation to structural change. Lloyd saw the removal of this government assistance as important in promoting structural change and economic growth.

Unilaterally removing layers of protection allowed New Zealand to access the benefits of openness. It also paved the way for more far-reaching liberalisation, for example, CER with Australia.

Capital

Once we allow factors of production to move the analysis becomes more complex. In this section we look at the impact of allowing free movement of capital across borders. This includes movement of both direct investment funds and portfolio investment funds.

There are a number of general benefits of allowing free capital flows[26]. To begin with the domestic cost of capital moves closer to the global cost of capital. The true value of an investment opportunity will be judged more accurately and resources will therefore be better allocated. Also contributing to better resource allocation is greater transparency, which reduces favouritism and corruption in the system; fewer resources are wasted on attempting to dodge controls through bribery for example. Secondly, countries may be able to borrow and lend on more favourable terms. This flows through into lower costs for firms sourcing capital. This gain stems from breaking the constraining link between domestic saving and investment as countries and firms can draw on foreign savings to finance domestic investment. However, pushing against this, there is evidence that home bias in portfolio investment remains, even with free capital flows, due to the perceived advantages of dealing with the 'familiar' outweighing the perceived benefits of diversification[27]. Allowing firms and countries to access foreign savings also raises issues around the level of the current account – a large appetite for foreign borrowing may increase the current account deficit to such a level as to increase the cost of borrowing for the country as a whole.

Another general benefit of open capital markets is the greater level of portfolio diversification available. This can reduce the volatility of investment returns and even increase actual returns if higher returns may be gained on foreign asset holdings. Open capital markets also encourage innovation and efficiency in domestic financial markets, as well as supervision and good regulation of the financial sector. Finally, the multilateral trading system is supported by free capital flows, since payments for goods and services can be made freely, and more sophisticated financial arrangements (e.g. futures) can be entered into, which stimulates further trade.

There is some debate over whether capital flows are a substitute for trade. Trade theory tells us that movements of factors of production can alter production in such a way as to remove the need for trade in goods and services. However, given the simultaneous rise in both levels of trade and levels of capital flows over history, one could suggest that capital flows are a complement to trade, hence the idea that capital flows support the trading system.

There are some particular benefits to be gained from allowing free movement of direct investment funds. Inward direct investment often brings with it new technology and ideas, management competency and formal training of the workforce. It can also lead to greater competition in the marketplace. These factors all contribute to productivity improvements. The benefits can also

[26] Box (1999a), Chapman (2000)

[27] Helliwell (1998) pg 69-72

spillover to domestic firms as people move and ideas disperse, initiating further productivity improvements. A good example of the benefits of inward direct investment is provided by Ireland – foreign firms in Ireland employ highly skilled people and tend to pay significantly higher wages than domestic firms[28].

Outward direct investment brings benefits as well. Most importantly, New Zealand firms offshore may transfer new technology or knowledge back to New Zealand. Being located in an offshore market not only offers opportunities to pick up new ideas, it may also provide greater impetus to innovate if the market is large, as the potential to appropriate the gains is bigger. Secondly, offshore firms may provide domestic firms with access to networks of suppliers, distributors, researchers and other important contacts that provide valuable externalities that are inaccessible from a New Zealand base. Thirdly, it may be easier to access offshore markets via direct investment in the market, and it may also get around domestic production and marketing constraints and allow greater economies of scale. Finally, investing offshore may allow New Zealand firms to experiment with new techniques for management and with new organisational options, which can then be brought back to New Zealand and operationalised.

However, there are concerns over both inward and outward foreign direct investment. Inward foreign investment raises issues such as the ownership of assets and sovereignty, while outward investment raises issues such as the loss of domestic jobs. The first two concerns will be explored in more depth in Section 6. The loss of domestic activity will be discussed later in this section in the context of 'New Zealand as a region'.

There are also potential costs of having open capital markets[29]. These costs have taken on greater visibility of late with the financial crisis in Asia and earlier difficulties in Latin America. To begin with, capital flows may harm domestic economic activity. There are a number of reasons why this might occur. Firstly, capital flows cause adjustments in the real economy, that is, production and employment. As the real economy responds to change more slowly than financial capital there can be real adjustment costs imposed by volatile flows of capital, or by a sudden outflow of capital. A greater amount of liquidity will magnify any change in market sentiment and increase the risk of contagion. Secondly, capital flows may cause excessive changes in, and misalignment of, domestic asset prices and may lead to inflationary pressure. Excessive interest rate variability may lead to under-investment in real capital. Thirdly, free capital flows imply a freely floating exchange rate. New models of exchange rate determination that are based on the process of information gathering and expectation formation show that the exchange rate can get severely out of line with fundamentals, leading to the exchange rate being a source of shocks in the economy rather than an absorber of shocks. It can also cause resource misallocation, particularly between the tradeable and non-tradeable sectors[30].

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28 Barry & Bradley (1997), see Box (1998) for more information on the Irish economy.

29 Box (1999a), Chapman (2000)

30 See Coleman (1998)

However, others argue that strong institutions and well governed banking sectors will lessen the risk of open capital markets imposing costs on economies.

Another argument against free capital flows is that they may act as a constraint on government actions. International credit ratings affect the cost of capital faced by a country, thus monetary and fiscal policies come under the spotlight. On the other hand, free capital flows could be seen as positive constraints on government behaviour by making the costs of decisions more transparent. Other concerns are that the accumulation of foreign liabilities may also cause difficulties with the current account, as mentioned earlier in this section. Capital flows may also be a source of inequality within a country if foreign interests cause rapid asset price inflation, for example in land. There are also issues over ownership[31]. These latter issues will be discussed in more depth in Section 7.

To conclude, free flows of capital, both inward and outward, are another important source of productivity improvements. But they have potential costs. Better resource allocation and new sources of ideas and technology must be weighed up against possible greater volatility and uncertainty. Strong institutions and well-governed banking sectors may reduce the risks. A degree of home bias exists, which reduces the total volume of cross border capital flows.

Labour

The final stage of the analysis is to allow free flows of labour across borders. Of all the flows we have looked at, labour is the least likely to ever achieve full mobility. There are important cultural reasons why people stay attached to their homeland, and feel threatened by outsiders moving in. This section seeks to set out the benefits and costs of cross border labour movements.

The macroeconomic effects of inward flows are difficult to pin down[32]. Empirical estimates of the growth effect of immigration are highly dependant on the starting assumptions, particularly whether immigrants increase economies of scale. The overall effect is regarded as a small positive; economic activity overall will increase but the effect on per capita incomes is ambiguous, with the effect depending on migrants' personal profiles (skills, assets, education), saving and investment habits and consumption habits.

New Zealand seeks immigrants with high human capital and entrepreneurial skills in order to maximise the chances of positive growth effects. These attributes also contribute positively to productivity. Indeed, evidence shows that immigrants to New Zealand who have higher skill levels and good English proficiency have better labour market outcomes, and the intergenerational transmission of skills suggests their children too will perform better in the labour market. Entrepreneurship is more difficult to assess, as asset accumulation does not necessarily lead to investment in active ventures. Many wealthy migrants to New Zealand seem to prefer passive investment. However, even if high human capital and entrepreneurship could be easily assessed, New Zealand

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[31] Chapman (2000)

[32] See Box (1999b)

still faces the problem of attracting this type of migrant against competition from other migrant nations such as Australia, Canada and the US.

Immigration may also improve productivity by contributing to labour market efficiency. Migrants make up a disproportionately large fraction of marginal workers whose location decisions arbitrage differences across labour markets. US evidence has shown that new immigrants are more likely to choose the location that maximises their income, whereas residents and previous migrants tend to get stuck in a location and not respond immediately to wage differentials[33].

The distributional effects of inward flows of labour may be more important than the overall macroeconomic effects. Theoretically, free labour flows will increase pressure for wage equalisation as people move from places with low returns to places with high returns. There is some evidence from the US that immigrant inflows depress the employment rate and wages of natives in the same skill group[34], but overall there are still vast differences in wages across countries. However, there is evidence that wage equalisation already exists if one takes labour productivity into account – there are higher wages for labour with higher productivity across all countries, suggesting that the global labour market is at work[35].

Outward flows of labour also have important implications. Emigration of skilled people is often referred to as ‘braindrain’ and is considered to be a negative influence on growth and productivity in the home country. Yet these people often return to their home country with new skills, knowledge and networks of colleagues that have a positive influence on productivity. This suggests we need to think more broadly about what benefits the New Zealand economy. Contributions such as overseas experience and lifting New Zealand’s profile offshore may be just as important as fiscal measures such as tax paid. This discussion also raises the question of what it means to be a New Zealander – whether once someone leaves the country they cease to exist in the official statistics and so we lose sight of their achievements and contributions. This is an extremely thorny question, as it ultimately asks of policy – ‘whose welfare are we trying to maximise?’ This area is certainly worthy of more discussion and debate, and the question of identity is traversed in Section 7 of this paper.

As with flows of capital, we can ask whether labour movements are a substitute or complement to trade. We suggest the latter probably holds, particularly since labour maintains an immobile element due to cultural reasons. As alluded to above, emigrants can raise New Zealand’s profile offshore – this may be invaluable in building greater trade linkages and demand for New Zealand products. Immigrants can also assist in building trade linkages with other countries if they bring entrepreneurial skills, market knowledge and contacts/networks from their home country. It may be important for immigrants to have business skills to complement their language skills in order to fully

33 Borjas (1999)
34 David Card seminar – see Box (1999b) pg 11 footnote
35 Trefler (1993)

exploit these trade opportunities. Empirical evidence suggests there needs to be a critical mass of immigrants from a particular country before trade is stimulated, but the exact number is unclear. These immigrants may also need to be in the same place/city. The process of building trade linkages is a long-term one, requiring on-going effort.

Summary: New Zealand as a Nation

Free trade in goods and services yields productivity-improving benefits in the form of better resource allocation, specialisation, economies of scale and impetus for innovation. There are also consumer welfare benefits from increased choice in the marketplace. The temporary movement of labour associated with goods and services trade brings additional benefits in the form of new ideas and foreign contacts and networks. New Zealand's program of unilateral liberalisation allowed it to start tapping into these productivity benefits despite slower movement by trading partners.

Both inter- and intra-industry trade will take place. Intra-industry trade leads to smaller income distribution effects as this type of trade involves shifting resources between different varieties of the same industry, rather than shifting resources between whole industries.

Free flows of capital, both inward and outward, are another important source of productivity improvements. But they have potential costs. Better resource allocation and new sources of ideas and technology must be weighed up against possible greater volatility and uncertainty. Strong institutions and well-governed banking sectors may reduce the risks. A degree of home bias exists, which reduces the total volume of cross border capital flows.

Free labour flows bring productivity benefits in the form of efficient labour markets, human capital accumulation, innovation and scale. However, labour flows are more emotive than flows of goods, services and capital – different cultures, languages, attitudes and institutions hold the world back from complete labour mobility. Greater movement of people around the world raises issues of national identity and what it means to be a New Zealander. This creates tricky questions for policy, around whose welfare we are trying to maximise. We believe this is an area ripe for debate.

4.3.2 New Zealand as a region

Now let's change our perspective and look at New Zealand as a region within a larger geographical and economic area. When we begin to think about New Zealand as a region, we need to employ some spatial economic ideas.

Goods and services

From the discussion above we know that trade in goods and services will see countries specialising and perhaps ceasing to produce in certain industries or certain niches of industries. Resources will shift towards the area of specialisation. Adding in the spatial dimension suggests that export-oriented firms will feel a greater push to locate in places within New Zealand that have good market access, for example close to a port, or particularly good access to raw materials. This will help to lower costs and improve productivity. Their choice of location will also influence the location decisions of other firms that provide goods and services to those exporters or to the workers employed there.

The benefits from agglomeration, as discussed in section 4.2.8, all suggest there can be significant productivity improvements if firms, as a result of free trade in goods and services, decide to co-locate in particular areas. These productivity improvements are over and above those obtained from simple specialisation and resource reallocation between industries.

As only goods and services are moving in this initial stage of the analysis, the shifts in the location of resources we will see are within New Zealand, rather than between New Zealand and other countries. This has implications for New Zealand's regional activity levels – some areas may decline while others grow. While these shifts will generally have positive effects on productivity overall, equity concerns may be raised about regions experiencing a loss of activity.

The use of telecommunications technology to link producers and consumers is good news for New Zealand – despite our geographic disadvantage, the use of technology may allow us to compete in foreign markets. However, this must be tempered by caveats around how far technology can go in removing the need for proximity. Human contact is still extremely important due to the way information and knowledge flow between people. The most important flows are of tacit knowledge and since such knowledge is vague, difficult to codify and often only recognised by accident, it is important to transmit it face to face. It is likely that telecommunications will remain a complement to face-to-face contact rather than a substitute[36].

For regions within New Zealand, technology could be a double-edged sword. On one hand, technology could allow declining regions to maintain activity levels through, for example, providing remote services to the rest of New Zealand and perhaps foreign consumers. On the other hand, given the importance of agglomeration benefits, even firms that provide their services remotely may still choose to locate in a dense area. They may need access to technology support services, or feel that the business network available in an agglomeration will help them identify new customers. Dense areas also offer consumption benefits, which are attractive to workers who like greater variety and diversity. This leads cities to have a larger pool of prospective employees, again making dense areas attractive to firms. These effects would work against declining regions.

Capital

When we allow the free movement of capital across borders we can begin to ask interesting questions about firm location decisions. With the free movement of capital, firms are free to come to New Zealand but are also free to leave. Taking the argument from the 'goods and services' section further – if firms choose their location based on market access and access to raw materials and factors of

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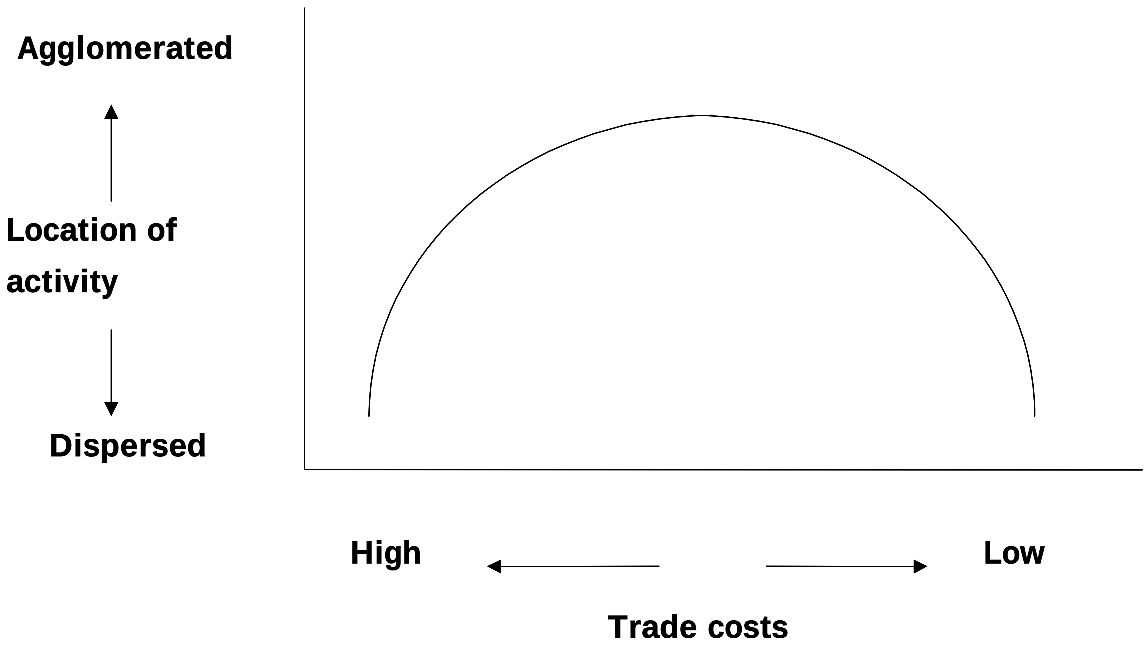
[36] Box (2000)

production, and if they take into account agglomeration benefits and costs, then would they choose to locate in New Zealand?

One way to examine this question more closely is to think about the level of trade costs (trade barriers and transport costs) in trade between countries[37]. These countries can be described as either ‘core’ or central countries, or as ‘periphery’ countries. When trade costs are high, activity/firms will spread across the core and periphery so that dispersed or immobile consumers can be served. At this point the benefits of agglomeration are not high enough to outweigh the costs of getting goods to dispersed consumers from a central production point. When trade costs start to fall it becomes easier to separate production from consumption and firms that operate under scale economies will choose to gain the benefits of agglomeration by clustering in the core. However, when trade costs fall to extremely low levels, the net benefits of agglomeration and proximity to others may diminish. Firms will be less willing to pay high wages in the core and may choose to disperse out to the periphery again. These relationships are illustrated in Figure 4 below.

The effect of technology on the relationship between trade costs and agglomeration is unclear. As suggested in the previous section, technology can act as a double-edged sword. It can make it easer to access agglomeration benefits remotely and provide goods and services locally (i.e. locate in the periphery), or it can make it easier to agglomerate and provide goods and services remotely (i.e. locate in the core). It is up to individual businesses to assess their own situations and choose the scenario that best serves them.

Figure 4: Trade costs and firm location



[37] Venables (1998)

The questions are: where on this diagram is New Zealand; and how fast are we moving along the curve as trade costs fall? As a small geographically distant economy we could realistically describe ourselves as belonging to the periphery. Are firms at the point of wanting or needing to be in New Zealand; that is, are the dispersion forces pushing firms to locate in New Zealand? Or are agglomeration forces dominating, and if they are, is New Zealand able to sustain an agglomeration of its own or will the country become a declining region on the periphery? Will technology ever reduce the need for proximity enough to make mass dispersion to the periphery a viable option?

These questions could reveal a sombre scenario – one where firms seek to locate in regional hubs rather than New Zealand so that they may enjoy the benefits of agglomeration. That is, resources may be reallocated and achieve higher productivity, but at the same time the overall level of activity in New Zealand may drop as these productivity improvements are gained from resources moving offshore. This is even more of a concern if cumulative causation sets in. This would happen when regional decline makes a region even more unattractive, with the result being a negative spiral ending perhaps in regional death. Another concern is that increased specialisation resulting from firm exit may make New Zealand more fragile and vulnerable to external shocks.

However, we must be careful to conduct a reality check. The scenario above is based in theory. While theory works on the basis of free capital flows, in reality there are often practical reasons for firms to be wary of offshore operations – it is harder to operate in a foreign market with different rules, regulations and approaches. These 'barriers' to cross border integration are referred to as border effects and they play an important role in determining trade and investment flows. These border effects may place upper limits on the movement of activity offshore. Different industries will also prefer different levels of density, depending on the type of operation. This means that those firms who are happy operating in a less dense environment will be more inclined to stay within New Zealand. It would be interesting to know how various levels of density appeal to different types of firms, both within New Zealand and offshore. And of course, some firms, particularly those involved in natural resource based activities, have less ability to relocate.

Empirically, the evidence on 'footloose' firms is mixed – some industries, such as assembly, seem to follow lower costs around the world, while others seem very loyal to their home market. A recent survey of manufacturing exporters in New Zealand found many owners would choose to remain in New Zealand for lifestyle reasons or because they felt some sort of 'social conscience' in supporting the local economy. This was true even if there were opportunities offshore[38]. This is an important reminder that location decisions are complex and the result of many factors. More analysis is needed in New Zealand to determine just how mobile firms really are, how many firms move and where they go to and the effects of firm departure on remaining activity. It will also be useful to monitor progress in the European Union, as a large natural experiment in the effects of integration.

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38 Infometrics (1999)

Lion Nathan Roars off to Oz

Earlier this year, Lion Nathan shifted its headquarters to Australia. Also this year, Carter Holt Harvey's packaging division moved its head office to Melbourne, while the group's tissue division had already moved its head office there over a year previously.

What is the impact on New Zealand of moves such as these? Are they cause for concern?

One view is that New Zealand is an incubator. Firms expand to a certain point then spread their wings and move offshore. Since new firms are often the most innovative and dynamic, being a business incubator may not be a bad thing.

However, in practice, are there enough births of high quality new firms to balance the outflow of mature firms? Does the exit of firms lead to lower overall business confidence and investor confidence in New Zealand? If we take the ideas about cumulative causation and the decline of regions seriously, could industrial policy be seen in the light of maintaining critical mass? Given that headstarts count when external economies of scale exist, could there be a rationale for supporting industries if we think increasing openness could erode New Zealand's activity base?

More work is needed to unpick the story around firm birth, death and mobility so that we can begin to answer these important questions.

Before we move on to discuss cross border flows of labour, we can ask what the consequences are of having free capital flows but no labour mobility. We have seen in this section that firms may decide to move offshore to access agglomeration benefits. If people are unable to move, they may find that their particular skills are not in demand domestically – there may be higher unemployment unless people can retrain. This does not bode well for a highly skilled workforce if New Zealand's specialisation remains in primary products. There are also implications for social spending; lower activity levels suggest lower tax revenue, which puts pressure on fiscal initiatives. This is particularly so in a country that does not receive transfers from a larger regional body. The next section explores the consequences of allowing free labour movement.

Labour

Allowing free movement of labour takes us to the depths of what it really means to be a region. So far the discussion has looked at the consequences of goods, services and capital flows in the context of New Zealand as a region of a larger space. We have seen that once factors of production start to move there are important consequences for the location of activity. The true definition of a region is where there are high trade flows, a high degree of specialisation and capital mobility and a high level of labour mobility. We now add this last step.

As in the 'New Zealand as a nation' discussion, completely mobile labour leads to wages equalising across regions as workers move towards higher wages and away from lower wages. This has an important implication – a region can only export goods in which they have an absolute advantage (i.e. lower unit labour requirements/higher productivity than any other region). Those regions that do not have an absolute advantage in anything will decline[39].

This idea can come as a surprise. Trade theory usually tells us that comparative advantage is the key concept. That is, countries specialise in and export that good in which they have comparative advantage – absolute advantage is not needed because low wages will make up for low productivity and the goods will be cost competitive. But in an integrated market where countries begin to look like regions it is absolute advantage that matters. This is because free labour flows will stimulate wage convergence across the region – workers will move towards higher wages and away from regions with low wages. Once wages are equalised across the region, low productivity is no longer matched by low wages, making low productivity areas unattractive to firms. Locations need to be absolutely more productive in some good or service in order to sustain activity.

Changes in tastes or technology can alter the absolute advantage of a region for better or worse. In New Zealand for example, the reduction in the use of coal as a fuel has led to the decline of many 'coal towns', but aerial top-dressing of fertiliser enabled some marginal land to become productive. However, there are other forces at work that suggest regional decline or growth, once started, may be self-reinforcing. Agglomeration forces can mean that a region that loses some industries will then become unattractive to other industries, leading to a cumulative process of decline. The level of change needed in tastes or technology to reverse this process is unclear.

Applying these ideas to New Zealand, it appears that free labour flows could conceivably lead to large-scale emigration as people move offshore in search of higher wages. At the limit, if New Zealand had no absolute advantage in any good or service, the country would depopulate.

However, this is a theoretical scenario. In reality, it is unlikely that labour will ever be completely mobile between countries. Different cultures, languages, attitudes and institutions will ensure that cross-border labour mobility will not reach 'within country' levels[40]. In addition, New Zealand would appear to have an absolute advantage in at least tourism and some agricultural products – if there was complete labour mobility it is likely that activity would still locate in New Zealand. Look at New Zealand's specialisation when it was tightly linked to the United Kingdom, for example.

What does openness and integration mean in the more realistic case of incomplete labour mobility? More highly skilled people tend to be more mobile

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39 Krugman & Obstfeld (1994) pg 182

40 Helliwell (1998)

than the unskilled. Thus, skilled and educated workers tend to leave declining areas first, reducing job opportunities for those who remain. Of those remaining, some may be unable to move because of barriers to adjustment, for example, being unable to afford a house in a bigger town. Others may not want to move for cultural reasons. Others may stay simply because they are happiest there. Whatever the reason though, people remaining in declining regions are likely to face persistent unemployment and disadvantage.

The implications of incomplete labour mobility for New Zealand could be that, as a region, we lose many skilled workers and are left in decline. This is particularly so if agglomeration forces make offshore locations more attractive to firms as well. The ‘brain-drain’ may become a bigger issue if there is no activity in New Zealand for these people to return to. Cumulative causation could ensure a permanent decline.

More work needs to be done to understand international labour mobility, in particular ascertaining how mobile various subgroups of the population are and what drives their decisions. Understanding the factors that might draw people back to their home country is also important from a policy perspective. As noted in the previous section, lifestyle considerations can be an important driver of location decisions. New Zealand’s attractive physical attributes, smaller population and slower pace of life may well swing the balance in favour of remaining at home, or returning home after a spell overseas.

Migration – Practical Policy Issues

The movement of people across borders can raise some tricky policy problems.

For example, a young New Zealander finishes university with a $30,000 student loan and then moves to the US to work. Should the New Zealand government be able to recover loans from citizens while they are overseas in the same way they do for citizens within New Zealand? How would we go about this?

Another interesting policy issue concerns superannuation. Should a retired New Zealander be able to take their super entitlement with them if they move overseas in their retirement? Or, if someone has spent a considerable amount of their working life overseas, should they be entitled to super payments on their return to New Zealand?

And tax rates – does increasing mobility of people mean that there is increased pressure for lower income tax rates?

In the past we traditionally took a ‘New Zealand as a nation’ model, and one option under this view was a closed economy. However returning to ‘fortress New Zealand’ is no longer an option: technology, communications and the global economy have changed too much. People are mobile and this is likely to continue. Some policies based in the nation state paradigm will therefore come under increasing pressure to change in the future and we need to be prepared to think about them.

As a final comment, the idea that we need to worry about New Zealand declining implicitly assumes that we are more concerned with people remaining in New Zealand (residents) than we are about New Zealanders scattered about the globe (citizens) – while integration may well leave residents worse off, there will be many citizens who enjoy great opportunity and advantage from being able to migrate themselves or their firms to offshore locations. Again, we highlight the importance of this issue of 'whose welfare we are optimising' in an increasingly integrated world.

Summary: New Zealand as a Region

Analysing New Zealand as a region introduces us to some important new concepts around the location of activity. Looking first at free flows of goods and services we find that the stimulation of agglomeration within New Zealand will lead to productivity-improving effects beyond those revealed by standard trade theory. However, the movement of resources within New Zealand will cause some regions to grow while others decline, and this may cause concern.

Technology opens up opportunities to service markets remotely. This could be important both for New Zealand and for regions within New Zealand. However, face-to-face contact is very important for the exchange of tacit information and this type of information is vital for the development of new ideas, processes and products. This suggests limits to the use of technology in overcoming geographic disadvantage. Agglomeration benefits may encourage remote service firms to still locate within a dense area.

Analysing New Zealand as a region also reveals further implications of free capital flows. Crucial questions about firm location are raised. Can a small country on the periphery sustain an agglomeration? Will technology ever completely remove the need for proximity? Are there important border effects that put an upper limit on the flow of cross border capital? Could the loss of activity lead to an ongoing negative spiral ending in stagnation for New Zealand? These questions need to be informed by empirical work – how footloose is capital in reality, what level of density do various firms need and how far can we take these theoretical predictions?

Moving on to labour flows, we find that a 'true' region is defined as having a very high level of labour mobility. Integration to the point of regionalisation results in decline for those regions with no absolute advantage. Cumulative causation often ensures this decline is permanent. The level of change needed in tastes of technology to reverse this process unclear.

However, as with capital flows, there are border effects that place an upper limit on labour mobility. What does openness mean when there is incomplete labour mobility? It can mean that people will get stuck in a declining region and suffer persistent unemployment and disadvantage. This becomes a larger concern if you define the region to be New Zealand. More work needs to be done on understanding international labour mobility and its consequences, so that we can assess the likelihood of various theoretical scenarios. We must also remember that New Zealand has some unique consumption benefits, such as the uncrowded, relatively clean environment, that may tip the balance in favour of staying in New Zealand.

4.4 Empirical evidence

Evidence on the relationship between goods trade and growth or productivity is mixed. Data problems and disagreement over appropriate measures of openness make it difficult to draw decisive conclusions.

Edwards (1997) uses data on 93 countries to look at the relationship between openness and TFP. He uses nine different indices of trade policy and finds that they consistently show more open countries have experienced faster productivity growth. The underlying model is that more open countries have a greater ability to absorb ideas from the rest of the world. His results are robust to the use of openness indicator, estimation technique, time period and functional form. However, Edwards does find that openness is relatively less important than initial GDP and human capital in explaining cross-country differences in TFP growth.

Rodriguez and Rodrik (1999) take issue with Edwards' paper and other recent papers that support trade openness. They find shortcomings in the various methodological approaches, and say that it is futile to continue to look for strong negative relationships in the data between trade barriers and economic growth. While they acknowledge that there is no evidence to suggest trade restrictions are systematically associated with higher growth rates, they believe there has been a tendency to overstate the evidence in favour of trade openness. Rodriguez and Rodrik support looking for contingent relationships such as, do trade restrictions operate differently in low vs high income countries? They also suggest looking at plant level data sets to uncover the ways in which trade policy affects production, employment and technological performance of firms.

Srinivasan and Bhagwati (1999) respond to Rodriguez and Rodrik by commenting that of course there are nuances and qualifications around trade theories and models, which suggest trade is not always good for growth. However, they say policy judgements tend to opt for openness, because careful in-depth studies of individual countries show 'export promoting' countries have fared better than 'import substituting' countries. Srinivasan and Bhagwati warn against overusing cross-country regressions to draw conclusions on the merits of openness, saying they are not the best tools for understanding the linkages between trade and growth. Rather, careful country studies should be used. This does not seem to be at odds with Rodriguez and Rodrik's suggestion of contingent relationship studies.

The Australian Productivity Commission (1999) cites several pieces of research in support of the claim that higher levels of openness positively affect productivity determinants[41]. One paper finds that open and poor countries are more likely not to be poor in the future than closed and poor countries. Another finds a positive relationship between trade liberalisation and the performance of Australian firms. The mechanisms they suggested were at work included international exposure encouraging greater learning, greater pressures to be

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41 Productivity Commission (1999) pg 158

efficient and greater selection between firms as weaker firms are forced to adjust or decline.

The Productivity Commission also conducted several industry case studies. In the manufacturing sector they concluded that changes in government policy brought increased import penetration and greater competition for domestic producers[42]. The key responses were to increase specialisation, reorganise production, invest in new plant and equipment and improve management and workplace organisation. Reforms were implemented earlier and more quickly in the whitegoods industry than in the automotive and textile/clothing/footwear (TCF) industries. As a result the whitegoods industry has experienced significant productivity improvement, while the automotive and TCF industries are improving more slowly.

In terms of specific 'negotiated openings', work has shown there to be gains from increased openness with trading partners. For example, New Zealand's experience with CER is regarded very positively, particularly as a first step in increasing the efficiency of the manufacturing sector by exposing it to greater competition. CER was able to 'sell' the idea of liberalisation by offering New Zealand firms a major benefit in terms of increased access to the larger Australian market, thus the agreement was also the crucial breakthrough that allowed the development of an irreversible momentum in favour of broad trade liberalisation[43].

Quantitatively, CER is also regarded in a positive light. The Australian Bureau of Industry Economics conducted a static economy-wide analysis of the effects of CER and found it to have a small but positive effect on Australian and New Zealand GDP and economic welfare (as measured by household utility). Of the two countries, New Zealand was estimated to have received the largest benefits from CER. This analysis would have underestimated the gains as it was a static analysis only (i.e. looking at simple reallocation of resources between sectors) and did not capture the accompanying productivity improvements.

There have also been estimations of the effects of the GATT Uruguay Round liberalisation on New Zealand. MFAT (1994) predicted that the Round would produce a modest one-off increase in growth of 2-3% over the following decade, with the gains mainly coming through the agricultural sector. These results are sensitive to model assumptions, but there was general agreement that the economy would grow as a result of the Round.

Summary: Empirical Evidence

The evidence on the effect of openness and integration on growth and productivity is mixed. Cross-country regressions tend to find positive relationships but there are concerns over the robustness of the methodology. More specific case studies of countries or industries tend to support openness.

42 Productivity Commission (1999) pg 110-111
43 Scollay (1996)

4.5 Integration and productivity: conclusions

Productivity is the key to higher incomes, and is thus very important in securing higher living standards for New Zealand. We identify seven mechanisms through which openness and integration may affect productivity:

- resource allocation;
- scale, scope and specialisation;
- technological advance;
- accumulation of human capital;
- accumulation of physical capital;
- firm organization, management practices and work arrangements; and
- plant/firm turnover.

Importantly, there is also a spatial dimension to productivity. The agglomeration of resources and production in a particular location can improve productivity as greater density leads to lower transport costs, greater specialisation of production and labour, labour market pooling effects and knowledge spillovers. This spatial dimension was a motivating factor for splitting the analysis into 'New Zealand as a nation' and 'New Zealand as a region', as we sought to understand the implications of viewing New Zealand through different conceptual windows.

While domestic policy has an influence over the productivity-improving mechanisms and the spread of activity across space, openness is also important. For smaller countries, such as New Zealand, openness may assume greater significance than it would for a larger country that suffers less from market-size and resource constraints.

Significantly, there may be diminishing returns to openness. If a country is open enough to receive knowledge transfers of the sort required to achieve convergence to higher growth and productivity, then further integration beyond that may not be important for growth. It is unclear what the optimal level of openness is for New Zealand and so the remainder of the discussion focuses on the effects of varying degrees of openness in order to inform the debate.

Looking at the theory on cross border flows of goods, services, capital and labour through the 'New Zealand as a nation' lens, we find openness generally yields productivity improving effects. However, looking at New Zealand with a spatial perspective highlights some additional risks as well as benefits of openness. In particular, capital and labour could move out of New Zealand to more agglomerated places, in search of the higher productivity and wages associated with density. While these firms and workers may be more productive offshore, the benefits of their productivity improvements are lost to New Zealand.

From the literature we identify four factors that are central in estimating the size of the 'spatial' risks of openness. The factors are technology, critical mass/agglomeration, absolute advantage and border effects.

1. Technology is important because it can reduce the need for face-to-face contact. However, this can work two ways – it may reduce the need to be

in an agglomeration to tap into productivity benefits, and so make it easier for firms to locate in the periphery, or it may reduce the need to be near the consumer, thus enabling firms to locate in the core and service the periphery market from a distance. The response of firms to technology improvements is crucial for understanding location decisions.

2. Critical mass or agglomeration levels in New Zealand are another key factor in location decisions. The important question is whether firms are able to find suitable levels of density for their needs in New Zealand cities and towns, or if they have to go offshore to access that density and its benefits. Different firms have different needs – this has implications for the type of firm that may be attracted to New Zealand and therefore the structure of the economy.

3. Absolute advantage is important as it gives an indication of the types of activity that would be sustainable in a fully integrated market. An integrated market with full labour mobility will not sustain wage differentials, thus those locations that do not have an absolute productivity advantage in some activity will decline. The implication for countries is that integration will push their pattern of specialisation towards those activities where they have an absolute advantage. If the country as a whole does not have absolute advantage in some activity then it will fail to attract firms or workers and will decline. Again this idea has implications for the level and type of activity that New Zealand might sustain in the future.

4. Finally, border effects will affect the amount of cross border flows that occur. Border effects can be thought of as less explicit barriers to integration, and include such things as different languages, institutions, trust and social capital. Countries tend to maintain some level of home bias because of these border effects – put simply; there is a higher degree of comfort in dealing with the familiar. This may act to place an upper limit on the amount of activity that flows out of a country.

We believe more empirical work would shed valuable light on these issues. In particular, work on mobility of firms and people, the levels of density needed for various firm activities and the response of firms to technology would be extremely useful.

On a broad level, the empirical evidence on the effect of openness and integration on growth and productivity is mixed. Cross-country regressions tend to find positive relationships, but there are concerns over the robustness of the methodology. More specific case studies of countries or industries tend to support openness.

We believe the ideas in this section are an important step in understanding the implications of openness and integration for New Zealand. While we cannot conclude what the optimal level of openness is for New Zealand, we can clearly see the benefits and risks of different levels of openness. The difficulty in assessing an optimal point is attaching a level of welfare to each level of openness and its associated risks and benefits. Not only is utility or welfare extremely hard to pin down, we have also raised in this section the question of whose welfare we are trying to maximise in an increasingly globalised world. We leave this as food for thought for the reader!

5. Integration and Income Distribution

The discussion thus far has focussed on the effects of economic integration on productivity. Higher incomes are a central component of higher living standards and productivity was identified as the key to higher incomes. As discussed in Section 3, however, there are many other components of well-being. We now turn to the relationship between economic integration and income distribution. A classic critique of openness and globalisation, is that openness makes the distribution of income more unequal.

It is important to note at the outset that there is no objectively ‘correct’ income distribution. It is a value judgement and reasonable people differ. What we think about distribution and fairness might depend on whether we compare ourselves to other countries (and which countries), to our own past (and which time period), or use some other yardstick. As a nation we have traditionally had a strong egalitarian ethic and have favoured some degree of redistribution. However, not all New Zealanders would view a wider distribution as a bad thing. Whatever our views and preferences on this issue, we make them felt through the political process. The job of this section is not to take a position on what a preferred income distribution might be, but to draw out evidence about the links with openness and highlight issues.

The claim that economic integration causes more inequality is often focused on the effect of imports. The argument is that competition from cheap imports puts pressure on wages and jobs in firms that compete in these industries. Affected workers and business owners become poorer as resources are shifted to other areas of the economy. We think of car plants in Thames, woollen mills in Mosgiel, and Bendon factories in Te Aroha.

Open capital markets are also cited as cause for concern. Global capital flows permit movement of activity and firms. While the effect on income distribution within New Zealand is unclear, it is argued that global capital flows make redistribution more difficult. The cost of imposing relatively high tax rates in an open economy is the risk that investment may flow out of the country in favour of economies with lower tax rates. Some argue that this precludes domestic governments from certain policy options and amounts to a loss of national sovereignty. These issues will be discussed in Section 6.

Many also associate income distribution issues with integration in the labour market. The fear is that cheap migrant labour will compete with domestic workers, particularly for unskilled jobs. This seems to have been less of an issue for New Zealand than for other countries such as the US, possibly because we do not have a large, poor pool of potential migrants on our doorstep.[44]

It is true that income distribution in New Zealand has become more unequal.

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[44] Although we do have Pacific Island nations, we seem to be less concerned about this than the US is about poor migrants. It may be the case that New Zealand has embraced such a strong pacific identity that we accept further Pacific Island immigration as natural and appropriate.

How much of this, if any, is attributable to increased economic integration is much less clear. Let's review the trends and survey evidence on the relationship between trade and income distribution.

5.1 Widening income distribution

Relative to the early 1980s the distribution of incomes in New Zealand has become more unequal. In other words, the spread between the highest and the lowest annual incomes has been widening. The timing of increased inequality is concentrated in the late 1980s. Statistics on the earnings of individuals, the market incomes of households and the disposable incomes of households all reveal a similar pattern.[45]

Rising inequality has been a worldwide phenomenon in industrialised countries. However, the increase in New Zealand seems to have been proportionally larger than in countries such as the UK and Australia, although direct comparisons are problematic.

Changes in income distribution result from the complex interaction of many factors. These include changes in household composition, changes in labour force participation and qualifications of the population, technological change and deregulation in the domestic economy as well as changes to external policy. Some of these factors are within the control of government policies, however many are beyond government's control. Government directly affects the distribution of income through tax and transfer policies. Government policies may also have an indirect effect on the distribution of earnings (for example where deregulation of product markets alters the relative demand for different skill groups). However, many of the factors driving distributional changes arise from market forces, often global in nature, such as technological changes driving up the demand for skilled workers.

Furthermore, it is extremely difficult to determine empirically how these causal factors interact, and measure their relative impact on income distribution. The timing of growing inequality in New Zealand suggests that policy changes may have been a contributing factor. However, disentangling the effect of policies such as trade liberalisation, from other factors influencing the distribution of income, is not straightforward.

Despite the complexities involved, some studies have attempted to unpick the causes of changes in income distribution. Traditionally research has looked at the relationship between 'trade and income distribution', or 'immigration and income distribution' separately, rather than looking at 'economic integration and income distribution' as a whole.

When thinking about the effect of openness on income it is important to bear in mind that even if some people are worse off in nominal income terms, it is not immediately clear that their *welfare* has diminished. Openness brings many consumption benefits in the form of cheaper products. People may be able to

[45] O'Dea (2000)

buy more goods with less income and this should be factored into the analysis when looking at the effect of, say, a tariff reduction. To get a more accurate picture, studies would need to examine changes in terms of purchasing power rather than simply income.

5.1.1 Overseas evidence

International research on earnings distribution finds that trade effects play quite a small role in increased earnings inequality over time. Much of this research investigates the effect of trade on the relative earnings of different groups of workers in the United States. The consensus appears to be that trade can explain between 5 and 20 per cent of the overall changes in earnings inequality. Technological change appears to have had the largest effect on earnings inequality.[46]

International research is not directly applicable to New Zealand, given differences in the degree of openness, and the speed of policy change. However, the international findings suggest caution in attributing too much of the increase in inequality to trade liberalisation.

5.1.2 New Zealand evidence

New Zealand evidence on trade and income distribution is almost non-existent. The main exception is recent research by Deardoff and Lattimore[47], which finds that trade liberalisation might actually have improved the distribution by increasing returns to unskilled labour. They show that New Zealand industries protected under the import-licensing regime were relatively intensive in their use of skilled labour. Conversely, export industries that expanded following liberalisation were relatively more intensive in their use of unskilled labour.

They conclude that trade liberalisation skewed wage differentials in favour of low skilled workers, especially women, and owners of the factors used in export production (owners of land and capital). Conversely, trade liberalisation reduced relative wage rates for qualified workers (especially male workers) employed in industries such as metal fabricating that had been protected by import licensing regimes.

More research is necessary to assess the full impact of trade liberalisation on income distribution in New Zealand. The Deardoff and Lattimore research does not investigate the distributional consequences of changes in who is employed and who is unemployed, or the extent to which this was driven by trade liberalisation, other regulatory change, or broader economic factors such as terms of trade shocks. Their research concerns the distribution of labour market earnings, whereas income also includes the social assistance income received by people outside the labour market, and income from capital or other sources. Nevertheless, change in the distribution of labour market earnings has been

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46 See Borland (2000)

47 Deardoff A and Lattimore R (1999), 71-91

shown to be the main driver of overall changes in New Zealand income distribution.[48]

5.2 Winners and losers

Although the distribution of income in New Zealand has certainly widened over the past two decades it is difficult to determine how much of this is due to increased openness and economic integration. International evidence suggests trade liberalisation plays a relatively modest role and that a key driver is technological change. Nevertheless, even if openness does not significantly widen the income distribution, it is likely to alter the position of individuals and groups within it. Some individuals and groups within New Zealand will benefit; others will not. Change almost inevitably brings winners and losers.

Let's consider the case of a tariff reduction. This one change will affect the distribution of income through a variety of channels.

Access to cheaper foreign goods such as clothing, footwear and cars confers a gain in real income on households as well as direct consumption benefits resulting from access to a wider range of goods. Which consumers benefit most from this depends on the particular goods that now face lower tariffs, and the consumption patterns of different households. Typically, however, these items represent a large share of expenditure for low income households, so there is an inherent bias in the benefits of liberalisation towards these households.

There will be winners and losers in business. In some cases lower tariffs and increased competition may expose a lack of international competitiveness, forcing businesses to become more efficient or cease trading. In other cases lower tariffs may reduce the costs of importable inputs to farms and businesses, making them more internationally competitive and allowing them to expand their output. Some industries and sectors are likely to benefit, while others are likely to lose viability.

Workers will, of course, be affected. These changes in the mix and level of output across firms, industries and sectors will change the demand for labour in different industries and different skill levels. Who wins and loses will depend on whether the trend is toward industries employing higher skilled workers or those employing relatively large amounts of unskilled labour.

The second round effects of a tariff reduction on income distribution flow throughout the economy. It is possible that the real exchange rate will alter, again sending signals to some industries to expand and others to contract. Different expansion paths may imply differences in the amount of part time employment available and lead to changes in labour force participation rates.

What this example illustrates is that, while the net impact of trade liberalisation on New Zealand is unclear, there are likely to be distributional consequences for particular groups. Even determining what these distributional consequences are

48 O'Dea (2000)

is not obvious. However, in general winners from trade liberalisation tend to be firms and workers (and potential workers) in exporting industries, as well as all consumers of imported goods. Losers tend to be firms and workers in import competing industries.

Part of the problem with the change in income distribution resulting from increased openness, is that the costs are likely to be concentrated on relatively small groups of workers, while the benefits are more diffuse. This means that the costs are often more visible than the benefits. It is important to recognise both: those who oppose integration on the basis of groups who are negatively affected need to be aware of the benefits. On the other hand, government needs to acknowledge that there are likely to be losers as well as winners and consider policy responses to ease adjustment for these groups.

5.2.1 Adjustment

A key issue for policy is whether the losers are permanently disadvantaged by the change, or whether the dislocation is a relatively temporary one. A large firm may go out of business as a result of being unable to compete with cheap imports, and all its employees may lose their jobs. This is a serious blow to those concerned, however many may be able to find other jobs in their area, or retrain, or move to locations where there are jobs, either in their field or in new sectors. If labour market adjustment mechanisms are working well, then although the immediate costs for individuals and their community may be high, the long term effect is less serious. Government may nevertheless want to consider transitional assistance to help people cope with the temporary shock.

For others, however, the shock may be permanent. Some individuals and groups in society may have limited ability to retrain (eg, unskilled labourers in their 50s). There may be inadequate employment locally, and moving location in search of work may not be an option (eg, some may have cultural or historical connections with particular areas perhaps, or strong family ties). If the mechanisms for labour market adjustment are unavailable then these groups may not be able to recover. The policy responses in this scenario will differ from those in which the shock is a temporary setback – some groups may need permanent assistance. The economic gains arising from increased integration will be adequate for the rest of society to assist in this way if required.

The ability of displaced groups to adjust, through finding alternative employment, will depend on opportunities available elsewhere in their locality, their ability and willingness to move to job-rich locations, and their ability to retrain. We need to investigate more closely mechanisms of labour market adjustment after a shock. Do people retrain? How costly is it? Do people move? It would be illuminating to know the current situation of former Thames car plant workers. Answers to these questions will help us understand the nature of shifting patterns of income distribution as a result of openness, and types of policy responses that might be appropriate.

5.2.2 Regions

There is an important regional dimension to this issue. Regions tend to have fewer and less diverse employers than larger cities. Small rural towns will sometimes be dominated by only one major employer. People living in these areas are therefore more exposed if this employer closes down.[49] For them, getting another job will often require a change of location, quite possibly to a larger town in the region or a city.[50]

Theory would suggest that government ensure that there are no impediments to movement of labour. It might provide information on training and employment options in other locations, or even assistance with transport and relocation costs. The aim would not be to influence people to move to a particular place, but rather to not distort the location decision.[51] People should not be trapped in depressed areas if they would like to relocate in search of employment, but lack the information or means to do so.

However, many would like to see regions within New Zealand survive and prosper because they are interested in the *place* in and of itself. We may value a New Zealand that has people living and working in Southland and the Far North as well as the main centres. Individuals may have strong attachments to certain places. This would lead to quite different policies – government might attempt to attract industry to the regions, sometimes in quite direct ways. There is a tension between helping the people (which may imply assisting them to move to other areas where there is employment) and valuing the place (which may imply some form of regional assistance). It is important that policy is clear about which objective it is pursuing.

5.3 Conclusions

Income distribution in New Zealand has widened over the past two decades. While part of this may be due to increased economic integration, it is very difficult to disentangle from the many other factors influencing income distribution. International evidence has attributed perhaps 5 to 20 percent of the change in the distribution of earnings to trade. There is little New Zealand evidence on trade and income distribution. One study finds that trade liberalisation in New Zealand might have actually improved the distribution by increasing returns to unskilled labour.

Even if some people are worse off in nominal income terms, it is not immediately clear that their *welfare* has diminished. Openness brings many consumption benefits in the form of more and cheaper products. Income distribution may not

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49 This does not imply that regional based industries are necessarily more likely to be losers than those in cities. However in cities the adjustment mechanisms are likely to operate faster and more effectively. There are many alternative employers, training opportunities etc.

50 For the economic advantages of agglomeration see Box (2000)

51 In this context it is an interesting question whether regional policy will help or impede labour market adjustment.

be the best measure – one would need to look at the effect of changes in terms of purchasing power.

Openness, particularly tariff reductions, may not have noticeably widened the income distribution, but it has certainly changed the position of individuals within the distribution. There are winners and losers, both in terms of individuals, groups within society, and regions within New Zealand. The costs are likely to be concentrated on relatively small groups of workers, while the benefits are more diffuse.

A key question is: are the losers permanently disadvantaged, or is the dislocation a relatively temporary one? If labour markets adjust rapidly, through people moving or retraining or both, the effect of the shock will be temporary. Government may still want to consider temporary assistance to help people cope with the effects of integration. For some the shock may be permanent and they may not be able to recover. We need to study more closely mechanisms of labour market adjustment in order to know what sort of policy response is appropriate.

In the case of regions there is a tension between helping the people (which may imply assisting them to move to other areas where there is employment) and valuing the place in and of itself (which may imply some form of regional assistance).

Summary: Income Distribution

Income distribution in New Zealand has widened over the past two decades. Part of this may be due to increased economic integration, although it is very difficult to disentangle from the many other factors influencing income distribution. International evidence has attributed perhaps 5 to 20 percent of the change in the distribution of earnings to trade.

Although the effect of integration on the overall distribution of income is unclear, trade liberalisation is likely to change the position of individuals and groups within the distribution, and result in winners and losers. Consumers will benefit, through access to lower priced goods. Costs are likely to be concentrated on relatively small groups of workers in sectors that are no longer competitive.

A key question is: are the losers permanently disadvantaged, or is the dislocation a relatively temporary one? If labour markets adjust rapidly, through people moving or retraining or both, the effect of the shock will be temporary. Government may still want to consider temporary assistance to help people cope with the effects of integration. For some the shock may be permanent and they may not be able to recover. We need to study more closely mechanisms of labour market adjustment in order to know what sort of policy response is appropriate.

6. Integration and Decision Making

6.1 New Zealand the nation state: questions of sovereignty

A central component of well-being or living standards for individuals is autonomy: a sense of choice, freedom and control over one's life. Autonomy requires that one's life not be conditioned by external forces. It does not imply complete independence from others, or complete freedom from state control. There is often a fine balance between being influenced by forces outside one's self, and being controlled by them; sometimes it is hard to tell when an individual is acting autonomously and when they are not.[52] Nevertheless autonomy, or liberty, are values that Western democracies hold dear.

At an aggregate level the desire for individual autonomy is often expressed as a desire for national sovereignty: to be a citizen of a nation state with control over its own affairs.[53] Sovereignty can be defined as:

> *The power or authority which comprises the attributes of an ultimate arbitral agent – whether a person or group of persons – entitled to make decisions and settle disputes within a political hierarchy with some degree of finality. To be able to take such decisions implies independence from external powers and ultimate authority or dominance over internal groups.*[54]

In short, sovereignty is decision-making power. It is a central concept in the modern world order. Property rights are allocated by nation[55] and it is generally assumed that a nation is able to follow its own values, select its political arrangements and use its property without interference from others.[56]

As in the case of individual autonomy, however, independence of nation states from external forces is a problematic concept. No social or political entity is

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52 And the issue has never been resolved, as evidenced by the centuries old debate between free will and determinism.

53 The link between individual sovereignty and national sovereignty is not as straightforward as it might appear. In Western democracies, we expect the two to occur together. Higher levels of individual autonomy are associated with high national sovereignty. However there is no necessary connection. We can imagine highly sovereign nation states that deny their citizens basic civil liberties. The relationship between individual and national sovereignty depends entirely on the nature of the political hierarchy.

54 King.

55 With the exception of 'global commons' such as outer space, the seabed etc.

56 Although this principle is not held consistently. Nations often believe strongly in their own rights to sovereignty but will violate the sovereignty of other nations in certain circumstances. This is usually justified on moral grounds (human rights, labour standards) or spillovers (environmental protection). Those advocating moral arguments may defend themselves against the charge of hypocrisy by claiming that the situations are completely different – the nations concerned do not respect the individual sovereignty of their citizens therefore the principle of sovereignty itself justifies interference. It seems we do not hold the principle of sovereignty as inviolable – sovereignty is contingent upon the exercise of it in certain ways.

entirely independent of every other. Nations interact and influence each other and this need not amount to loss of independence or sovereignty.

> *Nevertheless, it remains open as to how regularly one sovereign entity may sway another before it becomes inappropriate to speak of the latter as 'sovereign'.*[57]

It is uncertain exactly how much independence and decision-making power a nation needs to be sovereign. This uncertainty is compounded by the perception that national sovereignty is increasingly under threat from globalisation. In the contemporary world the scope for exercise of national sovereignty appears to be shrinking: it is not possible for a nation to function as a closed entity, isolated from the world at large. "The effective domains of economic markets have come to coincide less and less with national governmental jurisdictions."[58] In an increasingly integrated world the fear is that sovereignty will be diminished through loss of independence, as nations are subjected to international forces and international decision-making.[59]

As nations lose control over their affairs, individuals in those nations fear that, by extension, they too will have less control over their circumstances than they used to. It is thought that if options available to domestic governments are limited, then options available to the citizens of those governments must also be limited. National governments would be less responsive to the full range of preferences of their voters (since some options will be closed off), people may feel the political processes don't represent them as well anymore and feel abandoned.[60]

The issue of the effect of increasing global integration on individual autonomy is an important and interesting avenue in its own right. The focus of this section, however, is on the effect of integration on national sovereignty.

In Section 6.1 we adopt the traditional perspective of the nation state in thinking about sovereignty. Section 6.1.1 discusses the claim that global market forces limit the options open to domestic governments. Section 6.1.2 discusses the trend toward international decision making and its effect on sovereignty. These are complicated issues, and Section 6.1.3 concludes that thinking in terms of costs and benefits is more useful than the slippery notion of sovereignty.

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57 King, ibid.

58 Kahler, pg xv.

59 There are additional reasons why the concept of sovereignty may have less force than it used to. When sovereignty resides with a democratic Parliament the notion of an ultimate arbitral agent becomes circular – the prime minister may be the highest power, but higher still are the people, or the electorate, which are at the same time the base of the political hierarchy. It is also diffuse, in that no one person or body decides all matters.

60 This connection between loss of sovereignty for nations and loss of sovereignty for individuals is not at all clear. As argued in an earlier footnote, there is no necessary relationship. Globalisation is often seen as reducing national sovereignty and consequently also reducing the individual sovereignty of citizens. However, it's not obvious that individual autonomy fares worse the more remote the decision maker. In some cases reducing national sovereignty actually increases the individual autonomy of citizens, by subjecting the worst excesses of nation state power to international scrutiny and human rights pressure.

Section 6.2 takes the newer perspective of New Zealand as a region and in doing so we find that questions of sovereignty are recast as issues about the level of governance at which decision-making is best carried out.

6.1.1 Sovereignty and global market forces

As cross-border flows increase, governments have greater difficulties trying to control what happens within their borders. There are concerns about the effects of both inward and outward flows.

Outward flows

Global capital flows have risen dramatically over the past 15 to 20 years.[61] Portfolio investment (so called 'hot money') moves around the world extremely rapidly in response, partially, to relative economic conditions. Direct investment is slower to move, but will also respond to differences between economies. Conditions favourable to investment include stable macroeconomic environments, liberal regulations and low taxation. If nations want to retain domestic investment and attract foreign investment they will therefore emphasise these features in their policies. Furthermore, policies that are favourable to investment may be particularly important for small geographically isolated countries such as New Zealand. Lower tax rates, reduced regulations and more flexible markets may be necessary to compensate for natural disadvantages such as lack of economies of scale, high transport costs and lack of access to large export markets.

The perceived threat to national sovereignty from these global capital flows lies in the fact that they place limits on domestic policies. Governments are voted in on the pledge that they will carry out certain policies. However, it is harder to impose taxes, minimum wages, environmental restrictions and so on in an open economy, where investment is free to flow out of those countries and into countries without such policies. Although nations are still technically free to follow whatever domestic policies they choose, they do so at their peril. New Zealand pays great attention to international ratings agencies, reflecting awareness that our credit rating will affect economic prosperity. In short, the concern is that world financial markets generate economic pressures that override domestic policies.

It may be argued that labour mobility creates similar incentives for policy. If a nation wants to retain its best and brightest, as well as attract world-class experts from other countries, it is prudent to follow certain policies. In particular, it has been argued that the threat of brain drain limits redistribution. If taxation is too progressive those at the top end will relocate. As well as directly bearing on issues of income distribution, it affects sovereignty by limiting options open to governments.

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61 For further discussion of the trends see Plater and Claridge (2000)

What can we make of these arguments? Do global capital and labour markets and the risk of outward flows reduce domestic choices and therefore sovereignty?

It is undeniably true that portfolio investment responds to conditions and policies in domestic economies. If governments are interested in this sort of investment they will therefore keep their policy settings within the broad parameters necessary to attract it. This is a limitation. It may be a positive one. Openness provides a restraint on the potential abuse of power by governments, since the consequences and costs of their actions are immediately apparent. The highly controlled and closed environment of the Muldoon era allowed the costs of his policies to be hidden. Muldoon's policies would not have been sustainable in an open environment. In this sense global markets encourage such things as the Fiscal Responsibility Act and other instruments for stable government; they promote transparency and bind commitment into the future. The fact that there are international pressures to run stable and consistent macroeconomic and fiscal policies runs *with* what is good for the domestic economy, not against it.

It is less clear that direct investment and labour respond in the same way as portfolio investment to domestic policies. Location decisions for firms and people are based on a range of factors; it is the total package that matters. Different people are attracted by different policy mixes. Many countries in the EU have high tax rates but retain people and investment. It is far from clear what policies a government wishing to retain and attract firms and skilled labour would pursue. Extremely redistributive policies are likely to be thwarted by firm and labour mobility. However, a government can still spend significantly on social welfare programmes in an open economy if they are paid for by the immobile or valued by the mobile. Mobile factors mean that redistributive policies will need to have a broader base of support: again, it is not clear that this is a bad thing. Global markets set limiting parameters around some government actions, while being consistent with a wide range of more moderate policy settings, including a considerable degree of redistribution.

We can conclude that, to some degree, open factor markets influence the viable options available to domestic governments. Does this mean that we therefore have diminished national sovereignty? Here we come up against the difficulty raised when we tried to define sovereignty: sovereignty does not entail that all choices are open to us; it does mean we have choices. Exactly how much choice, and what sort of choices, do we need to be a sovereign nation?

Choices are always limited; as individuals and as a nation we are always operating in a world we cannot control. This was true before globalisation, as after. In a closed economy we had a narrow range of consumption goods, reduced capacity to borrow and invest, fewer resources in general, and what resources we did have were poorly allocated. In an open economy we have the pressures of global markets to limit us, as discussed above. As a nation, our bundle of viable options has certainly changed. Have we lost sovereignty because of this change? Probably not. Given that choices have always been limited, if we ever had sovereignty, we still have it now. We may reasonably worry that the forces that shape our world are changing and wonder how we should best respond to the new environment. But it is confusing the idea of sovereignty to say we have no choices here.

Inward flows

Open capital markets and the threat of more open labour markets have led to concerns about the effects of investment and people flowing *into* New Zealand as well as out of it. There are arguments that inward flows also reduce sovereignty through reduced domestic choices and control.

A common source of opposition to foreign direct investment (FDI) is the worry that New Zealand will become 'owned by foreigners'.[62] Non-New Zealanders buying assets, and in particular 'strategic' assets, will reduce New Zealanders' control over the country's resources. The fear seems to be that if we lose control of the bulk of the country's resources to foreigners, we will lose decision-making power and sovereignty to foreigners.[63] An issue for New Zealand is that direct investment, particularly in land, may also have Treaty of Waitangi implications.

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[62] Portfolio investment doesn't tend to evoke the same concerns, as it is not usually associated with the degree of control that direct investment is.

[63] The concern tends to become bound up in issues of privatisation vs Government ownership as well.

All Investment is Not Equal

Peoples' concern about losing decision-making power and control over the domestic resources of their own countries was a key factor behind the failure of the OECD-sponsored Multilateral Agreement on Investment (MAI) in 1998. The purpose of the MAI was to establish rules to manage the perceived risks arising from the further freeing of international flows of private foreign direct investment (FDI). To this end, it would have placed additional limits on the freedom of signatory governments to impose or maintain unreasonable restrictions on such flows, similar to the rules governing international trade in goods and services operated by the World Trade Organisation. Like the WTO's rules-based system, the MAI would have provided a framework within which smaller economies could exercise their rights. The MAI was based on a non-discrimination principle – signatories would have to treat foreign investment the same as domestic investment. However, as negotiations on the MAI developed, reservations to non-discrimination were built in to the draft agreement to take account of governments' strategic, cultural and identity concerns.

There was strong and well coordinated opposition to the MAI throughout the world, including in New Zealand. Groups had disparate motivations for opposing the MAI. One of the main concerns was the belief that FDI removes peoples' decision-making power and control over the domestic resources of their own countries. Other concerns included the belief that FDI leads to exploitation of vulnerable groups in societies and environmental degradation. The concerns of opposition groups were increasingly taken up by politicians and officials and support for the MAI was steadily eroded.

The ultimate demise of the MAI in 1998 can be partly related to the strength of opposition and concerns about a loss of national sovereignty as a result of FDI. It was also due to the desire of many governments to include in the MAI a plethora of exemptions and reservations to the principle of non-discrimination, which in the end would have made the agreement unwieldy and unlikely to deliver substantive advances towards liberalisation. Finally, the demise of the MAI was also a function of the fact that the OECD is not a negotiating forum and, as a result, was not equipped to manage the process.

In response to the concern that inward flows will reduce sovereignty, we have chosen to place limits on direct overseas investment in New Zealand, and particularly on land sales.[64] There are prohibitions on certain types of foreign investment (fishing rights and the 'kiwi share' in Telecom and Air New Zealand). Other classes of investments require the approval of the Overseas Investment Commission (OIC), although in practice this has not served to place significant

64 An alternative might have been the Cook Island model. They have a law that you can't buy or sell land (can lease up to 100 years). The land is inefficiently used and broken up into small units but nevertheless not owned by foreigners.

restrictions on foreign investment.[65] These restrictions reflect the concern New Zealanders have about some types of foreign investment. They also remind us that we do have some control here: if the concerns about foreign ownership outweigh the economic gains of FDI we have the option of limiting it.

Of course it is unclear just how much concern New Zealanders actually do have about foreign ownership. New Zealanders' actions can contribute to their own loss of sovereignty. When New Zealanders choose to buy imported goods, or to sell their assets to foreigners, or to buy overseas assets they are exercising their individual sovereignty but, one could argue, losing control over production in the process. This indicates a revealed preference for individual sovereignty over national sovereignty.

Inflows of people resulting from open labour markets can also provoke fear and opposition. However, unless immigrants arrived in such vast and cohesive groups that they had a major impact on parliamentary political outcomes, the issues of open labour markets are not primarily sovereignty issues.[66] It is feared that immigrants will take jobs that should be filled by New Zealanders; this relates to distribution issues, discussed in Section Five. It is also feared that immigration will change and threaten our culture and what makes us New Zealanders; this relates to issues of national identity and will be discussed in Section Seven.

How realistic is this fear that capital inflows will result in loss of our productive resources to foreigners? How much foreign investment would it take? That is a difficult empirical question about which this paper can offer no view. The interesting issue for us is the relationship between resources and sovereignty, because whether or not foreign ownership reduces sovereignty depends on the degree to which decision-making power and independence requires control over assets.

One view is that political authority is more important than resources: as long as you have a parliament and an executive you can always legislate, regulate and tax.[67]

However resources give you real choices. Is sovereignty worth anything if you do not have the economic clout to back it up if threatened? The cynical view is that, to have genuine decision-making power as a nation, you need enormous resources. Under this view, a very few politically and economically powerful nations have true sovereignty; all other nations have sovereignty, in effect, by permission of the powerful. To exercise sovereignty you need power; the more power the more sovereignty.

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65 See Plater and Claridge for further discussion, and Chapman for a thorough description of the rules governing FDI in New Zealand.

66 Clearly inflows of people have altered the power balance in nations: New Zealand Maori and native Fijians, for example, have lost sovereignty to newcomers. However within modern parliamentary democracies controlled immigration is less likely to have such dramatic political effects in short time frames.

67 At the extreme, you could even nationalise strategic assets.

6.1.2 *Sovereignty and political decision making*

International market forces have raised concerns about national sovereignty because they appear to limit domestic choices. We have argued that sovereignty does not entail limitless choices. Nations have always operated within the parameters of the options actually open to them and the pressures upon them. In a changing world those options and pressures have changed. This may require some adjustment, but it is a mistake to view it in terms of loss of sovereignty.

A more serious threat to national sovereignty, however, may be the increasing trend toward international decision-making. Governments have attempted to manage the tensions between global forces for integration and national autonomy by international co-operation. Over the past few decades there has been a proliferation of multilateral organisations and agreements. These include functional groupings devoted to particular issues (eg, IMF, ILO), regional arrangements (eg, EU, NAFTA, APEC), semi-global co-ordinating organisations (United Nations, WTO, OECD) and innumerable bilateral relationships (eg, CER).

International organisations and agreements tend to set parameters around the actions of nation states. The concern is that this represents a transfer of power and decision making from nation states to international organisations and therefore harms sovereignty. Types of agreements reached, ranging in order of their departure from national autonomy, include mutual recognition, monitored decentralisation, coordination, explicit harmonisation and mutual governance.[68]

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68 See Kahler, pg xxii

The Face of Discontent

A particularly high profile focus for concern over loss of national sovereignty is the World Trade Organisation. This is often played out in the arena of environmental protection.

One function of the WTO is to help members settle disputes under rules they all agreed to follow. WTO rules place few constraints on a member protecting its environment against damage from domestic production or from the consumption of domestic or imported products. Members can also pursue non-protectionist regulatory objectives that restrict trade as long as there is either scientific evidence supporting the measure or the measure is a provisional response during a period of scientific uncertainty.

Environmentalists consider that the WTO encourages governments to converge to international standards because uniformity reduces the incidence of trade disputes. If these standards serve as ceilings, not floors, the incentive for governments to experiment and become genuine pacesetters in environmental law is reduced.

The dispute over beef hormones illustrates this tension. In 1998, the WTO found that while a country has broad discretion in choosing levels of biosecurity, the ban on hormone-produced meat by the EU was not rationally related to the risk assessments performed. The EU did not comply with the ruling. After a period of negotiation, in 1999 the dispute panel authorised the USA to suspend tariff concessions to the EU equivalent to the annual harm to U.S. exports resulting from the ban: US$ 116.8 million.

Has sovereignty been violated? Environmentalists might say yes- international pressure was bought to bear on the EU for a decision about their own environment, which affected domestic and imported products alike. Others would say no – the WTO is a club the EU freely chose to join, agreeing to abide by its rules. And what's more, despite the costs, they maintained the ban.

Does signing up to international agreements limit sovereignty? One view is that it does not. No parliament can bind another. While a nation still has its parliament it can retreat from international commitments at any time. Joining an international organisation merely raises the costs of bailing out in the future. In the end, adherence is voluntary; nations cannot be compelled.

The principal distinction between national and international law is in the area of enforcement. National laws have courts to watch over them. The WTO, however, is not a court. It has no power of enforcement. If a member refuses to comply with the rules it previously volunteered to follow, all the WTO can do is approve a request by the complaining member to impose sanctions. This is an option that member governments have always been able to wield unilaterally. Failure to comply with a panel ruling does not result in expulsion from the WTO.

Another view is that, while it may be technically true that nations can change their minds, the reality is somewhat different. Although international law generally provides a mechanism for nations to back out of commitments, there is wide agreement that governments should keep their promises. The costs of withdrawing from some international commitments are extremely high. Where commitments are reciprocal others, who were the beneficiaries of our commitments, may withdraw some of the benefits of commitments they have made to us. Although New Zealand *could* choose to pull out of the WTO on sovereignty grounds, the economic and diplomatic cost of this course of action makes it prohibitive. We normally think of choices as viable options, not merely technical ones.[69] Entering into international agreements, therefore, does effectively limit domestic behaviour.

However, as argued previously, sovereignty does not entail that all options are open, that we could reasonably change our minds at any point, or that we are completely independent. We generally consider that individuals are able to enter into contracts without loss of autonomy. In fact a contract could be seen as an expression of autonomy, since it will be entered into because the individual expects the agreement to increase their welfare. Individuals in the nation state have permanently limited their personal freedom via a 'social contract' with the state because they reap the benefits the state provides.[70] Nations too, often find it in their best interests to subject themselves to a contract or external constraint in the expectation of even greater benefit.[71]

More Sovereignty and Economic Integration Too

Since the break-up of the Soviet bloc, we have witnessed the formation of a great number of new nation states. In Eastern Europe the political unit is getting smaller – nations states built on greater cultural and ethnic homogeneity are emerging. At the same time almost all of these Central and Eastern European nations are queuing up to join the European Union because of the economic advantages they perceive in doing so. While the political unit is shrinking, the economic unit appears to be enlarging. Pursuing economic integration is consistent with increased sovereignty.

A similar theme is apparent in the case for Scottish independence. The movement believes they will have more sovereignty as part of a bigger unit centred in Brussels. Why be a disadvantaged region of the United Kingdom when you can be a sovereign nation in the EU?

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69 In the sense that if someone was holding a gun to your head you *could* choose not to give them your wallet, but this is not what we would consider a genuine choice.

70 Nations arguably have more autonomy in the WTO than individuals do in a western democracy.

71 Again, the degree to which this is consistent with *individual* sovereignty depends on the degree to which the government mandate is the result of democratic political processes.

Discussion of international agreements and organisations simply in terms of sovereignty is therefore not particularly useful.[72] Signing up to international norms sets parameters on national policy. It will therefore only be undertaken for a greater expected benefit. This may amount to a loss of sovereignty (in the same sense that signing a contract limits an individual), but the real question is whether the benefits outweigh the costs of signing.

6.1.3 The way forward – thinking about costs and benefits

Assessing the benefits and costs of signing up to international agreements is no easy matter. Many factors will enter into our calculation of national interest. These include likely economic effects (the implications for growth, jobs, living standards etc), impact on other social goals (sovereignty, identity, the environment, etc), as well as a myriad of pragmatic 'tactical' considerations (effect on our negotiating position in other areas etc). Some of these have been discussed at a general level in this paper; others are outside its scope. When considering particular international agreements all these factors come together and difficult judgements must be made. There is a high risk of making mistakes.[73]

Furthermore, even if in principle the benefits are calculated to outweigh the costs if a particular area is liberalised, the devil is in the detail. If the agreement designed to implement the liberalisation is badly formulated, requiring high compliance costs or leading to bureaucratic and legal battles, then the agreement will deliver bad outcomes for New Zealanders.

So how do we avoid badly designed treaties? There will be general principles and questions we can ask ourselves that might guide our assessment of costs and benefits.

- How does the proposal support domestic policy priorities, both economic and social?
- What are the dynamic impacts?
- How does it cohere with the rest of our international commitments and relationships?
- The possibility of maintaining sovereignty over time depends on democratic involvement and voice in the system. To what degree will New Zealand have a voice in the institutions that result?
- Are the processes transparent?
- How reversible is the commitment?
- To what degree is the declaration worth the resources being put into it?

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72 And in fact some objections to international cooperation on sovereignty grounds may be less about sovereignty and more about not liking the decision or policy. People employ any argument that supports their general position, making them hard to disentangle.

73 Consider the original New Zealand Australia Free Trade Area (NAFTA) negotiated in the 1960s, which effectively locked into place all the barriers that existed in both countries.

- Is the agreement outcomes based? It is preferable to give nations the freedom and flexibility to choose the means by which they achieve standards.

Trans Tasman Mutual Recognition Agreement

The Trans-Tasman Mutual Recognition Arrangement (TTMRA) came into effect on 1 May 1998. The objective is to mutually reduce regulatory barriers to the movements of goods and services between Australia and New Zealand. The Agreement means that:

- **if a good can legally be sold in New Zealand it can be sold in Australia (and vice versa); and**
- **if a person is registered to practise an occupation in New Zealand then they are entitled to practise that occupation in Australia (and vice versa).**

There are currently 25 product standards, information standards and product bans that are not immediately capable of mutual recognition, which are covered by a special exemption. The TTMRA include a process for working through outstanding items with a view to recommending mutual recognition, harmonisation or continuing exemption.

The TTMRA is a unique agreement that recognises the mutual confidence that Australia and New Zealand have in each other's regulatory settings. It facilitates integration while providing, through the exemptions, for retention of sovereignty in areas that are of particular importance to one or the other nation.

In New Zealand, the power to take treaty action rests with the Executive. However the Government has recently decided that all multilateral treaties that have been considered by Cabinet must be presented to the House before formal steps of ratification, accession, acceptance, approval, withdrawal or denunciation can proceed.[74] The Minister of Foreign Affairs and Trade may also decide to present major bilateral treaties of particular significance for consideration by the House. The Government will not take any binding treaty action until the relevant Parliamentary Committee has reported, or until 15 days have elapsed since tabling.

Treaties presented before the House for consideration must be accompanied by a National Interest Analysis. This sets out reasons for New Zealand to become party to the Treaty (or denounce/withdraw), advantages and disadvantages, obligations resulting from signing, economic, social, cultural and environmental effects, costs, the possibility of any future protocols, implementation implications, and provisions for withdrawal or denunciation. It is prepared by the lead Department in consultation with others.

[74] CAB (97) M 46/11G(1) and CAB (00) M 5/1E(1)

The National Interest Analysis is the key vehicle through which costs and benefits of international co-operation with respect to a particular area are set out, debated and worked through. It is also the key document that many Ministers and parliamentarians will read and base their discussion on. It is therefore crucial that this analysis is robust and that consultation is well executed. We need to be very clear about what we are giving up and what we are gaining. This calculus runs well beyond the policy area traditionally thought of as 'external policy' and it is therefore vital that agencies undertaking the analysis are thinking broadly about the issues and liaising effectively with all relevant parties.

Although assessment of the costs and benefits of international cooperation must ultimately be carried out on a case by case basis, a useful area for further work might be the development of a framework or taxonomy for how we think about these issues. Questions of regulatory cooperation and Trans-Tasman harmonisation have been raised as particular areas worth addressing in more detail.

Summary: Sovereignty

National sovereignty is the decision making power of nation states. There is a concern that the independence and sovereignty of nation states is diminished in an increasingly integrated and global world.

As cross border flows of capital and labour increase there is concern that domestic policy options will be reduced. The fear is that world financial and labour markets, and the risk of outward flows that openness creates, generate economic pressures that place limits on domestic policies. There are also fears that inward flows will reduce sovereignty through foreigners buying assets and reducing domestic choice and control.

To some degree global capital markets do limit choices. This may not be a bad thing if it supports domestic policy and binds commitment from successive governments. More fundamentally, sovereignty does not require limitless choices. Nations have always operated within the parameters of the options actually open to them and the pressures upon them. In a changing world these options and pressures have changed. This may require some adjustment, but the idea that we had sovereignty and now we are losing it is largely illusory.

A more serious threat to national sovereignty may be the increasing trend toward international decision-making. International organisations and agreements tend to set parameters around the actions of nation states. The concern is that this represents a transfer of power and decision making from nation states to international organisations and therefore harms sovereignty.

Thinking about international decision making in terms of sovereignty, however, isn't very useful. Signing up to international norms sets parameters on national policy. It will therefore only be undertaken for a greater expected benefit. This may amount to a loss of sovereignty (in the same sense that signing a contract limits an individual) but the real question is whether the benefits to New Zealand outweigh the costs of signing. Developing a framework or taxonomy for how we think about the costs and benefits of international cooperation is an important area for further work.

6.2 New Zealand the region: questions of levels of governance

Discussions of sovereignty are very much based within the perspective of New Zealand as a nation state. The issue is then about when it is in New Zealand's interests to give up some sovereignty in order to reap the benefits of cooperation with other nations.

However, in Section Three, we introduced a second conceptual window – that of viewing New Zealand as a region within a larger area. Under this view, decision making location can be seen as a series of concentric circles: decisions can be made by individuals, local governments, nation states, international organizations and at many other levels in between. It is clear that different decisions need to be made at different levels. Nations decide on the punishment for burglary, local governments decide which day is rubbish day and individuals decide what to wear when they get up in the morning. There may also be decisions that are most sensibly made at a supranational level.

By taking the emphasis off the nation state the issue is opened up. Rather than trying to decide when New Zealand should give up some of its sovereignty to international fora, the question can be recast as an issue about at what level of governance should decision-making be carried out. There is no presumption that it will necessarily be the nation state, and increasingly we are seeing states devolving to lower levels of government as well as cooperating internationally with higher levels. Of course, often the nation state *is* the optimal level of governance, but by looking at the question in a different way we might pick up things we've missed. The discussion that follows is intended to stimulate thinking on the kinds of situations in which governance at international level may be optimal.[75]

There is a long tradition in Western democracies for individual autonomy.[76] People should be free to pursue their own choices consistent with the preservation of similar freedoms for others. The default is for the state to stay out of the lives of individuals unless there are good reasons for interference. There *are* good reasons for interference however, if it can be established that the benefits of intervention outweigh its costs. Economics points to the establishment and maintenance of property rights, public goods and commons, externalities and information failures. Political theory argues over how much state intervention is justifiable and for what purpose, but even proponents of the most minimal state acknowledge a role for the state in such things as law and order[77]. Once it is established that there is a role for government the question of *which level* of government remains.

The principle of subsidiarity[78] argues for governance and decision-making to be located at the lowest level possible, unless there are reasons why it should be located at a higher level. Devolved decision-making allows for better private

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75 For another cut on this question see Lawrence, Bressand & Ito.

76 Kant, Hume, Mill, Rawls, etc.

77 eg, Nozick's 'night watchman state'

78 I believe this term originally came from the Roman Catholic Church, to describe the appropriate jurisdiction of the church in individuals' lives!

preference revelation and respects diversity in preferences, conditions and values. The smaller the decision-making unit, the better preferences are reflected in decisions. Furthermore, devolution increases government accountability. It preserves autonomy and aids communal solidarity and identity. Devolution allows utilisation of local knowledge and promotes experimentation. This would create a presumption for local government over national, and for national government over international. Like individuals, nations should be sovereign over their own affairs unless there are good reasons why not. Nevertheless, there are many cases where nation states will choose to give up some control over domestic policy because there are greater gains to be had.

Theories of fiscal federalism assert that the jurisdiction of decision-making should correspond to the jurisdiction of effects.[79] Kerr, Claridge and Milicich[80] have further developed this idea. They identify three principles and criteria for determining optimally efficient levels of decision-making and cost bearing.

1. Balanced decision-making: decisions should be located, where possible, with the jurisdiction of effects and costs. People who make decisions should be those who receive benefits and bear costs. This will avoid interjurisdictional externalities that could lead to under or over provision of a public good.

2. Informed decision-making: good decisions reflect all the relevant subjective and objective information. Those who experience the effects should make the decisions, since it is they who have subjective preferences about the issue. People with the skills and resources to access objective information should also be involved in decision-making.

3. Cost effective decision-making: when costs of decision-making are high and preferences are relatively homogeneous, decision-making at a higher level can save on duplication costs.

Local decision-making is therefore likely to be optimal when:

- There are no externalities;
- Objective information is held locally, or is unimportant;
- Subjective preferences are important and vary;
- Costs of decision making are low.

Central decision-making is likely to be optimal when:

- There are externalities;
- Objective information is held centrally and is important;
- Subjective preferences are homogeneous;
- Costs of decision making are high.

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[79] Oates, (1999)

[80] Kerr, Claridge & Milicich (1998)

Sovereignty is mentioned briefly; Kerr et al acknowledge that if decision-making *in itself* is something that people value strongly then this will weigh in the balance.

> In spite of the many arguments in favour of centralised decision making and implementation we may still bias toward devolving decision making to local communities if the social importance of local identity and control outweighs the social choice and efficiency benefits of more centralised control.[81]

Kerr et al have applied these principles to issues of devolution within nations but they also give clues as to when decision-making might be better carried out *between* nations.[82]

6.2.1 Balanced decision making

Provision of a public good or avoidance of a 'public bad' will be optimal if decisions are made by the people who feel the effects, and these same people also bear the costs. Balanced decision-making will avoid interjurisdictional externalities. Externalities and public goods may be international in scope. International cooperation is therefore important to internalise international spillovers and provide international public goods. Let's consider some examples.

Environmental concerns are a classic example of an area that has long been regarded as appropriate for international cooperation. Without co-ordination, pollution will be overproduced because the producer does not bear the costs of negative externalities to other nations. In a simple two-country situation Coasian theory would suggest that this problem could be resolved and the optimal level of pollution reached if the party without the property rights compensates the other. However, because pollution generally affects many countries, free rider problems are likely to arise making more explicit coordination necessary. International environmental agreements and fora aim to enlarge the decision-making jurisdiction to include all those affected and so provide a mechanism for affected nations to express preferences.[83]

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81 Kerr et al, (1998) pg 5

82 The major difference, when applying the framework to international decision-making, is that in the local/national devolution case we are optimising for the national level, whereas in the national/international case we only care about what is optimal for our nation, not the whole planet. Furthermore, there isn't a strong trans-national forum equivalent to 'central' decision making in the central/local case. The closer analogy would be if local regions within New Zealand were deciding when it was optimal for them to club together. This difference changes some of the analysis. For example, it makes issues of interjurisdictional spillovers more difficult because no overarching government has the mandate to take the interests of all those affected into account. It also makes redistribution largely voluntary – coercion is more difficult (we may not think this is a bad thing!). Nevertheless, the general principles provide a useful way of thinking more deeply about these sorts of decisions.

83 Another example would be enlarging the jurisdiction of financial risk externalities, through the IMF.

Another case where international institutions and alliances have long been active is in security matters. Security is an international public good. The benefits often extend beyond national boundaries. There are obvious incentives for free riding – a small country will inevitably benefit from the defence spending of a large, wealthy, friendly neighbour. There is likely to be inefficient underprovision – by opting out of cost bearing the small country will also opt out of decision-making and the resulting security is likely to suit it imperfectly.[84] Is this a case for making cost bearing and decision making trans-national, at least between countries with similar security interests? It may be in New Zealand's interests to free ride to some degree on Australia's defence efforts, even though they will under-provide for our needs, if we can tolerate the costs to our reputation.[85] Although Australia will provide the efficient amount of security for Australian needs, they could object to us free riding and, quite reasonably, use diplomatic pressure to stop us. It may be more optimal for both countries to cooperate in terms of defence planning and cost bearing in a more integrated way than currently occurs.

6.2.2 Informed decision making

The relative balance between objective and subjective information is central in determining who is best placed to make decisions. Subjective information refers to the preferences of those who will be affected by the decision. If preferences vary a lot and are strongly held then there is a strong case for decision making to be devolved to the lowest possible level. However, if preferences are relatively homogenous and unimportant and objective facts are important, then decision-making would best be done by those who hold the objective information. Objective information could be held at various levels of government, but in the case of complex scientific information it is often higher levels of government that will have the resources and capability to access it. This balance may become clearer if we think about an example.

Health and safety standards for food products involve a lot of objective information. It's just a scientific fact that certain things are bad for human physiology. Preferences are unlikely to vary much about the presence of certain toxic chemicals in food – cyanide is objectively very bad for us and we are unlikely to disagree about this. The objective information about food standards is complex and advanced. It is generally held at least at national government level, if not international. Many countries defer to the American FDA because they lack the skill and scientific economies of scale to test everything.

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[84] Conversely, if the large and powerful neighbour is a potential enemy rather than an ally, inefficient overprovision of security will occur as countries get locked into arms races.

[85] Although not totally – defence is an important private good for a nation as well as having international public good features. Australia's defence interests and risks are not absolutely parallel to ours. They're a mid sized power; they have an Indian Ocean coastline; and they're closer to Indonesia/Timor/Irian Jaya /Bouganville than us. Furthermore, free riding may not be optimal if we think of our interests in a wide sense, as including reputational values.

However, subjective preferences are also important in setting food standards. Scientific information is incomplete and, in the absence of conclusive evidence, standards may be based on attitudes to risk. These are like to be highly personal. New Zealanders may have less appetite for risk than other nations, and risk preferences may vary significantly within New Zealand.

This issue has been thrown into sharp focus in the GMO debate. New Zealand sets its food standards in collaboration with Australia through the Australia New Zealand Food Authority (ANZFA). Although we have special status as a separate state with regard to consultation, we otherwise have one vote on a panel of ten. Decision-making on food standards occurs at a level of governance higher than the nation state. However, given the lack of hard evidence on the health effects of GMOs in food products and the fact that subjective risk preferences seem to be extremely important in this case, this seems to be an argument for keeping decision making, on this issue at least, firmly within New Zealand.

6.2.3 Cost effective decision making

Kerr et al refer to the costs of the decision making process. Where costs are high and preferences are homogeneous there may be economies of scale from making one decision at a higher level and cutting out duplication. This principle has less relevance to the international context than the national one since there will be fewer situations where preferences are homogeneous. There may be some however.

A certain absolute level of bureaucratic decision-making is a necessity for a sovereign state, whether the population is 3 million or 30 million. For a country of 3 million, the bureaucracy has to be funded from a much smaller tax base. There may be some decisions that, rather than being made by the state, could be 'borrowed' from other countries, or made at an international level in cases where there are common priorities or perspectives. Standards are costly to develop; there are economies of scale if we piggyback on larger units. Niue and the Cook Islands provide good illustrations of small countries adopting other countries' policies as a solution to the high marginal costs of having their own. Both are self-governing in free association with New Zealand, which means that New Zealand looks after their defence and external representation. New Zealand is also a relatively small country. It may be inefficient for us to make choices about absolutely everything. The principle of cost effective decision-making reminds us that decision-making itself is costly. How much decision-making do we want given our size? How revolutionary and world leading do we want to be, given our size?

In conclusion, we need to reassess our views on what should be decided at which level of government from a fresh perspective, that questions the presumption that the nation state is automatically the privileged level. There are many innovative governance options that can co-exist to deal with different types of issues. This section has proposed some examples of the sorts of issues that are likely to be contenders for international cooperation. Applying the principles of balanced, informed and cost-effective decision-making is no simple matter; as always, costs and benefits need to be worked through on a case-by-case basis.

Attention will also need to be paid to issues of competence and accountability. This is an area ripe for further thinking.

Summary: Levels of Governance

If we change our perspective and view all levels of political organisation as equal, without an automatic presumption toward the nation state, then decisions about when to enter into international agreements change. Rather than trying to decide when New Zealand should give up some of its sovereignty to international fora, the question can be recast as an issue about subsidiarity: at what level of governance should decision-making be carried out.

There are similarities, in principle, between consideration of devolution to lower levels of government and consideration of 'devolution up' to supranational levels of government. The principles that guide decisions of devolution may also be applicable to decisions of international cooperation. The paper has discussed the principles of balanced, informed and cost effective decision-making in the international context.

Decision-making at lower levels of government has the advantages of allowing for and respecting diversity in preferences, conditions and values across nation states, and increasing government accountability.

Decision-making at trans-national levels of government may be optimal:

- **Where there are externalities that cross national borders;**
- **To provide international or regional public goods;**
- **Where scientific objective information is important and hard to access;**
- **Where international preferences are homogeneous;**
- **Where decisions could be more cost effectively made by, or in cooperation with, others.**

7. Integration and Identity

Sovereignty is closely linked to another notion – national identity. A strong thread running through concerns about national sovereignty is the concern that our national *identity* will be threatened or lost through integration and globalisation. If sovereignty was hard to pin down, identity is even more so.

Identity is the answers we give to the question "who am I?" There are a multitude of answers to this question – individuals have many aspects to their identity: family, territory, class, religion, ethnicity, gender, occupation or profession, education, leisure activities, values and beliefs, and so on.

Different aspects of our self may take precedence at different times and in different environments, and people will weigh the various aspects differently. Feminists may see their identity primarily in terms of their gender. Marxists define themselves and others according to socio-economic class. We have all met people who place great emphasis on their sport. Some identify strongly with their locality or region, seeing themselves as a West Coaster, or an Aucklander. For others their ethnic group, even if members are spread over a number of regions, is their prime focus. Religious and ethnic identities both strive to include more than one class, region, or gender within the communities they create around them. The two have been closely related, potent sources of group identification throughout history. In the modern era an enduring collective identity based on the category of the nation-state has emerged.

The nation is particularly good at helping us with the question of who we are – it gives us rich and satisfying answers. It offers a lot of identity markers with which we can orient ourselves. Nations are associated with an historic territory or homeland. In many, but not all, cases there is an ethnic bond of common descent. It is likely that members share common historical myths, memories, symbols and traditions, which are manifest in a common mass public culture. Language, accents and particular expressions all serve to unite groups. The idea of 'being a New Zealander' is layered with emotional complexity and meaning – it is hard to spell it out, but it gives us a sense of self and binds us to other New Zealanders. National identity refers essentially to a psychological bond – it is a community of sentiment, where members share ideals, aspirations, interests and traditions.[86]

The concept of a 'nation' can be distinguished from that of a 'state'. A nation refers to a cultural, emotional bond. A state is a political administrative arrangement – a bureaucratic subdivision of the world. Over the last 200 years cultural communities based on nations have emerged as the preferred basis of political organisation: the nation-state has been the primary political unit of the modern world. Emerging national identity has led to greater interest in national sovereignty.

86 See Smith (1991) for further discussion.

We have talked about why globalisation might threaten sovereignty. Let's look at why globalisation might threaten national identity.

7.1 The threat to national identity

7.1.1 Trade in goods

An argument that is sometimes advanced is that trade, in and of itself, erodes national identity. Free trade changes the pressures on an economy. Things in which a country specialised in the past may no longer be areas of comparative advantage. If national identity is closely connected with this past way of life, and it becomes unsustainable, then trade is a threat.

C'est la bonne vie

Imagine a nation that traditionally had small farms of 20 odd cows, muddy lanes, stone walls, bicycles with baskets, and anyone could farm this way if they chose. As the world modernised this style of farming turned out to be, not surprisingly, inefficient. As international trade increased it turned out that other nations could farm much more efficiently and provide farm products at cheaper prices. However, there remains the possibility that this nation may decide that the benefits of modernisation and openness do not outweigh the costs of losing this idyllic traditional lifestyle.

Aspects of French identity are closely connected with a rural way of life. Although only about 8% of French people live on farms it has been estimated that up to 40% have some connection with rural lifestyles, through being related to a farmer, or living on a farm as a child, and many more have looser emotional connections with the countryside.[87] Preserving the rural lifestyle is a political objective in France and the French are primary supporters of the European Union's common agricultural policy (CAP), which is aimed at supporting inefficient agriculture. Concerns about the CAP aside[88], if a nation genuinely has a preference for preserving an element of their identity at the expense of some material well-being, this is not automatically as 'irrational' as some economists would maintain.[89]

Despite connection to place and traditional ways of life in parts of Europe, as well as generous EU subsidies, people are still choosing to move off the land. It's hard work to farm in the traditional way and people are attracted to the material benefits bestowed by technology and growth. Governments may try and preserve history, but if affection for, and links to, tradition weaken as tastes alter, then tradition will change regardless.

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87 It would be interesting to compare this with New Zealand's situation.

88 And there are many. It is an inefficient and distortionary means of achieving its stated goals.

89 Although in this case it is not clear to what degree the French have a preference for support for agriculture – the French farm lobby is particularly powerful and may or may not represent wider national sentiment.

This type of argument does not seem to feature as largely in New Zealand. Other than Maori, we are all very recent immigrants. We have had less time to become attached to one, unchanging, way of life and greater geographical and occupational mobility. In Europe, when they say "my family is from Perugia" they may mean for the last 1000 years![90]

7.1.2 Global labour markets and the movement of people

Concern about our national identity tends to be primarily associated with flows of people. Immigration, over time, changes a nation's identity. Even if migrants assimilate well into the destination country's existing culture, they bring with them new elements that, over time, become part of that culture. If identity is about shared values and community of sentiment then inward flows of people, particularly from ethnic groups other than those currently dominant in New Zealand, may erode New Zealand values. This concern is particularly felt if immigration has been rapid and sourced from 'different' groups. The fear that immigration will erode national identity is compounded by the fear that outward flows, and in particular the 'brain drain', will hasten this change.

New Zealand is not without control in defining the direction it would like to evolve in as a people. We can and do respond to concerns about identity through immigration policy. We choose whom we let in – who can become a New Zealander. Historically we marketed ourselves in a way that attracted cultures that are likely to be compatible (although it could be argued that we are now doing this less). These responses need to be weighed against the benefits of immigration to New Zealand, as discussed in Section 4.

However, even in the absence of flows of people, identity may be threatened by flows of ideas. While new ideas and innovation are key mechanisms through which the economic benefits of integration and openness are felt, they also provoke concern. We fear becoming Americanised. Information and communication technology have contributed to fears of cultural homogenisation and anonymity. Responses to this include resistance to US spelling, lobbying for local content on TV, and so on.

7.2 Some observations about national identity

7.2.1 Identity is important

It is clear that identity is important. We seem to want to define ourselves – to have a sense of who we are. We seem to want to feel that we belong to, and identify with, sub groups smaller than 'all of humanity'. There is a multitude of ways we do this; national identity is one that has been particularly powerful.

Since national identity is important to New Zealanders, it is a legitimate policy concern. It will function as a limiting parameter when considering how much

[90] The implication of this is that openness may have hit Maori harder. The coming of the European can be viewed as Maori being exposed to the global economy.

policy integration is feasible, and with whom. The arguments canvassed in this paper about the benefits of integration are not sufficient for further integration. In a democratic system high levels of policy integration can only occur to the degree that people feel comfortable with it; when they feel that there is a community of sentiment between current New Zealanders and future groups we might cooperate with.

7.2.2 Identity is not always threatened by integration

Although identity is important, it is a mistake to see all steps toward integration as threatening to identity. There will not always be a trade off. We have discussed the way market integration in the goods or labour markets might cause concerns. But there will also be aspects of integration that allow us to maintain what matters of identity. The effect on identity of policy integration will vary case by case.

The relationship between identity and sovereignty is important to consider. Identity is currently strongly linked to the nation state, and also to sovereignty. However these links are neither necessary nor universal – they are a relatively recent phenomenon. The age of nationalism began in Europe with the French Revolution. Prior to this social organisation was based on agrarian social structures that were both smaller than nation state units (city states, feudal principalities) and larger (empires, both secular and religious). The imperative that boundaries of political units and cultures converge is a thoroughly modern notion. This implies that identity is possible without sovereignty and without nation states. The fact that it is possible to retain a strong national identity while integrating political structures is already evident in the evolution of the European Union.

7.2.3 Identity is dynamic

Identity may be important, but it is also dynamic. The whole idea that we have a clear ‘national identity’ that can be threatened and undermined is rather odd. It assumes a very static view of who we are: that our identity is fixed to one point in time, often claimed to be the present, or some golden bygone age. Preserving national identity therefore means freezing history. But why is 1950’s New Zealand any more privileged than 2000 New Zealand, or 2050 New Zealand? No one time is the ‘real’ New Zealand.

The Real India[91]

The sari – a classic and unique symbol of Indian culture. Right? Yes and no...

The contemporary wedding sari is machine embroidered and hand beaded. Machine embroidery is common throughout India but designs can be heavily influenced by textile traditions from Europe and England. Beading was introduced into India in the nineteenth century from Africa.

Parsi saris of the nineteenth and early twentieth centuries used Chinese silk and motifs. The Chinese origins were attributed to trade.

The 'kalga' motif was derived from floral patterns, developed into a fertility symbol (since it was shaped like a mango), was adopted by the English in the nineteenth century, made famous in textile mills in Paisley, Scotland, and developed into the paisley designs common in Europe and the US.

Cultural influences can absorb others and be absorbed. Just because aspects of the sari came from Africa, China and Europe doesn't make saris any less Indian. Just because sari motifs were transformed into paisley doesn't make saris less Indian. Or paisley more tasteful...

Cultures are dynamic, evolving and changing over time with each new force or influence. In stable periods of history cultures may remain unchanged for long periods and when cultural change happens it occurs gradually and organically so that we scarcely notice that customs and values are combining and assimilating and evolving. In periods of transition and rapid change the evolution of culture troubles us more. It's less clear that all those in our borders share a community of sentiment. Traditional life is disrupted and this sense of dislocation often results in even stronger calls for the preservation of national identity, as people search for stability. Rapid change unsettles us because we don't know who we are anymore.

In the west, the past century has seen unprecedented social change reaching fundamental parts of our lives. The changing role of women, and their movement from private to public domains, has had huge implications for the way women and men define their roles and identities in the family and society. We are very much in a time of transformation and adjustment: the old certainties about ourselves and our relationships are increasingly less relevant, and we are struggling to develop new ways of thinking about ourselves. Is it any wonder we are worried about identity?

91 Example drawn from "Colour and Ritual: A Celebration of the Indian Sari", Dowse Art Museum, Lower Hutt, 15 July – 8 Oct 2000

7.2.4 *Change is not necessarily bad*

Cultural change may not only be inevitable, it may be a good thing. Cultural diversity makes us much more cosmopolitan. A multi-cultural society may make us more open and tolerant of difference. Immigrants bring fresh ideas and perspectives, which have economic and social benefits. Many of those who seem to be part of the brain drain in fact return. Travel has allowed New Zealanders to spot enterprise opportunities and to expand the tastes and horizons of those who stay at home. It's not clear that it is desirable for most of the population of a small country to remain within it.

7.2.5 *National identity is not necessarily good*

Any discussion of national identity needs to include a cautionary note. Some sense of belonging seems to be a fundamental human need and we therefore tend to think of national identity as a good thing. We think, warmly, of the relaxed kiwi lifestyle; of baches and marmite and gumboots and ingenuity (or whatever romantic version of kiwiana that particularly inspires you).

However national identity has a dark side: nationalism. National sentiment is a powerful force and when directed against people identified as 'not belonging', whether they are within a nation's borders or outside, can become particularly nasty.

> *In the name of 'national identity' people have allegedly been willing to surrender their own liberties and curtail those of others. They have been prepared to trample on the civil and religious rights of ethnic, racial and religious minorities whom the nation could not absorb. ... The ideal of the nation, transplanted across the globe from its Western heartlands, has brought with it confusion, instability, strife and terror, particularly in areas of mixed ethnic and religious character. Nationalism ... offers a narrow, conflict-laden legitimation for political community, which inevitably pits culture-communities against each other.*[92]

Whether national identity is positive or negative might depend on whether it is inclusive or exclusive. 1930s Nazi Germans defined their identity in terms of an ethnically exclusive club and then proceeded to 'purify' their nation internally as well as expand externally. Colonial European powers expressed their nationalism through imperialism. Former Yugoslavia has long seen nationalistic conflict, and most recently 'ethnic cleansing', resulting from competing cultures in overlapping geographical areas all asserting that they are the authentic culture, and therefore nation, in the land. This contrasts with American national identity which, although passionate, is inclusive and adaptive – people of many ethnic and cultural groups can, and have, become Americans. This is also true of New Zealand. In the end, however, all groups define their identity *in contrast* to others, so national identity may, at its core, be a fundamentally antagonistic notion.

Nationalism has been a powerful force because national identity has been, and continues to be, particularly good at helping us answer the question of who we

[92] Smith (1991), 17-18

are. It bestows a sense of security and belonging that we value. However nationalism becomes a dangerous force when individuals and governments decide that national identity is *the* overwhelming policy objective. European experience differs significantly from the situations facing New Zealand. Nevertheless, there are lessons for us. To the extent that the state adopts a role in promoting national identity, it is important that an inclusive and adaptive New Zealand be promoted. Furthermore, the state must be aware of the risk that, even if it promotes an inclusive national identity, not all New Zealanders will interpret these messages in such a tolerant and open way.

7.3 New Zealand as a nation or a region: the challenge

Powerful new economic, political and cultural forces are shaping tomorrow's world. Transport and communication technology has fundamentally altered the world we live in. Mobility of people around the globe is unlikely to cease. The perspective of the world as containing isolated and self-contained nation states has long since ceased to bear much resemblance to reality. This has led some to speculate that we are seeing the end of the age of nationalism. Nation states will be eroded by the twin forces of increasing internationalism and increasing devolution to regions.

Others argue that, despite growing global interdependencies, we are a long way from witnessing the eclipse of the nation state. Collective identity at the nation state level will continue to command humanity's allegiances for a long time to come.[93] Whether we continue to operate primarily through the nation state lens, or move to a more regional perspective, we face a challenging future.

If nation states decline in importance, and we lose a strong sense of New Zealand identity, we will still be faced with the basic need for answers to the question 'who am I?' We may retain a concept of New Zealandness – our identity is in part conferred by our physical isolation, and we will always have this even without the nation state. Alternatively we will look to other aspects of our identity to answer this. We may see the rise of South Island identity perhaps, or Australasian identity, or class-based identity, or others. In this changing world we will need new ways of generating the security and sense of belonging that comes with national cultural identity. In the end all cultures will be left with a challenge: how do we foster an evolving sense of identity in a world of increasing mobility and merging of cultural influence?

If New Zealand the nation state retains its primacy in terms of demarcating our community of allegiance, and continues to be able to provide us with a cohesive sense of self, we still have to deal with the effects of mobility and globalisation. One option is that the State step up its traditional role of reinforcing and encouraging a sense of identification with symbols of public culture, through mass education and the media. Although there are likely to be welfare gains through an increased sense of belonging, it will be important to manage the risk of an intolerant or exclusive sense of national identity developing.

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93 See Smith (1991)

Summary: Identity

Identity, a sense of who we are, seems to be important to us. There is a multitude of ways that we define ourselves; national identity is one that has been particularly powerful.

To the extent that we value it, national identity represents a limiting parameter for policy. Policy integration can only occur to the degree that people feel comfortable with it. However, not all steps toward integration threaten national identity – there is not necessarily a trade off.

Identity is dynamic. Identity and culture have always evolved over time. Change can be beneficial in terms of opening New Zealand to new ideas and different perspectives, which may make us more tolerant as well as innovative. It may be the rapid speed of evolution in culture and identity that causes us particular dislocation and concern.

National identity can also be negative. Nationalism has been a powerful and destructive force when directed against those identified as not belonging. It is important that any promotion of New Zealand national identity be inclusive and adaptive.

Whether or not the nation-state remains a primary focus of identity, we will have to deal with the effects of mobility and globalisation. The challenge for the future is: how do we foster an evolving sense of identity in a world of increasing mobility and merging of cultural influence?

8. Conclusions and Implications for Policy

8.1 Costs and benefits of market integration

In order to assess what level of integration is optimal for New Zealand we need to understand the effects of integration on the living standards of New Zealanders. This paper has attempted to identify costs and benefits of integration across goods, services, capital and labour markets in terms of both material, and less tangible, aspects of living standards. Figure 5 summarises the key elements in our analysis.

Government is acting in an environment in which its power and influence is limited; globalisation is something that governments can influence only at the margin. Nevertheless, government is not without choices and these choices can make a big difference to New Zealanders' welfare even in this, largely reactive, field. Being clear about benefits and costs of market integration should help clarify our objectives.

That said, there are many things government can't influence. To a significant degree, thinking about external economic policy should be viewed in the context of thinking about how to manage the implications and consequences of a process largely outside our control. In these areas 'costs and benefits' are better thought of as 'positive and negative implications of integration' that will need to be managed.

Figure 5: Costs and Benefits

	Benefits	**Costs**
Incomes	Greater productivity and higher incomes through: better resource allocation; scale, scope and specialisation; technological advance; accumulation of human and physical capital; firm organisation and management practices; and plant/firm turnover. Particularly important for a small isolated economy like New Zealand.	Risk that activity will be more likely to locate offshore and New Zealanders remaining in New Zealand will not capture the benefits of greater productivity.
Income distribution	May contribute to narrower income distribution and less inequality. Access to lower priced goods disproportionately benefits those on lower incomes.	May contribute to wider income distribution and more inequality. Costs may be concentrated on particular sectors that are no longer competitive. Some individuals, groups and regions will be worse off.

Decision making	Opportunity for more efficient governance in some areas.	Difficult governance trade-offs to be made. Risk of making mistakes and ceding sovereignty inappropriately.
Identity	Opportunity for alternative forms of identity less closely linked with the nation state.	Dislocation as rapid change disturbs traditional views of New Zealand identity.

8.2 How do we decide the matter?

The question this paper has been attempting to address is: how integrated do we wish to be? We have identified key considerations that might influence the answer. However, reaching a definitive judgement about their relative weights is not possible because it involves empirical uncertainties and political judgements.

Empirical uncertainties

Integration is good for productivity. However, much of the analysis about the productivity advantages of integration hinges on how seriously we view the risk that economic activity will locate offshore as factor markets free up, and how much we can influence this. We lack the data to make a firm judgement.

- A particular development priority is work aimed at understanding the nature of capital and labour mobility between New Zealand and other countries. Do firms and people move? What influences their location decisions? How strong are the border effects keeping activity in New Zealand?

Other areas that would inform an assessment of the costs and benefits for New Zealand include work on the levels of density needed for various firm activities, and the response of firms to technology – does technology lead to dispersion or further agglomeration?

Concerns about income distribution centre on the fact that some will suffer as a result of a changed environment. How much of a problem this is may depend, to a large degree, on the speed of labour market adjustment. This is another area for further work.

- How effectively do labour market adjustment mechanisms work after a shock? Is the dislocation temporary or permanent? Do people retrain and/or move within New Zealand in order to find employment?

Political judgements

At the centre of the analysis lie matters of value. They cannot be resolved by applying economic analysis. They concern the preferences and attitudes of New Zealanders and should be vigorously debated in the public sphere and decided through the political process. What are we optimising for? Who and what do we care about? People or places? Which people? Which places?

We have identified mobility of capital and labour as a risk, particularly in terms of outflows. However, how we think about this depends on whom we 'count'. Those who relocate offshore will presumably be benefiting a lot from openness, whereas those remaining in New Zealand may suffer. If we include the welfare of all New Zealanders wherever they may reside, then there will be distributional effects, but it is less clear that loss of activity is, automatically, a bad thing.

- Do we care about the welfare and living standards of all New Zealand citizens, including those located outside New Zealand? Or should our policies be aimed at New Zealand residents?

- Do we value the prosperity of 'this nation' and 'this land' over and above the welfare of New Zealanders within and outside its physical borders?

Labour market adjustment may mitigate the 'winners and losers' problem regarding income distribution amongst individuals and groups. Their misfortune may be transitional. However, for regions within New Zealand, change is likely to be more serious.

- Do we care about places as well as people? Do we value the prosperity of regions within New Zealand over and above the welfare of New Zealand people? If we do, how much are we prepared to forgo to support them?

We are witnessing trends of devolution to lower levels of government as well as increasing international cooperation. Political units seem to be getting smaller while economic units are getting larger. Although issues of the appropriate level of governance may be informed by analysis and theory, a large element of this is also a political judgement.

- In what areas, and to what degree, is it important to New Zealanders to retain decision-making power?

- In what areas, and to whom, are we comfortable with relinquishing some control for a greater gain?

Value judgements cut to the heart of our identity.

- How do we see ourselves? What does it mean to be a New Zealander? What level of integration are New Zealanders comfortable with, and with whom?

- How do we foster an evolving sense of national identity in a world of increasing mobility and merging of cultural influence?

- National identity can be a negative as well as a positive force. In a changing world, should we even be aiming to base our identity on a concept of the nation state?

8.3 Implications for policy questions

Applying the insights about costs and benefits of integration to concrete policy choices facing officials and Ministers is vital further work. This work will need to draw on analysis of global economic and political trends to determine what might be achievable. An in-depth treatment of policy is outside the scope of this paper. We hope that others will take up the challenge.

The following section identifies key ideas that shape the analysis of policy and illustrates them with some current policy questions. It foreshadows more expansive work, combining policy objectives canvassed in this paper with practical considerations, to better illuminate policy choices.

8.3.1 Identify goals and objectives

The first rule of policy – be clear about your objectives when formulating policy. This sounds obvious, but it is too easy to become immersed in strategies and policy details and discussions about what we can and cannot do, and lose sight of what we want to do. We need to keep in mind the questions:

- What level of integration makes sense for New Zealand in an increasingly open global economy?
- On balance, would further integration serve our interests?

8.3.2 Make linkages across policy areas

This paper has attempted to approach issues of integration in new and broader ways. We look at integration across all markets rather than just focusing on trade. We look wider than just economic theories of productivity – living standards are about a lot more than this. We take a spatial perspective as well as a traditional 'nation state' perspective.

It is important to understand the full impact of policy decisions, and drawing out the linkages between policy areas helps us do that in a more explicit way. If we make changes to immigration policy, for example, we need to be aware that it may have effects on the flow of goods and services and capital as well as labour. When formulating policy advice we must ask ourselves:

- What are the implications of policy options on the goods, services, capital and labour markets?
- What are the implications of policy options on the range of elements that contribute to living standards?
- What are the implications of policy options on the location of activity?
- Have we taken into account mobility of capital and people?

Thinking Broadly

In a recent speech[94], Hon Dr Cullen mentioned the idea of an "Australia strategy". This paints a picture of New Zealand thinking about its relationship with Australia across policy areas, and beyond purely economic considerations. It suggests a perspective of New Zealand and Australia as a region sharing a great deal of common ground and highlights the usefulness of co-operating more.

8.3.3 Recognise what we can't control

In many domains further integration is inevitable. Every day individuals and businesses are making decisions and taking actions that cross national borders. The appropriate response from government is to be realistic about what the trends are, and identify what can and cannot be influenced. In the case of aspects of integration outside government control, policy responses are better framed in terms of how to deal with the consequences for, and impact on, New Zealanders.

Issues of national identity are a prime example. Identity is something that is subtle, intangible and not at all easily influenced by governments. It is always a fluid socially constructed phenomenon, but rapid change brings dislocation as traditional sources of identity are disturbed. A rapidly changing world is not something the government can control or stop. Disturbances in feelings of identity are also not easy to address, although the government may be able to play a role in trying to ease the transition through, perhaps, signalling a multi-cultural global identity for New Zealand.

It is important to subject policy choices to the following questions:

- Do we have any control over what is happening?
- For those things that are beyond government influence, what can we do to maximise the benefits for New Zealanders and minimise the costs? How can we capitalise best on the inevitable?

94 Address to Deloitte Touche Tohmatsu & the Council for Economic Development of Australia, Melbourne, 9 August 2000

Can't stop those people

Skilled labour is highly mobile – talented people have the ability to move internationally, regardless of what the New Zealand government does. Unskilled labour is also pretty mobile, at least to Australia. The movement of people across borders can raise some tricky policy problems.

For example, a young New Zealander finishes university with a $30,000 student loan and then moves to the US to work. Should the New Zealand government be able to recover loans from citizens while they are overseas in the same way they do for citizens within New Zealand? How would we go about this?

Another interesting policy issue concerns superannuation. Should a retired New Zealander be able to take their super entitlement with them if they move overseas in their retirement? Or, if someone has spent a considerable amount of their working life overseas, should they be entitled to super payments on their return to New Zealand?

And tax rates – does increasing mobility of people mean that there is increased pressure for lower income tax rates?

Returning to a closed economy is no longer an option; technology, communications and the global economy have changed too much. People are mobile and this is likely to continue. Policies based in the nation state paradigm will therefore come under increasing pressure to change in the future and we need to be prepared to think about them.

8.3.4 Identify where we do have choices

Despite the, sometimes overwhelming, lack of influence government has on integration we do have choices. There are a number of dimensions across which government can act to oil the wheels or put sand in the wheels of continuing integration.

We have choices about policy area. Options include: tariffs, non-tariff barriers, regulations and legal systems, competition policy, monetary policy, fiscal policy, investment regime, immigration policy, and the physical infrastructure.

We have choices about level of engagement with other countries. The options are generally characterised in terms of unilateral, bilateral, regional and multilateral tracks. By definition, we have a great deal of control over our unilateral choices. Multilateral forums, at the other extreme, are time-consuming, fraught with disagreement, and leave most individual nations with very little control. Countries persist because the gains, when they come, can be high particularly for small nations like New Zealand. Acting in consort, or free riding, are also options.

If we engage bilaterally or regionally with other countries we have choices about how far to go. Options might include: free trade agreements, customs unions, common markets, economic unions or even political union. We also have to decide with whom we engage, and when. Finally we have choices about which sectors agreements might cover. Obviously these bilateral and regional decisions are highly dependent on having a likeminded partner/s. What we can realistically achieve must inform what we seek to achieve.

Policy questions include:

- Which policy area/s?
- What level of engagement with other countries?
- How far?
- With whom?
- Which sectors?

Money money money

If we decide to oil the wheels of integration, there are a number of tools that are under the control of government. Monetary policy is one that has received considerable attention in recent times.

Monetary policy integration can offer a reduction in transaction costs and uncertainty when dealing with another country. Integration can take the form of a system of fixed exchange rates between countries, or an irrevocably fixed system such as a common currency or the adoption of another country's currency. There are also costs associated with losing control of monetary policy as a policy instrument. The general theory behind monetary policy integration argues that such regimes are most appropriate for areas closely integrated through trade and factor movements. The optimal size of the currency area depends on the trade-off of microeconomic efficiency against macroeconomic flexibility[95]. New theoretical developments also suggest that there are benefits from a common currency deriving from reducing exchange rate variability. Studies have been done on the costs and benefits of New Zealand forming a common currency with Australia or the United States.[96]

8.3.5 Prioritise

It is clear that there are many policy options that may affect our objectives. Once we have sorted areas in which government is basically a responder from areas it can influence, we are still left with a wide range of policy options. Not unlimited choice, but much wider than the resources of a country of 3.8 million people can support.

95 See Coleman (1999) for a discussion of economic integration and monetary union.

96 See Grimes & Holmes (2000)

It is necessary to prioritise. We want to know which policies, what types of international agreements, with whom, and covering what, will provide the biggest benefits for New Zealand at the least cost.

The answers to these questions are difficult, depending not only on being clear about objectives and domestic preferences but also on the complex and ever-shifting international political and economic environment. This has been identified as the subject for follow-on work.

- Which choices are likely to provide greatest benefits for New Zealand at least cost?

Who are we interested in?

The question of with whom New Zealand should pursue economic relations is clearly one where strict prioritisation is vital. We need to assess the strategic importance of various relationships, both actual and possible.

Currently New Zealand has a very close relationship with Australia and has recently signed a closer economic partnership agreement with Singapore. New Zealand also has close ties with some Pacific nations and is a member of APEC. We also consider the multilateral WTO process of central importance.

One important question to answer is whether the gains are larger from continuing to integrate with current close partners such as Australia or from having lower levels of integration with a larger number of partners. One might conclude from the material in this paper that the marginal gains from integration are highest at the lower levels of integration, and so New Zealand would get the most 'bang from its buck' by pursuing free trade agreements, say, with many different countries. However, we have also seen that policy integration is more likely to yield benefits where there are high levels of social integration, implying we should focus on countries most similar to us. Furthermore, there are sunk costs involved in negotiating agreements with other countries which may make it easier and cheaper to extend relationships with current partners, even though the benefits may be less. As a small country it is important that we not over-diversify in terms of the relationships we are able to maintain. There is no point in spreading ourselves too thin and failing to make an impact anywhere because our effort was inadequately focused.

It will be important to develop criteria to inform this issue. Criteria would depend on the policy issue. Candidates for goods market integration might be filtered according to, for example, the size of their economy, prospects of social integration, political factors, view of future trade bloc arrangements etc. Criteria for capital market/currency area integration include the extent of goods and labour market integration, business cycle synchronisation etc.

8.3.6 Think harder about trade-offs between 'first best' domestic options vs. options that facilitate integration

There are costs and benefits to being different. Difference allows New Zealand to have its own preferences exactly reflected in policy. It also allows policies to be fine-tuned to the New Zealand environment so that they are 'first-best'. However, different policies can sometimes be a barrier to integration, not least because they are less likely to be well understood outside New Zealand. There may be a trade-off, in some instances, between having ideal policy from a domestic point of view, and having ideal policy from an integration point of view.

- Thinking harder about the trade-offs between the costs and benefits of being different is an important area for development. Have we viewed policy options from the perspective of 'New Zealand in the world' as well as from a domestic perspective?

Nobody understands us![97]

Costs of being different are evident in a recent case concerning takeover codes. A Japanese brewer bought shares in Lion Nathan belonging to key board interests, and some other players, at above market price, and secured control. Some of the Australian fund managers were left as minority holders without the option of selling their shares at that price. They were critical of New Zealand law, arguing that this is why they had not secured the offer price themselves.

We have chosen our system of regulations because we believe it is best for us. However there is a danger that, because we are small, people don't spend much time researching our market. Although big shareholders understood our rules very well, some foreign investors, in the absence of any further information, are likely to assume we are like others. If this occurs, and investors are caught out, it may ultimately harm investment in New Zealand. We would be well advised to consider this global perspective as well as the purely domestic optimum when regulating.

If we decide the advantages of being the same as others are convincing, there are various methods we can use to synchronise policies. One is harmonisation, where a common policy is adopted between countries. Another possibility is mutual recognition, where each country maintains its own policy but will accept the policy of the partner country. Other options include unilateral adoption of another countries regulations.

Australia and New Zealand have utilised both mutual recognition and harmonisation. The Trans-Tasman Mutual Recognition Agreement (TTMRA) provides that goods that can be legally sold in one country can be sold in the other, and that people who are registered to carry out an occupation in one

[97] Example drawn from a seminar given by Credit Suisse First Boston.

country are entitled to practice an equivalent occupation in the other. The Australia New Zealand Food Authority (ANZFA), by contrast, have opted for harmonisation, and common food standards for both countries are determined jointly. The European Union has largely gone for mutual recognition, in part because of the enormous difficulty in negotiating shared standards among a large number of nations.

8.3.7 Keep an open mind about location of decision making

The paper has argued that we shouldn't assume that the nation state is automatically the optimal level of decision-making. In many cases it will be. But there may be some situations in which international co-operation is desirable. How much national policy choice should we give up to gain the benefits of policy integration? Further work is required to put a framework around criteria for location of decision-making.

- How do we think more clearly about the benefits and costs of signing up to international agreements?

- What are appropriate domestic processes to ensure that decisions to cooperate internationally are made competently and in consideration of all relevant information and preferences?

8.4 Key themes

Integration is happening, whether we like it or not. This presents both opportunities and risks for New Zealand's future economic performance and has implications for income distribution, regional distribution, governance and identity. Issues about how New Zealand should respond will still face us in five to ten years time, and are likely to become more pressing. As such, a careful analysis of where New Zealand's interests lie, and its implications for policy, is a matter of strategic importance.

Government is acting in an environment in which its power and influence is limited; globalisation is something that governments can influence only at the margin. It can oil the wheels or put sand in the wheels of integration – it cannot drive the machine. Whilst governments can hasten or hinder the pace of integration much of their role will be around responding to the implications of integration. We need to understand where government has choices, where it doesn't, and what the benefits, costs and implications are.

Applying an understanding of the costs and benefits of integration to policy choices is not straightforward. We are operating in an environment of uncertainty, making conclusions difficult. Integration is likely to bring significant benefits to a small country like New Zealand. However we need to know more about capital and labour mobility to evaluate the risk that activity will locate offshore.

Furthermore, at the heart of an evaluation of costs and benefits of integration lie value judgements that go beyond calculations of economic welfare. An economic perspective is crucial in informing these judgements; but the judgements themselves are broader. The paper has identified political judgements that need to be made in the areas of location of people and activity, levels of governance, and identity.

APPENDIX 1: Input Accumulation

Galt (2000) finds there is no international consensus about appropriate theoretical models of growth. Various theoretical approaches include:

- Neoclassical growth models, which suggest that accumulation of factors, such as capital, labour and human capital, should raise output levels over time but with diminishing returns. In the long term this means any burst in additional factor accumulation will be temporary, even if leading to a higher income level. Growth can be boosted persistently through exogenous factors such as improvements in technology.

- Endogenous growth models, which suggest that growth may be able to continue indefinitely, with contributions from phenomena such as technical change being embodied in the capital stock; human capital investments; R&D spillovers; economies of scale or increased specialisation in intermediate inputs.

Other theorists suggest that the nature of the institutions and culture in a society; the role and size of Government; macroeconomic conditions and many other matters may contribute to growth performance.

This paper has focused on the type of effects described in the endogenous growth literature. These effects are of particular interest as they can lead to consistent long-term growth. Our position, that a focus on productivity is more important, hinges on beliefs that improving productivity will increase growth, incomes and employment to a greater degree, and for longer, than simply accumulating factors of production.

Nevertheless, input accumulation has been a significant factor in the initial growth of countries. For instance, many authors regard the East Asian economies as good examples of the benefits factor accumulation can bring in the early stages of development. For this reason this appendix briefly discusses some of the key ideas surrounding the accumulation of labour and capital.

The link between the level of productive inputs and the achievable level of output is relatively obvious. In almost any business, productive capacity can be made larger by increasing one or more key inputs. Note that this does not mean increasing any input will increase output – it is only true for the subset of inputs that are constraining productive capacity at that time. These inputs may also need to be of a certain quality.

Expanding the stock of labour

There is a range of ways to increase the size of the labour force over the longer-term: higher birth rates; lower death, sickness and accident rates; higher levels of labour force participation (for example, of the unemployed or women); and higher levels of immigration. All of these will lead to higher levels of economic output. To the extent that the changes are ongoing (e.g. sickness and accident rates are improved by 1% a year, each year) they will lead to sustained higher growth.

It should be noted, however, that in most developed economies it is the availability of high quality labour that constrains productive capacity, rather than the quantity. This is why it is important to focus on the human capital aspect of labour. Education and training approaches are particularly important, as discussed earlier in the paper.

Also, while the methods that involve increasing the total workforce will increase the aggregate level of a country's output, they may not necessarily increase the level of output per person (i.e. labour productivity). It is also worth noting that as countries become wealthier, their labour force participation rates can fall (as can the average level of hours worked by those in employment) as some of the higher income is taken as leisure.

Accumulation of physical capital

The level of physical capital in an economy can be augmented by higher levels of domestic saving and by tapping into the saving of foreigners.

Currently in New Zealand domestic saving and foreign saving contribute fairly equally to new investment. Note that the level of foreign saving in the economy corresponds to the current account balance. There are often debates over whether domestic saving should be actively encouraged in order to stimulate growth, and reduce reliance on foreign sources of saving. However, the empirical evidence to date suggests that while higher growth may lead to higher domestic saving, higher domestic saving does not necessarily seem to lead to higher growth. A cross-section view of countries domestic saving rates and growth performance reveals no discernable pattern. For example in the United States, domestic savings have fallen over the past two decades while growth rates and output have steadily risen. In addition there does not seem to be a limit to how long a country can rely on the savings of others. Countries such as Australia and New Zealand have run current account deficits for many years.

The effect of increasing the level of physical capital, say by raising the savings rate, is to provide a temporary boost to growth. This occurs as the economy moves to a higher level of output with its larger stock of capital. Per capita incomes will be larger, but per capita income growth will return to its original path[98].

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[98] See for example Barro & Sala-I-Martin (1995)

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