## Whither trans‑Tasman economic relations? Some emerging themes

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## Introduction

Next year marks the 30th anniversary of the Closer Economic Relations (CER) agreement between Australia and New Zealand. Over that time, our economic relations have become a lot closer. Tariffs on merchandise trade between the two countries have been all but eliminated. Many barriers to trade in services and to the flow of people and capital have also been removed. These changes have increased trade, investment and people movements between Australia and New Zealand and yielded benefits for both countries.

But is there more that could usefully be done? In March, Prime Ministers Gillard and Key asked the Productivity Commissions of each country – the New Zealand one having been established just over a year ago – to conduct a ‘joint scoping study’ to explore this question and identify reforms that would further enhance economic integration and improve economic outcomes for both countries.

We have now been at it for nearly three months, and have undertaken consultations with government, business and community groups as well as receiving around 60 submissions. A message from some of our consultations is that progress on integration seems to have lost momentum. There is recognition that much has been achieved, but also indications that more could be. Our task is to assess this and make proposals for consideration by the two Prime Ministers at their next meeting in early 2013.

It should be acknowledged that economic integration has been getting a bad press of late, courtesy of the European debt crisis. But it is important not to lose sight of the benefits that greater integration can bring for living standards in the countries concerned — by reducing transactions costs that inhibit the exchange of goods, services, capital and technology and the movement of people (for work and tourism). While much economic integration is driven by the actions of profit-motivated businesses and individuals, governments can do things to reduce transaction costs directly (like reducing tariffs) as well as prompt markets to drive costs down (for example, by making it easier for new firms to compete).

It should also be recognised that the world economy, and the Asian region in particular, have undergone extraordinary changes since the signing of the CER 30 years ago, and so have our economic relations with other countries. The Commissions will endeavour to map out a trans‑Tasman integration agenda that is relevant to these wider horizons and their opportunities and challenges.

## What has been achieved?

The genesis of the CER goes back to a meeting of Prime Ministers Fraser and Muldoon in Wellington in 1980, when it was agreed that, as the Australian Prime Minister expressed it:

If the two countries can cooperate more closely in their own trading relationship, with each concentrating on what it does best, it will help both countries to grow stronger and to compete in wider markets. We agreed in Wellington that any closer economic relationship must be outward‑looking…

The CER agenda initially focused on goods trade, but it has evolved considerably to also cover trade in services, investment, business environment, taxation and government procurement. By 2004, these extensions were encompassed in the ambition of creating a ‘single economic market’. The current work program is directed at this, with the aim of enabling business, consumers and investors to conduct operations ‘seamlessly’ across the Tasman.

It will not surprise an Australian audience that such a seamless regulatory environment has yet to be realised, given the lack of one across our own country. But much has been achieved, and the results are reflected in our economic dealings. For example:

* the value of two-way merchandise trade between Australia and New Zealand has grown at an average annual rate of 8 per cent, which is higher than growth in Australia’s trade overall
* services trade via commercial presence in the partner country has expanded greatly in sectors such as banking and telecommunications
* the New Zealand born population in Australia (a group that has a high workforce participation rate) has nearly tripled

As noted, such increased economic integration, by expanding the extent of the market enables countries to capture greater scale advantages and specialise more in those things they do relatively well, with lower priced imports taking the place of more costly domestically produced goods and services in a dynamic competitive process. Consumers benefit from lower prices and greater choice. And the integration of labour markets, a prominent feature of the trans‑Tasman relationship, opens up opportunities for people to develop and apply their skills and earn higher wages.

But where integration is pursued bilaterally, there is also the possibility that it might come at the expense of integration with other countries. For example, some studies indicate that the CER has resulted in trade diversion – switching imports from lower-cost third country suppliers - and, therefore, that the net benefits may not have been as large as thought (some studies even suggest net losses).

It should be said that such studies have some limitations, including the difficulty in isolating CER‑induced effects on trade from those caused by changes in market conditions and other policy settings. And they mostly focus on merchandise trade, whereas the CER agenda has expanded to encompass services trade and investment.

It is also possible that CER helped engender reform to broader policy settings in Australia and New Zealand. It has been suggested that the CER helped to change opinions about trade protection for manufacturing and paved the way for unilateral reductions in tariffs generally, particularly in New Zealand (Scollay, Findlay and Kaufmann 2011). In this way, and unlike some other agreements, CER appears to have acted more as a ‘building block’ than ‘stumbling block’ in the pursuit of wider integration.

The quantitative studies nevertheless underscore an important point: the ultimate test of policy initiatives across the Tasman is not whether they simply increase mutual trade or investment, but whether in doing so they yield net benefits overall for our populations, accounting for broader regional relationships and interactions. That is the test that the two Commissions will be applying in the agenda we ultimately propose.

This will not be straight forward, since, looking beyond the current work program, it is clear from our consultations and work thus far that much of the ‘low hanging fruit’ has been picked. Extending or deepening the trans‑Tasman integration agenda will require tackling some more complex and contentious areas of policy and regulation.

## Some emerging themes

Some themes are already emerging from consultations and submissions and from our own deliberations, which help to frame the more detailed assessments of policy options.

#### Closer, but not too close?

Our Issues Paper included a stylised representation of different levels of integration, commencing with free trade at one end and economic and political union at the other. None of these levels is necessarily superior to the others, as their impacts on economic outcomes can be ambiguous. Current trans‑Tasman arrangements embody elements of free trade and a common market. Could or should we go further?

On the basis of what we have been hearing thus far, the answer would seem to be ‘not too much further’, at least in this textbook categorization of the options. Political union — a real prospect at the dawn of Australia’s Federation and still contemplated in our Constitution — is clearly no longer a live option. (As an aside, with the upcoming London Olympics in mind, some might be aware that in the 1908 and 1912 Olympics we fielded a joint team. This could well be characterised as our integration high point! For example, there was no dissent at one of our recent roundtables when a New Zealander ruled out the prospect of a joint national rugby team!)

That political union is a step too far is therefore generally accepted. However a less recognised implication is that this also rules out or limits the scope for key elements of economic union as well, to the extent that they would effectively necessitate adherence to common policy/political positions over time. (Recent developments in the European Union have been instructive in this respect.)

This was underlined by the reaction on both sides of the Tasman to the brief mention in our Issues Paper of a common currency. This is an idea that has been raised and rejected more than once in the past. A key argument against it is manifest in Australia’s recent mining boom and the appreciation of Australia’s dollar relative to that of New Zealand.

Countries with different economic structures and conditions will face differential pressures for adjustment through their exchange rates. Within a Federation the adverse impacts stemming from the absence of such a mechanism can be at least partly alleviated through fiscal transfers. But that requires a ‘national’ government. (And even then it is not without difficulties, as the recent controversy over the extent of the transfers under Australia’s elaborate system of Horizontal Fiscal Equalisation demonstrates).

Even if two countries had identical economic structures, and therefore identical ‘shocks’ through trade, their fiscal and monetary policies may diverge for reasons that have more to do with democracy than economics. And under a common currency any such divergence would give rise to costs for one party.

Regulatory harmonisation also tests the boundaries of sovereignty. Governments will cede autonomy over those areas of regulation where they see larger benefits to their constituencies — either through the reduction of transaction costs or to constrain decisions that could otherwise favour special interests at collective cost. Tariff policy is a case in point (though other forms of protection have had a habit of breaking out).

Many areas of regulation reflect local circumstances or preferences — economic, environmental or social — and governments rightly resist ceding autonomy where their electorates expect them to be responsive and will hold them accountable. So it would be idle to expect our two governments to agree to harmonise many environmental regulations, for example, even where existing differences impose costs on business. Even in areas of business regulation harmonisation can be difficult to achieve, as Australia’s experience in areas such as rail safety, Chemicals and OHS illustrates. To be achievable, the harmonisation of sovereign areas of regulation requires a common understanding that the benefits of the harmonised option will exceed the costs for both parties, not only in the immediate term but also into the (uncertain) future.

While the ‘highest’ levels of integration in the textbook hierarchy are therefore unlikely to eventuate, similarities in culture, institutions and values bode well for deeper economic integration between our two countries than could be expected with any third country. As Australia’s Prime Minister recently expressed it, New Zealand is ‘family’. That also means that decisions about our economic relations will inevitably be driven by more than a narrow economic calculation of national benefit on either side of the Tasman.

#### The benefits must outweigh the costs (overall)

There is nevertheless agreement that the integration agenda should result in net benefits overall for each country, as specified in the Terms of Reference. The Commissions are also asked to identify those areas of reform where ‘joint net benefits’ appear highest.

What is not referred to is how the benefits should be distributed across the two countries, or at what level of policy aggregation the net benefit calculation should be made. Those participants who have addressed this question, which was raised in our Issues Paper, have generally argued that the fact that there may be uneven distribution of benefits, or even losses to one party, from actions on a specific item, should not matter provided a ‘win-win’ outcome is achieved ‘overall’. The level of aggregation that ‘overall’ might apply to will likely depend on the linkages among different components of the reform agenda as politically agreed. Our main job is to try to determine the values for the individual components of the calculus.

Asymmetry in the distribution of gains is probably inevitable in most policy areas, given the size of the two countries and their different relative significance to each other. For example, while Australia accounts for around 20 per cent of New Zealand’s trade, New Zealand accounts for only 3-4 per cent of Australia’s. (This underlying asymmetry is reflected in the greater interest in the inquiry and its likely outcomes displayed in New Zealand than in Australia thus far.)

Some participants have expressed concerns about integration leading to a ‘hollowing out’ of the New Zealand economy; for example, that skilled New Zealanders are being attracted to large Australian cities such as Sydney or Melbourne, where knowledge-intensive activities tend to cluster and remuneration is higher.

This concern should not be ignored or lightly dismissed. But a number of matters are relevant in assessing it. One is understanding what has been happening in practice. For example, there has clearly been a sharp rise in New Zealanders crossing the Tasman to work in Australia. But the old joke about this enhancing both nations suggests that not all these workers have been the most highly skilled. This is reflected in available statistics relating to skills. There is also the counterfactual to consider: to what extent in the absence of formal integration initiatives, labour outflows would have occurred anyway — either to Australia or to other countries. And there is also the question of how to treat the enhanced incomes of (temporary) expatriates in a calculation of net national benefits.

Concerns about ‘hollowing out’ focus on a subset of the costs and benefits of integration and there is a need to look at the whole picture. It may also be that the best policy response to these concerns is to accelerate domestic reforms that increase the attractiveness of doing business in both countries.

#### The bigger regional picture is important

The trans‑Tasman integration agenda needs to ‘fit’ with the broader challenges and opportunities in what is becoming known as the ‘Asian century’. This has always been true and, as noted, was acknowledged at the inception of the CER agreement. But much has changed internationally and within each country since that agreement was signed in 1983.

For example:

* Australia and New Zealand have undertaken major economic reforms (including substantially reducing their import barriers generally), which have furthered international integration.
* Capital has become much more mobile across national borders, with global financial flows increasing from around 17 per cent of global production to 54 per cent (PC 2010).
* Market driven integration has been given a boost from technological progress and cost reductions in international communications and transport.
* The rise of Asia has seen the share of global GDP within 10 000 kilometres of Australia and New Zealand double in the last 50 years. And since 1983:
* Asia’s share of global output has increased from 17 per cent to 26 per cent (and it is forecast to reach 50 per cent by 2050);
* the proportion of Australia’s trade accounted for by Asia has increased from around 41 per cent to 64 per cent;
* the proportion of New Zealand’s trade accounted for by Asia has increased from around 29 per cent to 43 per cent.

At the same time, multilateral efforts to promote trade liberalisation have clearly lost momentum. The Doha Round began 12 years ago, but is yet to be concluded and its future is uncertain. By contrast, bilateral and regional trade agreements have proliferated. When CER was signed there were fewer than 20 other such agreements in place — by 2010 there were 288, with more being negotiated, including by Australia and New Zealand (WTO 2010).

All of this has reinforced the need to consider trans-Tasman integration in a broader regional and global context. This means avoiding doing things that impede integration with other countries. It also means considering how we can extend trans‑Tasman initiatives to reap further gains from broader integration in multilateral fora and at a wider regional level, such as within APEC or the emerging Trans Pacific Partnership. It was observed earlier that CER has previously involved some trade diversion from other trading parties. Fortunately this was at least partially mitigated by our extensive unilateral MFN liberalisation. Finding ways to ensure that trade and investment creation predominates more generally should continue to be an objective for us moving forward.

The rise of Asia presents great opportunities for both our countries — with benefits that potentially greatly outweigh those on offer through our own further integration, significant though these may be. The best way of positioning ourselves to capture the benefits of the ‘Asian Century’ will be to enhance the productivity and competitiveness of our own economies.

#### Domestic reform by one partner is also good for the other

The domestic reforms that have occurred since CER was introduced have already paid dividends in this respect, as well as bringing purely domestic benefits. But neither country could be said to have come near exhausting the possibilities for enhancing productivity though domestic reforms. There is much more to do, and it is important to consider how the domestic reform imperative can be advanced through the Trans-Tasman relationship. For example, we have each undertaken beneficial reforms from which the other can learn.

Moreover, to the extent that such reforms raise incomes in one country, the other country will benefit anyway. To get a better fix on the magnitude of this ‘prosperity spill over’, Commission researchers in Australia have been undertaking some economic modelling that can account for both direct and indirect linkages within and across our economies. This indicates that a 1 per cent expansion of the Australian economy leads to an expansion of 0.3 per cent in New Zealand. In other words, the New Zealand economy is projected to get a boost proportionately equal to nearly one‑third of what Australia gets from any productivity enhancing domestic reforms. The key linkages are through trade and investment: as Australian incomes grow, demand for New Zealand’s exports increase, as do investment flows from Australia to New Zealand.

Australia obviously receives a much smaller stimulus from economic growth in New Zealand. But some sectors of the Australian economy were found to benefit significantly, such as mineral products and other metals and construction services.

By the same token, any policies that served to reduce Australia’s productivity performance and income growth would also impact negatively on New Zealand. Each country, therefore, has a strong interest in good public policy across the Tasman.

#### The way forward: a grand vision or (more) ‘Kiwi–Aussie pragmatism’?

A message we are hearing from consultations is that the general predilection of Kiwis and Aussies for getting on with the job, while steering clear of grand gestures, fits well with the challenges and opportunities ahead. But it is necessary to have a clear idea of what the ‘job’ is. So articulating a ‘vision’ for the trans-Tasman relationship also makes sense. That is not to suggest that there have been none to date. The aspirations in the concepts of a ‘single economic market’, or ‘seamless regulatory environment’ — in which people and business from one country can have a ‘domestic-like’ experience when in the other — already constitutes a vision. It is grounded in the practicalities of our relationship and one that still seems relevant to the future, though perhaps augmented with a more explicit acknowledgement of the wider regional context.

‘Kiwi-Aussie’ pragmatism (a term used by a participant at one of our roundtables) is likely to serve us well in:

* the ambitions and priorities we set for further trans‑Tasman integration
* assessing joint net benefits and dealing with any sensitive distributional issues that may arise
* working through issues where national autonomy considerations come to the fore
* learning from the things that the other country does better, and
* reforming or devising new governance/institutional arrangements to manage the ongoing integration agenda.

Harmonisation of business regulations is a case in point. One option that has been raised would be to follow a decision rule based on a ‘negative list’ — that all regulations should be harmonised except where a good case is made against it. An alternative is to focus harmonisation efforts on those areas of regulation that pass certain threshold tests based on likely net benefits — such as common agreed regulatory objectives and large transactions costs from current regulatory differences. A more pragmatic additional ‘filter’ might be whether or not such areas of regulation have succeeded in becoming harmonised across Australia’s Federation. Where this is not so, or the relative costs and benefits are uncertain, harmonisation will probably not be worth pursuing, at least in the short term. That said, mutual recognition remains an important (and arguably underutilised) alternative and potential precursor to harmonisation.

## Emerging policy action areas

As shown in the Issues Paper, we are using a framework based on the ‘four freedoms’ — in trade in goods and services, and in the movement of capital and labour — to identify potential areas for further integration. But our framework also encompasses freedom of knowledge and integration or interaction of government functions. Government regulation and other measures can impede these freedoms at various points — between the borders, at the border or post‑border.

There are lots of items to consider. Potential reforms can be screened according to their:

* width of reach (number of entities and/or value of activity affected)
* depth of reach (degree to which entities are affected and/or compliance and other costs of the current arrangements)
* implementation costs
* how costs and benefits are shared between the two countries (with higher priority assigned to those that produce clear net benefits for each) including any impacts on ‘third country’ relationships.

Evidence needed for this is coming from submissions, consultations, previous studies or reviews and from our own research.

We are also looking out for impediments that, while not imposing great costs, may be causing unnecessary irritation and going against the spirit of the ‘domestic‑like’ experience. It has been suggested to us that current mobile phone roaming charges, departure taxes and bank transfer fees all fall into this category.

Without pre-empting what we might say in our draft report — still nearly 3 months off — we can alert you to some other potential policy initiatives to advance the ‘four freedoms’ that have been featuring in discussions on both sides of the Tasman.

#### First freedom: a Customs Union?

Under the CER, imports from the partner country enter duty free, although they first have to comply with ‘rules of origin’ that are costly to administer and can lead to distortions in production.

While this means that there is already just one regime for goods trade across the Tasman, Australia and New Zealand have different tariff regimes for other countries. One option we have been prompted to explore is a ‘customs union’, under which Australia and New Zealand would set a common external tariff on imported items. Depending on the details, this option would allow for the CER RoO to be abolished. It would also join the two partners at the hip for future trade negotiations, which some commentators have suggested would increase our bargaining power and help ensure that New Zealand in particular is not left out of any worthwhile future trade blocs, particularly in Asia.

However, there are also costs and complexities in forming a customs union, and being ‘joined at the hip’ could sometimes prove awkward. There may be other options that produce broadly the same benefits but at less cost. For example, unilateral reductions in tariff peaks could also enhance productivity and remove the need for rules of origin, and Australia and New Zealand would still be free to jointly pursue Asian initiatives where appropriate.

#### Second freedom: more integrated transport services?

The CER provides for free trade in services, with the following exclusions:

* air services, broadcasting, third party insurance, postal services and coastal shipping for Australia
* air services and coastal shipping in the case of New Zealand.

Our consultations are raising questions about whether there are valid reasons for maintaining these exclusions. In particular, restrictions on transport across our two countries would seem inimical to the integration of our economies. There has been considerable progress in liberalising air services between our two countries through the Single Aviation and Open Skies Agreement — and air travel now looks pretty competitive — but the Tasman Sea is still regarded as an ‘expensive stretch of water’. Reforms that could reduce trans‑Tasman shipping costs are worth exploring.

#### Third freedom: harmonised business taxation?

The Henry Tax Review suggested that:

If increased integration of the Australian and New Zealand economies is desired, a broad examination of the appropriate degree of harmonisation of business income tax arrangements between Australia and New Zealand should be undertaken.

It has become abundantly clear from our consultations that the number one issue for businesses operating across the Tasman is mutual recognition of imputation credits. Imputation credits are used in Australia and New Zealand to prevent the double taxing of company profits in the hands of shareholders, but they only apply domestically. This potentially creates a bias against offshore investment, including across the Tasman. The Australia New Zealand Leadership Forum (sub. 15) contends:

The tariff on capital that arises from the lack of mutual recognition of franking and imputation credits has been of longstanding concern to business on both sides of the Tasman. Political leadership is required to resolve this issue.

That this is of “long standing concern” suggests that it is not a straight forward matter to address. There are in fact a number of dimensions to it, bilaterally and more widely. In brief, the merits of mutual recognition of imputation credits would seem to depend on:

* the size of investment distortions under the current arrangements
* economic implications of the fiscal shortfall from mutual recognition (including the extent to which this would give rise to new distortions), and
* whether or not either country is likely to move away from a business tax system involving imputation credits in the medium term.

We understand that the ANZ Leadership Forum has commissioned modelling from the NZIER and CIE to help answer the first two questions. This should provide a useful contribution to our own analysis.

#### Fourth freedom: even freer labour movements?

The free flow of people across the Tasman has effectively been in place since 1923, and more formally since 1973 under the Trans-Tasman Travel Arrangement. New Zealand and Australian citizens are able to enter each other's country freely to visit, live and work provided they satisfy health and character requirements. As noted, in part due to wages generally being higher in Australia, many more New Zealanders than Australians travel across the Tasman to take up employment opportunities.

This relative ‘borderlessness' distinguishes the trans-Tasman relationship from most other bilateral arrangements. Also while preferential trade agreements are common, these have rarely been preceded by such extensive relaxation of immigration restrictions, again illustrating the ‘family’ connection.

But people may still be deterred from moving for work due to issues concerning superannuation portability, occupational licensing and access to government entitlements. Progress has already been made on some of these issues, but we need to test whether the current arrangements impede efficiency‑enhancing movement of people across the Tasman.

Issues of fairness have also been raised. For example, there is concern that some New Zealanders who have lived, worked and started families in Australia may be without access to a social safety net under current eligibility rules. Equally, New Zealanders who are long-time residents in Australia may find that they have little prospect of gaining permanent residency and perhaps less prospect than temporary 457 visa holders. These present some knotty questions, which have been examined in previous reviews. Given the complete freedom of entry to Australia, and the potential benefits this brings, it remains important that people’s decisions are mainly influenced by differences in productivity and its rewards, rather than by differences in social security or other entitlements.

#### Better government services?

Where transaction costs are lowered, firms and individuals can be expected to exploit the new opportunities for profitable exchange that emerge. But if one country has a better way of producing a government service or addressing a policy problem, there is no automatic mechanism for this being spread to the other. So there is a need to think differently about integration when it comes to government functions. Given that government expenditure makes up around 35 per cent of GDP in Australia and 40 per cent in New Zealand, this is a significant issue. Even small improvements in service delivery costs could reap large dividends.

There are various options for enhancing government functions through the medium of the bilateral relationship, including: undertaking some functions jointly (for example, moving to a single trans-Tasman regulator in some areas); emulating successful approaches from across the Tasman, including use of private delivery and contestability; and, related to this, increased benchmarking of government services. These options again raise questions of the governance and institutional arrangements around the CER.

## Concluding remarks

We will test these and other ideas and lay out various options in a ‘discussion draft’ that we plan to release in mid-September. Our draft proposals will fall into four categories:

* ‘Get on with it’ (for items on the current CER work program that would clearly be beneficial, but need progressing)
* ‘Just do it, or don’t do it’ (where we have obtained sufficient evidence to recommend such a course)
* ‘Look further into it’ (for areas we identify as prospective of net gains, but which require further work to properly assess)
* ‘Stop doing it’ (for areas currently being pursued that do not look promising or sufficiently worthwhile relative to other options)

There are also some lessons from the COAG reform experience in Australia about not attempting to do too much at once and paying attention to prioritisation and sequencing — to take advantage of complementarities, to achieve solid outcomes from existing reform efforts before moving on to the next thing, and to lay the groundwork (technical and ‘educational’) for more complex or contentious reforms. The institutional arrangements for managing and monitoring the integration agenda are again important from this perspective, including to ensure that implementation occurs as intended.

In sum, much has been achieved over the last 30 years, but the journey is not over. The report by the two Productivity Commissions will outline further steps to advance the Trans-Tasman relationship in a mutually beneficial way, but without losing sight of the bigger international picture and the ongoing importance of domestic reform.

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