University of Otago
Te Whare Wānanga o Otāgo
New Zealand

# EcoNZ@Otago

ISSUE 25
AUGUST 2010

email: econz@otago.ac.nz

A MAGAZINE ABOUT CONTEMPORARY ECONOMIC ISSUES FOR EVERYONE

## FROM THE EDITOR

As most readers already know, *EcoNZ@Otago* is a magazine about contemporary economic issues published by the University of Otago's Department of Economics.

In this issue, we investigate the decision made by international students to stay abroad. We also look at the recent controversy over a free trade agreement with the US, the financial troubles of the Greek economy, and the optimality of changes to New Zealand tax rates.

The contents of previous *EcoNZ@Otago* issues are listed at the back of this issue, and single issues are available on request (our addresses are below).

If there are any economic issues that you would like examined in a future issue of *EcoNZ@Otago*, please email your suggestions to econz@otago.ac.nz. Alternatively you can write to *EcoNZ@Otago*, Department of Economics, University of Otago, PO Box 56, Dunedin, 9054.

DAN FARHAT

### INSIDE THIS ISSUE

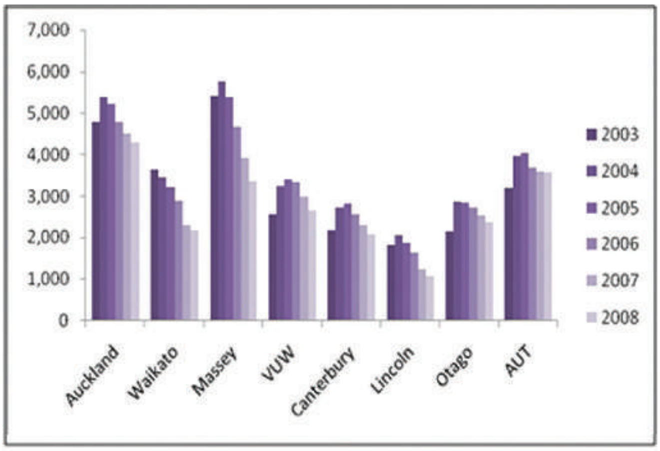


# Go East, young man!... and stay East?

**Jan-Jan Soon**
soon@uum.edu.my

Adapting Stark's (2005) analogy, let there be two orchestras in the world, a mediocre one and an excellent one, with the same pay structure. Suppose that you are an orchestra player from the mediocre orchestra and have been admitted into the excellent orchestra to learn more about musicianship. Upon joining the excellent orchestra, you have broader opportunities to learn from master musicians and more performance opportunities to hone your new-found skills. Will you now consider staying with the excellent orchestra or return to the mediocre one?

International flows of skilled workers and university students have traditionally headed towards 'western' countries, particularly to the US, the UK, and Europe. It is only recently that more and more people have started to look 'east', at countries such as Australia, Japan, and China as their choice of work or study destinations.




New Zealand has recently become an emerging global player as a world-class provider of education to international students at all levels of study, from high school to tertiary level. In 2000, there were only 8,210 international students in New Zealand. By 2007, that number increased by more than 300% to 33,047 (UNESCO, 2003; 2009). In the Asia-Pacific region, New Zealand is currently ranked third after Australia and Japan as the most popular destination country for international education and is among the top five most popular destinations among students from certain Asian and Pacific Island countries (UNESCO, 2009).

For the tertiary level alone, however, international students' enrolment in New Zealand universities first saw an increase in 2003-2004 but gradually decreased after that, as shown in Figure 1. The University of Auckland and Massey University were the two universities with the largest number of international students in that period, while Lincoln University had the smallest number.

It is a widely accepted notion that a fraction of students who study abroad will subsequently settle there (Angel-Urdinola *et al.,* 2008; Tremblay, 2001; Altbach, 2004). Such student non-return, a term used in the literature which reflects a subtle form of 'brain drain', is a concerning issue with the increase in the number of students studying abroad. This article addresses whether or not international students studying in New Zealand universities want to return to their home countries upon completion of their studies.

## WHO?

To examine the extent of student non-return in New Zealand, I use a sample of 623 international students studying at tertiary level programmes at the University of Otago and the University of Canterbury. Their responses were obtained through a web-based survey. Table 1 shows the breakdown of the respondents' return intention.

Approximately 46% of the respondents have no intention of returning to their home countries upon completion of their studies. Looking closer at Table 1, some of the characteristics of those who do not intend to return home stand out: they have stayed in New Zealand for a longer period of time, they have families who are supportive of their migration intentions, they mostly study in health science-related disciplines, and they have close family ties at home.

*Table 1: Descriptive statistics by return intention*

| | Not Return | Return | | |
|---|---|---|---|---|
| | | Immediate | Education | Work |
| *Demographic and family-related characteristics* | | | | |
| Age | 24.3 | 26.2 | 22.8 | 24.5 |
| Years of stay in New Zealand | 3.0 | 2.1 | 2.9 | 2.6 |
| Years of work experience | 1.1 | 2.2 | 0.5 | 1.4 |
| Single | 45.9 | 17.9 | 13.2 | 23.0 |
| Male | 45.0 | 17.5 | 12.8 | 24.8 |
| Initially intended to return home | 19.8 | 26.5 | 18.6 | 35.1 |
| Family supports migration plan | 55.0 | 13.9 | 9.9 | 21.2 |
| Father tertiary-educated | 44.9 | 18.8 | 13.3 | 23.0 |
| *Education-related characteristics* | | | | |
| PhD level of study | 50.6 | 22.1 | 3.3 | 24.0 |
| Have studied abroad | 50.7 | 12.9 | 12.5 | 23.9 |
| Science discipline | 44.7 | 20.4 | 10.6 | 24.3 |
| Health science discipline | 56.8 | 9.9 | 9.9 | 23.4 |
| Humanities discipline | 40.9 | 25.2 | 14.2 | 19.7 |
| Commerce discipline | 42.7 | 16.0 | 16.7 | 24.7 |
| *Perception-related characteristics* | | | | |
| Good work environment at home | 29.6 | 33.1 | 15.5 | 21.8 |
| Competitive wage at home | 37.7 | 29.0 | 12.6 | 20.8 |
| Good skill use opportunities at home | 26.9 | 35.1 | 17.5 | 20.5 |
| Good lifestyle at home | 21.4 | 33.3 | 17.9 | 27.4 |
| Close family/social ties at home | 38.7 | 22.0 | 13.0 | 26.4 |
| Race equality at home | 37.6 | 16.8 | 17.3 | 28.3 |
| Total | **45.6** | **18.4** | **12.7** | **23.3** |

*Note: Mean figures for age, years of stay in New Zealand and years of work experience. Remaining figures are in percentages. Sample size = 623 respondents.*

## WHEN?

Knowing some of the characteristics of the students who intend to return home, I look at when they actually intend to return. As shown in Table 1, not everyone who intends to return wants to do so immediately after finishing their studies. Some of them intend to delay their return for either further education or for foreign work experience. Approximately 18% intend to return immediately and the remaining 36% intend to delay their return.

Those who intend to return immediately are, on average, older and have more work experience than those who intend otherwise. They have also stayed the least amount of time in New Zealand and study in humanities-related disciplines. They prefer the lifestyle back at home and have good perceptions of the work environment and skill use opportunities in their home country. Among those who intend to delay their return, most are doctoral-level students studying in science-related or commerce-related disciplines. They also perceive an uncompetitive wage structure in the home country.

## WHERE TO?

Within our sample, about 15% of the respondents come from China, 39% from other Asian countries, 22% from European countries, 10% from the US, while the rest come from African, Latin American, Middle East and small-island countries. For those who have no intention of returning home, where do they want to go?

*Table 2: Descriptive statistics by intended destination country*

| | Home | New Zealand | Australia/US | Others/UK |
|---|---|---|---|---|
| *Demographic and family-related characteristics* | | | | |
| Age | 24.7 | 24.2 | 24.2 | 24.9 |
| Years of stay in New Zealand | 2.5 | 3.1 | 3.0 | 2.5 |
| Years of work experience | 1.5 | 1.2 | 1.2 | 0.6 |
| Single | 54.1 | 29.1 | 7.7 | 9.1 |
| Male | 55.0 | 27.9 | 8.4 | 8.7 |
| Initially intended to return home | 80.2 | 13.6 | 2.1 | 4.1 |
| Family supports migration plan | 45.0 | 35.8 | 8.3 | 10.9 |
| Father tertiary-educated | 55.1 | 28.2 | 7.1 | 9.6 |
| *Education-related characteristics* | | | | |
| PhD level of study | 49.4 | 25.3 | 10.4 | 14.9 |
| Have studied abroad | 49.3 | 31.1 | 9.6 | 10.0 |
| Science discipline | 55.3 | 27.2 | 7.7 | 9.8 |
| Health science discipline | 43.3 | 31.5 | 16.2 | 9.0 |
| Humanities discipline | 59.1 | 26.8 | 2.3 | 11.8 |
| Commerce discipline | 57.3 | 29.3 | 8.0 | 5.3 |
| *Perception-related characteristics* | | | | |
| Good work environment at home | 70.4 | 17.6 | 4.9 | 7.0 |
| Competitive wage at home | 62.3 | 24.7 | 4.3 | 8.7 |
| Good skill use opportunities at home | 73.1 | 21.6 | 3.5 | 1.8 |
| Good lifestyle at home | 78.6 | 11.9 | 3.6 | 6.0 |
| Close family/social ties at home | 61.3 | 22.7 | 8.0 | 8.0 |
| Race equality at home | 62.4 | 22.1 | 8.9 | 6.6 |
| Total | **54.4** | **28.4** | **8.2** | **9.0** |

*Note: Mean figures for age, years of stay in New Zealand and years of work experience. Remaining figures are in percentages. Sample size = 623 respondents. The Australia/US category includes Canada.*

Table 2 shows that, among those who do not intend to return home, 28% of them intend to stay on in New Zealand, while the rest intend to go either to Australia/US/Canada (8%) or to the UK/Europe (9%). On average, those who have stayed the longest in New Zealand intend to stay on here. A longer stay duration in New Zealand allows the students to gain first-hand information about their host country and to make comparisons with their home country, plausibly leading to their staying-on intention. This seems consistent with the conjecture that a longer stay duration enables students to become more familiar with the host country and, in the process of doing so, are able to make a more informed decision about permanent migration (Ziguras & Law, 2006).

Student characteristics greatly influence their location decisions. Students who have the most work experience, on average, choose to head back home upon graduation. Age is apparently unrelated to the choice of destination country.

Larger proportions of humanities and commerce students select home as their favourite location, while students from the health science disciplines appear to prefer countries other than home. Also, health science students comprise the largest proportion of students intending to stay on in New Zealand.

Further, we would expect that students who perceive close family/social ties at home to choose home as the destination. However, results in Table 2 seem inconsistent with that intuition. Among all the perception-related characteristics, students with close social ties at home have the lowest proportion of selecting home as the destination.

## I CAME, I SAW,…, I STAYED?

It appears that New Zealand is attracting students to come here for their tertiary education and to subsequently stay on. Heading and staying East, particularly for students in science disciplines, is certainly becoming another attractive option compared to the more conventional option of heading and staying West. For many, remaining East is more likely to be transitory than permanent; the students might engage in return migration after further education or foreign working stints. Home may still well be the eventual destination. Go East? Definitely. Stay East? Probably not.

## QUESTIONS TO CONSIDER

1. Are you among those foreign-born students contributing to the non-return phenomenon or the staying-on rates in New Zealand? If yes/no, why or why not?
2. What is the most important factor pulling you home and/or pushing you away?

## FURTHER READING

C Kuptsch (2006), Students and talent flow – the case of Europe: From castle to harbour?, in C Kuptsch & E F Pang (eds), *Competing for global talent*, Geneva: International Institute for Labour Studies, 33-61.

## USEFUL WEBSITES

www.educationcounts.govt.nz/ (Information and statistics about tertiary and international students in New Zealand).

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P G Altbach (2004), Higher education crosses borders, *Change*, 36(2), 18-24.

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## SPECIAL THANKS


I would like to thank my doctoral thesis supervisors, Dr Robert Alexander and Dr Murat Genç, for their role in this project. Under their tutelage, I experienced first-hand what a world-class education is. I dare say I have learnt more about economics (and econometrics) than I ever would have, had I not been so luckily assigned to their mentorship. Robert, who is to me the Milton Friedman of Otago, takes on the responsibility of helping me with the structuring of the thesis's larger picture and moulds my writing into a presentable form. His best advice: write in simple plain English to convey my message. Murat, who is to me the Gary Becker of Otago, checks the nuts and bolts of the thesis's modelling approaches. Unknowingly to him, he has single-handedly allayed my fear of econometrics. His best advice: why use a complicated model when a simpler one would do? The most amazing trait of their combination is that they always seem to be able to read each other's mind and their comments on my work have never been in dispute with one another. They have both mentored me into the privileged world of academia and showed me what a true scholar does. To them I owe my lifetime gratitude, which I could never repay in full.


## HIGHLIGHT: 'BIENVENIDOS LOS BRACEROS'

In the 1940s, the US turned to Mexico to fill jobs left vacant on farms along its southern border as looming fears of labour shortages in the agricultural sector accompanied America's entrance into World War II. Beginning on August 4th 1942, the Bracero Programme (*bracero* is Spanish for "arm-man" or manual labour), allowed Mexican labourers to temporarily work on American farms (and eventually in other sectors) at regulated wage rates provided they return to Mexico at the end of a contracted period. Although farms had occasionally hired seasonal workers from Mexico prior to the 1940s, this was one of the first instances in US history where foreign workers were allowed to gain employment inside the US for extended periods of time without fully immigrating (known as a *guest-worker programme*). By the programme's end in 1964, as many as 1.44 million Bracero contracts had been issued.

At the start, everyone was a winner. Under the legislation, standards for room and board, wage rates and working conditions were set, improving the lives of both the workers and their families left behind. Farm owners in the US received the labour they so badly needed at relatively reasonable costs, even after paying to house and transport the workers. The US government's fears about fallow fields limiting food stocks during war times were quelled and the Mexican government was able to reduce its own unemployment rate and support the allied forces in the war effort whilst remaining politically neutral.

By the 1960s, however, drawbacks of the policy began to outweigh the benefits. The supply of potential braceros was always larger than demand, inducing an estimated 5 million workers to enter the US illegally (with as many as 1.71 million illegal workers deported, 1.18 times the number of legal braceros) during the 22 years the programme operated and depressing both wages and working conditions. Controlling illegal immigration, ensuring that legal braceros returned to Mexico at the end of their contracts, monitoring employer practices and regulating recruitment became costly and excessively bureaucratic for both countries. Concerns that the relatively cheap labour (both legal and illegal) from Mexico would reduce wages and employment for domestic workers and restrict union strike power in the American labour market began to emerge as both World War II and the Korean War ended. Although the Bracero Programme provided benefits when the economy was unstable, the shortcomings of the programme under normal economic conditions led to its eventual downfall in 1964.

Labour issues are at the forefront of current policy debates as trade becomes increasingly liberalised in industrial countries around the world. New Zealanders are aware of the issues all too well, with as many as 140,000 permanent or long-term residents flowing either in or out of the country during the past year. Lessons learned from the Bracero Programme beg the question: is there a way to get the benefits from guest worker programmes without any of the pitfalls? It's something to work on.

Interested in immigration? See page 14 for references and further reading.

# Freer trade with the US: don't believe the (negative) hype[1]

**John Ballingall**
Deputy Chief Executive, New Zealand Institute of Economic Research[2]
john.ballingall@nzier.org.nz

**If one were to believe some of the recent media articles in New Zealand, it would be easy to think that we're completely mad to be negotiating a free trade agreement with the US.[3] This article takes a pragmatic look at the current negotiations with the US via the Trans-Pacific Partnership regional agreement.**

## PATCH PROTECTION – NOT REALLY A SURPRISE

Sparking recent debate about what might take place in the negotiations with the US was a letter to the US Trade Representative, Hon. Ron Kirk, signed by 30 US senators. The letter expressed deep concern about entering a free trade agreement (FTA) with New Zealand because our dairy farmers are more efficient than theirs (Carpo, 2010). This is a typical piece of politicking. What has been surprising, however, is that some New Zealand commentators seem not to have seen this gesture for the cynical opening negotiation manoeuvre it is. Any rational business would be concerned if its potential inefficiencies were about to be shown up through enhanced international competition.

## IT'S NOT US VERSUS THE US

Let's first be clear about what sort of trade agreement we are discussing here. New Zealand is not negotiating with the US bilaterally. New Zealand is negotiating with the US as part of the Trans-Pacific Partnership (TPP) grouping. The TPP is an extension of the plurilateral P4 regional trade agreement already in place between New Zealand, Singapore, Chile, and Brunei (Vietnam has joined as an associated member). The US, Australia and Peru are committed to joining the TPP and the negotiations are already underway. The US will be 'docking' onto the P4, not setting the ground rules from the outset. The US will certainly have a significant influence on the negotiations but with seven other smart, savvy and strategic negotiators at the table, the US won't have it all its own way.

## EXCLUDING AGRICULTURE FROM ANY FREE TRADE DEAL ISN'T AN OPTION

The P4 has been liberalising trade between the four partner countries since 2005. There are already 'modalities' or negotiating frameworks in place that are legally binding. Acceding countries, including the US, will need to agree to the existing structure already in place under the P4, including the liberalisation of agriculture, albeit with some phasing and other transitory mechanisms. The current P4 doesn't exclude dairy or beef and neither will the TPP. The Senators' letter is pure posture: how can an FTA end up being *more* trade restrictive than the current access arrangement? Moreover, New Zealand might be small but we are sovereign. Why would we (and other TPP partners) accept such an outcome?

Furthermore, all FTAs must cover substantially all trade to be consistent with international trade law, specifically article XXIV of the General Agreement on Tariffs and Trade. While the precise definition of "substantially all trade" has never been tightly defined, it is highly unlikely that a TPP which excluded agriculture would pass the laugh test, let alone the substantially all trade test. In general, US FTAs are high quality and ambitious. Of course they seek to promote their interests, and their FTAs contain some safeguards, but they usually play by the rules. Their approach to TPP should be no different.

## SHOW ME THE MONEY...

Let's be realistic: there will be adjustments required while import protection in New Zealand is transitioned out through the TPP and other FTAs. But it's easy to unduly worry about the threats of trade liberalisation. We need to remember that the whole idea of signing a trade agreement with the US under the TPP is to deliver a net economic benefit to New Zealand. Using NZIER's Global Trade Analysis Project (GTAP) general equilibrium model of the world economy, a basic estimate suggests gains to New Zealand of around $650 million per year.[4] Not too shabby at all.

In addition, expanding the TPP places New Zealand at the heart of Asia-Pacific regional integration. We know that global economic growth is set to be dominated by the wider Asian region in the decades ahead, and New Zealand needs to be closer to the action.

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1 A version of this article was initially published on 25 March 2010 by NZIER as part of its self-funded Public Good research programme. The original is at www.nzier.org.nz/includes/download.aspx?ID=108094
2 NZIER is an independent non-profit organisation, founded in 1958, that uses applied economic analysis to provide business and policy advice to clients in the public and private sectors.
3 For example, see Hickey (2010).
4 These are indicative results only. They are from a scenario where all tariffs amongst TPP members are reduced to zero. In this respect, it's over-optimistic. However, the estimate of benefits is from goods liberalisation only and does not account for gains from services liberalisation, investment liberalisation and other dynamic gains from trade. A much more detailed modelling exercise is required to look at multiple potential outcomes, but this ballpark estimate does at least highlight the potential gains to the NZ economy from liberalisation with the US under a TPP.

## LEVEL PLAYING FIELD

FTAs are proliferating around the world, particularly in the Asia Pacific region. These agreements can give New Zealand's competitors preferential treatment into key markets (e.g. Australia into the US; Chile into Korea), making it harder for New Zealand firms to compete. New Zealand needs to be a part of the FTA trend so that we are not left out in the cold waiting, possibly in vain, for a multilateral solution via the WTO. The latter remains New Zealand's number one trade priority, but we have to investigate alternative approaches to liberalisation until the big boys decide they want to play nicely again in Geneva.

## THE AUSTRALIA-US FTA: NOT AN OCKER SHOCKER

Critics have pointed to the outcomes of the Australia-US FTA as a demonstration of what might happen to New Zealand if we were to sign up to an agreement with the US via TPP. Yet implying that the Australia-US FTA caused Australian exports to grow more slowly or fall is simply misleading and mischievous. There's a *correlation* perhaps, but no *causation*. Attributing the slow export growth to the FTA is simply not possible without in-depth analysis.

To determine the effect of the FTA on Australia's exports to the US following the FTA, you first need to determine the counterfactual: what would have happened in the absence of the US FTA? Strong growth in Australian exports to other countries such as China and Japan have necessarily drawn resources away from other markets such as the US. But that's nothing to do with the Australia-US FTA. In addition, the counterfactual would need to consider what tariff lines have been liberalised, what has happened to commodity prices, exchange rates, US growth relative to other markets, etc. Ex-post empirical analysis of FTAs is therefore rarely attempted.[5]

## KNOW WHEN TO HOLD 'EM; KNOW WHEN TO FOLD 'EM …

To be an effective international player, New Zealand needs to be grown up – in other words, recognise what we are and what we are not. We are small beer internationally; the USA is BIG. In negotiations, all countries seek to use whatever they can to get an edge. Thus the US can regularly be seen "strong-arming" smaller countries like New Zealand into accepting outcomes that aren't ideal. Welcome to the real world of trade negotiations, as it happens to a small country.

We live in a world of second-best trade solutions, and that includes FTAs such as the TPP. Negotiations between small and large countries are never easy. New Zealand has limited negotiating coin, but that hasn't stopped us signing recent agreements with major global players such as China, the ASEAN group, Malaysia, Hong Kong, the Gulf Countries and others, in addition to older agreements with Australia, Singapore and Thailand. Clearly we have something to offer such countries, be it our agricultural know-how, a safe and reliable supply of primary products, a small but relatively wealthy domestic market or investment opportunities.

In each of these negotiations, we've had to deal with sensitive areas, strong lobby groups and seemingly immovable negotiating positions. And there are always pockets of the New Zealand economy that experience adjustment costs following liberalisation (although given New Zealand's very low tariff levels, the vast majority of this adjustment has already taken place).

But in each case, our trade negotiators have found a way through the blockages. They're a cunning bunch, and have cunning plans to know what to trade off and when in order to generate outcomes that will benefit New Zealand. Strong opening positions from prospective FTA partners are nothing new. It's like buying a house – you never start with your real offer. You start tough and then you work towards a compromise solution. That's what will happen in the TPP.

## IN A NUTSHELL: TPP WON'T BE PERFECT; BUT IT WON'T BE A DISASTER EITHER

Trade deals are never perfect, and some of the necessary trade-offs are not ideal. We may have to face some rather tricky IP restrictions to get (say) a meat or dairy access deal. But that shouldn't obscure the fact that the TPP offers New Zealand businesses some significant economic and strategic opportunities. And these opportunities (and threats) should be identified through robust economic analysis and consultation with New Zealand businesses, not by rhetorical arguments and scaremongering.

## QUESTIONS TO CONSIDER

1. Why do globalisation and trade liberalisation generate such a huge amount of controversy, when most sensible people realise that freer trade delivers aggregate welfare benefits?
2. How might a mechanism be designed to help compensate the potential NZ 'losers' from trade liberalisation?
3. What process is more likely to deliver a high quality trade agreement: a plurilateral arrangement or a bilateral arrangement? Why?
4. What is the difference between correlation and causation? When might they get confused, and what are the possible consequences?

## FURTHER READING

J Bhagwati & A Panagaria (1999), Preferential trading areas and multilateralism- strangers, friends, or foes?, in J Bhagwati, P Krishna & A Panagaria (eds), *Trading blocs: alternative approaches to analyzing preferential trade agreements*, Cambridge: MIT Press, 33-100.

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## USEFUL WEBSITES

OECD Trade Policy Working Papers
www.oecd.org/document/40/0,3343,en_2649_37431_44756840_1_1_1_1,00.html

World Bank papers on trade policy
www-wds.worldbank.org/external/default/main?pagePK=64187830&piPK=64187926&theSitePK=523679&function=BrowseFR&menuPK=64187515&siteName=WDS&searchMenuPK=64258545&conceptattcode=644298&pathtreeid=TERATOPIC_SUBTOPIC&sortattcode=DOCDT+Desc

Oxfam (for a dissenting view and nifty interactive diagrams)
www.oxfam.org/en/campaigns/trade/riggedrules/rtas

NZIER Trade Consortium website at http://nzier.org.nz/Site/Publications/NZ_trade.aspx

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B Hickey (2010), Why bother with a US FTA?, New Zealand Herald (23/5/2010), available at www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10633801.

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World Trade Organization (1994), General Agreement on Tariffs and Trade Article XXIV, available at www.wto.org/english/tratop_e/region_e/regatt_e.htm#.

5 Mischievously, a quick look at the growth in New Zealand exports to China since the New Zealand-China FTA entered into force (up 60% in the first year after implementation) provides an interesting counter-argument. What do they say about lies, damned lies and trade statistics again?!

## HIGHLIGHT: MORE THAN MEATS THE EYE

Sometimes you get more than you bargain for. In 2007, Australia exported approximately 14,530 tonnes of kangaroo meat worth A$ 27 million (approximately NZ$ 33.5 million). Surprisingly, almost 80% of the kangaroo meat produced that is fit for human consumption (which amounts to 56% of the total kill) is sold outside Australia. The majority, 76% of total exports, went to satisfy Russia's desire for exotic game meats while the remainder made its way to Europe, South Africa and the United States. There are people who *neither produce nor consume* kangaroo meat that may significantly benefit from the kangaroo trade in both the exporting and importing countries.

Some reap benefits when others lead healthier lives. Kangaroo meat is lower in saturated fat than other meats (not to mention high in protein, zinc and iron) and rich in conjugated linoleic acid (CLA), which has been shown to reduce body fat. As a healthier alternative to other red meats, an increase in the consumption of kangaroo in countries concerned with expanding waistlines may lead to reduced instances of serious health problems (such as heart disease and diabetes). In turn, fewer resources are spent on treating these ailments, lessening the financial burden on the government and freeing up hospital resources for other patients.

Most reap benefits when the environment improves. While other livestock emits significant amounts of methane gas, kangaroos emit hardly any. With a warming potential 21 times greater than $CO_2$, small reductions in agricultural methane emission can have large environmental benefits. If 175 million kangaroos took the place of 7 million cattle and 36 million sheep on Australian pastures (yielding equivalent meat), Australia could reduce its green house gas emissions by 16 megatonnes (3% of the total current annual emissions) by 2020. Further, since kangaroos have soft, padded feet, the damage done to the soil from cloven-hoved animals grazing on the fragile Australian landscape would be reduced. Also, since kangaroos are free-range animals, they do not suffer from the same diseases, handling conditions and abattoir processes as other livestock. As 'game', these animals enjoy their natural habitat for the duration of their lives, something not experienced by commercial livestock.

The presence of these extra benefits (known in economics as *externalities*) may warrant policies to foster and increase the production of kangaroo. However, potentially serious hardships are faced by the industry. Recent fears over the transmission of E. Coli led Russia to ban imports of kangaroo meat in 2009. The humane killing of kangaroos, while carefully monitored by the government, is of persistent concern to animal rights groups. Eating a national icon is considered an insult against Australian heritage for many Australians. For the presence of external benefits to make added investment in the kangaroo trade worth considering, these and other obstacles must be overcome.

Interested in agricultural trade? See page 14 for references and further reading.

## SPOTLIGHT: ONUR KOSKA, A RECENT PhD GRADUATE

Onur joined the PhD programme at Otago University in 2006 after having completed a BSc in Economics at Hacettepe University in Turkey. Onur's research interests are in the areas of international trade, the economics of multinational firms and general equilibrium modelling. His PhD thesis focused on multinational firms, market entry and foreign direct investment.

He is currently working on an analysis of auctions and commitment which scrutinises the failure to commit to a certain allocation mechanism in a private values, first-price, sealed-bid auction. He is also constructing a general equilibrium model of international trade in which capital is used to establish firms and labor is used for production. In addition, he is analysing the recent Union for the Mediterranean agreement and its potential impacts on Turkish trade and FDI flows. Onur is also writing a book chapter about multinational enterprises.

Onur completed the requirements for a PhD in Economics at Otago University in early 2010 and graduated in May. Currently, Onur holds a lecturer position (Chair of International Macroeconomics) in the Economics department at the University of W rzburg, Germany. For more information about the activities of current graduate students in the Economics Department at Otago University, visit www.business.otago.ac.nz/econ/staff

# Owed on a Grecian earn

**Arlene Garces-Ozanne and Stuart McDougall**
arlene.ozanne@otago.ac.nz, stuart.mcdougall@otago.ac.nz

**In the past, Greece was known as the epitome of beauty and glory. Today, however, Greece has become a symbol of fiscal instability. Although the Greek economy had grown at a rate of 4% per year prior to the 2004 Olympic Games in Athens, growth slowed to only 2% by 2008. The Greek government persistently failed to earn enough through taxes to cover expenditures, resulting in negligent amounts of sovereign debt accumulating for much of the past decade. The Greek economy entered into a recession during the global financial crisis in 2009 and was in danger of defaulting on its massive debt. To save Greece from bankruptcy, the European Union (EU) established a €110 billion (NZ$ 193.55 billion) fund in May, 2010. Shortly afterwards, the European Union agreed to allocate €750 billion (NZ$1.32 trillion) to bail out troubled European economies, casting much doubt on the strength of the single European currency, the euro. To shed light on why this is currently happening, this article reviews how Greece went wrong and how they may recover.**

## THE FIX

From the 19th century until the early 1970s, fixed exchange rates were the norm for all countries (Husted & Melvin, 2010). Under the Gold Standard, which prevailed until 1914, each country's domestic currency was valued in terms of gold, which defined a system of "fixed exchange rates" between different currencies. For example, if gold in the US was priced at $1,000 per ounce and gold in Japan was priced at ¥110,000 per ounce, then the exchange rate between the two countries would be $1,000/¥110,000 = $0.009/¥. During the post war era, 1944 to 1973, the Bretton Woods system was created. In this system, the US dollar was the only currency convertible to gold and all other currencies were pegged to the US dollar.

After the Bretton Woods system's breakdown in 1973, currencies floated freely against the dollar, allowing exchange rates to be determined by currency markets. While this might be the current norm in principle, many economies today still maintain fixed exchange rates. In fact, there are a number of countries that have taken fixed exchange rate regimes further by adopting single currencies, either by abandoning their currency altogether in place of another (e.g. Dollarisation) and/or by creating a new common currency (e.g. the euro[1]).

Fixed exchange rates are sometimes desirable because they help facilitate international trade by providing more stable prices. Further, fixed exchange rates help lower inflation. A country with a history of price instability or high inflation may wish to fix its currency to a more stable, low-inflation currency, essentially adopting the other country's monetary policies in the process. However, this results in a loss of monetary policy independence which can be a disadvantage. A country that has a very different economy to that of the other members of the exchange rate system will want to set its own monetary policies to address its own specific problems. This is one of the primary reasons why Greece is in such a state.

## GREECE AND THE EURO

To enhance Europe's role in the world monetary system and to turn the European Union into a truly unified market, 11 European nations (Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Portugal, Finland, Ireland and Luxembourg) launched the euro on January 1, 1999. At that time, Greece had not met the Maastricht criteria, which required members to have low and stable inflation rates, sound fiscal policies, low public debt, stable interest rates, and stable exchange rates, for entrance into the currency union. On January 1, 2001, Greece qualified and joined the EU as the 12th member. Euro notes and coins became legal tender in all 12 countries on January 1st, 2002, and national currencies disappeared on July 1st, 2002.

Being a part of the Euro bloc has massive benefits. Member countries avoid currency conversion costs and exchange rate risks. Prices between countries become transparent, which increases competition among firms and lowers costs. Capital is allocated more effectively and interest rates are standardised. Policy is made more credible by eliminating adjustments for currency devaluations. These advantages coupled with the promise of prosperity and low inflation made joining the EU attractive.

There are also severe costs. By adopting the euro, monetary policy for all members is determined by the European Central Bank (ECB). In addition to giving up the ability to control their own money supply, fiscal policy was also constrained by the Stability and Growth Pact (1997). This pact was designed to stabilise interest rates by discouraging reckless fiscal borrowing by any member. Without this, recurring budget deficits may occur which can lead to severe depreciation of the euro coupled with a risk of inflation across Europe.

1 While member countries' currencies are "fixed" to each other through the euro, the euro itself freely floats in the currency market.

## THE CURRENT CRISIS IN GREECE

Even though the Greek economy was one of the fastest growing in the Eurozone area, growing at an annual rate of 4.2% from 2000 to 2007, it has not managed to contain its large and growing fiscal imbalance. Successive Greek governments have, among other things, run large deficits to finance public sector jobs, pensions, and other social benefits. When Greece joined the EU, the Greek government gained the ability to borrow freely at a low interest rate. Since then, their debt to GDP ratio has remained above 100% and is projected to reach 150% by 2014 (even if recommended austerity measures are implemented, which is unlikely). High budget deficits and increasing debt leads to increasing current account deficits. Since current account deficits require an inflow of investment dollars from abroad, this sort of fiscal strategy means that Greece is at the mercy of international investors.

For a time, successive Greek governments managed to falsely report their budget deficits so as to keep within the Maastricht treaty guidelines: an annual government budget deficit lower than 3% of GDP and a debt to GDP ratio less than 60%. Successive governments made payments to ensure that certain transactions were hidden to mask the true state of the government's deficits and debt so they could spend beyond their means. Starting in 2005, the government made attempts to reduce excess spending through increased privatisation, labour market reforms, pay ceiling and pension programme reforms, and by ending jobs for life in the public sector. These policies were all met with social and industrial unrest in the form of strikes and riots which were exacerbated by the spread of the global financial crisis that had hit the Greek tourism and shipping industries particularly hard.

By December 2009, the government's annual budget deficit had blown out to 12.7% of GDP. Their accumulated debt, mostly held by foreigners, was estimated at €300 billion (approximately NZ$ 547.32 billion), causing international ratings agencies to downgrade sovereign Greek debt. In response, the Prime Minister announced a programme of tough public spending cuts, public sector pay cuts, fuel price increases and a crackdown on tax evasion, all of which induced a further series of general strikes and protests. By late April, fears that the Greek government might default on servicing their debt led S&P to lower Greek debt to 'junk' status.

## TO THE RESCUE

The reduction in the Greek credit rating prompted the European Central Bank to suspend its minimum threshold for Greek debt, effectively guaranteeing Greek banks' access to ECB funding which reassured existing and potential new investors. An EU/IMF bail-out package of €110 billion was agreed for the Greek government, provided they introduce a fourth and final round of additional tax, welfare, public sector wage and public owned company reforms. The loans are meant to cover Greece's funding needs over the next three years. By that time, it is hoped that the planned reforms will have reversed the fiscal policy slippage that had brought on this debt crisis.

Without this bail-out agreement, it was almost a *fait accompli* that the Greek government would have either defaulted on or needed to restructure its debt obligations.[2] Unlike the US during their most recent financial crisis, Greece is unable to inflate away its debt or to stimulate its domestic economy with monetary policy, as it had given up this option when it joined the European currency union. By joining the EU, Greece sacrificed some of its ability to help itself out of the crisis but gained access to help from the other EU members.

What *can* Greece do on its own? The challenge facing Greece now is to move from budget deficits to surpluses and to then reduce government debt. Weakening Greek reliance on foreign investors can also be accomplished by reducing budget deficits which encourages private sector saving, reduces consumption of imports and therefore reduces the current account deficit. A broader based and more equitable tax system with less generous welfare and retirement payments and a leaner public sector with more reliance on a more competitive and dynamic private sector are steps that will help it on the path to recovery. These policies all require broad understanding and acceptance from Greek citizens, which makes the chances of a successful government fiscal policy solution politically unlikely. Instead, some combination of fiscal policy along with debt restructuring is more likely as long-term ability to reduce the sovereign debt becomes progressively more difficult.

Greece's EU status continues to ensure their access to aid during these troubled times. Not only has the Greek government received support from the other EU members, but recent multi-billion euro business deals from China have spurred investor confidence in the Greek economy. While these deals do benefit Greece by attracting Chinese investors, they also give China a foothold into European markets. Even though the cost of joining the European currency union was high, it has proven to be of tremendous benefit to Greece during this crisis.

Unlike Keats' (1819) *Ode on a Grecian Urn* where "Beauty is truth, truth beauty ...", the truth about this more recent Grecian 'earn' isn't so beautiful.

## QUESTIONS TO CONSIDER

1. Under what conditions would a single currency area be an optimal currency area?
2. Compare the advantages and disadvantages of fixed and floating exchange rate regimes. Under what conditions might each exchange rate regime be attractive to a country?

## USEFUL WEBSITES

The European Economic Commission's Euro website: http://ec.europa.eu/economy_finance/euro/index_en.htm.

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2 This is where creditors are only paid a proportion of what they were owed.

# The efficiency of New Zealand's 2010 tax reforms

**Chris Hajzler**
chris.hajzler@otago.ac.nz

**Recently, New Zealand issued a series of tax reforms which included increases in the Goods and Services Tax (GST) rate and lower income taxes. These reforms may represent steps towards a more efficient tax system according to generally accepted theories in macroeconomics and public finance. Although a thorough evaluation of the impact that these reforms have on the welfare of Kiwi consumers requires a more detailed investigation, this article aims to broadly review how and why optimal tax systems are created and the conventional wisdom behind the recent reforms.**

## MAKING THE BEST OF IT

Imagine being able to measure the 'costs' to society from a given tax system by determining the total amount of personal income that citizens would be willing to pay to have all taxes removed, accounting for changes in prices and purchase decisions that may result but assuming no change in the provision of public goods and services. Any positive difference between this amount and the government's revenue from the tax system is the efficiency cost (or "excess burden") associated with the tax plan. This discrepancy results from distortions in household decisions about spending, income and savings brought about by changes in the relative costs of these activities that the tax system imposes.

In a completely efficient tax system, there are no such distortions. 'Optimal taxation' is concerned with "keeping tax distortions to a minimum, subject to restrictions introduced by the need to raise revenue and maintain an equitable tax burden" (Auerbach and Hines, 2002). This problem is especially relevant for policy due to the common use of proportional taxes, or 'tax rates', which are inherently distortionary.[1] A common approach to finding the most efficient proportional tax rates is to solve for a set of these proportional tax rates on different categories of income and expenditures which minimises the excess burden. Simple and valuable insights pertaining to the effective use of proportional taxes can be gained from this exercise.

## THE CONVENTIONAL WISDOM

The most striking and commonly cited feature of an optimal income-tax policy is that taxes on capital income should be zero. This result, first established by Chamley (1986) and Judd (1985) in the context of a standard growth model with infinitely-lived households, highlights the extreme distortionary nature of taxes on savings instruments. When the returns from savings are taxed, a wedge between consuming today relative to saving and consuming in the future is created. Even if the wedge between consuming today and consuming in the following year is small, the wedge between consuming today versus saving for the more distant future would grow exponentially with time.

For example, consider a $1000 investment into capital which yields a 5% per annum return taxed at 25%. After one year, this investment yields after-tax income equal to $37.50, or 75% of the $50 gross return that you would have received if there was no tax. If this investment is carried over for a second year, the after-tax income received is $76.50 ($1037.50 invested at a 5% interest rate less $12.96 in additional taxes in the second year yields $1076.40). This is slightly less than 75% of the $102.50 return that would have been received in the absence of the tax for a two-year investment. After 10 years, after tax earnings would drop to 70% of the corresponding income without taxes. After 30 years, this share would further decrease to 60%. The tax therefore creates a considerable disincentive to invest in capital over long periods of time, resulting in reduced savings, lower future income levels and less future consumption. It becomes optimal to have a zero tax rate on capital.[2]

A variety of studies corroborate this finding using different theoretical frameworks (Summers, 1981; Erosa & Gervais, 2001; Bernheim, 2002). However, an optimal tax scheme with zero capital taxes unfortunately calls for taxing previously accumulated private assets very heavily (at a confiscatory rate, if necessary) in order to reduce the need for other distorting taxes down the road. Because accumulated assets are the product of past decisions, taxing them does not impact current or future choices. Not surprisingly, this is usually regarded as an impractical solution since confiscation of assets would be perceived as a severe violation of private property rights (which certainly won't help policymakers get re-elected). Ruling out the expropriation of initial assets, it is still optimal to adopt very high taxes on capital for a finite number of periods and then set the capital tax to the lowest possible level thereafter.

In addition to a near-zero tax on capital, an optimal proportional tax system also places restrictions on consumption (or sales) taxes. Sales taxes do cause distortions, but it is possible to show that these distortions can be offset if labour effort is subsidised in the long run. Ideally, we would want to apply the sales tax to all goods and services, including leisure time. Because taxing leisure time is not possible (although one could in principle partially do so indirectly by disproportionately taxing goods and services which are complementary to leisure, such as golf

1 Although an alternative way to collect tax revenue is through collecting a fixed amount from households in each period (called "lump sum" taxes, which are inherently non-distortionary), this method is often infeasible and sometimes considered unfair to the poor.

2 This result is robust even when households are heterogeneous. Judd (1985) and Chari and Kehoe (1999) have demonstrated that, even in a world where capital owners and workers are distinct household types, a zero capital tax is optimal in the long run from the perspective of all agents.

memberships), consumers would respond to an increase in sales taxes for goods and services by spending more time at leisure (i.e. by consuming less because of the taxes, but also working less). A subsidy to work effort offsets this effect by increasing the incentive to work. If subsidising labour income is not a viable option, reducing income taxes in response to a rise in the sales tax is less distortionary than raising both tax rates simultaneously. Under certain assumptions, the optimal labour subsidy equals the consumption tax rate (Wickens, 2008). The main lesson is that an increase in the sales tax should be accompanied by a reduction in the labour income tax.

## DO THE RECENT TAX REFORMS GO FAR ENOUGH?

In a nutshell, moving towards an optimal tax regime involves lowering taxes on capital and labour income and raising sales taxes. To determine whether or not changes to an existing tax system really improve efficiency, however, it is ideal to consider changes that have little to no impact on the government's budget deficit (called 'fiscally neutral'). This means that changes in the economy will be a result of consumer decisions alone. If planned tax changes are not fiscally neutral, then the government may be providing more or less public services, which makes evaluating changes in social welfare more difficult. The New Zealand government projects that the tax reforms will be fiscally neutral, at least over the medium term. This facilitates our discussion of the potential efficiency gains attributed to the three major aspects of the recent tax reforms: changes in personal income taxes, capital income taxes, and the sales tax.

The goods and services tax will be increased from 12.5% to 15%, which is accompanied by across-the-board reductions in personal income taxes (on the order of 2.5-5%, depending on earnings). As outlined in the previous section, increasing the tax on consumption without also reducing the tax on labour income results in larger efficiency losses, and therefore these reforms seem quite sensible. These changes appear even more pragmatic when one accounts for the fact that they permit a reduction in capital income taxes as well. The company tax rate will fall from 30% to 28%, and the tax rates for most portfolio investment entities (PIEs) will also fall by similar amounts. This could represent the most significant change in light of the negative long run welfare effects of capital taxes. Taken together, these changes are intended to promote savings and investment.[3] Further, the reduction in labour income taxes may also have an additional positive impact on efficiency to the extent that this income includes human capital investments. Just as in the case of savings, a labour income tax potentially implies distortions to the return to educational investments which increase with the time horizon.

An important caveat is that the level of public debt will remain high. Conventional theory suggests it may, in some cases, be optimal to keep capital income taxes relatively high temporarily in order to bring down the debt and to reduce the need for high future taxes. In 2009, the gross government debt in New Zealand had already reached NZ$43 billion, or approximately 24% of New Zealand's GDP. To be fair, the current government (and the one before it) had pursued a course of gradual debt reduction that was interrupted only last year. Needed investments in health, education and infrastructure, which are expected to have a positive impact on long run growth, combined with the recent global recession suggest that it is not the right time to focus on debt reduction. Furthermore, the political incentives to target fiscal surpluses for the sake of reducing future taxes could be low. The budgetary sacrifices needed by today's government to pave the way for its successors to implement a completely efficient tax system might not be realistic, but any movement in this direction is considerable progress nonetheless (Auerbach & Hines, 2002).

So the question is: Do the recent tax cuts represent a movement towards this ideal, given the political constraints faced by governments? Even without a reduction in government debt, theory suggests that immediate capital income tax reductions will result in positive efficiency gains.[4] Further support for this strategy in relation to the New Zealand economy is provided in the recent quantitative analysis of Schule (2010). Thus the prospect of a more efficient tax system looks good so far. There is significant potential for further improvements in efficiency if the government resumes its course of debt reduction and, to whatever extent is politically feasible, an eventual further reduction in all income taxes.

## QUESTIONS TO CONSIDER

1. If different tax rates were to be applied to various categories of goods and services, which goods could be taxed more heavily in order to raise revenues while minimizing the amount of economic distortions? How do these choices depend on (a) the extent these goods complement leisure, and (b) the responsiveness of demand and supply to price changes?
2. In what ways might efficiency goals in designing an optimal tax plan conflict with equity objectives?

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3 It is worth pointing out, however, that some of the proposed efficiency gains will also come from changes in certain tax rules and reducing tax avoidance.
4 See Judd (1987).

## HIGHLIGHT: THE CERTAINTY OF DEATH AND TAXES

People respond to incentives, sometimes in extreme ways. Prior to 1978, the Australian government levied a proportional tax as high as 28% on inheritance income (also known as an *estate tax*). In November of 1977, the government announced that it would be repealing this tax. The policy change was scheduled to take effect in July of 1979, which meant that bequests by those who died before June 30th were subject to the tax while bequests by those who died afterwards were not. As a result, more than half of the individuals near death in the few days prior to the policy change that would have been subject to the tax (about 50 people) managed to prolong life until July, successfully avoiding any payment to the government. This phenomenon has also occurred in the United States and Sweden amidst changes to estate tax rates.

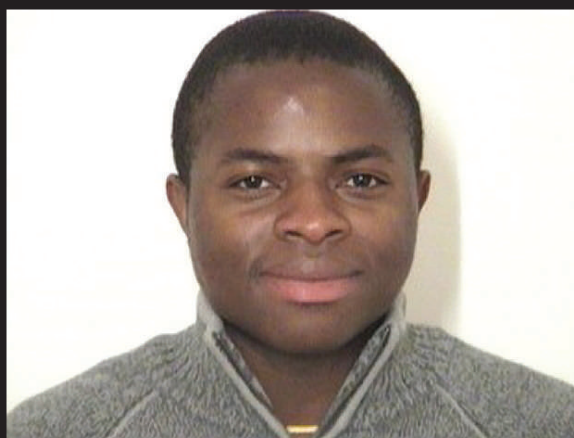
There are two main theories as to why this marvel might transpire. The first is that these people willed themselves to live until after the policy took effect. Studies have shown that some patients near death have managed to prolong life by sheer force of will until an event has occurred (such as Christmas, New Years, Passover, the Harvest Moon Festival, etc.). If their motive for bequesting a large inheritance to their next-of-kin is strong, a person near death just prior to the policy change may be willing themselves to live just a few days longer if their offspring can substantially benefit.

The less optimistic theory is that people choose methods for artificially prolonging life based, in part, on tax policy. A patient might choose to accept treatments that prolong life until the estate tax drops to ensure that their offspring get a larger inheritance. Unfortunately, this argument goes both ways. If the estate tax were expected to rise, a patient might reduce or refuse treatment in the hopes of dying before the policy change. Further, the offspring of terminally ill patients who expect to receive a large inheritance may also maximise their own payout by either refusing or encouraging treatment on their loved one's behalf (i.e., to leave on or turn off the life support machine based on their tax obligations).

Currently, the US taxes inheritance income at one of the highest rates in the world (45% in 2009). In 2001, the US announced that it would be making a change to its estate tax policy. Under new legislation, those who died in 2009 would be subject to the tax while those who died in 2010 would not. Further, the exemption would be repealed in 2011 and the estate tax would be raised to 55%. We would expect attempts to prolong life at the end 2009, but reduced efforts in December 2010. We won't know until 2011 how this policy will affect death trends in the US, but so far it looks like 2010 is a very good year to die.

Interested in estate taxes? See page 14 for references and further reading.

## SPOTLIGHT: ALVIN ETANG NDIP, A RECENT PhD GRADUATE



After receiving a BSc in Banking and Finance from the University of Buea in Cameroon and an MA in Microfinance from the University of Bergamo in Italy, Alvin Etang Ndip came to Otago University to pursue a PhD in Economics.

Alvin's research interests are in the areas of economic development, microfinance, experimental economics, and social capital. His PhD thesis focused on empirical analyses of the importance of trust and trustworthiness in social and economic interactions. Specifically, Alvin has analysed the relationship between trust and membership of rotating savings and credit associations. He has also analysed whether people from a rural community are more trusting of people from their own village than they are of people from a neighbouring village. Alvin has previously studied the operations of microfinance, which is commonly believed to be important for poverty reduction and economic development in developing countries.

Since 2010, Alvin has been a research fellow at the University of Otago. In 2010, Alvin completed the requirements for a PhD in Economics and hopes to take a post-doctorate research position at a university overseas. He will graduate in August. For more information about the activities of current graduate students in the Economics Department at Otago University, visit www.business.otago.ac.nz/econ/staff/

# Commentary on the New Zealand economy

**Alan King**
alan.king@otago.ac.nz

| | Mar 2010 | Dec 2009 | Sep 2009 | Jun 2009 | Mar 2009 |
|---|---|---|---|---|---|
| GDP (real, annual growth rate, %) | -0.4 | -1.7 | -2.4 | -2.2 | -1.4 |
| Consumption (real, annual growth rate, %) | 0.7 | 0.0 | -0.3 | -0.4 | 0.1 |
| Investment (real, annual growth rate, %) | -16.4 | -21.0 | -20.6 | -14.3 | -5.9 |
| Employment: full-time (000s) | 1684 | 1658 | 1658 | 1666 | 1684 |
| Employment: part-time (000s) | 494 | 497 | 497 | 502 | 496 |
| Unemployment (% of labour force) | 6.0 | 7.1 | 6.5 | 5.9 | 5.1 |
| Consumer Price Inflation (annual rate, %) | 2.0 | 2.0 | 1.7 | 1.9 | 3.0 |
| Food Price Inflation (annual rate, %) | 1.2 | 1.4 | 5.4 | 7.5 | 8.8 |
| Producer Price Inflation (outputs, annual rate, %) | -0.5 | -3.6 | -2.1 | 2.1 | 6.5 |
| Producer Price Inflation (inputs, annual rate, %) | 0.6 | -3.2 | -5.8 | -1.2 | 4.7 |
| Salary and Wage Rates (annual growth rate, %) | 1.5 | 1.8 | 2.1 | 2.9 | 3.4 |
| Narrow Money Supply (M1, annual growth rate, %) | -0.3 | 1.3 | 1.4 | -2.6 | 2.5 |
| Broad Money Supply (M3, annual growth rate, %) | -3.5 | -1.1 | 2.8 | 3.0 | 6.8 |
| Interest rates (90-day bank bills, %) | 2.67 | 2.78 | 2.77 | 2.78 | 3.24 |
| Exchange rate (TWI, June 1979 = 100) | 65.1 | 64.7 | 64.3 | 60.3 | 53.8 |
| Exports (fob, $m, year to date) | 39,546 | 39,672 | 41,588 | 43,028 | 43,353 |
| Imports (cif, $m, year to date) | 39,740 | 40,221 | 43,257 | 46,139 | 48,037 |
| Exports (volume, June 2002 [not seas. adj.] = 1000) | 1162 | 1128 | 1137 | 1134 | 1060 |
| Imports (volume, June 2002 [not seas. adj.] = 1000) | 1489 | 1449 | 1425 | 1398 | 1428 |
| Terms of Trade (June 2002 = 1000) | 1183 | 1118 | 1057 | 1074 | 1185 |
| Current Account Balance (% of GDP, year to date) | -2.4 | -2.9 | -3.2 | -5.6 | -7.9 |

*Sources: Statistics New Zealand (www.stats.govt.nz), Reserve Bank of New Zealand (www.rbnz.govt.nz)*

The New Zealand economy has been expanding for four successive quarters. Output for the past 12 months is still slightly below that of the previous year simply because the expansion has been slower than the preceding contraction. In terms of the quarterly GDP series, the economy is now back to where it was on the eve of the financial crisis in September 2008, though that means it is 1.6% smaller than at its pre-recession peak. In per capita terms, output is still a full 4% below its December 2007 level. So, the economy is in recovery mode, but it has a way to go to regain the ground it lost.

One particular component of aggregate demand – investment spending – is causing some concern about the future path the recovery will take. Investment spending is a relatively volatile component of GDP and dramatic changes in its growth rate over the business cycle are not unusual. However, its decline during the current recession has been particularly marked. To a large extent this was driven by the very high rate of de-stocking by firms during 2009 and the one-third cut in the rate of residential construction, but investment in other fixed assets (e.g., the factories, machinery and equipment, etc. that contribute to the productive capacity of the economy) also fell sharply – to 13% below its previous peak – and is yet to show signs of an upswing. Although the spare capacity in the economy created by the recession offers some scope for output growth to occur over the short run, its ability to maintain or improve on the current rate of growth beyond that point critically depends on the speed and strength of the recovery in investment in productive assets.

Business surveys indicate that firms are generally confident (though the latest surveys suggest this confidence has waned a little) about the outlook for their own output and are showing some signs of wanting to invest in new plant and machinery, but it is possible that the tougher lending criteria introduced by banks in the aftermath of the financial crisis and their increased aversion to risk will make it difficult for many firms.

A short-term solution to such a problem for some firms may be to expand output by taking on more workers (who are paid as they produce output for sale) rather than through installing more machines (which someone has to pay for outright before they begin to generate income). This strategy may have contributed to the surprisingly large drop in the unemployment rate in the March quarter.

However, while rapidly falling unemployment is of itself a good thing, without a commensurate rise in productive investment spending it will only signal a quicker return of inflationary pressure and rising interest rates.

# References and Further Reading for Highlights

All Highlights in this issue were provided by Dan Farhat **dan.farhat@otago.ac.nz**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***EcoNZ@Otago***

**Department of Economics**

**University of Otago**

**PO Box 56**

**Dunedin**

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