Productivity Commission
Te Kōmihana Whai Hua o Aotearoa
Briefing to the Incoming Minister 2020

NEW ZEALAND
PRODUCTIVITY COMMISSION
Te Kōmihana Whai Hua o Aotearoa

Purpose

This briefing provides you with an overview of the Commission's functions and how it adds value; sets out your role as the Minister responsible for the Productivity Commission; summarises our current and recent work programme; and provides an overview of our thinking on the path to lifting productivity.

Key points

- Higher productivity is necessary for sustainably higher living standards and incomes, and for widening the options available to all New Zealanders for greater wellbeing.
- New Zealand's productivity performance has been weak for decades. The challenge is to lift productivity by generating more value from productive inputs, while preserving and improving the environment, and making sure the benefits of growth are enjoyed by all New Zealanders.
- COVID-19 poses additional challenges. Some recent drivers of economic growth, such as migration, tourism and international education have halted and may not recover to earlier levels. Trends already evident, such as remote working and e-commerce, have accelerated with lockdowns, presenting both challenges and opportunities for businesses. The economic downturn will increase public spending and debt. Government will be faced with difficult choices about cushioning the effects of the downturn and consolidating public finances to restore resilience against future shocks.
- There is no single prescription for lifting productivity across the board. The Commission has been at the forefront of research into the drivers of, and the barriers to, improved productivity, and we have developed a broad diagnostic of New Zealand's poor productivity performance. Our inquiries have detailed policy recommendations to improve performance in specific areas.
- We will release a draft inquiry report in December *New Zealand firms: reaching for the frontier*. We welcome the opportunity to brief you on this report and discuss with you how we can strengthen our usefulness and relevance.
- You face decisions in the near term, including appointing a replacement Chair, selecting new inquiry topics, responding to completed inquiries, and considering an increased budget allocation.

Lifting productivity is key to raising living standards and wellbeing

Whatever priorities different governments may have for the wellbeing of New Zealanders, the nation's productivity performance is at the heart of achieving sustained higher living standards and greater wellbeing.

Although productivity is often measured by metrics such as GDP per capita or GDP per hour worked, it is not a narrow financial concept. It is observed in measures of wellbeing such as those captured in the Living Standards Framework developed by the Treasury. The attributes of greater wellbeing to which New Zealanders' aspire – including environmental sustainability, social equity and cohesion, better health, housing and education, and higher wages and incomes – are both a measure of our national productivity performance and dependent on it. Above all, it is productivity growth that enables the goals and aspirations of New Zealanders – as a nation, as distinct communities, and as families and whānau – to be realised.

Poor productivity performance is a longstanding problem for New Zealand

New Zealand's poor productivity performance is no new phenomenon. The decline in relative performance, as measured against leading economies, began in the 1950s and has become a persistent feature of the New Zealand story.

The Commission's work has contributed to understanding New Zealand's productivity problem

Productivity is not straightforward to measure. Nor is it straightforward to devise public policy interventions with certainty about their effectiveness. While the likely sources of New Zealand's sluggish productivity performance in recent years include those identified in earlier decades, specific circumstances and the options for response have changed over time. Being a small and remote economy is a factor, but that has always been the case. New Zealand needs strategies that takes its economic geography into account.

New Zealand's core institutional settings – fiscal, monetary and regulatory policies, institutional quality and social cohesion – are important. In cross-country comparisons, New Zealand is generally regarded as near the top of the class. These core settings support high productivity but have proved insufficient of themselves to maintain New Zealand's relative performance.

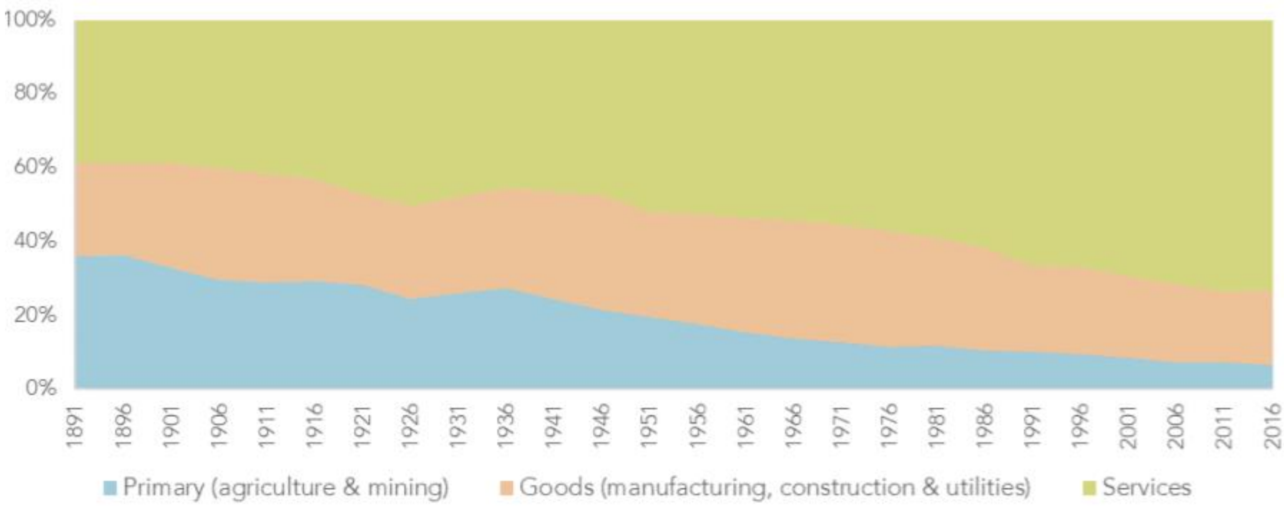
Other small, advanced economies are characterised by well-educated populations, who work with sophisticated physical capital and intellectual property to produce goods and services that are competitive in their domestic and international markets.

The gaps we see in New Zealand, compared to such countries, include an uncomfortably large cohort of young New Zealanders leaving the compulsory education system without the literacy and numeracy skills to prosper in the workplace; and small firms that lack the capital intensity to generate sophisticated well-paid jobs, and are focussed on producing for the domestic market.

The sources of low productivity have changed over time

Like other small advanced countries, New Zealand has become a predominantly services economy. The services sector produces about 70% of GDP, accounts for more than 75% of employment, and over half of the value of total exports[1]. Lifting the productivity of firms and organisations in the services sector is key to lifting the productivity of the overall economy.

Figure 1: Employment by industry sector 1891–2016



Digital technology has transformed the world economy over the past couple of decades. But rather than technology overcoming New Zealand's twin disadvantages of size and distance, digital technologies have

[1] When service inputs to merchandise exports are included.

increased the returns to scale and agglomeration. Proximity to innovation centres has become increasingly important for firms and entrepreneurs.

Despite one of the fastest population growth rates in the developed world, New Zealand's domestic market remains tiny. Small markets are associated with weak competition, which can, in turn, hold back resource reallocation and technology diffusion. Firms in such markets are under-prepared for the intensity of competition they encounter when attempting to enter international markets.

New Zealand's connectedness to international markets is among the lowest in the OECD.[2] Those firms that are internationally connected have relatively higher productivity levels and higher capital intensity than domestically focused firms.

Our research shows that New Zealand's frontier firms underperform

Our deep examination of both aggregate and micro/firm-level data across both New Zealand firms and those in successful small advanced economies has produced new insights into the role of capital shallowness and the processes of reallocation and diffusion. A large gap exists between the level of productivity achieved on average by New Zealand's most productive firms and those in a group of European small advanced economies. Resources like labour and capital are also better allocated in those economies towards high-productivity firms than they are in New Zealand. These findings have helped us "get under the hood" of New Zealand's poor productivity performance. We expect further insights from our frontier firms inquiry.

Our inquiries have found policies that impair resource reallocation

Inquiries, as directed by Ministers, constitute the bulk of our work. These inevitably lead us to focus on the micro-economic and regulatory elements of productivity in particular sectors, as opposed to the structural and macro issues that shape the overall performance of the economy. Both the macro and the micro perspectives matter if we are to make progress in lifting productivity.

Almost all of our inquiries have made recommendations to address policy weaknesses that contribute to impaired reallocation and diffusion. For example:

- Our *Technological change and future of work* inquiry found that New Zealand's slow adoption of technology was partly due to the fear of what new technology will do to jobs. We recommended supporting workers through change, including options for better income smoothing for workers who lose their jobs. The report also made recommendations for the tertiary education system to make retraining easier to help workers adjust to changes in work.
- Our *New models of tertiary education* inquiry made recommendations to address the barriers to the tertiary education system being more responsive to the needs of firms and industry.
- Our *Technological change and future of work* inquiry found that high house prices are a barrier to people re-locating for jobs that better match their skills and aspirations. Several of our inquiries – *Housing affordability*, *Using land for housing* and *Better urban planning* – have made recommendations to remove regulatory impediments to the reallocation of resources for housing.

Our current inquiry *New Zealand firms: reaching for the frontier* will identify the levers available to Government to lift the productivity of New Zealand's frontier firms, thereby helping to lift the performance of the rest of the economy.

See Annex 1 for further details of recently completed inquiries, and Government responses to date.

[2] Measured by export intensity and participation in global value chains as a percentage of exports.

The challenge for New Zealand

New Zealand's policy challenge is to transition from working ever more hours and depleting capital stocks (especially natural capital), to lifting wellbeing by generating more value from productive inputs. There are obstacles, as the past few decades of underperformance demonstrate. The diffusion of technologies and ideas from overseas and throughout the economy is slow. Few New Zealand firms operate at the global productivity frontier, and many low-productivity firms survive in small, fragmented and insular domestic markets. And while New Zealand's broader policy settings have been broadly sound and adaptive to the rapidly changing demands of COVID-19, there are barriers to the reallocation of resources to their highest value use. Some issues, like housing affordability, have so far proven intractable. Resolving these issues will have positive consequences for productivity and wellbeing.

Protecting and enhancing the four capitals

Sustainability and inclusion sit at the heart of the challenge. The Treasury's Living Standards Framework identifies four "capitals" – natural, social, human and physical/financial – that underpin New Zealanders' wellbeing. The productivity of New Zealand's investments in them will be crucial to protecting, maintaining and improving the capitals. And, in turn, the productivity of the capitals in producing wellbeing will determine the actual outcomes New Zealanders enjoy.

The world is not standing still – continuing trends and fresh challenges

New technologies are creating opportunities for New Zealanders – the challenge is in making sure that young New Zealanders have the educational foundations to take them up. Rates of achievement are declining in maths and science, and a there is a wide gap in achievement between our highest and lowest achieving students.[3]

New Zealand will need to confront fundamental environmental tensions – climate change, freshwater quality and the health of the world's oceans. These will increasingly come to dominate policy attention and reshape how New Zealanders think about wellbeing.

The COVID-19 crisis poses fresh challenges and raises questions around the economy's future path. Some recent drivers of economic growth, such as migration, tourism and international education, have halted and may not recover to previous levels for some time, if at all. Future prosperity depends not just on the recovery of New Zealand firms and industries, but in boosting their productivity.

The economic downturn and government response to the COVID-19 crisis will increase public spending and debt, and significantly reduce public net worth. The government will be faced with difficult choices around cushioning the effects of the downturn and consolidating public finances to restore resilience against future shocks. The recovery is an opportunity to move the economy to a higher productivity path, while helping people to transition to new opportunities and new jobs along the way. Careful investment choices by government is central to those outcomes.

Boosting productivity growth should be a central plank of any strategy to lift and sustain the future prosperity and wellbeing of New Zealanders.

A focused, coherent and long-term agenda is needed

The importance of good policy foundations that promote flexibility in the use of resources, openness to global opportunities and competition, and receptiveness to new technology, have long been recognised as important for lifting productivity.

Successive governments have created institutions and implemented policies to tackle these challenges. Initiatives have aimed to improve international connections, overcome barriers to domestic competition, attract talent, make education and training more responsive to the changing demands of work, and raise the rate of successful innovation in firms. Yet it is apparent that no initiative or combination of initiatives has had the cut-through over recent decades to lift New Zealand's productivity.

[3] As measured by PISA scores.

No one programme or policy change by itself is likely to have a large effect on New Zealand's productivity path. A set of interventions is needed – of sufficient scale and duration, well focussed and coherent, and leveraging off public- and private-sector synergies. The challenge is to design and implement a coordinated policy agenda – aligning investments in R&D, promoting the uptake of new technology, developing skills, and building quality infrastructure.

The changes required to improve overall living standards will be disruptive for some businesses, some occupations and some regions. Social services and income support will need to be directed towards those adversely affected. To make this happen, there is a pressing need to improve the efficiency and efficacy of public service delivery. The public sector will need to be responsive to evidence of effectiveness, be prepared to scrap unsuccessful initiatives and adapt its institutions.

New Zealand can draw lessons from the experience of other small advanced economies, particularly those whose productivity has been high and sustained over the past few decades. Lessons will have to account for differences in history, economic structure, geography, and cultural, socio-political and institutional contexts. Even so, it should be possible to get a picture of the type, scale, duration, and governance of successful interventions and how these compare with what New Zealand has attempted in the past.

The Commission is well placed to provide advice on the policies needed for a productivity-fuelled recovery, supporting the future wellbeing of New Zealanders.

Functions of the Productivity Commission

The New Zealand Productivity Commission Act 2010 established us as an independent Crown entity to "provide advice to the Government on improving productivity in a way that is directed to supporting the overall well-being of New Zealanders, having regard to a wide range of communities of interest and population groups in New Zealand society" (s 7).

As described in the Act, our functions are:

- to undertake inquiries into productivity-related matters as assigned by referring Ministers;
- to undertake and publish research about productivity-related matters;
- to promote public understanding of productivity-related matters; and
- to act independently in performing our functions and duties.

The Commission's value - Te Kōmihana Whai Hua o Aotearoa

The Commission informs debate and makes recommendations that contribute to improved public policy with the aim of lifting productivity and the wellbeing of all New Zealanders. To do this effectively, our policy advice must be both rigorous and trusted.

Independence

We are an independent research and advisory body. We do not run or implement policies or programmes. We rely solely on the power and communication of our ideas and analysis to influence and shape policy.

A direct measure of our impact is the proportion of our inquiry recommendations that are adopted and implemented by Government. The Government is under no obligation to implement our recommendations nor to respond to our reports. In practice, the Government has issued formal responses to most of our inquiry reports, specifying which recommendations it agrees with and will implement.

It would be unrealistic and probably undesirable to expect all our inquiry recommendations to be accepted. As an independent organisation with a strong focus on the public interest, we should push boundaries on complex issues. Done well, our research and inquiry reports should spark a recalibration of thinking within relevant agencies and stakeholders. We can put difficult issues on the agenda and encourage discussion and action on topics that other agencies consider too sensitive. We have and will continue to test ideas and challenge the status quo in the interests of improving the wellbeing of New Zealanders – providing the best advice, rather than the most palatable.

Comprehensive engagement

Central to our impact and influence is our comprehensive public engagement process. We engage widely with interested parties during each inquiry, gathering ideas and testing findings. Stakeholders have a direct input and can influence our recommendations.

High quality research and analysis

Our people have well-developed research and analytical skills, and the ability to undertake high-quality analysis and shape that into influential policy advice.

We supplement our permanent staff with consultants to bring specialist knowledge, experience and fresh perspectives, as required, and through secondments we can take advantage of expertise across the public sector. For example, we seconded a Principal Advisor from the Ministry of Education's tertiary and international education group to our *Technological change and the future of work* inquiry team. In the same way, one of our Principal Advisors on the *Low-emissions economy* inquiry team was seconded to the Ministry of Business, Innovation and Employment to work on climate change policy and another of our Principal Advisors was seconded to the Secretariat to the Interim Climate Change Committee.

Some commentators observe that the core public service has lost much of its deep subject matter expertise, and its ability to tackle large, complicated cross-cutting policy issues. We have the skillset to help fill this gap and to help the Government address its more difficult, longer-term policy challenges. David Skilling, in his 2018 review of the Commission for the Treasury, noted that we are "a valuable source of capacity in a relatively small public sector".

Your role as Minister

The Minister of Finance is the Minister responsible for the Productivity Commission.

Appoint Commissioners

The Commission is typically governed by a board of three Commissioners (although there is scope in the Act for a fourth) whom you appoint. The current board has four part-time Commissioners. The terms of two Commissioners expire in 2021.

Table 2: The current board of the Productivity Commission

Commissioner	Background	Term expires
Murray Sherwin CNZM, Chair	Former Chief Executive and Director General of the Ministry of Agriculture and Forestry; former Deputy Governor of the Reserve Bank of New Zealand.	30 January 2021
Dr Bill Rosenberg	Former Policy Director & Economist at the New Zealand Council of Trade Unions. Dr Rosenberg maintains a part-time role as Future of Work Director at the CTU and is a Senior Associate at Victoria University's Institute for Governance and Policy Studies and Research Associate at the University of Waikato. He holds a B.Com in Economics, a BSc Hons in Mathematics and a PhD in Mathematical Psychology.	1 September 2021
Andrew Sweet	Director of economic and public policy consulting firm Firecone NZ, former head of the secretariat of the Small Advanced Economics Initiative, and former Policy Advisor, Department of the Prime Minister and Cabinet.	31 May 2022
Professor Gail Pacheco	Professor of Economics and Director of the New Zealand Work Research Institute at Auckland University of Technology. Professor Pacheco was awarded the NZIER Economics Award in 2018 and AUT's University Medal (its top award for research and scholarship) in 2019.	30 June 2022

Appoint a Chair and consider extending a Commissioner's term

- Murray Sherwin will finish his term on 30 January 2021. It is your role as Minister to appoint a new Chair.
- You appointed Dr Bill Rosenberg as a Commissioner on 1 September 2020 for a term of one year. It will be your decision whether to extend his term.

Select inquiry topics

Treasury officials under your direction (and relevant portfolio Ministers) develop the terms of reference for inquiries. Through the terms of reference, referring Ministers can direct us to focus on particular issues, exclude certain issues from the scope, and set inquiry timeframes.

We anticipated receiving a further inquiry in the first half of the 2020 calendar year. The Government refrained from confirming this inquiry as its attention was fully occupied by the COVID-19 crisis. Instead we assisted the Treasury in providing advice to the Government.

The selection of a new inquiry topic, and one to follow on from the frontier firms inquiry (due for completion in March 2021) is an opportunity for you to set the work programme and agenda for the Commission in the first eighteen months or so of your new term in Government.

In your August 2019 *Letter of Expectations*, you asked us to work closely with the Treasury to provide a prioritised list of topics, and for Treasury to rank and assess proposals, based on the extent to which they

- use our position as an independent agency with high quality analytical capability and a focus on public engagement;
- have the potential to deliver practical policy recommendations to improve the overall wellbeing of New Zealanders;
- require a substantial degree of analysis to resolve a complex set of issues; and
- are related to the sources of New Zealand's low productivity and have an appropriate balance between inquiry into the tradeable and non-tradeable sectors.

The Treasury will make its assessment of new topic proposals based on the above criteria, but also on how the Government can use the Commission to progress important longer term work related to the COVID-19 recovery, at a time when other government agencies are, by necessity, focussed on the immediate response.

Assign new inquiry topics

We would like you to consider:

- assigning us a new inquiry topic in the near term; and
- assigning a topic to follow on from the frontier firms inquiry, ideally by March 2021.

Respond to inquiry reports

We provide advance copies of *draft* reports and summary material to referring Ministers shortly before release. We expect to follow this convention with the release of our draft report *New Zealand firms: reaching for the frontier* on Friday 4 December. Commissioners can also meet with referring Ministers to provide a verbal briefing. We have generally advised Ministers to refrain from publicly supporting or rejecting draft recommendations, which gives more scope to the Commission to respond to stakeholders and submitters without appearing to breach our statutory independence obligation.

Receive a verbal briefing

- An advance copy of our draft report *New Zealand firms: reaching for the frontier* will be sent to you on Monday 30 November. We would welcome an opportunity to provide you with a verbal briefing on this report.

We provide advance copies of *final* reports and summary material to referring Ministers and usually meet with referring Ministers to provide a verbal briefing.[4] The New Zealand Productivity Commission Act 2010 requires you to present our final reports to the House of Representatives "as soon as practicable". The Government has typically issued formal responses to inquiry reports, specifying which recommendations it agrees with and will implement. The Government's response is made available on the Treasury's website and supports the transparency of the process and the credibility of the Commission in the eyes of the public.

Respond to the final reports of completed inquiries

We are awaiting the Government to formally respond to completed inquiries, specifically:

- *Technological change and the future of work*, and
- *Local Government funding and financing.*

Make decisions about resourcing and level of output

Our work demands a high level of capability and performance. We employ people who can add significant value to any inquiry supplemented with secondments, fixed-term contractors and specialist consultants. In the research space, we employ some of New Zealand's top economic thinkers and quantitative researchers. We employ between 15 and 20 people depending on our work cycles.

The Commission's appropriation is $5.030 million per annum. This appropriation now comes in a single output class (previously two). Our overall funding level has been unchanged in nominal terms since we were established in 2011. As costs rise, we will be unable to maintain the quality and volume of our inquiry and research outputs on the current appropriation.

The Commission will seek additional funding in the 2021 budget round so we can continue to maintain high-quality analytical capability, undertake the depth and breadth of analysis required to resolve complex issues, and maintain high levels of public engagement. If we are unable to secure additional funding, we believe our best path forward would be to drop back to one inquiry, rather than the current two, and redeploy resources into our Economics & Research function in line with the recommendations of the Skilling review.

Consider increasing the Commission's budget appropriation

- We would like you to consider increasing the budget appropriation for the Commission, so that we can continue to carry out two inquiries at a time and maintain our research outputs.

[4] We also make ourselves available to brief other political parties on our reports.

Work programme

Inquiries

We currently have one active inquiry *New Zealand firms: reaching for the frontier*. We published an issues paper in April 2020 and will release a draft report in December 2020. A final report is due in March 2021. Referring Ministers are you as Minister of Finance, the Minister for Economic Development and the Minister for Trade and Export Growth. The inquiry is investigating the drivers that could lift the productivity of New Zealand's most productive firms closer to global best practice, while raising the performance of other firms and of the economy as a whole.

Research on productivity performance

Our research aims to understand New Zealand's productivity performance and the role of policy in lifting productivity. We have investigated employment and firm dynamics, technology diffusion, innovation, and public-sector productivity. Over the past two years we have focused on spatial productivity and regional development, to better understand the diversity of economic performance across New Zealand's smaller cities, and the regional effects of economic shocks on productivity and population growth.

Much of our research has used Stats NZ's Longitudinal Business Database (LBD) where firms are the unit of analysis. However, our ability to undertake further LBD research is hampered by resource constraints. We have reduced the size of our research team over the past year, and stepped back from servicing the Productivity Hub and coordinating cross-agency LBD research.

Latterly, our research team has been engaged in directly supporting our inquiries with quantitative analysis. This includes estimating income-replacement rates for displaced workers for the *Technological change and future of work* inquiry; and comparing industry productivity distributions across countries for the frontier firms inquiry.

We are committed to annual reporting on New Zealand's productivity performance, as set out in your August 2019 *Letter of Expectations*. This takes the form of our *Productivity by the numbers* publication. Our current resourcing limits our ability to provide commentary on trends and provide in-depth analysis of issues worth further inquiry.

Promoting greater public understanding of productivity

The Commission has an active communications programme to promote understanding of productivity. We receive and accept numerous invitations to speak at events – about inquiry themes and productivity more generally. This shows widespread interest in raising New Zealand's productivity and wellbeing, as well as public interest in our role.

We look forward to working with you

We look forward to working with you and your colleagues to improve New Zealand's productivity performance to hasten recovery from the COVID-19 recession and secure the future prosperity and wellbeing of New Zealanders.

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Annex 1: Recently completed inquiries

The Commission has now completed 16 inquiries. Among recently completed inquiries, the Government has already responded to the recommendations of *Low emissions economy* (completed in August 2018) with the establishment of a Climate Change Commission, the passage of the Climate Change Response (Zero Carbon) Amendment Act 2019, and strengthening of the Emissions Trading Scheme.

Better urban planning (completed in March 2017) identified ways to make land and infrastructure supply more responsive to demand, and highlighted the need for development to occur within clearer protective limits for the natural environment, and in ways that better recognise and protect Māori Treaty interests. We subsequently met with the officials supporting the Resource Management Review panel and with Ministers to offer advice around implementing the main inquiry recommendations.

Local government funding and financing (completed in December 2019) found that the property-based rates systems continued to be appropriate as the mainstay of local government funding in New Zealand. Some councils could make better use of their existing funding tools, and there is a need for greater transparency and accountability around decisions and performance. Upgrading local three-waters services to better meet existing and rising health and environmental standards will place many councils under funding pressure. Some smaller councils lack the scale to attract the necessary expertise to provide efficient services and often have weak rating capacity. Adapting to climate change (for instance through relocating infrastructure) will impose large costs on some councils in the medium term.

We recommended that the Government extend existing funding models to find fair and sustainable ways for councils to meet this challenge. Councils serving fast-growing cities sometimes struggle to finance infrastructure to facilitate growth. The Government introduced legislation to support financing through special purpose vehicles, which was one of the recommendations of this inquiry.

Technological change and the future of work (completed in March 2020) assessed the potential impacts on work in New Zealand arising from technological change. It identified the importance of new technology for productivity growth, and attributed New Zealand's poor productivity growth performance to low rates of technological adoption and diffusion. We recommended building on existing strengths such as a flexible and adaptive labour market and a well-educated workforce, while tackling areas of weakness. These include falling and uneven performance in the school system, which leaves children from socio-economically disadvantaged communities with persistently poor outcomes; and a poorly performing housing market that hinders workers moving to find the best job match for their skills.

We recommended making training more flexible and accessible for workers, improving careers guidance, and providing greater income smoothing for displaced workers. The Government adopted the latter recommendation on a time-limited basis as part of its response to the COVID-19 crisis.