

2 November 2017

Hon Grant Roberston
Minister of Finance
Private Bag 18041
Parliament Buildings
Wellington (6160)

Dear Minister

Congratulations on your appointment as Minister of Finance. I am assuming that your portfolio will include responsibility for the Productivity Commission and in that connection, my colleagues and I look forward to working with you as we continue to provide the government with advice on “improving productivity in a way which 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” – our statutory purpose.

I attach a short introductory briefing on the Commission providing background on our functions, current work programme and other issues of relevance to our relationship. While the Commission is an independent body, its work programme is set by Ministers, most notably you as lead Minister.

I and my colleagues will be pleased to meet with you to discuss the Commission and its work as your schedule allows. We look forward to discussing with you where we might be able to add most value in our common pursuit of enhanced wellbeing for all New Zealanders.

We would also be delighted to host you at the Commission’s office at some stage, so you can meet our small team and engage directly with our people should you wish.

Your sincerely



M A Sherwin
Chair

Productivity Commission

Briefing to the Incoming Minister 2017

Key points

- Productivity growth is the essential driver of higher incomes, greater material wellbeing and widening the range of options available to all New Zealanders. New Zealand's productivity performance has been weak and lifting productivity is the country's most pressing economic challenge.
- The Commission has been developing its understanding of the factors preventing people, firms and government from reaching their productivity potential and the policy and institutional changes that would incentivise higher productivity. There is no single prescription, in our view, and the issues are both structural and policy related. We would welcome the opportunity to brief you and your colleagues on pathways to improve New Zealand's productivity performance.
- We have two draft inquiry reports coming out in the next few months: *Measuring and improving state sector productivity* and *Transitioning to a low emissions economy*. We would like to discuss the status of these reports with you. There is no precedent for managing inquiries through a change of government, but we certainly want to ensure that this work is highly relevant to the new Government's agenda. We would also like to discuss your interests in future inquiries and other work for the Commission.
- This briefing provides 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 a short overview of the lessons from the Commission's work to date.

Functions of the Productivity Commission

The Productivity Commission is an independent Crown entity established by the New Zealand Productivity Commission Act 2010 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, the Commission's functions are:

- to undertake inquiries into productivity-related matters as assigned to it 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 its functions and duties.

The Commission's value

The Commission has been operating for more than six years and is well established, having completed ten inquiries and a significant volume of research on issues central to lifting productivity. The Commission's capability and value rests on a number of factors:

- We have a dedicated focus on our inquiries and research, undistracted by operational demands that can crowd out future-focused work in government departments. We can build and develop a body of evidence through our research and inquiry functions which contributes to understanding and responding to New Zealand's productivity challenge.
- In both our inquiries and our self-initiated research, experience has shown we are able to work across the silos of government agencies or policy portfolios in a way that core agencies struggle to achieve.

- We are committed to deep engagement processes as a neutral player in complex matters where core agencies are often constrained. Integral to deep engagement is our practice of publishing submissions, draft reports, research and discussion documents, and promoting dialogue and engagement across stakeholder groups.
- Our independence allows the Commission to raise or comment on matters that core government agencies might seek to avoid or downplay.
- Nevertheless, we are a team player and work collaboratively with core government agencies when this is appropriate and adds value. Our interest is in the best possible advice on productivity-related topics being available to Ministers.
- We have built a small pool of people with a mix of professional backgrounds and disciplines, bringing high quality quantitative and qualitative analytical skills to bear on complex issues.

Your role as Minister

The Minister of Finance has been the Minister responsible for the Productivity Commission. We are currently assuming this is still the case. The Commission is governed by a board of three Commissioners (there is scope in the Act for a fourth) whom you appoint (via a recommendation to the Governor-General).

The Board is currently made up of three part-time Commissioners:

- 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. Mr Sherwin's term expires on 30 January 2021.
- Professor Sally Davenport – Professor of Management at Victoria Business School teaching innovation and entrepreneurship. Professor Davenport's term expires on 31 March 2020.
- Dr Graham Scott CB – public sector reform consultant, former Chair of the Health Funding Authority and former Secretary of the Treasury. Dr Scott's term expires on 31 March 2019.

Select inquiry topics

Terms of reference for inquiries are developed by Treasury officials under the direction of the responsible Minister and relevant portfolio Ministers (collectively, the referring Ministers). The Commission strongly supports this practice as it ensures that topics are relevant and that Ministers have a stake in the outcome. Through the terms of reference, Ministers are able to direct the Commission to focus on particular issues, exclude certain issues from the scope, and set the inquiry timeframe.

Our past inquiries have typically been big pieces of analysis, taking 12–18 months. The time enables the Commission to engage extensively with interested parties, access and analyse the best local and international data and research, and to explore different perspectives and ideas.

The Productivity Commission provides advance copies of draft and final reports and summary material to referring Ministers shortly before their release, and usually meets with referring Ministers to provide a verbal briefing. The Commission also makes itself available to brief other political parties on our reports and major pieces of non-inquiry research.

Respond to final inquiry reports

The Government is under no legal obligation to implement Commission recommendations nor to respond to our reports. Under the New Zealand Productivity Commission Act 2010, the responsible Minister for the Commission is only required to present our final reports to the House of Representatives "as soon as practicable." In practice, however, the Government has issued formal responses to Commission inquiry reports, specifying which recommendations it agrees with and will implement. This is supported by the Commission as it compels government agencies to consider our advice and commit to implementing selected recommendations. It also reinforces a transparent process in which the Government's response is

made publically available on the Treasury's website and supports the credibility of the Commission in the eyes of the public.

Future direction of the Productivity Commission

We note that the Labour party has expressed a desire to review the Productivity Commission's mandate "so that it has a focus on wage growth and addresses explicitly the development of appropriate high-engagement high-performance measures and behaviours in New Zealand workplaces and industries".¹

Much of our research has been done using Statistics New Zealand's state-of-the-art Longitudinal Business Database and puts firms at the centre of the analysis. This provides a fresh perspective and broadens our understanding beyond what is possible using aggregate and industry-level data. So in conjunction with our current inquiry into state-sector productivity, we already have some understanding of productivity within New Zealand workplaces and are well-placed to address the focus areas mentioned above through the selection of inquiry topics, and supporting research and strategic communications initiatives. Note that we have maintained regular engagement with the CTU and PSA through our inquiry work and through participation in the Productivity Hub. We would welcome the opportunity to discuss your vision for the Commission, and options for achieving this.

Resourcing

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

The Commission's appropriation is \$5.030 million per annum. This appropriation comes in two output classes, with 87.5% of this funding allocated to the Commission's inquiry function and 12.5% for research and promoting public understanding of productivity-related matters. Our preference would be to move to a single output class given the administrative inflexibilities inherent in the current arrangements.

The Commission's 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 is likely to seek additional funding to address the inevitable cost pressures that arise from a fixed baseline and in order to make the most of opportunities to improve evidence-based policy. Any changes in the Commission's function may also have resourcing implications.

Work programme

Active inquiries

We have two inquiries in progress with draft reports due for release in the next few months, *Measuring and improving state sector productivity* and *Transitioning to a low emissions economy*. We will be pleased to hear of your interests and perspectives in these inquiries.

Timeframes for the Commission's current inquiries are set out below:

Inquiry	Referring Ministers	Issues paper released	Planned release of draft report	Final report due
Low-emissions economy	Minister for Climate Change Issues Minister of Finance Minister for Economic Development	August 2017	March 2018	June 2018

¹ Labour workplace relations policy, accessed 20 September 2017 from <http://www.labour.org.nz/workplace-relations-policy>

Low-emissions economy is examining two broad questions:

- What opportunities exist for the New Zealand economy to maximise the benefits and minimise the cost entailed in the transition to a low net-emissions economy, while continuing to grow incomes and improve wellbeing?
- How could New Zealand's regulatory, technological, financial and institutional systems, processes and practices help realise the benefits and minimise the costs and risks of the transition to a lower net emissions economy?

There has been widespread interest in this topic – 127 submissions received so far and counting – and we expect this interest to continue throughout the course of the inquiry. We have already published a Research Note on *Examining the UK Climate Change Act 2008* as a background resource for this inquiry. This note examines the UK's Climate Change Act 2008, including the background to the Act's introduction, its key design features, performance to date and lessons from the UK experience that may be relevant for New Zealand.

We note that the Coalition Agreement and the Confidence and Supply Agreement outline policy and institutional arrangements for the transition to a lower net emissions economy, including introducing a Zero Carbon Act and establishing an Independent Climate Commission.

In light of this, you may want to consider whether the terms of reference for this inquiry should remain as they are or be refocussed on issues outside of the Coalition and Confidence and Supply Agreements. We would be happy to discuss ways of doing this with you.

Measuring and improving state sector productivity will:

- provide advice on how to measure efficiency in the health, education, justice and social support sectors, at both a sector and service level;
- provide advice on the appropriate role of these measures in public sector performance frameworks; and
- provide advice on any capability, culture or systems issues that will support agencies to measure, understand, and improve productivity.

As part of the inquiry the Commission is working directly with government agencies to develop quantitative examples of productivity measures across a selection of core state sector activity. The Commission intends that the outputs of this inquiry will become a valuable resource for public officials tasked with developing performance/productivity measures, and for decision-makers at different levels of government.

The current timing for this inquiry is to deliver the final report by 30 August 2018. However, this inquiry is progressing well and could be finished earlier if you wanted to develop a new terms of reference for an inquiry in a different area of interest to the new government. We would be happy to discuss this with you.

Recently completed inquiries

The Commission's most recently completed inquiries were *New models of tertiary education* and *Better urban planning* (both released in March 2017).

New models of tertiary education examined how well New Zealand's tertiary education system is set up to respond to emerging trends, such as new technology, changes in the skills needed in the economy and society and demographic shifts in the student cohort. This is key in meeting the challenges that come with *The future of work*. The report found that the tertiary system performs well for many, but that it could be better, and it could do more to extend the benefits of tertiary education to groups who currently can't access it. The system is tightly controlled by government funding and regulatory settings, resulting in an inflexible system in which providers have too few incentives to find better ways of reaching and teaching

learners. The report recommends changes to improve the tertiary education system's ability to respond flexibly to future pressures and opportunities.

The outgoing government agreed a suite of policy work to take forward the recommendations from *New models*, and the Minister of Education will receive advice on these in due course from the Ministry of Education.

Better urban planning took a blue-skies approach to what a future urban planning system could look like. Too often, the connection between urban planning rules and the wellbeing of communities is weak, the supply of infrastructure and zoned land fails to keep pace with demand, and the natural environment is degraded. The report identifies ways to make land and infrastructure supply more responsive and highlights the need for development to occur within clearer protective limits for the natural environment, and in ways that better recognises and protects Māori Treaty interests. Stronger stewardship of the system from central government as well as improved planning capability and culture are also needed.

This inquiry built on previous inquiries the Commission has undertaken on local government regulation, housing affordability, and the use of land for housing. The Commission's work on urban planning and housing affordability aligns well with many aspects of the incoming Government's policies.

Past inquiries

We have now completed ten inquiries. The remaining eight were:

2015	<ul style="list-style-type: none">- Using land for housing- More effective social services
2014	<ul style="list-style-type: none">- Regulatory institutions and practices- Boosting productivity in the services sector
2013	<ul style="list-style-type: none">- Towards better local regulation
2012	<ul style="list-style-type: none">- Strengthening trans-Tasman economic relations – joint study with the Australian Productivity Commission- Housing affordability- International freight transport services

Research

The Commission's research aims to understand New Zealand's productivity performance and the broad role of policy in lifting productivity. An important focus of our research is building an evidence base from insights found in Statistics NZ's firm-level Longitudinal Business Database (LBD). The LBD is the firm-level equivalent of the person-centric part of the Integrated Data Infrastructure now being drawn on to underpin the investment approach to social services.

To date, we have used our research function to investigate a range of policy-relevant issues including employment and firm dynamics, technology diffusion, innovation and public sector productivity. We also undertake quantitative research on particular issues that arise in the inquiries.

In November 2016, the Commission published a Research Paper on New Zealand's productivity performance – *Achieving New Zealand's productivity potential*. This paper pulls together many different pieces of research to generate a diagnosis of why the New Zealand economy has struggled to lift its productivity. The paper also examines the implications of this diagnosis for policy. This work will be regularly reviewed and updated as our understanding of New Zealand's productivity challenges continues to improve.

This comprehensive overview of New Zealand's productivity issues provides context for and feeds into the more detailed policy prescriptions in the Commission's inquiries. It also highlights areas for future inquiries and our forward-looking research agenda.

We believe this work usefully complements the findings of the Labour Party's Future of Work Commission. We have already discussed the paper with the Labour Caucus and we would welcome the opportunity to provide you with additional briefings.

The Commission's research currently focuses on spatial productivity and regional development. The aim is to better understand the diversity of economic performance across New Zealand's second-tier cities, in terms of both productivity and population growth. On the back of this research, we aim to develop policy recommendations to improve regional economic performance.

Given our leadership role in productivity research we established and we chair the Productivity Hub. This is a cross-agency initiative that includes Treasury, MBIE, and Statistics NZ. The Hub commissions research of common interest to the agencies (for example, it had a substantial research contract with Motu to use Motu's deep technical expertise). The Hub also builds and maintains research networks (for example, with the OECD and with selected academics here and abroad).

Promoting understanding

The Commission has an active communications programme to promote understanding of productivity. Commissioners and staff accept numerous invitations to speak at events – about specific research inquiry topics and productivity more generally – which is indicative of widespread interest in finding ways to increase New Zealand's productivity and wellbeing (and of the Commission's role).

In conjunction with the Productivity Hub, the Commission will host conferences in February 2018 on "the production revolution" and in mid-2018 on regional economic development. Both events will include presentations from leading domestic and international researchers and policymakers with a major focus on improving the links between research and policy. We are also developing a range of communications material to tell the wider productivity story to a broad audience over 2018.

Lessons from the Commission's work to date

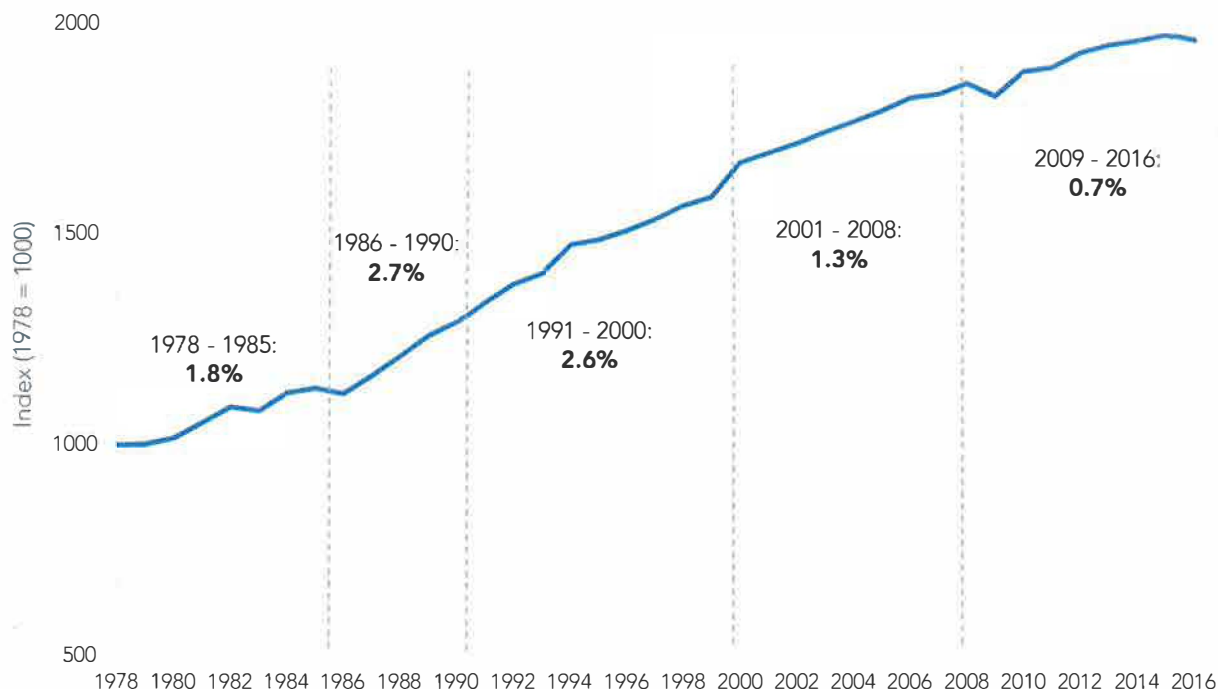
Productivity describes the process by which communities or societies lift their living standards. It is the essential driver of increasing incomes, greater material wellbeing and, importantly, widening the range of options available to all New Zealanders. At one level, the concept is readily understood – it essentially describes how people, firms and governments can extract more value from each unit of input in a production process. At another level, the productivity concept is quite slippery, with substantial technical challenges in measuring productivity performance, identifying the factors responsible for that performance and policy changes that will drive improvements.

In broad terms, productivity growth comes from improvements in the quality of a country's productive resources and the effectiveness with which they are combined to produce output. The stocks of productive resources includes human capital, natural capital and physical capital and also knowledge based capital (which includes R&D and managerial quality). Another component is social capital (including the rule of law and property rights).

From colonial times, the New Zealand economy has relied heavily on the intensive use of natural capital to produce output. While this generated considerable wealth for a small country, strong population growth and increasingly pressing environmental constraints have pushed the limits of this approach.

More recently, since the Global Financial Crisis, growth in per capita incomes have been driven by improvements in New Zealand's terms of trade and a labour market that has been one of the most successful in the OECD at lifting employment. In contrast – and notwithstanding a lift in the late 1980s and 1990s following economic reform – New Zealand's productivity growth performance has been weak. This poor productivity performance is the main reason why per capita incomes are still below the OECD average, despite recent growth in GDP.

Labour productivity in New Zealand



The challenge

New Zealand's key economic challenge is to transition from a development model based on working more hours per person and depleting its resource of natural capital to one based on lifting productivity by generating more value from the stocks of productive inputs. Sustainability and inclusion sit at the heart of this agenda so that the natural environment is preserved and improved and the benefits of growth are widely dispersed across the population.

This transition presents a huge challenge. New Zealand's small population and low population density and its geographic isolation from international markets makes lifting productivity difficult. Our work shows that the diffusion of new technologies and ideas throughout the economy has been slow, with few New Zealand firms operating at the global productivity frontier and with long tails of low-productivity firms surviving in small, fragmented and insular domestic markets.

In addition, a number of trends pose increasing challenges for policy. These include skill-biased technological change, environmental pressures and population ageing. The Government's response to these trends will shape the future prosperity and wellbeing of New Zealanders.

On the other hand, New Zealand is in some respects well placed to tackle this challenge. The economy has weathered the Global Financial Crisis with reasonable income growth and high labour force participation. Public finances are strong and inflation expectations are subdued – both critical elements to future economic and social success. Importantly, ongoing changes in technology and in the global trading environment are creating new opportunities for New Zealand firms to engage internationally.

Policy

Making the most of these opportunities and mitigating the risks requires some fresh policy thinking. With rapid changes in technology, and the global trading environment putting a premium on skills, the reform challenge is in some ways different from what has been faced previously. It demands flexibility, openness, and receptiveness to new technology. However, some perennial concerns remain – for example, how can policy help lift both firm scale and competition in a small and remote economy?

Getting this right requires a deep understanding of New Zealand's productivity track record and potential in the 21st century global economy. Through our research and inquiry work, the Productivity Commission has worked on some key aspects of this challenge.

Our work highlights the importance of international connection in improving productivity. Strong international links expose New Zealand firms to new ideas and technologies and gives productive firms the room to grow and expand while exposing unproductive firms to international competition. Accordingly, policy needs to facilitate New Zealand firms engaging in traditional and new ways internationally, including in services and digital products.

The importance of the services sector in moving from volume-based, commodity growth to knowledge-intensive and high-value-add growth has also come up repeatedly in our work. Policy changes to improve competition have emerged as a common theme, with a number of inquiries highlighting the negative impact of weak competition and deficiencies in competition laws. As the importance of the services sector continues to grow, policy changes aimed at lifting competition and improving performance in this part of the economy will become increasingly important.

The skills of the workforce are also critical. By equipping people with skills and the ability to acquire skills that will be in demand in the future, the education system is key to winning the race between the relevancy of skills and technological change. As highlighted in our recent inquiry, the skills system needs to be more flexible and responsive to needs of the labour market and of a more diverse set of learners. A strong and deliberate focus on high-skilled migration would also help lift human capital while improvements in the housing market would allow more people to live where their skills are most valued.

The science and innovation systems could also do more to build deep pools of relevant knowledge and expertise so that firms can produce and commercialise new ideas and technologies with opportunities for upscaling driven by high global visibility. For example, a concerted research effort on reducing agricultural emissions, which is critical if New Zealand is to meet its climate-change objectives, could generate valuable frontier technologies for New Zealand firms to roll out internationally. The challenge here is to implement a coordinated policy agenda that supports the building of thematic knowledge platforms. This would require aligned investments in R&D and technology diffusion, regulation, skills and world-class infrastructure.

While new technologies and globalisation bring great potential for improved living standards, they can be disruptive and affect different workers and regions differently. So policy must ensure that social support and social services function effectively to deal with the negative side effects of rapid technological change.

Conclusion

The Commission has used its research function to develop a broad diagnostic of New Zealand's poor productivity performance while its inquiries provide detailed policy recommendations to improve performance in specific areas. Importantly, this work does not yet provide a complete policy agenda – as knowledge of New Zealand's productivity drivers and associated regulatory issues continues to evolve, the list of associated policy considerations will naturally evolve.

However, the work to date does provide many of the key elements of a policy agenda aimed at lifting productivity. This agenda represents a considerable shift from current policy and institutional settings in a number of areas. Delivering on this agenda presents a formidable policymaking challenge, and our work has identified a number of cross-cutting weaknesses and capacity gaps in the policymaking process.

We look forward to working with you and your colleagues to improve New Zealand's productivity performance. We have in mind a number of potential future inquiry topics, which we would be pleased to discuss with you at the appropriate time together with a future research agenda.