

## Economic Survey of New Zealand, 2007

**How is the economy performing?**

**How can longer-run living standards be enhanced?**

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### Summary

New Zealand has undertaken wide-ranging reforms over the past 20 years and now has one of the most flexible and resilient economies in the OECD. However, a large external deficit, very low household saving and still-strong inflation pressures indicate an unbalanced growth pattern. There are some signs that these imbalances are starting to unwind, but the short-term outlook remains uncertain. On current settings, it will take time for inflation pressures to dissipate and, notwithstanding a large fiscal surplus, strong growth in government spending is complicating the stabilisation task of the Reserve Bank. Moreover, additional fiscal stimulus beyond present plans – whether from spending increases or tax reductions – would delay internal and external rebalancing and exacerbate the adjustment required to ensure fiscal sustainability in the longer term.

Despite strong economic growth since the early 1990s and policy settings in product and labour markets that for the most part enhance efficiency, total economy labour productivity growth has been lacklustre although productivity growth in the “measured sector” has been somewhat stronger. A number of factors have affected productivity, but the persistent gap in living standards with the rest of the OECD is still not well understood. This Survey explores whether the large medium-term swings in the NZ dollar and higher long-term interest rates than in other OECD countries might play a role. Looking ahead, the key challenges will be to maximise improvements in living standards and to absorb pressures for increasing health and superannuation spending as the population ages. In this light, this Survey focuses on the following issues.

**Improving pension and retirement savings policies.** Overall, the foundations of public pensions are sound, but the pre-funding approach will only partially meet the pressures from rising pension outlays. Without undermining the basic design of New Zealand Superannuation, two measures could diminish its long-term cost: using a lower indexation formula for pension payments

*This Policy Brief presents the assessment and recommendations of the 2007 OECD Economic Survey of New Zealand. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

and/or lifting the eligibility age. Moreover, automatically adjusting the retirement age to changing life expectancy would help to manage fiscal risks. KiwiSaver is being introduced to encourage New Zealanders to accumulate assets for their retirement and is expected to raise household saving rates. The removal of its pro-housing elements would promote a more diversified mix in households' asset portfolios.

**Deepening and enhancing the efficiency of financial markets.** More developed financial markets make for better resource allocation and risk management, but New Zealand's markets remain relatively thin: higher savings for retirement might help to deepen them. Although there are no major regulatory barriers impeding the expansion of financial markets, refinements of the governance framework for collective investment schemes and stronger disclosure requirements would help, as would further efforts to boost financial literacy. More generally, a better understanding of why some parts of the country's financial markets remain under-developed and why households are accumulating so few financial assets despite high rates of return would permit a fuller assessment of the role for policy.

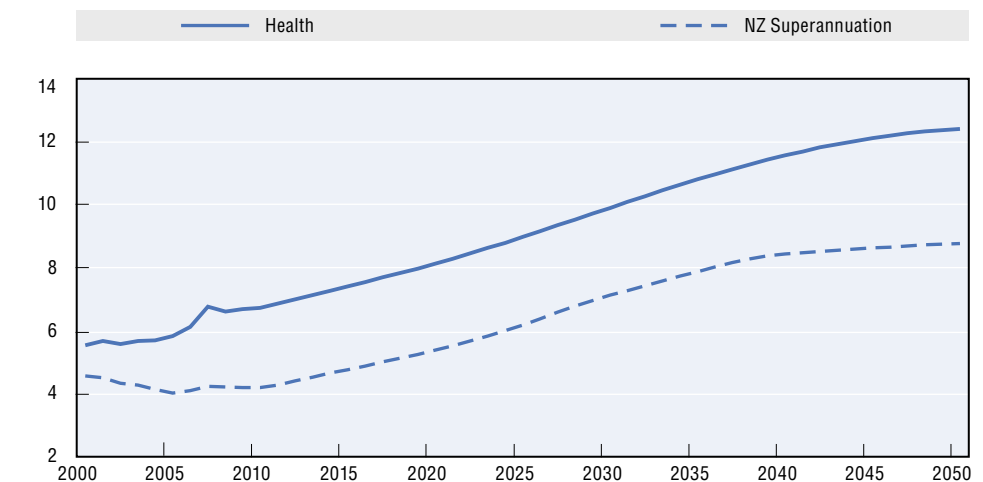
**Adapting the tax system to future needs.** The tax system has long been regarded as one of the most efficient within the OECD. Looking forward, however, the system will face challenges, including risks to the tax base arising from increasingly mobile capital and labour. A clearer strategic direction for the tax system is needed to help maximise living standards in the long term. There are at least two broad options: adapting the system within a comprehensive income approach or moving to a dual income tax system, in which capital income is taxed at a lower rate than earned income. These options should be evaluated against the criteria of efficiency, equity, simplicity and transition costs within an inter-temporal economy-wide framework. In any case, weak points within the current tax bases should be re-examined, recognising the merits of a "broad-base, low-rate" approach. Any actions taken in the near-term should avoid adding to domestic demand and be consistent with the long-term direction eventually adopted. Reforms should also not put long-term fiscal sustainability at risk: a higher GST rate could help achieve this objective. ■

**How is the economy performing?**

The New Zealand economy decelerated during 2005, after six years of strong economic growth of around 4% on average per year, and remained sluggish in 2006. But there is, as yet, little sign of spare capacity, and the labour market has so far been resilient. Nevertheless, a series of inter-related imbalances have accumulated in the economy and have started to unwind only very slowly. Strong household income growth and ongoing immigration flows have stimulated house sales and put upward pressure on real estate prices. Banks have met the resulting increases in demand for mortgage finance by borrowing offshore, a process that has been facilitated by ample global liquidity and low risk aversion. While the government has a high saving rate, the household saving rate is significantly negative and household debt has climbed sharply to around 160% of disposable income, a ratio that is higher than in most other OECD countries. The net result is a current account deficit that stood at 9% of GDP at the end of 2006. Despite headline inflation falling sharply with the drop in the oil price, the maintenance of fairly strong domestic demand has limited progress in curbing underlying price pressures.

It is still unclear whether the economy has reached the bottom of the cycle, and the mechanisms for moving back to a more sustainable growth path and their timing are uncertain. The present restrictive stance of monetary policy will eventually rein in household spending and lead to more stable house prices, while the high exchange rate has already put a considerable squeeze on exporters' profits. Ongoing losses of export incomes would reduce domestic demand. A period of slow growth will be needed before inflation pressures dissipate and the Reserve Bank can cut interest rates, allowing the exchange rate to depreciate. Alternatively, a sharp reduction in foreign investors' confidence and a fall in demand for NZ dollar-denominated assets could lead to an abrupt depreciation in the exchange rate that would chill domestic demand and improve the external balance. But the cold shower could generate financial hardships for some households.

**Figure 1.**  
**LONG-TERM FISCAL PROJECTIONS**  
Per cent of GDP



Source: Treasury (2006), Statement of Long-term Fiscal Position.

The task of monetary policy is particularly complex given the current uncertainties, and the Reserve Bank has been justifiably concerned by the persistence of inflation near the top of its target range. Moreover, sustained upward pressure on the exchange rate resulting from tight domestic monetary policy led to consideration of additional tools to manage inflation, with attention focused on the housing market given the role of house prices in this cycle. Various supplementary measures were examined. These included discretionary instruments such as a mortgage interest levy. But the case for instruments of this type is not compelling, as they are difficult to develop and enforce, and could blur the responsibilities of the fiscal and monetary authorities. Other measures included regulatory procedures affecting housing supply, the tax treatment of residential property and capital requirements on banks' residential mortgage lending. Notwithstanding the possible support that such policy changes could contribute, conventional stabilisation instruments should remain the primary way to manage macroeconomic fluctuations. At this point, fiscal policy also has an important role to play. Tax cuts or spending increases beyond current plans could further exacerbate inflationary strains, thereby leading to higher interest and exchange rates than otherwise. Indeed, delaying the planned fiscal impulse for the next two years would reduce the strength of domestic demand and inflationary pressures and allow a lower interest-rate path than currently envisaged. This would facilitate a fall in the exchange rate and accelerate the external rebalancing process. Such restraint may be politically difficult, given the sizable budget surplus, but it could allow a smoother unwinding of the imbalances and avoid more painful adjustments in the future. In any case, any positive revenue surprises over the near term should not be used in a way that adds to domestic demand pressures. Furthermore, the stabilisation task, and policy advice more generally, could also be made easier at minimal budgetary cost by the availability of better official statistics. ■

### How can longer-run living standards be enhanced?

Despite strong growth performance since the early 1990s and the adoption over the past 20 years of structural policies that are, for the most part, consistent with OECD best practices, living standards have remained some 16% below the OECD median for some years. Labour utilisation has increased substantially, but total economy hourly productivity growth has been lacklustre. Several reasons can be offered that might explain this outcome. *First*, common to many countries, productivity measurement issues are important. Productivity growth has been stronger in the “measured” sector (where independent measures of both inputs and outputs exist) than in the total economy and has been comparable to that of Australia. *Second*, the large increase in labour absorption that New Zealand has achieved over the past decade – partly in response to relative prices of labour and capital – may have come at the cost of a temporary decline in productivity growth as less productive workers were absorbed into the labour force.

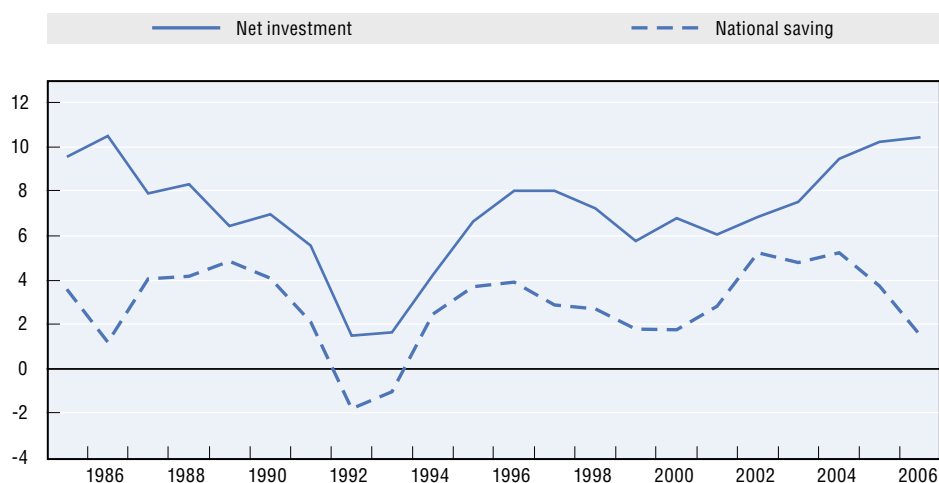
While structural policy influences on productivity growth have been studied in depth, including in previous *Surveys*, it is still not well understood why the gap in living standards has persisted. This *Survey* examines whether

two “stylised facts” about the New Zealand economy have played a role in holding back growth in per-capita GDP. *First*, the economy is subject to large medium-term swings in both nominal and real exchange rates. World prices for New Zealand’s export commodities play a role in explaining these movements, which provide some income-smoothing benefit for commodity producers. But on the other hand, such swings may deter investment in the export and import competing sectors and reduce incentives for small firms to grow or to remain in New Zealand. *Second*, New Zealanders have had to pay systematically higher bond and mortgage interest rates than those in other OECD countries, increasing the cost of capital and curbing investment at the margin. Further investigation of these features and their relationship to productivity growth is warranted. If there were structural policy measures that could attenuate these aspects of the economic landscape without creating other distortions, they might help the economy reach a higher growth path, but such options are not obvious.

Looking forward, the key challenges are to raise national incomes and to meet the fiscal pressures that are likely to arise over the longer term from an ageing population. The share of GDP devoted to health and pension spending could more than double by 2050 according to Treasury projections. Faster productivity growth is one important element in generating higher incomes and will become increasingly important as the room to further raise labour utilisation is limited. This Survey focuses on the following important issues:

- pursuing a consistent set of public pension and other retirement savings policies;
- facilitating the deepening of financial markets; and
- developing a long-term tax strategy that best meets the future challenges facing the economy. ■

**Figure 2.**  
**NET INVESTMENT  
AND SAVING**  
Per cent of GDP, year ended  
March



Source: Statistics New Zealand.

## Could pensions policies be improved?

The government has already taken important steps to reform the public pension system. These have included raising the age of entitlement to a pension to 65 years and establishing the New Zealand Superannuation Fund to partially pre-fund future pension liabilities. Overall, the main features of New Zealand Superannuation are well crafted and have successfully erased poverty among the elderly by providing a flat-rate pension to everyone who has satisfied the residential eligibility criteria. As benefits are not income-tested and there is no requirement to retire, the system has also avoided the pitfall of favouring early withdrawal from the labour market. However, since it provides everyone with a basic level of retirement income, it may discourage private saving. Indeed, for some low-income earners, their expected replacement income from NZ Superannuation would allow them to maintain their consumption patterns in retirement, without needing other income sources. The move to a partial pre-funding approach is projected to alleviate around only a third of the additional budgetary requirements arising from future increases in pension costs.

Policy changes will be required to ensure fiscal sustainability over the very long run and, if taken early, small changes in a number of policy areas could be sufficient. This is particularly true for spending on health and public pensions. The fiscal cost of NZ Superannuation could be pared back over time without compromising its many positive features. One option would be to shift progressively the indexation of superannuation payments to an adjustment formula that raises real benefit rates at a slower pace than real wages. However, this would result in lower retirement income for those pensioners who had not compensated for the future loss in NZ Superannuation payments by increasing their private savings. In this context, the authorities would need to monitor the situation closely and ensure that elderly poverty does not re-emerge. An alternative measure would be to lift the age of pension eligibility. This change would help to reduce public pension outlays by providing benefits to a smaller share of the elderly population and would raise participation rates of older age groups. It would be appropriate to consider a mechanism that automatically adjusts pension expenditure for changes in life expectancy.

New Zealand Superannuation is only one component of a whole set of retirement income arrangements. Ensuring that individuals face reasonably strong incentives to save and to develop an optimal asset mix would improve replacement income in retirement. But only a small proportion of the working-age population is enrolled in a formal private pension scheme, with households typically accumulating a disproportionate share of their capital in the form of housing rather than financial assets. Against this background, the government has introduced the KiwiSaver scheme. Starting in July 2007, it creates investment-based personal retirement accounts on a defined-contribution basis, using the tax system to collect contributions and pass them on to pension providers. One noteworthy feature of KiwiSaver is that, although it is voluntary, new employees are automatically enrolled, with the right to opt out during their first eight weeks. Existing workers can opt in, as can the self-employed and those not currently working. The scheme is

a welcome development, which should contribute to raising private savings, although the provisions relating to housing may be counter-productive.

Indeed, some of the benefits of KiwiSaver could be undermined because it explicitly allows households to use “mortgage diversion” of the employee share of contributions, permits a one-time capital withdrawal and provides financial advantages for first-home buyers. These pro-housing elements may reduce the extent to which the scheme encourages a switch in the allocation of households’ net wealth away from housing investment. There have also been some calls for KiwiSaver to be made compulsory. The main advantages of compulsion in the NZ context would be to effect a larger increase in private saving, force households to diversify their wealth portfolios, and help consumption smoothing for some. It could also reduce the fiscal cost of the programme and help deepen financial markets, although a significant voluntary uptake would have a similar effect on the latter. However, for low-income households, compulsion could see their consumption constrained during their working lives by more than they would have otherwise chosen so as to give them higher income in retirement. On the other hand, higher-income households are more likely to be able to rearrange their affairs to reduce their saving in other forms in order to maintain their desired level of consumption. Overall, it is premature to judge whether KiwiSaver should be converted into a compulsory scheme. That judgement should be put off until its take-up rate can be evaluated.

The advent of KiwiSaver is expected to affect other players in the pension market such as occupational or retail schemes. To avoid disadvantaging current employer-based arrangements, the government has announced that from July 2007, employer contributions to all registered superannuation plans that meet specified criteria will be tax-free up to a ceiling. This is intended to encourage employers to contribute to their employees’ savings for retirement and will provide incentives for people to save through this type of arrangement. But it could lead to substitution effects whereby tax-advantaged occupational schemes crowd out existing retail plans. It would be advisable to maintain a level playing field between all types of pension plans by extending an equivalent tax exemption to retail schemes that have the same savings lock-in requirements. ■

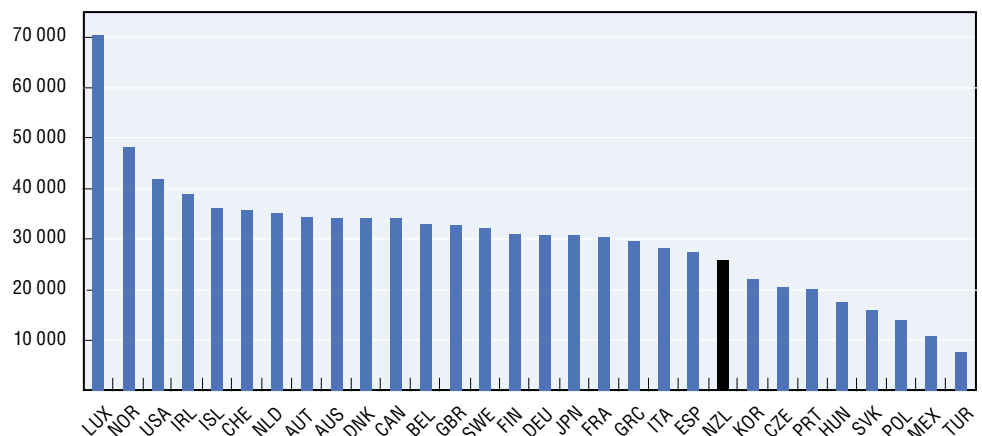
### What role could more developed financial markets play?

With the expected growth of private pension funds in coming years, one task for the government will be to ascertain that there is no impediment to enhancing the depth of financial markets, so that funds can best manage their various risks. At the moment, NZ financial markets are relatively small by OECD standards, despite widespread financial liberalisation undertaken in the 1980s, and bank loans are the main source of financing to both firms and households. Nonetheless, the country scores extremely well on the OECD’s indicators of banking and securities market regulation. Developing a better understanding of why some parts of the market remain under-developed and why New Zealanders borrow so much and save so little in the face of high interest rates would allow a clearer assessment of the role that other policy settings might be playing. Well-developed financial markets benefit

the country as a whole, as they allow a better allocation of risks at the enterprise and macroeconomic level. They also provide more opportunities for businesses to access funds for investment, potentially at a lower user cost. Finally, financial markets facilitate households' management of their retirement savings portfolios over time. Growth in KiwiSaver accounts is likely to expand financial markets somewhat, assuming they will not be exclusively used to purchase offshore assets. The level of government bonds on issue has fallen over recent years and is not expected to fall further. In order to support liquidity, issuance has been consolidated into a number of benchmark maturities. In addition, a very deep and active market in interest-rate swaps has developed. Nonetheless, it remains unclear whether this provides a sufficient benchmark yield curve for the economy as a whole and whether increased government bond issuance may be warranted. The current existence of legal opportunities to avoid paying the Approved Issuer Levy – effectively a very low rate non-resident withholding tax on yields – reinforces market incentives for banks and firms to issue bonds offshore rather than onshore: the net impact of removing these opportunities should be assessed. Privatisation of state-owned enterprises, especially those operating in competitive markets, would enhance economic efficiency and could also provide additional options for New Zealand investors.

Care should be taken to ensure that the financial sector's regulatory structure is sufficiently flexible to respond as circumstances change. New Zealand has a good overall financial regulation framework, with no major regulatory barriers inhibiting the development of its financial markets. However, improvements could be made in some segments. In particular, the regulatory framework for collective investment schemes could be streamlined – as currently proposed by a government review – and harmonised across schemes. Firms offering collective investment instruments need to have an appropriate governance structure and regulators need to ensure that a rigorous approach is taken to disclosure requirements for fees and expenses. This would help consumer choice by improving transparency and facilitating

**Figure 3.**  
**GDP PER CAPITA**  
**USD current prices and**  
**current PPPs, 2005**



Source: OECD, Annual National Accounts Database.

comparisons across products. Further developing financial education by providing information on retirement options is a low-cost measure that could also enhance New Zealanders' awareness of the importance of increasing savings. The government has made a major effort to improve financial literacy and plans to integrate financial education into the school curriculum by 2009. This initiative is welcome, and further efforts in this direction should be pursued. ■

### What strategic direction should guide tax reform?

Creating a more favourable environment for savings and investment will also require a well-designed tax system consistent with the objective of raising living standards. The NZ regime has long been regarded as one of the simplest and most efficient in the OECD. Looking forward, however, the system will face challenges. These include risks to the tax base arising from increasingly mobile capital and labour. It is thus important to have in place a clearer strategic direction for the tax system, but this will take time to identify and fully develop. Any changes in the interim should be designed so that they would not be inconsistent with the long-term strategy eventually adopted. Against the backdrop of a currently strong fiscal position, the government has already announced that the forthcoming budget will present a business tax package for implementation in 2008. Any wider reform should remain consistent with longer-term fiscal sustainability. Moreover, at this stage of the business cycle implementing substantial tax cuts beyond those already signalled could lead to additional monetary policy tightening.

In defining the direction for the tax system, there are at least two broad options that could be considered. One possibility would be to adapt the system within a comprehensive income tax approach. This could include lowering rates and flattening the structure so as to reduce efficiency losses, removing the existing small concessions and resisting calls for the introduction of new tax incentives. Another approach would be to move to a dual income system whereby capital income is taxed at a lower rate than labour income. By lowering the tax on savings and investment, this approach could help to increase the capital stock, which will be critical for future productivity growth in New Zealand. It also has the result that consumption in different periods is taxed more neutrally than in a comprehensive income taxation approach. However, this would require rules to avoid reclassification of employee compensation as returns to capital by owners of small businesses (including farms) especially if the tax rates on labour are considerably higher than those on capital. International experience with implementing changes such as a dual income tax system should be monitored, and developments appraised in light of New Zealand's long-term strategy and objectives. Extending the dual income approach to the point of not taxing capital at all would approximate an expenditure tax. Any option to address the long-term challenges would need to be carefully evaluated against the criteria of efficiency, equity, simplicity and transition costs. Assessments need to be undertaken in an inter-temporal, general equilibrium framework to capture the full impact of each choice. ■

### How can distortions to tax bases be minimised?

No matter what strategy is selected, a number of distortions within the present tax bases should be reviewed. *First*, the government has increasingly used the tax system as a tool to deliver on other policy objectives. This has complicated the tax system and has had some adverse effects on individual economic behaviour. The Working for Families package provides assistance to families with children. The package has increased the incentives for some of those on welfare to move towards work and for some to increase their hours of work. But changes in the last Budget extended the income range over which assistance is withdrawn, which has raised the number of families for whom working additional hours becomes less attractive financially because of higher effective marginal tax rates. Alternative ways of supporting families without these negative effects on incentives to work could do more to raise living standards and should be investigated further. Shifting the balance of funding towards more generalised assistance with childcare costs for working parents would be one option. The negative effects could also be partially reduced by cutting the top personal marginal rate, which would also have the advantage of curbing income diversion towards income trusts, which are taxed at a lower rate. *Second*, by proposing tax credits for firms investing in R&D, exporting companies and employers providing skills training, the government has signalled its willingness to depart from a broad tax base. Any new or existing deviations from the broad base principle should be supported by strong evidence that the benefits exceed the cost. However, if the government wants to offer R&D tax credits, it should at least scale back the grants through which most R&D support is currently provided.

Large-scale tax reforms are usually financially costly, mainly because losers need to be at least partially compensated. One way to make substantial tax changes without compromising fiscal sustainability would be to raise the rate of the Goods and Services Tax (GST), while keeping the considerable merits of a single rate. For instance, a 1 percentage point increase in the rate would generate almost NZD 1 billion (0.6% of GDP) of revenue. Because GST is a low, flat tax with few exemptions, rebalancing the tax mix toward GST would also reduce distortions to savings and thereby increase future consumption possibilities. The resulting effect on income distribution is likely to be limited, once evaluated in a life-cycle perspective, although if there were concerns about regressivity, they could be addressed, for example, through a modest refundable lump-sum income tax credit. ■

### What other reforms need to be completed?

To the extent that New Zealand is more exposed to macroeconomic volatility than most other OECD countries, the country should aim for regulations and institutions whose design and efficiency are at “best practice” levels. In many areas, reforms have guaranteed that markets are flexible and responsive, but some further efforts are needed, as mentioned in the OECD’s 2007 *Going for Growth* recommendations. *First*, the government’s policy to provide free early childhood education and care for 20 hours per week to all three and four year-olds is heading towards implementation, but there are increasing concerns about the likely availability of places. There is a particular risk that disadvantaged children will be unable to access these services, especially

as parallel initiatives to upgrade staff qualification requirements will push up costs. *Second*, educational services require a sharper focus on outcomes, particularly reducing under-achievement of Maori and Pacific Island youth. It would also be desirable to reward the teachers who upgrade their skills and to develop the tools to link remuneration with success in improving educational outcomes. *Third*, proposed reforms to deliver efficient provision of road infrastructure need to be taken through to completion. Congestion pricing should be applied more broadly, together with other measures that enhance efficiency in the use of urban infrastructure and public transport. *Fourth*, further competition also needs to be injected into network industries, such as telecommunication and electricity. In the latter sector, the authorities' top priority should be to remove policy-related uncertainties currently holding back investment, including those related to climate change.

The government has recently renewed its efforts to address climate change. It has released discussion papers on energy and climate change policies, focusing on the years within and also beyond the first commitment period of the Kyoto protocol. A number of measures to reduce greenhouse gas emissions are envisaged, but the authorities have indicated their clear preference for using price-based mechanisms across a wide range of key sectors. However, these documents make clear that the government's willingness to proceed towards implementation of climate change policies depends on the engagement of other countries. It is to be hoped that this requirement will indeed be satisfied. ■

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**Economic Outlook No. 80**, December 2006.

More information about this publication can be found on the OECD's website at [www.oecd.org/eco/Economic\\_Outlook](http://www.oecd.org/eco/Economic_Outlook).

**Economic Policy Reforms: Going for Growth**, 2007 edition.

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