POLICY BRIEF

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What are the main challenges?

Can competition be strengthened in some product markets?

Could capital and labour markets be more efficient and flexible?

How can innovation policies be improved?

How could education spending be better oriented?

What measures could boost labour participation?

Could the management of public finances be enhanced?

For further information

For further reading

Where to contact us?

Summary

The economy has continued on its strong upward course and living standards – measured as real GDP per person – have risen steadily over the past decade, putting the country on track towards the government's objective of returning to the top half of the OECD. But capacity has become increasingly strained, and monetary policy has been tightened to ensure inflation remains well anchored. The country's prospects are bright, with potential growth projected to remain comfortably above 3% per year over the medium term.

Against this favourable backdrop, the key policy challenges are: *first,* to raise productivity growth, which remains relatively weak by OECD standards; *second*, to lift participation rates in the pockets where they are still relatively low; and, *third*, to enhance the management of public finances.

Competitive pressures in some sectors could be strengthened to spur productivity gains

Most product markets are working well, with healthy competition providing firms with the incentives to become more efficient and to innovate. One exception is the electricity sector, where regulatory uncertainties, including those relating to resource use, need to be resolved in order for market participants to be willing to undertake investment in either new generation or transmission capacity.

This Policy Brief presents the assessment and recommendations of the 2005 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.

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Some tax and regulatory changes would improve the efficiency of capital

Tax distortions in investment decisions need to be minimised and especially avoid discouraging investment in short-lived assets, including ICT. Changes introduced in Budget 2005 should go a long way to addressing this. Congestion charging could help reduce road transport bottlenecks and help to signal where additional road infrastructure is needed.

Labour market flexibility should be preserved

Last year's legislative changes further reduce the flexibility of labour markets, and the government should monitor developments closely and be prepared to take corrective action if necessary. Relaxing the rules on initial trial periods and fixed term contracts would help to mitigate the effects of increased employment protection.

Education services require a sharper focus on results

Although a better educated workforce facilitates productivity growth, some of the recent rise in participation has come in courses of low quality or subjects that have only remote career relevance. The government's recent efforts to reorient public funds towards high quality, job-relevant programmes need to succeed. Providing free early childhood education for 20 hours per week to all three and four year-olds would be easier to deliver if private for-profit providers were allowed to participate.

Labour utilisation could be boosted

Many mothers face financial or practical obstacles if they wish to work. Easier access to affordable care would help, as would reducing the disincentive effects for some families in the *Working for Families* package, in ways that take careful account of fiscal costs. Sole parents and other welfare beneficiaries would benefit from more intensive case management and effective activation strategies, including clear sanctions for non-compliance.

Management of public finances could be enhanced

Despite the solid framework for public finances, upward spending pressures suggest no room for complacency, and any further tax or spending initiatives should be financed through more systematic reprioritisation of existing programmes. Efforts should be redoubled to ensure that public-sector outputs, deliver, and can be seen to deliver, the government's desired outcomes without any waste of resources. ■

What are the main challenges?

The New Zealand economy has continued to expand at a vigorous clip, with last year's growth of just under 4½ per cent bringing the annual average rate of growth since the recession of the early nineties to 3¾ per cent. More importantly, increases in real GDP per person have outpaced the OECD 10-year moving average since 2000, putting the country on track towards achieving the government's longer-term objective of lifting GDP per person back into the top half of the OECD, a position it has not held since the early 1980s. This is a deserved reward for the wide-reaching macroeconomic and structural reforms put in place over the past 20 years. Much of the increased output has been generated by more hours of paid work: trend labour productivity growth has also improved since the mid-1990s, but it remains around ½ percentage point per year lower than the OECD median. Last year the country achieved a general government surplus of more than 4% of GDP, one of the largest among OECD countries and government net debt has fallen from over 50 % of GDP in 1992 to around 7½ per cent now.

With very strong employment growth and earlier slack now used up, the economy is running at full capacity, with the unemployment rate under 4%, skilled and unskilled labour harder to find, and wage and price increases having picked up. The Reserve Bank has raised official short-term interest rates by 1¾ percentage points since the beginning of 2004, and financial conditions have tightened, while long-term rates have moved up only little, reflecting global developments and the Bank's credibility. The exchange rate has appreciated a further 6½ per cent since the start of last year. Overall, the pace of activity is expected to cool during the course of the year, bringing the economy onto a more sustainable growth path. Medium-term prospects remain bright – growth in line with estimated potential for the rest of the decade would be between 3¼ and 3½ per cent per year. If realised, New Zealand would be on its way to achieving the government's aforementioned goal.

The task now is to build effectively on this strong base of economic success and take it forward in order to further accelerate gains in living standards for all New Zealanders. This presents policymakers with three broad challenges:

- *The primary challenge is to raise productivity growth further*, as this will become the more critical driver of growth in the future. Of course, no government can make productivity growth happen; the best it can do

is to identify and remove obstacles to growth and provide an economic environment in which firms and individuals can flourish. Despite the extensive reforms already undertaken, some areas remain where further policy improvements could be made, including in the areas of product market competition, business taxation, infrastructure provision, labour markets, innovation and human capital formation.

- *The second challenge is to boost participation among groups that remain under-represented in the labour market.* There are two groups that warrant particular attention. One is non-beneficiary mothers who would like to work but face financial or practical obstacles to doing so. The other is working-age beneficiaries of whom there are almost 300 000 (including sole parents), some of whom face limited pressure and receive minimal help to move from benefit dependency into work, despite increased emphasis on work activation measures over the past five years.
- *The third challenge is to continue managing public finances prudently and effectively* and maintain the gains from the fiscal consolidation achieved over the past decade. Fiscal caution is warranted, given ageing and other future expenditure pressures, while public spending needs to be more effectively channelled into the highest priority areas so as to deliver the best "value for money". ■

Can competition be strengthened in some product markets?

Overall, product markets work well, especially given the constraints faced by a small and geographically isolated nation. Indeed, the country was a leader in deregulating a range of sectors that were previously shielded from competition and has in place well designed laws and institutions that provide a solid framework to underpin competition and promote efficiency. Minimising barriers to entry has been especially important for promoting competition by constraining potentially anti-competitive behaviour. At the same time, it makes sense to assess the merits of allowing firms exposed to international competition to become more productive through consolidation, as the Commerce Commission does by applying a total-surplus standard in assessing mergers and acquisitions. This formula also gives recognition to dynamic efficiency gains. The Commission's recently announced leniency and co-operation tools and its new "cease and desist" powers are welcome and should now be applied vigorously to combat cartels and monopolies. More generally, the Commission's work would be even more effective if it were empowered to exchange information and co-operate in enforcement matters with overseas authorities. The Government's recent initiatives to strengthen the Commission's ability to provide investigative assistance and share information with overseas competition regulators will help.

The main sector where competition is not working satisfactorily is electricity, which has been through a series of droughts and regulatory changes in recent years. Significant new generation capacity will be needed to ensure that supply keeps up with expected future demand and to replace production that currently depends on soon-to-be-exhausted Maui gas. But regulatory and other uncertainties have stymied some new investment plans by making it difficult to determine the most cost-effective alternatives among various possible projects that would use a range of different energy sources, including coal, wind, hydro or liquefied natural gas. The recent announcement of the level of the carbon tax has removed one source of short-term uncertainty, but others still need to be addressed before investors will be willing to get some projects off the ground. In 2003, the government shifted away from a light-handed regulatory approach and established the Electricity Commission to oversee the electricity market. The Commission is also charged with laying out a decision-making process and pricing methodology for upgrading the transmission grid, providing for security of supply, improving demand-side participation in the wholesale market and ensuring consumer protection. As quickly as possible it needs to specify clearly how it will deal with these issues. For its part, the government needs to make sure that planned changes in the Resource Management Act effectively reduce the risk of long delays in project approval without curtailing proper consideration of the environmental dimensions involved. It also needs to expedite the current broad review of water rights and ensure an effective mechanism is in place for allocating water among all its competing uses.

Transmission of energy – electricity or gas – involves natural monopolies. In 1998, to promote competition in electricity retailing, the local electricity distribution companies were obliged to divest their retail activities. But most were sold to generators, resulting in vertical integration and making it difficult for new retailers to enter the market and/or for an effective market in forward contracts to develop. Further investigation into

the impact of vertically integrated suppliers on competition is warranted, and the costs and benefits of splitting them up need to be carefully assessed against other alternatives. For the natural gas network, transmission costs would be minimised if restrictions on access to pipelines were lifted and rules established to foster the development of a wholesale market amongst gas suppliers. In addition, a surveillance price-threshold approach similar to that used for the electricity network would be less distorting and provide producers with greater flexibility than the direct price-control approach recommended by the Commerce Commission, while providing safeguards against any abuse of monopoly power.

Elsewhere, competition is thriving in many sectors, including retail trade, banking, broadcasting and passenger and freight transportation services. But some improvements could be made in others. Prices are high in some *telecommunications* market segments, including mobile telephony. This suggests that regulation of mobile call termination charges is needed, but it will be important to minimise uncertainties and distortions such regulation could potentially generate. Prices for broadband Internet access have been falling relative to dial-up access, contributing to an increase in broadband penetration. But it remains low by OECD standards. The authorities should closely monitor price developments and investigate whether any regulatory impediments exist that require corrective action. In addition, given the trend toward more government involvement in market activities since the beginning of the decade, resuming *privatisation*, especially in potentially competitive sectors, would be likely to yield important improvements in static and dynamic efficiency. In contrast, there is vibrant competition among *agricultural producers*, who receive virtually no government support, in contrast with their rivals in most other OECD countries: their capacity to compete successfully on world markets and contribute to overall productivity growth in the economy would be significantly enhanced by the successful completion of the Doha round. ■

Could capital and labour markets be more efficient and flexible?

Although the country has seen a surge in capital formation as labour has become scarcer and the user cost of capital has fallen, tax rules have distorted investment decisions and affected the flow of financing towards firms in ways that can lead to a lower overall capital stock and a sub-optimal mix of fixed assets. The 2005 Budget addressed two important problem areas. The *first* arose because capital gains on equity are generally untaxed, except for those earned by actively managed unit trusts. This reduced the flow of funds channelled through such instruments, which are often the most suitable source of funds for business expansion. The changes announced in the Budget should lead to better matching between savers' preferences for risk and businesses' financing needs. The *second* concerned the gap between depreciation allowances for tax purposes and economic depreciation rates: the formula that has been used amortised short-lived assets (such as ICT) too slowly and long-lived assets (such as buildings and structures) too rapidly. Budget changes to depreciation rates to more closely mirror true economic depreciation should lead both to a more efficient investment mix for firms and a more rapid diffusion through the economy of technological progress embodied in high-tech capital. A *third* issue concerns the tax treatment of some foreign equity investors. A large share of the country's investment is directly or indirectly financed from offshore, enabling companies to access funds at a lower cost than otherwise, but these flows may be inhibited by the current tax rules. This has led some observers to call for lower corporate tax rates, but given the imputation system, this would introduce other biases between dividend payouts and retained income. It would be better to tackle the problem *via* a more direct method applied only to foreign investors, but further work is needed to find an appropriate solution.

Investment in upgrading the country's road network has been a topic of extensive and drawn-out debate, especially given congestion in the Auckland and, to a lesser extent, Wellington regions. A cautious approach is warranted because increased infrastructure does not automatically result in increased productivity. If the current mix of charges and taxes were more closely aligned with actual road use and included a congestion charge, it would provide some assurance that additional investments in roads were economically justified. Thus, a more rational set of road pricing arrangements should be established as soon as possible. The Land Transport Management Act (2003) formalises the framework for road infrastructure investment, allowing for public-private partnerships and tolls on new roads. The overall thrust of this legislation – to introduce market-type mechanisms and draw on private-sector expertise – is welcome. But the rules may be unnecessarily strict to

allow this to happen in practice. Relaxing these rules should encourage a greater variety of funding and pricing arrangements over time.

New Zealand has one of the most dynamic and flexible labour markets in the OECD. However, last year's changes to the Employment Relations and Holidays Acts reduce labour market flexibility and add to labour costs, although it is too early to assess the extent of roll-back, especially as some aspects may need to be clarified through the courts. For example, the recent judicial ruling obliging Auckland University to give further consideration to multi-employer collective bargaining sets a precedent that may strengthen the scope for unions to press for such agreements. Furthermore, the full implications for job mobility may not become apparent until the economy has faced an economic shock requiring significant adjustment. In the meantime, the situation should be closely monitored, with the government ready to take corrective action if it looks like the legislation is starting to significantly undermine its broader growth objectives. In any case, the potentially damaging effects of increases in employment protection on the job prospects of marginal groups of workers could be mitigated by allowing an initial trial period during which the employer would be exempt from unjustified-dismissal procedures. Employers might also be more willing to hire older workers if restrictions on fixed-term contracts were eased. ■

How can innovation policies be improved?

The government's *Growth and Innovation Framework* highlights the importance attached to strengthening innovation, which plays a key role in expanding the output the country can produce with its available inputs. The overall strategy appears to be well designed, and the innovation rate among firms – as well as it can be measured – is around the EU level, although business R&D expenditures are well below the OECD average. Within the tax system, the depreciation allowances for capital equipment and economic depreciation in general also apply to fixed assets used for R&D, and the gap that existed for short-lived assets may have discouraged such activity at the margin. The more neutral approach announced in the Budget is welcome. The government has chosen to deliver public support for private innovation through a wide range of grants and subsidies: these could be streamlined, better co-ordinated and carefully evaluated to improve policy coherence and minimise the risk of "programme clutter". Innovation policies would also benefit from closer integration with education, immigration and labour market policies to improve the private sector's capacity to absorb new knowledge. At the same time, closer collaboration between universities and private firms could expedite the diffusion and commercial application of publicly funded R&D and complement the already stronger commercial focus of the Crown Research Institutes. ■

How could education spending be better oriented?

Human capital plays an important role in productivity growth, not only because of specific skills but also because a well educated workforce is more adaptable and can more quickly integrate new equipment and processes. However, the very rapid expansion of post-secondary education – NZ resident enrolments were almost 35% higher last year than in 1999 – reflects a proliferation of courses that are of low quality and/or in subjects that have only remote career relevance. The government now has a set of instruments in place designed to channel public funds towards priority areas and has recently signalled its wish to see funding withdrawn from courses that offer a negligible contribution to work-related capabilities. It remains to be seen whether these changes can deliver the necessary redirection the sector needs, but if they fail a more radical restructuring of incentives for providers and students will need to be considered.

For children under five years, policies involve an integrated approach to early childhood education and care (ECEC), with a primary focus on educational outcomes. To support this, the government has specified that by 2012 all ECEC staff will require a recognised teacher qualification; funding is greater for centres that have a higher proportion of such staff. If teacher shortages were to emerge, there is a risk of more affluent children receiving better services, while some more disadvantaged pre-schoolers receive an inferior service or none at all. The government needs to be alert to this risk. It has also made a decision to finance 20 hours per week free access to early childhood education for all three and four year-olds by 2007, which represents important progress towards giving all children a more robust pedagogical start in life. But it is not an entitlement, and parents will have to find a place with a community-based provider in order to take advantage of the 100% subsidy. Ensuring sufficient places are available would be sig-

nificantly easier if that funding were extended to private for-profit providers. At the same time a better use of scarce teaching resources might be achieved if per-child funding rates were redesigned to encourage centres to provide concentrated teacher-led sessions for these 20 hours, organised separately from other care provided on the same site. This would provide a more intensive pre-school experience for older children, while allowing centres to offer high-quality, but more flexible and less expensive, care arrangements for any supplementary hours and for younger children. Making a clearer distinction between meeting educational objectives and subsidising childcare for working parents would represent a major change in policy approach in New Zealand. ■

What measures could boost labour participation?

Higher labour utilisation can also make a contribution to boosting living standards. Although on average, NZ workers put in relatively high annual hours, some people face particular barriers in participating in the workforce. Others work part-time but would prefer to increase their hours. There are two key groups on which attention should be focussed. One group is non-beneficiary families where both parents would like to work, but one may be discouraged from doing so. This could be because they cannot find good quality and affordable childcare for under-fives and out-of-school care, and they may also be affected by the withdrawal of family assistance. The other group is those working-age people on benefits for whom expectations about work capacity may be unnecessarily low. These could be strengthened by more effective assistance to make the transition into work.

Finding suitable and affordable childcare is sometimes difficult, despite the subsidies the government already pays to ECEC providers and the planned free hours for three and four year-olds. Removing obstacles to increased supply of places and more help with childcare costs would facilitate family members, particularly women, working the hours that they prefer. This could strengthen their participation and allow them to maintain and add to their human capital, enhancing economy-wide productivity growth. The design of policies in this area would need to take careful account of the fiscal costs involved.

The government's 2004 *Working for Families* package significantly increases income transfers to low- and middle-income families over the next two years. The new in-work payment provides an additional incentive to enter work. Alongside this, changes will be made to the abatement regime to allow families to earn more market income before their family assistance payments are cut back. These changes should improve the incentives for some of those on welfare to move towards work and for some in work but on low incomes to increase their hours of work. But the package also extends the income range over which the range of assistance will be withdrawn, which raises the number of families where working additional hours becomes less attractive financially because of very high effective marginal tax rates. This may especially affect potential second earners, who are predominantly women, exacerbating economic gender gaps. Alternative ways of supporting families without such damaging 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 government has agreed in principle to replace the range of income support benefits (unemployment, domestic purposes, sickness, invalid, etc.) with a new single core benefit from 2007. This would apply one set of criteria to all working-age beneficiaries and include more emphasis on individualised and effective back-to-work strategies for clients. It would be complemented by a new service delivery model, which would deliver employment assistance to clients based on their individual circumstances in terms of their work readiness rather than their benefit category. For example, those currently drawing sickness or invalid benefits would be able to more readily access employment services that have to date been largely offered only to unemployment beneficiaries, and to receive more practical assistance and rehabilitation to assist with their return to employment. These changes would also provide an important opportunity to strengthen work-availability requirements, especially for sole parents receiving the domestic purposes benefit even though their children attend school. This would give practical reinforcement to the government's message that having their parents engaged in paid work is important for children's longer-term well-being, not least by reducing child poverty. However, for the new approach to be successful, the benefit administration may need a significant upgrade of its case-management capacity and must clearly apply the "mutual obligations" principle whereby all types of beneficiaries will face effective sanctions for non-compliance. Those activation measures already being

used in New Zealand show that beneficiaries respond positively to mutual obligations and sanctions, indicating their potential for wider application. ■

Could the management of public finances be enhanced?

The country has turned in a strong fiscal performance in recent years, although decisions taken in the 2004 and 2005 budgets significantly scale back the central government's overall surplus over coming years. Looking ahead, the government's forecasts show outlays rising by around 2 percentage points of GDP over the coming five years, even with a much smaller allowance for new spending initiatives in the future than in the previous two Budgets. Further out, the country will not be immune to the spending pressures of an ageing population and difficulties in constraining increases in health care coverage and costs. Against this backdrop, it would be regrettable if spending or tax initiatives were implemented that significantly weakened the long-term fiscal outlook. The change embodied in the Public Finance Amendment Act passed last December to require a more systematic and transparent assessment of the medium- and long-term fiscal position will be helpful in bringing a longer-term perspective to current decision-making and highlighting policy trade-offs.

Strong economic growth and buoyant tax revenues have made it possible for the government to channel an increasing share of spending to the education and health sectors as well as to introduce new initiatives such as the *Working for Families* package. In the environment of large surpluses there has been relatively little evidence of counter-balancing these increases by pruning back lower-priority spending. In order to leave sufficient room for new policy initiatives and to meet its fiscal objectives, the government is likely to require more reprioritisation in the future. A well designed ongoing review process could identify those programmes that do not contribute enough to offset the deadweight losses associated with the taxes required to fund them. This could free resources for higher value uses. The "managing for outcomes" approach, designed to link government outlays and desired results, has now been enshrined in legislation, but it remains very ambitious and will require skill and commitment to implement successfully. At the same time, care needs to be taken to ensure that this stronger emphasis on outcomes does not compromise control of, and accountability for, outputs.

Across public-sector spending, particularly on education and health, information about performance is still patchy. This makes it difficult to establish how productive different parts of the sectors are and whether they deliver "value for money". A significant improvement in information is needed to fill this gap and make it possible to monitor productivity growth over time. At the same time, the government should examine whether more could be done to strengthen the incentives on public-sector managers to identify and implement efficiency improvements. In education, a national testing system for children at the beginning and end of each year to provide an estimate of the value added of the year's schooling could be considered against the alternative of getting more system-wide information out of existing assessment instruments. In health, the technical challenges of measurement are complex but not insurmountable, especially given parallel initiatives in other OECD countries and the start that has already been made to upgrade data collection across the sector. ■

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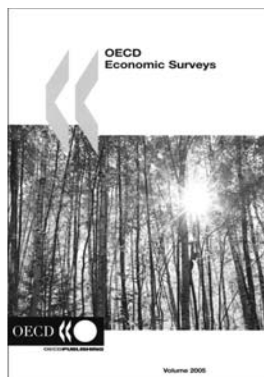

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- **Economic Outlook No. 77,** June 2005. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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