

## Economic Survey of New Zealand, 2003

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paid off?**

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### Summary

Past macroeconomic and structural reforms have been contributing to stronger growth for the last decade. The economy has also become more resilient, weathering the recent global slowdown well. Productivity growth has picked up, although not by enough to have yet moved New Zealand up the OECD income rankings. Its small size and remoteness may be factors, so encouraging global linkages is important, but more remains to be done to strengthen fundamentals. Recent economic performance has been encouraging: buoyant domestic demand has helped maintain output growth in spite of weak trading partner growth, an appreciating exchange rate and a fall in the terms of trade from recent high levels. Monetary policy will need to be vigilant, given that the economy is probably operating above potential and the housing market is strong. In considering fiscal policy options, the focus should be on those that contribute to the growth performance of the economy, whilst remaining firmly based on a prudent assessment of future revenues and of the long-term challenges connected to ageing. In its growth strategy the government appropriately emphasises fostering innovation, skills and talent, and developing global linkages, but it should maintain a level playing field and avoid sector-specific incentives. It should continue to remove regulatory obstacles to investment, particularly in the area of infrastructure, by improving and speeding up the environmental consent process. The decision to resume cutting tariffs is commendable and also furthers the objective of supporting development in poorer countries. Immigration helps to enlarge the pool of available skills and to develop global

*This Policy Brief presents the assessment and recommendations of the 2003 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.*

connections, both of which contribute to enhancing growth potential. Recent changes that focus admissions policy more toward skilled and more employable immigrants will help, though the temptation to link immigration policy too closely to manpower planning should be resisted. The labour market functions reasonably well, but the government should avoid measures that would reduce flexibility and raise labour costs. The employment rates of marginal groups could be improved by strengthening incentives to move from welfare to work. In short, only through this whole range of efforts to boost productivity growth and improve labour market outcomes can the nation meet its income aspirations. ■

### Have the economic reforms paid off?

New Zealand has been one of the faster growing economies within the OECD during the past decade. From 1992 to 2002 it grew at an average annual rate of 3.6 per cent, and has maintained a robust pace of expansion during the more recent period of global downturn. This represents a marked improvement on the economic performance of the preceding two decades, during which per-capita income levels in New Zealand declined relative to the OECD average. Underpinning this improved performance has been the programme of reforms that began almost 20 years ago. Those reforms have provided the economy with several important strengths: a sound macroeconomic policy framework; low inflation and a fiscal surplus; a flexible labour market; high-quality public administration and regulation; and an education system that delivers top-class overall results for the majority. These reforms have boosted the economy's sustainable growth rate and its resilience to recent adverse shocks. However, some weaknesses and challenges remain: there is scope to further increase foreign trade; investment in equipment, R&D and information and communication technologies (ICT) is low, possibly because high foreign debt raises the cost of capital; the distribution of education outcomes is wide, with too many people having inadequate skills for a modern economy; and several infrastructure bottlenecks have developed. But the reforms have halted the decline in relative living standards observed since the 1960s, per-capita incomes having grown at an average annual rate of 2½ per cent over the past decade, a little faster than for the OECD as a whole. It is encouraging that this has reflected not only a recovery of employment rates but also, more recently, a pick-up in labour productivity growth. The traditional

primary export industries have achieved efficiency gains, but manufacturing productivity has been disappointing, despite some success stories in a few niche products. Yet something is still missing, as potential output has not been rising fast enough for New Zealand to return to the top half of the OECD rankings, the government's announced objective. ■

### How can productivity growth be raised further?

The key challenge is to boost productivity growth. The reasons why past reforms have not yielded larger productivity gains are not fully understood. Some further increase may still be in the pipeline, but it would be unwise to assume that it will be large. Attention has shifted toward specific handicaps that may be holding back New Zealand's growth, and in particular whether size and distance may limit the scope for exploiting economies of scale and agglomeration externalities. Relatively small firm size and the fact that so few manage to lift employment and break into export markets appears consistent with this view. New Zealand faces the additional challenge that agriculture, in which it has a substantial comparative advantage, faces very high trade barriers abroad. But even if geography and trade barriers matter, their effects are not mechanical, as they interact with the other determinants of a country's comparative advantage. Addressing the residual weaknesses in fundamentals should thus be the top policy priority. In particular, policies should focus on:

- *Strengthening global linkages.* The government's Growth and Innovation Framework (GIF) is intended to help co-ordinate its growth policies. There are four main strands: increasing global connectedness, promoting the development of skills and talent, fostering innovation, and catalysing development in some "focus" sectors. A key element is the strengthening of global linkages in areas such as external trade, investment, human capital and research. The policy regime for trade and investment is already very open, and there are sizeable two-way flows of migration, but there is room to make the economy even more outward-oriented. For example, the recent decision to resume the process of unilaterally cutting tariffs from 2005 after the current freeze expires is welcome, though complete elimination would be even better. Further regulatory harmonisation with Australia and other trading partners would also facilitate trade integration. New Zealand has low regulatory

obstacles to foreign direct investment (FDI), and the government has resisted the temptation to use tax breaks or subsidies to attract FDI, despite increasing international competition in this area. However, tax rates that are around the OECD average may not be attractive enough. The pressure to take a more active approach may increase in the future, particularly if the United States concludes a bilateral free trade agreement with Australia ahead of New Zealand. However, it is unlikely that lowering taxes for foreign investors (either across the board or more narrowly targeted) would generate sufficient gains to offset the associated fiscal and efficiency costs. The more neutral alternative of lowering the statutory corporate tax rate for domestic as well as foreign investors should be preferred.

- *Streamlining enterprise support programmes.* One way in which the government is acting to promote global linkages is by addressing the obstacles to exporting faced by small firms. There are many programmes offering information, training and consulting services (as well as some limited financial assistance), but a challenge has been to streamline and redesign them based on a clear definition of the market failures they should offset. The integration of enterprise support and trade promotion into a single agency has made it easier for users to access those services. However, overlap and fragmentation of programmes is still excessive, and low take-up for some suggests that they are not really filling a gap in the market.
- *Fostering innovation.* Strengthening innovation capacity is a further key element of the government's growth strategy. Business expenditure on R&D is low in proportion to GDP. Small firm size and a prevalence of foreign subsidiaries are two reasons, but a complex tax regime for R&D may also be to blame. Its simplification should be a priority, although some steps have already been taken to this end. The competitive system for allocating public research money among Crown Research Institutes (CRIs), universities and industry is well designed, and the guidelines for managing intellectual property rights by CRIs and universities encourage commercialisation. CRIs play an important role in the science and innovation system: a large part of their research is commissioned by or performed in partnership with private firms. However, they should pay a share of profits back to the government's funding pool so that the overall allocation of funds can be made according to the public-good rationale of public-sector science. Universities are taking part in the effort to strengthen

international research linkages, which is crucial for progress in biotechnology and other fields. Helping them achieve minimum efficient scale by forming consortia and centres of excellence seems the right approach.

- *Avoiding the temptation to "pick winners".* A controversial element of the government's strategy is its focus on actively assisting growth in three sectors: biotechnology, ICT and "creative industries" such as film production, design and fashion. The first two are relatively well established in New Zealand, even though they are still struggling to reach critical mass. Biotechnology can also count on potentially valuable synergies with agriculture and a strong public research base. Growth of creative industries, of which film production has been most notable, has been a more recent development. Support for screen production was initially in the form of a tax loophole, but has more recently shifted to a system of grants. While this is the only case so far where subsidies have been used, it sets an unhelpful precedent. Setting an uneven playing field may not only misallocate resources but would also create incentives for wasteful rent-seeking.
- *Unblocking infrastructure bottlenecks.* Improving infrastructure would create an environment more favourable to both foreign and domestic investment, thereby strengthening global linkages. Two areas where bottlenecks have emerged are transport and electricity. In each case, a better regulatory environment is needed. *Road policy* faces the challenge of maintaining a high-quality network in a sparsely populated country, while at the same time addressing localised congestion problems. In order to increase the resources available for road construction, consideration should be given to raising user fees (which at present mainly take the form of a petrol levy) and making them congestion-related through road pricing. Bringing road fees into line with the true social cost would also help the government assess the economic viability of the *rail service* and decide whether supporting it is justified. As regards *electricity*, recent dry-weather episodes have revealed problems on both the demand and supply sides of the market. Limited retail competition and the cost of time-of-use metering mean that households face no price signal to cut back their consumption in times of shortage. With demand-side responses largely confined to major users of electricity, more backup generating capacity is needed. However, private investment in generation is discouraged by the uncertain return, a changing regulatory environment

and difficulties in getting environmental approvals for some new projects. The government is addressing the supply-side issue by adding some ring-fenced dry-year capacity. A pre-announced price threshold has been set for activating this capacity, but some provisos around activation rules may create uncertainty. In addition, an improved regulatory framework is needed to encourage investment in order to overcome transmission bottlenecks.

- *Improving the environmental consent process (the RMA).* Another factor holding back infrastructure projects and investment more generally has been the uncertainty and delays related to environmental consent procedures associated with the Resource Management Act (RMA). While the government has spent a small amount of money to speed up the process, it is difficult to judge whether more is needed. But if the business sector is right in claiming RMA administration to be a major barrier to investment – including FDI – then there could be a high payoff to a small further increase. Consent decisions, which are made at the local level, also need to place more weight on national interests. The government is currently considering measures to address this problem including introduction of a fast-track process for major infrastructure projects and better identification of national-interest considerations. ■

## How can New Zealand make the most of migration flows?

Migration is another valuable link with the rest of the world. It is generally accepted that net immigration brings economic as well as social and cultural benefits and that significant inward migration will continue for the foreseeable future. Unlike most OECD countries, New Zealand has significant migrant flows in both directions. Thus, net flows oscillate considerably and have shifted from an outflow at the end of the 1990s to a record inflow over the past two years. Geographical factors mean that policy can concentrate on choosing among applicants, although it is more difficult to control net flows since these depend on emigrating and returning New Zealanders. Since the early 1990s selection policies have focused on immigrants' skills, rather than their country of origin. The majority of permanent settlers are admitted through a points test based largely on qualifications, age, work experience and English language skills. Family connections account for a further 30 per cent,

and the remainder enter under the humanitarian programme, which includes quotas for Pacific Islanders.

Recent policy refinements have focused on boosting employment rates of skilled immigrants, which were disappointing in the 1990s. This was attributed mainly to insufficient English language skills, although cultural obstacles to "fitting in" to the close-knit work environment of small firms and employer discrimination may also have played a role. The minimum English language requirement has been raised twice, and several measures to improve integration have been introduced, including job-matching and employer-awareness programmes. Very recent changes have increased the emphasis on employability, with priority given to those with job offers, and a provision for candidates to be given temporary visas to determine their suitability on the domestic job market. These changes should help improve labour-market success, at least in the short run. However, putting too much emphasis on filling particular skill or industry shortages, or on priority sectors, should be avoided. Experience locally and overseas suggests this approach may not work well in a rapidly changing economy.

It is difficult to quantify the gains from immigration for the existing population, though an important consideration is that, because many New Zealanders also emigrate, the population would stagnate or fall without immigration. Moreover, agglomeration effects or economies of scale at the national level may be important for a small and isolated country such as New Zealand. Immigration can help to maintain a critical mass of human capital to benefit from externalities at home – from expanding the labour force and domestic markets, with associated network and scale effects – at the same time as expanding connections with the rest of the world. The composition of migrant flows is also important. Emigrants tend to be relatively highly educated, but evidence suggests that the education and skill level of immigrants tends to match those of emigrants. Although it is encouraging that most emigrants eventually return, probably with higher productivity and earnings as a result of their overseas experience, it seems that fewer may be doing so than in the past, or that more are staying away longer.

Beyond any benefits connected to net inflows, the large size of migration flows in both directions is itself important because of the connections maintained by immigrants and New Zealand expatriates with their countries of origin. In addition to the likely favourable effects on trade, these movements mean increased

opportunities for exchanging knowledge and ideas, a powerful driver of innovation. In this context, the ability of the domestic education sector to attract large numbers of foreign students is a promising development. Not only is it a flourishing export sector, but it attracts people who subsequently, if they decide to stay, will have few difficulties in integrating in the labour market. Strengthening the ability of universities to build on this base to create successful graduate programmes that can attract foreign researchers should be a further objective. ■

### What can be done to get more people into work?

While raising productivity growth is the foremost challenge facing New Zealand, a second is to extend to marginal groups the good labour-market outcomes that the majority of New Zealanders enjoy. While the employment rate is well above average, matching the OECD's best performers would go one-third of the way towards the goal of returning to the top half of the OECD. The labour market works well for the easily employable majority, but outcomes are less favourable for marginal groups such as the young, the less-skilled, and especially single parents, who have one of the lowest employment rates in the OECD. About 9 per cent of the working-age population has been on a benefit for more than a year. The gap between different ethnic groups is wide, partly reflecting low average education levels of Maori and Pacific Islanders, and their share of the working-age population is expected to reach one quarter by 2020.

Strengthening work incentives in the welfare system could improve employment and social outcomes for these groups. Income replacement rates for families with children and for the long-term jobless are above average, so many beneficiaries are better off on welfare unless they can move into a full-time job paying at least the average wage. The wedge between income from welfare and work needs to be increased, but the government has ruled out benefit cuts because of their potential impact on poverty. An alternative is therefore to make more use of in-work benefits. But in the presence of a budget constraint, there can be a trade-off between the objectives of income support and work incentives. The more weight is placed on the latter, the more effective it may be to target the policy at the groups with the greatest labour-market problems. A time-limited back-to-work benefit (as has been used in Ireland and Canada) is

also worth considering, while an increase in childcare subsidies may be needed as well. Simply extending the existing but small in-work tax credit would provide greater income support for families but would not help the long-term unemployed, most of whom do not have children.

Experience in countries such as Denmark, Sweden and the Netherlands has shown that financial incentives work best when combined with stronger job-search obligations and other activation policies. The preferred approach in New Zealand is to use case management to assist people to become self-reliant, but the system remains too passive. Case loads per manager are too high, although recent funding increases should help reduce them, and contact with the public employment service can be infrequent. The government has taken some useful steps toward stronger activation policies, for example a firmer application of the work test for recipients of the unemployment benefit and the introduction of such a test for mature (aged 55+) unemployed (but it has moved against international trends by relaxing requirements on sole parents to look for work). However, further strengthening of activation policies is required. The government should also consider following Denmark's lead by extending a culture of mutual obligations, such as by making all beneficiaries out of work for a year participate in an employment or training programme. ■

### Is the labour market becoming less flexible?

Although the labour market remains one of the most flexible in the OECD, recent years have seen a clear trend towards greater rigidities and higher labour costs. Further such changes are in the pipeline. Individually the measures have been fairly benign, but cumulatively their impact may be important. Industrial relations legislation is being reviewed, in part because it has not achieved its goal of increasing collective and multi-employer bargaining, which was hoped would enhance employee negotiating strength. This review will also examine the extent to which continuity of employment and working conditions should be protected when a business is sold or contracted out. While such "technical redundancy" provisions could increase rigidities and may not achieve their social goal of making workers better off, the consequences are unlikely to be dramatic. But going further by allowing employees to quit yet still receive severance payments,

as some groups are calling for, could be more serious insofar as it would promote “gaming” strategies by employees. Personal grievance rules should also be clarified, and setting a minimum probation period for new employees should be considered in order to give marginal groups, such as young people and immigrants, a better chance of getting their foot in the door. Proposed legislation to lift the minimum annual leave from three to four weeks would also increase employment costs. While this is a matter of social choice, it is not consistent with the government’s goal of raising per-capita incomes. Hence, social objectives need to be balanced against the benefits of labour market flexibility – namely, faster productivity growth and a more stable and resilient economy. ■

### **Is fiscal policy ready for the challenges of population ageing?**

A third challenge is to maintain public spending discipline in the face of some larger than forecast operating surpluses. Strong economic growth has boosted tax revenues, but it is unclear how much of this windfall is merely cyclical. Although the trend rate of output growth has picked up, specific one-off factors have also played a part. Activity has expanded at an average pace of around 3½ per cent over the past two years, driven by export incomes – supported in 2002 by a weak exchange rate and high world prices for dairy and meat – and by a sharp increase in net immigration, which has fed a surge in consumption and housing construction. The first of these factors has already turned around, with the exchange rate up by 32 per cent since early 2002 and export prices back around long-term averages. But domestic demand remains robust and the economy is probably operating above full capacity. The contrast between domestic and external demand is also apparent in price developments, where a moderate headline inflation rate masks divergent trends for tradeables and non-tradeables. This persistent strength in domestic demand, as well as considerable buoyancy in the housing market could pose a challenge for the central bank, which cut interest rates earlier this year in the expectation of a slowdown but has now appropriately moved to a “wait and see” stance. It also poses a challenge for fiscal policy. Given the uncertainty as to how much of the fiscal improvement is cyclical, the government should be cautious about new permanent spending obligations. Moreover, health, education and infrastructure outlays are likely to keep rising faster than

GDP in coming years. If, in addition, international competition increases the pressure for lowering taxes, especially those that dull incentives to work, save and invest, the headroom available for further initiatives may prove more limited than the government has forecast.

The government’s fiscal policy approach is aimed at maintaining structural fiscal surpluses in order to smooth the pressures arising from projected increases in public pensions. This places a constraint on spending increases. Long-term projections suggest a fiscal shortfall over a 50-year horizon of 1½ per cent of GDP, assuming that health and education expenditures rise in line with productivity. While this gap is smaller than in many other countries, it could be much larger if expenditure pressures in these areas persist, as is likely. The budgetary situation is healthy, with low and falling net debt, but preparing for these challenges and finding room for additional growth-supporting measures will continue to require careful fiscal management. Long-term planning will be enhanced by the proposed legal requirement to publish long-term projections every four years. On the other hand, some elements of top-down short-term fiscal control have been made more flexible. The policy of pre-announcing three-year caps on new spending (the “provisions”) has been removed. Instead, the government is increasing its focus on the desired five- and ten-year tracks for the operating balance and debt. Although motivated by a desire to allow more effective decision-making, this change has removed a visible constraint that had worked well in the past and will require the government to find equally effective ways of containing future spending pressures. ■

### **How can environmental goals be achieved most efficiently?**

Another challenge is to ensure that economic development is sustainable in both environmental and social terms. In ratifying the Kyoto Protocol, the government committed to keeping greenhouse gas emissions in 2008-12 to their 1990 level. It should meet this target comfortably through carbon capture in forests. However, emissions still have an opportunity cost because any further reduction below target will give rise to permits that can be sold on the world market. Recognising this, the government plans to introduce an emissions charge at a rate regularly adjusted

to global permit prices. This approach is close to being economically optimal, but its efficiency is limited by two exemptions. Emission-intensive industrial firms exposed to foreign competition can negotiate special treatment in exchange for commitments to contain emissions. The scheme maintains the full marginal incentive to reduce emissions, but there is a risk that negotiated targets may be overly lax, as firms have superior knowledge of their own abatement costs. In addition, New Zealand, like all other Kyoto signatories, will exempt on-farm emissions from the tax, despite the fact that they account for half of all emissions. The government felt that the tax would have little impact on emissions but might have large distributional effects. Finally, credits for forest sinks and liabilities for deforestation should be devolved to landowners rather than being retained by the Crown. Doing so would internalise the value of carbon, encouraging greater afforestation.

Water pollution could also restrict future development. Water quality is high, but deteriorating. Current policies focus on point sources, relying on discharge permits. Emissions have been contained, but in an overly costly way because permits cannot be traded. Sparsely regulated and diffuse runoffs from farms now constitute the main threat to water quality. A recent agreement between the dairy industry and the government asks farmers to comply with a range of technical measures, including keeping nutrient accounts. This accounting framework could be used to introduce economic instruments such as excess nutrient permits tradable within catchments, including by point-source permit holders. This would reduce abatement costs without compromising water-quality objectives. Also, water users should be billed according to their consumption so as to encourage efficient use of the infrastructure. ■

## Is New Zealand doing enough to help poorer countries?

Lastly, all OECD countries have a responsibility to assist poorer nations in their development efforts. New Zealand provides favourable opportunities to developing-world exporters, especially since its agricultural markets are the least protected in the OECD. The most effective way to encourage their further development is to abolish remaining tariff barriers, and the decision to resume tariff reductions in 2005 is a positive step, although tariffs on some manufacturing goods will remain relatively high. While tariffs were removed for least developed country imports in 2001, and developing countries are entitled to tariff preferences, these are not always taken advantage of because of the administrative costs (associated with rules of origin). Some obstacles also arise from the stringent biosecurity regulations designed to protect New Zealand's natural resource base, but which can be a burden for developing countries. The aid programme is therefore increasing its emphasis on trade facilitation aimed at helping prospective developing-country exporters. Official development assistance is comparatively low, so completing the ongoing reform, particularly regarding evaluation and the focus on a core group of partner countries, should increase aid effectiveness, allowing a larger financial contribution in the future. ■

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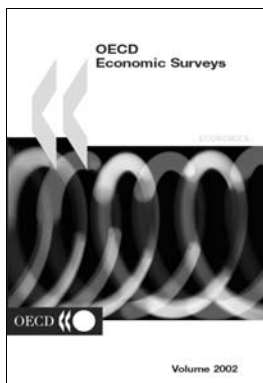
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Public Affairs and Communications Directorate.

They are published under the responsibility of the Secretary-General.

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