OECD Economic Surveys
NEW ZEALAND

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OVERVIEW

OECD

Summary

Main findings

The New Zealand economy is beginning to gain some momentum, with post-earthquake reconstruction, business investment and household spending gathering pace. Risks to growth remain, however, stemming from high private debt levels, weak foreign demand, large external imbalances, volatile terms of trade, a severe drought and an exchange rate that appears overvalued. The main structural challenge will be to create the conditions that encourage resources to shift towards more sustainable sources of prosperity. Incomes per head are well below the OECD average, and productivity growth has been sluggish for a long time. Lifting living standards sustainably and equitably will require structural reforms to improve productivity performance and the quality of human capital.

Macroeconomic policies strike the right balance between supporting the recovery and ensuring medium-term sustainability. Monetary policy is appropriately accommodative, given the high exchange rate, weak employment growth and subdued inflation. However, domestic demand is firming, and price pressures from earthquake rebuilding and housing markets are likely to strengthen. The largely Australian owned banking system is in good shape, and effectively supervised, but rising house prices could pose risks to financial stability. Fiscal consolidation is on track to restoring surpluses. Achieving sustained reductions in government debt will establish a favourable starting position for confronting the longer-term cost pressures resulting from demographic ageing. It will also tend to raise national saving rates, thereby reducing external vulnerabilities.

Policy makers are increasingly attuned to social equity and welfare. Though New Zealand ranks highly on many dimensions of well-being, some show a wide dispersion. The redistributive power of the tax and transfer system is around the OECD average. To soften the impact of henceforth tight budgets on social protection, reforms are underway for improved prioritisation, efficiency and coherence in service delivery by central government. Tax and spending changes to bolster fiscal policy's contributions to growth, equity and the environment remain important. Welfare reforms are attempting to reduce long-run benefit dependency by emphasising education and training of at-risk youth, with greater conditionality on beneficiaries and strengthened accountability on public and private providers. Improving education, health, employment and social outcomes for the large Maori and Pacific minorities is needed to reduce social disparities.

Boosting productivity is key to long-term growth prospects. Low trade intensity and limited engagement in global value chains suggest New Zealand is not reaping the full productivity-enhancing benefits of globalisation, perhaps in part because of the persistent overvaluation of the exchange rate. Inefficiencies in the information and communications technology infrastructure may undermine international connectedness. Regulatory uncertainties may be stunting competitive pressures and opportunities for foreign investment. Meanwhile, low levels of research and development may also be impeding the adoption of foreign technologies and ideas. New Zealand makes generally efficient use of its abundant natural capital, which bodes well for the sustainability of growth. The carbon price signal remains muted in the absence of internationally agreed emissions targets, and some tax settings appear to favour fossil fuel exploration.

There are weaknesses in school-to-work transitions, notably among ethnic minorities, hindering the development and use of the nation's human capital. Standardised tests indicate a long "tail" of school underachievers, despite high average scores. The high drop-out rate is a concern; as part of its growth agenda, the government aims to reduce it rapidly. Lack of school qualifications results in youth unemployment, which has increased sharply since the crisis, and high rates of youth neither in education nor in employment or training. The government has targeted improved teaching quality to reduce disparities in scholastic achievement. It has also created new vocational pathways to engage at-risk youth and to strengthen education–work linkages.

Key recommendations

Adapting the macroeconomic policy mix to changing circumstances

- Maintain the current monetary policy stance, but as excess capacity dissipates and forecast inflation picks up, gradually remove monetary stimulus.
- Deliver on the fiscal consolidation targets. If the economy picks up more strongly than expected, accelerate structural fiscal consolidation in light of external vulnerabilities.
- While recognising the current strength of the financial system, contain emerging risks to financial system stability with tighter prudential policy settings, including the deployment of new macro-prudential policy instruments. Consider implementing bank leverage ratios, permanent deposit insurance and higher capital requirements for too-big-to-fail banks.

Adjusting policies to improve equity and efficiency

- Take early steps to address long-term cost pressures associated with an ageing population.
- Raise the pension eligibility age in line with longevity. Consider increasing further the KiwiSaver minimum contribution rates and indexing NZ Superannuation benefits wholly or partly to the CPI.
- Target the Working for Families programme more tightly on the working poor by lowering upper income thresholds and increasing abatement rates. Likewise, vary early childhood education (ECE) subsidies with the level of income.
- Implement a capital gains tax and boost environmental and property or land taxes to facilitate a more efficient and equitable tax structure.

Supporting sustainable long-term growth

- Clarify the competition policy framework for the broadband market, and adjust regulations to ensure clear and consistent pricing strategies for copper and fibre networks.
- Improve the transparency of the foreign direct investment screening regime, and streamline approval processes within the Resource Management Act.
- Review the tax treatment of patent sales to ensure consistency with international best practice, and consider allowing accelerated depreciation of patent assets. Redesign the Technology Development Grants to clarify and simplify the approval criteria and ensure access for small start-ups.
- Strengthen price signals within the Emissions Trading Scheme by phasing out transition provisions. In the meantime cap and auction domestic allocations. Remove tax concessions for petroleum exploration.

Improving the school-to-work transition

- Ensure greater ECE participation by children from disadvantaged backgrounds by increasing incentives for suppliers to enter into areas of low provision and for demand from parents to increase.
- Provide incentives and opportunities to amalgamate and cluster fragmented school networks so as to achieve efficiencies and educational benefits.
- Devolve funding for a greater share of overall school costs, including teacher pay, providing schools with greater flexibility to allocate resources and manage performance.
- Strengthen the quality of apprenticeships by facilitating participation by disadvantaged youth, improving quality assurance, and ensuring funding adequacy and enhanced accountability for outcomes.

Assessment and recommendations

Overview

The outlook for the NZ economy in 2013 and beyond looks brighter than seen thus far in the recovery. Negative international spillovers may gradually diminish as global growth picks up. Construction investment should be supportive, due to Canterbury rebuilding and housing strength more generally. Meanwhile, banks have further strengthened their capital positions, boding well for future stability. Fiscal policy has embarked on a steady tightening path, which is appropriate. With inflation still very low, monetary policymakers can provide short-term support while monitoring risks from high house prices and household debt.

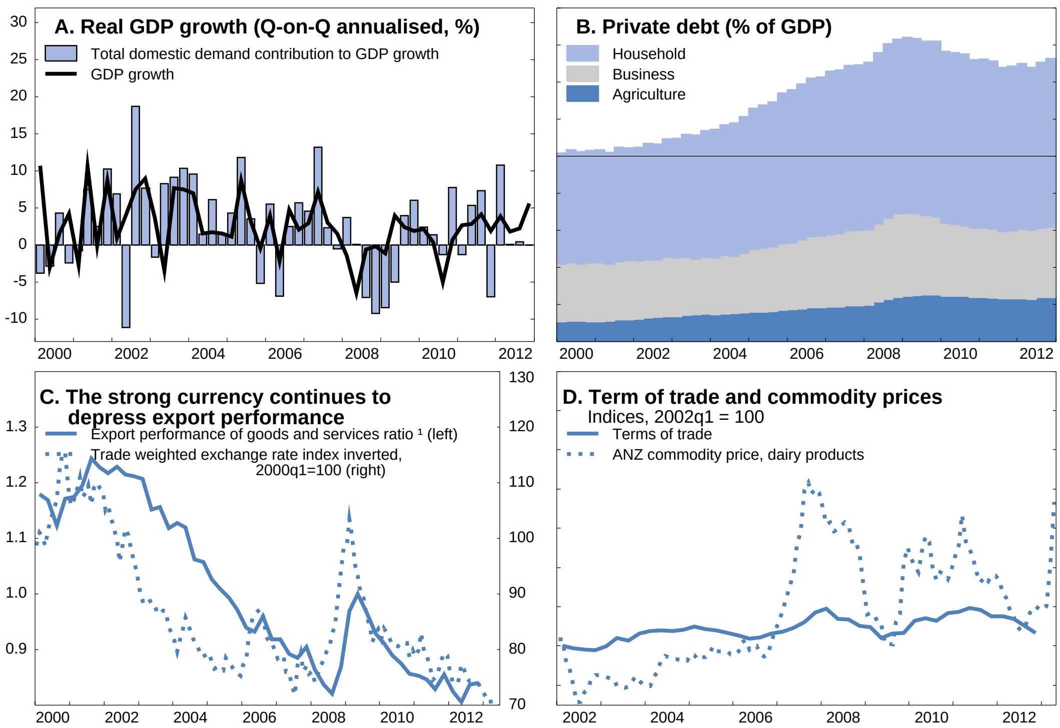
New Zealand enjoys good structural fundamentals, yet longer-run challenges are substantial. Fiscal consolidation needs will be ongoing, reflecting the desirability of eventually returning public debt to its low pre-recession level, the ageing population and structurally low private saving. Macroeconomic vulnerability in the form of high external indebtedness remains significant, and real exchange-rate appreciation has impeded the growth of the export sector, which is the basis upon which debt will ultimately have to be repaid. Income inequality is higher than the OECD average and low incomes are more prevalent among Maori and Pacific minorities. As ageing pressures increase, higher productivity growth is sorely needed to address these challenges. Human capital and skills development will assume even greater importance as the fundamental drivers of long-run prosperity. Immigration will remain an important part of the solution, though other countries are also competing for the highly skilled, implying greater need to develop skills at home. Reducing inequities in education outcomes and more fully utilising human potential should provide an effective means of lifting productivity and output growth, and improving broader living standards.

This survey takes a closer look at the New Zealand conundrum of low productivity and incomes – despite comparatively good structural and macroeconomic policy frameworks – yet surprisingly good metrics for many other dimensions of well-being. Policies are generally on the right track and ways to further strengthen them will be presented. In Chapter 1, the sources of sustainable long-run growth are analysed, and the initial disadvantages of size and distance are examined for their impacts on openness, competition and other framework conditions for growth. Proposals are made to overcome these challenges by bringing policies even closer to the best-practice frontier while capitalising on the country's comparative advantages. Chapter 2 examines the issue of youth transitions from education to work. Human capital is the basis for not only innovation and productivity growth, but also social equity and well-being. Ways are enumerated to reduce youth drop-outs and joblessness and to invest all young people with the right types of skills for good jobs in the "knowledge economy".

The economic situation

The economy is beginning to gain some momentum, supported by recovering residential and business investment and a pickup in consumer spending. Post-earthquake rebuilding in Canterbury is beginning to ramp up, and the terms of trade are benefitting from a hike in dairy prices since late 2012 (Figure 1, Panel D). However, a drought will curb agricultural production in the near term, and the recovery is uneven: the unemployment rate has remained high, while weak overseas demand and the strong currency continue to depress the export sector (Figure 1, Panel C). Private debt looms large (Figure 1, Panel B), although household deleveraging has brought the debt-to-income ratio 10 percentage points below its 2008 peak (Figure 2, Panel A). The household saving rate has thus risen by around 8 percentage points since 2003 (Figure 2, Panel B). While the current account deficit improved sharply following the recession due to cyclical and temporary factors, it has widened anew and is now around 5% of GDP (Figure 3, Panel A). Housing activity began firming over the course of 2012 (Figure 2, Panel D).

Figure 1. **Macroeconomic indicators**



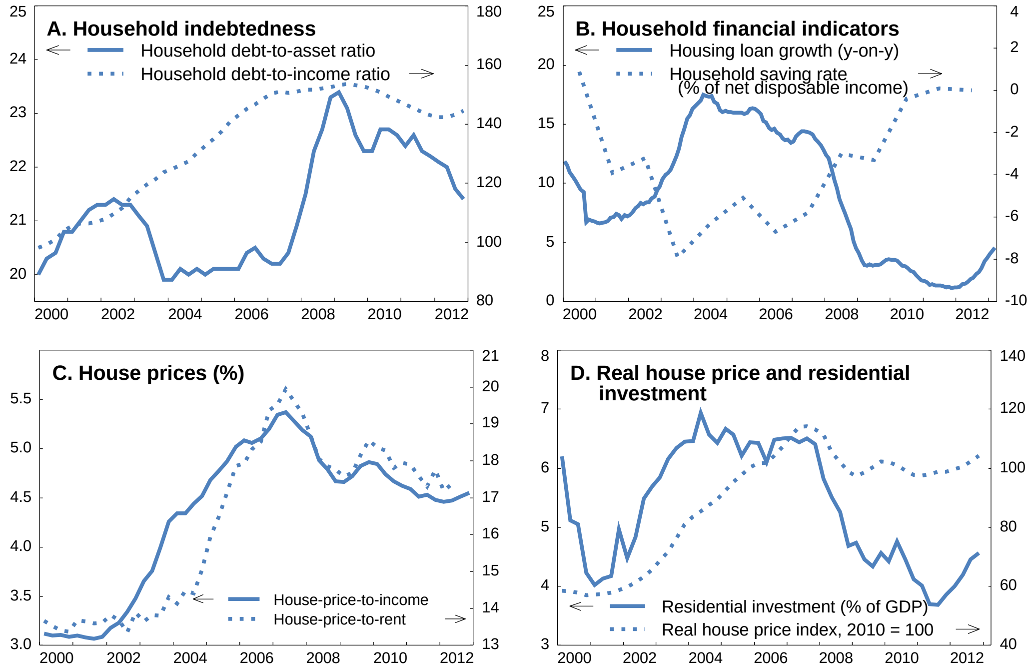
1. The export performance ratio is the ratio of export volume to export market (defined as the trade-weighted average of trading partners' imports).

Source: ANZ; Reserve Bank of New Zealand; Statistics New Zealand; Thomson Datastream; and OECD Economic Outlook 93 database.

House prices remain at historically high levels in real terms and relative to incomes and rents (Figure 2, Panel C). Prices have risen most in Christchurch and Auckland, where supply shortages are prominent, but price increases have started to appear in other markets. The government is currently exploring ways to address growing housing-market pressures, focusing on relaxing regulatory restrictions on land supply and reforming the Resource Management Act to alleviate bottlenecks in residential development. A six-month time limit was introduced for regional councils to process permits for medium-sized construction projects. Macro-prudential measures are also being applied to the major banks (see below), so as to strengthen their ability to weather a potential housing downturn and to encourage them to reassess the riskiness of their current loan portfolios.

Figure 2. **Housing and household financial indicators**

Per cent

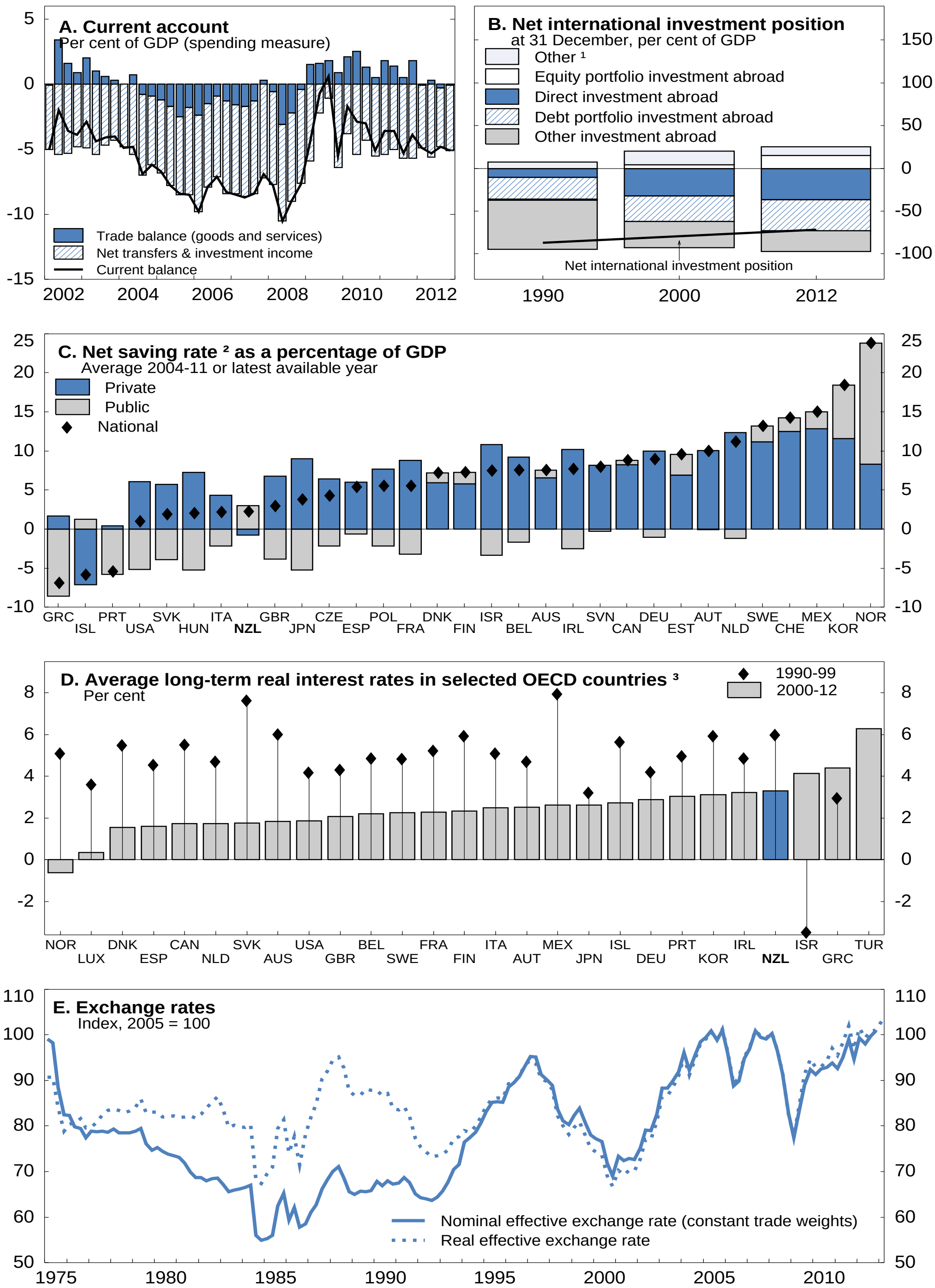


Source: Reserve Bank of New Zealand and Statistics New Zealand.

The economy is projected to expand moderately, though unevenly (Table 1), with earthquake rebuilding providing a key source of strength, offset in part by the temporary impact of drought on agricultural export volumes. Accelerating housing investment will be the main catalyst, although further household deleveraging needs will check consumption growth. Firming business sentiment will help bolster non-residential investment and improve employment conditions. On the other hand, growth will be restrained by persistent headwinds from the struggling global economy, fiscal consolidation and the high exchange rate.

Risks surrounding the projection are substantial. On the external side, they include ongoing uncertainty over the global recovery and the impact on financial flows of a potential worsening of the European sovereign debt crisis. However, New Zealand's economy would be less vulnerable than many to renewed weakness in Europe and North America, given its strong orientation towards Australia and China. Nevertheless, a sharper than expected slowdown in the latter countries would materially reduce exports and the terms of trade. Domestically, although households reduced their debt exposures during the recession, vulnerabilities to a significant house price correction are now increasing. The unemployment rate remained stubbornly high through end-2012, though improving modestly in the first months of 2013. The highly indebted agriculture sector is also exposed to a sustained drop in commodity prices or a prolonged drought. Furthermore, a 20% decline in dairy farm values since the crisis has driven up the proportion of farm debt with high loan-to-value (LTV) ratios (above 80%) by over 20 percentage points (RBNZ, 2012).

Figure 3. **Financial and external indicators**



1. Other is reserve assets and financial derivatives.
2. Gross saving adjusted for depreciation.
3. 10-year government bond rates based on changes in the lagged GDP deflator.

Source: ANZ; Reserve Bank of New Zealand; Statistics New Zealand; International Monetary Fund database; OECD National Accounts database; OECD Economic Outlook 93 database.

Table 1. **Economic indicators and projections**

Annual percentage change, volume (chained 1995/96, NZD)

	2009	2010	2011	2012	2013	2014
Demand and output						
Private consumption	-1.4	2.6	2.0	2.1	3.0	3.1
Government consumption	1.1	1.3	2.0	0.3	0.2	0.1
Gross fixed capital formation	-13.6	-0.3	3.2	6.6	9.1	9.5
Final domestic demand	-3.6	1.8	2.3	2.5	3.6	3.8
Stockbuilding[1]	-1.2	0.7	0.3	0.1	-1.2	-0.1
Total domestic demand	**-4.8**	**2.5**	**2.6**	**2.7**	**2.3**	**3.7**
Exports of goods and services	2.3	3.7	2.7	2.1	1.7	2.7
Imports of goods and services	-14.1	10.9	6.6	1.4	1.9	4.8
Net exports[1]	5.3	-1.9	-1.0	0.2	-0.1	-0.6
GDP	**0.3**	**0.9**	**1.3**	**3.0**	**2.6**	**3.1**
GDP deflator	**0.3**	**4.2**	**2.6**	**-0.6**	**1.5**	**1.6**
Memorandum items:						
Consumer price index	2.1	2.3	4.0	1.1	1.1	1.8
Underlying inflation	2.2	1.9	2.7	1.0	1.2	1.8
Unemployment rate	6.1	6.5	6.5	6.9	6.9	6.4
General government financial balance[2]	-2.7	-7.5	-5.3	-3.9	-2.4	-1.1
Cyclically adjusted government primary balance[2]	-1.7	-6.0	-3.2	-2.0	-0.7	0.2
General government gross debt[2]	34.2	37.9	41.6	44.3	46.3	46.9
General government net debt[3]	-1.0	1.7	4.5	8.3	10.4	11.0
Current account balance[2]	-2.5	-3.2	-4.1	-5.0	-4.4	-5.1
Trade balance[2]	1.5	1.5	1.4	0.0	0.8	0.1
Household saving ratio	-0.5	0.2	-0.1	0.3	0.1	-0.2

1. Contributions to changes in real GDP (percentage of real GDP in previous year).
2. As a percentage of GDP.
3. General government net debt differs from the New Zealand government's measure of "net core Crown debt" by the inclusion of local government debt as well as financial assets held within the NZ Superannuation Fund.

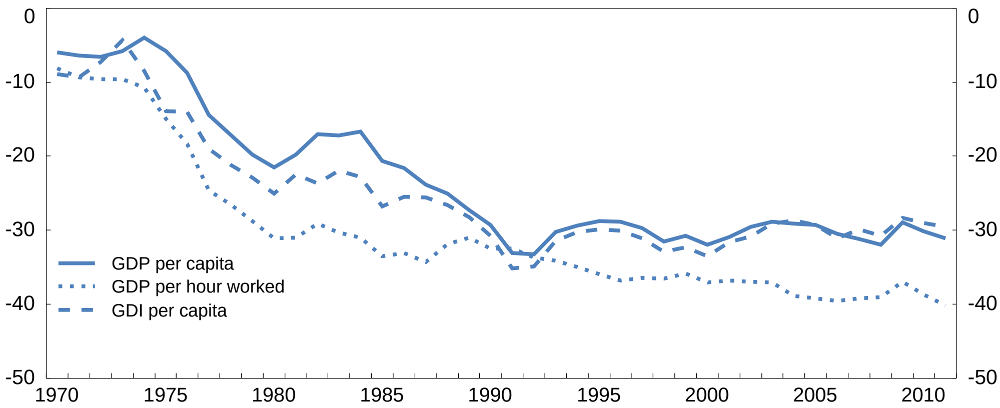
Source: OECD Economic Outlook 93 database.

Socio-economic challenges

A central policy objective is to achieve higher sustainable living standards for all New Zealanders (English, 2012). Average per capita incomes have long trailed the upper half of OECD countries, mainly due to disappointing productivity performance (Figure 4). Sustainability will also depend on the equitable distribution of incomes and other aspects of well-being that are often correlated with incomes (health, education, environment, social inclusion, etc.). Disposable income inequality has widened materially since the 1980s, albeit from a lower level than in other advanced low-tax countries, and remains high (Figure 5, Panel A). This almost entirely reflects a sharp increase in market income inequality between the mid-1980s and mid-1990s, only weakly countered by the tax and benefit system; since then, income inequality has stabilised (OECD, 2011b). Within New Zealand, sizable income gaps for Maori and Pacific minorities have not improved – from 1990 to 2011 respectively standing at 75% and 72% of the Pakeha/European equivalised median household income.

Figure 4. **Gaps in GDP per capita and productivity remain wide**

Gap to the upper half of OECD countries[1], per cent

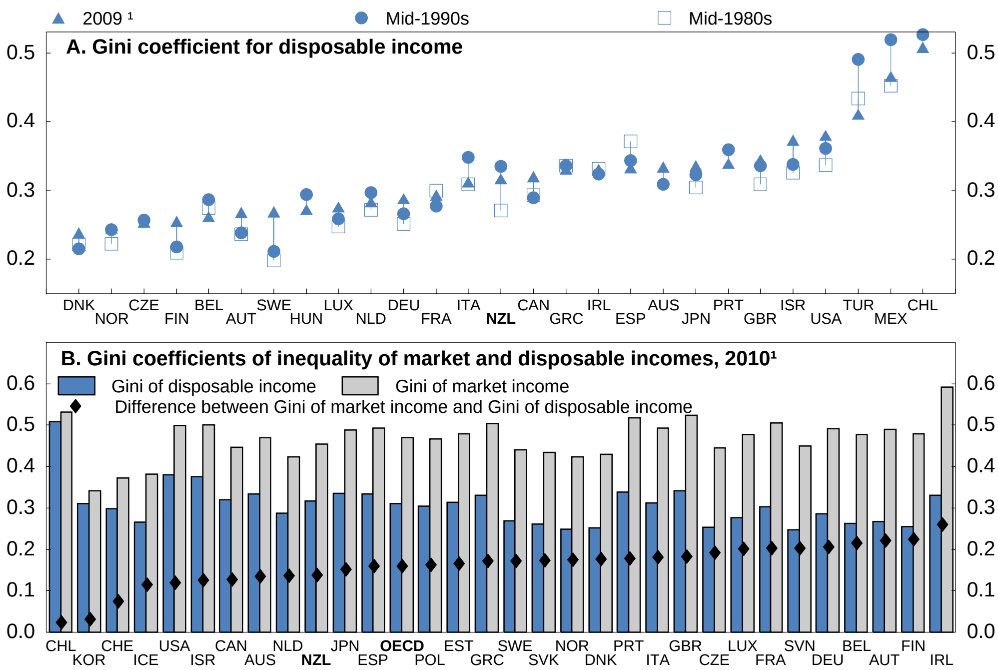


1. Percentage gap with respect to the simple average of the highest 17 OECD countries in terms of GDP per capita, GDP per hour worked and GDI per capita (in constant 2005 PPPs).

Source: OECD (2013), *Economic Policy Reforms 2013: Going for Growth*, OECD Publishing.

Figure 5. **Inequality of market and disposable incomes**

Total population



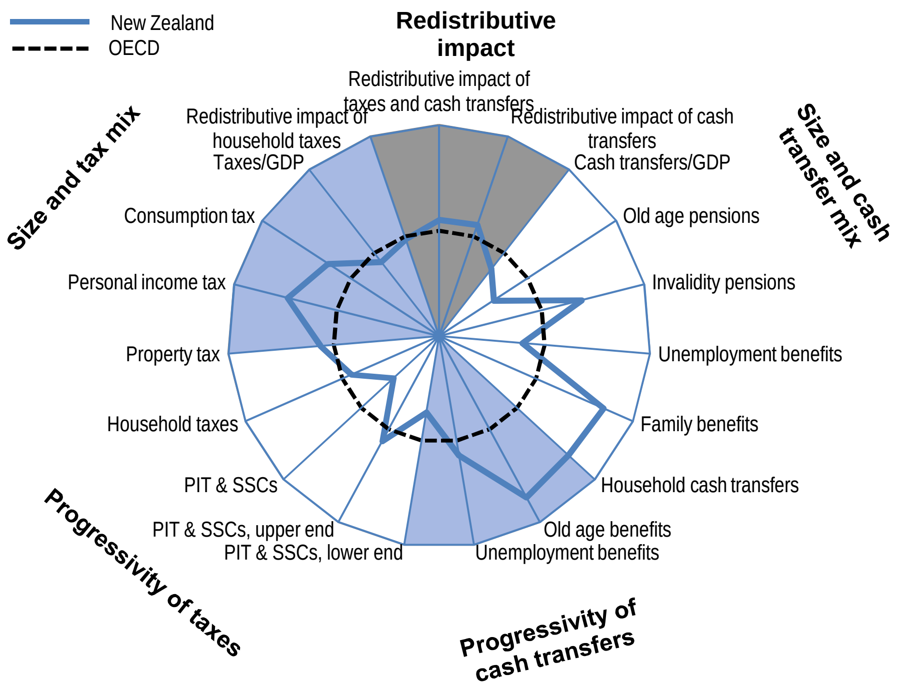
1. Or latest available year.

Source: OECD Income and Poverty Distribution Databases.

How to read this figure: The Gini index assesses inequality by measuring how far the distribution of income among households deviates from a perfectly equal distribution. A Gini index of zero represents perfect equality and 1, maximum inequality. In New Zealand, the system of taxes and transfers reduces inequality less than in most OECD countries.

While many factors drive market income inequality (e.g. labour market institutions affecting the degree of wage compression), this is an issue that needs to be addressed in the design of fiscal policies. The redistributive impact of taxes and benefits has not been sufficient to offset the increased inequality of market incomes, and is below the median of OECD countries (Figure 5, Panel B). Cash transfers have a relatively strong impact, thanks to large family and invalidity benefits and highly progressive household transfers and old age benefits; and, though taxes are less progressive than elsewhere, the personal income tax still redistributes at close to the OECD average due to its large size (Figure 6). Other fiscal measures such as indirect taxes and in-kind social spending (including education and universal health care) act further to reduce income inequality, but their redistributive impact has diminished over time (Aziz et al., 2012).

Figure 6. **Redistributive cash transfers and direct taxes: New Zealand v. OECD average**



Notes:

Size and mix of taxes

Taxes/GDP= Total tax revenue, % of GDP;
Consumption tax = Taxes on goods and services, % total tax revenue;
Personal income tax = Income taxes on individuals, % total tax revenue;
Property tax = Taxes on property, % total tax revenue.

Progressivity of taxes

Household taxes = Progressivity of total household taxes;
PIT & SSCs = Net personal tax progressivity, synthetic indicator, based on income tax plus employee contributions less cash benefits as a % of gross wage earning, single person without children;
PIT & SSCs, upper end = As above, gap in tax rate between those earning 167% and 100% of the average wage;
PIT & SSCs, lower end = As above, gap in tax rate between those earning the average wage and those at 67% of the average wage.

Size and mix of cash transfers

Cash transfers/GDP=Total cash transfers, public and mandatory private sources, % of GDP;
Old age pensions = Old age + survivors pensions, % total cash transfers;
Invalidity pensions = Incapacity related cash transfers, % total cash transfers;
Unemployment benefits = Unemployment cash benefits, % total cash transfers;
Family benefits = Family cash benefits, % total cash transfers.

Progressivity of cash transfers

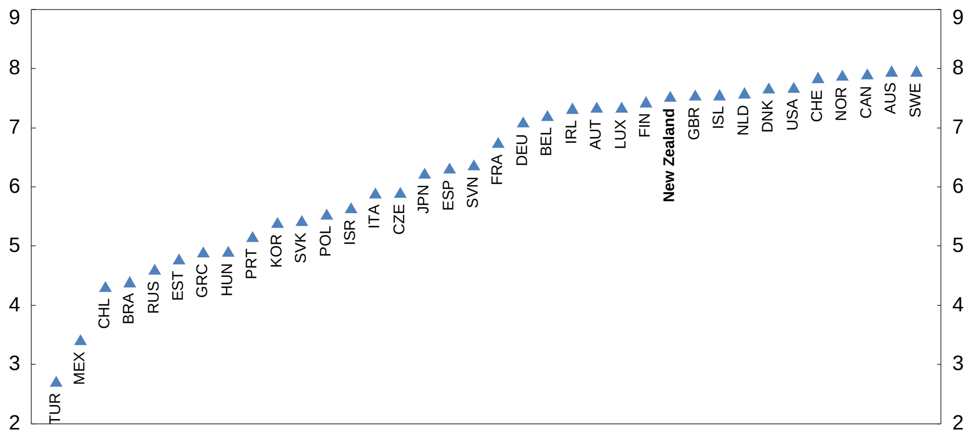
Household cash transfers = Progressivity of total household cash transfers, total population;
Old age benefits = Progressivity of pensions and entitlement earnings;
Unemployment benefits = Progressivity of unemployment benefits, net of taxes for a single person.

Source: Joumard, I., M. Pisu and D. Bloch (2012), "Less Income Inequality and More Growth – Are They Compatible? Part 3. Income Redistribution via Taxes and Transfers Across OECD Countries", *OECD Economics Department Working Papers*, No. 926, OECD Publishing.

How to read this figure: The redistributive impact of the tax-and-transfer system is broken down in this chart into a) the progressivity (per dollar redistributive impact) and b) the relative size of the various fiscal instruments (defined above) within each broad category.

The OECD has recently developed a multi-dimensional measure of well-being and social progress (Figure 7). New Zealand ranks more highly in most of its components than it does in per capita GDP, as it does in other comprehensive measures such as the UN human development index, indicating a striking ability to deliver good life-quality outcomes despite lower incomes (Table 2). On the other hand aspects of broader well-being, not just income, are distributed unequally (Tables 2 and 3).

Figure 7. **Better life index**



Source: OECD, Better Life Index database.

How to read this figure: For illustrative purpose, the Better Life Index (BLI) is calculated here with equal weights on the 11 dimensions (income, jobs, housing, health, work and life balance, education, community, civic engagement, safety, environment and life satisfaction). Please note that the OECD does not officially rank countries in terms of their BLI performance.

Furthermore, despite strong institutions, the country faces some poor social outcomes: high rates of incarceration, childhood illnesses and abuse, youth joblessness and suicide, various behaviours detrimental to health, all heavily concentrated among the poor and minorities (Rashbrooke, 2013; Table 3). The government's programme of Better Public Services has set targets in many of these areas, namely: reducing long-term welfare dependence, boosting skills and employment, reducing crime, improving interaction with government, and supporting vulnerable children. The new welfare reform seeks to move people off benefits and into sustained work through targeted human-capital investments (see Boxes 1 and 2 below).

Table 2. **New Zealand's well-being, various indicators**

Absolute rankings within OECD24

	1960	1980	2005
Gross Domestic Product per head[1] – Maddison (2006)	3/22	17/22	18/22
Gross National Income per head[2] – World Bank	-	18/24	22/24
Life Expectancy at birth – World Bank	9/24	18/24	11/24
Ratio of Female to Male life expectancy at birth – World Bank	14/24	19/24	23/24
Ecological Footprint—Happy Planet Index	23/23	16/23	20/23
Life Satisfaction- Happy Planet Index	15/23	15/23	9/23
Life Satisfaction-Mean score, World Values Survey	-	21/24	20/24
Life Satisfaction-Standard deviation, World Values Survey	-	24/24	22/24
Better Life Index[3] – unweighted, OECD	-	-	11/36
Gini coefficient of income inequality –CIA Factbook and OECD	-	10/23	20/23
Human Development Index – UNDP	-	5/23	4/24

Note: A low absolute ranking implies a comparatively a high level of well-being.

1. In PPP terms, 1990 US dollars.
2. In PPP terms, current US dollars.
3. For illustrative purpose, the BLI is calculated here with equal weights on the 11 dimensions (income, jobs, housing, health, work and life balance, education, community, civic engagement, safety, environment and life satisfaction). Please note that the OECD does not officially rank countries in terms of their BLI performance. The index is calculated for 34 OECD countries plus the Russian Federation and Brazil. The reference year is generally around 2009/10.

Source: Grimes, A., L. Oxley and N. Tarrant (2012), "Does Money Buy Me Love? Testing Alternative Measures of National Wellbeing", *Motu Working Paper 12-09*, Motu Economic and Public Policy Research, August; OECD Better Life Index, *http://www.oecdbetterlifeindex.org/countries/new-zealand/*.

Table 3. **Health statistics by ethnicity**

Percentage in each group, latest available data

	Maori	Pacific	Asian	European/ other	Total
Visited a GP in the past 12 months	75	75	71	80	78
Chronic pain	18	14	10	17	16
Medicated high blood pressure	13	11	10	17	16
Diagnosed ischaemic heart disease	5.1	1.7	1.9	6.0	5.5
Diagnosed diabetes	7.3	10.2	6.2	4.7	5.5
Obesity – adults	44	62	16	26	28
Obesity – child (2-14 years)	16.6	23.5	7.5	6.2	10.2
Medicated asthma	17	9	4	11	11
Current smoking	41	26	10	17	18
Drank alcohol daily in the past 12 months[1]	3.6	1.2	1.3	6.8	5.8
Life expectancy at birth (2006):					
Male	70.4	←79→			78
Female	75.1	←83→			82.2
Fetal deaths (rate per 1 000 births, 2009)	8.1	9.3	←7.0→		7.6
Memorandum items:					
Share in population[2]	14.9	7.2	9.7	77.7	

1. Among total population, unadjusted prevalence.
2. Total does not equal to 100 because ethnicity is self-reported and an individual can belong to more than one ethnic group.

Source: Ministry of Health (2011/12), *The Health of New Zealand Adults*; *The Health of New Zealand Children*; and Statistics New Zealand.

External imbalances persist

New Zealand continues to grapple with the combination of a large net foreign liability position (Figure 3, Panel B), an overvalued exchange rate and low national saving (Panel C). The private sector holds the bulk of external debt, although the public-sector share almost tripled since the financial crisis to reach 20% at end-2012. As discussed in the 2011 *Economic Survey* (OECD, 2011a)*,* low private saving rates are associated with shallow capital markets, poor growth prospects and wealth effects of strong house price appreciation. As a result, a large part of domestic investment has been funded by borrowing from abroad through the banking system.

Furthermore, domestic interest rates have remained higher than in most other advanced economies for much of the past two decades (Figure 3, Panel D), driving up the cost of capital and, through the carry trade, the exchange rate (Panel E). Recent estimates suggest that by mid-2012 the exchange rate was about 10-20% higher than levels that would be associated with a sustainable external balance (IMF, 2012), and it has since appreciated further. This combination of high interest rates and high exchange rates probably reflects low domestic saving relative to the investment demands of the economy and high external indebtedness rather than overly tight monetary policy: with inflation averaging slightly above 2% during this period, the monetary policy framework and settings appear to have been generally appropriate. Moreover, the strong currency appears to be part of a longer-term puzzle in which the real exchange rate has failed to adjust down to levels consistent with New Zealand's productivity underperformance relative to other advanced countries (Reddell, 2013).

The mid-2007 implementation of KiwiSaver, the voluntary subsidised retirement savings scheme, appears to have promoted a moderate increase in private saving, but at a heavy public cost. By 2012 the scheme covered 55% of the eligible working age population spread evenly across income groups, an exemplary achievement by OECD standards (OECD, 2012a). An early survey of members reveals that about one third of individuals' contributions represented new saving (Law et al., 2011); using the value of total managed funds as of mid-2012, rough calculations based on these estimates would suggest that KiwiSaver generated under NZD 2 billion in new private saving in its first five years. Given that government subsidies amounted to almost NZD 5 billion over this period (mostly because of the one-off lump sum payment to new members), overall national saving may have even declined, at least in the short term.

Accordingly, the government began curtailing subsidies in mid-2011, halving the tax credit on member contributions and removing the tax exemptions on employer contributions. The minimum contribution rate was also increased from 2% to 3% of weekly earnings (6% including matching employer contributions) in April 2013. Further changes may help raise national saving and promote growth. For example, tax credits could be limited to low-income members, as recommended in the 2011 *Survey*, allowing greater fiscal space to extend automatic enrolment to all employees (not just new ones). Moreover, the six default funds hold some 15-25% in shares, following a conservative investment strategy, with the majority in cash and bonds. Changing the investment approach of default providers to suit members' age and risk profiles (i.e. a "life cycle" approach) could help promote equity-market deepening.

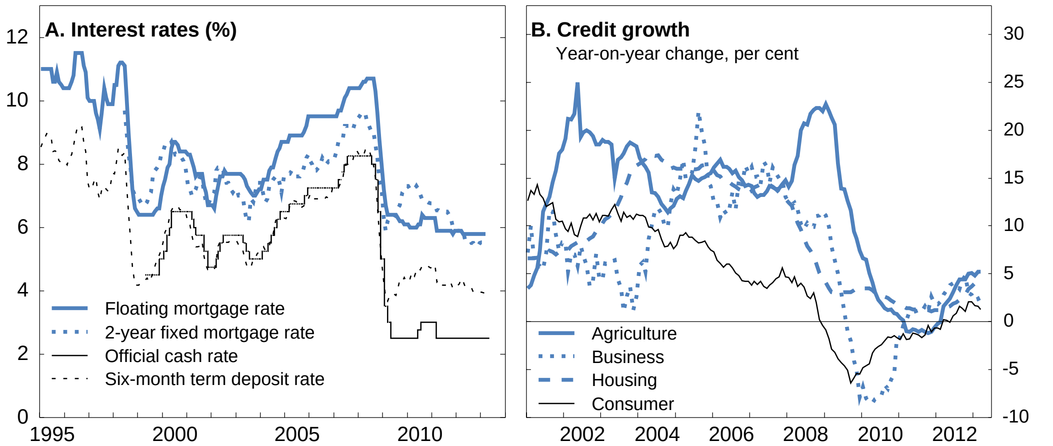
Monetary and macro-prudential policies to ensure low and stable inflation and preserve financial system stability

Monetary policy has remained accommodative

Monetary policy has been accommodative, with the Reserve Bank (RBNZ) keeping the Official Cash Rate (OCR) at a record low of 2.5% since March 2011. This stimulus has been appropriate as headline and core (excluding food and energy) inflation have fallen below 1%, and the unemployment rate has remained high. However, the apparently brisk pace of economic expansion at the end of 2012 and accelerating Canterbury reconstruction suggest economic slack will dissipate over 2013-14 and, as inflation pressures emerge, monetary stimulus should then be gradually removed.

The framework of inflation targeting and a flexible exchange rate has served the country well. The Reserve Bank has, however, acknowledged that monetary policy was probably too loose in the years leading up to the crisis and that greater weight should have been given to credit developments (Figure 8, Panel B) (RBNZ, 2012). In September 2012, the Governor and the Minister of Finance signed a new Policy Targets Agreement (PTA), which retained the 1-3% target range for inflation but increased the emphasis on keeping annual inflation close to the 2% midpoint. The PTA gave greater prominence to the long-standing statutory obligation that monetary policy should "give regard to the efficiency and soundness of the financial system" and introduced a requirement that the Bank monitor asset prices. Together, these changes suggest that the Bank could lean more heavily against future cyclical swings. Because interest rates may not sufficiently address both inflation and financial-stability objectives, there is likely to be more reliance on macro-prudential instruments (see below).

Figure 8. **Monetary indicators**



Source: ANZ; Reserve Bank of New Zealand; Statistics New Zealand; Thomson Datastream; and OECD Economic Outlook 93 database.

Banking and macro-prudential reforms

Conservative management and sound supervision helped to preserve banking stability in the global crisis and recession, and steady progress is being made to build a strong defence against any future recurrence. Banks are in a comfortable position to meet their core funding and Basel III capital ratios (minima of 75% and 8.5%, respectively), which became effective 1 January 2013. Non-performing loan ratios are low at less than 2%. The banks are eager to lend, but credit growth has heretofore been largely demand constrained. This has led banks to relax lending standards from recessionary levels, resulting in a rising share of high-LTV mortgage loans. Low interest rates, together with declining global funding costs for banks more recently, are being passed through into lower mortgage interest rates. Consequently, household and farm debt are again rising from already high levels.

In response to the emerging risks to financial stability emanating from the housing sector, the RBNZ is raising the minimum level of capital that the four major banks are required to hold against mortgages with LTVs above 80% (RBNZ, 2013b). The RBNZ has also recently proposed four macro-prudential tools that it could use from time to time to help manage risks arising from the credit cycle (RBNZ, 2013a). There has been a period of public consultation, and the Finance Minister is expected to sign a memorandum of understanding on macro-prudential tools with the Governor alongside the 2013 budget. The new toolkit would apply to registered banks only, and is as follows:

- a counter-cyclical capital buffer provision, which could be applied as from 2014 as part of the Basel III capital adequacy regime, effectively requiring banks to hold more capital during credit booms, and is expected to range up to around 2.5% of risk-weighted assets;
- adjustments to the minimum core funding ratio, i.e. altering the amount of retail funds and longer-term wholesale funding banks have to hold;
- sectoral capital requirements, i.e. increased holding of bank capital in response to sector-specific risks; and
- restrictions on high-LTV residential mortgage lending.

LTV caps are the most controversial of these tools, as they affect the supply of mortgage credit directly, rather than indirectly as do capital and leverage rules or interest rate changes. The RBNZ itself has expressed concerns that LTVs could distort the mortgage market by locking out first-time home buyers and opening the door to unregulated lenders (RBNZ, 2012). It has also indicated that macro-prudential and monetary policies should normally be mutually supportive (RBNZ, 2013a). This suggests that LTV caps could supplement eventual monetary policy tightening, if need be, in controlling excessive mortgage credit growth, rather than being used to substitute for monetary policy action.

NZ banks face significant risk due to their sizeable offshore borrowing and to highly indebted domestic households and farms. The banking system is among the most concentrated in the OECD, so that many of these banks are "too big to fail" and pose fiscal risks as well (Jang and Kataoka, 2013). The Reserve Bank should therefore require even higher capital buffers than currently envisaged for the four systemically important banks, as Canada has recently done for its big banks. Despite relatively simple bank balance sheets and extensive regulatory add-ons applied to minimum risk weights in New Zealand, the Bank should also consider applying a maximum leverage ratio, as recommended in the 2011 *Survey*, to backstop the use of banks' internal model-based assessments of asset risks upon which the Basel ratios are based. Such a policy has been followed, with success, in Canada (OECD, 2010a). OECD research has found that the leverage ratio is a far better predictor of "distance-to-default" than was the Basel Tier 1 ratio (Blundell-Wignall and Roulet, 2013).

An Open Bank Resolution (OBR) policy has been developed as one potential tool to manage bank failures in a way that avoids systemic disruptions and taxpayer support. Under OBR, in the event of a bank failure retail depositors would face losses along with all other unsecured creditors, while a government guarantee would kick in for the unfrozen portion of their assets and new deposits so as to allow the bank to keep operating until longer-term choices can be made about the future of the institution. However, this may not be enough to prevent bank runs in all circumstances, as once OBR is applied to one bank, depositors may fear contagion to the others. Implementing a permanent deposit insurance scheme may help reduce risks of retail runs. To be sure, deposit insurance raises moral hazard, but that should be handled by tighter bank supervision. Furthermore, some moral hazard exists already: the fact that deposit insurance was adopted under urgency in 2008 (and progressively removed over the following few years) may lead to the expectation that a similar policy would be implemented in a future crisis.

Fiscal policy on the path of spending and debt reduction

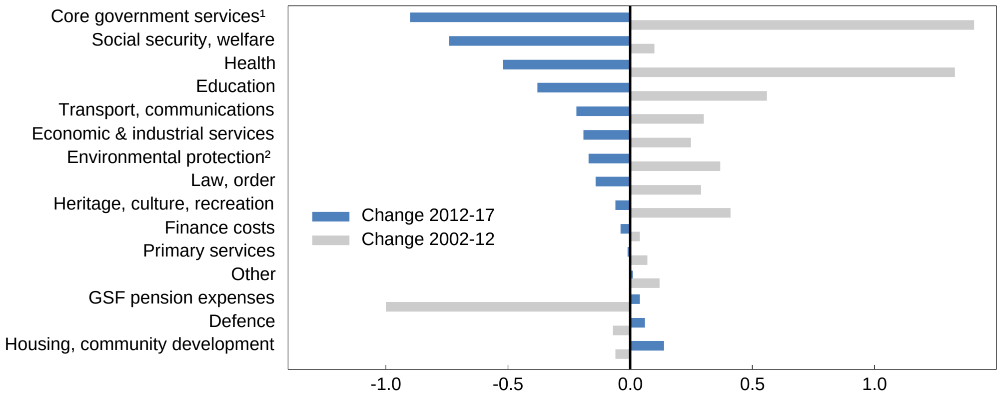
The current policy mix, which combines tightening fiscal policy and continuing low interest rates, is limiting pressure on the exchange rate. If the economy were to grow more strongly than foreseen, then the government should accelerate structural fiscal consolidation. The central government's measure of net "core Crown" debt (which excludes assets held in the NZ Superannuation Fund) has risen to about 25% of GDP, an increase of almost 20 percentage points since the crisis, and is projected to approach 30% in 2015-16. Although these levels are low by OECD standards, they should be seen in the light of high private-sector external indebtedness.

The central government has committed to balance its operating budget (before gains and losses) by 2014-15 from a deficit of 4.4% of GDP in 2011-12. Much of the consolidation will be accomplished via spending restraint, with core Crown expenses falling from a peak of 35% of GDP in 2011 to 30% by 2016, thereby returning to early 2000s levels. Restraint will be most pronounced in so-called core government services and working-age welfare benefits (Figure 9).

The government should consider being more explicit about how it intends to achieve its 20% net debt objective by 2020, as stated in its 2012 Fiscal Strategy Report. While the 20% objective seems a reasonable starting point, lower levels should also be considered, given sizeable external vulnerabilities. While the government's transparency-based principles approach (defined in the Public Finance Act) appears to work well, some form of intermediate target could help maintain discipline and transparency in the budget process following the return to surplus, for future governments, especially during cyclical upturns. Furthermore, establishing a fiscal council as recommended in the 2011 *Survey* could contribute to deeper budget analysis, monitoring and debate.

Figure 9. **Changes in government spending**

As a percentage of GDP



1. Official development assistance, indemnity and guarantee expenses, departmental and non-departmental expenses, tax receivable write-down and impairments, science expenses and other expenses including those associated with the Canterbury earthquake.
2. In previous Economic and Fiscal Updates, expenses relating to environmental protection were included within the heritage, culture and recreation classification. From HYEFU 2012, environmental protection expenses are separated out into their own functional classification.

Source: Treasury, *2012 Half Year Economic and Fiscal Update* (HYEFU).

The government's 2009 Long-term Fiscal Statement projected that under current policy settings ageing-related cost pressures in pension and health care would put significant pressure on spending in the coming decades. These pressures, if not addressed, would combine with associated financing costs to push net debt levels above 200% of GDP within 50 years. Given the scale of these pressures, early steps to confront them would be desirable. Projections using the Treasury's long-term fiscal model indicate that stabilising net core Crown debt at 20% of GDP by 2024 would require general government deficits averaging about 0.4% over the 2015-60 period. This translates into core Crown operating surpluses averaging 1.9% of GDP over the coming decade, and 1.3% on average from 2025-60 (Bell, 2012), assuming net capital expenditures evolve in line with their historical average and local governments maintain balanced budgets.

Spending and tax reforms for sustainable fiscal consolidation

Fiscal consolidation should be designed to mitigate possibly conflicting effects on poverty reduction and economic growth. Structural reforms in baseline public spending, public governance and asset management can also increase possibilities for beneficial policy manoeuvre.

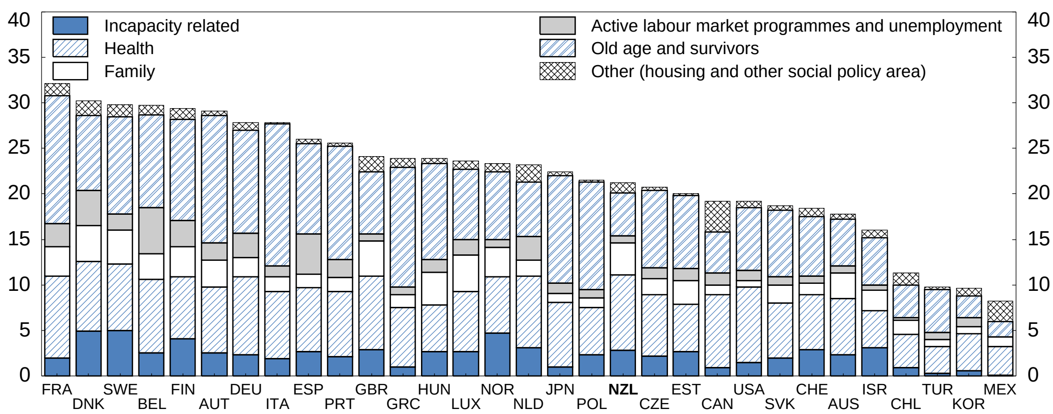
Reforms for equitable spending control

As social programmes are a large share of public spending, restraint in this area is a prominent part of fiscal consolidation. Non-old age benefit spending is the ninth highest in the OECD relative to GDP (Figure 10), and long-term unemployment benefit earned-income replacement rates are around fourth highest in the OECD (see *www.oecd.org/els/social/workincentives*). Transfers to households have risen sharply since 2008 due to new provisions ("20 Hours ECE", Working for Families (WFF), KiwiSaver), the recession and the Canterbury earthquakes, but are projected to decline again, thanks to both falling unemployment and welfare reforms (Box 1). WFF is a costly in-work tax expenditure that could be much more effectively targeted on the working poor by adjusting abatement rates and upper income thresholds. Similarly, the universal 20 Hours early childhood education (ECE) programme has disproportionately benefited wealthier families, who have better access to childcare facilities. Cash transfers to needy families are already among the most redistributive in the OECD (Figure 6), while work-incentive issues are being addressed by recent welfare reforms. Old-age pension spending, as a flat universal benefit funded through general taxation, is modest in comparison with other countries but strongly redistributive (Figure 6).

Health and education spending are set to at least partly reverse their earlier strong run-ups (Figure 9). Most of the previous increases went into high pay growth for doctors and teachers, without obvious corresponding performance improvements (OECD, 2009). Accordingly, part of the forecast decline reflects wage moderation. Savings in education are also a function of projected decreases in the number of secondary and tertiary students. Restraining health spending as a share of GDP as ageing intensifies will be a major challenge. Yet, structural reforms to boost efficiency rather than reducing access or quality can be welfare-enhancing as well as cost-reducing.

Figure 10. **Non-old-age welfare benefits are comparatively high, though pension spending is modest**

As a percentage of GDP, 2009[1]



1. Or latest available year.

Source: OECD social expenditure database.

Box 1. **New Zealand's "investment approach" to welfare reforms**

The NZ government is significantly reforming the welfare system, based on an active "investment approach" that focuses on reducing long-term benefit dependency through targeted support and services that move recipients into employment. The principle of liability is integral to the reforms. That is, welfare interventions should be considered an investment in people at risk that avoids paying much larger sums in lifetime welfare costs. This type of approach favours training in youth. A new performance measure incentivises the Ministry of Social Development to concentrate resources where they make the most difference.

Alongside the investment approach, welfare reform is being implemented in three phases: the youth service component from August 2012 (see Chapter 2); new work obligations for certain types of benefit recipients from October 2012; and the replacement of the nine main benefit payments with three benefit types from July 2013 (Table 4). The budgetary impact of the welfare reforms is highly uncertain. The government estimates that the overall package will cost NZD 520 million but could result in NZD 1.0-1.6 billion in fiscal savings in 2012-16, with 28-44 thousand fewer benefit recipients by FY 2016. Although the unemployment rate may temporarily increase as more people enter the labour force, the reforms are likely to boost growth in the long term as the structural unemployment rate declines

Table 4. **A shift to work-oriented welfare benefits**

New Benefit Type	Replaces	Work expectations
Jobseeker Support	Unemployment Benefit Sickness Benefit Domestic Purposes Benefit: sole parent, youngest child over age 13 Widow's Benefit: youngest child over age 13 Domestic Purposes Benefit: women alone	Recipients will be expected to look for work according to their capability. People with injury, illness or disability will be assessed for their capacity to work either full time or part time, or can have their work obligations temporarily deferred. All others will be expected to search for full-time work.
Sole Parent Support	Domestic Purposes Benefit: sole parent, child up to age 13 Widow's Benefit: child up to age 13	Individuals will be required to look for part-time work when their youngest child reaches age 6, and full-time work once that child reaches age 14 (when they will transfer to Jobseeker Support).
Supported Living Payment	Invalid's Benefit Domestic Purposes Benefit: care of sick and infirm	No work obligations for those assessed to have permanently restricted ability to work.

Source: Ministry of Social Development.

The government has committed to getting better results and value for money from its public services and is implementing a set of public-sector reforms to lock in long-term expenditure control (Box 2). Such efficiency gains should help attain the sharp decline in core government services projected in the budget (Figure 9). It is important that reforms continue to improve both top-down controls and agents' incentives for efficient service delivery, especially where cost pressures are tenacious, as in health care.

Box 2. **Public sector management reforms**

Better public services

Achieving sustainable results will very likely require structural public-sector reforms. New Zealand's New Public Management reforms following the budget crises of the 1980s stressed competitive delivery of commercial services replacing former government monopolies, accountability to the taxpayer through performance-based contracts for use of public money, and prefunding of implicit liabilities. Social spending was decentralised to better serve the local customer base. During the 2000s, however, public spending surged again, and employment in core government services rose by nearly 30%. Recent reforms have sought to re-establish spending discipline and efficacy, while remaining grounded in the principles of transparency, accountability, responsiveness and fiscal probity.

The government is currently overhauling core government structures and procedures to better enable agencies to reconcile zero budget growth (until 2017) with their public service obligations. The Better Public Services initiative has notably given ministers and chief executives high-stakes responsibility for achieving targets and facilitated co-operation across the disparate agencies often operating in common policy areas.

An evaluation of the initiative carried out by Ernst & Young stated that much work remains to increase ambitions for cultural change in government (Coleman, 2013). Nonetheless, some changes are already palpable. In the prison service, the drive to deliver the high-level target of reducing recidivism by 25% by 2018 has seen the introduction of a two-year programme for 2000 prisoners leading to NCEA qualifications, as a result of a partnership between Corrections and Open Polytechnic (Tolley, 2013). Lack of education is a major driver of crime (90% of inmates cannot read or write), and there are plans to expand such pilots. In education, the high level target of 85% NCEA level 2s among 18 year-olds has already led to major innovations at upper secondary and tertiary levels (see below).

Health-care reform

Longer-term challenges concern mainly the effectiveness and containment of health spending pressures. As discussed in the special chapter of the 2009 Survey, a key problem is that the 20 District Health Boards (DHBs), as both budget holders/purchasers of health services and owners/operators of public hospitals, may face conflicting interests. Indeed, acute-care services and administration are comparatively inefficient in New Zealand (Joumard et al., 2010). The government has taken steps to drive up productivity in this sector as follows:

- public benchmarking of some performance measures including: waiting times, public targets for electives volumes, performance-based funding and ongoing tight budget constraints;
- bulk procurement and sharing of back-office services; regional approaches to service planning; pressure for DHBs to sharpen their contracting with third parties and purchasing from their own provider arms;
- requiring DHBs to devolve control of more services to primary-care providers. The Ministry of Health is also working on a new national framework for performance-based funding in primary care.

Balance sheet management

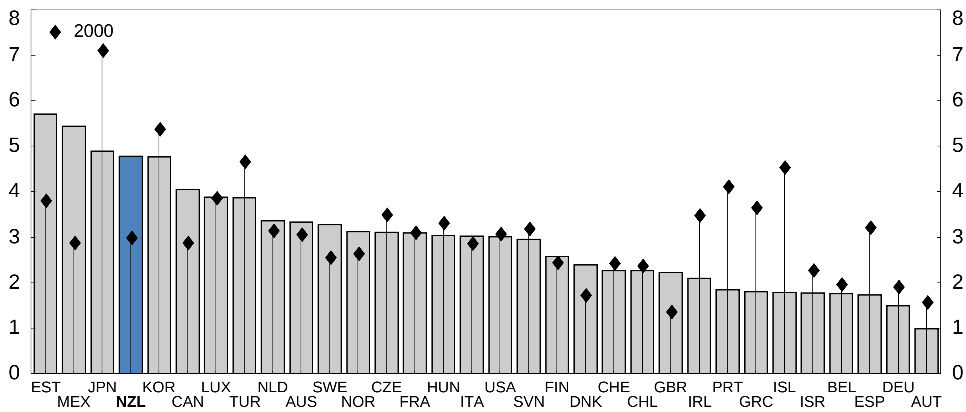
The government is also looking to improve the structure of its balance sheet. Reducing public ownership in five state-owned enterprises – consistent with recommendations in the 2011 Survey – is expected to improve their management efficiency and generate about NZD 6 billion in sale proceeds (2.9% of GDP).

> **Possible future directions**
>
> While the core economic principles of New Public Management remain valid, more fundamental reform of the public service model might be considered. Evans et al. (2012), for example, propose applying insights from the modern theory of incomplete contracts – i.e. not all contingencies can be anticipated and specified in advance – so that optimising flexibility in setting the government's boundaries is required. This suggests that contracting between private and public sectors, or the allocation of functions within the public sector itself, should ascribe residual decision rights to the party best placed (in terms of capacity and incentives) to make value-enhancing investments in the asset or activity in question, while being subject to hard budget constraints on total cost. This may have implications for efforts to engage private partners in public service delivery and asset management, and to further raise accountability incentives within government.

Public spending is also being reprioritised to support growth. Capital spending on infrastructure – roads, rail, ultrafast broadband, schools and hospitals – has already risen strongly (Figure 11). It will be important to subject these public investments, which may involve private partners, to cost-benefit analysis to ensure that they are indeed pro-growth. Local-authority investment spending has slowed but should likewise be assessed, particularly concerning its environmental impacts (OECD, 2011a).

Figure 11. **Capital spending is high**

General government gross fixed capital formation as a percentage of GDP, 2012[1]

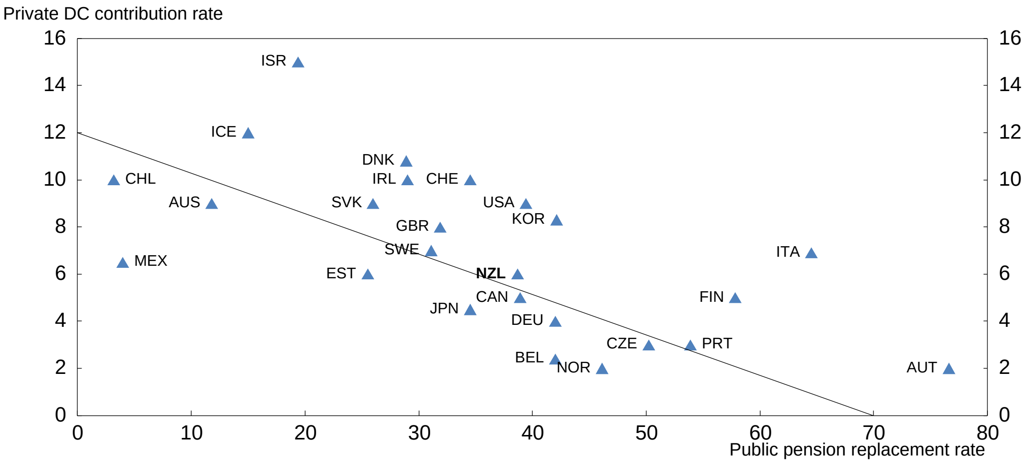


1. Or latest available year.

Source: OECD Economic Outlook 93 database.

Reforms will be needed to make NZ Superannuation (the universal public pension system) both more affordable and supportive of growth. Life expectancies are projected to rise by about six years in the next half century. Increasing the age of eligibility (from 65) in line with longevity is a sensible option that would improve fiscal sustainability while bolstering long-term growth, as discussed below. Good transitional provisions might be required for those physically unable to work longer. There may be merits (albeit risks as well) in shifting KiwiSaver fund default allocations towards greater equity investments: OECD analysis suggests that making KiwiSaver settings consistent with an overall 70% replacement rate (the black line in Figure 12) would require funds to hold 60% in equities, compared to the current 15-25% (OECD, 2012a). Increasing KiwiSaver minimum contribution rates further could also help reduce pressure on the public pension system and facilitate a switch to indexing pension benefits on prices rather than wages, as recommended in the 2011 *Survey*.

Figure 12. **Coherence and adequacy of retirement income systems**



Source: OECD (2012a), OECD Pension Outlook.

How to read this figure: This chart compares projected public pension benefits with mandatory contribution rates of private defined-contribution (DC) pension plans. The black line shows the combination that would deliver an overall replacement rate of 70% on average, assuming a 40-year contribution period, nominal returns of 7%, a 60%/40% split of equity and fixed income portfolio allocations, and 20-year life expectancies at age 65.

Efficiency-boosting tax reforms

The government remains committed to avoiding general tax increases as part of the consolidation effort. Such an approach is understandable as it generates pressure to seek efficiencies in public spending, while a low tax burden is conducive to long-term growth. However, some tax changes merit consideration to make the tax system more conducive to both growth and equity:

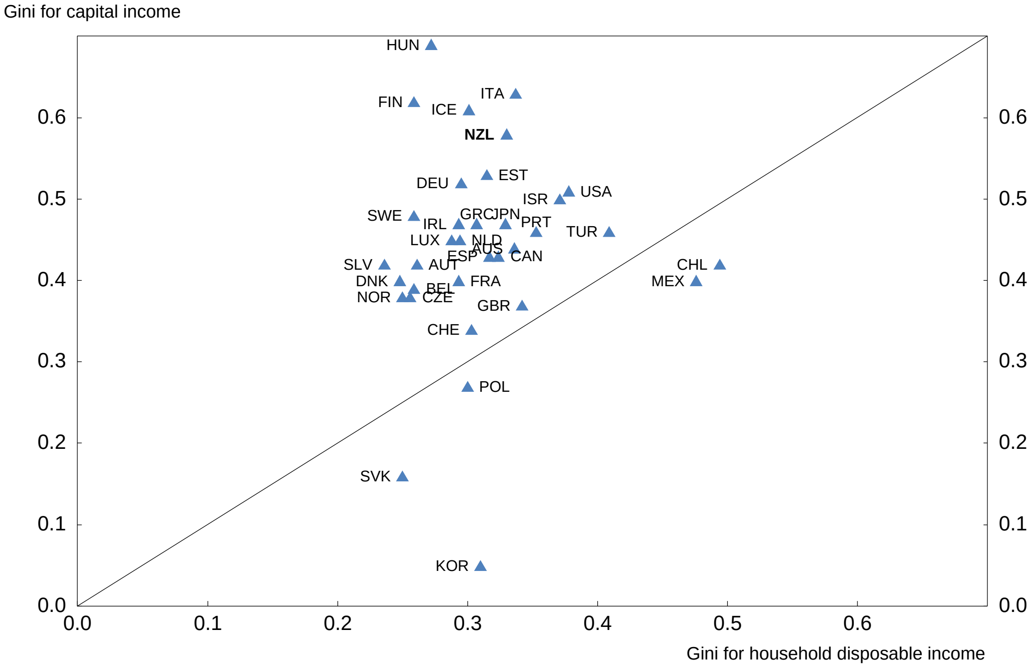
- New Zealand belongs to a group of five OECD countries with particularly high pre-tax capital-income inequality (Figure 13). As much of this income, especially at the top levels, takes the form of capital gains, the lack of a capital gains tax in New Zealand exacerbates inequality (by reducing the redistributive power of taxation). It also reinforces a bias toward speculative housing investments and undermines housing affordability, as argued in the 2011 *Survey*.

- Estimations by the OECD suggest that recurrent taxes on immovable property are the tax category least harmful to long-term growth, followed by other property taxes (Johansson et al., 2008). There is a risk, however, that property taxes are regressive. As recommended in the 2011 *Survey*, to reduce this risk the property tax could be scaled by the owner's marginal income tax rate.

- Expanding the use of environmental taxes, which appear low by OECD standards (Figure 14), could help enhance the quality of growth. For example, such taxes could include congestion charges or a tax on polluting activities like dumping or burning waste. Such measures could complement the removal of free permit allocations under the emissions trading scheme, as discussed below.

Figure 13. **Inequality of income and wealth**

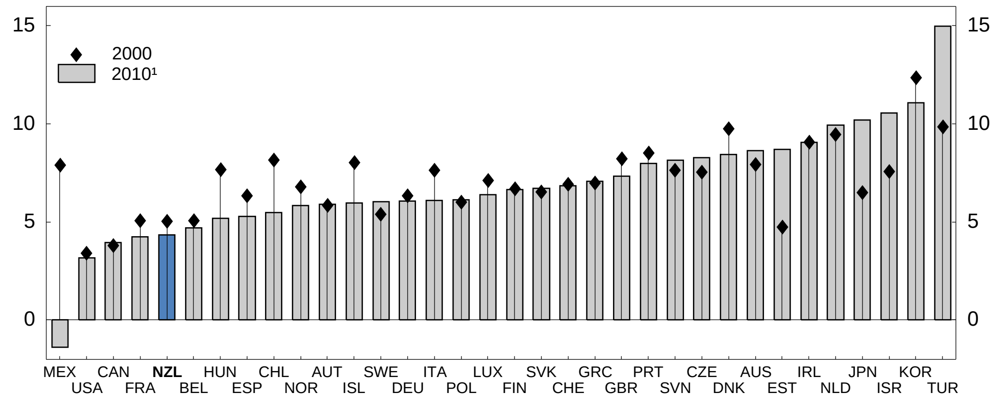
Late 2000s



Source: OECD Income and Poverty Distribution Databases and P. Hoeller *et al.* (2012), "Less income inequality and more growth – are they compatible? Part 1. Mapping income inequality across the OECD", *OECD Economics Working Papers*, No. 924.

Figure 14. **Revenues from environmentally related taxes**

As a share of total tax revenue



1. Or latest available year.

Source: OECD, EEA database.

Box 3. Recommendations for macroeconomic and macro-prudential policies

Monetary-fiscal policy mix

- Maintain the current monetary policy stance, but as excess capacity dissipates and forecast inflation picks up, gradually remove monetary stimulus.
- Deliver on the fiscal consolidation targets. If the economy picks up more strongly than expected, accelerate structural fiscal consolidation in light of external vulnerabilities.

Prudential policy

- While recognising the current strength of the financial system, contain emerging risks to financial system stability with tighter prudential policy settings, including the deployment of new macro-prudential policy instruments. Consider implementing bank leverage ratios, permanent deposit insurance and higher capital requirements for too-big-to-fail banks.

Spending reform

- Take early steps to address long-term cost pressures associated with an ageing population.
- Raise the pension eligibility age in line with longevity. Consider increasing further the KiwiSaver minimum contribution rates and indexing NZ Superannuation benefits wholly or partly to the CPI.
- Focus on engaging private partners in productivity-enhancing investments and practices, especially in health care and education, with careful cost-benefit analysis to ensure that this leads to greater efficiencies.
- Target the Working for Families programme more tightly on the working poor by lowering upper income thresholds and increasing abatement rates. Likewise, vary early childhood education (ECE) subsidies with the level of income.

Tax reform

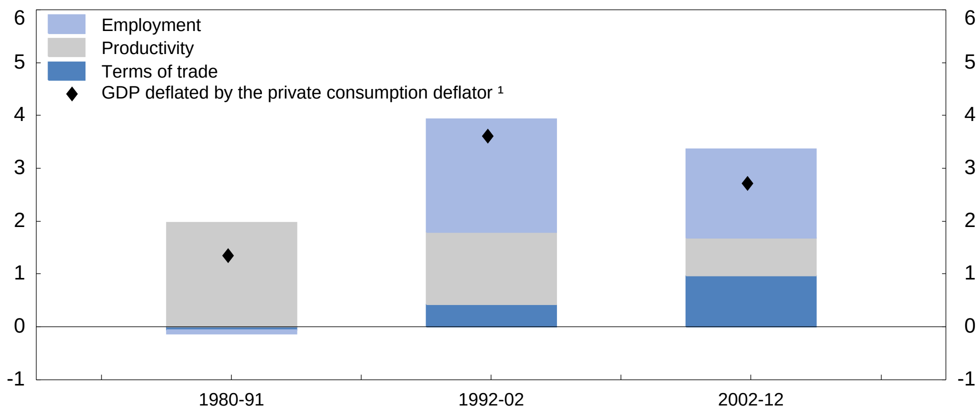
- Consider limiting the KiwiSaver tax credits to only low-income members, and extend automatic enrolments to all existing employees. Change the investment strategy for default funds to a life-cycle approach that is adapted to the member's age.
- Implement a capital gains tax and boost environmental and property or land taxes to facilitate a more efficient and equitable tax structure.

Policies to support sustained growth

Growth over the past decade has been substantially debt-financed and driven by strong investment associated with rapid population growth and the real income effects of terms-of-trade gains (Figure 15). On the supply side, rising labour input has contributed, thanks mainly to greater participation by women and immigrants, but demographic trends (Figure 16) will make it necessary to find more sustainable sources of prosperity. Projections using the OECD long-term growth model (Johansson *et al.*, 2013) suggest that the labour force will begin to shrink from about 2025, and potential output growth will then depend mainly on multi-factor productivity gains, which have been extremely low for some time. Reforms will therefore be needed to improve the country's productivity performance.

Figure 15. **Terms of trade and labour utilisation have driven rising real incomes**

Sources of real national income growth, per cent



1. Real national income defined as gross domestic product deflated by the private consumption deflator.

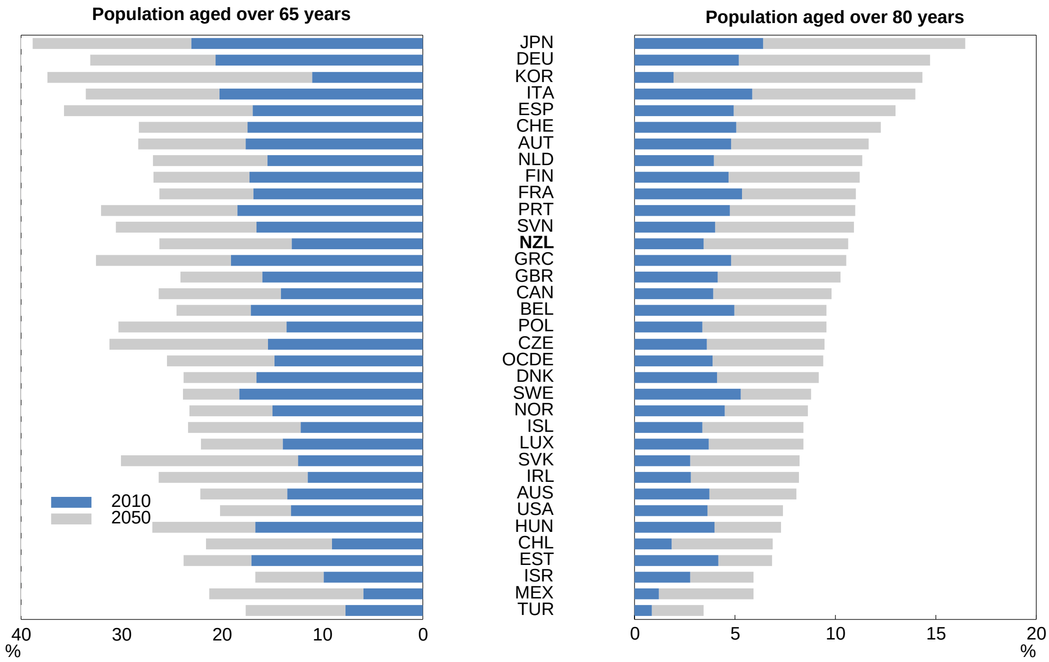
Source: OECD National Accounts database and Economic Outlook 93 database.

Far-reaching structural reform programmes in the late-1980s and early-1990s put New Zealand among the forefront of policy regimes, positioning the country well to reverse the long-term decline in per capita incomes relative to the OECD average. Despite these reforms, income and productivity gaps have shown no signs of narrowing (Figure 4). The reasons for the continued underperformance remain unclear. Size and remoteness have clearly limited New Zealand's potential – distance from markets may contribute to lowering its GDP per capita by as much as 10% relative to the average OECD country (Boulhol and de Serres, 2008). In addition, the persistently high level of the exchange rate has probably hindered growth in the tradables sector and helped constrain productivity growth.

Fostering international trade linkages is crucial for a small and distant country to promote scale economies, knowledge diffusion and competitive pressures in domestic markets. New Zealand has both low trade intensity and limited overall participation in global value chains (GVCs), according to data from the new OECD-WTO *Trade in Value Added* database, although it is relatively well connected to GVCs in the agriculture and food sectors. Transferring resources towards the production of high-value, knowledge-intensive goods and services would help broaden trade linkages and capitalise on expanding opportunities from income growth in emerging Asia. Indeed, China is rapidly becoming the country's top export market. Efforts should continue to further develop the single economic market with Australia, building on those proposed by the joint Productivity Commission study (Australian Productivity Commission and New Zealand Productivity Commission, 2012).

Figure 16. **The elderly population share will rise markedly by 2050**

2010 and 2050



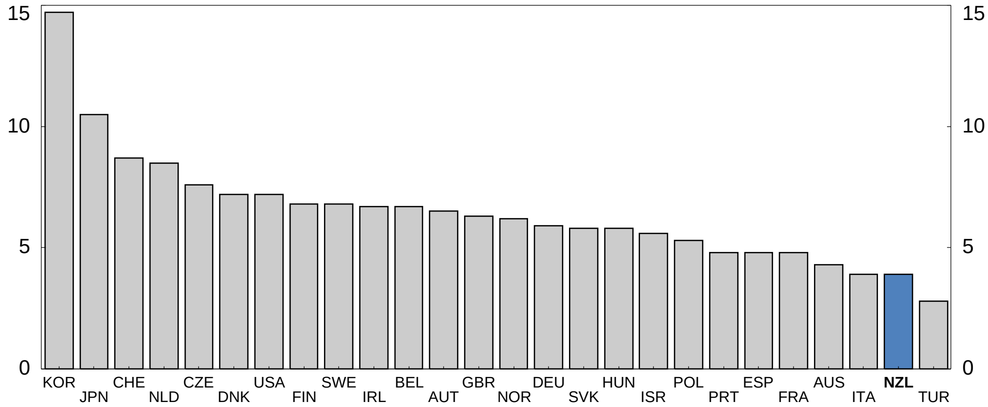
Source: OECD, demographic database.

Reducing effective distance

The declining cost of information and communications technology (ICT) and rising Internet use present significant opportunities for New Zealand to expand its services trade. However, despite growing broadband penetration, Internet connection remains relatively expensive and slow (Figure 17). Improving the ICT infrastructure will be critical to reducing the country's effective distance from major markets. While the government's ultra-fast broadband (UFB) initiative to broaden access to fibre-based Internet aims to enhance productivity and competitiveness, some significant regulatory uncertainties may impede private industry investment and fibre uptake (Chapter 1). These were accentuated by the government's decision to delay implementing the Commerce Commission's draft proposal to reduce prices that Chorus, the company owning the existing copper infrastructure, can charge for wholesale network access. Because Chorus also owns much of the fibre network, the government was concerned that such price cuts would depress Chorus's income and ability to invest in UFB. The government has launched a comprehensive review of the telecommunications regulatory framework, which would benefit from clearer regulation of fibre network pricing that is consistent with the cost-based benchmark approach used for copper.

Figure 17. **Average measured connection speeds by country**

Average Mbit/s, 2012Q3



Source: Akamai State of the Internet Report, 2012Q3.

Although formal trade barriers are low, New Zealand should aim to lower its trade costs by more than other countries in order to shorten its effective distance from major markets, as has been done with Australia through Closer Economic Relations. This will involve reducing transactions costs and remaining tariffs and unnecessary restrictions in foreign trade, investment and transport services, and more generally ensuring product market regulations (PMR) encourage competition and investment. The government has taken welcome steps to consolidate import and export procedures by developing a Trade Single Window. In addition, anti-competitive regulatory provisions in the international transport industry should be removed, such as those that allow price fixing in international shipping agreements (New Zealand Productivity Commission, 2012). Passing the Commerce (Cartels and Other Matters) Amendment Bill will help in this regard.

OECD model simulations suggest that moving the country`s PMR to best practice could boost potential GDP growth by 0.2-0.3 percentage point (Chapter 1), although New Zealand's growth has historically undershot predictions based on its policy settings (Barnes et al., 2011). Examples of reforms that could help boost growth include increasing transparency in the foreign direct investment (FDI) screening regime, as recommended in the 2011 *Survey*. FDI can catalyse productive technology transfers and knowledge spillovers. Although New Zealand is relatively open to inward FDI, much of it flows to the banking sector, and the screening regime may create uncertainties that deter potential foreign investors. Streamlining processes in the Resource Management Act (currently under review) to accelerate development and improve the environment for attracting investment will also be needed.

Boosting innovation

Stimulating innovation is key to achieving sustainable productivity gains. New Zealand`s innovation system boasts many strengths, particularly in scientific skills and research. However, business and government R&D expenditures are low by OECD standards, and there may be a shortage of skills in management and engineering (see below). The government has implemented several initiatives to improve its innovation performance consistent with recommendations from the 2007 OECD *Review of Innovation Policy*, including establishing core funding streams for Crown Research Institutes. Its Business Growth Agenda includes an objective to double business R&D spending to 1% of GDP.

This may be hindered by New Zealand's tax treatment of intangible assets, which appears less favourable than elsewhere. Unlike most OECD countries, it provides no tax benefits through accelerated depreciation of patent assets or credits for R&D costs. Furthermore, the entire proceeds from patent sales are taxed as income, rather than netting out the undepreciated capital cost. An R&D tax credit was introduced in 2009 but was quickly repealed and replaced with a modest programme of Technology Development Grants, which reimburse 20% of eligible expenditures for established technology-intensive firms with a strong R&D history. This may unfairly disadvantage smaller start-up companies with innovative potential. Furthermore, firms are selected via a subjective judgment process, creating obscure administrative complexities. The government's current review should aim to redesign the grant to address these weaknesses. While it could be worthwhile in the future to reinstate a more transparent, administratively efficient refundable tax credit once fiscal space becomes available, care should be taken to maintain some policy stability in this area.

Boosting human capital and labour input

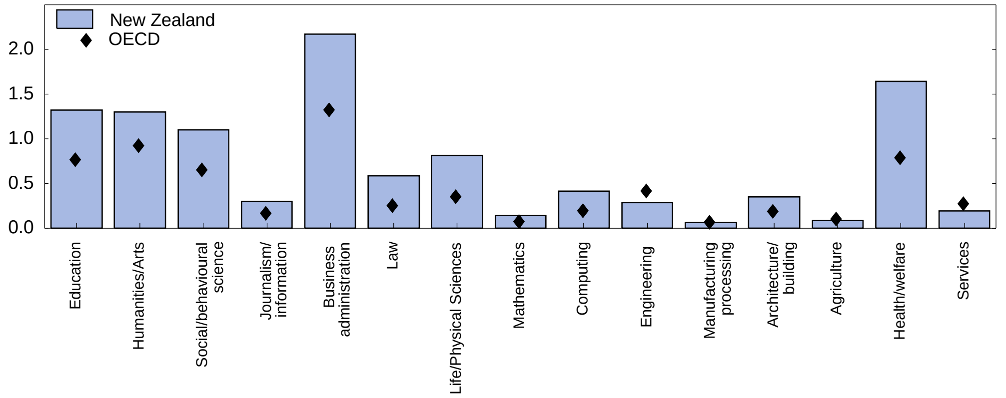
Maintaining a highly skilled workforce is critical to staying competitive in an increasingly knowledge-based global economy. OECD model simulations suggest that policies to continuously raise human capital levels towards best practice could boost potential output growth as much as 0.2 percentage point annually (Chapter 1). Migration flows affect New Zealand's stock of human capital substantially. A relatively large share of the tertiary-educated move abroad, both reflecting and aggravating the poor domestic productivity record, and much of this skills loss is replaced by high-skilled immigrants, in particular from Asia. The immigration system tends to favour high-skilled workers between ages 20 and 55 with pre-existing attachment to the labour force. Nevertheless, it will become ever more difficult to attract such individuals as wages rise in increasingly knowledge-intensive Asian economies. Hence, it will be increasingly important to produce those skills domestically.

Skills in science, technology, engineering and mathematics (STEM) are essential to innovation. New Zealand graduates a relatively low share of engineers per capita, but a comparatively high share in computing and sciences (Figure 18). To address expected future shortages the government has funded more engineering places within tertiary institutions while lowering their tuition fees. However, this investment may prove futile if graduates move abroad, where engineers' wages tend to be higher (Department of Labour, 2008). Given industry reports that NZ engineering graduates often lack practical experience (Department of Labour, 2008), consideration could also be given to supporting greater internship opportunities for students at local firms, especially where engineering clusters already exist.

Low private saving rates and features of NZ Superannuation tend to encourage older New Zealanders to continue working until the age of 65, when they become eligible for a public pension (Hurnard, 2005). A small number of those who wish to retire early may be eligible for unemployment or disability benefits, but these are not as generous. Raising the age of pension eligibility would therefore boost potential growth. OECD model simulations indicate that linking the pensionable age to life expectancy could boost long-term output growth by 0.4 percentage point (Chapter 1). However, these estimates assume "healthy ageing", and the actual impact is likely to be smaller.

Figure 18. **University graduates by field of study**

Per thousand population, 2010

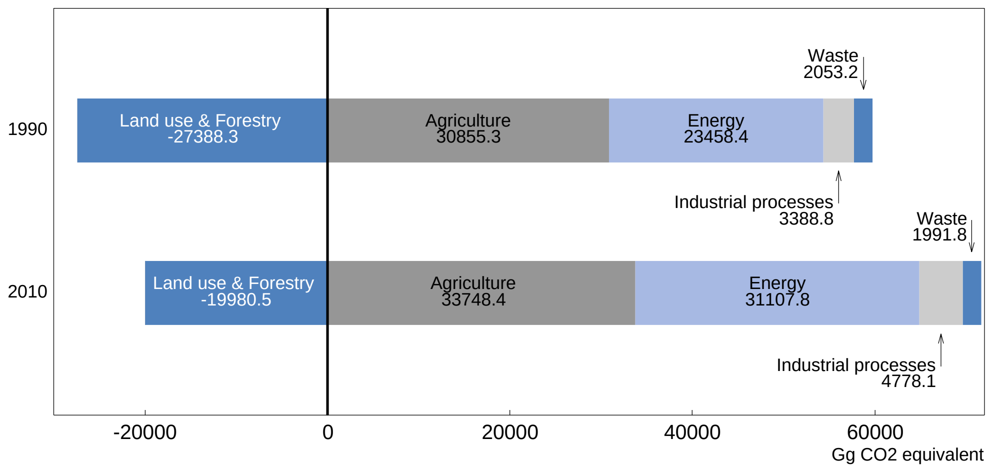


Source: OECD, Education database.

Managing natural capital and countering climate change

Natural assets play an important role in New Zealand's economic prosperity, and achieving sustainable increases in living standards will depend on how efficiently it uses its environmental resources. The country boasts a strong overall environmental performance, with high national air- and water-quality standards and energy efficiency that is close to the OECD average and improving over time. Greenhouse gas (GHG) emissions per capita are very high, however, almost half of which emanate from the agriculture sector (Figure 19), reflecting the country's large pastoral farming sector. The related challenges were assessed in the chapter on green growth in the 2011 *Survey*. Furthermore, the energy sector has been the principal driver of rising overall emissions (Figure 19), mostly reflecting high vehicle use and an old fleet. New Zealand has the OECD's second highest car-ownership rate and the fourth highest road-transport emissions per capita (Figure 20), probably related to its low population density. Prices and taxes on motor vehicle fuels are low by international standards (Chapter 1).

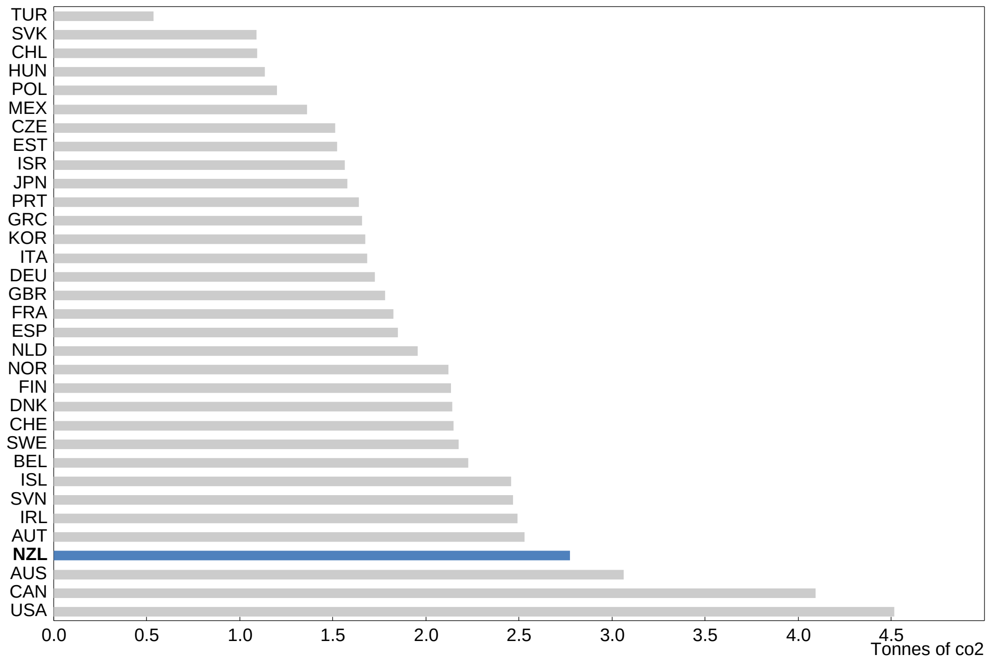
Figure 19. **New Zealand's emissions by sector in 1990 and 2010**



Source: Ministry for Environment, New Zealand's Greenhouse Gas Inventory 1990-2010.

Figure 20. **Road transport emissions per capita, 2010**

Tonnes of CO_2



Source: OECD, Energy database.

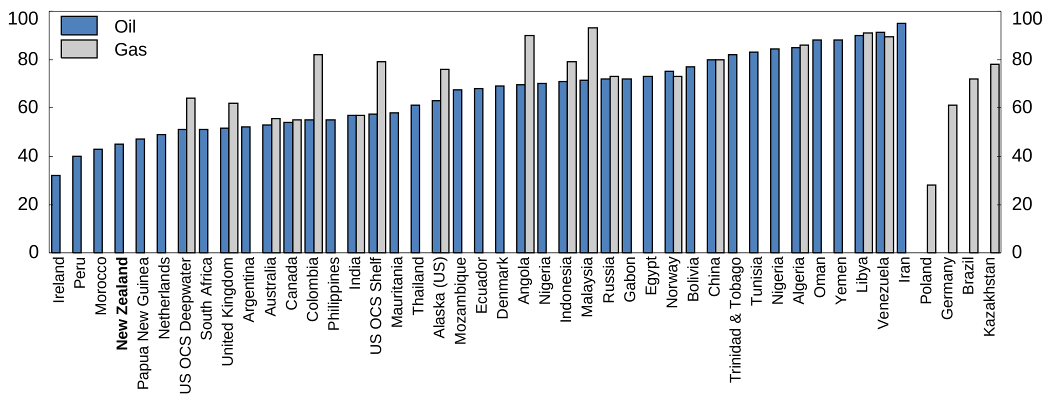
The NZ Emissions Trading System (ETS), introduced in 2008, remains the most developed, comprehensive carbon-trading scheme of its type outside the European Union, representing a bold step forward. Following its first official review in 2011, however, the soft economic outlook and uncertainty over international action on climate change led the government to extend transitional provisions until the next review in 2015. These include a temporary price cap of NZD 25 per tonne on emissions units, along with a 50% discount on surrender obligations and free permit allocations to energy-intensive, trade-exposed sectors based on current production levels. While legislation has been passed to allow the capping and auctioning of domestic allocations, consistent with recommendations in the 2011 *Survey*, the government has yet to announce any plans to do so. The review also delayed the agriculture sector's entry date (originally planned for 2015) indefinitely. This decision appears reasonable, as no other country taxes agricultural emissions and cost-effective abatement technologies have yet to be developed. The government is investing substantially in R&D in this area, however. At over 13%, the share of the public R&D budget devoted to environmental objectives is easily the highest in the OECD (OECD, 2012c). Meanwhile, the government has withdrawn from the second Kyoto Protocol commitment period, while remaining within the UN Framework Convention.

Encouraging investment in GHG mitigation technologies and transport infrastructure will require stronger price signals from the ETS. This should involve capping and auctioning domestic permit allocations. Transition provisions should be gradually withdrawn, although the pace of removal may depend on progress made in other major countries to price emissions.

Achieving sustainable and equitable growth will require ensuring that natural capital is used efficiently and that royalty revenues from the exploitation of non-renewable assets provide long-term benefits for future generations. The government's tax take from the petroleum sector appears low by international standards (Figure 21). It currently encourages petroleum exploration by allowing related expenditures to be deducted for tax purposes in the year they are incurred, rather than over the lifetime of the well; these items are clawed back upon reaching the development stage. Furthermore, since 2005 income tax exemptions have been granted to non-resident companies exploring and developing offshore. Since the majority of oil production is for export, these tax provisions form part of the government's growth strategy to increase export earnings and promote New Zealand as a global destination for petroleum exploration and investment. However, these tax concessions distort investment decisions in favour of fossil fuel production over more sustainable sources of growth and counteract New Zealand's efforts to address global climate change and should thus be discontinued.

Figure 21. **Average government take in oil and gas fiscal regimes**

Share of profits captured by the state



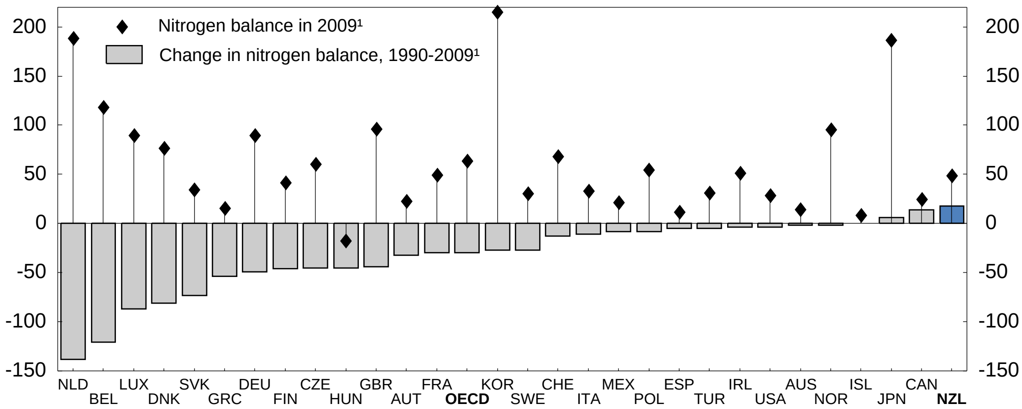
Source: I. Agalliu (2011), "Comparative Assessment of the Federal Oil and Gas Fiscal Systems", U.S. Department of the Interior, Bureau of Ocean Energy Management, Herndon, VA for oil, and D. Johnston (2008), "Changing Fiscal Landscape", *Journal of World Energy Law & Business*, Vol. 1, pp. 31-54 for gas.

The petroleum royalty regime could also benefit from changes to improve efficiency. Currently companies pay the higher of: *i*) 5% of petroleum production revenues (net of transport or storage costs), or *ii*) 20% of accounting profits, in addition to the 28% standard corporate income tax. Revenue-based royalties are less efficient than those applied on pure rents or profits, since they ignore the costs of exploration and may thus discourage investment in new or marginal fields. A government review of the regime concluded that a rent tax would be administratively too costly, given the low revenues currently involved. Nonetheless, removing the revenue-based portion of the royalty could still generate efficiencies. To ensure benefits are shared with future generations, proceeds should be reserved for public debt repayment or saved in a sovereign wealth fund.

Intensifying land use for pastoral farming over the last decade has placed increasing pressure on water supply and quality. Although water consumption per capita is among the highest in the OECD, signs of scarcity are minimal at the national level due to abundant water resources. Intensity of water use varies widely by region, however, with higher usage observed in Canterbury and Otago, related to irrigation demand for a range of primary industries. Nitrogen leaching has damaged water quality, reflecting livestock waste and increasing rates of fertiliser use (Figure 22). A more efficient approach to water allocation needs to be developed to replace the current first-come, first-served system of water consents. The government released a National Policy Statement on water management in July 2011, requiring local governments to devise plans to define and enforce water-quality standards and to maximise the efficiency of fresh-water allocation. Applying market-based approaches where possible would promote efficiency gains, such as through tradable water consents and nutrient-trading systems to address water quality, as recommended in the 2011 *Survey*.

Figure 22. **Level and change in nitrogen balance 1990-2009¹**

Kg per hectare of agricultural land



1. Or latest available year.

Source: Joint Eurostat/OECD Questionnaire, OECD calculations

How to read this figure: The gross nitrogen balance is the quantity of nitrogen nutrients entering an agricultural system (mainly from fertilisers and livestock urine) less the quantity taken up by crops and grasslands. A build-up of surplus nutrients in excess of plant needs can lead to nutrient runoff and groundwater pollution, as well as air pollution and greenhouse gas emissions. The change in balance gives an indication of potential environmental pressures from agricultural activities.

Box 4. **Policies to support long term growth**

Improving capacity for international trade and investment:

- Clarify the competition policy framework for the broadband market, and adjust regulations to ensure consistent pricing strategies for copper and fibre networks.
- Improve the transparency of the FDI screening regime, and streamline approval processes within the Resource Management Act.
- Pass the Commerce (Cartels and Other Matters) Amendment Bill to reduce regulatory impediments to competition in international transport links.

Strengthening innovation and the contribution of human capital:

- Review the tax treatment of patent sales to ensure consistency with international best practice, and consider allowing accelerated depreciation of patent assets. Redesign the Technology Development Grants to clarify and simplify the approval criteria and ensure access by small start-ups.
- Consider boosting practical training components of engineering degrees through support for student internship opportunities, especially with tertiary providers located near engineering clusters.

Policies to manage natural capital and climate change:

- Strengthen price signals within the ETS by phasing out transition provisions. In the meantime cap and auction domestic allocations
- Remove tax concessions for petroleum exploration. Move to a profit-based royalty system and designate proceeds for debt repayment or, if significant

discoveries are made, sovereign wealth fund contributions.

- Encourage the development of market-based mechanisms where possible to manage water resources.

Policies to improve the school-to-work transition

Youth labour-market performance

New skills are required to achieve technology-intensive production and adaptability to rapid structural change. This poses important challenges for the education system and the quality of its linkages to the labour market. New Zealand enjoys good labour-market performance, with high youth participation and employment rates and traditionally low youth unemployment. Long-term unemployment among all age groups is low. But since 2001 youth unemployment has grown sharply relative to adult unemployment (Table 5). Since the global economic crisis, the increases in youth unemployment and NEET rates have been among the largest in the OECD.

Table 5. **Scoreboard for youth aged 15-24[1], 2001 and 2011**

	2001			2011		
	New Zealand	EU[2]	OECD[2]	New Zealand	EU[2]	OECD[2]
Employment rate (% of the age group)	55.4	40.2	43.3	49.9	33.4	37.8
Unemployment rate (UR) (% of the labour force)	12.1	16.5	14.5	17.3	22.8	19.0
Relative UR youth/adult (15-24)/(25-54)	2.9	2.5	2.6	3.5	2.7	2.7
Unemployment to population ratio (% of the age group)	7.6	7.3	6.7	10.4	9.0	8.1
Incidence of long-term unemployment (% of unemployment)	8.7	25.4	18.7	3.9	28.0	22.1
Incidence of part-time work (% of employment)	37.3	16.8	20.6	39.6	25.4	27.9
NEET rate[3] (% of the age group)	11.7	12.0	12.3	12.7	11.7	12.3
School drop-outs[4] (% of the age group)	36.6	19.9	22.7	33.7	15.1	19.6
Relative UR low skills/high skills[5] (ISCED<3/ISCED>3)	2.0	2.6	2.5	1.8	2.3	2.2

Note: UR: unemployment rate; NEET: neither in education nor in employment or training; ISCED 3: international standard of education referring to upper secondary education.

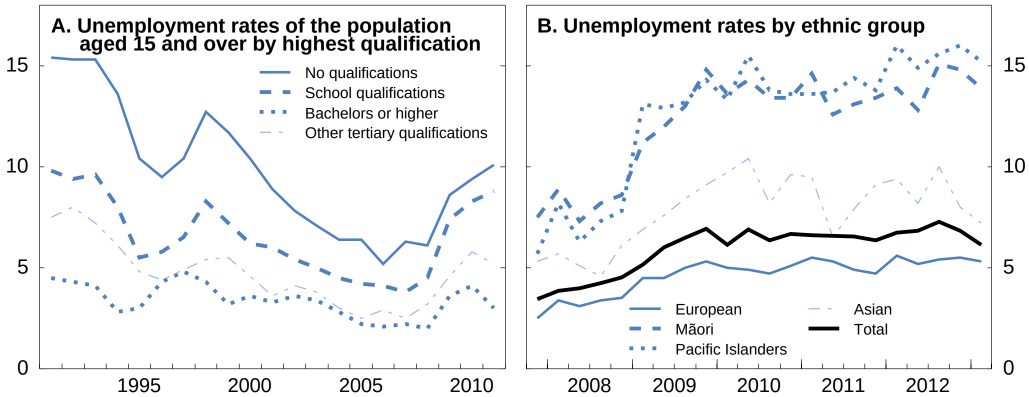
1. Except 16-24 for Iceland, Spain, Sweden, the United Kingdom and the United States.
2. Unweighted average of the 21 EU and 34 OECD countries.
3. Start year*:* 2002 for Austria and Ireland, 2003 for Estonia, Finland and Slovenia, 2004 for New Zealand. Yearly data are represented by Q1 for all OECD countries except Australia and New Zealand, for which May and Q2, respectively, are used.
4. Share of youth aged 20-24 not in education and without an ISCED 3 educational attainment; 2004 and 2009.
5. 1999 and 2009.

Source: OECD project on Jobs for Youth (*www.oecd.org/employment/youth*).

Education has shown itself to be the best lifelong protection against unemployment, low wages and poverty (OECD, 2011b), even if in New Zealand the advantage has shrunk over time, before rising again since the global financial crisis (Figure 23, Panel A). Rapid and profound structural changes have given rise to strong skill biases in OECD labour demand, putting young people at a disadvantage while requiring longer studies. Weakened demand conditions since the crisis have only reinforced this bias, as employers seek to retain skilled and experienced workers, preferring to let young and inexperienced workers go. This may also imply a longer and more difficult trajectory into initial employment. High and rising rates of youth unemployment and NEET (those not in employment, education or training) (Figure 24) undermine youths' self-confidence and depreciate their human capital. Because of high rates of part time work by young people in New Zealand, often in combination with studies, NEET is a better measure of transition difficulties than the unemployment rate.

Figure 23. **The less educated and ethnic minorities have borne the brunt of rising unemployment**

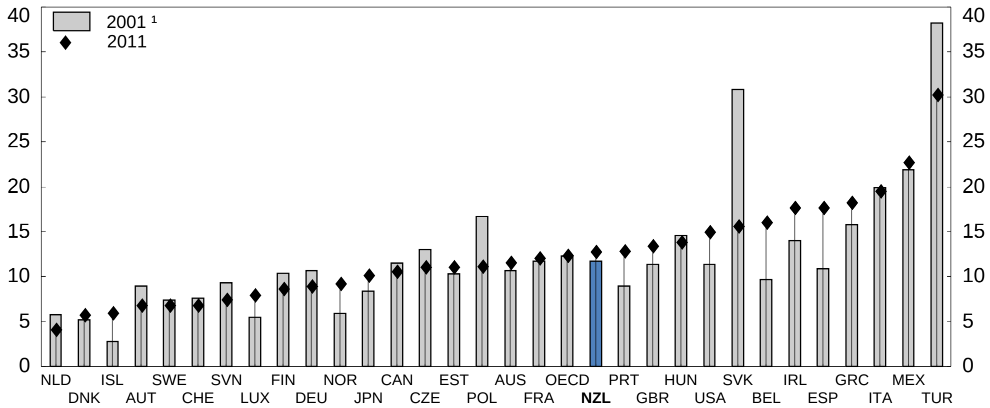
Per cent



Source: Education COUNTS database and Statistics New Zealand.

Figure 24. **NEET rate for youth aged 15-24**

Per cent



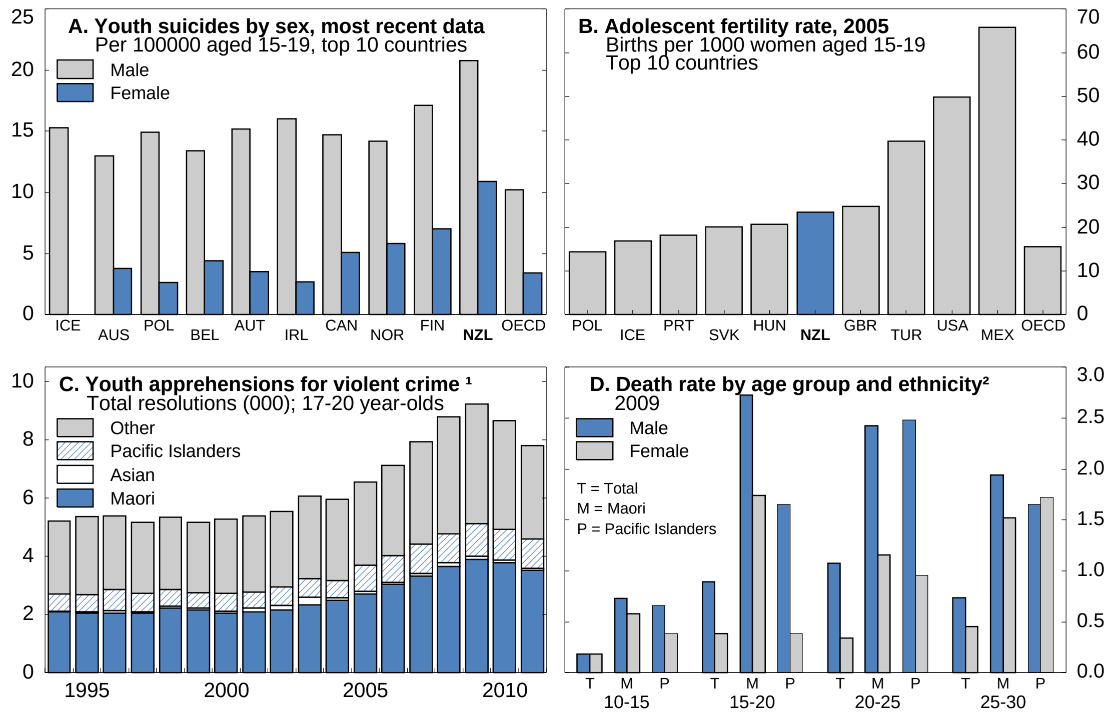
1. 2002 for Austria and Ireland, 2003 for Estonia, Finland and Slovenia, 2004 for New Zealand.

Source: OECD (2012), *Education at a Glance* and OECD estimates from National Labour Force Surveys.

How to read this figure: NEET denotes persons neither in education nor in employment or training. Because of distortions implied by school holidays, yearly data are represented by Q1 for all OECD countries except Australia and New Zealand, for which May and Q2, respectively, are used.

Youth (and overall) employment problems have a strong ethnic dimension (Figure 23, Panel B). Maori and Pacific Islanders have suffered disproportionately since the start of the recession, reflecting their generally lower educational attainment. Their incidence of NEET is likewise much higher, and nearly one-third of working-age Maori live on benefits (Nusche et al, 2012). The lack of attachment to work is associated with poor mental and physical health and risky youth behaviours (Figure 25). As these minorities account for one-third of the school population and their population shares are set to grow, it is essential to more fully develop their human capital, both for the sake of New Zealand's future growth potential and for basic social cohesion.

Figure 25. **Youth social indicators**



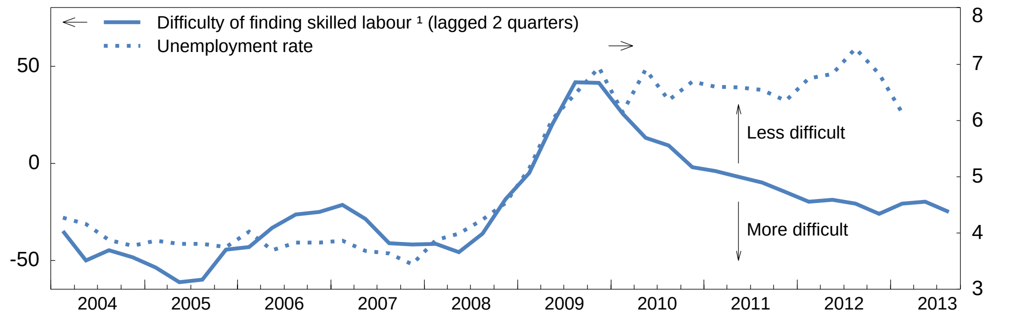
1. Apprehension statistics give the number of apprehensions of offenders and how such apprehensions were resolved. An apprehension means that a person has been identified by police as the offender and, where appropriate, dealt with in some manner, such as warned, prosecuted, referred to youth justice family group conference, or diverted. Violent crime includes homicide and related offences, acts intended to cause injury, sexual assault and related offences, dangerous or negligent acts endangering persons, abduction, harassment and other related offences against a person, robbery, extortion and related offences.
2. Percentage of deaths in the corresponding population.

Source: Ministry of Health, Statistics New Zealand and OECD (2009), *Doing better for children*.

Skill shortages

New Zealand's unemployment rate rose sharply in 2009 and has remained high since, albeit moderating in early 2013. Historically, labour-market slack has acted to ease skills shortages as employers find it much easier to recruit needed skills from the pool of unemployed, or from people changing jobs. However, since 2009, businesses have had increasing difficulties in finding skilled workers even though higher unemployment has largely persisted (Figure 26). Such a shift in the relationship between unemployment and the number of vacancies has occurred in a number of other OECD countries (Hobijn and Sahin, 2012). In New Zealand's case, it could reflect that the Canterbury earthquakes and subsequent start of rebuilding have caused a major change in the patterns of labour demand and supply (Craigie et al., 2012). Also, there has been a sharp fall in job turnover since the recession.

Figure 26. **Recent divergence between unemployment and ease of finding skilled labour**



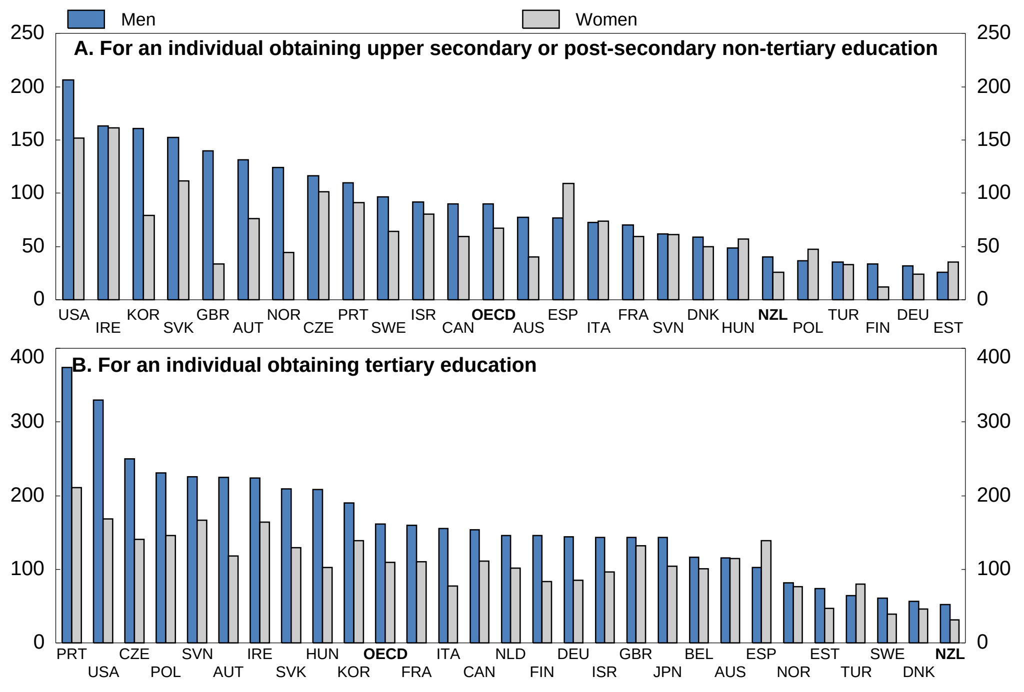
1. Negative figures mean employers finding it difficult exceed those who say it is easy.

Source: Department of Labour; NZIER, Quarterly Survey of Business Opinion and OECD Economic Outlook 93 database.

Market returns to education, as estimated by the OECD, are low in New Zealand (Figure 27). This could reflect quality problems in education and consequent insufficiency of useful skills. However, part of the gap is attributable to other factors, for example the mix of tertiary qualifications, with a large number of sub-degree and fewer post-graduate qualifications, and the unusually large number of post-secondary, non-tertiary qualifications (ISCED level 4) resulting in overqualification of many employees in jobs

Figure 27. **Market returns to education are comparatively low[1]**

Private net present value of education, 2008[1], thousand USD converted using PPPs for GDP



1. Or latest available year.

Source: OECD, *Education at a glance 2012*, Tables A9.1 and A9.3.

normally requiring only an upper secondary education (Quintini, 2011). Furthermore, foreign entrants (typically from Asia) may have high qualifications on paper, but often exhibit job mismatch and lower earnings in the first 5 to 10 years, reducing apparent returns to education through a mis-measurement effect (Zuccollo et al., 2013). Finally, employers' demand for skills is complementary to their productivity-enhancing investments to exploit profitable market opportunities, and a lack of these may lower the returns to skills.

Businesses unable to find the skills they need on the market can choose to train existing or new employees. However, in theory, employers may underinvest in training because they cannot fully capture the returns to skills that may prove useful to others. Wage subsidies to industry training may be justified if such externalities exist. International evidence suggests that this externality may be especially problematic in the case of youth apprenticeships, where rival firms may "poach" recently trained apprentices to reap the benefit of competitors' heavy investments, although in New Zealand this is unclear.

Education challenges

The government is responding to the dual problem of rising youth joblessness and growing skills shortages. "Downstream" solutions, notably the Youth Services for NEETs, emphasise a shift toward education and training-based activation policies for vulnerable youth. But "upstream" solutions, involving reforms to formal education to keep youth engaged in schooling and invest them with market-relevant skills, are better.

System performance

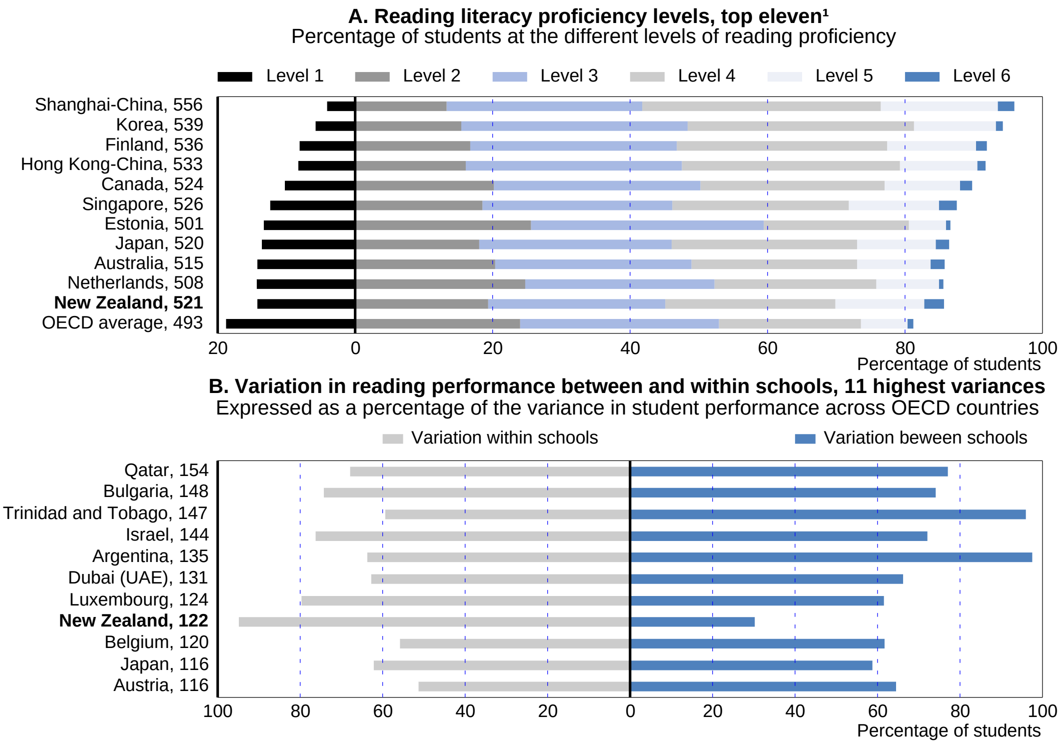
The NZ education system's performance appears to be one of the OECD's best. Tertiary attainment rates, for example, are the fifth highest. Although university attainment is more modest, younger cohorts are increasingly choosing university over vocational-track programmes, which were more popular 20 years ago. As to scholastic achievement, New Zealand ranks 11th among 65 jurisdictions according to PISA reading scores, the focus of the 2009 study (Figure 28, Panel A). It does similarly well in PISA scores for maths and science literacy, albeit somewhat worse for these subjects in the TIMSS study (IEA, 2012a and 2012b). Such results suggest that the school system is doing much that is right.

However, inequality in education outcomes is substantial. The within school variance of PISA scores is the highest in the PISA sample (Figure 28, Panel B), and there is a long "tail" of underachievers. School drop-out rates are among the OECD's highest (Table 5). Furthermore, there is strong intergenerational persistence: tertiary students are more likely to have highly educated parents than in any other OECD country (OECD, 2012b), and PISA scores are very sensitive to socio economic background. While ethnicity does not explain the entire problem of excessive socio-economic gaps, ethnic disparities in education mirror those in the labour market. Among the population lacking school qualifications, Maori have nearly double the incidence of people lacking school qualifications as Pakeha/Europeans and quadruple those of Asians, and conversely they show much lower rates of tertiary attainment. Whereas Maori and Pacific Islander tertiary attainment rates have been rising, they are not catching up to those of other ethnicities (Chapter 2).

School reform

NZ schooling is one of the most innovative in the OECD. Reforms in the late 1980s heavily devolved governance, management and pedagogy all the way to the individual school level. Schools thus enjoy autonomy in many respects, but are accountable to parents via elected boards of trustees. Assessments of schools, teachers and students stress teacher-student interaction and personal responsibility in the learning process, while downplaying standardised testing. These settings produce flexibility and experimentation in learning environments, where students can be better motivated and thrive. The practice of separating students by ability (streaming) at secondary level may have reinforced marginalisation of those who are less academically inclined (Smyth and McCoy, 2011), however, though it is partly related to very low grade repetition rates, considered by the OECD to be appropriate.

Figure 28. **PISA results for New Zealand are characterised by high means but high dispersion as well**



Note: The data near the country name are the reading score for Panel A and the total variance as a proportion of the OECD variance for Panel B.

1. Countries are ranked in descending order of the percentage of students at levels 2, 3, 4, 5 and 6.

Source: OECD (2010), PISA 2009 results: *What students know and can do – Student Performance in Reading, Mathematics and Science* (Volume 1) and *Overcoming Social Background* (Volume II).

A key objective must be to make the system work better for students at risk of dropping out. Indeed, the extremely high within-school PISA score dispersion indicates that even greater efforts are necessary to adapt education to the needs of highly diverse learners. This emphasises the value of high-quality teaching. A recent OECD report noted that teacher assessment is variable, linkages between teacher assessment and professional development are weak and there does not seem to be a clear career pathway for effective teachers (Nusche et al., 2012). These issues should be addressed, including by professional development of leaders and boards themselves. Teacher training geared to difficult learners should likewise be stepped up.

Schools may be hampered in their ability to deliver quality and innovate by continuing central control over personnel and capital budgets, which limits their flexibility to distribute resources in line with school needs. This suggests the desirability of devolving funding for an even greater share of overall school costs, thereby providing budgetary room for manoeuvre to meet student needs. It is furthermore unclear whether current mechanisms for targeting resources to disadvantaged students are effective. Schools are often hamstrung in their ability to attract and retain good teachers in disadvantaged areas or to devote sufficient resources to teaching disadvantaged students more generally. Given the high impact of socio-economic status on student achievement, this problem warrants further attention.

The system's fragmented structure moreover limits opportunities for learner and teacher networking, scale efficiencies and specialisation, while burdening leaders with excessive administrative duties and limiting competition in their selection. Incentives and opportunities should therefore be provided to encourage greater collaboration and clustering among schools.

Early childhood education (ECE) can help to overcome initial disadvantages. Substantial resources have been put into ECE in recent years, and there is a strong regulatory framework that supports high quality ECE. Culturally appropriate centres such as *te kohanga reo* and Pasifika language nests are part of the ECE landscape in New Zealand. Nevertheless, participation rates of Maori and Pacific children – who need it most – are lagging. Parental engagement is key to rectifying this situation, and some home instruction programmes have been shown to improve parental demand for ECE (BarHava et al., 1999). Some poorer areas suffer from a dearth of ECE capacity, however.

The government has set targets for reduced drop-out rates and backed them up by novel pathways for non-academically inclined learners to stay engaged and progress to tertiary studies (see below). It should also consider obligating learning – defined as being either in education, training or work while continuing to engage in study toward qualifications – up to age 18 (from 16 currently), as the United Kingdom is doing. Research shows that the "stick" of compulsion can help students to stay the course when temptations to quit abound (Chapter 2).

Education-work interface

Vocational education and training (VET) can play a central role in preparing youth for work, developing skills and meeting labour-market needs (OECD, 2010b). The NZ Youth Guarantee gives students who have either dropped out or are at risk a chance to continue with their studies toward minimum job-market qualifications in a tertiary setting, notably via the new Trades Academies, with stronger links to the world of work. Another programme, Vocational Pathways, brings together the standards and skills recommended by businesses and links them to study and employment possibilities. By making VET more relevant and accessible, these measures can improve options in an otherwise academically focused system for young people who learn better in an applied context.

Prior to the recession, industry training and apprenticeship programmes expanded significantly. However, all in-work training is costly, requiring equipment, close supervision and mentoring. Previous attempts have suffered from lack of money and uneven quality, while completion rates were very low. Encouragingly, the government has announced an expansion of funding designed to lift quality and increase the number of apprenticeships (Key, 2013). Businesses also need to make financial commitments, since they derive major benefits from successful apprenticeships. Unions should be involved too to protect apprentices' rights and help monitor programme quality. Quality apprenticeships should have a strong training component, resulting in new competencies. They should be flexible, encouraging a wide range of skills and adaptability for the changing needs of the knowledge economy, as NZ apprenticeships generally do.

The links between tertiary education and firms need to be strengthened. There already appear to be incentives for this to happen. Under a qualifications review, employer/industry representatives are involved with tertiary institutions in curriculum setting and rationalising the confusing plethora of qualifications (NZQA, 2013). A review of careers information, advice, guidance and education (CIAGE) is also underway (ERO, 2012). Sectoral reports are being published indicating career options and employment outcomes (MBIE, 2003), helping students with study choices. Such careers education should be embedded in the curriculum and made available to all secondary and tertiary students to inform them accurately of labour-market needs and train them to manage their own careers as an ongoing skill.

Box 5. **Recommendations for improving the school-to-work transition**

Pre-school and school: reducing drop-outs

- Ensure greater ECE participation by children from disadvantaged backgrounds by increasing incentives for suppliers to enter into areas of low provision and for demand from parents to increase.
- Provide incentives and opportunities to amalgamate and cluster fragmented school networks so as to achieve efficiencies and educational benefits.
- Devolve funding for a greater share of overall school costs, including teacher pay, providing schools with greater flexibility to allocate resources and maximise performance.
- Review current mechanisms for targeting resources to students of low socioeconomic background.
- Consider mandating learning (in-work or formal education) up to age 18 while improving relevance of curricula for disaffected students. Make greater efforts to keep such students in mainstream education.

Tertiary education for jobs

- Strengthen the quality of apprenticeships, by facilitating participation by disadvantaged youth, improving quality assurance, and ensuring funding adequacy and enhanced accountability for outcomes.
- Make education job-relevant by strategic planning (with involvement of business and labour), geared to likely market needs for different skills.
- Improve the quality of careers guidance at secondary and tertiary education levels through specialised professional development, networking with employers and clear links to school curricula.
- Increase tertiary sector responsiveness to labour market needs by information provision to students, formalising linkages between providers and employers, and directing funding to projected areas of skills shortfall.

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Annex

Progress in structural reform

This Annex reviews actions taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed at the end of the relevant chapter.

Recommendations	Action taken since previous *Survey* (April 2011)
LABOUR MARKETS AND SOCIAL PROGRAMMES	
Loosen restrictions on fixed-term contracts, especially for older workers.	No action taken.
POLICY MARKETS COMPETITION	
Clarify the responsibilities of ministries and regulators, particularly in telecoms and transport, to ensure independence. Increase the use of periodic reviews, sunset clauses and commit to minimising regulatory burden. Periodically assess the impact of independent regulators on the markets they regulate.	The Treasury has conducted and published a review of all major regulatory regimes against its Best Practice Regulation Principles. Ministers have set new expectations for departments' regulatory stewardship, including monitoring and assessing at regular intervals regulatory regimes' fitness for purpose. Result 9 of the Better Public Services Programme commits the government to developing faster online services and key performance ratings similar to leading private-sector firms, and reducing business costs from dealing with government by 25% by 2017.
Abolish the government's "Kiwi share" in Telecom. Make coverage obligations contestable by other telecommunications companies and technologically neutral.	The government has brought forward a wide ranging review of the Telecommunications Act, including the Telecommunications Service Obligation.
Use Regulatory Impact Assessments (RIAs) more consistently and rigorously in forming regulation.	Two independent evaluations have been made of samples of RIAs from across government to assess departmental performance with respect to RIAs and quality assurance, with results used for continued training and guidance.
Pass a suitably refined Regulatory Responsibility Act, and refine the "principles of reasonable regulation" that requires minimal interpretation by the courts.	Ministers have agreed to introduce legislation requiring disclosures to assess the extent to which regulatory expectations have been met, significant features or powers have been conferred, and costs, possible economic losses, and likely levels of compliance and enforcement realised.
Authorise the Commerce Commission to use a wider range of interventions to resolve cases more quickly. Expand the use of ex post evaluations of Commission decisions to assess performance. Enhance cooperation with the Commission's Australian counterpart.	The Commerce (International Co-operation, and Fees) Amendment Act was passed in 2012 to facilitate cooperation between the NZ Commerce Commission and the Australian Competition and Consumer Commission.
Move towards privatisation of SOEs.	The government will sell minority shares in four energy companies and Air New Zealand.
Remove all remaining tariffs and Zespri's export monopoly on kiwifruit.	No action taken.

Recommendations	Action taken since previous *Survey* (April 2011)
INNOVATION AND BUSINESS CREATION	
Foster a closer integration of education, immigration and labour-market policies with innovation policies.	No action taken.
Tie public R&D funding to private-sector funding. Ensure business R&D incentives work in concert with different R&D support programmes.	The Government recently established Callaghan Innovation to improve the transfer of knowledge, know-how and technology to firms and connect businesses accessing those grants with other publicly funded R&D activity.
Expand foreign-credentials recognition to a larger number of countries and facilitate residency acquisition for foreign students after graduation.	No action taken
TAXATION	
Eliminate the double-taxation of trans-Tasman profits distributed to shareholders by continuing to work towards agreement with Australia on mutual recognition of imputation and franking credits for foreign investment.	A joint Australia-New Zealand Productivity Commissions study was completed on the trans-Tasman relationship, which included analysis of mutual recognition of imputation credits.
Realign corporate, capital and top marginal income tax rates, or reduce capital income tax rates.	No action taken
Introduce a comprehensive realisation-based capital gains tax, or tax only the real portion of interest income, or move to an exempt-exempt-taxed (EET) system. Limit the tax deductibility of losses from rental property investments by allowing them to be offset against future rental income.	No action taken.
Introduce a property or land tax based on land value per hectare, and scale the tax rate by the owner's marginal income tax rate. Remove local rate differentials across residential, commercial and rural properties.	No action taken.
DEEPENING FINANCIAL MARKETS	
Ensure there is a streamlined regulatory framework that requires firms offering collective investment instruments to have appropriate governance structures with sufficiently stringent requirements for trustees to make sure that they are capable of discharging their duties.	The several Acts defining governance requirements for managed investment schemes will be replaced with a single governance regime, the Financial Markets Conduct Bill, for retail managed investment schemes. It will require a licensed external supervisor and for all managers of managed investment schemes to be licensed.
Adopt a more rigorous approach to disclosure requirements for fees and expenses for collective investment instruments so as to enhance transparency and allow for easier comparability across products.	The KiwiSaver (Periodic Disclosure) Regulations 2013 will require schemes to provide periodic reports on fund performance, fees, asset allocation, conflicts of interest and other matters using standardised calculation methods and disclosure statement templates, by 1 July 2013. The Financial Markets Conduct Bill will require managed investment schemes to produce shorter and simpler disclosures for investors that ease comparisons between products.
OVERCOMING GEOGRAPHIC DISADVANTAGES	
Facilitate maritime trade by cutting the time taken and documents needed to clear customs. Implement a single electronic window for different permits and authorisations.	A Joint Border Management System which includes an electronic Trade Single Window, is in final stages of development and expected to be fully operational sometime in 2013.
Consider reducing local government ownership of port assets to bring more market discipline to the sector.	No action taken.

Recommendations	Action taken since previous *Survey* (April 2011)
HEALTH CARE REFORM	
Give sufficient spending autonomy to DHBs, including responsibility for maternity and disability spending. Decentralise wage bargaining to allow the DHBs the flexibility to innovate.	The Ministry of Health retains responsibility for most maternity and disability support spending. Some primary health organisations (PHOs) have been given budget holding for additional services (e.g. community radiology). DHBs as employers determine their wage bargaining approach, within state sector guidelines.
Use economic criteria to examine opportunity costs of alternative allocations of the marginal health-care dollar.	A Capital Investment Committee has been established to assess major capital proposals. The National Health Committee (NHC) was appointed in 2011 to use evidence to prioritise new and existing health interventions, focusing on cost effectiveness and sustainability. The NHC has started a programme to identify areas of high expenditure and/or rapid growth and to prioritise new investments.
Evaluate whether government ownership of public hospitals, or outsourcing hospital management to an independent agency might help resolve DHB conflicts of interest and stimulate cost consciousness, efficiency and competition in the hospital sector.	No action taken.
Allow capitation payment to better "follow the patient", eliminating restrictions on access to such payments by individual physicians and practices.	No action taken.
Consider a role for wider private health-insurance coverage, with appropriate regulation and/or taxation.	No action taken.
Reduce the proportion of GP reimbursement paid by capitation while keeping a modest level of out-of-pocket fees. Set PHO patient fees in line with budget holding obligations, with full or partial reimbursement by the DHB contingent on patient outcomes.	The government is introducing changes designed to strengthen and improve performance in primary care, including a better performance management framework, increased performance funding for PHOs and practices and increased access to flexible funding.
Embed DRG payments within a hospital budget-holding approach following a points system. Publish comparisons of track records across individual hospitals. Determine doctors' salaries within the budget envelope set by output-based payment system.	DHBs are responsible for determining hospital funding, and can use DRGs in setting funding levels. DRG case weights are used to inform pricing where DHBs purchase services from one another, and where the Accident Compensation and Rehabilitation Corporation (ACC) purchases services from public hospitals. DHBs (but not individual hospitals) are benchmarked as part of their reporting against national health targets. There is also a focus on reducing duplication of audit and contracting requirements across NGOs.
HOUSING MARKETS	
Treat KiwiSaver withdrawals for first-home purchases as interest-bearing loans or limit them to low-income members.	No action taken.
Begin regular tenancy re-assessments for all occupants of state housing, accompanied by increased efforts to help tenants achieve financial independence and self-sufficiency.	First steps have been taken. Three-year reviewable tenancies have been applied to all new tenants since 1 July 2011.
Evaluate whether state housing tenants requiring more permanent housing provision such as the elderly and disabled may benefit from placement in specialised long-term housing facilities better catered to their needs.	No action taken.
Remove water rate subsidies to tenants paying market rents.	No action taken.

Recommendations	Action taken since previous *Survey* (April 2011)
Adopt spatial planning systems for all urban areas, and reform the Resource Management Act (RMA) to better incorporate urban development needs.	The RMA is currently being reformed to include new principles for RMA decision-makers to consider the effective functioning of the built environment and the availability of land for urban expansion, use and development. Councils intend to consolidate the three or more existing documents in their district into one within five years to improve planning for issues currently spread across areas/jurisdictions.
Re-evaluate Metropolitan Urban Limits (MULs), and assess social, economic and environmental costs and benefits. Establish a comprehensive framework to value land based on cost-benefit analyses of alternative uses. Increase use of pricing mechanisms to influence the location of development (e.g. financial contributions, road user charges, congestion tolls), and improve public transit services.	Auckland Council is in the process of defining a rural urban boundary (RUB) to ensure it has 30 years supply of greenfield land for residential and business growth. The RUB will replace the MULs and is being widely consulted on.
Distribute the cost of infrastructure through higher user fees on those benefitting from its services.	No action taken.
GREEN GROWTH	
Improve horizontal and vertical co-ordination of sustainable development policy. Central government should set national environmental standards and provide national policy statements and technical training for local authorities.	The Discussion Document on Resource Management Act reform released 27 February 2013 includes proposals to increase the ability of government to give national direction on these matters.
Ensure the Environmental Protection Authority (EPA) has sufficient independence and analytical capacity to oversee environmental policies.	The EPA was established as a stand-alone Crown Agent on 1 July 2011, with an independent Board. Under the Resource Management Act the EPA has the authority to make decisions on proposals of national significance, through an independent Board of Inquiry process.
Amend the RMA to integrate urban and rural land- and water-use planning and to facilitate the possible uses of market-based instruments. Enforce the RMA's requirement to consider the costs and benefits of alternative policies.	Draft legislation currently being considered by Parliament increases the specificity required in cost-benefit analyses.
Improve the measurement of water abstraction and quality via evolving national guidelines. Implement water charging for domestic, industrial and agricultural uses.	The Resource Management (Measurement and Reporting of Water Takes) Regulations 2010 introduced metering requirements to be phased in from 2012-16. By 2016, meters will cover 98% of all consented takes (which excludes domestic use and stock drinking water). Water permit holders must provide records to regional councils from 30 June 2013. The Government has just released a proposed package of reforms to the freshwater management system, including a National Objectives Framework to assist regional councils in setting limits for water quantity and quality; regulations requiring consistent accounting for water takes and discharges; and guidance on good management practice and water-use efficiency. Charging for reticulated water supply and wastewater disposal is currently undertaken in Auckland.

Recommendations	Action taken since previous *Survey* (April 2011)
Allow water consents to be tradable. Apply pollution-rights trading to address water and air pollution, with no free rights for newcomers.	The proposed RMA reform will consider ways for making transfer and trade of freshwater consents easier and less costly, including by using separate permits for water take and use and the development of standard trading platforms. The Bay of Plenty Regional Council is designing a nutrient trading scheme for the Rotorua Lakes. Recent changes to the Resource Management (National Environmental Standards for Air Quality) Regulations 2004 require that new industries be permitted to discharge only if they reduce emissions from other sources to prevent overall emissions from increasing.
Discontinue free emissions permit allocations to new entrants into protected EITE sectors.	No action taken.
Provide incentives under the ETS to create permanent carbon sinks, by protecting indigenous forest plantings and wetlands reclamation. Maintain afforestation grant schemes.	The government has extended the funding for the East Coast Afforestation Grant Scheme to 2020.
Investigate and promote innovations (e.g. smart metering, pastoral missions mitigation technology) proven to enhance responsiveness to ETS price signals.	In 2012, the Cabinet agreed to a work programme exploring complementary measures, in addition to the ETS to promote long-term emissions reductions.

Chapter summaries

Chapter 1. Policies to support sustainable long-term growth in New Zealand

As its workforce ages and major economies shift towards producing higher value-added goods and services, New Zealand will face increasing challenges to remain globally competitive and maintain high living standards. Future growth will need to come increasingly from productivity gains, and resources will have to shift towards activities that rely more on skills, technology and intangible assets. Strengthening international linkages will be crucial to overcoming geographic disadvantages and will require improvements in the information and communications technology infrastructure, together with innovation leveraged off the country's strong primary industry knowledge base. Continuing to raise skill levels and the pensionable age will also help counter the effects of ageing. Lifting national saving, partly by targeting a higher public saving rate, will reduce the persistently high relative real interest rates and the sustained overvaluation of the real exchange rate, which potentially harm economic activity. To improve the sustainability of growth, revenues from non-renewable resource extraction need to be invested for the benefit of future generations and greater efforts devoted to mitigate the damage to natural capital from economic activity, particularly with respect to water quality.

Chapter 2. Improving school-to-work transitions

The NZ labour market is among the most flexible in the OECD, and outcomes for its young people have been among the best. However, labour-market opportunities are heavily determined by initial education, where New Zealand's system is also successful and innovative in many ways. Average PISA results are among the OECD's highest, but the dispersion of performance is also high, indicating a sizable group of underachievers. Those in disadvantaged groups tend to have poor scholastic outcomes. These initial educational handicaps show up in higher drop-out rates and youth joblessness, greatly limiting these youths' future life chances. Indeed, intergenerational persistence in educational and employment outcomes appears very high. From both a social and economic point of view, it will be essential to develop more fully the human capital of the fast growing demographic group of ethnic minorities. Better teaching quality is needed, with more attention devoted to diversity of student needs and learning approaches to keep children in school. A related problem is the apparently large divergence between the nature of skills supplied by the education sector and the skills demanded by employers. A greater role for youth apprenticeships could help to raise skill levels while aligning them better to the economy's needs. All this has an important bearing on the government's ambition to secure strong and sustainable growth with rising living standards and equal opportunities for all.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of New Zealand were reviewed by the Committee on 23 April 2013. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 14 May 2013.

The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee and Calista Cheung under the supervision of Peter Jarrett. Research and editorial assistance was provided by Françoise Correia.

The previous Survey of New Zealand was issued in April 2011.

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