

# Productivity Commission Briefing to the Incoming Minister December 2016

21 December 2016

## Functions of the Productivity Commission

The Productivity Commission is an independent Crown entity established by the New Zealand Productivity Commission Act 2010 to “provide advice to the Government on improving productivity in a way that is directed to supporting the overall well-being of New Zealanders, having regard to a wide range of communities of interest and population groups in New Zealand society” (s 7).

As described in the Act, the Commission’s functions are:

- to undertake inquiries into productivity-related matters as assigned to it by referring Ministers
- to undertake and publish research about productivity-related matters
- to promote public understanding of productivity-related matters
- to act independently in performing its functions and duties.

## The Commission’s value

The Commission aims to provide evidence-based, high quality analysis and advice about issues with a productivity dimension. Its comparative advantage in doing this rests on a number of factors:

- It has a dedicated focus on its inquiries and research, undistracted by operational demands that can crowd out future-focused work. It can build and incorporate a body of knowledge through its research and inquiry functions which add to understandings of New Zealand’s productivity challenge.
- It can work across the silos of government agencies and policy portfolios in a way that core agencies struggle to achieve.
- It is able to commit to deep engagement processes with key stakeholders as a neutral party in complex matters where core agencies are often constrained in how deeply they can engage. Integral to deep engagement is our ability to publish submissions in almost all cases and promote dialogue and engagement across stakeholder groups as well as between them and the Commission.
- Its independence allows the Commission to raise or comment on matters that core government agencies might feel constrained to engage on, or to avoid or downplay.

- It has built a pool of people with a mix of professional backgrounds and disciplines, bringing high quality quantitative and qualitative analytical skills to bear on the complex issues assigned to it.
- It has a commitment to commissioning and publishing substantial peer reviews of its work, together with the results of independent focus group evaluations of processes and products.

## Work programme

### Inquiries

Ministers choose the topics to be assigned to the Commission, subject to consultation with the Commission on the Terms of Reference. The Commission has now completed eight inquiries<sup>1</sup> with two more nearing completion. Our most recently completed were *Using land for housing* (October 2015) and *More effective social services* (September 2015).

It has become standard practice for the Government to formally respond to the Commission's recommendations in due course. The Commission welcomes this practice. To date, the Government has formally responded to six of our eight completed inquiries. We understand a response to the *More effective social services* inquiry is due shortly leaving only the *Boosting productivity in the services sector inquiry* of June 2014 without a formal Government response.

### Active inquiries

The two inquiries nearing completion are:

Inquiry	Referring Ministers	Terms of Reference received	Issues paper released	Draft report released	Final report delivered to Ministers
Urban planning	Minister of Finance, Minister of Local Government, Minister for Building and Housing, Minister for the Environment, Minister of Transport	1 November 2015	9 December 2015	19 August 2016	Mid February 2017
New models of tertiary education	Minister of Finance, Minister for Tertiary Education, Skills and Employment	1 November 2015	24 February 2016	29 September 2016	End February 2017

<sup>1</sup> Inquiries completed to date:  
 Using land for housing (2015)  
 More effective social services (2015)  
 Regulatory institutions and practices (2014)  
 Boosting services sector productivity (2014)  
 Local government regulation (2013)  
 Trans-Tasman joint study (2012)  
 Housing affordability (2012)  
 International freight transport services (2012)

The Commission delivers each final inquiry report to referring Ministers. Under the Act, the responsible Minister is required to table the final report in Parliament as soon as is practicable.

## Research

The Commission's research function is oriented towards enhancing understanding of the underpinning influences on New Zealand's productivity performance. This diagnostic feeds into our policy positions and forward-looking research agenda. Our capacity in this work is small (limited to 12.5% of total budget, fully costed – ie, about \$625,000 pa including fully costed overheads).

Our focus in this area has been on using quantitative analysis to build an evidence base, with a strong emphasis on exploring the insights to be found in Statistics NZ's firm-level Longitudinal Business Database (LBD).

The LBD is the firm-level equivalent of the person-centric part of the IDI now being drawn on to underpin the investment approach to social services. As funding allows, we would like to build on our strong start in this area to enhance public sector capability in using firm-level analysis in policymaking and evaluation.

Given our leadership role in productivity research and limited research funding we have established and Chair the Productivity Hub. This is a cross-agency initiative focused on better coordinating and energising productivity-related research. In conjunction with our core Hub partners (Treasury, MBIE, and Statistics NZ) the Commission has developed a collaborative research agenda to support better understandings of productivity issues. The Hub partners have had a substantial research contract with Motu to access its deep technical expertise and have actively built research networks with other parties such as the OECD and selected academics here and abroad.

There is also increasing interest and engagement from other government agencies and private sector groups – notably Xero who are interested in how their own firm level database can be included in the sort of analysis being undertaken by Hub partners using the LBD.

## Promoting understanding

The Commission has an active communications programme to promote understanding of productivity issues. Much of this is built around our inquiry work, but we also engage heavily with universities, professional groups and general community groups who have an interest in our work.

## Resourcing

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

This overall funding level has remained flat in nominal terms since the Commission's establishment in 2011.

We employ people with diverse experience and skills enabling them to contribute to the wide range of inquiry topics that may be assigned to us. Those in-house skills and experience are supplemented, inquiry-by-inquiry, with secondments from relevant agencies, fixed-term contractors and use of

specialist consultants able to bring deep technical knowledge and experience where required. We also make use of student interns, particularly over the summer period. Across all those options, the Commission employs about 17 to 20 people, depending on where we are in our inquiry cycles.

## Board of the Productivity Commission

The Productivity Commission is governed by a board of three or four members. Currently there are three:

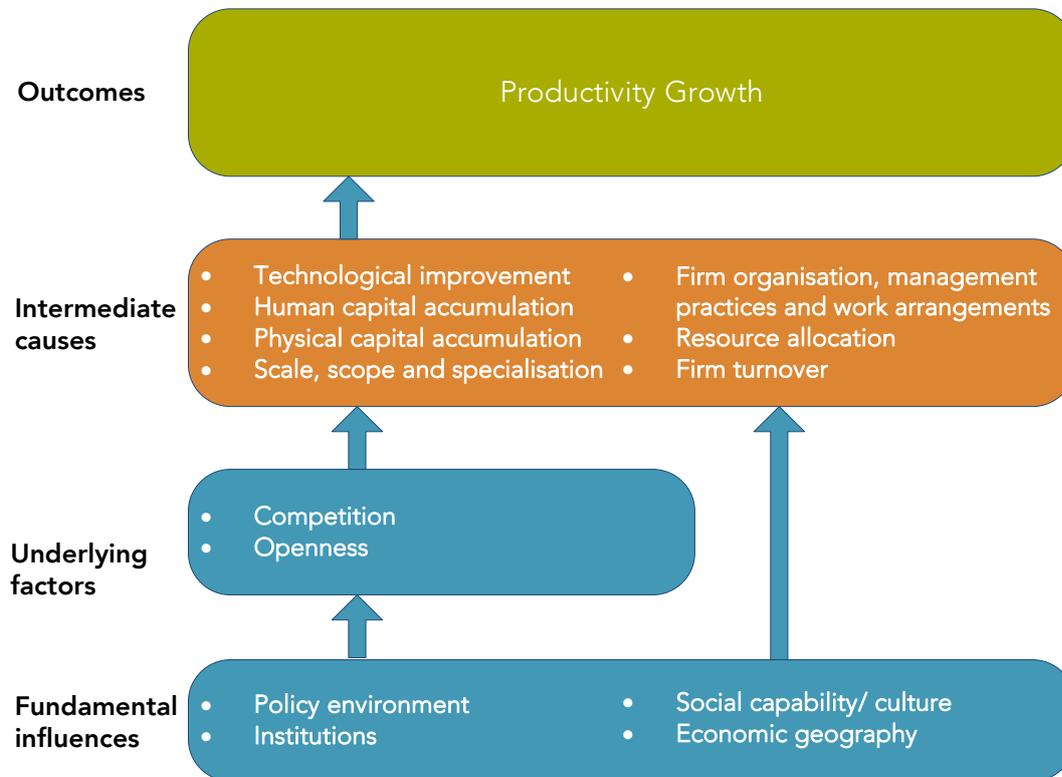
- Murray Sherwin CNZM, Chair – former Chief Executive and Director General of the Ministry of Agriculture and Forestry; former Deputy Governor of the Reserve Bank of New Zealand. Mr Sherwin’s term expires on 30 January 2021.
- Professor Sally Davenport – Professor of Management at Victoria Business School researching and teaching on innovation, productivity and entrepreneurship. Professor Davenport’s term expires on 31 March 2017.
- Dr Graham Scott CB – public sector reform consultant, former Chair of the Health Funding Authority and former Secretary of the Treasury. Dr Scott’s term expires on 31 March 2019.

## Our productivity framework

Productivity is the essential driver of increasing incomes, greater wellbeing and, importantly, widening the range of options available to all New Zealanders. At one level, the concept is readily understood – essentially, it describes the process of extracting more value from each unit of input in a production process. The spectacular exemplars of the enhanced productivity process in modern times are captured in computing by Moore’s law, with each generation of smaller, cheaper and more energy efficient devices providing exponentially greater processing capacity than the previous generation.

At another level, the productivity concept is quite slippery, with substantial technical challenges inherent in attempting to measure productivity performance, identify and quantify the factors responsible for that performance and identifying policy changes that will drive improvements. The chart below provides a summary schema of the factors we think of as primary influences on national productivity performance. It is a fairly standard international framework, adapted from one used by our Australian colleagues.

Figure 1: Productivity framework



New Zealand's productivity challenges first became evident in the 1950s. They emerged under two key influences. Firstly, New Zealand was attempting to build a manufacturing sector in order to reduce its reliance on primary products and lay the base for a more "modern" industrial society. Escaping from the instability induced by volatile and declining terms of trade was a key consideration in this drive to industrialise. But new industries, most notably motor vehicles and consumer electronics, required very high levels of border protection to survive. The industries were inherently negative value-adding – in that the incremental value of their output (at world prices) did not cover the costs of inputs such as component parts, capital employed and labour costs. The impact of that negative value add on aggregate productivity was exacerbated by the impact on otherwise viable industries – especially agriculture - which lost international competitiveness as a consequence of the increased costs and lower quality of locally-produced inputs.

Secondly, New Zealand had progressively become more ambitious in what it could achieve through public sector interventions, particularly in social programmes. A growing public sector inevitably means a growing share of the economy which is not subject to the usual disciplines of competition and financial accountability which the private sector faces.

That's not to say that a smaller public sector is essential to a more productive economy. There are small economies, most notably some of the Scandinavians, which have larger public sectors than ours and experience higher aggregate productivity levels. But it does mean that we need to maintain a sharp eye on the scope of public sector activities, their efficiency and effectiveness of delivery and on promoting innovation in service delivery in systems that are inherently risk averse and innovation-light.

On the back of the wrenching reforms of the 1980s, the 1990s saw a sizable step up in New Zealand's productivity levels. However, since the millennium, productivity growth has continued to lag our usual international benchmarks.

While productivity may have lagged, through the global financial crisis (GFC) and since, New Zealand's aggregate GDP growth and average per capita income growth has been relatively strong. That has occurred on the back of improved terms of trade and strong growth in labour force participation – an indication of the importance of a well-functioning and flexible labour market. But continued increases in hours worked per person above already high levels, and continued increases in the terms of trade will be difficult. As those sources of income growth approach their likely limits, enhanced productivity growth becomes increasingly important.

New Zealand is not alone in its productivity challenges. Many of the more advanced economies have experienced a pronounced slowdown in productivity performance post GFC. Even in the USA, there is evidence that a sharp productivity performance gap is emerging, with just a few industries in quite small defined regions providing most of the growth, while large parts of the country settle into a lower performance norm.

There are no easy or obvious paths to higher productivity. Rather, this is a matter of persistent and widespread actions and decisions, moving in small increments wherever we see opportunity to push the myriad of underlying influences on productivity in the direction of higher living standards. It was with that thought in mind that the architects of the Commission put such emphasis on the role of inquiries. These were intended as deep dives into areas where specific obstacles to improved productivity could be identified and remedied.

Across the economy, decisions are taken daily on where to invest, where to spend, what to regulate and how. All of those decisions reflect the incentives faced by the decision-makers and shape the future performance of the economy. Each of those decisions is taken within a mental model of what the expected outcomes will be. Our challenge is to add evidence and information to increase the visibility of the productivity consequences and opportunities of those decisions and consequently to lift their positive impact.

This is not the setting to rehearse the full range of factors that shape New Zealand's performance. Figure 1 captures at a high level the key influences. We know that on many dimensions, New Zealand provides a strong platform for high performance, most notably around quality of institutions and related factors. It is also the case that the combination of being very small and very isolated makes a difference to the sorts of industries that emerge and flourish here. Increasingly, connections with global value chains and networks of knowledge capital matter.

A long standing issue for New Zealand has been the different behaviours in what we can refer to as the exposed and sheltered sectors, with the internationally exposed sector having to relentlessly drive efficiency and productivity to survive while the sheltered or domestically-oriented sectors do not face the same disciplines. Promoting openness to trade and competition across the widest possible sweep of the economy is a key consideration in many of our policy choices.

## Conclusion

The Commission looks forward to providing you with our reports into *Urban planning* and *New models of tertiary education* in February 2017. We would also welcome an early opportunity to discuss with you our future work programmes and how we can bring greatest value to the task of enhancing the wellbeing of New Zealanders through higher productivity.