

Productivity Commission Submission on Possible Inquiry Topics

16 February 2018

Criteria and prioritisation

The Treasury has called for nominations for the next inquiry topics for the Productivity Commission. The Minister of Finance has previously approved criteria against which nominations for inquiry topics could be assessed. These were to:

- Use the Commission's unique position as an independent agency with high quality analytical ability and a focus on public engagement;
- Have the potential to deliver practical policy recommendations to improve productivity and support the overall wellbeing of New Zealanders; and
- Require a substantial degree of analysis to resolve a complex set of issues.

The Productivity Commission has considered a range of topics against these criteria and our priority topics are below. This prioritisation reflects the criteria above and our judgement of the potential benefits from building on previous inquiries. While it is important to remain flexible and open to new and emerging issues, previous inquiries may raise important policy questions suitable for further investigation. Inquiries also represent a significant investment in the Commission's expertise and networks in particular areas. Building on previous inquiries could allow the Government to maximise its return on this investment.

The suggested topics also reflect our assessment of New Zealand's productivity challenge. The Commission's inquiry and research functions are together building a significant body of knowledge with a dedicated focus on productivity. This work is important as New Zealand does not have a typical economy and so simply applying the same recipes that are used overseas to boost productivity growth may not work here. Insights from this work point to a number of potential inquiry topics, which we have then assessed against the criteria above.

At our discussion in December 2017 you noted an interest in pursuing in-depth work within the broad theme of 'technological change and productivity'. It is likely you will receive topic submissions that traverse this area. While we haven't prepared detailed topic briefs within this theme we have included some thoughts later in this note on key areas related to 'technological change and productivity' that could form the basis of more in-depth research work or inquiries by the Commission or that may assist you in narrowing or prioritizing topic nominations received via the current process.

Summary of inquiry topic proposals

Proposals for three possible topics are included in this note and are summarised below. These draw on a mixture of new topics and older ones which continue to be relevant (and which have been updated to reflect recent research). A short description of each proposed topic is below:

The economic impact of migration and population growth

This inquiry would examine the impacts of migration and population growth on New Zealand's productivity, growth in income per capita and overall economic wellbeing. Recommendations would be made on the ways in which current migration policy settings can be enhanced. The inquiry would also identify legislative and other impediments preventing New Zealand from realizing productivity gains from migration and population growth.

Towards an innovative and sustainable health system

This inquiry would examine the various institutional components of the health system and how they interact and relate to each other. It would identify the fundamental drivers of rising health care costs and the avenues available to government to improve the fiscal sustainability of the system. Current governance and funding arrangements within the system would be assessed and recommendations made on ways to improve and promote greater efficiency, access and quality of health care. The inquiry would identify ways of encouraging innovation and facilitating the spread of more productive approaches to delivering health care services, particularly for those not well served by current arrangements. The extent to which regulatory and institutional arrangements can accommodate new models of health care delivery would also be assessed and recommendations made (where applicable) for changes that would facilitate the uptake of new models of care.

Local government funding and financing

This inquiry would examine the adequacy and efficiency of the existing local government funding and financing framework. It would make recommendations on whether additional revenue-raising tools are needed for local authorities and what changes, if any, are needed in central government's approach to funding and financing local government. Changes in the governance and oversight of local authority revenue-raising and expenditure needed to accompany new or different tools, and the transition to an enhanced model would also be investigated.

The Commission has discussed this topic with the Department of Internal Affairs and we understand that the Department is preparing its own topic proposal in this area for consideration.

The economic impact of migration and population growth

Background & context

Migration has played a critical role in shaping New Zealand's society and economy. As a policy issue, migration is seen as significant in the context of an ageing population, the supply of skills and the prospects for economic growth, as well as for its social and environmental impacts.

The various ways or channels through which migration and population growth might influence growth in productivity and income per capita include:

- **In the labour market:** labour supply, and the skill composition of the workforce, wages, and capital intensity.
- **Infrastructure:** demand for housing and other social and economic infrastructure.
- **Macroeconomic impact:** possible impacts on aggregate demand, interest rates, and the exchange rate.
- **Fiscal:** demand for government services, transfer payments and taxation.
- **Agglomeration effects:** size economies and competition.
- **International connection and technology diffusion:** international trade, technology transfer and innovation.

Some of these factors contribute positively, others negatively. The overall outcome depends on the sum of the contributions and is essentially an empirical matter (although the effects of migration can be difficult to measure).

The key drivers of the economic effects of migration are the level of migration relative to the size of the population and the differences between migrants and the existing resident population.

- The level of migration. The flow of migrants at any point in time matters because of absorptive capacity — the capacity of the market and non-market sectors to respond to the increased demand for goods and services induced by migration and population growth.
- The mix of migration. Younger and more skilled immigrants are best placed to make a positive economic contribution to New Zealand. These types of migrants may provide a demographic dividend by increasing the proportion of people in the workforce, thus reducing the negative impacts associated with an ageing population. Yet young migrants eventually age themselves. Skilled migrants may enhance productivity by filling skill shortages, introducing new technologies, innovating and facilitating international trade and investment links with their countries of origin.

A key question is whether current migration policy settings are set at the right level and mix to deliver the best outcomes for the New Zealand community over the longer term. This question needs to be posed against some of the key challenges that New Zealand faces – slow productivity growth, an ageing population and environmental degradation. It also needs to be put in the context of some major changes in global migration patterns (such as much greater diversity in source countries, destination countries and the frequency and duration of migrants' movements). Reductions in travel costs and advances in information technology have also led to a substantial increase in the level of migration, especially for short-term working holidays or education.

Scope

The inquiry would examine the impacts that migration and population growth have on New Zealand's productivity, growth in income per capita and overall economic wellbeing. Specifically:

- the nature of international migration flows, and the factors driving migration trends
- the impact of skilled, semi-skilled and low-skilled migration on the New Zealand labour force
- the effects of migration and population growth on New Zealand's productivity, and growth in income per capita on average and across different economic and social groups
- the mechanisms through which the impacts of migration on productivity and economic wellbeing are transmitted

The inquiry would make recommendations on:

- the ways the current migration policy settings can be enhanced leading to improvements in productivity and growth in income per capita
- removing legislative and other impediments preventing New Zealand from realising productivity gains from migration and population growth.

In examining these issues, the Commission will consider the impacts on the income, wealth and living standards of New Zealand citizens as well as on the budgets and balance sheets of the New Zealand government. In looking at options for the selection of migrants, the inquiry will take into account New Zealand's humanitarian commitments and other international responsibilities and obligations to foreign residents.

Towards an innovative and sustainable health system

Background & context

The health system has delivered increased life expectancy and improved health for New Zealanders. A study by Tobias and Yea (2009) estimated that a third of the dramatic gain in life expectancy between 1981 and 2004 could be attributed to a decline in amenable mortality.¹ Tobias and Yea (2009) also found that one quarter of the disparity in mortality rates between subgroups of the population were due to causes of death that are amenable to health care intervention. This indicates that improvement in access to, and quality of, health care for disadvantaged groups could substantively reduce health inequalities.

Increased life expectancy and improved health has, however, been accompanied by steeply rising health care costs. Tobias and Yea (2009) note “[h]ealth expenditure has risen steeply over the past two or three decades in most of the established market economies, both in absolute terms and as a proportion of gross domestic product (GDP)” and “[t]his has generated concern about health system efficiency and motivated efforts to reform national health systems so as to raise productivity”.

The increasing demand for health care services and rising costs is placing pressure on the long-term fiscal sustainability of New Zealand’s health system. In 2015, health care accounted for 6.2% of New Zealand’s GDP. If historical spending patterns continue, Treasury projects health care will consume 8.3% of GDP by 2045 (Treasury 2016). Further, there is growing concern about equitable access to health care; nearly 30% of New Zealanders report they are unable to access timely primary health care (Downs, 2017).

Opportunities to make the health system more flexible and responsive to the needs of New Zealanders undoubtedly exist. These opportunities could improve both the efficiency of the health system and the outcomes it delivers for individuals and communities. For example, through earlier intervention and better management of long-term health problems, the primary health care system has the potential to moderate the future rate of increase in health expenditure (Mays & Blick, NZ Treasury, 2008).

The Minister of Health has also stressed the opportunities to “better use our highly-qualified health workforce, [so] health professionals [can] work smarter and use all their training and expertise to improve people’s health” (David Clark, speech, 2018). Transformative technologies also have the potential to fundamentally change the way patients interact with health care professionals, enabling New Zealanders to play a more proactive role in managing their own health care.

However, there are questions about the ability of the current system to accommodate new approaches to health care or to stimulate and spread new ideas. Many of these questions stem from the design of the system and how different components of the system interact with each other. This inquiry would unpack these issues and to explore opportunities to make New Zealand’s health system more fiscally sustainable, equitable and responsive to the needs of communities.

Scope

- Outline and explain the various components of the health system and how they interact and relate to each other and identify the fundamental drivers of rising health care costs and the avenues available to government to manage the fiscal sustainability of the health system.
- Explore current governance and funding arrangements within the health system and recommend improvements that would promote the efficiency, access and quality of health care in New Zealand.

¹ Amenable mortality refers to deaths from diseases, such as diabetes, that are potentially preventable with effective and timely health care.

- Identify measures to encourage innovation within the health system and the spread of cost-effective ways of delivering health care services to New Zealanders – particularly for those not well served by current arrangements.
- Examine the extent to which regulatory and institutional arrangements can accommodate new models of health care delivery and make recommendations (where applicable) for changes that would facilitate the uptake of new models of care.

References

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New Zealand Treasury (2016). He Tohanga Mokopuna: 2016 Statement of the long-term fiscal position. Retrieved 9 February 2018 from www.treasury.govt.nz/government/longterm/fiscalposition/2016/he-tirohanga-mokopuna/ltfs-16-htm.pdf

Local government funding and financing

Background & context

Local government aims to enable “democratic local decision-making and action by, and on behalf of, communities” and meet “the current and future needs of communities for good-quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost-effective for households and businesses” [section 10 (1), Local Government Act 2002].

Reflecting these important roles, local government makes a considerable direct contribution to the economy. In June 2016, councils collectively owned \$112 billion worth of fixed assets, employed over 25,000 full-time equivalent staff, had annual operating expenditure of \$9.3 billion and operating income of \$8.9 billion.

Figure 1: Local authority operating revenue sources, June 2016

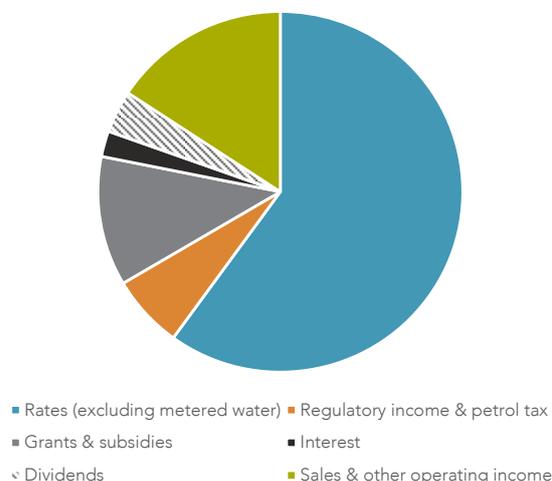
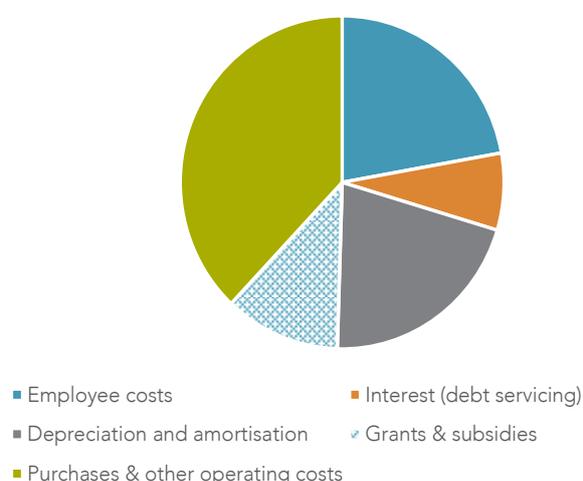


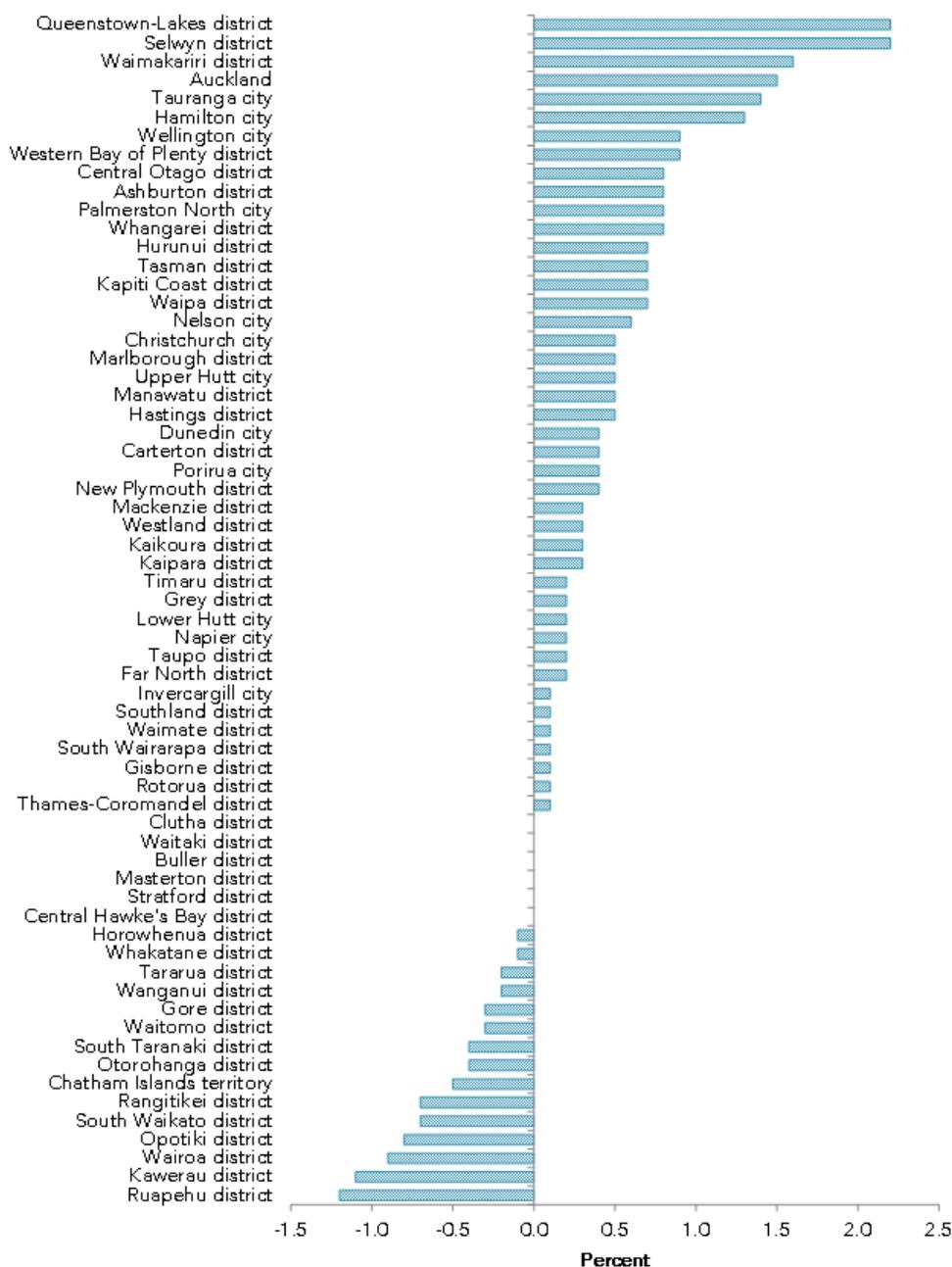
Figure 2: Local authority operating expenditure, June 2016



The costs of, and pressures facing, local government have increased in recent years:

- Between June 2007 and 2016, total council operating revenue increased by 54%, and revenue from rates grew by 60%. Consumer prices over the same period rose by only 18%.
- Individual local authorities face dramatically different demographic futures (Figure 3). This has implications for their ability to raise revenue.

Figure 3: Projected average annual population growth by territorial authority, 2006-2031



- For fast-growing areas, there are rising expectations that city and district councils will increase the supply of development capacity to address declining housing affordability, yet a number of local authorities argue that they are reaching the limits of their ability to finance this growth. Councils currently rely very heavily on one funding mechanism (rates) which creates economic inefficiencies, and councils lack access to funding and financing tools available to similar bodies overseas.
- In addition to the need to extend the road and sewer networks to respond to growth, existing assets will need to be replaced at the end of their useful lives. Recent reviews have suggested that there may be a gap between the planned funding and the spending needed for replacement of around \$6-7 billion (OAG, 2014) Funding asset replacement is a particular challenge for local authorities with low or negative population growth.

- Other investigations have found that the relationship between central and local government is often poor, and that there are capability gaps in both levels of government (NZPC, 2013).

Recognising these issues, the Labour and New Zealand First Coalition Agreement contained a commitment to 'hold a public inquiry "A decade after Shand" to investigate the drivers of local government costs and its revenue base'.

Scope

The inquiry would examine the adequacy and efficiency of the existing local government funding and financing framework, drawing upon the public finance literature on fiscal decentralisation. Specifically:

- the ability of the current funding and financing model for councils to deliver on the expectations of local communities and central government;
- how well the current model promotes responsiveness, efficiency, equity, and quality spending choices;
- the advantages and disadvantages of other potential funding and financing tools, not currently available to New Zealand local authorities.

The inquiry would consider and make recommendations on:

- whether additional funding and financing tools are needed for local authorities;
- what changes, if any, are needed in central government's funding and financing towards local government;
- what changes, if any, are needed in the governance and oversight of local authority revenue-raising and expenditure to accompany new or different funding and financing tools; and
- how the transition to a new funding and financing model could be managed.

In examining these issues, the Commission will consider:

- the distributional impacts of any changes to the funding and financing frameworks;
- the varying circumstances of individual local authorities and their ability to effectively implement new funding and financing tools;
- the desirability of having a national taxation and public revenue system that is coherent and efficient; and
- lessons learned from recent changes to local government structures, roles and funding/financing systems in New Zealand (e.g., the emergence of Auckland Council) and from other jurisdictions.

Possible topics on technological change and productivity

New technology has the potential to improve New Zealand's lacklustre productivity performance and aspects of everyday life. However, there are a number of challenges associated with the current wave of technology, including a risk that the benefits are unevenly distributed. So policies to encourage the use of technology need to also encourage a wide dispersion of the benefits.

The Commission could do an overarching inquiry on whether regulatory and institutional settings are fit for purpose given rapid technological change. It would cover a lot of ground and aim to improve coordination across different policy areas. However, breadth would come at the expense of depth and we may be better off focusing on more specific aspects of this policy challenge as identified in the list of ideas below.

Embracing technology at the firm level

The uptake of new technologies does not happen automatically. Very few New Zealand firms operate at the global technological frontier in their industry and there are long tails of low-tech firms. So an inquiry in the broad area of technology use by firms could focus on encouraging innovation and commercialisation by leading firms or on the diffusion of new technology across lagging firms. Potential topics include:

Improving the science and innovation system. This inquiry could assess how the science and innovation systems work together to lift firm productivity. Because innovation and international connection go hand-in-hand, it could also consider policies to encourage internationalisation. Is there scope for greater policy coherence across these areas?

Financing investment in knowledge based capital. Knowledge based assets are tricky to finance and there are indications that our financial system struggles to direct funding towards innovative start-ups. An inquiry in this space might include work on the impact of financial constraints on firm performance and access to private-sector funding for innovation.

The foreign investment regime. This inquiry could assess whether New Zealand's foreign investment regime maximises the contribution of multinationals to the New Zealand economy. For example, it could assess policies aimed at encouraging successful knowledge spill-overs from multinationals to domestic firms.

Addressing inequality via improvements in labour market regulation

Adjusting to technology shocks is disruptive for workers and can increase income inequality by amplifying the talent and luck of a relatively small group of individuals. There are ways in which policy can mitigate the impact of new technology on inequality stemming from the labour market. Potential inquiry topics in this area include:

Skills. Ensuring that the skills system is operating well enough to "win the race between skills and technology" is the most effective way of spreading the gains from innovation. This is a major challenge for New Zealand. This inquiry would build on our recent tertiary inquiry and investigate improvements in the education and skill systems to ensure as many people as possible benefit from new technology.

Active labour market policies. Technological change can generate large job and worker flows across and within industries. While an important source of productivity growth, this can imply significant

costs for workers. New Zealand spends very little on programmes designed to help people deal with these changes, suggesting that active labour market policies could be significantly strengthened. This inquiry would investigate these issues.

Occupational licensing. Excessive occupational regulation may increase income inequality by excluding people from high-wage occupations. An inquiry into occupational licensing could assess the extent to which new technological such as Blockchain reduce the need for restrictive licensing regimes relative to the benefits of consumer protection.

Spreading the gains of new technology across space

New technology can lead to sharp divisions in the geographic areas that benefit from changing technology versus those that don't. Rapid technological change implies a risk to regional development in that second-tier cities and regions could increasingly become centres for low-productivity/low-wage activity. **An inquiry into regional development** could assess policy initiatives aimed at improving the productivity in New Zealand's poorer-performing regions. This inquiry could build on the Commission's current research project on "spatial productivity" that aims to improve our understanding of the drivers of productivity in second tier cities.