Briefing to the Incoming Minister of Finance

Medium-term economic challenges

2008

THE TREASURY
Kaitohutohu Kaupapa Rawa

CONTENTS

EXECUTIVE SUMMARY

This briefing discusses New Zealand's medium-term economic outlook. In the immediate future, international economic conditions will be dominated by events in the financial sector and their aftermath. The full impact of this instability on the real economy remains uncertain. We have prepared updated forecasts and advice on how you might respond to the current downturn. While the immediate circumstances will test us, New Zealand's success will be measured by how we use the opportunities they present to lift our medium-term economic performance and to raise New Zealand's living standards as better economic conditions emerge.

BUSINESS PRODUCTIVITY AND INCOME LEVELS

New Zealanders aspire to have living standards among the best in the world. Achieving this aspiration will require long-term commitment to raising our incomes and improving economic growth. The key to achieving this is higher productivity growth. Our businesses are operating in a rapidly changing world, which will affect their ability to increase productivity. These changes will also raise new challenges for the Government in developing policy and managing the public sector. Significant trends include:

- globalisation
- international integration
- technology change
- natural resources pressures
- demographic changes and increasing expectations on the state.

Taken together, these trends will create a very different economic environment in the medium term. New Zealand's economic growth depends on how well our businesses can adapt to the new world. The challenge for the Government is how well it can anticipate and respond to these challenges, and create an environment where businesses can take advantage of the opportunities. A strategy that relies on marginal adjustment to current policies over time is unlikely to address the significant challenges New Zealand faces.

POLICY DIRECTIONS FOR GROWTH

In light of these trends, our assessment is that the following broad directions would help to achieve higher productivity and improve living standards:

- maintaining a stable economic environment that supports economic adjustment
- making New Zealand more connected to the world economy
- creating a business environment that encourages enterprise and investment
- increasing the contribution from skills to productivity and opportunity
- improving the management of natural resources
- enhancing the effectiveness and efficiency of the public sector
- making progress towards a sustainable fiscal position.

The Treasury's advice on policy direction in each area is identified below. These policy directions are deliberately medium term but not without urgency, particularly where decisions made now will affect the economic performance for years to come. The contribution they make to productivity is discussed in the body of the report.

MAINTAINING ECONOMIC STABILITY

- Past macroeconomic policies have put New Zealand in a reasonably strong position to weather economic shocks.
- Significant fiscal stimulus is already in train, and tax and spending should be allowed to adjust as the economy slows. In the medium-term, fiscal consolidation will be needed.
- Temporary government guarantees should maintain confidence in the financial system, but our frameworks for financial stability will require strengthening.
- Some of the structural policies identified below aim to improve economic growth, but should also help prevent the build-up of vulnerabilities in future economic cycles.

MAKING NEW ZEALAND MORE CONNECTED TO THE WORLD ECONOMY

- Pursue a long-term agenda to make New Zealand an integral part of the developing Asia-Pacific regional economic market.
- Reduce remaining barriers at the border to inward investment and trade.
- Maintain momentum on improving market access through multilateral, plurilateral and bilateral forums.
- Ensure domestic policy settings facilitate strong international links and make New Zealand an attractive environment to work, invest and do business.

A BUSINESS ENVIRONMENT THAT ENCOURAGES ENTERPRISE AND INVESTMENT

Tax and regulation

- Shift taxes from bases that are internationally mobile and lower growth (labour and capital) to tax bases that are less mobile and less damaging to productivity growth (consumption and land) over time.
- Equalise rates of tax on different forms of investment, including capital gains, to improve savings and investment.
- Ensure average tax rates on corporate income don't get too far out of alignment with other countries and so encourage businesses to locate and invest in New Zealand.
- Strengthen systems to ensure the quality of new regulation and support effective executive and parliamentary decision-making and review of regulations.
- As the first step in an ongoing programme, review the impact of: (i) the Resource Management Act 1991; (ii) Hazardous Substances and New Organisms Act 1996; (iii) labour market regulations.

Institutions, innovation, investment and infrastructure

- Improve decision-making on public investment across infrastructure priorities and maintain a stable environment for investment.
- Re-orientate the innovation system to be more firm-facing and reduce fragmentation of policy and programmes.
- Continue to support KiwiSaver with some changes to improve its cost-effectiveness.

THE CONTRIBUTION FROM SKILLS TO PRODUCTIVITY AND OPPORTUNITY

- Improve participation in quality early childhood education for children from disadvantaged backgrounds.
- Shift spending in compulsory education from investment with low returns (such as lower student-teacher ratios) to high returns (such as improved accountability for student achievement and development of teaching practice).
- Shift tertiary sector investment towards courses with better labour market outcomes and above average completion rates.
- Encourage participation in the labour market by skilled older workers and parents.

MANAGEMENT OF NATURAL RESOURCES

- Negotiate an equitable international climate change commitment for New Zealand that recognises our unique emissions profile and adopt domestic policies that meet this target at least cost.
- The Emissions Trading Scheme (ETS) is sound, but improvements would include revenue neutrality, allowing the use of all Kyoto-compliant emissions units and removing other mitigation policies now superseded by the ETS.
- Develop mechanisms for allocating water rights and usage to their most efficient use.

EFFECTIVENESS AND EFFICIENCY OF THE PUBLIC SECTOR

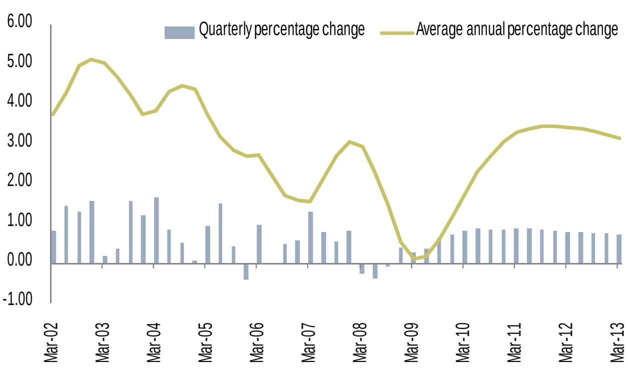
- Ensure government priorities drive the public service through clear communication and accountability.
- Strengthen mechanisms for assessing performance, such as the quality of performance information, and ex-post monitoring and accountability.
- Adapt successful processes undertaken overseas to review areas of government spending that require particular attention.
- In the short term, make fiscal saving in order to manage within spending set out in the current fiscal strategy and pursue new priorities.

A SUSTAINABLE FISCAL POSITION

- Signal in advance how policy may need to adjust to ensure fiscal expenditure remains sustainable and allows individuals time to adjust.
- Maintain a level of government savings which over time keeps gross debt at around 20% and provides for contributions to the New Zealand Superannuation Fund.
- Moderate expenditure growth in key spending areas, such as health and justice, which will require better performance and productivity in large expenditure areas.
- Long-term changes in the tax structure identified above will help ensure the sustainability of tax base.

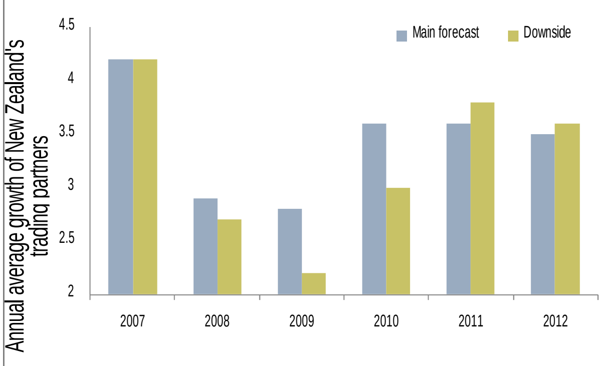
Economic outlook: Growth has slowed sharply in New Zealand and our trading partners

Real GDP growth: Pre-election update



Source: Treasury Pre-election Economic and Fiscal Update

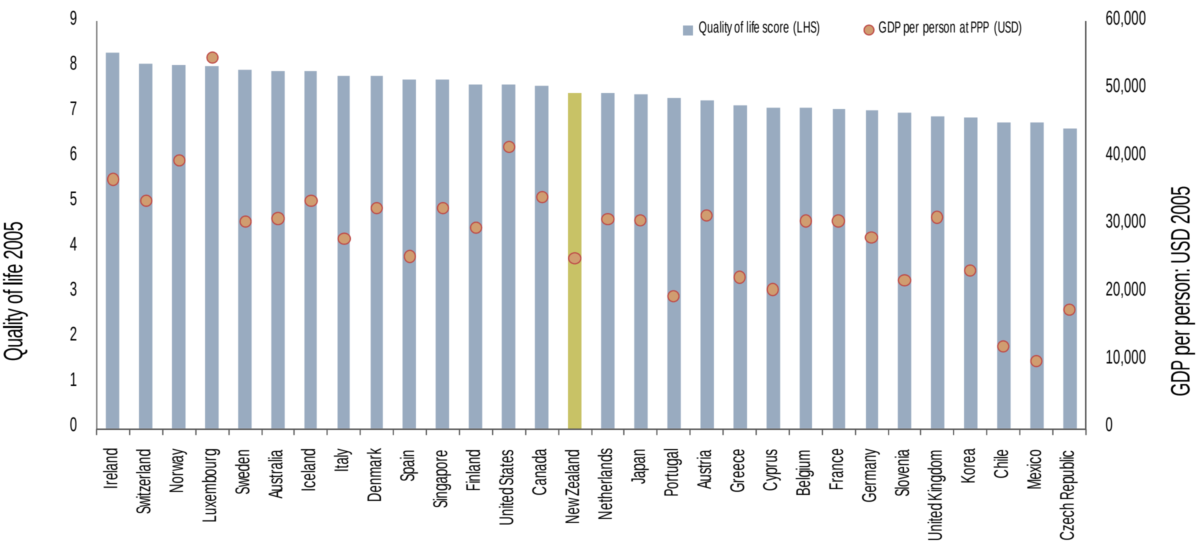
Trading partner growth: downside scenario



Sources: Treasury and Consensus Economics

New Zealand ranks higher on relative measures of quality of life than GDP per capita

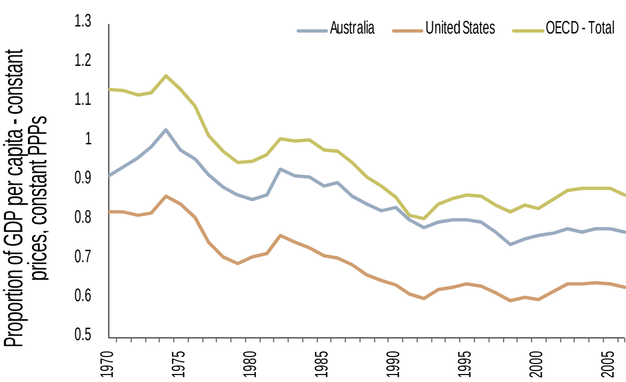
Quality of life and per capita GDP



Source: Economist Intelligence Unit

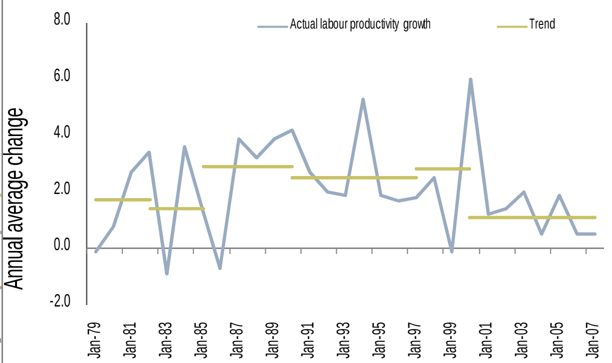
Over the past 15 years the gaps in relative GDP per capita have not narrowed and productivity growth in the measured sector has slowed

New Zealand's GDP per capita as a proportion of selected OECD countries



Source: OECD

Productivity growth in the measured sector



Source: Statistics New Zealand

MEDIUM-TERM ECONOMIC CHALLENGES

INTRODUCTION

This briefing sets out a short assessment on what the Government can do to ensure New Zealanders will have world-class opportunities and incomes into the medium term. The advice reflects the Treasury's perspective as your economic and financial advisor.

THIS BRIEFING DISCUSSES NEW ZEALAND'S MEDIUM-TERM ECONOMIC OUTLOOK

New Zealand's economic fortunes are tied to those of the world economy. In the immediate future, international economic conditions will be dominated by events in the financial sector and their aftermath. The instability of global financial markets has required radical policy responses to stabilise financial systems. The full impact of this instability on economic activity remains uncertain, but a key factor will be the speed with which stability returns to financial markets. Economic growth has already weakened significantly around the world accompanied by substantial losses in wealth. These international developments are hitting New Zealand at a time when the domestic economy has slowed and an extended period of fiscal deficits is projected. The international financial situation has also highlighted the vulnerability associated with New Zealand's very high level of external private debt.

Managing the economy through the immediate pressures will be a critical focus in the early days of your newly formed administration. At the same time it will be important to maintain a focus on the medium-term policy direction, to ensure New Zealand continues to improve its economic performance. The policy challenges and directions identified in this report that aim to raise medium-term economic performance will remain critical even if the economic situation worsens further in the short term. For example, lower growth for a more extended period of time would make the current difficult fiscal position more acute, making it more pressing to improve public sector performance and address long-term fiscal challenges.

WHILE THE CURRENT ECONOMIC SITUATION IS EXTREMELY CHALLENGING, THE FOCUS NEED TO REMAIN ON LIFTING THE MEDIUM-TERM ECONOMIC PERFORMANCE

This briefing aims to assist you to look beyond short-term pressures to the medium-term environment for growth and productivity. We have also separately updated projections of the economic and fiscal situation, and in light of this are ready to advise on advancing your more immediate policy priorities and responses to the rapidly evolving financial stability risks.

New Zealand's growth story is a productivity story. For our workers and businesses to have world-class opportunities and incomes, our businesses need to make the most of the potential in our people, our ideas and our natural environment. There are profound changes occurring globally and domestically that are transforming the way business is done and the types of products and services in demand. These trends offer New Zealand opportunities for better economic performance if we position ourselves to take advantage of them. However, making the changes needed to position ourselves will be challenging. There are some significant implications for our policy settings if government is to provide an environment in which businesses and individuals participate fully in the new world. If we do not make these changes New Zealand risks a gradual decline in our relative living standards.

This briefing discusses:

1 The centrality of business productivity to our living standards
2 The opportunities and challenges New Zealand will face over the next five to 15 years
3 How well positioned New Zealand currently is to respond to these changes
4 Broad policy directions that would improve New Zealand's productivity over the medium term.

1 BUSINESS PRODUCTIVITY AND INCOME LEVELS

New Zealanders aspire to living standards that compare with the best in the world. Whether we can achieve them will be determined largely by our economic performance. While we already enjoy high levels of non-income elements of living standards such as quality of life and life satisfaction, our incomes remain 30% to 40% lower than those of the leading OECD countries.

NEW ZEALANDERS ASPIRE TO HAVE LIVING STANDARDS THAT COMPARE WITH THE BEST IN THE WORLD

Lower per capita incomes ultimately constrain the wider factors that contribute to living standards: the quality and quantity of available goods and services, the quality of public services, the quality of the environment, the degree of economic security and the choices and opportunities available to all New Zealanders.

ECONOMIC PERFORMANCE UNDERPINS THE WIDE RANGE OF FACTORS THAT INFLUENCE OUR LIVING STANDARDS

Many of the issues identified here will improve the quality of people's lives directly as well as improving the environment for business. Charting a path through the current economic uncertainties will provide New Zealanders with greater security, while increasing the value-for-money of public services will improve social outcomes such as health and education. But further increases in our relative living standards will require a long-term commitment to raising our incomes and improving economic growth.

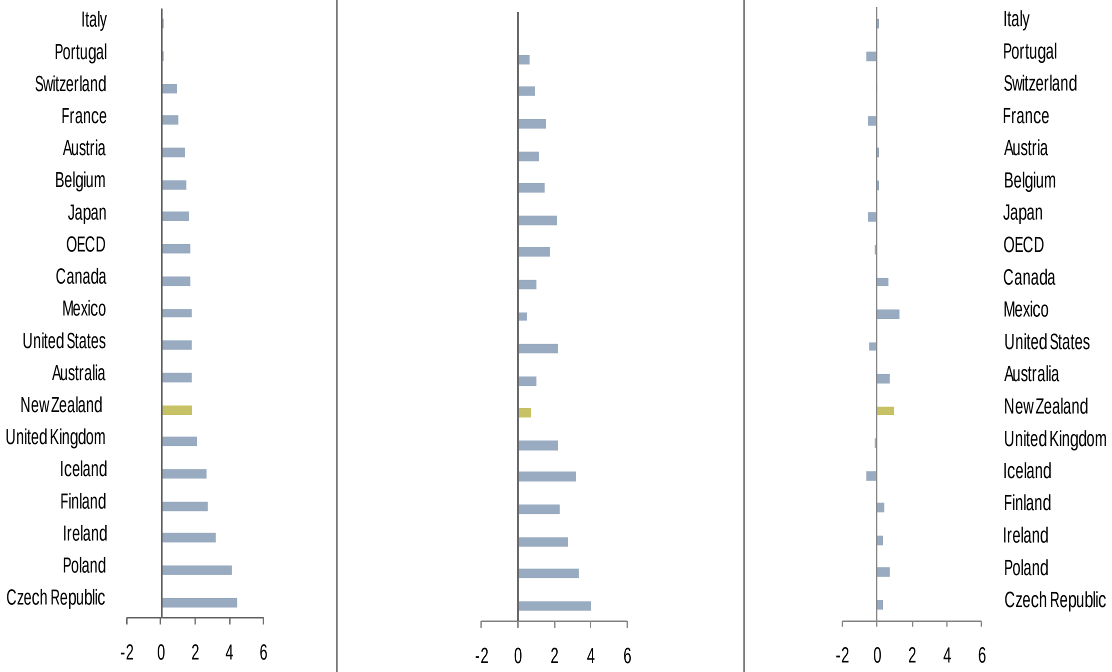
The difference between our incomes and those of the leading OECD countries primarily reflects our economy's productive capacity – how effective our businesses are at combining labour and capital – and the prices of what we produce. Higher productivity means producing more value with the same amount of labour – being smarter about bringing together people, equipment and ideas to develop products and services.

In the mid-1990s New Zealand's level of labour productivity was in the lower half of the OECD. Most other countries that were also in the bottom half of OECD have narrowed the gap in labour productivity over the past 10 years. New Zealand has not. The growth in New Zealand's relative income per capita has been largely supported by increasing participation in work. In future, further gains to growth from this source will be constrained by high average labour force participation, population ageing and slower labour force growth.

THE MOST IMPORTANT CONSTRAINT TO HIGHER ECONOMIC GROWTH IS NEW ZEALAND'S LOW PRODUCTIVITY LEVEL

Increases in hours worked rather than productivity has contributed the bulk of New Zealand's economic growth

Growth in GDP per capita (2001-2006)	= Growth in GDP per hour worked	+ Growth in hours worked



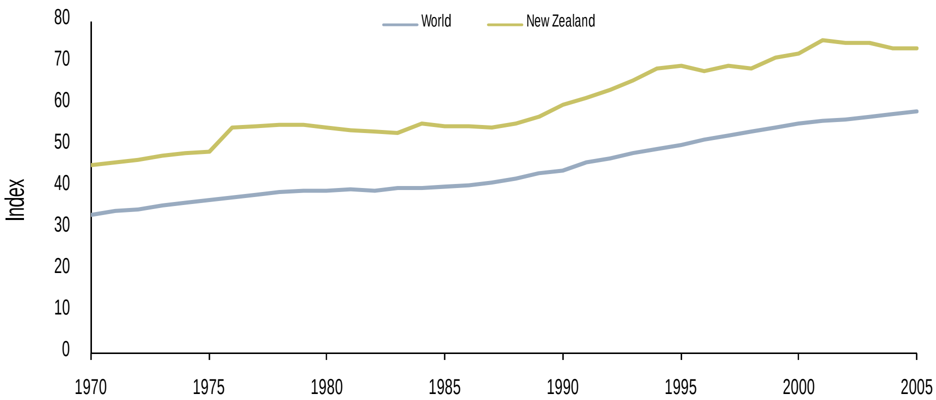
Source: OECD

Source: OECD

Source: OECD

Globalisation: Since the 1970s there has been a steady rise in economic links between countries

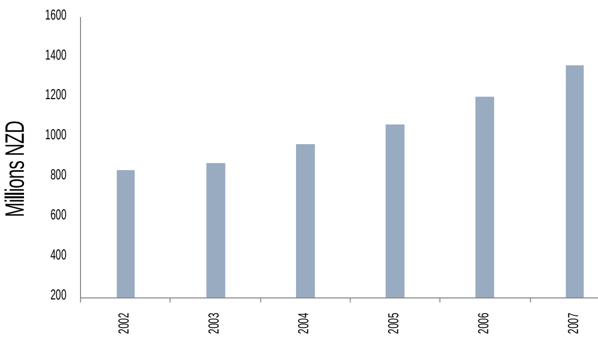
KOF Index of Globalisation



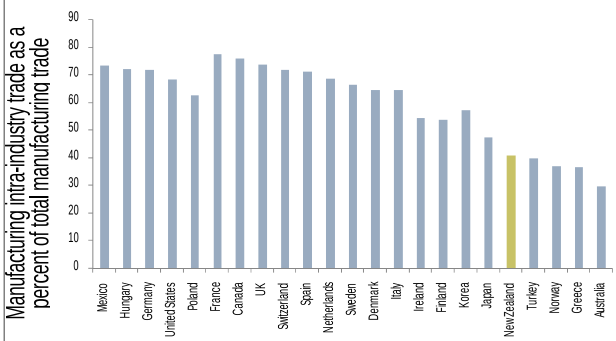
Source: Swiss Federal Institute of Technology

International integration: Imports of previously untraded services are increasing and manufacturing trade is becoming more integrated across countries

Import of Business Services (eg, includes legal, accounting, engineering)	Intra-industry trade (selected OECD countries)



Source: Statistics New Zealand



Source: OECD Economic Outlook 2002

Future gains to economic growth will need to be driven by increases in productivity growth. Improving productivity will have benefits for individuals, businesses and for society as a whole. A more productive New Zealand will offer our people opportunities to earn world-class incomes without having to go overseas to achieve this. It will allow New Zealand businesses to provide sophisticated products to the world without having to relocate their head offices. Higher incomes will underpin a public sector that can provide high-quality services, which will lead to improved social outcomes in crucial areas such as health and education. Higher productivity will make New Zealand a more attractive place to live, work and do business with and from.

For government, this entails understanding the context our businesses are operating in and looking at how to enhance policy settings that affect businesses:

- Section 2 looks at the opportunities and challenges New Zealand will face over the next 15 years.
- Section 3 focuses on how well positioned New Zealand currently is to respond to these challenges.
- Section 4 suggests broad policy directions that would improve New Zealand's productivity over the medium term.

SIGNIFICANT TRENDS ARE CHANGING THE NATURE OF BUSINESS AROUND THE WORLD

2 OPPORTUNITIES AND CHALLENGES FACING NEW ZEALAND

A number of social and economic trends are changing the world our businesses operate in, including:

- globalisation
- international integration
- technology change
- natural resources pressures
- demographic changes and increasing expectations on the state.

These broader trends offer opportunities and challenges for New Zealand. Successfully adapting to them will enable us to narrow the income gap with other countries and attain the living standards we aspire to. Not doing so will likely exacerbate the gap.

Globalisation

Globalisation is likely to continue to change the nature of trade and deepen economic links between countries. While the international situation is likely to increase attention on how flows of capital are managed and how regulation is coordinated, it is unlikely to reverse the longer-term trends. More and more countries are becoming involved in the world economy. Global flows of people, capital, trade and ideas are likely to continue to strengthen.

GLOBALISATION WILL REMAIN CRITICAL TO SHAPING OUR ECONOMY AND POLICY SETTINGS...

Globalisation also provides an ever more competitive environment for a wider range of our businesses domestically as well as internationally. Parts of the production chain are increasingly being separated, often across borders, as technology allows companies to coordinate and specialise without being located in the same place. These changes will continue to increase the range of goods and services that can be traded. New Zealand has a range of strengths to build on, including a relatively flexible economy, natural resource advantages and relatively low energy costs to expand and diversify the range of what we trade and exploit new and more specialised markets.

Competition to attract and retain skills and access investment capital is likely to intensify. Greater choice over which countries to work or invest in will prompt stiff competition across tax, regulatory settings and quality of public services. New Zealand will need to offer an attractive business environment and work opportunities if it is to avoid becoming solely an incubator of business ventures and skilled workers that then migrate elsewhere.

...AND WILL INCREASE COMPETITION FOR FACTORS OF PRODUCTION

International integration

As economies become ever more integrated, emerging economic problems and their solutions increasingly involve coordination across national borders, greater international rule-making and greater convergence of national rules. As a small external player, New Zealand benefits from greater certainty around the "rules of the game" but also needs to consider the international dimensions and interactions with domestic policy settings. Where our settings differ from those of our trading partners it may create barriers to economic integration. One implication is that significant differentiation of our policy frameworks from our trading partners needs to deliver clear benefits to New Zealand.

DEEPER ECONOMIC INTEGRATION WILL SEE GREATER INTEGRATION OF THE "RULES OF THE GAME"

Financial systems are a key mechanism through which economies are integrated. Current weaknesses in international financial systems that led to excessive leverage and poor management of risk will take some time to resolve. Without financial market stability, the world economy could experience an extended period of lower growth and a higher cost of capital. International discussions are underway on ways to address the weaknesses that led to the current situation, including poor regulation of the financial system and the build-up of economic imbalances. New Zealand, as a capital importing country that relies heavily on trade, has much to gain from ensuring that any response tackles the underlying weaknesses without significantly increasing the costs or reducing the availability of capital.

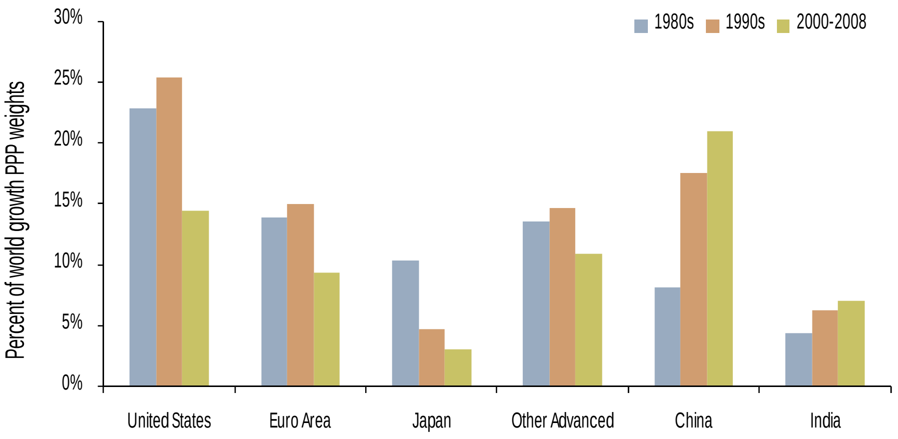
Looking more broadly at global demand, shifts in economic weight towards Asia will see changing geopolitical interests and economic relationships. The Asia-Pacific region continues to be the most dynamic and fast-growing part of the world economy. Significant growth within our region provides us with opportunities, increasing demand for the goods and services New Zealand firms produce well, and increasing the pool of skilled people and ideas generated. This regional aspect will need to be reflected in New Zealand's priorities for international engagement and increasingly influence our policy choices.

Technology change

Technological advances will continue to underpin long-run economic growth in the leading economies. Emerging economies are also increasing their reliance on innovation as they shift to producing more sophisticated goods and services. Technology will continue to play an important role in driving international integration, allowing previously non-traded sectors to become traded, and reinforcing global economic integration as more parts of the value chain are traded across borders.

China and India have become a significant source of world economic growth since 2000

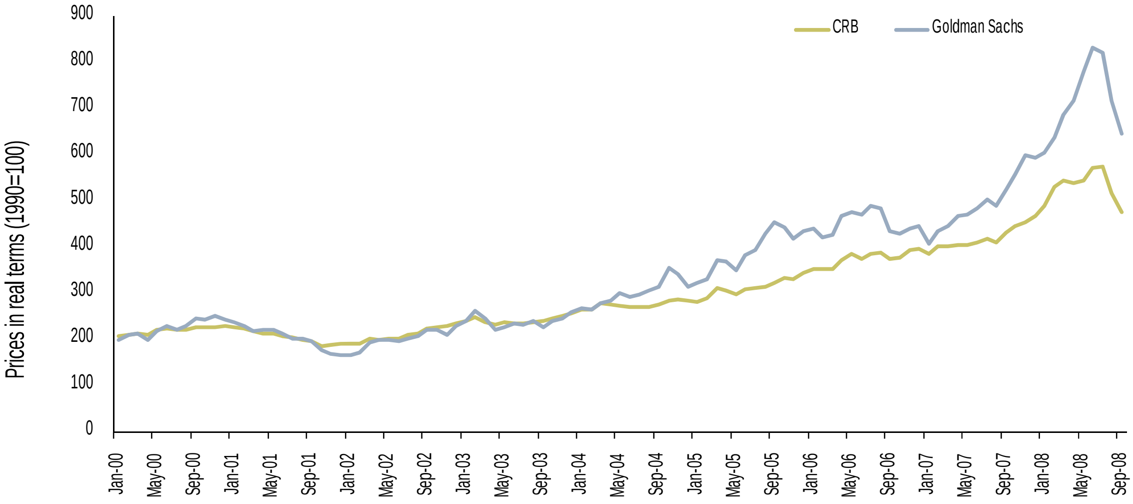
Contributions to real GDP growth



Source: IMF 2008 World Economic Outlook

Increasing world commodity prices are contributing to domestic resource pressures

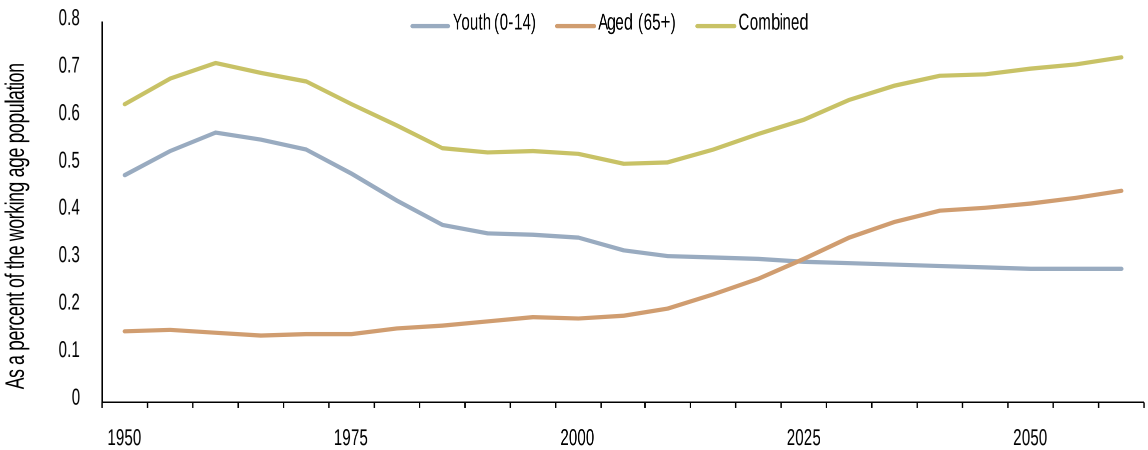
Terms of trade



Source: IMF World Economic Outlook

New Zealand is facing a permanent increase in the age of our population

Dependency ratios



Source: Statistics New Zealand

TECHNOLOGY CHANGE IS THE ULTIMATE SOURCE OF ECONOMIC GROWTH AND WILL OFFER BETTER PROSPECTS FOR HIGHLY- SKILLED COUNTRIES

The fast pace of technological change is likely to continue, making knowledge transfer critical. New Zealand's growth potential will be determined in part by how quickly our firms adapt and adopt new technology that is generated offshore. Experience suggests that the greatest gains from globalisation accrue to those countries that can best access, integrate and apply organisational, institutional and technological innovation. Broadly, these gains accrue more quickly to countries that are well integrated with the world economy.

Technological change also plays a significant role in increasing the economic returns to skills. More specifically, countries and people with higher levels of education and skills are well placed to take advantage of the opportunities arising out of globalisation. New Zealand will benefit from these changes provided we are successful in attracting, developing and retaining skilled workers.

Natural resource pressures

Global growth and limits on the availability of natural resources have increased the demand and price for goods and resources in which New Zealand is naturally abundant. These trends have generally strengthened New Zealand terms of trade over the past 10 years. Increased international demand will intensify the need for us to manage our natural resources well. However, continued intensification of land use is further reducing the availability and quality of water in some areas where extraction is already approaching maximum sustainable levels.

GLOBAL DEMAND AND THE STRUCTURE OF NEW ZEALAND'S PRODUCTION ARE INCREASING PRESSURE ON NATURAL RESOURCES, PARTICULARLY CARBON EMISSIONS AND WATER

Emerging global responses to climate change will influence New Zealand's own commitments to managing climate change. While there is a sense of international momentum in tackling levels of carbon emissions, the pace and strength of the policy responses are uneven across countries. The limited scope for low-cost emissions reductions in New Zealand needs to influence our approach to future commitments. In the longer term, the economic response will be a shift in relative prices that will reduce the carbon and energy intensity of production.

Demographic changes and increasing expectations on the state

New Zealand and many developed countries will see significant demographic change over the coming decades, from an ageing population and immigration. The economic and social impacts of an ageing population are already evident in some countries, and begin to have significant implications for New Zealand from 2010. These changes may also increase international demand and competition for skilled migrants. Effectively managing changes in the structure of the population will require increased attention to policies that facilitate participation in the economy from migrants and older people. More concerted attention is needed to spell out how New Zealand will adapt policy to ensure sustainable finances to underpin the public sector.

DEMOGRAPHIC CHANGES WILL INCREASE DEMAND FOR SKILLED MIGRANTS, AND INCREASE DEMAND FOR PUBLIC SERVICES AND TRANSFERS

Within New Zealand, the public sector is also serving a society that is changing. New Zealand is becoming more ethnically diverse and technological improvements and higher incomes are creating greater expectations on the state. Governments are also looking to address a wider range of more complex social and environmental issues. These trends place more complex requirements on the development of education, health, social support and other programmes that will need to be delivered within more constrained expenditure allowances.

Cumulative effect of changes

Taken together these trends will create a very different economic environment in the medium term. They will require substantial changes in the way businesses and government operate. New Zealand's economic growth depends on how well our businesses can adapt to the new world and take advantage of the opportunities it offers. Businesses will need to make changes to their processes, move into new areas of production and service new markets. At the same time, government will need to make some major changes to policy settings and maintain quality institutions.

NEW ZEALAND'S FUTURE ECONOMIC PERFORMANCE DEPENDS ON HOW WELL OUR BUSINESSES ADAPT TO THESE TRENDS

Not adapting will see New Zealand's economic position increasingly fall behind that of the countries we compare ourselves with. These countries are unlikely to stand still – they are also in the process of addressing their own constraints to better economic performance. A strategy that relies on marginal adjustment over time to current policies is unlikely to address the significant challenges New Zealand faces.

3 CURRENT NEW ZEALAND SITUATION

While productivity is a consequence of business decisions, government can assist business to improve productivity by:

- maintaining a *stable economic environment* that supports economic adjustment
- providing a *business environment* that supports productivity growth
- ensuring *value for money and sustainability of public services*.

GOVERNMENT POLICY SETTINGS WILL IMPACT ON BUSINESS PRODUCTIVITY

This section discusses New Zealand's current settings in these three areas and outlines where more can be done to assist productivity.

Stable economic environment

A stable macroeconomic environment gives investors confidence in the New Zealand economy as a place to invest. It gives New Zealand businesses a degree of certainty for making business decisions. Successive governments have done a good job of getting the New Zealand economy in a position where it can respond well to economic shocks. Low levels of public debt allow freedom to look through short-term cyclical fluctuations and there is room to adjust monetary policy to support demand. However, the recent sharp revisions to the economic outlook have resulted in projections of an extended period of fiscal deficits. This worsening in the medium term fiscal outlook takes place in an environment where the international financial crisis has highlighted the vulnerability associated with New Zealand's very high level of external debt, the government has taken on significant contingent liabilities, and risk aversion has increased funding costs.

THE CURRENT SITUATION PUTS A PREMIUM ON MAINTAINING ECONOMIC STABILITY

Ensuring financial sector stability is critical to supporting the medium-term challenge of lifting productivity, given its influence on the availability of capital and security of payments systems. It will be important that the temporary arrangements to guarantee financial system liabilities are unwound in a way that continues to support confidence, liquidity and the effective intermediation of funds to households and businesses.

IT MAY ALSO REQUIRE CHANGES TO FISCAL POLICY AND FINANCIAL SECTOR REGULATION IN THE MEDIUM TERM

There are significant economic imbalances in New Zealand that will need to adjust over time. Retaining flexible economic settings should help ensure this adjustment is orderly. Adjustment and rebalancing of economic activity will likely see faster growth in the tradeable sector, increases in household savings and a reduction in household debt in response to lower asset prices. A stronger national savings position over the longer term would help New Zealand to better manage external vulnerability and volatility.

Business environment for productivity growth

Raising productivity is the key driver for achieving higher incomes. Economic growth is a dynamic process of creation and destruction; the creation of new firms, new investments and new methods of production drive growth and replace the old, less productive firms and methods of the past. In the long term, entrepreneurship, innovation and technological change create productivity growth. While there is no single recipe for lifting productivity, a range of factors is consistently emphasised in economic evidence and shapes our choice of priorities. Some of these factors are more important because of New Zealand's characteristics and the nature of the trends identified above.

THE POLICY DIRECTIONS OUTLINED TO IMPROVE PRODUCTIVITY BUILD ON INTERNATIONAL EVIDENCE AND NEW ZEALAND- SPECIFIC FACTORS

New Zealand needs to become more connected with the world economy

Small economies that have high productivity rely heavily on international economic connections. New Zealand is currently only moderately well connected to the world economy based on measures such as the intensity with which we trade and invest offshore and the integration of our firms into international production chains. Evidence from the OECD suggests that distance plays a significant role in explaining New Zealand's lower productivity.

SMALL ECONOMIES THAT ARE PRODUCTIVE HAVE STRONG LINKS TO THE REST OF THE WORLD THAT STIMULATE COMPETITION AND SPECIALISISATION, AND INTRODUCE NEW IDEAS AND PROVIDE ACCESS TO RESOURCES

Recent turbulence in global financial markets has highlighted some of the risks associated with globalisation. A consequence could be that less rather than more integration is seen as desirable in the future. In our view that would be a mistake. There are clearly lessons to be learnt for how countries manage global financial and macroeconomic issues. But as a country with much to gain from greater international connections, New Zealand would be significantly worse off from moves to halt or reverse the trend toward greater globalisation.

Deepening New Zealand's international links will be critical to lifting our productivity growth. We need to attract and retain the ideas, firms, individuals and capital that drive productivity. In the absence of a large market in close proximity, international connections allow New Zealand to:

- access resources that will facilitate higher productivity: skilled people, foreign capital to overcome the domestic savings constraint and international goods and services
- specialise in areas of comparative advantage and benefit from economies of scale
- absorb and apply international knowledge to New Zealand's resources
- stimulate competition that spurs innovation and moves resources to areas of comparative advantage.

A business environment that increases investment and productivity growth

The environment government creates for business investment and innovation is critical to productivity growth. A competitive business environment requires institutions and policies that reward innovation and risk-taking, support long-term investment in the factors that drive productivity and recognise the wider international business environment in which New Zealand competes for resources and markets its products.

A COMPETITIVE BUSINESS ENVIRONMENT REWARDS BUSINESS INVESTMENT AND INNOVATION

There is increasing recognition that policies that may compare well with OECD averages are unlikely to be sufficient to overcome some of the constraints to productivity growth for a small distant economy. Evidence suggests that New Zealand currently has a low level of capital per worker, and moderate business investment implies that this gap is not narrowing. Addressing low levels of capital requires policies that raise the returns to investment and overcome those factors that may unnecessarily raise the costs of accessing capital.

Overall, our assessment is that medium-term policy changes are required in taxation, regulation and the public institutions that support business investment. Another factor is New Zealand's private savings rate, which appears to have been low for some time. Higher domestic saving is likely over time to reduce the cost of capital, aid development of deep capital markets and increase business investment.

Skills and participation: an opportunity to improve long-run productivity

A highly skilled labour force is critical for economic growth. Skills increase the productivity of individuals, and those they work with. They can also raise the returns to investment in capital and technology, and enable firms to innovate and move to higher value-added production. The link from skills to productivity depends on how the supply of skills is matched to changing demand, on firms' ability to effectively utilise workforce skills and on how well individuals are able to use their skills.

Acquiring skills is also one of the most effective ways in which to make best use of the personal abilities that exist across society. Opportunity, economic growth and productivity are interrelated. For example, if those from poor families face barriers which make it difficult for them to acquire and use their skills, their economic potential is wasted, social cohesion is undermined and social expenditure comes under pressure.

HIGHER SKILLS LIFT PRODUCTIVITY AND ARE KEY TO PEOPLE PARTICIPATING FULLY

Demand and competition for skills is increasing world-wide. Population ageing will require that we make better use of our human capital. Demographic changes also mean that our workforce will be increasingly diverse, and we will need to address the long-standing disparities in educational achievement across socio-economic and ethnic groups to maintain and improve our skill base.

Current skills settings provide a mixed picture. Average levels of participation in education and performance compare well with other countries. This may not be sufficient to meet future needs however, and there are concerns about the amount of variation in performance. Wide disparities in achievement are evident at all ages and stages of education, with scope for increased participation in early childhood education by disadvantaged children and in secondary schooling of those aged 15 to 17. Increased participation in tertiary education has been dominated by sub-degree qualifications. To at least keep pace, we will need improvements across the skills system.

Natural resources and climate change: better management of natural resources

New Zealand relies heavily on our natural resources to generate income. Natural resource limits and international measures to reduce climate change emissions increasingly influence economic growth as these inputs to production become more scarce and costly. The way in which these pressures are managed is important to maintaining and improving New Zealand's productivity.

NEW ZEALAND NEEDS TO PUT IN PLACE POLICIES THAT ENSURE THE MORE PRODUCTIVE USE OF NATURAL RESOURCES

Protecting our natural resource base will involve establishing limits on resource usage where these do not currently exist. More intense land use is putting more pressure on water availability and quality. We need to embed policies and mechanisms to encourage innovation to manage within these limits, and ensure that resources are applied to their highest value use. Such a process will require trade-offs across differing priorities, but could offer significant economic opportunities and is essential to increasing New Zealand's national welfare over time.

In the case of climate change, it will be important to negotiate outcomes that reflect New Zealand's circumstances and the speed and ambition of other countries' commitments. New Zealand has a low carbon-intensive energy sector and substantial emissions from agriculture, making New Zealand's future emission reduction commitments expensive.

Improving the value for money and sustainability of public services

More effective and efficient public sector

If the public sector performs well, it has the potential to lift New Zealanders' living standards, strengthen social capital and increase New Zealand's productivity. The public sector plays a crucial role in the provision of infrastructure, development of skills and support for innovation that are important intermediate influences on productivity. It also determines the quality of regulation and manages other institutions that directly influence the investment environment. In delivering a range of services, the public sector also uses a significant proportion of New Zealand's resources. This means these resources are not available to increase production in the private sector and potentially raises the cost of inputs to business. This puts a premium on ensuring the effectiveness and efficiency of its activities.

TIGHTER FISCAL CONDITIONS INCREASE THE URGENCY OF IMPROVING THE QUALITY OF EXISTING SPENDING

There are opportunities to improve the effectiveness and efficiency of public sector spending. There is little information available to assess whether public expenditure is delivering on its objectives. The system lacks strong emphasis on performance and incentives to manage fiscal pressures. Addressing the challenging fiscal conditions ahead and creating fiscal headroom to pursue tax and spending priorities will require greater value for money in public expenditure. Expenditure growth needs to slow from the pace of the past several years if it is to remain sustainable. The options we identify later in this briefing are aimed at strengthening the public management system's critical levers: focusing resources on priorities and strengthening accountability. This can be supported by adapting approaches used overseas to review areas that require particular attention.

Sustainable fiscal position

A range of adjustments to current policy settings will be required to ensure the longer-term sustainability of public sector activity in the face of expenditure pressures arising mainly from the transition to an older population. In the face of uncertainty these decisions raise a range of difficult trade-offs across generations. The tendency is to delay these decisions and face these choices closer to the time. However, earlier adjustment in some areas will be smaller and less disruptive in the long term. Over the next several years, more concerted attention will need to be given to how policies will adjust over time and what compensatory changes must be made.

A PERMANENT SHIFT TO AN OLDER POPULATION WILL BE LESS DISRUPTIVE IF WE ADJUST POLICIES EARLIER

4 POLICY DIRECTIONS

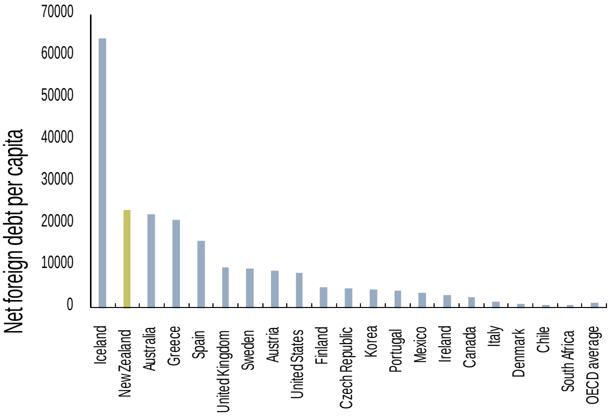
The remainder of the document provides a brief assessment of current policy. Building on this broad assessment the following sections indicate some policy directions and choices available to address macroeconomic conditions, improve the business environment and strengthen public sector performance:

- maintaining a stable economic environment that supports economic adjustment
- making New Zealand more connected to the world economy
- creating a business environment that encourages enterprise and investment
- increasing the contribution from skills to productivity and opportunity
- improving the management of natural resources
- enhancing the effectiveness and efficiency of the public sector
- addressing the sustainability of the fiscal position.

This note is deliberately focused. Further in-depth analysis and advice can be provided to you in each of these areas.

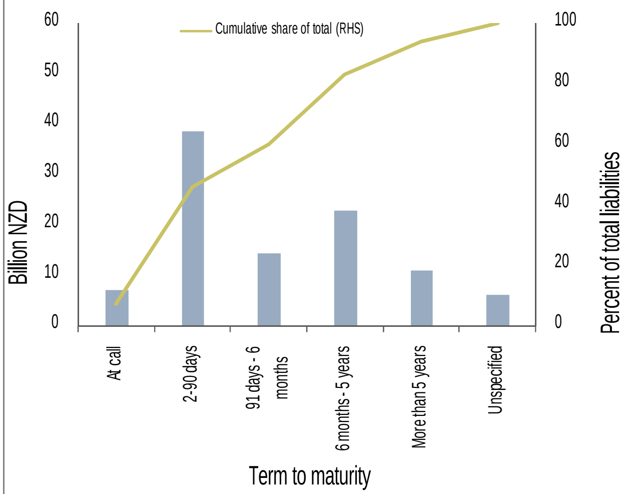
New Zealand's level of foreign debt is among the highest in the OECD and our banks are reliant on short-term funding

Net foreign debt per capita



Source: Statistics New Zealand

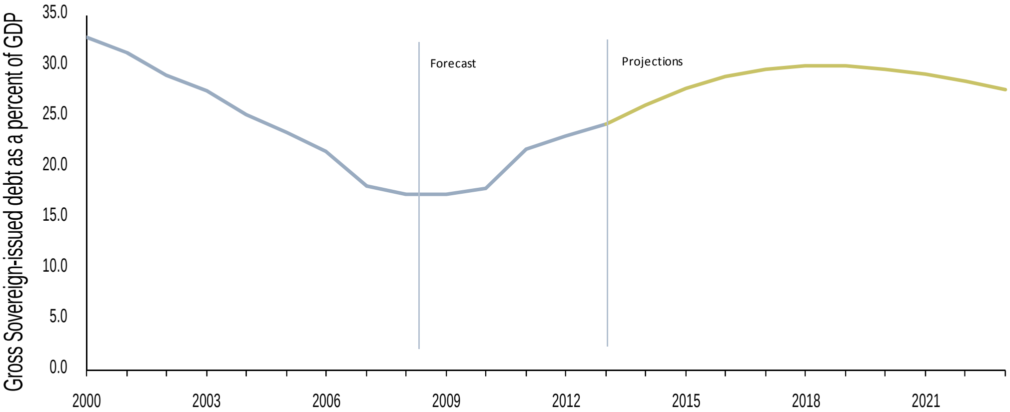
Sources of New Zealand bank funding



Sources: Statistics New Zealand and Reserve Bank of New Zealand

A strong public sector balance sheet allows the flexibility to respond to slower growth in the short term

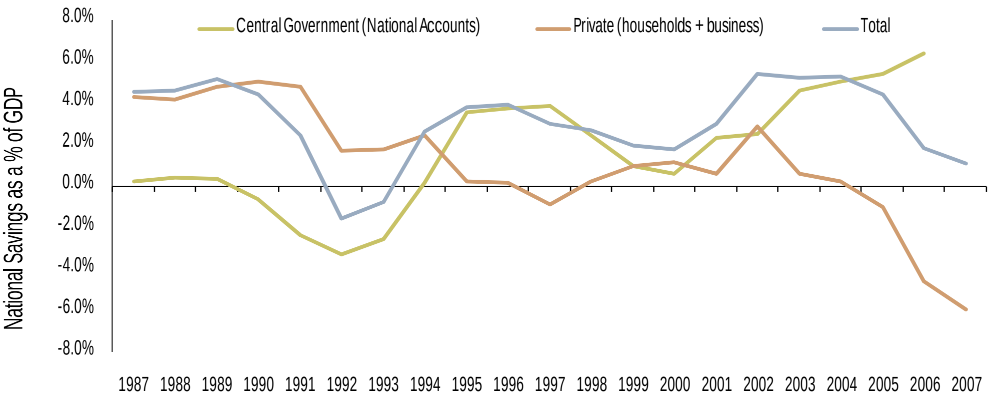
Scenarios for gross sovereign-issued debt: Pre-election update



Source: Treasury Pre-election Fiscal and Economic Update

Private savings have weakened over the past economic cycle while public savings have been strong

National Savings as a % of GDP



Sources: Statistics New Zealand and the Treasury

MAINTAINING A STABLE ECONOMIC ENVIRONMENT THAT SUPPORTS ECONOMIC ADJUSTMENT

While economic growth and productivity gains are core to future advances in the welfare of New Zealanders, the ongoing effects of the financial crisis are also likely to have an impact on the policy agenda over the medium term. Despite vulnerabilities, such as high indebtedness, New Zealand has fared relatively well to date, but the economy remains exposed to the global economic downturn through both higher funding costs abroad and a decline in overseas demand for exports.

LOW GLOBAL GROWTH AND HEIGHTENED RISK AVERSION WILL AFFECT NEW ZEALAND

Managing fiscal policy

Slowing economic growth, both abroad and in New Zealand, has led to a deterioration of the New Zealand Government's fiscal outlook. Tax revenue will grow more slowly, while unemployment and debt will rise alongside increases in spending on social services. In this environment it is desirable to allow the automatic stabilisers to work. However, there has been deterioration in the longer-term fiscal outlook with gross sovereign-issued debt forecast to rise to 24% of GDP by 2013 and medium-term projections that show it peaking at around 30% in 2018. It is expected that this will further worsen further from the *Pre-election Fiscal and Economic Update* (PREFU). In addition, the government has recently taken on significant contingent liabilities to maintain confidence in the financial system. This influences rating agency and external investors assessment of risk and funding costs for the New Zealand government and businesses. Action will be needed to ensure consolidation of this fiscal picture of the medium-term. The earlier action is taken, the easier it is to ensure your medium-term strategy is credible.

Tighter budgets and the deterioration in the fiscal position will raise the importance of both public sector productivity and focusing government spending on initiatives that can secure long-term economic growth. Further prioritisation of existing expenditure may be required.

Governments abroad have countered the rapid decline in economic growth with large fiscal stimulus packages. In New Zealand, the current Budget already incorporates a substantive fiscal stimulus of around 2.8% of GDP in 2008/09 in the form of the income tax reductions and spending plans. This is already larger than the stimulus being undertaken in most OECD countries that have announced fiscal stimulus packages, including Australia. The use of fiscal stimulus will be costly in the short term and may require savings later to avoid further deterioration in the medium-term fiscal outlook. Our judgement is that a stimulus package is not required at this point, although close attention will need to be given to continued developments. Should additional fiscal stimulus be used in the short term, it will need to be timely, targeted, temporary and focused on enhancing our ongoing growth performance.

EXISTING PLANS ALREADY CONTAIN SIGNIFICANT FISCAL EASING, SUGGESTING A WAIT-AND-SEE APPROACH TO FURTHER FISCAL STIMULUS

Maintaining confidence in the financial system

Maintaining confidence in the New Zealand economy, especially the financial sector, will be the policy priority in the short term. The global financial situation is still unsettled and, while the final implications of the crisis are still unclear, there are questions as to the future shape and direction of regulation in financial markets more generally.

A POLICY STRATEGY WILL BE REQUIRED TO EXIT FROM THE SIGNIFICANT EXPOSURE TO THE FINANCIAL SYSTEM

New Zealand banks currently have a level of high dependence on relatively short-term international funding. Threats to access to international financial markets and the large amount of government guaranteed debt now being issued by other countries led to the issuance of a government guarantee on wholesale bank funding. This aligns closely with actions taken abroad as government guarantees of private sector financial institutions have been a common policy response.

A retail deposit guarantee scheme has been offered for a two-year period to maintain depositor confidence in New Zealand's financial system. The scheme creates a contingent fiscal liability for the Crown that is estimated to grow to around $150 billion. Prior to expiry, a decision will be required as to desirability of replacing the retail deposit guarantee scheme with a permanent alternative, such as a deposit insurance scheme. Exit arrangements from the guarantee scheme will need to have regard to Australian and other country developments. Should a permanent scheme be required, the design needs to minimise moral hazard and support confidence in the broader financial sector.

The implications of the guarantees introduced will need to be carefully considered as expectations about the Government's response to financial instability and institutional failures will have changed. In future, New Zealand's relatively high reliance upon market discipline may need to be supported by strengthened prudential regulation and stricter oversight that operates to support individual decision-making and improvements in risk management. The financial crisis has also highlighted the importance of continuing to strengthen trans-Tasman coordination and cooperation for effective crisis management.

The vulnerability of the economy to future cycles

Beyond the immediate economic cycle, economic policy needs to look beyond managing risks and focus on policies aimed at securing economic growth and productivity increases. Many of the policies aimed at improving our growth prospects or strengthening the New Zealand business environment will also have a positive influence on macro-stability through reductions in the build-up of risks and imbalances in future economic cycles.

POLICY TO REDUCE FUTURE VULNERABILITY COULD INCLUDE STRENGTHENING FINANCIAL SECTOR REGULATION, PRIVATE SAVINGS AND TAX TREATMENT OF INVESTMENTS RETURNS

Increasing savings, a reduced reliance on international capital and a more diversified portfolio of assets on bank and household balance sheets could reduce systemic risk for banks, households and the economy. Part of the adjustment is likely to take place as individuals and households respond to lower expectations of future asset prices. Policy frameworks such as KiwiSaver and the changes we propose later in the briefing in the tax system could help address behavioural impediments to savings and reduce remaining differences between housing and other assets.

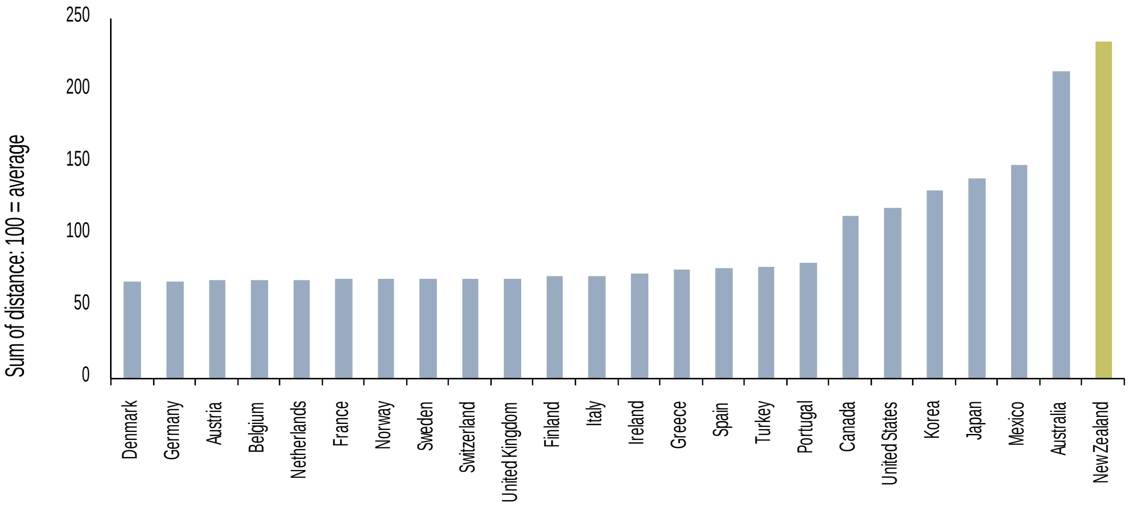
International connections matter for economic performance…

> *"During their periods of fast growth, [13 successful economies in the post-war period] all made the most of the global economy. This is their most important shared characteristic and the central lesson of this report. ... To put it very simply, they imported what the rest of the world knew, and exported what it wanted."*

The Growth Report: Strategies for Sustained Growth and Inclusive Development, Commission on Growth and Development

…but New Zealand faces particular challenges from its small size and distance from markets

Distance/proximity to markets



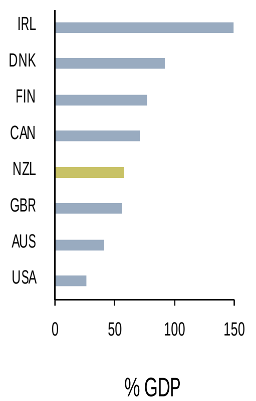
Sources: OECD "Going for Growth". Note: Measures the sum of capital-to-capital distances from the country to the world centres of economic activity. The measure is then normalised so the average across countries is equal to 100.

The New Zealand economy is relatively open, but there is still room for improvement

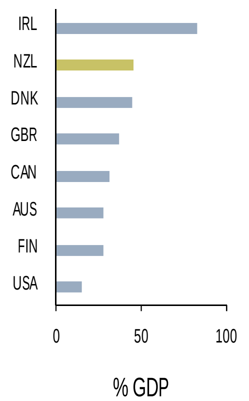
Tariffs on imports	39th / 124 countries	World Bank, 2008
Total tariff and non-tariff barriers on imports	18th / 26 countries	OECD, 2008
FDI regulatory restrictiveness	29th / 43 countries	OECD, 2008
Investment freedom	18th / 157 countries	Index of Economic Freedom, 2008

New Zealand is only moderately well-connected to the world economy

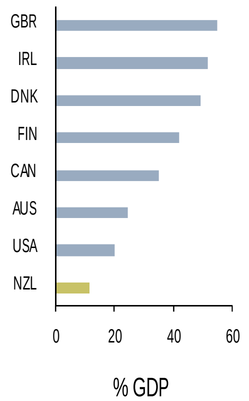
Exports and imports



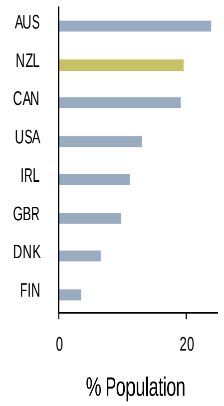
Stock of inward direct investment



Stock of outward direct investment



Foreign-born population



Source: OECD 2005

THERE IS SCOPE FOR NEW ZEALAND TO BE MORE CONNECTED TO THE WORLD ECONOMY

New Zealand is only moderately well-connected to the world economy, and less well-connected than other small advanced economies:

- Long-term people flows are relatively high, with a large stock of permanent and long-term immigrants. A sizeable proportion of tertiary students are international students. New Zealand's diaspora is the second largest in the OECD after Ireland in relative terms. Short-term people flows are relatively high and increasing. In net migration, the long-term trend is for small net inflows.
- There are strong flows of inward direct investment but very low levels of outward direct investment.
- Export intensity is lower than the level achieved by other small advanced economies even accounting for distance from markets. New Zealand firms do not seem to be well-connected to emerging international production networks.
- New Zealand's distance from the main producers of new knowledge and our low levels of business R&D suggest that firms may have difficulty in accessing cutting-edge technological developments.

NEW ZEALAND IS LESS WELL-CONNECTED WITH THE WORLD THAN OTHER SMALL ECONOMIES

Pursuing regional economic integration

New Zealand's longer-term objective could be founded on being an integral part of an Asia-Pacific regional economic market. Flows of trade, capital, ideas and people are already strong with Australia, Asia and the US. But these relationships are likely to increase in importance as the weight of global economic activity increasingly shifts towards Asia. Participation in regional economic integration will be critical for New Zealand's prospects.

To achieve this, government needs a clear strategy for engagement in the Asia-Pacific region, and to promote regional economic integration, both at and behind the border. As part of this wider aim, New Zealand would benefit from continuing moves towards a single economic market with Australia, through ongoing incremental improvements over time.

NEW ZEALAND WOULD BENEFIT FROM BEING AN INTEGRAL PART OF AN ASIA-PACIFIC REGIONAL ECONOMIC MARKET

Remaining barriers at the border

New Zealand's formal restrictions on international flows are generally low, and other at-the-border policy settings compare reasonably well internationally. On the other hand, New Zealand's distance from markets sharply reduces our connections with the rest of the world. And while imperfect, existing indicators of these policy settings suggest room for policy improvements. Given the importance of international connections to New Zealand, the costs of both inward and outward flows need to be as low as possible, within the constraints of achieving other government objectives.

FURTHER REDUCING BARRIERS AT THE BORDER WOULD SUPPORT GREATER ECONOMIC INTEGRATION

There is scope to further lower at-border costs to advance integration, including the phasing out of remaining trade barriers; the removal of screening of foreign investment – or changes that enhance the level of certainty and implementation of the regime; and addressing barriers in transport and communications links with the rest of the world. High tariffs and other barriers, particularly those facing agricultural exports and higher value-added goods and services, are likely holding back New Zealand's economic development. Continued attention is required to reduce these barriers in multilateral, plurilateral and bilateral forums.

Broader domestic policy settings

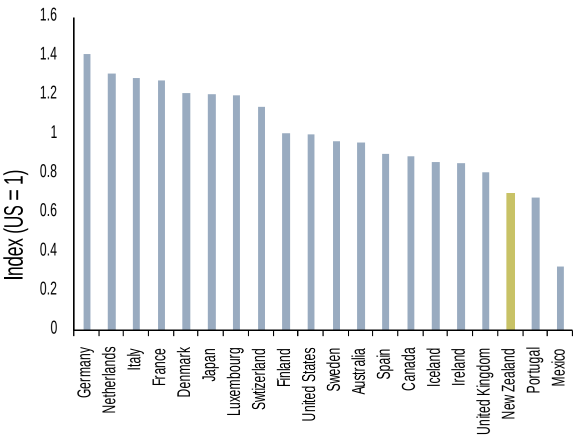
Policy settings across the board can affect international connections, even those that on face value seem intrinsically domestic. With low obvious policy barriers to deeper integration at the border, these domestic policy choices are likely to be where most gains are possible. Priorities with a strong international dimension include those that facilitate the development of future comparative advantage, ensure New Zealand is a competitive location for people and capital and maximise opportunities to capture economic benefits from our existing resources.

- Dampening medium-term exchange rate cycles, which are likely to increase uncertainty and impact on investment and productivity growth in the tradeable sector, by reducing the risk of pro-cyclical fiscal policy when the economy is at capacity.
- Developing a more integrated approach to international flows of people that includes domestic policies as well as at-border controls, and covers emigration and immigration, international students and New Zealanders studying abroad, and links between international researchers and businesses.
- Reducing barriers faced by New Zealand firms doing business abroad through a more effective offshore presence, and maintaining a well-functioning innovation system that facilitates international knowledge transfer.
- Allocating natural resources more efficiently to support development and investment in sectors that use water as an input in production, and produce greenhouse gases as a by-product of production.
- Changing our tax and regulatory settings to encourage entrepreneurial and innovative people and economic activity to be located in New Zealand.

DOMESTIC POLICY IS CRITICAL TO FIRMS AND INDIVIDUALS MAKING THE MOST OF NEW ZEALAND'S INTERNATIONAL OPPORTUNITIES

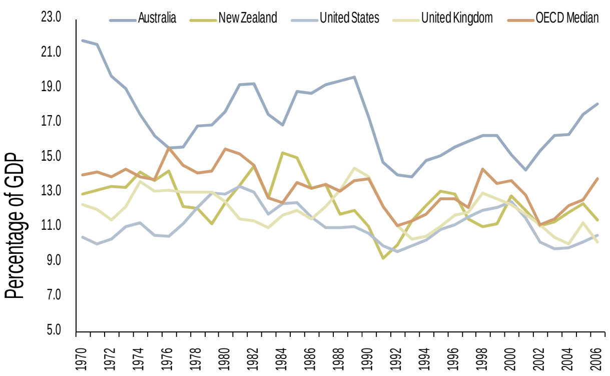
New Zealand has low levels of capital intensity and business investment rates below the OECD median

Capital intensity relative to the United States (2002)



Sources: Treasury and Ministry of Economic Development, 2005

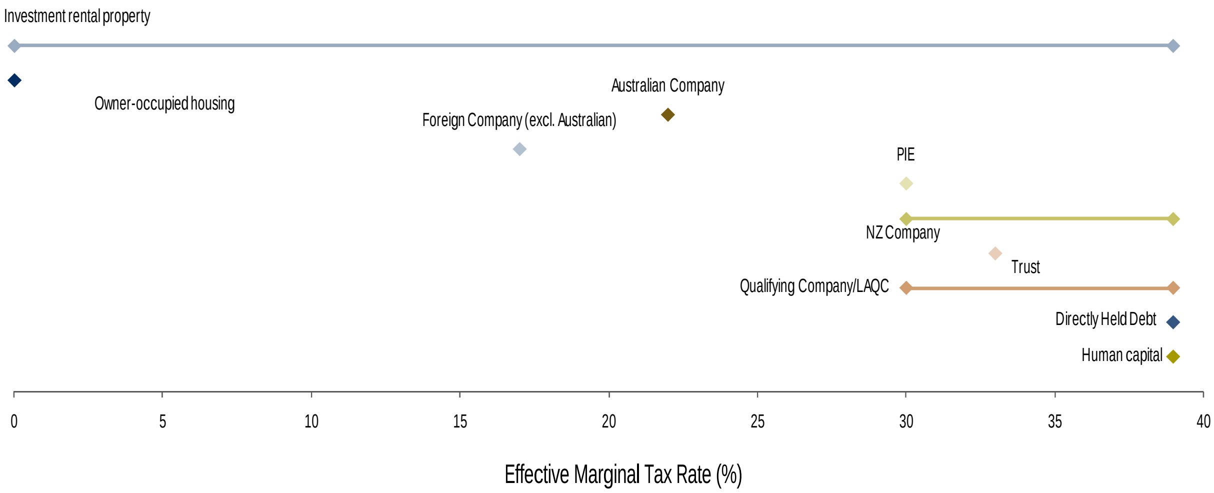
Business investment as a % of GDP



Source: OECD Economic Outlook 82

Tax rates on investment returns vary widely across sources and types of investment returns

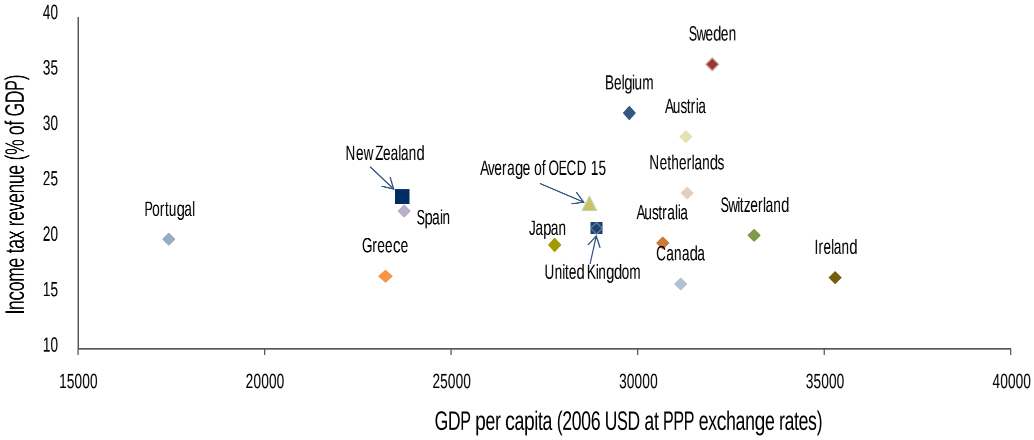
Tax rates on investment returns



Source: The Treasury
Human capital shown here at the rate applicable to a taxpayer facing the 39% top personal rate. EMTRs can be considerably higher if abatement of targeted social assistance programmes also applies.

New Zealand has a high reliance on income tax given our relative income

Income tax and GDP per capita



Source: OECD

A BUSINESS ENVIRONMENT THAT INCREASES INVESTMENT AND PRODUCTIVITY GROWTH

A snapshot of indicators of New Zealand's institutions and policies influencing the business environment suggests that they compare reasonably well with other OECD countries. But New Zealand's geography and size pose unique challenges to closing the gap in productivity, meaning that policy settings that are average compared with the OECD are unlikely to be sufficient to lift our economic performance. As other countries have continued to reform their settings, indicators of the relative quality of New Zealand's policies have slipped. It is increasingly the case that systemic weaknesses in a number of areas constrain our productivity growth.

MEDIUM-TERM PRIORITIES AIM TO INCREASE INVESTMENT AND ENTREPRENEURSHIP

There is scope for a set of reinforcing changes introduced over time to increase the returns to entrepreneurship and innovation, underpin higher levels of competition in the economy and upgrade the quality of policies and institutions that underpin New Zealand's relative attractiveness as a destination for investment. We see three main priorities for creating a more dynamic and innovative business environment: changes in tax policy and regulatory settings, and improvements in public sector institutions that influence the business environment.

DESPITE RECENT CHANGES, THE NEW ZEALAND TAX SYSTEM CONTINUES TO RELY TOO HEAVILY ON TAXES THAT ARE MOST DAMAGING FOR ECONOMIC GROWTH

The structure of the tax system

The location of firms, and individuals' decisions to invest or supply labour, increasingly span international borders. New Zealand's tax system can no longer be considered in isolation, and international competition for goods, capital and labour will increasingly shape the economic landscape in which domestic taxes are set. The ease of resource flows and our close geographic proximity to Australia are especially important in this respect. Without medium-term reform, there is a risk that the current mix of our revenue base will undermine productivity growth, and will deteriorate as sources of tax move offshore. New Zealand currently has:

- a large proportion of total revenue raised through personal and corporate taxes
- a company tax rate still among the highest found in the smaller OECD economies
- a wide variety of effective tax rates on capital investment income depending on the type of investment and its source.

IT WILL BE NECESSARY TO SHIFT THE TAX MIX FROM MOBILE TO IMMOBILE FACTORS

Over the medium term, there is a need to shift taxes from bases that are internationally mobile and have the most detrimental impact on growth to tax bases that are less mobile and less damaging to productivity growth. Policy direction that will contribute to productivity improvements and revenue sustainability, include:

- reducing high marginal personal tax rates in order to improve incentives for labour supply, entrepreneurship and the retention of skilled labour within New Zealand
- equalising rates of tax on different forms of investment to improve savings and investment, including reducing the rate of tax on some existing forms of investment income and introducing a tax on capital gains to reduce the diversion of investment into tax-favoured or tax-exempt forms
- moving towards a tax system more heavily weighted towards consumption taxes and, over a longer horizon, with a greater contribution from property taxes.

In the near term, we recommend equalising investment tax rates, including capital gains, and bringing statutory rates on personal income together at around the current level of the corporate tax rate. Given the level of tax rates compared to other countries is becoming increasingly important, as other jurisdictions continue to reduce tax rates the next highest priority will be to ensure that our corporate tax rate doesn't get too far out of alignment.

THE NEXT HIGHEST PRIORITY WILL BE TO ENSURE THAT OUR CORPORATE TAX RATE DOESN'T GET TOO FAR OUT OF ALIGNMENT WITH OTHER COUNTRIES

To remain within a workable fiscal strategy, some of the more significant changes above would need to be matched with appropriate expenditure control or revenue-raising measures. Reductions in the top personal tax rate affect the distribution of taxes across the population. Equity concerns are often more effectively addressed through suitably targeted transfers and spending programmes. Nonetheless, broadening the tax base to include capital income and gains would help offset any negative distributional implications, since these returns are skewed to higher-income individuals.

Improving regulatory quality

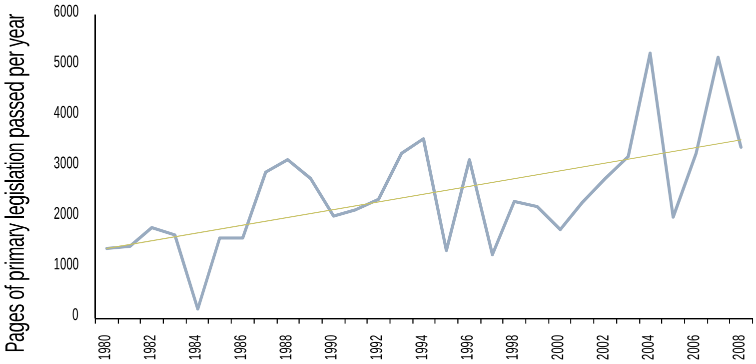
Regulation plays an important role in correcting various forms of market failure and supporting government's social and environmental objectives. In doing so, regulation alters the incentives to innovate and invest. Regulation also influences the availability of business opportunities, the costs of pursuing them and the returns from doing so. It follows that regulation is a key driver of productivity and has a pervasive impact on the allocation of resources in an economy. Although New Zealand rates well on international measures of regulatory quality and the ease of doing business, the combination of the significant amount of new regulation and improvements in other OECD countries means that many countries are catching up to, or surpassing, us in international indices of regulatory impact and competitiveness.

Characteristics of the regulatory landscape include:

- Significant development of new regulation – about 29,000 new pages of primary legislation over the last decade. New Zealand's OECD ranking for product market regulatory quality has steadily declined from 4th in 1998 to 12th in 2007.
- The quality, pace and implementation of some of this new regulation has been uneven, suggesting improvements are required to regulatory management systems and institutions.
- New Zealand does not currently take a systematic approach to reviewing the performance of the stock of existing regulation and there are weaknesses in our approach to assuring the quality of new regulation.

The pace of new legislation and regulation has increased

Pages of regulation and legislation



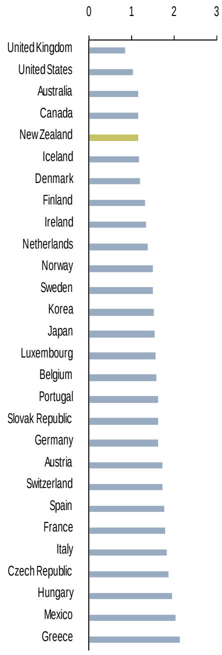
Sources: Parliamentary Library and Parliamentary Council Office

Ratings of the relative quality of our regulatory environment have slipped

Index of product market regulatory - 1998

Indicators scale: 0-6 from least to most restrictive
Source: OECD regulatory database

Index of product market regulatory - 2003



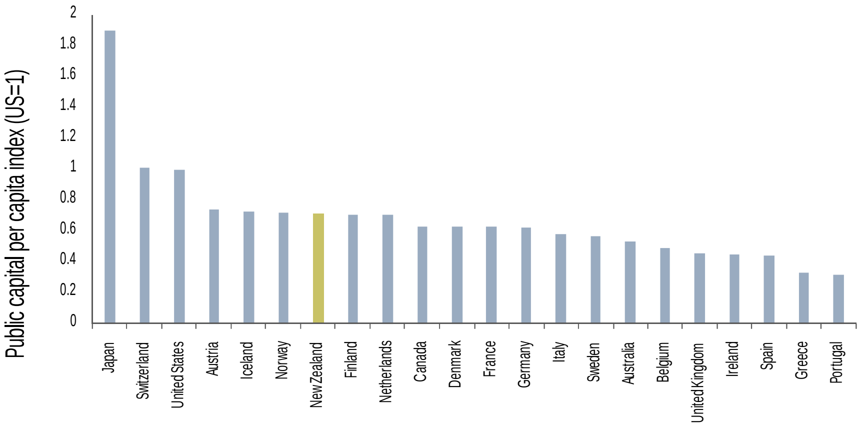
Indicators scale: 0-6 from least to most restrictive
Source: OECD regulatory database

Index of product market regulatory - 2007

Indicators scale: 0-6 from least to most restrictive
Source: OECD regulatory database

Objective measures suggest New Zealand's total stock of infrastructure compares well with other OECD countries

Public capital stock per capita OECD 2000



Source: Kaamps (2006) IMF staff papers

Taking a more systematic approach to regulatory quality that focuses on institutions, processes and incentives is critical to lifting the quality of new and existing regulation over time. This approach would also provide greater certainty and predictability to businesses about the regulatory environment they operate in, and take into account the way implementation by regulators affects regulatory performance. Improving these areas will require strong leadership and ongoing commitment from senior Ministers.

Good systems and disciplines to assure the quality of new regulation will help make sure that regulation maximises the net benefits to society and doesn't introduce unnecessary barriers to competition and innovation. Improvements would include: (i) strengthening the systems and processes that support informed decision-making by Ministers and ensuring new proposals are assessed against the Government's overarching policy objectives; (ii) improving the quality of the information base on which decisions are taken; and (iii) lifting the capability and incentives of officials, including chief executives, to meet the desired quality standards for regulatory policy advice.

Stronger regulatory advocacy and oversight of regulatory quality: As recommended by the Commerce Select Committee's report on the Regulatory Responsibility Bill, we would support an expert taskforce established to recommend improvements to current executive and parliamentary regulatory review and decision-making processes. Dedicated senior ministerial leadership on regulatory quality will be required.

Priorities for improving existing regulation: Establishing a programme of one to two in-depth reviews of regulatory regimes with pervasive economic impacts per year would be a first step towards embedding a system for reviewing existing regulation. Based on a range of assessments, our judgement is that the priorities for action in the first instance are:

- Resource Management Act 1991 and the scope for further process improvements, including trading off broad participation versus speed and certainty and the balance between environmental protection and economic growth
- Hazardous Substances and New Organisms Act 1996 and the impact it has on innovation, including reviewing the balance between precaution and opportunities
- labour market regulations and the impact on compliance cost concerns associated with the Health and Safety in Employment Act 1999 and Holidays Act 2003; the level of the minimum wage for youth and young adults entering the labour market; and specific provisions in the Employment Relations Act 2000 relating to hiring (e.g. probationary periods) and dismissal.

Institutions that support innovation, infrastructure, savings and investment

A number of other policies are important for supporting productivity growth: well-developed financial markets provide sources of funding for new investments; a robust innovation system embeds new sources of knowledge in the economy; infrastructure investments unlock entrepreneurial opportunities; and sound management of natural resources allows inputs to flow to their highest value uses. There is scope to improve the quality of public institutions that directly influence the drivers of productivity and the performance of publicly-owned companies.

Reviews confirm that, overall, our economic infrastructure, such as energy, water supply, telecommunications, roads, rail, ports and airports, is well-developed. There has been a significant increase in investment over the past five to 10 years. Recent regulatory reforms have been targeted at improving competition and investment. Further significant investment increases are currently planned in areas such as telecommunications, electricity transmission and generation. Policy will need to increase the value of the Government's spending and assets through more efficient use of existing infrastructure, including a more active role for demand management and more rigorous project evaluation processes to direct funds to the most valuable projects across infrastructure sectors. Managing long-term projections of additional investment will require increased attention on those factors that facilitate private investment. These include the maintenance of a predictable investment environment for all investors, regulatory certainty and public investment that avoids crowding out private investment.

A more effective, firm-centred innovation system is needed to generate new ideas, collect the ideas of others from the global pool and facilitate their use in business. Strong linkages between different parts of the innovation system, including between firms and public research organisations, are also critical. The Fast Forward Fund has some of the features of arrangements that support a firm-focused approach to generating and using innovative ideas.

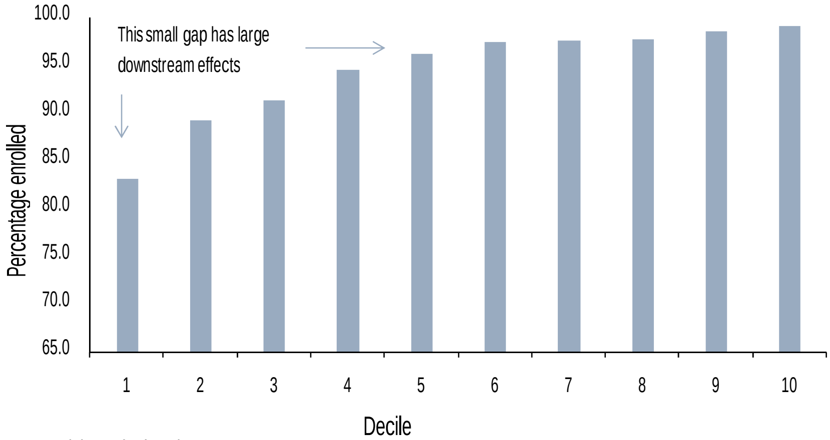
In an environment where there is broad political support for retaining state control and ownership of commercial assets, the State-Owned Enterprise model provides a sound framework. However, at an operational level, the model has eroded over time and needs to be reinvigorated. While we think the best way to reinvigorate the model is to move towards greater private sector involvement in the enterprises, there is a range of other options for achieving this, including addressing the weaknesses in the objectives, governance, transparency and monitoring of wholly Crown-owned commercial enterprises to ensure sound commercial decision-making within the enterprises.

A stronger domestic savings position would assist businesses that are looking to invest through greater financial market development. The availability of more sophisticated products and services, in areas such as equity, venture capital and bond markets, would be particularly beneficial for those companies based on intangible "knowledge" assets. Domestic savings can play a role in aiding the development of deeper financial markets. KiwiSaver was introduced recently to encourage greater private saving and it will be some years before we are able to fully assess its impact on savings. Continuing with KiwiSaver, possibly with changes in some of its features to enhance cost-effectiveness, would maintain confidence in the new savings architecture. Changes to tax settings that equalise the treatment of different investment returns may also support private saving.

There is a range of policy options that would improve the public institutions that directly impact on the business environment, including: (i) getting clearer strategic policy advice within the environment and natural resources sector; (ii) developing mechanisms that would provide for better decisions on the relative quality of investment across the Government's infrastructure priorities; and (iii) resolving the issues around fragmentation of policy and implementation within the innovation system.

There is lower participation in early childhood education for children who go on to low-decile schools

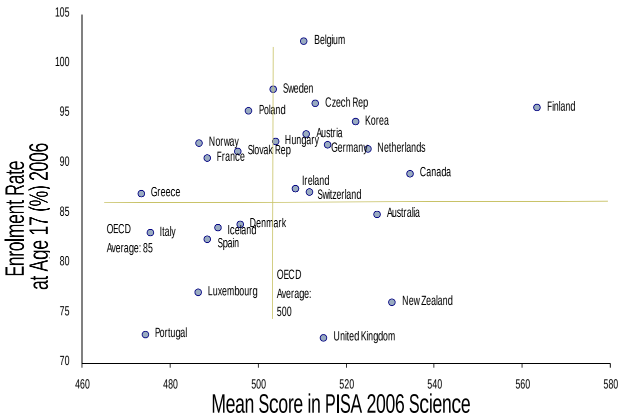
Previous Participation in ECE of Year 1 students



Source: Ministry of Education

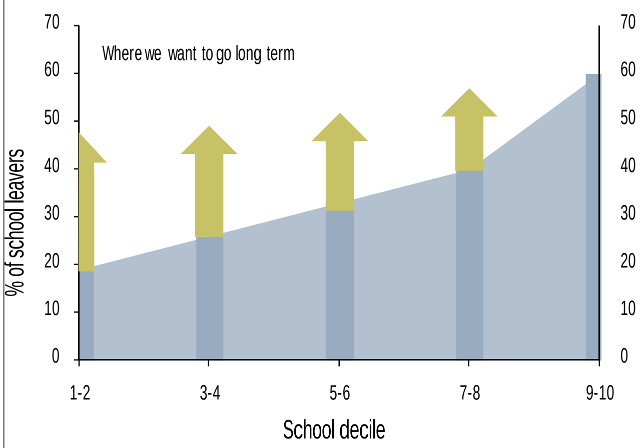
Average school performance is relatively good, but there is considerable room to improve the retention of school students beyond age 16 and improve the qualifications of school leavers

PISA Science Performance (Mean Score) at Age 15 and Enrolment Rates at Age 17



Sources: OECD Education at a Glance 2008
Note: Low outliers Mexico and Turkey are not shown. Excluded: Japan and USA (missing enrolment data)

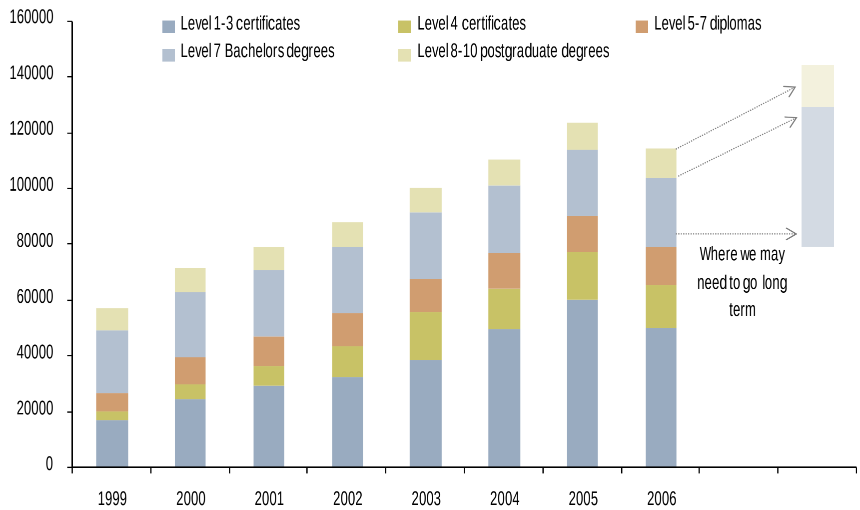
School leavers with University Entrance standard qualifications



Source: Ministry of Education

We should move towards more degree completions in tertiary education in future

Tertiary qualification completion – trends and future direction



Source: Ministry of Education

IMPROVING SKILLS PERFORMANCE PROVIDES A SIGNIFICANT OPPORTUNITY TO IMPROVE LONG-RUN PRODUCTIVITY

A highly skilled labour force is critical to economic growth and results in higher incomes for individuals. Skills increase the productivity of individuals, and those they work with. They can also raise the output of other firm inputs, and enable firms to be innovative and move to higher value-added production. A wide range of policy settings affect skills. For example, tax settings and the business environment can affect the incentives to acquire and use skills, and the education and training systems influence supply.

SKILL LEVELS WILL NEED TO RISE IF NEW ZEALAND IS TO OUTPERFORM OTHER COUNTRIES IN TERMS OF PRODUCTIVITY GROWTH

Demand and competition for skills is increasing world-wide, and we expect demand for skills in New Zealand to follow a similar trend. Our high levels of people flows mean New Zealand is particularly exposed to the impacts of increasing competition. Other countries are investing in lifting the skills of their people, and our skills performance will need to be above average by international standards if New Zealand firms are to compete successfully.

There are two distinct aspects to the challenge of raising skills performance. We need to lift the supply and quality of our skill base, and ensure that we are using those skills effectively. Over the long term, the biggest returns on investment may come from improving the quality of the "flow" of skills into the labour market. In the short term, however, we will need to improve and make better use of the current stock of skills. To achieve a significant increase in the contribution of skills to productivity, action will be needed across all of the different parts of the skills system. We will need to:

- lift both cognitive and non-cognitive or "soft" skills
- lift the skills of the current workforce
- improve the skill levels of those moving through the formal education and training system
- make better use of more of our skills through higher labour market participation and more effective utilisation in firms.

The performance of our skills system

Our skills system currently performs comparatively well on average, giving us a strong foundation to build on, but we will need to make the most of opportunities to do better. The following are areas where significant improvement is needed.

THE PERFORMANCE OF THE SKILLS SYSTEM AND CHARACTERISTICS OF OUR LABOUR MARKET SUGGEST WHERE POLICY EFFORT SHOULD BE FOCUSED

Participation is increasing over time in early childhood education (ECE), but there are persistent concerns about lower rates of participation in ECE by children from disadvantaged backgrounds and Māori and Pasifika children. This is a particular concern given the importance of ECE participation in developing non-cognitive skills, such as communication and social skills. Learning experiences in early childhood can establish or limit lifetime opportunities and learning potential, and therefore potential productivity.

In terms of school-age education, New Zealand has a wide spread in achievement and comparatively low participation rates of 15- to 19-year-olds in education. Staying in school matters for productivity – completing an additional year of secondary school is associated with an increase in lifetime income of around 10%.

ACROSS THE SPECTRUM OF POLICIES THERE IS SCOPE TO IMPROVE OUTCOMES AND THE COST-EFFECTIVENESS OF OUR INVESTMENT

Performance is mixed in the tertiary education sector. Almost all the growth in tertiary education participation has been in sub-degree certificates and diplomas. There has been little growth in degrees which have better labour market returns. New Zealand also has comparatively low completion rates, which reduces the value of investment for both the student and the Government and reduces the contribution these people might otherwise make.

Our adult skills profile shows considerable room for more improvement. The proportion of the population with a tertiary qualification is growing, but we are likely to need more people with degree-level qualifications in future. Higher-level qualifications have higher public and private returns, indicating higher levels of productivity. A significant proportion of the workforce has low foundation skills, limiting their ability to increase their productivity. It is particularly challenging to improve foundation skills because there is a lack of evidence on cost-effective approaches.

New Zealand's labour participation is above average, but international comparisons indicate participation rates are low for some groups, such as parents of pre-school children and older workers. There may also be potential to make better use of the skills of individuals already participating in the workforce.

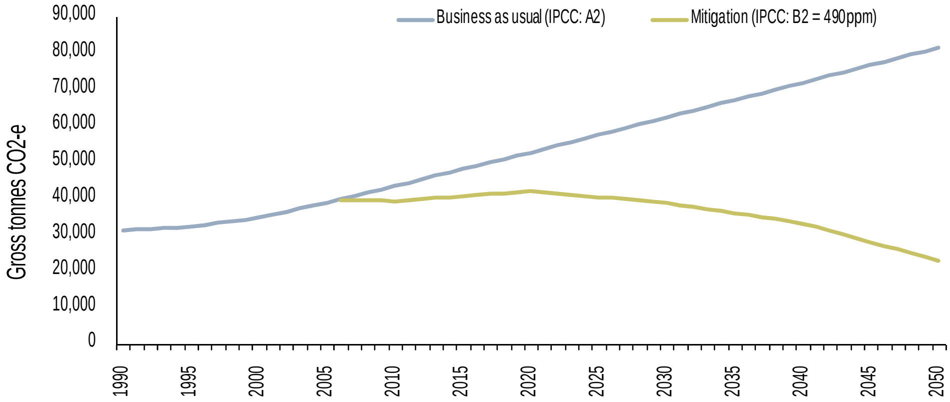
Opportunities for further gains from our investment

Opportunities exist to achieve a significant increase in the contribution skills make to productivity and improve the effectiveness of investment. Over time, we will need to develop a comprehensive approach that addresses the size of the challenge we face. In the short term, we can start by:

- targeting resources towards improving the accessibility of quality early years education for disadvantaged children and Māori and Pasifika children, with the aim of realising the potential for ECE to establish learning foundations and improve the effectiveness of later investments
- shifting investment in the compulsory sector from high-cost/low-impact strategies (such as lower student-teacher ratios) to high-impact strategies (such as improving accountability for student achievement and embedding professional development strategies that improve teaching practice). These initial steps are aimed at raising achievement overall and reducing the current wide disparities in outcomes
- shifting expenditure in the tertiary sector towards courses with better labour market outcomes and above average completion rates, with a view to shifting provision in the medium-term towards degree-level qualifications
- taking an experimental approach to improving foundation skills in the workforce, carefully evaluating results and adjusting our strategy as we learn more, so that we become better placed to meet the challenge of raising the skills of the existing workforce
- supporting labour force participation of parents (such as by prioritising access to ECE over further quality improvements), and older workers (such as by considering ongoing skill development needs and financial incentives to work and investigating health barriers).

Major emission reductions are required globally to stabilise greenhouse gas concentrations in the atmosphere

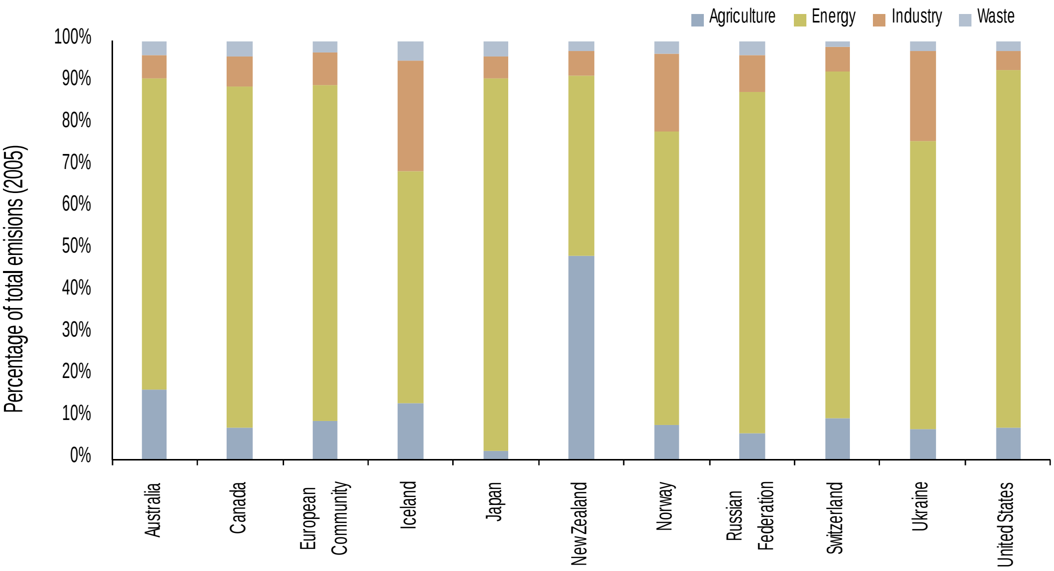
Global emissions reduction scenarios



Source: IPCC

New Zealand's emission profile is dominated by agriculture

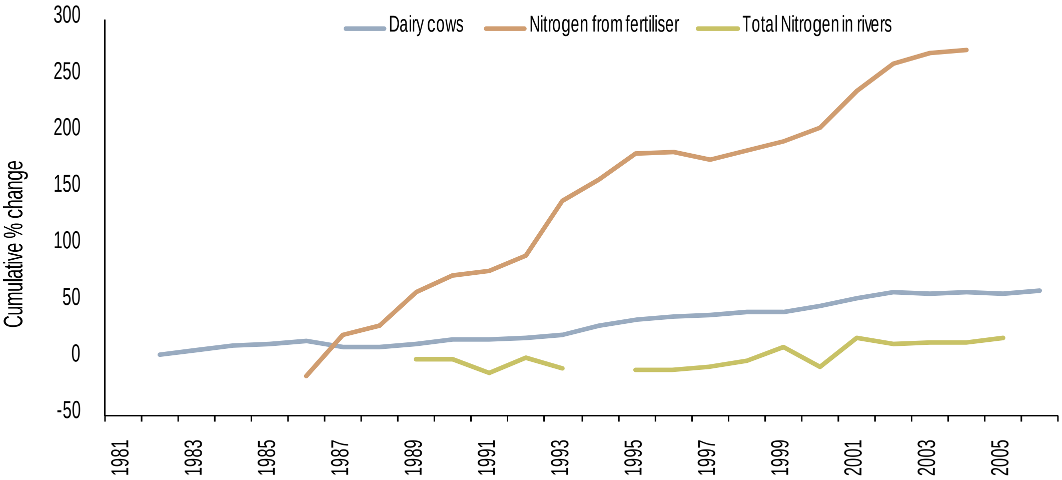
Emissions profile of Kyoto annex 1 countries



Source: 2007 submissions from parties to the Kyoto protocol

There are signs of escalating pressures on water quality

Trends in dairy cows, fertiliser application and nitrogen levels in rivers



Sources: MAF and The National River Quality Network

BETTER MANAGEMENT OF NATURAL RESOURCES IS CRITICAL TO ECONOMIC DEVELOPMENT

New Zealand is experiencing pressure on our natural resources such as water and our share of the atmosphere's ability to absorb greenhouse gases. These pressures are both national and international in nature:

- Pressures from consumers for environmentally friendly production are growing, along with New Zealanders' expectations for environmental outcomes.
- Demand for freshwater in some areas exceeds sustainable levels and intensive land use is degrading water quality.
- International action on climate change is spreading and becoming more pressing.

THE PRIORITIES FOR BETTER MANAGING NATURAL RESOURCES ARE CLIMATE CHANGE COMMITMENTS AND MANAGEMENT OF WATER RESOURCES

Meeting these challenges will require difficult trade-offs across differing priorities. For example, the Government may need to reconsider its views on how to achieve protection goals on private land, and on the potential for alternative uses of the conservation estate if it wishes to promote further renewable energy development such as wind farms. These trade-offs may involve risks to current levels of economic activity and potential growth.

Climate change commitments

Policies on emissions need to focus on negotiating an equitable international climate change commitment for New Zealand that recognises our unique emissions profile and adopting domestic policies that meet this target at least cost. The most important decision on climate change will be whether to commit to a new international climate agreement, which is due to be finalised in December 2009. The agreement is likely to include binding emission reduction targets for developed countries, specific mitigation "actions" required from developing countries and increased financial support for countries facing high costs of adaptation. New Zealand's negotiating strategy needs to involve a clear understanding of the costs imposed on New Zealand by a future emission reduction target and identify our bottom lines. These bottom lines must include recognition of our unique emissions profile when setting our target, and agreement to a level of stringency that is appropriate relative to other countries' targets – in particular the major emitters such as the USA and China, but also the advanced developing countries, such as Singapore, South Korea and regions of the Middle East.

INTERNATIONAL CLIMATE CHANGE COMMITMENTS WILL SHAPE THE COSTS NEW ZEALAND FACES

The international commitment that New Zealand negotiates generates the economic cost for New Zealand of its climate change policy. The Emissions Trading Scheme (ETS) then determines how this cost is spread between emitters and taxpayers and acts to minimise the cost by giving an incentive to emitters to abate emissions where it is cost-effective to do so. It is not possible to mitigate the costs of a given international target by providing generous treatment to emitters under the ETS as this does not reduce the cost but simply transfers it to taxpayers. While the proposed ETS design is sound, some changes would be beneficial. The scheme ought to be revenue neutral with any net revenues returned through reductions in other taxes over time. The scheme should also allow emitters to use units that are compliant under Kyoto to meet their obligations under the scheme.

MECHANISMS ARE NEEDED THAT MANAGE WATER RESOURCES MORE EFFECTIVELY AND IMPROVE WATER QUALITY

By pricing emissions, New Zealand has made many of the emissions reductions policies introduced prior to the ETS redundant. Productivity may be compromised if businesses are required to comply with layers of emissions reductions policies that are not required. These policies are warranted only where they target a market failure that is not addressed by the ETS. Policies such as the thermal moratorium, biofuel standards and vehicle-fleet fuel-economy standards do not meet this test – they are costly and unnecessary when an ETS is in place. Research expenditure, particularly in agricultural emission mitigation options, is a valuable complementary measure. Energy efficiency programmes have some justification but funding provided needs to be conditional on rigorous assessment of costs and benefits, ex-post reviews of effectiveness and comparison with other government expenditure priorities through the Budget process. The recent expansion of expenditure in these areas by a further $1 billion over the next 15 years was not based on this type of analysis and we recommend it be reconsidered.

Managing water resources

Increasingly, the economic value of water is being recognised. The challenge for policy is to develop mechanisms that allow society to gain the most long-term value from this resource. Water is a major input to production in pastoral agriculture as a direct input and a sump for pollutants. New Zealand has not priced water for either of these functions in the past and in some cases sustainable limits have yet to be agreed.

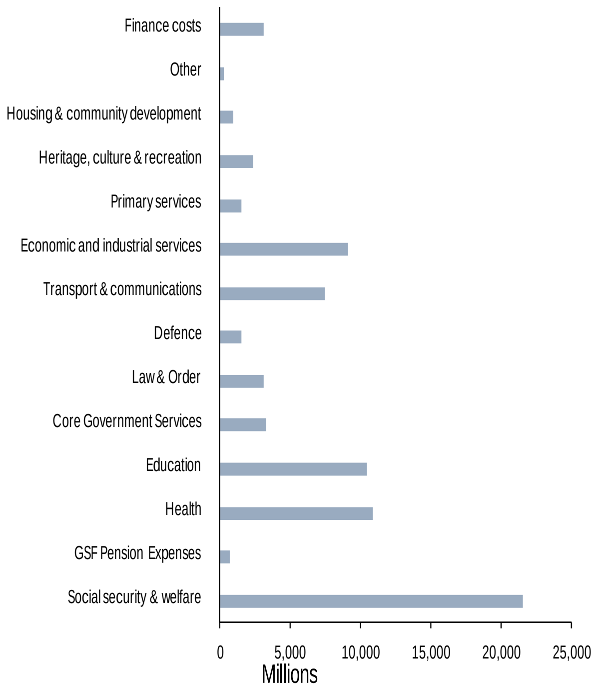
The National Policy Statement (NPS) on Freshwater Management under the Resource Management Act 1991 (RMA) is currently being developed. This includes the efficient use of water as a policy objective (among other objectives) and provides for the "transferability of resource consents for the use of water". Policy development along these lines would produce a market price for water, and therefore result in more efficient allocation among different uses. It will also be necessary to take interim action on allocation and reallocation, in light of the pressure evident in particularly water-stressed regions of New Zealand. The potential impact of limited new allocations of water on the scope for economic growth is significant, but the risks to current land users from measures to improve water quality are even greater. Sound regimes and new approaches to mitigating the effects of land use on water are a high priority.

The way Māori interests in water will be integrated in any governance regimes developed for water will need to be considered carefully. Recent settlements such as those for the Waikato River have established arrangements for iwi that work through or alongside the RMA and Local Government Act 2002. While there are benefits from this approach, such as integrated management of the river ecosystem, it also generates uncertainty and costs for resource users. Greater clarity of objectives and property rights will maximise economic opportunities and minimise costs. Engagement with Māori on these issues at both national and regional levels would assist the Government in taking forward the wider debate on the use of this increasingly scarce resource.

Government expenditure has grown as a proportion of GDP

Government expenditure by function	Nominal expenditure ($m)		% GDP	
	2002	2008	2002	2008
Social security & welfare	13,485	17,877	10.7	9.9
GSF	676	690	0.5	0.4
Health	7,032	11,297	5.6	6.3
Education	6,473	9,551	5.1	5.3
Core Government Services	1,890	3,371	1.5	1.9
Law & Order	1733	2,894	1.4	1.6
Defence	1,162	1,562	0.9	0.9
Transport & communications	989	2244	0.8	1.2
Economic and industrial services	1013	2889	0.8	1.6
Heritage, culture & recreation	434	1,107	0.3	0.6
Other	507	1,055	0.4	0.6
Finance costs	2,118	2,460	1.7	1.4
Total	37,512	56,997	29.8	31.7

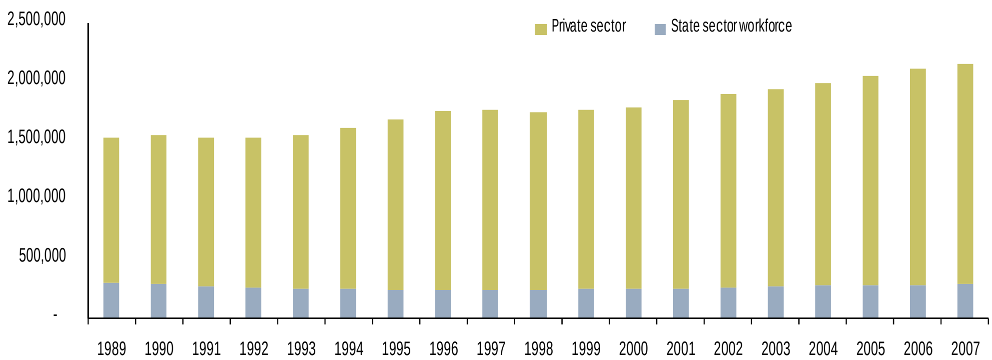
Total crown expenses



Source: The Treasury

The state sector workforce as a proportion of the total workforce has remained relatively constant over the last twenty years

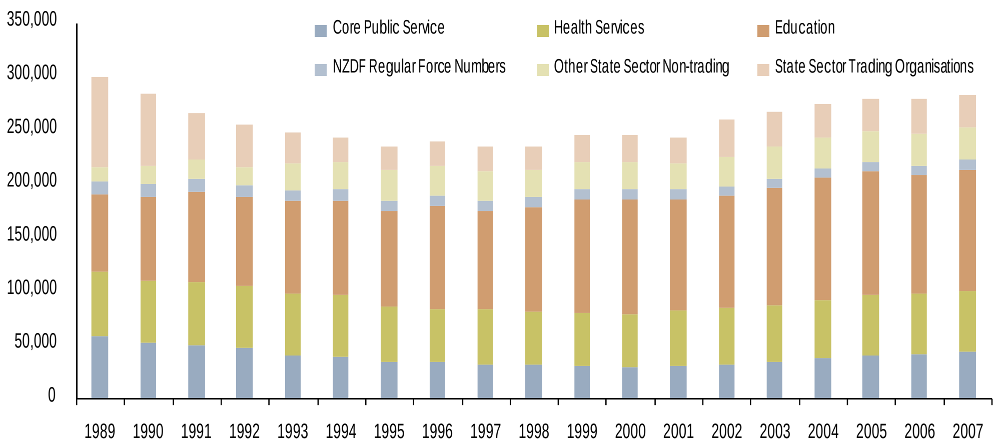
Composition of the New Zealand workforce



Sources: Statistics New Zealand and State Services Commission

Within the state sector, the core public service has grown the most, by around a third, since 2000

Composition of the state sector workforce



Sources: State Services Commission and Statistics New Zealand

THE PUBLIC SECTOR WILL NEED TO DELIVER MORE FROM EXISTING RESOURCES

Improving the performance of the public service has been identified as an issue for some time; measures have been put in place to improve it but do not yet appear to be delivering the outcomes sought. The following section provides some examples of weaknesses in the current system based on a review of the public service undertaken from a value-for-money (VFM) perspective. A drive to improve VFM means finding better ways to achieve desired outcomes.

Current performance of the public sector

With a few exceptions, government expenditure has grown across the board as a percentage of GDP during a period of strong economic growth. The rate that expenditure has increased cannot be sustained even in the short term, given the current economic and fiscal climate, nor in the longer term with projected pressures from an ageing population. Ensuring the quality of spending – in both value and impact – is just as important as restraining growth in spending because it enables government to maximise what it gets from existing resources and provides opportunities for funding other priorities. Using public sector resources efficiently will contribute to New Zealand's productivity by providing more services for a given level of labour, and freeing up labour to contribute to business production in the wider economy.

THE PUBLIC SECTOR IS STRUGGLING TO PROVIDE ASSURANCES ON PERFORMANCE AND VALUE FOR MONEY

While there is a link between significant policy initiatives and growth in resources, it is a challenge to link much of the increased funding to specific performance goals or gains. A "cost plus" approach appears to have been taken by agencies when proposing or discussing the provision of new services. In addition, some agencies have had significant personnel growth that does not appear to be warranted by the size or significance of the policy or services to which it is linked.

Over 40% of CEOs responding to a recent review on financial management capability in the public sector claimed that there were few incentives to identify or use savings. Increases in the level of unspent resources (under-spends) provide one indication that many sectors are now either over-resourced, or are not managing their resources optimally. The latter observation is reinforced by the practice of separate financial and operational reporting in 55% of government departments.

These findings provide broad support for concerns expressed by the Auditor General about the relevance and quality of performance reporting. There are marked information gaps in sectors where Crown entities dominate the delivery environment, particularly in the health and education sectors. Across the board, there is insufficient information explaining the link between the resources (inputs) used by government to purchase goods and services from departments and crown entities (outputs) to achieve specified outcomes (results). In short, we cannot say whether the resources being delivered represent VFM. Information required for external reporting is a subset of information required to manage an organisation. If information used in external reporting is poor, it seems unlikely that the quality of information used for internal management is sufficient.

THE RESPONSE WILL NEED TO STRENGTHEN THE MOST CRITICAL LEVERS IN THE CURRENT PUBLIC MANAGEMENT SYSTEM

Improving public sector performance

The nature of the services provided by the state and the complexity of the competing interests of the players involved, means that there is no "silver bullet" for improving public sector performance. To deliver greater VFM, we need to reinforce the principles of public sector management: clear specification of objectives; freedom to manage; incentives to perform; and provision of information on results. Making greater use of the system's existing levers; for example, linking budget management and departmental performance to chief executive accountability, is likely to deliver better results than structural changes to the system at this point. A package to improve public sector performance should include:

- ensuring Ministers' priorities and expectations drive the public service, through clear communication and accountability with a priority on VFM
- improving information on the performance of departments and Crown entities and the services they deliver to aid assessment of the extent to which the goods and services the government purchases have contributed to results that it wants to achieve
- strengthening ex-post monitoring and accountability within the public service based on better information. A consistent standardised framework for assessing the performance of departments could help drive a culture change to make VFM a priority for the state sector and assure Ministers that their core priorities are being advanced. Over time, making results of assessments public could be considered to increase citizens' stake in the performance of the public sector
- learning from successful processes undertaken overseas, and adapting them to the New Zealand context, to review areas of government spending that require particular attention. For example, these could be led by the public sector or experienced private sector individuals and could take a number of forms. The UK undertakes Comprehensive Spending Reviews which set departments' spending requirements, which include targeted savings for key departments as well as new performance management requirements and a sharper focus on key priorities. Other jurisdictions have implemented four-yearly reviews of agencies to identify the lowest VFM activities; set publicly stated targets and public reporting of progress; and established independent productivity measurement and reporting agencies, such as the Productivity Commission.

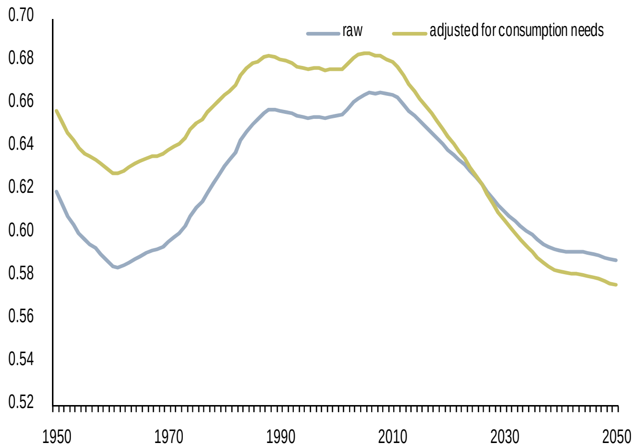
Managing short-term fiscal pressures

Living within the $1.75 billion operating spending increase set aside for future Budgets will be very challenging. Funding new priorities from this amount will be even more difficult. Fiscal savings will need to be made within existing expenditure to meet the costs of new priorities. Some spending areas, such as health, have the capacity to deliver service quality while living within a lower increment to spending than in the past. In other areas, such as justice, policy changes are needed to prevent rapid spending growth. There may also be a need to revisit pre-committed expenditure and reprioritising discretionary and low-value programmes to higher-value uses. In the medium term, efficiency increases and shifts of expenditure from low- to high-value uses will be necessary to achieve the Government's objectives.

TO MANAGE SHORT-TERM FISCAL PRESSURES, CURRENT SPENDING WILL NEED TO BE REALLOCATED TO NEW PRIORITIES

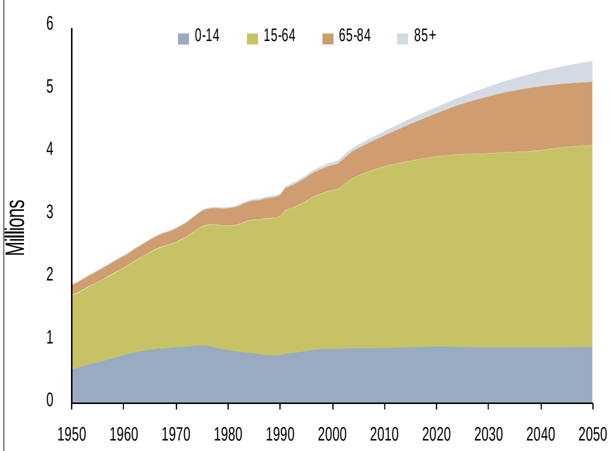
Population ageing will change the ratio of people in work to those in retirement

Ratio of working age population to total population



Source: Statistics New Zealand

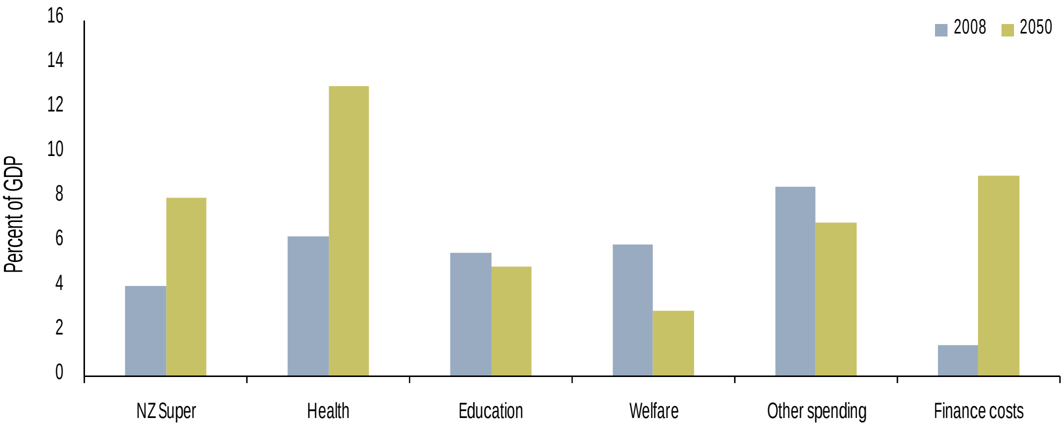
Older age groups grow



Source: Statistics New Zealand

Projected spending pressures are most significant in health and pensions

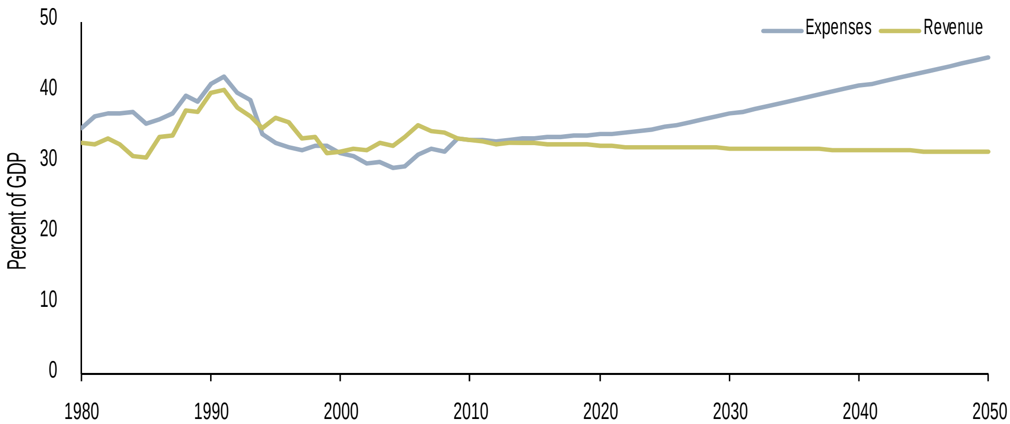
Projected core Crown spending changes between 2008 and 2050 (% GDP)



Source: Treasury Long-Term Fiscal Model

Debt or taxes will need to rise unless projected growth rates of spending slow

Revenue and expenses (% GDP)



Source: Long-term Fiscal model (as at Budget 2008)

DELIVERING QUALITY PUBLIC SERVICES OVER THE LONG TERM REQUIRES CHANGES THAT ADDRESS THE SUSTAINABILITY OF THE FISCAL POSITION

While the fiscal position has strengthened considerably over the past 15 years, this has occurred in a time of favourable demographics and a strong international economy. Ageing of the population will begin to accelerate significantly in 2011. The proportion of the population aged over 65 is projected to double, from 12.6% in 2008 to 25% in 2050. Associated with this change will be rising pressures on government expenditure, particularly health and New Zealand Superannuation. These pressures are reinforced by public expectations of increasing state services as technology improves and incomes rise. Our assessment is that the longer-term fiscal outlook has worsened in the two years since the Treasury published the *Statement of the Long-term Fiscal Position*, mainly due to changes in policy.

THE FISCAL POSITION WILL NEED TO ADJUST IN RESPONSE TO EXPENDITURE PRESSURES FROM DEMOGRAPHIC CHANGE

If no changes are made to moderate the rates of growth in spending experienced in recent years, then future governments will face very difficult choices about making real cuts in spending or increasing taxes, in order to stabilise debt in the longer term. The longer governments delay adjustments to address long-term spending pressures, the larger the adjustments to spending or taxes will need to be in the future.

SMALLER, INCREMENTAL AND EARLIER CHANGES TO EXPENDITURE AND TAX POLICIES WILL BE LESS COSTLY

Early and gradual adjustments to spending areas are likely to result in a more stable environment for individuals and firms to plan and make long-term decisions about savings and investment. The establishment of the New Zealand Superannuation Fund is one measure that seeks to ease the adjustment in the longer term, although it only funds around a fifth of the estimated cost of New Zealand Superannuation in 40 years time.

Preparing now for future fiscal pressures by maintaining a low level of debt and contributing to the New Zealand Superannuation Fund allows some flexibility to make wise spending and tax adjustments over time. Low debt also provides insurance by allowing debt to be raised when economic shocks occur without placing significant upward pressure on interest rates, and without requiring sudden changes to tax rates or government spending.

A strategy for addressing fiscal pressures

Although some reprioritisation is desirable in the short term, large and sudden changes in spending are not necessary to address the longer-term fiscal outlook. A strategy for addressing these longer-term pressures would include the following actions:

ELEMENTS OF A STRATEGY WOULD INCLUDE A MIX OF EXPENDITURE CONTROL AND IDENTIFYING HOW SOME POLICIES NEED TO ADJUST OVER TIME

- *Identifying changes that are best signalled in advance:* In areas where individuals need time to be able to respond to changes, these are better signalled well in advance so that people can adjust their plans in anticipation. For example, signalling changes to retirement income policies many years in advance allows people sufficient time to adjust their work and saving plans. Strains on fiscal expenditure could mean that programmes like New Zealand Superannuation have to become less generous in the future. Higher levels of private saving will increase the options available to government to ensure the fiscal position is sustainable in the long term and would contribute to income adequacy in retirement.
- *Maintaining a level of net debt which provides greater scope to adjust policy:* Overall, we consider the total amount of government saving that would occur by achieving the long-term gross debt objective of around 20% and making contributions to the New Zealand Superannuation Fund to be about right. As mentioned above, maintaining a low level of debt gives government the flexibility to adjust to emerging fiscal challenges over time.
- *Restraining expenditure:* Expenditure growth in key spending areas at the rate experienced in the past five to 10 years is unsustainable in the longer term unless taxes or debt rise significantly. In the *Pre-election Economic and Fiscal Update*, the Treasury assumed that new spending initiatives are met within a $1.75 billion operating allowance, growing at CPI. This level of spending restraint will be challenging, particularly in health where spending increases have been substantial in recent years. Living within these fiscal parameters, while delivering the health services and outcomes that New Zealanders want, will require transformational change in the performance and productivity of the health sector on an ongoing basis. It is important to build a degree of consensus around the need to moderate spending growth to manage long-term spending challenges in health and in other areas.
- *Recognising the importance of economic performance:* Higher growth will deliver higher living standards and make us better placed to meet future economic challenges. Tax and spending decisions can enhance New Zealand's growth performance. But while economic growth has many benefits, it may only help ease future fiscal pressures at the margin. This is in part because the increases in demand for government services have tended to be closely related to increases in income. A significant part of government expenditure is spent on wages which tend to rise with economic growth. However, the link between economic growth and higher spending can be weakened to the extent that explicit decisions are made to moderate increases in services and control public sector wage growth.
- *Ensuring the sustainability of the tax base:* A declining proportion of working-age people and the long-run pressures on expenditure mean that it is important to protect and sustain New Zealand's tax base. The direction of tax strategy identified above includes base-broadening measures and moving the tax system from one based on internationally mobile factors to one more weighted towards tax bases that are less mobile.