

The Treasury

Productivity Commission Inquiry into Maximising the Economic Contribution of New Zealand's Frontier Firms: Terms of Reference Information Release

February 2020

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Treasury Report: Review of the Productivity Commission: Assessment and Potential Changes

Date:	13 December 2018	Report No:	T2018/2085
		File Number:	SH-11-1-3-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	<p>note the findings and recommendations of this light-touch review;</p> <p>agree to meet officials in the new year to discuss your views, OR</p> <p>direct the Treasury to implement the proposed changes contained in this report.</p>	None.

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Timothy Holland	Analyst, Economic Strategy and Productivity	[39]	N/A (mob) ✓
Simon McLoughlin	Manager, Economic Strategy and Productivity	[39]	[35]

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes – *Insights from the International Experience of Productivity Commissions*, Dr. David Skilling, Landfall Strategy Group

Treasury Report: Review of the Productivity Commission: Assessment and Potential Changes

Executive Summary

The Productivity Commission (the Commission) provides a centralised policy resource to produce independent research, generate recommendations and improve the focus and quality of productivity-related advice across government.

In early 2018, you directed the Treasury to conduct a light-touch review of the Commission. This report summarises the review work so far and attaches a report prepared by an independent consultant (Dr David Skilling, Landfall Strategy Group).

Overall, Skilling concludes the Commission has largely performed well and its operating model is fit for purpose. He makes four recommendations

- inquiries should focus more on the externally facing, tradeable sector of the economy;
- the inquiry selection process should be more structured and include criteria related to aggregate productivity;
- the Commission should have more flexibility in its inquiry formats, moving towards more thematic inquiries (inquiries building an assessment and evidence base around a strategic economic issue, without necessarily producing specific recommendations); and
- the Commission should be tasked with additional public communication on New Zealand's productivity performance, including regular productivity reporting and benchmarking performance internationally.

The Treasury broadly agrees with Skilling's report, but we add nuance and reformulate his recommendations slightly:

- Rebalance the focus of productivity-related inquiries to include more emphasis on New Zealand's structural productivity constraints. This could be achieved with clearer advice on the priority policy areas during the inquiry selection phase and allowing the Commission to comment. In addition, the selection criteria could be improved for productivity-related inquiries to increase the focus on the sources of New Zealand's long-standing productivity underperformance;
- We concur there should be more flexibility in the inquiry process so inquiries are more responsive to the policy process, including some thematic inquiries alongside the status quo linear process; and
- Consider the role and resourcing of the Commission's Economics and Research Team (ERT) to ensure more continuous reporting and analysis of productivity performance.

We seek your consideration of these potential changes, and a discussion with you in the New Year. Alternatively, you can direct the Treasury to start implementing the recommended changes based on the advice contained in this report.

Recommended Action

We recommend that you:

- a **note** that earlier in 2018 you indicated you wanted a light-touch review conducted regarding the Productivity Commission's operating model and areas of focus;
- b **note** Dr David Skilling has prepared an independent report on the Productivity Commission, concluding that the Commission's structure and focus is fit-for-purpose but with four key recommendations:
- inquiries should focus more on the externally facing, tradeable sector of the economy;
 - the inquiry selection process should be more structured and include criteria related to aggregate productivity;
 - the Commission should have more flexibility in its inquiry formats, including thematic inquiries; and
 - the Commission should be tasked with additional public communication on New Zealand's productivity performance, including regular productivity reporting and benchmarking performance internationally.
- c **note** we broadly agree with his assessment and recommendations, but with some exceptions:
- there should be more balance in terms of inquiry topics, rather than refocusing inquiries on the externally facing, tradeable sector of the economy;
 - there is a case for the inquiry work to better reflect the priorities identified in various productivity narratives (including those prepared by the Treasury and OECD), rather than focusing on international competitiveness;
 - we concur there should be more flexibility in inquiry structures; and
 - there is a case to consider the resourcing of the Economics and Research Team more broadly, rather than adding a benchmarking function.
- d [33]
- e
- f **agree** to meet officials to indicate your views in the New Year.

OR

- g **agree** for the Treasury to draft a refreshed letter of expectations to the Commission requesting them to take a more flexible approach to inquiries;
- h **direct** the Treasury to make changes to the next inquiry selection process to achieve a better focus on New Zealand's productivity constraints; and

Simon McLoughlin
Manager, Economic Strategy and Productivity

Hon Grant Robertson
Minister of Finance

Treasury Report: Review of the Productivity Commission: Assessment and Potential Changes

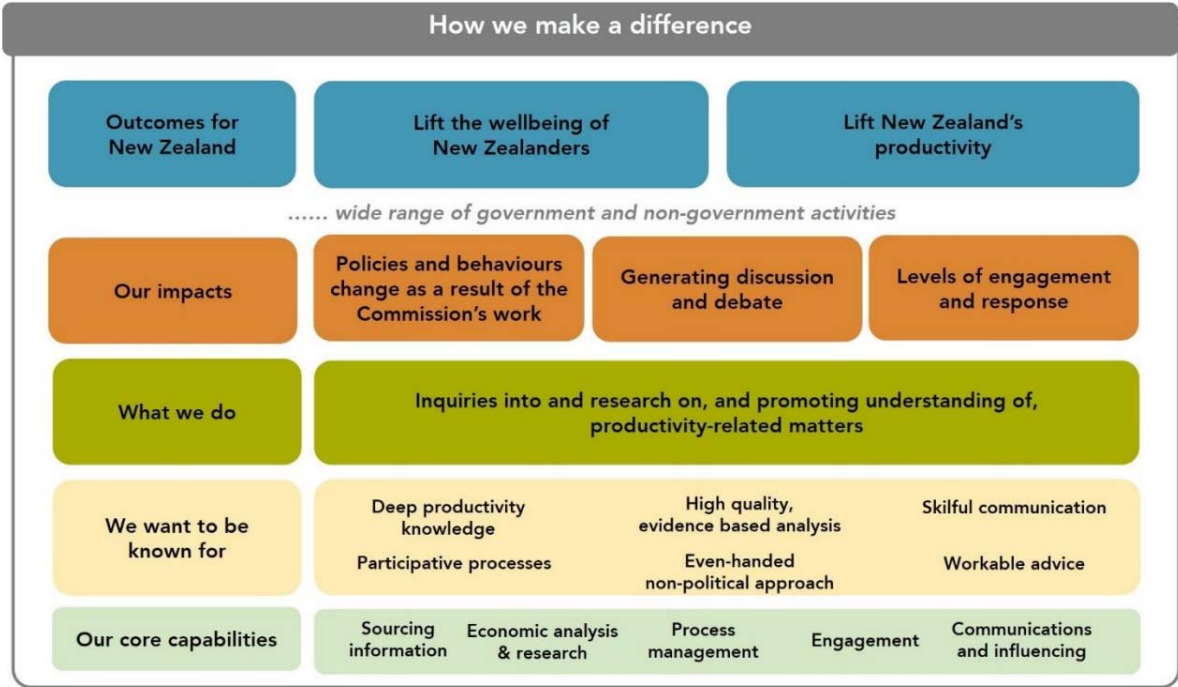
Purpose of Report

1. In early 2018, you indicated you wanted the Treasury to do a light-touch review of the New Zealand Productivity Commission (the Commission). This report summarises the work conducted to date and attaches a report prepared by Dr David Skilling titled *Insights from the international experience of productivity commissions*.
2. The report briefly explains the role of the Commission, before analysing the operating model and Skilling's assessment. The report concludes with Skilling's specific recommendations and the Treasury response to these.
3. We have consulted with the Productivity Commission both on this report and on David Skilling's work.

The Role of the Commission

4. Multiple agencies are responsible for productivity-related analysis and policy, given the numerous drivers of productivity growth. The Commission plays a particular role through its inquiries and research. Agencies such as the Treasury and MBIE apply additional perspectives in terms of taxation, macroeconomics and industry analysis. Other agencies are involved in the implementation and monitoring of regulations (e.g. Commerce Commission, MBIE), directly providing business support to firms (e.g. NZTE, Callaghan Innovation) and fostering underlying productivity drivers (e.g. the education sector).
5. The Commission is distinct because its focus is productivity, it has significant levels of independence, and it convenes the 'Productivity Hub', which coordinates research between agencies. The Commission self-report they also try to connect research with policy through roundtables, conferences and secondary research.
6. Figure 1 illustrates where the Commission evaluates its impacts, and where these sit in relation to better productivity outcomes.

Figure 1 – Productivity Commission outcomes framework



Analysis of the Commission Operating Model

7. The Commission has two main outputs – inquiries and research. Government mandated inquiries take up about 85 per cent of the Commission’s resources and are conducted by two inquiry teams. The smaller Economics and Research Team (ERT) carries out the Commission’s self-selected research agenda, and accounts for around 15 per cent of the Commission’s resourcing. The ERT also provide analytical and modelling support to the inquiry teams.

Inquiries

- 8. Inquiries provide a direct way for the Commission to influence policy, providing specific recommendations and identifying areas for reform. The Government chooses inquiries, ensuring they are relevant to policy priorities.
- 9. Inquiries take 12-15 months. A large proportion of this time involves consultation. The consultation process is extensive and should be considered an output by itself, helping to build understanding of cross cutting policy issues. To date, inquiries have followed a linear process, with the release of an issues paper, followed by extensive consultation leading to the production of a draft report. The Commission receives submissions on this report and continues with more targeted consultation, resulting in a final report that is briefed to referral Ministers before being tabled at Parliament.
- 10. The most obvious measure of the Commission’s impact on policy is the proportion of inquiry recommendations accepted and implemented by Government. To date, the Commission has completed 12 inquiry reports with 528 policy recommendations. Overall, Government has accepted over half of these recommendations in full or in principle.
- 11. While the inquiry reports are comprehensive and well-structured, they are relatively long and this may dilute some of the policy impact of their recommendations. However, the Commission has released an increasingly wider range of products with each inquiry – including ‘at a glance’ summaries and policy A3s. The recently-concluded inquiry into *State sector productivity* provides a good example of increased

reporting flexibility, with the inquiry broken down into two main reports and separate case studies.

12. The Government usually prepares an official response to inquiries. [33]
13. The Commission is open to increasing the flexibility of their inquiry function. This year they responded at short notice to a request by MFAT to conduct a short joint study with the Australian Productivity Commission titled *Growing the digital economy and maximising opportunities for small and medium sized enterprises (SMES)*. The terms of reference for the forthcoming inquiry into *Technological change, disruption and the future of work* requests that the Commission break the inquiry down into a series of shorter reports, to give effect to feedback that the publication of shorter reports more frequently would increase their impact on the policy process.

Research into and promotion of productivity

14. The ERT's work includes technical research into specific areas as well as narrative-style reports (*Achieving New Zealand's Productivity Potential* and *Can the Kiwi Fly?*). These narrative reports weave together the Commission's inquiry findings with their technical research and have identified a number of issues:
 - a Lack of dynamism limiting the diffusion of technology and reallocation of resources from low to higher productivity firms;
 - b Weak international connections: a combination of geography, poor integration into global value chains, low levels of foreign direct investment, low levels of international investment, and the effects of a high real exchange rate;
 - c Small and insular markets, creating a local focus and limiting the ability for firms to scale up and weakening competitive intensity;
 - d Capital shallowness, which is associated with slower diffusion of technologies embedded in capital equipment, low export diversity and low labour-productivity;
 - e Weak investments in knowledge-based capital, which covers intangibles like software, research and developments and networks; and
 - f Low levels of management capability.
15. The ERT makes considerable use of firm-level microdata from the Longitudinal Business Database (LBD). The increased use of firm-level data has been one of the biggest changes to productivity analysis in recent years and is a cornerstone of OECD work. Recent projects using the LBD include *Innovation and the performance of New Zealand firms* and *The impact of R&D grants on the performance of New Zealand Firms*.
16. The Commission also chairs and convenes the Productivity Hub, a group of public sector agencies that aims to improve productivity-related analysis and policy. Recently, the Commission have not been able to sustain regular Productivity Hub activities due to resourcing constraints.
17. The Commission have contracted for external reviews of their research function. The most recent review, delivered by NZIER in 2016, found that the research was technically sound and had a suitably broad focus, covering the multifaceted drivers of productivity underperformance. The reviewer observed that to increase impact, papers could be less technical and greater effort could be made to communicate research findings. The review also commented that the ERT was under resourced, and implied

that a small amount of additional funding would generate more continuity of research and focus throughout the Productivity Hub agencies.

18. A more recent independent review from 2018, conducted by Professor Bob Buckle, concluded that ERT had maintained a high quality of research output, suitable for submission to high-quality journals. Professor Buckle also observed that the ERT would benefit from better medium-term planning of their research outputs and access to other funding sources to increase the frequency of their research on New Zealand productivity.

International comparison with similar institutions

19. The Skilling report includes a detailed cross-country comparison of institutional models. His findings are summarised in Annex One, with our judgements added.
20. Separate to Skilling's work, in 2017 the OECD released a working paper titled *Pro-Productivity Institutions: Learning from national experience*. This paper assessed New Zealand's institutional structure favourably in terms of linkages to the policy process, mandate, skilled staff, independence and transparency. This paper also comments on the overlap between productivity policy and wellbeing, observing that 'focusing on long-term wellbeing, rather than productivity in a strict sense, is important to elicit trust and signal the relevance of the institution's work'.
21. We assess that the Commission's structure satisfactorily blends aspects of all three models identified by Skilling. Overall, the bulk of the Commission's completed inquiry work aligns most closely with the Australian model, with inquiries that focus on domestic sector issues, taking a micro approach. This was a deliberate design choice. However, there is a case to achieve a better balance in the focus of inquiry topics.
22. We do not think there is a strong case to change the Commission's model to reflect a national competitiveness agency, in line with Skilling's implicit suggestion that such models are more suitable for small open economies. The ERT could achieve a similar purpose but without the express focus on the export-oriented sectors of the economy or macroeconomic benchmarking against key indicators.
23. Some of the Commission's work is similar in scope to the strategic, time-limited model identified by Skilling. The recently concluded inquiry into *Transition to a low emissions economy* is an example, as will be the inquiry into *Technological change, disruption and the future of work*. There is a case to make these larger investigations thematic in nature – producing a series of reports into more specific areas of inquiry. However, we think the Commission should continue to release some linear, focused inquiries where suitable.
24. The Commission performs favourably against five of Skilling's six success factors (see Annex Two for details). His recommendations for improving the Commission are a result of his view that the most important driver of productivity growth in small advanced economies like New Zealand is the competitiveness of the externally facing tradeable sector, and the policy conditions that support this. He calls for "increased emphasis on the factors that shape New Zealand's performance in international markets. To make this a little more concrete, this include issues around how best to respond to changes in the global environment, such as disruptive technology, changing globalisation, and a low emissions model; and important domestic issues, such as the impact of migration (and population) on New Zealand."
25. In their response to Skilling's report, the Commission have noted (and we agree) that many of the inquiries completed to date do indeed address sources of economic inefficiency and low productivity growth in New Zealand. This is particularly true for the inquiries into *Housing affordability*, *Using land for housing*, *Regulatory institutions and practices*, *Boosting services sector productivity*, and *Local government regulation*.

26. While we agree broadly that the externally-facing, tradeable sector is important for generating productivity gains, Skilling slightly overstates the level of focus the Commission should have on this sector. In our view, another way of approaching the lack of focus suggested by Skilling is to bridge the gap between the structural constraints on productivity identified in the Commission's research (issues such as weak international connection, capital shallowness) and the topics of the inquiries. This would lead to inquiries more tightly focused on aggregate productivity, and tailor this to New Zealand's particular context. We think this would be a more balanced approach, which could lead to more inquiries focusing on the externally-facing sectors of the New Zealand economy while retaining the Commission's function to examine specific domestic policy areas.

Potential changes to the operating model and Treasury response

Inquiry selection

27. Skilling suggests that the Commission's lack of focus on New Zealand's binding productivity constraints is partially a function of the way inquiries are selected, and proposes a more structured approach to inquiry selection.
28. The current process for selecting inquiries is coordinated by the Treasury. It starts with the Minister of Finance seeking inquiry topic suggestions from Ministerial colleagues and other key stakeholders. The Treasury then collates the suggestions and prepares an unranked shortlist for the Minister of Finance to consider. Proposals are selected for the shortlist based on the extent to which they:
- a use the Commission's unique position as an independent agency with high quality analytical ability and a focus on public engagement;
 - b have the potential to deliver practical policy recommendations to improve productivity and support the overall well-being of New Zealanders; and
 - c require a substantial degree of analysis to resolve a complex set of issues.
29. We think there is some merit in Skilling's recommendation to add a criterion expressly linking inquiry proposals to aggregate productivity, alongside more formal Productivity Commission comment on the shortlist. This would be straightforward and could be achieved during the next inquiry selection process, as there are no legislative requirements for how this process is run, other than the Minister responsible formally refers inquiry topics.
30. Should you agree, we will implement changes to the next inquiry process, which we expect to commence in late 2019.

Greater flexibility for inquiries and report formats, including thematic inquiries

31. To maximise the impact of the inquiries, Skilling recommends the Commission adopt a less-linear and more thematic approach to inquiries. These thematic inquiries would focus on emerging strategic issues that impact on New Zealand's productivity performance. His thematic approach has two dimensions. First, thematic inquiries would focus on structured descriptions and analysis of an emerging strategic trend, rather than be directed at producing a set of recommendations to guide reform. Second, thematic inquiries would produce a higher frequency of shorter papers on various elements of the inquiry theme – as opposed to the more formal, set-piece reports that are currently produced. He suggests this would help structure the issues and options when examining emerging economic trends.

32. In response, the Commission has indicated openness to increasing the flexibility of their inquiry reporting, and were already taking steps to produce a more diverse range of reports. They have also indicated that for some areas of inquiry, a linear approach is more suitable as frequently they are unable to build a clear and coherent picture of the issues in question until they have undertaken a longer system-wide examination and widespread consultation.
33. We think this recommendation could be moulded into a more general direction that the Commission has more flexibility with its inquiry structures. This would allow for some future inquiries to be thematic in nature, such as the inquiry into *Technological change, disruption and the future of work*, while retaining the linear format for areas where this approach is appropriate.
34. Should you agree, we will begin drafting a refreshed letter of expectations to the Commission, requesting they take a more flexible approach to inquiries. This letter will outline possible inquiry formats.

Benchmarking productivity performance

35. Skilling's third substantive recommendation is that the Commission should be explicitly tasked with public communication of New Zealand's productivity performance. He suggests the Commission leads a 'systematic programme of productivity reporting and benchmarking against peer countries: perhaps in the form of an annual productivity scorecard'. This is partially a result of his favourable assessment of the Irish National Competitiveness Council and its regular benchmarking reports.
36. Skilling argues that currently, productivity reporting is done by various agencies and is consequently fragmented and irregular. Different datasets are used and comparisons to other countries are inconsistent. We agree that more consistent productivity reporting and an accompanying narrative would be valuable in monitoring progress in improving productivity.
37. We think this recommendation needs more work to define what types of reporting and product would be most useful. Our understanding is that the Commission is currently looking to update comparative analysis (e.g., the 2013 *Productivity by the numbers*) on a somewhat more regular basis. Tasking the Commission to produce detailed annual benchmarking reports may not be the best approach, as productivity data changes slowly. It could also crowd out the other valuable work undertaken by the ERT, such as the development of productivity narratives. A less frequent reporting cycle might be more appropriate.
38. [33]

Annex One: International pro-productivity institutional models

<p>Standard Productivity Commission model (e.g. Australia, New Zealand)</p>	<p><i>Characteristics</i></p> <ul style="list-style-type: none"> • Operationally independent of Government and bipartisan. Government decides areas of study. • Contributes to productivity policy through a bottom-up, micro-economic focus on identifying and removing distortions in specific areas of the economy. Commentary or analysis on aggregate productivity performance is a lower priority. • Predominantly focuses on domestic sectors of the economy. • Can be used to deliver independent analysis of crosscutting policy issues, taking a cross-portfolio approach. <p><i>Shortcomings</i></p> <ul style="list-style-type: none"> • May be better suited to larger economies, where there are more gains to be had by sector-specific microeconomic reform. • In small advanced economies with higher quality policy settings (such as New Zealand), Skilling argues policy attention may be better focused on enhancing international competitiveness rather than domestic efficiency. • Topics chosen may reflect political priorities and ministerial interest, rather than New Zealand's binding productivity constraints. To a certain extent, the Productivity Commission's work so far reflects a broader focus on general policy issues, crowding out the productivity focus.
<p>Agencies with a competitiveness mandate (e.g. Irish National Competitiveness Council, Sweden Growth Agency)</p>	<p><i>Characteristics</i></p> <ul style="list-style-type: none"> • These agencies adopt a more macroeconomic perspective on productivity performance, focusing on international dynamics and the international competitive positioning of the economy. • Some of these agencies carry out regular benchmarking/comparisons of key competitiveness indicators. • Independently evaluate government policies related to international competitiveness. • More common in small advanced economies, where there are arguably greater productivity gains to be had through improving conditions for externally-facing firms; and only marginal gains from microeconomic reform in specific domestic sectors (especially when policy and regulatory settings are already advanced). <p><i>Shortcomings</i></p> <ul style="list-style-type: none"> • Findings may not be as immediately practical for policy. • Over time, this type of model may not be seen as useful and relevant to the Government of the day if it cannot be used to

	<p>focus on politically important policy problems.</p> <ul style="list-style-type: none"> • These institutions are less engaged in providing detailed and specific policy recommendations to Government. • The less-formal nature of these organisations and the absence of a formal commissioning mechanism can detract from the impact of their analysis and recommendations.
<p>Time-limited processes around strategic economic issues (e.g. Singapore's Committee for the Future Economy)</p>	<p><i>Characteristics</i></p> <ul style="list-style-type: none"> • These are non-permanent organisations or processes tasked with responding to a specific policy issue or trend, for example globalisation or economic development. • These processes are staffed with a range of stakeholders from both business and government departments, and can be led by Government Ministers. • These processes are often successful in the short term due to the engagement of Ministers, business leaders and academics <p><i>Shortcomings</i></p> <ul style="list-style-type: none"> • These processes are political in nature and their findings and recommendations may be discarded following a change in government. • Given the long term and bipartisan challenge of addressing structurally low productivity, a more permanent institutional solution is more appropriate for the New Zealand policy context.

Annex Two: Assessment against key success factors

<p>High quality staff and access to international experts</p>	<p>The Commission has strong internal capacity and ‘critical mass’ of high quality policy capability. Specific expertise is procured or retained for inquiries. The staffing of the Commission may be ‘policy-heavy’ in terms of background, which may reduce the diversity of their approach to productivity analysis.</p>
<p>Independence of work</p>	<p>The Commission’s work is independent, and is not seen as partisan. The observation the previous Government disagreed with recommendations from the Commission suggests a degree of editorial independence.</p> <p>Institutionally, the referral of inquiry topics by Ministers allows the Commission to maintain cross-party relevance, and this should be maintained.</p>
<p>Stakeholder engagement</p>	<p>This is a particular strength of the New Zealand model. The stakeholder engagement led by the Commission throughout the inquiry process enhances system-wide understanding of crosscutting policy issues.</p> <p>The Commission currently has capacity to coordinate stakeholder engagement processes and run consultation – a capability that some international comparators lack as they have more of an academic and research-oriented structure.</p>
<p>Public communications</p>	<p>The New Zealand Productivity Commission’s public communication is comparable to international equivalent institutions.</p> <p>New inquiry and reporting formats, as well as regular productivity benchmarking, may enable more frequent public releases of productivity related issues. This could build public awareness and maintain policy attention on productivity.</p>
<p>Political leadership and support</p>	<p>The Commission has managed its first change of Government well, and Ministers have sought out the Commission for fulfilling coalition commitments and (<i>Local Government Funding and Financing Inquiry</i>, Joint work with the Australian Productivity Commission).</p> <p>It is important to balance the independence of the Commission against responsiveness and relevance to the Government of the day.</p>
<p>Substantive focus on the key drivers of productivity growth</p>	<p>In Skilling’s view, productivity is a misnomer for what the Commission focuses on. The inquiry topics so far do not focus tightly enough on New Zealand’s unique productivity challenges or on aggregate productivity trends,</p> <p>Instead, he argues, the Commission ‘has been used as a high quality policy agency for hard cross cutting questions where sustained analysis is required... and where an arms-length relationship with government is useful’. He thinks the inquiry topics to date overly focus on improving regulatory efficiency in the domestic sectors of the economy, or on difficult policy issues that have a long chain of attribution to aggregate productivity.</p>

