New Zealand Treasury

Improving the Living Standards of New Zealanders: Moving from a Framework to Implementation

Conference Paper

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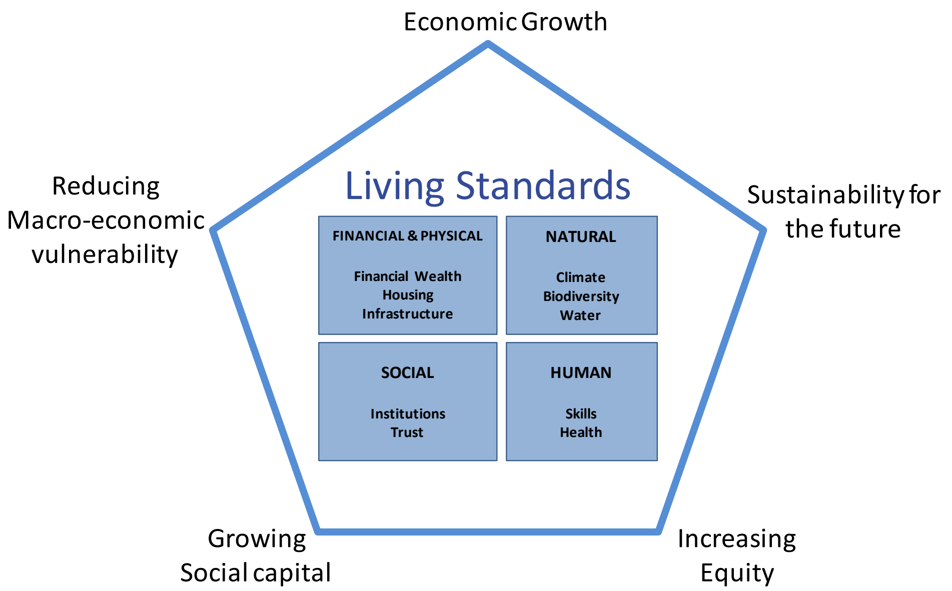
THE TREASURY
Kaitohutohu Kaupapa Rawa
New Zealand Government

Summary

In May 2011 Treasury released a working paper outlining what it meant by living standards in its vision "working for higher living standards for New Zealanders". This provided a coherent framework for approaching living standards, but it was not intended to either signal that Treasury had changed its own view, nor to be the end of the story.

This paper presents the next step in the Treasury's Living Standards work. It presents the case for, and details of, a living standards tool designed to assist policy analysts to consider the key elements of the living standards framework in their day-to-day work. To do this the tool has given priority to being practical – focusing on a few key factors that Treasury believes are both important for overall living standards, central to its own role in policy advice, and amenable to government policy initiatives.

The five key focus areas that Treasury suggests are economic growth, reducing macro-economic vulnerability, sustainability for the future, growing social capital, and increasing equity. In choosing these five, Treasury both thinks they cover the key aspects of the Living Standards framework, and represent the important drivers for improving living standards for New Zealand in today's environment.



Treasury proposes that this tool now be trialled within Treasury to see if it does achieve the objective of implementing the Living Standards framework in its advice and to seek feedback from the public on whether this represents an appropriate next step for the Living Standards Framework.

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Introduction

In May 2011 Treasury released a working paper outlining what it meant with its vision statement that it sought to be “a world class Treasury working for higher living standards for New Zealanders”[1]. When releasing the paper, the then Secretary to the Treasury, John Whitehead, indicated that this was not a new innovation but rather it reflected the thinking that had underpinned Treasury’s advice for at least the previous decade.

The Treasury wanted to make its position clearer not because it had changed its thinking, but rather, because it had come up against a general perception that it was focused only on the material issues of higher income or GDP and it was ignoring other aspects of life that were important.

From Treasury’s viewpoint this misperception was not a minor inconvenience. As John Whitehead said in his speech when launching the framework:

> “Misperceptions of the role Treasury has played during and since the 1980s have limited our ability to be persuasive when talking about what matters most for living standards. Some people have never got beyond believing that we are the root of all New Zealand's economic evils. Others see us as little more than the defenders of fiscal virtue, obsessed with eliminating deficits and debt - the organisation that knows the price of everything but the value of nothing. But of course the Treasury is about a lot more than just fiscal rectitude.”

Since its launch, the Living Standards framework has been discussed in many quarters, and the feedback has been largely positive. There has been general agreement with both the concept that there are many different aspects that contribute to living standards and with the particular framework proposed by the Treasury.

However, the working paper itself indicated that it was but a first step in a longer process. While Treasury’s advice has been framed in terms of the wider considerations of the Living Standards Framework, it has not necessarily been consistent in doing so. In moving forward, the Treasury’s focus has, therefore, been on developing a practical tool that could be used on a daily basis when Treasury is developing its policy advice.

Developing a tool has not been straight-forward. To be useful any tool needs to be simple and relevant. Simplicity is difficult when there are so many important aspects to living standards, and relevant necessarily means focusing on the issues of the present. We are proposing a tool – but it is a starting point of something that will inevitably be refined as we reflect on the reaction from the wider community and as we road-test it in real life.

[1] *Working Towards Higher Living Standards for New Zealanders* New Zealand Treasury Paper 11/02 available from http://www.treasury.govt.nz/publications/research-policy/tp/higherlivingstandards

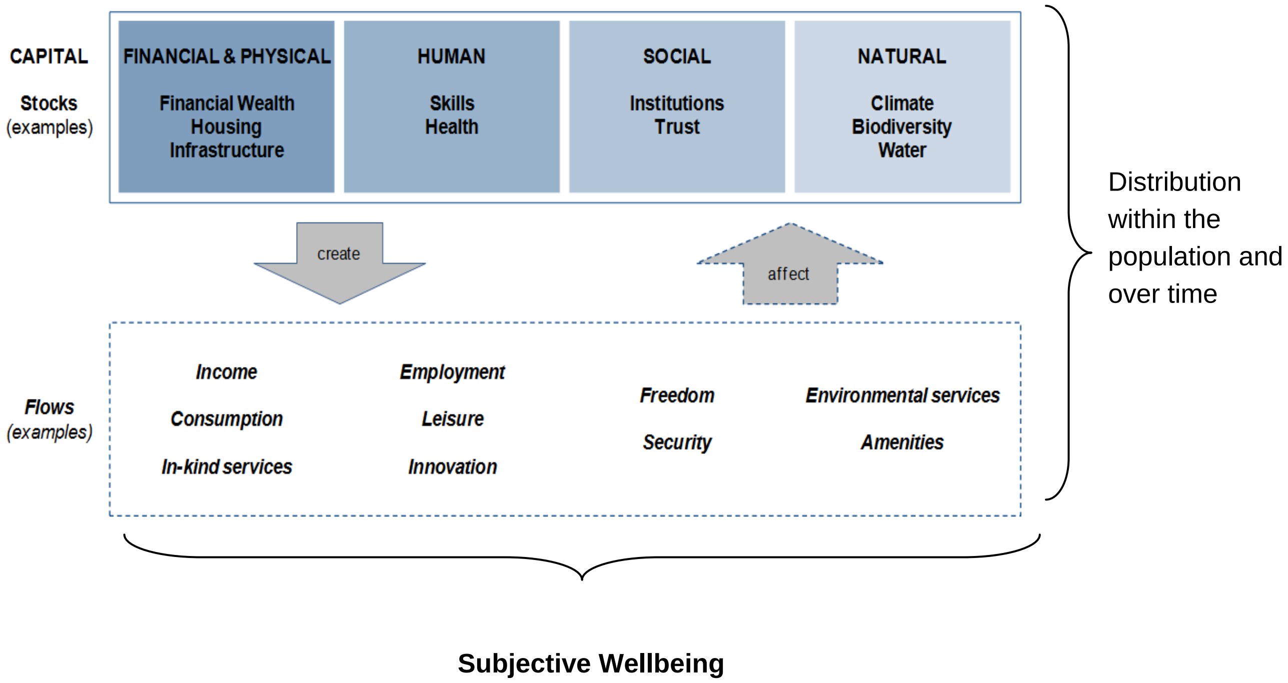
1 The Key Elements of the Living Standards Framework

The Living Standards framework was built upon five key elements:

- There is a broad range of **material and non-material determinants** of living standards beyond income and Gross Domestic Product
- **freedoms, rights and capabilities** are important for living standards
- the **distribution of living standards** across different groups in society is an ethical concern for the public, and a political concern for governments
- the **sustainability of living standards** over time is important, so analysis of policy needs to weigh up short-term and long-term costs and benefits
- measuring living standards with **subjective measures of wellbeing** provides a useful cross-check of what is important to individuals.

These were drawn together using concepts from economics – that of stocks and flows. The four key stocks – financial and physical; human; social and natural resources – are the things underpin the current flows in society. But in turn the flows – such as income, employment, leisure, freedom, security and amenities – affect the future stocks and so future living standards.

Figure 1 -



2 Moving Forward from the Framework

Publishing a framework has been an important step forward for the Treasury. It has encouraged a wider discussion of what could or should be included in the goal of "higher living standards". A wide range of people and organisations in New Zealand[2], interacted with the Living Standards report, including mainstream newspapers, organisations ranging from businesses to social sector interest groups, and commentators on blog sites. The general feedback has been positive, suggesting that overall it has captured the key elements of what people in New Zealand value. However, publishing the framework was always seen by Treasury as only the first step of a multi-step process.

One option for the next stage was to use the framework to evaluate New Zealand's performance over time and against other countries, building on the appendix of indicators in the Living Standards paper. However, we have chosen not to pursue this approach. This is, in part, because others are doing this evaluation already such as the Ministry of Social Development's evaluation of well-being produced as part of the Social Report[3] and the Sustainable Development Approach[4] by Statistics New Zealand. Overseas there is the comprehensive OECD Better Life Index that is built on a similar framework. Instead we have focused on how to use the Living Standards framework more effectively when we develop our advice on a day-to day basis.

The need for practical usefulness was raised early in a speech by David Gruen of the Australian Treasury about their experiences with their own framework:

> "This is because since its development, the [Australian] framework's intended role has been to provide a broad context and high level direction for policy advice, and not to provide a checklist to be applied in every circumstance, which might result if a list of measures is prescribed. As part of our review of our wellbeing framework, we found however that the intended purpose and usage of the framework has not been clear to many staff, and that some wanted a tool that would deliver concrete answers to the policy questions they encountered.
>
> The New Zealand framework similarly states that it is intended to be used as an input to the policy process, rather than an analytical tool. But from the living standards paper, it is evident that your framework is more ambitious by more directly addressing measurement related issues. For example, in its direct recognition of subjective wellbeing measures, and the extended coverage of measures. Related to this, the detailed discussion of the different stocks can give a reader a strong sense of policy directions.
>
> So it will be interesting for me to see how you find staff use, or want to use, your living standards framework. Based on our experience, being clear about how you expect it to be used and getting a sense at some point on how staff are travelling may be worthwhile. It would then be interesting to compare notes".[5]

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2 Such as http://www.stuff.co.nz/dominion-post/news/politics/5056148/Treasury-into-science-of-happiness http://www.mentalhealth.org.nz/page/882-news+2011 http://wintonbates.blogspot.co.nz/2011/06/will-nz-treasurys-living-standards.html

3 http://socialreport.msd.govt.nz/summary/social-wellbeing.html

4 www.stats.govt.nz/browse_for_stats/environment/sustainable_development/sustainable-development.aspx

5 http://www.treasury.govt.nz/downloads/pdfs/tgls-gruen-speech.pdf

From Treasury's perspective, the challenge is not how to embed the wider concept of living standards into our advice (since that has been happening for many years) but rather to do so more systematically and visibly. The focus, therefore, has been on developing a useful tool for front-line policy analysts. Success will be measured in whether what is created is something that staff find helps them to think about the living standards impact, rather than – mirroring the position of the Australian Treasury – something that is adopted as a checklist or compliance exercise.

It also will never be a substitute for all the analysis that lies behind good quality policy advice. Rather, it is intended to be a tool that challenges its staff to consistently and systematically consider holistically how any particular piece of policy advice fits within the broader vision that the Treasury aspires to achieve.

3 Creating a Useful Tool

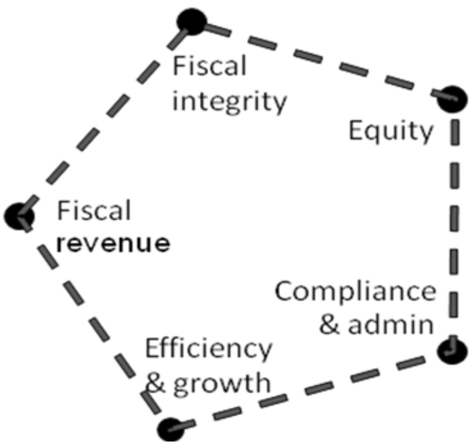
The Living Standards framework is comprehensive, covering all of the different aspects of life that impact on well-being. This is a strength for an overarching framework, but a weakness when it comes to embedding it in daily work. There are too many things, and not enough indication of what are the key factors.

The tool is intended to be different. It is intended to ensure that policy analysts consider a manageable list of the key issues that make the most difference. Its strength is that it is more tractable; its weakness is that it cannot be comprehensive.

Simplifying down choices in complex areas is, of course, not a new issue for Treasury. So when considering what might make a useful tool we looked at what we had already found worked, both because it helped assess the different factors, and because it helped us to explain the options and tensions to Ministers.

Of all the different approaches, the one developed to show the implications of different tax regimes has influenced the development of the living standards policy tool. This presented the information against the five key impacts, enabling a large amount of information to be presented in comparable ways for different types of tax. The full diagram of the impact of changing the rate of GST, which was released publicly on the Tax Working Group website, is shown in Appendix 1.

Figure 2 -



If only a few key issues are to be used then clearly they need to be chosen carefully. In developing the tool to this stage we have been guided by four key criteria:

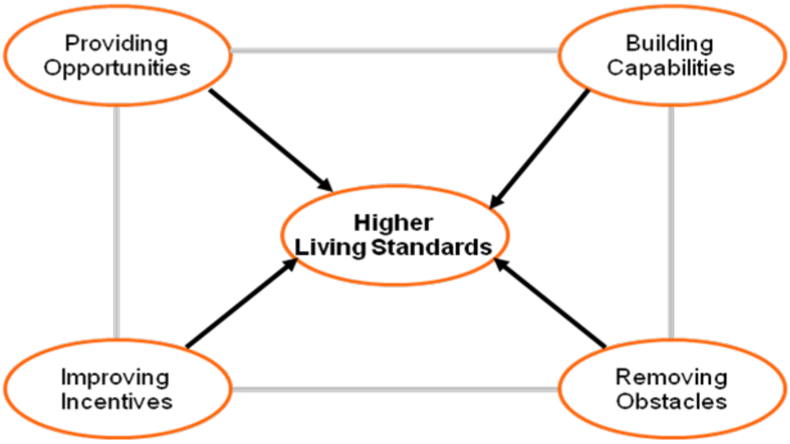
- They are areas where ***government decisions are a key influence***. There are many things that are important to living standards that are personal choices and not things that the Government either can or would want to determine.
- They reflect ***Treasury's role*** in the Government's policy development process, reflecting the fact that this is a tool for Treasury's own staff.
- They are focused on areas that make a ***major difference*** to living standards, but in combination cover all the key elements of the Living Standards framework. There is no point in focusing on areas that make only marginal difference, but neither do we want to miss any key element of the framework.
- They represent the key ***areas of tension*** where Government frequently is faced with competing objectives. While sometimes policy options meet all objectives, it is also the uncomfortable reality that it is also sometimes faced with trade-offs between what it wants to achieve in different areas. Ensuring that advice is housed within an holistic framework is perhaps even more important when these tensions are present.

4 Where Government Decisions are a Key Influence

The government does not make many of the key decisions that affect an individual's living standards, but government policy does heavily influence the environment in which that person makes their decision. Policy choices can lead to an environment that is rich in opportunities or one which imposes obstacles that limit the choices an individual can make. Obstacles are not necessarily bad; all societies impose limits for the health and safety of the whole, but they can unnecessarily limit choices that would lift the living standards of individuals.

In New Zealand the government also makes crucial decisions about the capabilities that will be developed. This includes the capability of the individual, such as their education and health, but also the systems that either support or undermine the decisions in wider society, such as access to infrastructure like roads, broadband internet, and the effective rule of law. This overall environment will provide incentives for people and firms to choose one option or another, and sometimes, though not always, these incentives are heavily determined by policy decisions.

Figure 3 -

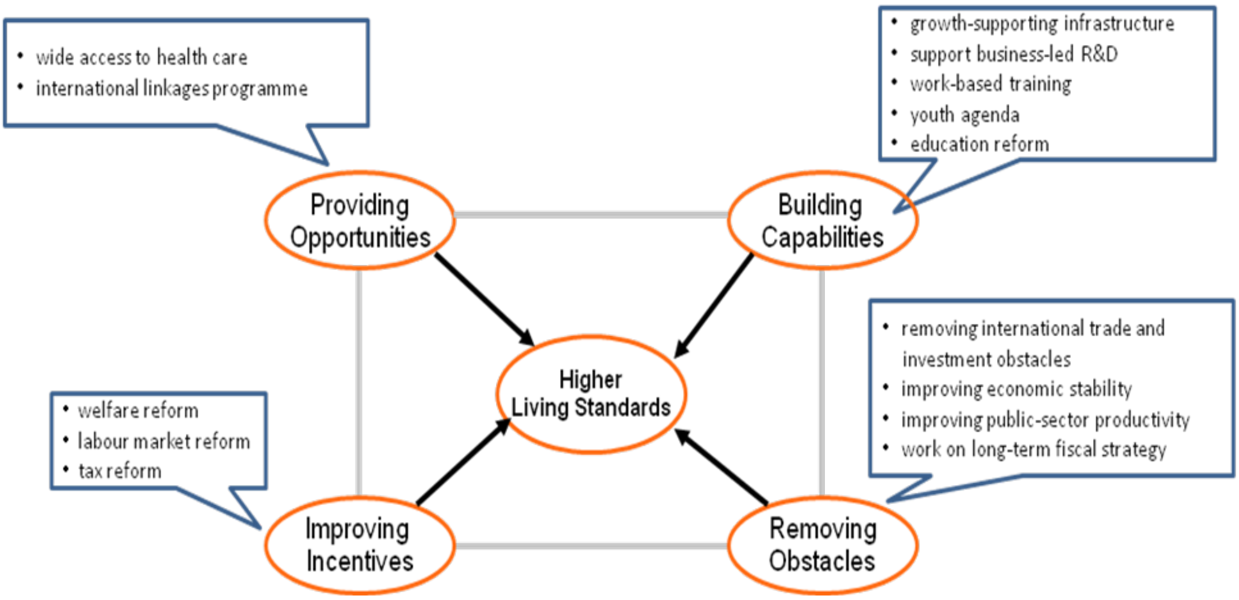


The government often has choices about the way it achieves its goals, or different ways of achieving the same ends. For higher living standards, good choices are those that provide more opportunities and reduce the obstacles people face to making the choices they want. Good choices also build capabilities both for individuals and the whole of society through supportive infrastructure and strong institutions, and improve the incentives embedded in government's own policies.

On the other hand, poorer choices are those that limit opportunities or build unnecessary barriers like "red tape". They are choices that reduce the incentives on people to make their own choices wisely, or their capability to do so.

The diagram below demonstrates the relationship between many of the recent highly-publicised policy recommendations by the Treasury and this framework. Treasury's focus on many of these areas reflect our view on what is needed to strengthen the overall Living Standards environment in New Zealand.

Figure 4 -



5 Focusing on Treasury's Role

Treasury's Statement of Intent sets out three key objectives under its overall goal of lifting living standards for New Zealanders. These are:

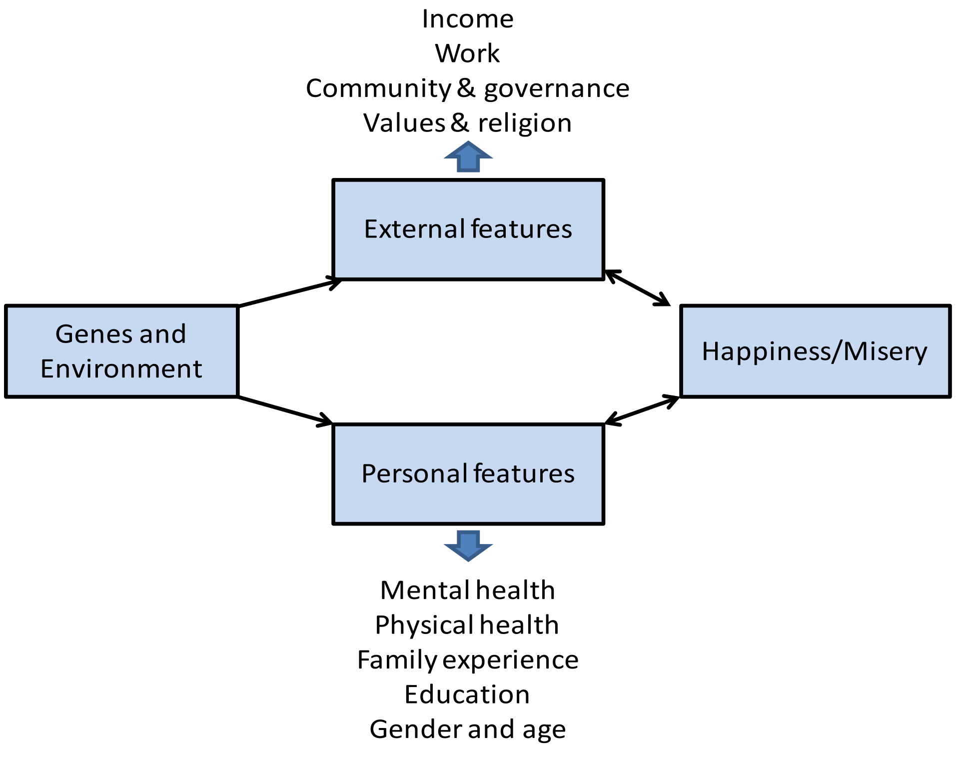
- Improved economic performance
- A high performing state sector that supports New Zealand's international competitiveness
- A stable and sustainable macro-economic environment.

Focusing on Treasury's role will inevitably mean that our tool will weight economic issues more highly than would be the case for another organisation. However as the living standards framework demonstrates, Treasury acknowledges that economic factors alone do not determine living standards, and there are other social and environmental factors that have to be considered.

6 Focusing on Factors Which Make a Significant Difference

There is a substantial literature on the impact of different factors on living standards, which has recently been summarised by the World Happiness Report commissioned and released by the United Nations.[6] They identified a short list of key determinants of subjective well-being which they are summarised in the diagram below.

Figure 5 -



[6] World Happiness Report 2012, ed by John Helliwell, Richard Layard, and Jeffery Sachs, available at http://www.earth.columbia.edu/sitefiles/file/Sachs%20Writing/2012/World%20Happiness%20Report.pdf

Source: Adapted from the World Happiness Report figure 3.1 and surrounding text

Some of these are not the focus of government policy (notably religion, gender and age) and some are only partly amenable to policy intervention (notably values and family experience).

This suggests that the most important factors which need to be considered by the framework are:

- Social capital areas, notably issues like social support, corruption levels, and the level of freedom, which had the most impact on an individual's sense of well-being
- Income, both the absolute level of income, but also its distribution volatility over time, as unemployment in particular has a significant and prolonged impact on the sense of well-being
- Health, both physical and mental, and
- the quality of the environment in which people live which affects both their physical and mental well-being.

7 The Five Factors

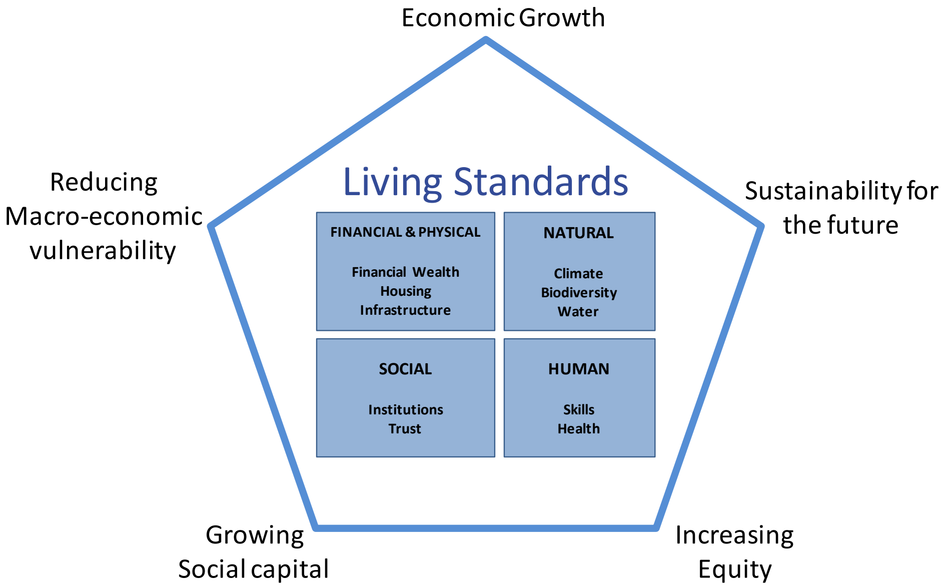
After considering all the different criteria, and reflecting on the areas where the Treasury most frequently finds it needs to consider tensions between competing policy goals, the Treasury proposes to trial using five key areas in a policy tool.

Choosing these areas involves an element of judgement and other options are possible. In addition to seeking the feedback from its own staff during this trial, the Treasury will also be seeking the views of the wider community on their appropriateness.

The five areas are:

- **Economic growth,** because it is important for living standards and stands at the core of the Treasury's role
- **Reducing macro-economic vulnerability**, because a stable macro-economic environment matters for living standards (particularly through unemployment), and again it stands at the core of the Treasury's role
- **Growing social capital**, because social capital has such an important role to play in both living standards and the economic environment
- **Increasing equity**, because the distribution of opportunities and capabilities impacts on the individual's experience, and
- **Sustainability for the future**, because when Treasury has as its goal to lift living standards of New Zealanders it does not just consider the people here and now, but also the New Zealand of the future.

Figure 6 -



Even if these five factors get general support now, the Treasury envisages that the areas of focus will be regularly reviewed. Unlike the Living Standards framework, which is comprehensive and will largely stay unchanged over time, this policy tool is, by necessity, something that focuses on the key issues of the time in which it is to be used. For instance, in the current world-wide uncertainties surrounding the macro-economic environment, the issue of vulnerability looms much larger than it may have in the past.

This means that there will need to be ongoing dialogue. While we do not anticipate the tool will change frequently, we will inevitably be looking to alter it to reflect changes in the environment in which it is being applied.

8 The Five Factors: The Synergies and Tensions between Them

Economic Growth

Increased economic resources provide more options for choices for individuals. They also increase their ability to secure other components that are central to living standards such as security, health, education, housing and work-life balance. This is true whether decisions about the relative allocation of resources are reached collectively (through public provision or transfers) or individually.

In the absence of windfall gains from natural resources, a strong and productive economic base is the only way to sustain income and wealth. Both household income and wealth are essential components; income because it provides for immediate consumption choices and wealth because it enables people to manage risk and sustain their living standards through shocks to current income. Variability and exposure to risk reduces an individuals' reported well-being.

The impact of economic growth on subjective well-being has been the subject of study for many years. The World Happiness Survey summarised the key findings of all this research as:

> "In a typical country, economic growth improves happiness other things equal. But other things are not necessarily equal, so economic growth does not automatically go with increased happiness. Thus policy makers should balance the argument for more rapid growth against the arguments for supporting other forms of happiness. This applies to countries at every level of development.
>
> In developed countries in particular there is strong micro-level evidence of the importance of income comparisons, which has not been disproved by aggregate data. For this reason, policies to raise average happiness must target much else besides economic growth." [7]

If economic growth on its own is insufficient to lift well-being then it is important to also understand the other factors involved. In fact, the research has not suggested that these are necessarily trade-offs, as in many cases the aggregate measures of income and other components of living standards are strongly positively correlated.[8]

While economic growth is most often thought to impact negatively on income distribution and environmental quality, there is little compelling evidence that simple trade-offs between income and these two dimensions are always negative. While there may sometimes be trade-offs, there are also policies which support both. For any particular policy issue, therefore, explicit consideration of the impact is required.

For example, the empirical evidence linking aggregate measures of income inequality and growth has been inconclusive, suggesting that there is not a strong linkage either positively or negatively. There is, however, stronger evidence around the marginal effect of particular growth policies. Some policies can lower income inequality and lead to higher GDP, including:

- improving the quality, quantity and equity of education outcomes
- increased spending on effective active labour market policies and improving the integration of migrants into the labour force
- fostering female labour market participation and fighting discrimination
- reducing tax expenditures on higher incomes, and
- moving from labour income to property and capital gains taxes.

Other policies to lift growth may lead to higher inequality, including:

- increasing the flexibility of wage setting, and
- shifting the tax base away from income and labour tax to real estate or consumption taxes.

This suggest the impact of policies that raise average levels of income need to be supplemented by an understanding of how economic resources are shared across the population and across generations.

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7 World Happiness Report p. 66.

8 See page 35 of the OECD publication "How's Life; Measuring Well-Being" for a summary of how the measures are correlated. The key negative correlations are for measures of environmental quality (air quality) and personal security (homicides and victimisation rates).

Reducing Macro-economic Vulnerability

A stable macro-economic environment is a fundamental precursor for strong, sustained economic growth because it allows households and firms to make the best possible decisions with respect to saving, investing, innovating and taking up opportunities. There is also considerable evidence that negative shocks, particularly those that lead to high levels of unemployment, have significant and long lasting negative impacts on subjective well-being.

Macro-economic stability is an exercise in risk management ensuring New Zealand has both the right macro-economic and microeconomic settings and environment in place to ensure that it can weather the inevitable shocks. It is important therefore that the impact of policy options on imbalances is recognised. In particular, high government deficits and external debt can hurt economic stability, raising the impact of external crises and pushing up real interest rates and borrowing costs. Consequent variability in GDP growth hurts decision-making, leading to lower average growth.

The key elements of macro-economic stability are:

- **Stable output and employment**

  Large fluctuations in output and employment have negative household income and social consequences. Avoiding recessions is an important component of achieving higher living standards over time. Recessions are costly as output lost during recessions is not always fully recovered. For instance, history shows New Zealand's level of GDP per capita has fallen behind that of Australia (and other OECD economies) mainly at times of recession here, and this gap is not usually closed during subsequent economic booms.

- **Price stability**

  High inflation is costly for the economy, increasing economic uncertainty and lowering people's living standards by undermining the value of their purchasing power. There is a broad range of factors that impact on inflation including monetary, regulatory policy, market structures and fiscal policy.

- **Financial stability**

  Experience shows that financial systems can transmit and amplify shocks to the rest of the economy. A stable and resilient financial system is one which can withstand a wide range of shocks and is not itself the source of severe shocks.

- **External balance**

  Savings-investment imbalances have been identified as a contributing cause of macro-economic vulnerability. Lifting national saving will reduce net debt while allowing New Zealand to invest in growth and help to reduce pressure on interest rates and the exchange rate, and support growth in the more productive tradable sector.

- **Fiscal balance**

  Providing the current generation with high-quality services is not sustainable if it raises the risk of future macro-economic instability or if current spending must be financed by increased debt, taxes and reduced services. A sustainable balance of debt and spending on current and future services prevents intergenerational inequity or the risk of future instability.

Achieving a stable macro-economic environment will in the long run assist with achieving other well-being goals, especially economic growth. Indeed, it could be argued that it is one element of a well-performing economy. But specific public policies can involve trade-offs between macro-economic stability and other dimensions. Some policies that may attempt to achieve a welfare improvement to the community may be inconsistent with a stable macro-economic environment (such as a deficit-financed increase in government spending) and other policies, which might promote macro-stability, may detract from microeconomic efficiency (such as variable tax rates).

Sustainability for the Future

An important part of Treasury's Living Standards is the concept of stocks and flows. Sustainability for the future asks the question of whether New Zealand is enhancing its current living standards by diminishing the key stocks of natural resources, physical and financial resources, and the human and social capital that will be available in the future.

Influential reports, such as the early reports of the Club of Rome (Meadows et al., 1972; Mihajlo & Pester, 1974) and the Brundtland report[8] have emphasised the idea that one should not only be mindful of current living standards but also those in the future. Sustainable development has been defined as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs"[9] or the capacity to provide non-declining future welfare.[10]

The sustainability of living standards over time is central to ensuring that improvements in living standards are permanent, with dynamic analysis of policy needed to weigh up short and long-term costs and benefits. The 'Sustainability for the Future' objective gives weight to the concept of sustainability, for example, with regard to natural resources, by ensuring that the potential long-term negative effects of damage to the natural environment are considered. It also recognises the life-cycle and an inter-generational impact of some capital flows (for example, the development of human capital). Finally, it acknowledges the fact that for some types of capital flows, investment in the short-term can take time to yield benefits for living standards (e.g. human capital, financial savings and investment in infrastructure and other forms of capital).

Sustaining living standards into the future may mean lower living standards in the present. For instance, the short-term expenditure on upgrading capital, whether it be human capital or physical capital, may require lower expenditure in other areas that may have had more immediate impacts on current living standards. Similarly, investment in environmental sustainability may mean we do not fully exploit the economic potential of natural resources, in order to preserve the environment or minimise environmental damage.

Growing Social Capital

Definitions of a well-functioning society commonly include the quality relationships between individuals and harmony between groups; a high level of social and civic activity; democracy; fairness in the application of the law; economic prosperity; access to healthcare and education; low crime; an effective infrastructure; a safe environment; culture and leisure

9 World Commission on Environment Development (1987) "Our Common Future" World Commission on Environment and Development. Oxford: Oxford University Press.

10 Neumayer, E. (1999) "The ISEW - not an index of sustainable economic welfare" Social Indicators Research, Volume 48, pp.77-101 See also Daly, H, and Farley, J (2003) "Ecological Economics: Principles and Applications". Washington: Island Press.

opportunities; and freedom of expression and of religion. Many of these things are encompassed by the term “social capital”.

The World Bank[11] defines social capital as “the degree of trust in a society and the ability of people to work together for common purposes”. Statistics New Zealand[12] defines it slightly differently, as “relationships among actors (individuals, groups and/or organisations) that create a capacity to act for mutual benefit or a common purpose”. By analogy with other types of capital, the core idea of social capital theory is that investments made affect the productivity of individuals and groups and have a measurable rate of return. The measurement of social capital can therefore be seen as a broad measure of communal health.[13]

Social capital is one of four types of capital stock identified in Treasury’s Living Standards Framework as underpinning living standards. There is a range of evidence that communities with a good “stock” of social capital are more likely to benefit from lower crime figures, better health, higher educational achievement, and better economic growth (Halpern 2009). Social capital is in fact frequently found to be the attribute that is most strongly correlated with subjective well-being. The World Happiness Report found that having social support in times of trouble was the single variable with the most effect on a person’s sense of well-being, with freedom and an absence of corruption also being significant factors.[14] There is particularly strong evidence that more socially cohesive societies are healthier with lower mortality.

Social capital influences outcomes in many ways, for example allowing for:

- The facilitation of labour market participation and matching, innovation, and diffusion of knowledge and best practice through interpersonal linkages[15]
- Lower transaction costs, through trust reducing the need for formal coordination mechanisms such as contracts
- Easier flows of knowledge and market information and sharing of financial risk
- Greater adaptability and earlier adjustments to emerging problems[16]
- Less burden on the institutional structure through trust and co-operation (positive reciprocity)[17], and
- More effective resource allocation and less resources being wasted on lobbying and poor public policy through good public sector governance.[13]

High income alone does not ensure a good life. As summed up in the OECD publication “How’s Life? Measuring Well-Being”, people in the richest countries are not necessarily the happiest, particularly when they suffer from low levels of social contact or trust in others. As recommended by the Commission on the Measurement of Economic Performance and

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11 World Bank (2006). Where is the Wealth of Nations? Measuring Capital for the 21st Century. p.xviii

12 Statistics New Zealand (2001). Framework for the Measurement of Social Capital in New Zealand. p.9

13 Alessandrini, M. (2002). Is Civil Society an Adequate Theory?

14 World Happiness Report, table 3.1

15 Saxenian, A (1994). Regional Advantage: Culture and Competition in Silicon Valley and Route 128. Fountain, J (1997). Investing in Innovation: Toward a Consensus Strategy for Federal Technology Policy.

16 Kaufmann, D, Kraay, A and Zoido-Lobatón, P (2000). *Governance Matters: From Measurement to Action*.

17 Knack, S and Keefer, P (1997). “Does Social Capital Have an Economic Payoff?” *Quarterly Journal of Economics*, 112.

Social Progress (Stiglitz et al. 2009), many national statistics agencies have begun to collect data on society with the aim of deriving “a more comprehensive measure of people’s quality of life and to allow a better understanding of its determinants”.

There is growing consensus that social capital is underpinned by:[18]

- ***Trust:*** a high level of interpersonal trust benefits social (and economic) cooperation and a low level hinders this
- ***Networks:*** social capital is strongly dependent on productive, durable formal and informal networks
- ***Good governance****:* the quality of government institutions strongly conditions people’s quality of life via fair application of the rules, transparency, and involvement of citizens in decision-making
- ***Resources:*** acquiring social capital requires time and also a stock of existing social capital – as with other types of capital, you need some to invest in order to generate more, and
- ***Social norms and sanctions:*** these regulate people’s behaviour and thereby govern interactions.

Given that much social capital is invested in families, communities and other civic collectives, an important policy challenge is ensuring the government interacts with these groups in a way that reinforces these investments.

Increasing Equity

New Zealand can be characterised as a society which has revealed a preference for a high level of mutual respect and trust between its members and few barriers stopping people from taking advantage of the available opportunities. While research has shown that income inequality has little impact on subjective well-being in most countries, it also shows that in our type of society, the average sense of well-being is lower if people do not think the system is being “fair”.[19] This suggests that policy which addresses the needs of those in difficulty, reducing their barriers to participation, it will improve the overall living standards over and above the direct impact of the policy.

Based on Amartya Sen’s capability approach, there are three key ways in which individuals may face barriers to their participation in the choices available in the wider society. They are:

- **Human capital**

  This includes physical and psychological functioning, work skills and the social capital to engage in both work and wider society, the expectation that participation leads to higher living standards and some understanding of society’s expectations. The distribution of access to the services, such as health services and education, which support people to develop these characteristics, will have an impact on the opportunities an individual has.

- **Social insurance**

  The original focus of welfare intervention was the need to protect against bad luck and the bad outcomes that could become mutually re-enforcing. The effectiveness of welfare in

[18] This excludes the concepts of human capital and equality, with the expectation that these are included in Investment for the Future and Intergenerational Mobility

[19] Summary of the findings of the World Happiness Report, page 71

preventing an individual being trapped by their circumstances is still likely to impact on overall well-being.

- **Removing institutional barriers**

  Whether intentionally, or otherwise, organisations may create barriers to people improving their wellbeing. The state has an important role in ensuring its processes are efficient and free of corruption, and are thus available across the population though such mechanisms as anti-discrimination legislation, protection of human rights, and the provision of information. More subtly it is important that agencies do not make some desirable choices harder such as through incentives to welfare dependence, educational biases to the more academic, occupational licensing rules that disadvantage those with few resources and market rigidities that reduce employment.

However, policies to reduce inequality often have two key trade-offs:

- Where resources need to be redistributed this directly reduces the well being of others. Such redistribution is obvious when income and capital are redistributed, but other scarce resources, such as access to the natural environment and the time of health professionals, are also important to reducing barriers where price rationing will lead to poor quality of life.

- Redistribution mechanisms are also frequently plagued by high deadweight costs. These are a particular issue when interventions create perverse incentives, though consequences like higher taxes and interest rates, rent seeking and distortion of important markets.

9 Using the Policy Tool

The intention is to use this tool on a day-to-day basis to ensure that Treasury's advice consistently considers all the five identified key aspects of living standards. However it is not, echoing the quote from the Australian Treasury, intended to be a checklist, nor is it intended to take the place of good policy development processes, including the evaluation of evidence, the development of options and the provision of free and frank advice on the Treasury's view of the best way forward.

In many cases it may be a tool that is in the back of an analyst's mind, something they can refer to when they want to ensure that they have considered all the different aspects that may be important (acknowledging that sometimes one or other aspect may not be significant to a particular decision). Other times, it may be that a more formal assessment would take place, informed by evidence when it is available and otherwise by judgment.

What might this analysis look like in practise? To give some idea, we have done a qualitative assessment of the Welfare Working Group's recommendations on welfare reform.

The Welfare Working Group recommendations

The Welfare Working Group was established in 2010 to look at options to reduce long-term welfare dependency in New Zealand. In February 2011 they presented their recommendations to Government to reduce long-term welfare dependency. The Government is considering its response to the recommendations and has announced changes to the work expectations and support for sole parents, young people and partners. Since the government's response is still under active consideration we focus here on the overall impact of the Welfare Working Group recommendations through a living standards approach, rather than any of the specific policy options under consideration.

Broadly speaking the Welfare Working Group proposed the following recommendations:[20]

- *A stronger focus on work for more people* – increasing the expectations on beneficiaries and MSD to support more beneficiaries into work. This included work expectations for sole parents and partners with children from the age of 3 years and re-examining the gateway on to sickness and disability benefits

- *A longer term view* - a greater focus on investing early to reduce the life-time costs of benefit receipt through the forward liability. In particular, it looked for an active early intervention approach for people with sickness and impairment to support them back into work

- *More effective delivery* – an outcomes focused delivery agency with new skills and capacities to deliver effective services to people at risk of long-term welfare dependency.

The Welfare Working Group's report presented evidence from Australia, the US and earlier New Zealand reforms that demonstrated that these reforms could result in 49,000-93,000 fewer people on a benefit by 2021. This could result in large fiscal savings in excess of $1b per annum. The modelling of the package subsequently has suggested that a feasible expectation for reform is that numbers on welfare are reduced by 28,000- 46,000 by 2015/16.

The Welfare Working Group also surveyed the large literature on the impacts of welfare reform on a variety of different outcomes. While there are a number of areas where there is significant uncertainty about the extent of the impacts, there were some areas where there was general agreement about the direction of change. Broadly speaking some key conclusions from the literature are:

- An active work-focused welfare reform can reduce numbers on benefits and reduce fiscal cost.[21]

- A successful work-focused reform can reduce the depth and level of poverty (including child poverty).[22]

- Welfare reform can reduce the risk of persistent detachment from the workforce. In addition, labour demand does respond to increases in labour supply over time.[23]

- Reduced welfare dependency and higher employment improves health, wellbeing and measures of community participation.

The welfare reform as a whole could have significant impacts on economic growth, equity and growing social capital; and positive albeit smaller impacts on investment and macro-stability.

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[20] http://ips.ac.nz/WelfareWorkingGroup/Downloads/Final%20Report/WWG-Final-Recommendations-Report-22-February-2011.pdf

[21] See Welfare Working Group: Recommendations report. The Welfare Working Group references, included reforms in Australia, in ACC, to the Job Search Service in New Zealand, and reforms to delivery in Australia and New Zealand

[22] Whiteford and Adema (2007) find that if New Zealand could lower the Share of jobless households to that experienced in the top performing countries then New Zealand's child poverty would drop by a quarter. Whiteford and Adema (2007); *What works best in reducing Childhood Poverty: A Benefit or Work Strategy*, OECD Social, Employment and Migration Working Paper 51.

[23] OECD (2005); "OECD Employment Outlook", page 178

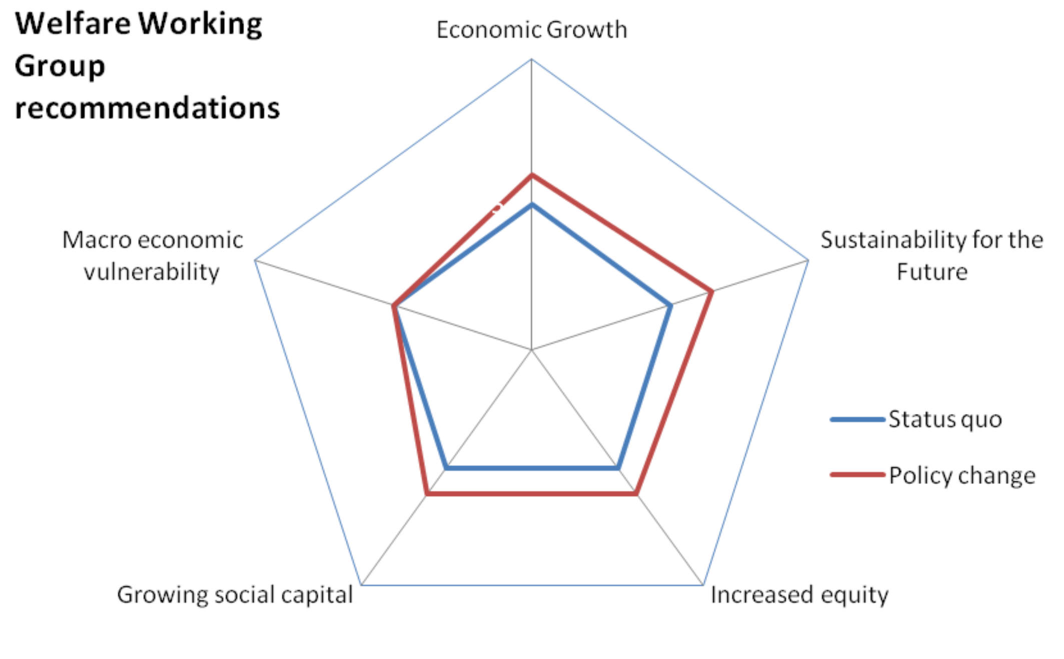
- ***Increasing equity and growing social capital*** – the primary objective of welfare reform is to improve equity and grow social capital by supporting more people to move from long-term welfare dependency to sustained employment. The impacts on benefit dependency and employment could be significant.
  - The medium scenario presented by the Welfare Working Group was for a 49,000 reduction in benefit numbers.
  - If NZ sole parent employment rate increased to the OECD average for this group it would result in a net increase in employment of 21,000 for this group.
  - Long-term low income is the major concern and is related to higher levels of deprivation. It is also related to lower educational outcomes for children and worse health and housing outcomes. This is why this specific reform is so important – it is targeted at those people with the worst long-term outcomes.
  - The key tension from a greater focus on work is that the system may not be tailored sufficiently for groups with specific needs, and that the transition may involve negative short-term consequences for some individuals. For instance, there is a concern that sole parents may not receive the support that sufficiently recognises their caring responsibilities. This is currently being considered as part of the response to the Welfare Working Group.
- ***Economic Growth*** – The impacts of welfare reform are to reduce fiscal cost and increase the level of employment. These results could be significant
  - As noted above, the reforms are expected to draw more people into the labour force. This may, in turn, put a one-off upward pressure on employment and economic activity over time.
  - Fiscal savings could be used to support higher economic growth priorities or reinvested in welfare reform to provide additional support for people into work.
- ***Sustainability for the future and macro-stability*** – the likely impacts of welfare reform on these two objectives are likely to be small but positive.
  - A greater focus on encouraging independence and work and providing support for people to up-skill may have a modest improvement in the level of investment in human capital (including work-related human capital).[24]
  - Reducing discouragement of jobseekers during recessions and the early stages of recovery may support a stronger and earlier recovery from high unemployment than would otherwise be the case.[25]

[24] Keane and Wolpin (2007) develop a model where the incentives created by the welfare system may have negative effects on skill acquisition by changing the incentives to acquire higher qualifications. Keane and Wolpin (2007); "The Role of Labor and Marriage Markets, Preference Heterogeneity and the Welfare System in the Life Cycle Decisions of Black, Hispanic and White Women " Working paper.

[25] Blanchard and Wolfers (1999) find that labour market institutions that shorten the duration of unemployment (such as active labour market policies) decrease the unemployment rate. Blanchard and Wolfers (1999); "The role of shocks and institutions in the rise of European unemployment: the aggregate evidence"; NBER working paper 7282.

This is only intended as a quick overview, but if we did reflect these considerations against the five key aspects of our living standards policy tool, they would suggest that the policy change would enhance living standards on four of the five dimensions. We have tried to suggest what these may look like on a diagram. Though clearly there is an element of judgement about the extent of these changes, they do illustrate that Treasury sees wider gains than just enhanced economic growth.

Figure 7 –



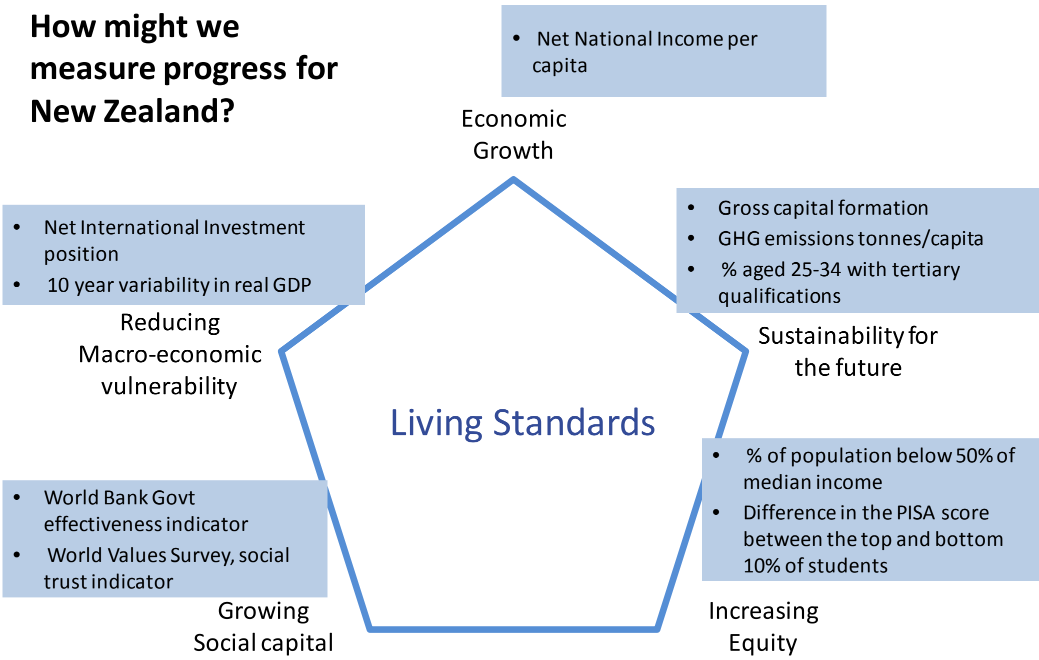
Note: This is intended to demonstrate how the diagram could be used, rather than a Treasury view of the recommendations

New Zealand's overall performance

We could also use an analysis of the key factors to assess overall progress. If Treasury does consider these to be the key factors in promoting Living Standards, then it should follow what is happening to them. Again, for the purpose of this paper we have only done a "back of the envelope" analysis.

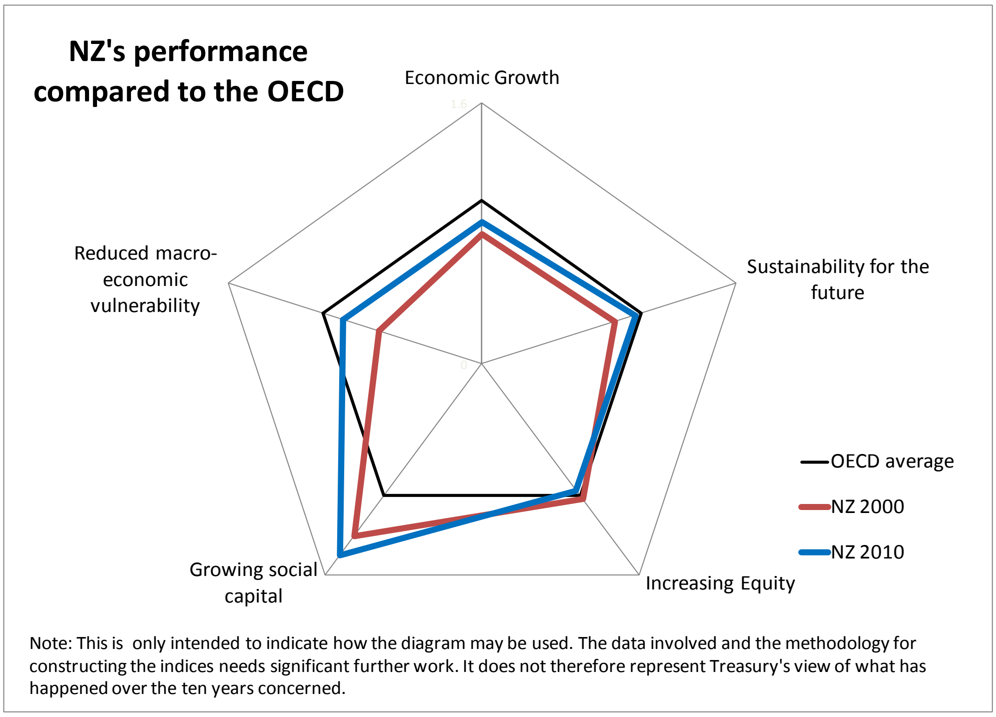
With the goal of simplicity in mind, the Treasury has sought one or two key robust and timely statistics for each of the aspects. The choices have been driven by the need to have comparable OECD data so that New Zealand's performance can be measured in context. The measures that have been chosen, and the rationale for each one, are provided in Appendix 2.

Figure 8 -



In this case the diagram represents how New Zealand compares against the OECD average in both 2000 and 2010 across the chosen measures. There is an element of judgement in how to use the data, and in using this as an example we have, for each axis, created an equally weighted composite of New Zealand's results as a percentage of the OECD average to give a sense of direction.[26]

Figure 9 –



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26 Because each axis is drawn from different data, it is not legitimate at this point to compare the level of movement on one axis with another. We plan to work with other departments who are thinking in this area to both refine our measures, and to improve the way in which we use them, so this representation should be taken as only indicative of what we hope to achieve.

10 Conclusion

When Treasury published its Living Standards paper in 2011 it was neither a new framework that changed the way it operated, nor the end of its living standards work. The framework rather explained and codified what has been the practice within Treasury for a considerable period of time. It was a first step in a process that was designed not to change its way of working but rather to make its current practise more transparent and more consistent in its application.

The tool that is now proposed is the next step in this process. The goal is to have something practical (so that it can be used on a daily basis to inform the policy advice given to Ministers), focused (recognising that it is impossible to do everything so focusing on those few things that make the most difference), and measurable (so that the direction of travel is clear). We consider the proposed five aspects are the best ones to fulfil this objective.

However this is also another step in the process rather than the end point. It is proposed that the tool will be trialled within Treasury to see if it does make the focus on living standards more consistent across our policy advice. But equally important, Treasury would like to now have feedback from the community on whether this next step is the right step for taking the living standards framework forward.

Appendix 1: Tax Working Group Framework

Changing the rate of GST

Description

- This summary examines the impact of a possible increase in the GST rate to either 15%, 17.5% or 20%;
- GST was introduced at 10% on 1 October 1986. It was increased to 12.5% from 1 July 1989;
- This measure should be seen as a possible revenue positive input to a broader package of reform, and the impacts of the overall package on revenue, efficiency, integrity, equity, and compliance should be assessed.

Fiscal revenue

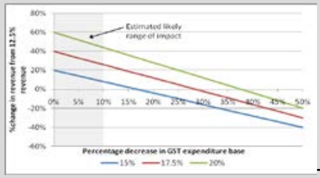
Mechanical effect of an increase (per year):

($ billion)	2007/08 GST	Estimated Additional Revenue at:		
Rate	12.5%	15%	17.5%	20%
Private sector revenue	11.115	2.150	4.200	6.170
Automatic Benefit Adjustment	N/A	(0.250)	(0.480)	(0.720)

Behavioural effect of an increase:
The mechanical effect of an increase in the rate could decrease as a result of behavioural changes if :

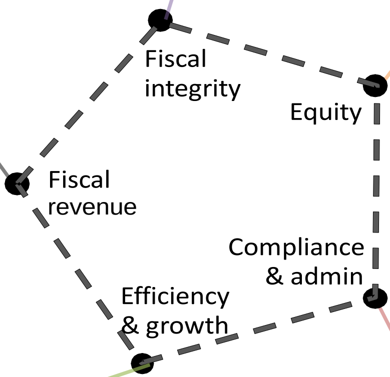
- Consumers alter the mix of their expenditure toward non-GST items;
- Consumers decrease expenditure as a proportion of income;
- There is an increase in avoidance behaviour

$ billion		15%	17.5%	20%
Additional revenue		+2.150	+4.200	+6.170
Behavioural effect leading to a reduction in GST base of:	0%	0	0	0
	5%	-0.65	- 0.74	- 0.82
	10%	-1.29	- 1.47	- 1.65
	15%	-1.94	- 2.21	- 2.47
	20%	-2.58	- 2.94	- 3.29
	25%	-3.23	- 3.68	- 4.11
	30%	-3.87	- 4.41	- 4.94
	35%	-4.52	- 5.15	- 5.76
	40%	-5.16	- 5.88	- 6.58
	45%	-5.81	- 6.62	- 7.40
	50%	-6.03	-6.89	-7.71



Fiscal integrity

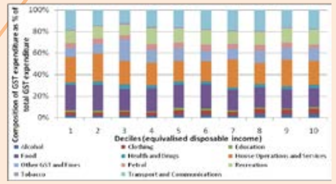
- Risk of fraud, such as carousel fraud, increases as a higher rate of tax provides a greater return.
- Risks associated with GST refunds increases.
- Increased incentive for private or recreational activities to try to register for GST to remove the legal incidence of GST.
- Additional pressure for special or reduced rates.
- Higher rates of GST may lead to households substituting spending toward non-taxable providers (such as, low value imported goods) or "self-supplying" (e.g growing their own vegetables)
- May improve integrity if part of broader reform, e.g. lower top personal rate.

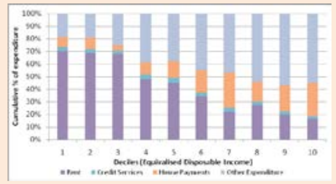


Equity

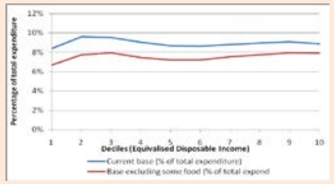
GST appears more regressive if measured as a proportion of annual income; equity effects should be measured relative to disposable income, or expenditure. GST is less regressive if measured as a proportion of lifetime income or expenditure …this is because consumption depends on lifetime income so expenditure is more stable across lifetimes than income…

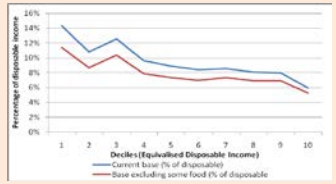
…The ratio of GST to non-GST expenditure is also relatively constant across deciles. The composition of GST expenditure is relatively stable across deciles; but the composition of non-GST expenditure varies –





Exempting food (but not takeaways/restaurant meals) from the base does not substantially improve equity; and would cost 15% of GST revenue:





Most benefits have a built in adjustment to reflect price increases; although these may be delayed. Providing adequate compensation is not straightforward; but an approximation of the amount of revenue needed to compensate for the increase is:

Quintile	WFF	NZS	Benefit	No assistance	Total
1	1.31	3.93	4.13	1.83	8.38
2	5.02	5.58	3.6	4.86	13.37
3	9.33	3.58	3.8	7.23	17.70
4	8.24	1.79	2.46	16.32	23.53
5	3.29	3.39	2.27	36.13	37.03

Efficiency & growth

GST can be broadly described as a tax on spending by households - an indirect tax on labour

Relative to income taxes, broad-based consumption taxes are :

- Less distorting to
  - firm and household decisions, and thus to GDP;
  - saving or investment decisions;
  - households' employment participation;
- Less progressive, as there is less scope for a progressive rate structure, or targeting to specific groups;
- Broad base and few exemptions reduce the deadweight cost connected with raising GST revenue and make avoidance more difficult.

	Possible short-run economic impact
Inflation	Introduction of GST, and previous increase had one-off price level impact. The price level impact would be dependent on Reserve bank response, wage settings, incidence of tax, consumers' response (e.g. changes in consumption patterns).
Consumption	Likely increase in quarter preceding increase, with fall in quarter following increase.
GDP	Impact on GDP is dependent on nature of consumer response, and on use of revenue: fiscal consolidation may be contractionary; expenditure or tax reforms may be neutral or expansionary.

Compliance & administration

- Tax simplification measures such as the "tax fraction" (e.g. 12.5% = 1/8th and 1/9th) and the payments basis of accounting become more difficult to use if the rate of GST is 15% or 17.5%.
- If special rates of GST are introduced, administration and compliance costs will rise in response to the new boundary.
- Higher rates of GST will have an impact on the profitability and operation of taxpayers that supply exempt goods and services, such as financial services providers (banks).

Appendix 2: Measures Used for the "Back of Envelope" of New Zealand's Performance 2000 and 2010

Aspect	Measures	Rationale for choosing this measure
Economic Growth	• Net National Income per capita	• An internationally recognised and comparable measure of income levels
Reduced macro-economic vulnerability	• Net International Investment position • Variability in real GDP over the previous 10 years	• NIIP is a recognised measure of the exposure of New Zealand to international economic shocks • The variability in real GDP shows the extent to which New Zealand has managed to maintain a stable environment
Increased equity	• % of population below 50% of median income before housing costs • The PISA score for the top 10% compared to the bottom 10% of students	• Internationally recognised indicator of low incomes within the community • Education is one of the key opportunities for breaking intergenerational transmission of socio-economic status
Growing social capital	• World Bank's worldwide government effectiveness indicator • Social Trust Indicator from the World Values Survey	• This is a composite index that assesses whether people have confidence in the major institutions provided by government • The level of social trust has been shown to be a good indicator of whether people have social support networks
Investing for the future	• Gross capital formation • % of those aged 25-34 with tertiary qualifications • GHG emissions tonne/capita (excluding LULUCF)	• These three measures cover the key aspects of investment in physical capital, human capital and the environment.

Note: New Zealand's performance was assessed relative to the OECD average for that year. When there is more than one measure, an unweighted average of the different measures was taken.