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Kaitohutohu Kaupapa Rawa

Intergenerational Wellbeing: Weaving the Living Standards Framework into Public Policy

Speech delivered by Gabriel Makhlouf, Secretary to the Treasury

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[Check on delivery]

Thank you for joining us today at the last Treasury Guest Lecture of 2017.

Just over a year ago, I spoke at Victoria University about my vision for public policy. I emphasised the importance of investing in sustainable improvements in wellbeing – or growing our economic capital – and the role of the Treasury's Living Standards Framework (LSF) in helping achieve that.

Not long after, we released *He Tirohanga Mokopuna*, which was an attempt to embed this perspective into one of our core statutory functions, the production of a long-term fiscal statement every four years.

I'd like to give you a flavour of the next stage in the Treasury's ambitions. For me 'Higher Living Standards' isn't a catchphrase. For some it sounds like we are going back to a phrase from the 1950s and 60s. It is, indeed, a mission statement, one that sharpens our minds on the ends of all public policy even while it helps to provide the practical means to improve our craft.

I want to tell you briefly about our plans for the next few months and beyond, and the importance we see in building a community to help steward this work. I'm also going to talk about intergenerational wellbeing and economic capitals, and some of the challenges in making these concepts real and grounded.

Economic Measurement and Economic Stories

Let me start by offering some reflections on why the Treasury is focused on living standards. The simple answer would be because it's good economics and good policy and, together, those things help us to raise living standards. This, to use the inelegant term of art, is my 'elevator pitch'. But as I have you for longer, I hope you'll indulge my more expansive take on this question.

At the risk of confirming jokes about the dismal science of economics, I'll start with the Great Depression. Many accounts of modern economic thought zoom in on the aftermath of this great global catastrophe and its role in giving prominence to thinking about the causes of fluctuations in national income. However, national income is hard to get a grip on without national accounts. And I'm from the Treasury, so naturally this is part of the story that is most thrilling to me.

Economist Diane Coyle writes persuasively about the role played by scholars like Simon Kuznets, Colin Clark and others in inventing GDP. These days statisticians and forecasters debate the finer points of seasonal adjustment; in those days academics and officials were more engaged in the task of inventing a framework for measurement. They were under no illusions about the limitations of the technology at the time.

Kuznets himself said: "The welfare of a nation can scarcely be inferred from a measurement of national income."

This isn't a novel point. The limitations of GDP are well known, if not always made explicit. But serious economic commentators aren't focused on just the headline GDP figures. They consider what the national income numbers say about productivity, GDP per capita, industry dynamics, inflationary pressures and many other issues central to economic analysis and economic welfare.

A robust measurement and conceptual framework is critical to enable this, and so GDP measurement and GDP growth remain foundational for economic policy. We know that higher incomes tend to correlate with better wellbeing outcomes for individuals and nations. This is why we constantly refine and augment GDP statistics to make sure we are measuring what we aim for, as the nature of the economy shifts.

Another example is the challenge of disruptive technology, new products and quality improvements for measuring consumer prices, both in history and in the future.

The reason I draw on these examples is only to highlight the point that measuring the economy is not like measuring the natural world. Economic relationships are always changing, and so our measurement systems need to adapt.

The way we choose to hold a tape measure to reality can influence the way we choose to cut our cloth.

The LSF is our analytical response to the need to broaden our understanding of economic phenomena and the impact they have on individuals and communities. Economics gives us a range of models to use, and we shouldn't be too dogmatic in how we apply them. One challenge going forward is to bring the 'fuzzier' concepts in the LSF into sharper definition so they are tractable and amenable to empirical analysis. I'll say more about this in a minute.

But before that, what about the LSF as a tool to guide policy advice? Sometimes, I hear the criticism that the Treasury's focus on living standards implies a lack of focus on the fundamentals. That what we should do is train our sights on the basics: sound public finances, value for money, stable macroeconomic frameworks, and robust microeconomic analysis.

I both agree and disagree with this sentiment.

I wholeheartedly agree that those fundamentals remain critical, for both New Zealand and the Treasury. As I've said before, it remains a fundamental truth that successful economies need, among other things, a stable and sustainable macroeconomic framework, sound monetary policy that delivers stable and predictable prices, a prudent fiscal policy and debt that's under control. For a small economy such as ours, fiscal control is critical and rumours of its death have been greatly exaggerated (and I'm happy to nominate any of my Public Sector Chief Executive colleagues as a reference on this point!).

I disagree that these fundamentals are all that we ought to focus on. The fundamentals are necessary but they're not sufficient.

Good public policy needs a wide-angle lens and, at its heart, the LSF is about what we mean by 'value'.

When I look at the history of the Treasury itself, I see echoes of this expanded focus – you could call it a *leap of thinking* – time and time again. Whether it be in the shift from bookkeeping to financial control in the 1920s and 1930s, or its leadership in focusing on microeconomic analysis from the 1960s, through to pioneering the creation of a framework for transparent fiscal management in the 1990s.

Another critique I sometimes hear is that the Treasury is faced with a dilemma in advancing its work on the LSF. One horn of the dilemma is the concern that the LSF goes too far in 'assuming social values', more so than is appropriate for a public service agency. On the other horn is the accusation that the LSF is too vague, and doesn't have any real substance to guide public policy analysis.

But this is a false dilemma. If the Treasury does not provide advice on, say, macroeconomic stability or on welfare, education, health, justice and other spending with a wide variety of objectives, then we are not doing our job. What we do is inescapably normative. And what the LSF does is help us consider how well spending meets these wider objectives in a consistent way so our advice to Ministers is more robust and more relevant to the needs of public policy advice.

As I've said, our ambition is to develop the LSF such that it helps us integrate a broader conception of economics and value into the everyday work of public policy. This can bring rigour and clarity to the trade-offs that the New Zealand public has to reflect on. Policy choices are still ultimately made by elected representatives within our democratic institutions.

Economists have a curious tendency to strive to describe themselves in terms of other professions. Esther Duflo has written recently about whether the profession should think of itself less like engineers and more like plumbers, practical and focused on implementing policy well. Keynes famously said it would be splendid if economists were thought of as humble and competent as dentists. And that a "master-economist" needed to combine the skills of mathematician, historian, statesman and philosopher. In fact Adam Smith was a professor of Moral Philosophy at Glasgow and saw the wealth of nations and the moral sentiments as continuous fields of inquiry.

My suggestion is that economists in New Zealand think of themselves as 'weavers'. Our challenge is to bring together different strands of evidence and analytical frameworks and weave them into baskets to carry forward public policy.

Developing the LSF is challenging and it is far from perfect. But to quote Confucius, "a diamond with a flaw is worth more than a pebble without imperfections". I'm not saying our

LSF is a rough diamond – far from it – but it's potential to reshape the way we think about the contribution of public policy to increasing intergenerational wellbeing is immense.

As Nobel Prize winner Jean Tirole says, "Economics not only documents and analyses individual and collective behaviour; it also aspires to recommend better public policy." And that's why I'm here today.

Explaining the LSF and the Capitals

I've talked about the '*why*' of the LSF and I'd like to turn now and focus on the '*what*' of the framework.

The LSF enables a comprehensive assessment of both tangible and intangible factors that impact on people's lives. It's a way of factoring in social, cultural, civic, environmental and economic aspects into our thinking when we frame up policy advice.

The four capitals at the heart of the LSF – which, together, I like to describe as our economic capital – generate flows of tangible and intangible benefits that enhance wellbeing now and in the future. Intergenerational wellbeing depends on the sustainable growth and distribution of the four capitals and wellbeing flows.

The basic idea underpinning this framework is quite simple: it's about stocks and flows. Traditionally, economists have focused their thinking about the factors of production, like land and labour, and how they are combined to create goods and services. In a way, our LSF is an adaptation of this notion: the four capitals – natural, human, social and financial/physical – are the stocks which combine to generate flows of wellbeing. It's quite orthodox, even as it lets us expand our understanding of a much broader range of economic relationships.

This approach recognises that good public policy needs to take into account issues beyond just income and GDP growth, important though they are. Our advice needs to consider how resilient the capitals are to future shocks, whether activities that deplete one or more capitals are sustainable in the longer term, how cohesive our society is and whether there's fair and equitable access to the capitals and the wellbeing benefits they provide. In essence, what the LSF does is allow us to look at the bigger picture.

So, onto a description of the capitals themselves. I need to stress that these are our starting point definitions of the capitals. We know we've got more work to do and I'll come back to that point a bit later.

Starting with *natural capital*, this refers to all aspects of the natural environment needed to support life and human activity. It includes things like soil, water, plants, animals, as well as minerals and energy resources.

New Zealand's natural resources underpin our economic, social and cultural activities. Some aspects of our natural capital, such as topsoil, biodiversity and fresh water are currently in decline or under threat. The planning system can be slow to respond to the depletion of natural resources from fast population growth and society's changing demands for resources and services. Freshwater pressures, for example, are symptoms of issues in the planning system, such as over-allocation and strains in the management of agricultural and urban storm-water run-off. The allocation of freshwater resources needs to recognise the ecological and economic interdependencies and incentivise more sustainable use.

Social capital describes the norms and values that underpin society. It includes things like trust, adherence to the rule of law, commitment to the Crown-Māori relationship, cultural identity and the connections between people and communities.

Generally, New Zealanders feel they can rely on each other, are active with their local community and have relatively high confidence in government institutions; yet high levels of incarceration and lack of access to some services suggest the benefits of relatively high social capital are not evenly distributed. There is also an important regional character to some of these disparities.

Human capital encompasses people's skills, knowledge and their physical and mental health. These are the things which enable people to participate fully in work, study, recreational activities and society more broadly.

New Zealand's educational performance is above the OECD average and NCEA qualification rates are increasing. New Zealand has relatively high rates of labour force participation and low levels of long-term unemployment. Overall health outcomes are comparable with other developed countries. In all three areas though, there are marked ethnic disparities (albeit narrowing), and educational performance in international studies has declined over the last decade. As the labour market evolves towards more non-standard work arrangements, there will be a need to ensure the maintenance of minimum protections for workers and support for transitions between jobs.

Financial/physical capital includes things like factories, houses, roads, hospitals and financial assets. These are the human-made things involved in commercial and non-commercial activity.

Low productivity attributable to low levels of capitalisation of the economy is a longstanding and unresolved challenge. It involves a wide range of factors, including some that we can't do much about such as small size and remoteness. However there are policy settings that influence physical and financial capital and do deserve examination such as tax, regulation, planning rules, and competition law.

Thinking about the four capitals together – and some of the policy issues associated with each of them – you start to see, from an economic policy perspective, how it's a bit like playing that string game Cat's Cradle which many of us played as children: everything interconnects and when you tug on one end it distorts the shape in other places.

For instance, let's look at natural capital and the very topical subject of freshwater. Notwithstanding the efforts of various organisations to address this the contamination of waterways not only depletes the freshwater stock of natural capital, but – to continue with the metaphor – has downstream effects on other capitals too. Social capital weakens as communities become increasingly concerned the recreational and conservation values of freshwater are being undermined for financial gain, resulting in lower social cohesion among community members in the vicinity, and lower levels of trust in institutions nationwide.

That's why our LSF imagery has changed to recognise this. As you can see on the screen behind me, we're now representing the four capitals visually as flax strands, with the condition of each capital represented by the width and strength of colour of each strand. When woven together (*raranga*), the strands come together to produce a sturdy *whariki* (mat) or *kete* (basket). Wellbeing is increased when the four capitals are all strong and supporting each other.

There are, inevitably, synergies and tensions between the four capitals, and policy development is often about managing the tensions and competing objectives, and having to make trade-offs.

The LSF doesn't remove any of those tensions, but it does enable a more holistic and coherent way of assessing those trade-offs as well as a dynamic and broader conversation about what contributes to raising the standards of living of New Zealanders.

The LSF doesn't diminish those fundamental truths that I mentioned earlier – on macro stability and sound public finances – nor the fact that properly functioning markets continue to matter, that a well-regulated financial system matters, that price signals matter and that incentives matter.

But its focus on the long-term, intergenerational wellbeing of New Zealanders does mean that the Treasury is delivering its stewardship role more comprehensively and more effectively.

I should add that we also intend the LSF to be amenable to the perspectives of different populations, including Māori. The challenge with more traditional economic approaches is how they essentially privilege certain ways of seeing the world, for example focusing on the measurable, forecastable or easy-to-count (like household incomes, as Marilyn Waring pointed out nearly 30 years ago). We want to broaden that to enable recognition and consideration of that which is also important, but more difficult to quantify – such as cultural capital – which is critical to the ability of Māori and others to live the lives they value. It's for this reason that the four capitals sit at the heart of the LSF.

Making Progress/Next Steps

So where are we taking this and how do we see it coming to life in real terms?

In February we'll be producing a series of discussion papers which will focus on fleshing out the definitions of the four capitals. They will be published on our website and we will be seeking input from people like yourselves on them.

And we're already well on the way in our development of the 2018 Investment Statement (IS).

The 2018 IS explores how, and how well, the Crown's balance sheet contributes to wellbeing. Using the LSF and the four capitals, the IS will assess performance at a government agency, sector, and system level, to support decisions about New Zealand's future investment strategy. The IS will aim to advance thinking about the link between effective government capital spending and asset management, and intergenerational wellbeing.

As I noted earlier, lots of this is about measurement. The ability to assess where we are now and where we're heading in the future is important. And while the LSF and four capitals provide us with a strong frame to work from, we know there's a great deal more to be done. There remain large gaps in our knowledge across all four of the capitals and the benefits they provide.

We'll be confronting these challenges as we continue to develop ways to measure wellbeing in New Zealand. We know this work is ambitious and will be difficult. We also know that no single agency, organisation, academic institution or individual will have all the answers or expertise and that includes the Treasury.

We therefore need and want to work with those in the academic and practitioner communities who share our ambition for increased wellbeing for New Zealanders, and engage with these critical issues together. The Treasury's goal is to energise these communities, to contribute to common understanding where we can, and to work together so the knowledge is enduring, practical and useful.

To provide a practical way of achieving that engagement, we recently launched the 'Community for Policy Research'. The aim is to provide an easy place of reference for policy makers to find academics who are experts in their areas. We (and other agencies) can then have conversations about the knowledge gaps that have been identified and potentially turn them into fruitful research opportunities.

Conclusion

I started by referring to my speech last year at Victoria University and I'll finish with a similar conclusion to twelve months ago.

Weaving the LSF into public policy provides a significant opportunity for the Treasury and the wider policy community. It is another *leap of thinking* and we want to stay at the leading edge through working together with others to develop new frameworks that redefine how we design and deliver policy. As I said a year ago I hope that, whatever sphere you are operating in, you will be enthusiastic participants in this collective effort.

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