Improving Living Standards -
Long Term Fiscal Statement

Presenting Key Trade Offs

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The Treasury
Treasury’s Vision

To be a world class Treasury working for higher living standards for New Zealanders.
From improving general well-being ...
The OECD

[Diagram showing concepts of human well-being and sustainability]

OECD Better Life Initiative

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Better Life vs. GDP
Income Inequality and Social Problems

NZ Indicator Rankings

Table 3: New Zealand Indicator Rankings (full sample and 24 OECD countries)

A low ranking and a low percentile implies a comparatively high level of wellbeing.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Full Sample Ranking</th>
<th>Full Sample Percentile</th>
<th>OECD 24 Country Ranking</th>
<th>OECD 24 Country Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNI(pc)</td>
<td>28 / 182</td>
<td>15</td>
<td>22 / 24</td>
<td>92</td>
</tr>
<tr>
<td>GDP(pc)</td>
<td>25 / 189</td>
<td>13</td>
<td>19 / 21</td>
<td>90</td>
</tr>
<tr>
<td>LifeExp</td>
<td>19 / 193</td>
<td>10</td>
<td>12 / 24</td>
<td>50</td>
</tr>
<tr>
<td>Fem/Male</td>
<td>132 / 194</td>
<td>68</td>
<td>21 / 24</td>
<td>88</td>
</tr>
<tr>
<td>HDI</td>
<td>5 / 187</td>
<td>3</td>
<td>5 / 24</td>
<td>21</td>
</tr>
<tr>
<td>EPI</td>
<td>14 / 131</td>
<td>11</td>
<td>11 / 24</td>
<td>46</td>
</tr>
<tr>
<td>EcoPrint</td>
<td>22 / 25</td>
<td>88</td>
<td>20 / 24</td>
<td>87</td>
</tr>
<tr>
<td>Eco-Glob</td>
<td>21 / 144</td>
<td>15</td>
<td>10 / 24</td>
<td>42</td>
</tr>
<tr>
<td>Soc-Glob</td>
<td>30 / 198</td>
<td>15</td>
<td>20 / 24</td>
<td>83</td>
</tr>
<tr>
<td>LS-HPI</td>
<td>9 / 25</td>
<td>36</td>
<td>9 / 23</td>
<td>39</td>
</tr>
<tr>
<td>OECD-BLI</td>
<td>4 / 33</td>
<td>12</td>
<td>4 / 23</td>
<td>17</td>
</tr>
<tr>
<td>LS-Mean</td>
<td>48 / 94</td>
<td>51</td>
<td>18 / 24</td>
<td>75</td>
</tr>
<tr>
<td>LS-Sdev</td>
<td>65 / 94</td>
<td>69</td>
<td>22 / 24</td>
<td>92</td>
</tr>
<tr>
<td>Gini</td>
<td>51 / 135</td>
<td>38</td>
<td>21 / 24</td>
<td>88</td>
</tr>
</tbody>
</table>

... to increasing living standards
Living Standards: Making it Operational

- Practical
- Focused
- Measureable
Key Questions

- What economic and social outcomes are we aiming for?
- How can government policy help us make progress towards the achievement of these outcomes?
- How do we know if we are succeeding?
Fundamentals – what is it all about?

What is “improving standards of living” all about?

It is about increasing the freedoms of individuals to enjoy the kinds of lives they wish to live. [Amartya Sen’s concept of justice and human rights.]

Need to focus on achieving this across society and across generations – that is what equity and sustainability are all about.
The Living Standards Framework

**CAPITAL**
- Financial & Physical (examples)
  - Financial Wealth
  - Housing
  - Infrastructure
- Human
  - Skills
  - Health
- Social
  - Institutions
  - Trust
- Natural
  - Climate
  - Biodiversity
  - Water

**Flows**
- (examples)
  - Income
  - Consumption
  - In-kind services
  - Employment
  - Leisure
  - Innovation
  - Freedom
  - Security
  - Environmental services
  - Amenities

**Distribution**
- within the population and over time

**Subjective Wellbeing**
A Proxy Social Welfare Function for NZ

Living Standards

- Economic Growth
- Social Infrastructure
- Reducing Risk
- Sustainability for the Future
- Increasing Equity

FINANCIAL & PHYSICAL
Financial Wealth
Housing
Infrastructure

NATURAL
Climate
Biodiversity
Water

SOCIAL
Institutions
Trust

HUMAN
Skills
Health

Increasing Equity
Additional Key Question

Instead of thinking of trade-offs between the five corners of the living standards cobweb on the previous page, can we come up with policies that make these corners mutually reinforcing – so that we can create an expanding dynamic cobweb?
**WHAT** should be the focus of government-policy interventions (in support of market processes) – Government Roles?

- Providing opportunities
- Building capabilities
- Improving incentives
- Removing obstacles

All of the above are about maintaining and building:
- physical/financial capital
- human capital
- social capital
- natural capital
Policy Tools

(Note: these need not involve extra public spending)

(Vito Tanzi. Government versus Markets. 2011)

- Fiscal Tools
  - Government Expenditure
  - Taxes
  - Public Debt and Public Loans

- Regulatory Tools
  - Regulations
  - Authorisations

- Other Tools
  - Ownership
  - Contingent Liabilities
  - Nudging or Cajoling
Four Big Themes ...

(... in thinking about the role of government and the choice of policy tools going forward)

Increasing:

- **Diversity** of our society
- **Complexity** of the world we live in
- **Influence of globalisation**
- **Pressures on government finances**
Current Policy Levers: BIM

Opportunities
- education reform
- wide access to health care
- international linkages programme

Capabilities
- growth-supporting infrastructure
- support business-led R&D
- work-based training
- youth agenda

Incentives
- welfare reform
- labour market reform
- tax reform

Obstacles
- removing international trade and investment obstacles
- improving economic stability
- improving public-sector productivity
- work on long-term fiscal strategy

Higher Living Standards

All of the above are about maintaining and building:
- physical/financial capital
- human capital
- social capital
- natural capital

• Providing opportunities
• Building capabilities
• Improving incentives
• Removing obstacles
How might we measure progress for NZ?

Economic Growth

- NNI / capita

Living Standards

Reducing Risk
- NII position of NZ
- Reducing crime rate
- Reduction in social welfare dependency

Social Infrastructure
- World Bank government effectiveness indicator
- World Values Survey: social trust indicator

Increasing Equity
- % of population below 50% of median income
- Difference in the PISA score between the top and bottom 10% of students

Sustainability for the Future
- gross capital formation
- GHG emissions tonnes/capita
- % aged between 35-34 with tertiary qualifications

FINANCIAL & PHYSICAL
- Financial Wealth
- Housing Infrastructure

NATURAL
- Climate
- Biodiversity
- Water

SOCIAL
- Institutions
- Trust

HUMAN
- Skills
- Health
**Example 1: Living Standards Assessment: Risk Management**

**Method:**
Increasing the freedoms of individuals to enjoy desired lifestyles

<table>
<thead>
<tr>
<th>Elements</th>
<th>Physical Capital</th>
<th>Human Capital</th>
<th>Social Capital</th>
<th>Natural Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risks</td>
<td>Earthquakes</td>
<td>Crime</td>
<td>Welfare dependency</td>
<td>Climate Change</td>
</tr>
<tr>
<td>e.g.</td>
<td>Floods</td>
<td>Ill health</td>
<td>Economic crises</td>
<td>Biodiversity risks</td>
</tr>
<tr>
<td>Eruptions</td>
<td></td>
<td>Skill Deficiency</td>
<td>Education failure</td>
<td>Erosion</td>
</tr>
<tr>
<td>Infrastructure disrepair</td>
<td></td>
<td></td>
<td>Civic society failure</td>
<td></td>
</tr>
<tr>
<td>White elephants</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</table>

**Mitigations**

- Insurance
- Education Policy
- Welfare Reform
- Emissions Trading
Example 2: Welfare Reforms

Note: This is intended to demonstrate how the diagram could be used, rather than a Treasury view of the recommendations.
Example 3: Tax Reforms

Policy Options:
- Status Quo
- Capital Gains Tax, including o - o property
- GST increase to 15%
Underpinned with high quality analysis: 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 examined.

**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.

**Mechanical effect of an increase (per year):**

<table>
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<tr>
<th>Rate</th>
<th>2007/08 GST</th>
<th>Estimated Additional Revenue at:</th>
</tr>
</thead>
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<tr>
<td>12.5%</td>
<td>15%</td>
<td>17.5%</td>
</tr>
<tr>
<td>Private sector revenue</td>
<td>11.115</td>
<td>2.150</td>
</tr>
<tr>
<td>Automatic Benefit Adjustment</td>
<td>N/A</td>
<td>(0.250)</td>
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</tbody>
</table>

**Equity**
- GST appears more 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…

**Risk of fraud**
- Such as carousel fraud, should be measured relative to disposable income, or expenditure. GST is less regressive if measured as a proportion of annual income; equity effects

**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

**Fiscal revenue**

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<th>($ billion)</th>
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**Efficiency & growth**
- GST can be broadly described as a tax on spending by households – an indirect tax on labour

**Possible short-run economic impact**
- 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).
- Likely increase in quarter preceding increase, with fall in quarter following increase.
- 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.

**Efficiency & 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 25% or 27.5%.
- 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).
Example 4: NZ's performance compared to the OECD

Economic Growth

Reducing Risks

Sustainability for the future

Social Infrastructure

Increasing Equity

Note: This is only intended to indicate how the diagram may be used. The data involved and the methodology for constructing the indices needs significant further work. It does not therefore represent Treasury's view of what has happened over the ten years concerned.
Living Standards Framework: Application to Long Term Fiscal Statement
Economic Growth

- reducing inefficiencies in taxes and spending

Living Standards

Reducing Risk

- reducing macroeconomic risks:
  - increasing national savings
  - reducing public debt

Social Infrastructure

- social cohesion
- broad political support

Increasing Equity

- intra- and intergenerational distribution

Sustainability for the Future

- fiscal sustainability
- environmental considerations

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- Financial Wealth
- Housing
- Infrastructure

NATURAL
- Climate
- Biodiversity
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SOCIAL
- Institutions
- Trust

HUMAN
- Skills
- Health
Key questions in the LTFS context …

- Given the fiscal pressures we are projecting, what are the sustainable (long-term) roles for government in economic life?

- What tools are best suited to perform these roles in a way that improves NZ’s long-term standard of living as represented by the “living standards cobweb” – while operating within our long-term budget constraint?

- In the most likely event that there is no “best” set of tools, what are the key trade-offs we are facing with alternative sets of tools?

- Is the “living standards cobweb” an adequate framework to represent these trade-offs?