

# Growing Our Economic Capital: Investing in Sustainable Improvement in Our Wellbeing

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Good afternoon, it's a pleasure to be here.

The personal and professional ties between Victoria University and the Treasury are very strong. A lot of people at the Treasury are Vic alumni, and each year more join us as graduate analysts or in other roles. And we have Treasury alumni at Vic, people like Professors Bob Buckle, Norman Gemmell and Girol Karacaoglu to name just a few. We benefitted from their thought leadership in the areas of public finance, economics and public policy, and clearly the university values it too.

Much of their thinking has contributed to what I'll be covering today. I'll talk about how the focus of public policy should be on enabling a more prosperous, sustainable and inclusive New Zealand, now and into the future. I want to discuss how New Zealand can invest in sustainable improvement in our wellbeing, in particular through growing our human capital, natural capital, social capital, and financial and physical capital.

That's a formidable goal for public policy to achieve. The challenges are many, they are difficult, and they are not just economic. The discipline of economics has brought a lot of good to the world, but like any healthy discipline it recognises that it has to challenge itself and grow. To solve society's most 'wicked problems' and make the most of opportunities, we need to

continue our good efforts to apply an open mind, long term thinking, and a multidisciplinary approach.

Let me start with one of those opportunities: our country is in comparatively good shape with a solid economic foundation to build on.

The New Zealand economy has been performing well over the past 4 years, relative to both the potential growth rate of the economy (of around 2.7%), and to most advanced economies. Over this period, our economic growth rate has averaged 2.8% while the average growth rate of OECD economies has been around 1.7%. Just yesterday we heard that our unemployment rate was 4.9% and our participation rate 70.1%. And of course we've seen the Crown's books return to surplus, debt kept under control, and New Zealand in the position to start rebuilding our buffers against future shocks.

These are commendable achievements, in a very challenging global environment. We should recognise that and celebrate it – there are no more than a handful of countries that can. But while we have earned the right to feel good about the current situation and recent past, as policy advisers we also need to continue to keep a focus on the medium to long-term. We need to look as much to lifting the economy's long-run average growth rate, one of the main sources of a sustainable increase in our collective wellbeing, as we do on worrying about whether the economy is operating at or close to its short term potential growth rate.

So there are two fundamental questions I wish to address:

- are we doing enough long-term thinking and, if and when we do, how are we approaching it, and
- are we learning from, and adapting to, our experiences as we move through time?

If I take media commentary as an indicator, it does look like we are spending a lot of time and energy on analysing whether the economy is operating at, or close to, its current potential growth rate, and whether inflation is or is not responding to lower interest rates. In a way, that's understandable, given the role media commentary plays in reporting on factors that could have an impact on financial markets. And of course it's important that we scrutinise the current cyclical position in New Zealand and elsewhere. The downside is that we see far less emphasis and effort on understanding how we can lift the sustainable growth rate of the economy, whether we're making good investments as a community and what the changing global environment means for our living standards. In short we don't appear to be spending enough time thinking about how to invest in lifting intergenerational wellbeing on a sustained basis.

Perhaps I shouldn't take media commentary as an indicator! Or perhaps it's just an inevitable feature of life, that we think about the here and now rather than the future. But public policy can't afford to limit itself this way. Back in August the Prime Minister commented that one of the most valuable things that officials can do is filter out some of the noise of social media and the relentless 24-hour news cycle, and help ministers focus on longer term considerations.

Underpinning the long-term growth rate of an economy are a range of fundamental factors, some of which don't get much time in the public spotlight. These include the quality of political, economic and social institutions; the quantity and the productivity of the workforce; the quantity

and quality of the (human and physical) capital stock; the availability of land and natural resources; the state of technical knowledge; the creativity and skills of entrepreneurs and managers; and, for a small open economy, our ability to connect our people, our ideas, our trade and our investments with the rest of the world. These are all valid potential targets for public investment because they have significant public good attributes.

So how does the Treasury approach the consideration of what matters for the long term? We start with the fundamentals of what we're here to do. The Treasury sees its job as improving the living standards of New Zealanders, helping people live better lives, now and into the future. In other words, to increase people's wellbeing on a sustained basis. That provides the frame for our long-term thinking, not a narrow focus on economic growth per se, which is very important but only one source of wellbeing. Using such a frame reinforces the need for an integrated and multi-disciplinary approach to economic, social and environmental policy.

I should say that we do not judge how people should be living their lives. We're not a curtain-twitching neighbour, or the nosy relative at a family reunion who asks why you're not married with kids yet. Our focus is on expanding the opportunities and capabilities of people to live the lives they have reason to value. We also care a great deal about making sure that we have institutions that motivate people to increase their capabilities, and that we have incentives in place that convert opportunities into outcomes that increase wellbeing. Undeniably, wellbeing will be significantly and positively affected by improvements in people's material living conditions. But we also know that there are other dimensions of wellbeing that are not very highly correlated with material conditions.

As The Beatles once said, "money can't buy me love," and they were right.

Based on extensive international research, we do know that the so-called domains of wellbeing are good enough for the practical purpose of influencing policy decisions. These are well summarised by the components of the OECD's Better Life Index, which are classified into two broad categories:

- *quality of life*, based on things like health status, work-home balance, education and skills, social connections, civic engagement and governance, environmental quality, personal security, and subjective wellbeing, and
- *material conditions*, such as income and wealth, jobs and earnings, and housing.

The things that need to be in place to promote wellbeing are the capital stocks which collectively comprise "comprehensive wealth": human capital (including education and health), natural capital, social capital (including culture), and financial and physical capital. I like to describe this "comprehensive wealth" as our "economic capital" although I know some prefer to see the latter phrase used more narrowly.

That's probably enough on the theory behind sustainable wellbeing, so let me turn to what's actually being done about it.

In the last few years you may have heard Ministers and others in central government talk about the investment approach, and wondered what it's all about. In my view it's at the heart of the modernisation of policy-making.

The investment approach to policy focuses on what we should be investing in, and how, to achieve a sustainable improvement in our collective wellbeing. The areas we invest in, how we invest in them, and how these investments are funded (for example, by borrowing or taxing), have very significant implications for the level and distribution of intergenerational wellbeing.

These decisions are by no means straightforward. At the very least, we need to recognise that there are interdependencies between the outcomes of various investments.

As an example, let's take a look at education. We believe that investing in education generates economic, social and environmental benefits. It raises skill levels and hence productivity. It is also arguably one of the most effective ways of raising awareness of the environmental consequences of human actions. And of course it broadens access to opportunities and helps those in persistent disadvantage, thus enhancing social cohesion. So undoubtedly it is one of the most important investments we can make in improving wellbeing on a sustained and intergenerational basis.

We need to be able to compare the long-term wellbeing impact of investing in education, through all these channels – and no doubt others – with the wellbeing impact of investing the same dollars on, say, building a road, or investing towards conservation projects, or investing in increasing our cybersecurity, and so on.

The key point to note is that the metric of comparison should be long-term wellbeing. And if we are to do a good job of assessing the wellbeing effects of one investment choice against several other worthy choices, then we need the collaboration of multidisciplinary teams bringing their economic, environmental, social, psychological and other perspectives to bear on policy design and delivery.

It's hard, but it is happening. There is a rich and growing literature on using subjective and objective wellbeing metrics to do cost-benefit analysis in terms of the long-term sustainable wellbeing impacts of policy options. We are actively exploring ways of incorporating such tools into our policy advice and cost-benefit analysis. The Treasury's own cost-benefit analysis tool, CBA(x), is a very good example of an attempt to value non-market goods and services.

If all this sounds like a tricky job for policy makers, it gets trickier still. An additional challenge we face is highlighted by the implications of complexity theory for designing and implementing policies.

The economy, society and the environment are all complex systems that are constantly interacting with each other. All we can hope for is to invest in environmental, economic and social infrastructures – including institutions – that increase opportunities and build resilience to manage the consequences of radical uncertainties. It's about being prepared for the unknown unknowns. And I should add that part of this preparation is making sure our institutions are fit for at least the next 25, 30 or 40 years.

If we simply focus on preserving institutions we may in fact be weakening them.

The bigger, and more complex, the problems we face, the greater the temptation to tighten one's grip on decision-making. In fact, what we learn from complexity theory is that the optimal

response to increasing complexity (especially when it comes to decisions relating to social investments and outcomes) is exactly the opposite. It calls for more devolution of responsibilities (and funding), supported by more investment in capability building in the devolved areas, but packaged with very tight specification of outcomes to be delivered.

I'll leave complexity theory there and move on to a higher magnitude of complexity still: people.

If we agree that the purpose of public policy is to ensure government's contribution supports sustainable improvement in people's lives, we can focus policy towards supporting people and communities in their efforts to raise their living standards.

What does all this mean in practice, from a public policy perspective in general, and for the investment approach in particular?

The focus of public policy should be on governing and investing, on behalf of people today and into the future, towards:

- enhancing resilience to systemic risks
- sustaining social cohesion
- increasing the growth potential of the economy
- improving equity across society and generations, and
- ensuring sustainability of wellbeing as people go about their daily business of living and improving their lives.

These dimensions are the ones the Treasury considers in its Living Standards Framework when we assess policies.

Government strives to take a system view. A system approach underpins the direction the public service has been moving in following the Better Public Services report in 2011. It reflects the fact that central government is well-positioned to observe and monitor the system dimensions that influence our collective wellbeing. It also has system-level instruments that can help make a difference, some of which are about devolving power and using the energy of communities.

At the centre, technology enables us to collect and share information on what various communities are doing to improve their lives. We also have the analytical capabilities to assess what works and does not, but we need to do the hard work of converting that potential into practical initiatives through appropriate investments in economic, environmental and social infrastructures.

A critical ingredient of these infrastructures, underpinned by social capital, is networks. Public policy can play a critical role in making networks function better. I believe that to do that the state sector firstly needs to be more flexible in response to evidence, and secondly needs to be focused on outcomes, not delivery lines. What we'd then be likely to see is better co-ordination and greater efficiency and effectiveness.

Let's examine social investment to think about what better coordination and greater efficiency and effectiveness might look like.

For example, I've been told that there are 83 social service agencies of all sorts operating in Feilding and that many people would like to have a "one stop shop" service. But if we want to focus on better outcomes for people, it's not just a question of whether or not there should be a one stop shop; the bigger question is whether or not funding almost seven dozen NGOs is the most effective way to deliver the services people need.

The investment approach is not only about generating good public policy ideas. It's also about effective and efficient policy implementation and delivery so that good ideas actually result in improved outcomes. This is precisely why better coordination of community, regional, and central activities and investments is so critical. In practice, policy design and implementation should be people-focused; we should worry both about our investment in services to people and our investment in relationships with them.

Thinking more broadly, better coordination and greater efficiency and effectiveness may also be a critical part of the solution to the so-called "productivity paradox". The ultimate source of productivity increases is the efforts of individuals, working together, in their various capacities, to improve their lives. We cannot second-guess how this will happen, nor can we manipulate it. What we can do is observe and support – through reducing the costs of cooperation and coordination – the emergent social and business initiatives towards the wider good. Our primary focus should encourage investing in opportunities and capabilities, and build resilience to systemic risks.

This (especially the resilience building dimension) brings me to the second fundamental question that I referred to at the very beginning of this talk: are we learning from, and adapting to, events as they unfold?

For example, one of the main events of the last ten years has been the global financial crisis. This was system failure *par excellence*. It showed us that a combination of placing too much weight on the wrong indicators, guided by mis-specified models, could lead to disastrous policy decisions being made in many countries and outcomes affecting millions of lives. These models ignored the critical role of financial markets and networks. The policy prescriptions they led to misjudged how complex systems work. They resulted in coordination and communication failures, among other things.

People are still trying to understand the lessons from the GFC. One area of learning which has had international attention is the critical role of better coordination of fiscal, monetary, financial and broader macroeconomic policies in order for those policies – whether fiscal, monetary, financial and broader macroeconomic – to be implemented effectively when one of them faces constraints. It can be the difference between a well-conducted orchestra playing a symphony and ninety disorganised musicians creating a cacophony. This area has been a focus of the G20 and IMF since 2008.

I should emphasise that New Zealand was one of the countries that coordinated fiscal and monetary policy effectively over the course of the GFC. Fiscal policy supported monetary policy through the crisis by being stimulatory when needed and then contractionary once the economy was recovering. But that doesn't give us an excuse to cut class when experience

delivers useful lessons and poses questions, including on policy coordination. And we should also make sure we learn the lessons of putting too much weight on simplified economic models.

Here are a few examples of the types of policy coordination that may be needed to deliver outcomes that can lift our wellbeing for the long haul.

Building on what I said earlier, my first example relates to the coordination of monetary, financial (including prudential) and fiscal policies towards not only keeping the economy operating close to its current growth potential, but doing so in a way that does not cause harm to the growth potential of the economy. Indeed it can enhance it.

International experience over the past 10 years and maybe more casts increasing doubts about the effectiveness and efficiency of monetary policy alone in managing the economy's performance relative to its current growth potential when it is adjusting to a large structural shock. In fact, relying on monetary policy alone to do that job risks the longer term growth potential of the economy as well, by leading to the misallocation of resources towards investments such as residential investment that are comparatively less productive in terms of generating wealth and well-paid jobs.

Equally important are the consequences of such a policy on wellbeing across society and generations. We know that, as interest rates rise towards more 'normal' levels, a lot of low-income people who have over-borrowed get severely hurt. Would better coordination of fiscal, monetary, and financial/prudential policy – especially the physical, social and environmental infrastructure investment component of fiscal policy – help the economy's performance over the cycle as well as help lift the economy's sustainable growth rate? How could we achieve that better coordination?

My second example relates to the interface between broader economic policies, infrastructure investment and regional economic policies. The importance of co-ordination around housing, transport and water infrastructure may be obvious. But let's look at tourism, one of our biggest earners. Tourism growth, if managed well, can keep generating substantial economic growth in New Zealand. But to extract most value from it on a sustainable basis, the tourism footprint needs to be better spread across the country. That's going to need deliberate and coordinated promotion of attractive New Zealand tourist destinations around the world, supported by investments in infrastructure across the country, so that they can accommodate the needs of more tourists while taking some of the load off currently popular tourist destinations.

A third example relates to the combination of environmental, economic and social policies. There is an ongoing debate in New Zealand between environmentalists and business people about the merits or otherwise of economic growth. To be clear, I'm not suggesting at all that being an environmentalist or a business person is mutually exclusive. One question being debated actively is whether we can keep increasing our milk production without causing damage to the environment. The question tends to be presented in a way which is a false and unnecessary dichotomy.

The right mix of incentives can encourage a switch to the use of cleaner technology, higher-value-add milk products, and overall increasing economic growth on a sustainable basis. If

also supported by investment in education and new skills, it would also enhance the skill base and productivity of our wider workforce.

Finally, consider the mix of social investment, fiscal and economic policies. Targeting the most at risk children of our society with education, housing, and family support initiatives is first and foremost about improving the quality of their lives and opening up opportunities. It would at the same time increase equity, productivity and economic growth, while also reducing the present value of medium- to long-term fiscal costs on society.

The point of these examples is to reiterate that a policy framework that focuses on increasing our collective wellbeing on a sustainable basis requires a mix of complementary economic, social and environmental policies.

A further point I'd like to make is that policy design needs to be complemented by outcomes-based policy implementation to have any lasting impacts. It's got to make a real difference in the real world, or as someone once said, "Great ideas need landing gear as well as wings." In my view, the types of 'wicked problems' we are having to deal with can have a better chance of success if they are addressed by an integrated approach to public policy design and delivery.

In summary, I come back to the importance of learning from experience. A system that learns from, and adapts to, knowledge, whether from successes or failures needs to respond through all channels: reviewing and revising economic theory and economics teaching, extending policy models, better coordination of policies, adopting the expertise of a broad range of disciplines in policy design and delivery, and learning the lessons from both successful delivery and implementation failures. We need to embrace complexity and act accordingly.

As Keynes once said: "the difficulty lies, not in the new ideas, but in escaping from the old ones". Escaping can indeed be difficult, but it can also be exciting. For those of us developing economic policy advice it's about taking the knowledge we have and building on it, incorporating insights from other areas of expertise, and drawing on the work of economists who are pushing economics into the field of the human science that it actually is.

Growing our economic capital and investing in sustainable improvements in our wellbeing – the objective of economic policy – requires a multidisciplinary approach to solving economic and social problems.

There are signs that all this is happening around the world. We are in a new era of policy frameworks and I'm proud to say the Treasury's Living Standards Framework is at the forefront of economic thinking. We want to stay at the leading edge, working together with others. In particular, I'd like to see universities – both their students and their staff – play a leading role in developing these multidisciplinary frameworks, creating momentum for a redefinition of how we design and deliver policy, and how we create feedback loops that help to ensure its effective implementation. I hope, whatever sphere you are operating in, you will be enthusiastic participants in this collective effort.