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**Working Paper**

## Towards an Inclusive Economy

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# TREASURY WORKING PAPER

01/15

## Towards an Inclusive Economy

The Treasury

### Abstract

There has recently been a rapid growth in international literature and research on the links between economic growth and social capability and their impact upon well-being. This paper draws on that literature to build upon previous Treasury work at the intersection of economic and social policy. It examines the relationship between a productive economy and a society that enjoys high levels of participation, connection and cohesion, and their combined impact of peoples' well-being. It suggests that the objective in an inclusive economy is to improve the well-being of New Zealanders by directing policy to ensure that there are broad based opportunities to participate in society and the economy.

The paper notes the 'virtuous' and 'vicious' circles that can occur when positive or negative interrelationships arise as a result of the above links. It suggests that there are five broad policy themes that are particularly important for building a more inclusive New Zealand economy. In particular there are a small number of policy areas where there appear to be opportunities for gains in equity and participation while being neutral or even positive for growth. These opportunities lie in focusing on education and jobs in the lower part of the distribution of attainment and skills; on strengthening Maori institutions and governance; and improving understanding of and reporting of the results of government action.

Three Treasury companion papers to this one expand on particular aspects of the inclusive economy. They are *Reducing Disparities in an Inclusive Economy* (forthcoming), *Human Capital and the Inclusive Economy* and *Geography and the Inclusive Economy: A Regional Perspective*.

**JEL classification:** A1 General economics, H0 Public economics - general, O2 Development planning and policy, R1 General special economics

**Keywords:** social capital, human capital, well being, economic growth, economic geography, values, governance

# Towards an Inclusive Economy

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July 2001



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This paper was written by members of the Inclusive Economy Working Group in Treasury. They are Megan Claridge, Ron Crawford, Hauraki Greenland, Roger Hurnard, Benedicte Jensen, Geoff Lewis, Nick Mays, Murray Petrie and Roger Procter. They acknowledge the assistance of officials in Treasury and other government departments, in the World Bank and OECD, and of academics and other colleagues who have commented on drafts, discussed concepts, shared research, and their enthusiasm for this area of enquiry.

The text for this paper has minor editorial and formatting changes that differ to the printed document "Towards an Inclusive Economy" of July 2001.

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# Foreword by the Minister

The vast majority of New Zealanders no doubt share my own vision for the future of this country. It is a vision where prosperity, opportunity and social justice combine to continuously improve the well-being of all citizens.

Achieving this requires us to build an economy that is both inclusive and innovative. This is by no means a straightforward task. We know that people have many aspirations and concerns. We know that these varying aspirations are not easy to reconcile. We know that providing for these aspirations requires a high-performing economy.

Working towards an inclusive economy requires a focus both on policies that enhance growth and on policies that enhance opportunities for New Zealanders of all cultures and backgrounds to participate in society and the economy. It also requires well-functioning and trustworthy institutions, along with certain freedoms and mutually respected values.

When I took over the Finance portfolio, I saw this work as being particularly important. I therefore instructed the Treasury to give a high priority to further work on the challenge of building a more inclusive and innovative economy.

I welcome the contribution of the Treasury team that produced *Towards an Inclusive Economy*. Their analysis and review of the evidence in this complex area improves our understanding of some key linkages among economic and social capabilities, and how these in turn might best be used to improve the well-being of New Zealanders.

The Treasury's work is complementary to other work being conducted within the Government, including the Ministry of Social Policy's work on social development, the Ministry of Economic Development's work on economic development, and the work being led by the Department of the Prime Minister and Cabinet on sustainable development.

This work will offer a means to improve policy advice on growing an innovative and inclusive economy, and on reducing inequalities. It will also facilitate improved co-ordination across a range of government activities.

Hon Dr Michael Cullen  
Treasurer and Minister of Finance

# Preface

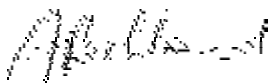
*Towards an Inclusive Economy* sets out the Treasury's thinking on how the Government can achieve its goal of an inclusive economy.

It builds on our briefing to the incoming Government, *Towards Higher Living Standards for New Zealanders*, and on our previous work at the intersection of social and economic policy. It advances that work by taking account of a rapidly evolving body of work and empirical evidence, much of it very recent. And, while based on past work, it represents a significant step forward in the Treasury's thinking on how to achieve higher living standards for New Zealanders.

Our aims for *Towards an Inclusive Economy* are ambitious. We want to give governments ways to help them reconcile objectives that are often seen as competing – economic growth and social equity. We want to help governments make tough decisions about how to prioritise spending to help secure well-being for all New Zealanders, while not compromising the essentials of a strong, innovative economy. We've therefore given a very high priority to this project, and committed significant resources to it.

I believe the end product achieves these aims, and I'm extremely proud of our achievement. The work has benefited from close engagement with a wide range of other departments, particularly the Ministry of Social Policy which is engaged in a complementary work programme focusing on social development.

I also hope this work will be of considerable assistance to all departments, including the Treasury, as we work towards building a productive economy and an inclusive society.



Dr A E Bollard  
Secretary to the Treasury

# Executive Summary

This paper forms part of Treasury's reporting on Key Priority 3: "An Inclusive Economy", one of four priority areas for 2000/1 agreed with the Minister of Finance.

It examines the relationship between a productive economy and a society that enjoys high levels of participation, connection and cohesion and their combined impact on people's well-being. It then looks at the broad implications of these linkages for policy choices. The report draws upon previous work within Treasury and upon a rapidly burgeoning but recent body of literature and evidence on social capability and the economy.

There are three companion pieces to this paper expanding on particular aspects of our work on an inclusive economy. They are a Treasury paper (Treasury, 2001a) *Human Capital and the Inclusive Economy*, a Treasury report (Treasury, 2001b) *Geography and the Inclusive Economy: A Regional Perspective*, and a Treasury paper (Treasury, 2000) *Framework for Closing the Gaps*.

## An inclusive economy

An inclusive economy provides well-being to New Zealanders by ensuring that there are broad-based opportunities to participate in society and the economy – thereby opening up the key routes to improved well-being. The objective of the government in such an economy is to improve well-being by ensuring that policy is directed to these ends.

An *inclusive economy* can be seen as deriving from the inter-relationships between social capability, productive capability, and well-being.

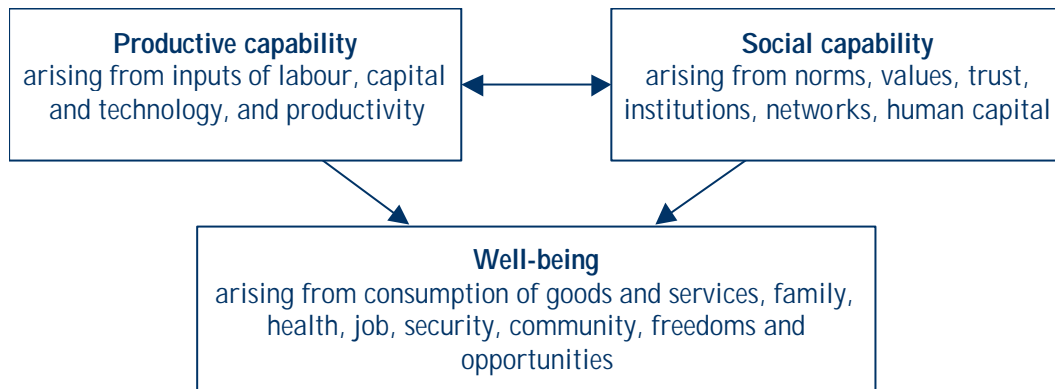
*Social capability*. When there are high levels of participation, interconnection and cohesion, there are correspondingly high levels of *social capability*; that is, a high level of the ability of various interests in society to co-operate towards common goals. Social capability is positively dependent on levels of human capital, well-functioning institutions, and social cohesion and connectedness, and negatively dependent on the extent of social exclusion of individuals and groups.

*Productive capability*, and the income and wealth it generates, is an important determinant of a country's standard of living. The amount of this wealth and income going to households on the lower rungs of the income distribution is also important.



*Well-being.* Individuals' sense of *well-being* has several aspects. One is the ability to participate in the economy, through jobs and incomes, and the important sense of fulfilment that accompanies satisfying jobs. Another is participation in society generally, through such things as social networks, family, whakapapa, community and tribal relationships, and civic activities.

The following diagram depicts the three main sets of relationships on which an inclusive economy depends.



The relationships can often be mutually reinforcing – for instance economic growth generally increases opportunities for active participation in the economy and in social relationships through the labour market while, at the same time, better social networks and the trust built up through economic transactions are positive for further economic growth.

However, there can also be negative interactions – for instance, growth may involve structural change, loss of jobs, and increased social tension as well as increased opportunities and living standards.

The positive linkages in each direction have the potential to generate virtuous (or vicious) circles, and win-win opportunities for policy. In the context of these relationships, we have identified five broad policy areas that are particularly important to building a more inclusive economy.

## **Growth and distribution**

Improved well-being of New Zealanders is vitally linked to our ability to achieve and sustain a steady rate of growth in our national income per head. Therefore, in looking for new and more effective ways to enhance well-being, we cannot afford to overlook the basics – those elements of fiscal, monetary and regulatory policy that are important for growth, stability and the efficient functioning of key markets – or to create, inadvertently, new conditions that undermine our growth fundamentals.

However, these considerations must be considered alongside policies to help deliver better outcomes for the poorer members of society, notably those in less well-off ethnic groups or regions.

Well-being is not a static state of being, but changes according to an individual's opportunities, choices and circumstances. We need to take account of the importance of helping those on the bottom rungs of the income distribution to improve their life chances while enhancing the prospects for economic growth. This suggests that a focus on education, training, and promotion of labour market participation is better than a focus on passive income transfers (with the associated downsides of passive tax redistribution) when trying to improve well-being for the most disadvantaged. It also suggests a need for greater public consensus so as to maintain policy stability.

## Human capital

There is strong and consistent evidence that human capital – that is, people's education and skills – is positively associated with well-being both directly and through raising economic performance and social capability. There is also a positive association between education and many other outcomes – including health, lower criminal offending, participation in voluntary community activity, political participation, and trust. In addition, there is probably some transmission of human capital across generations.

However, human capital has many different dimensions and is acquired in a wide variety of settings – from formal education to the community – which raises a number of questions about the best policies for the acquisition of human capital. In particular, there is a potential tension between human capital policies that aim to secure overall growth and those that aim to improve overall distributional outcomes. There are also questions over which level of education – early childhood, primary, secondary, post-compulsory – should receive most attention.

New Zealand ranks well internationally in educational attainment in the top half of the distribution, but does less well in the bottom quintile. This suggests that our prime focus should be on more cost-effective early interventions in childhood learning, particularly in the early primary school years, coupled with carefully selected second-chance education and training interventions, where these can be shown to be appropriate to the needs of specific individuals and groups. This will particularly help the Māori and Pacific Island populations given their relative predominance in younger cohorts.

Policies to promote “centres of excellence” in tertiary education, and better linkages between universities and technologically progressive industries are important for fostering innovation and growth.

## Jobs

The loss of jobs and the experience of unemployment have a strongly negative impact on personal well-being and sometimes that of whole communities. Conversely, high employment has a long list of benefits for society and the economy. This means policies to promote increased opportunities for meaningful employment should be a priority in the inclusive economy.

New Zealand's unemployment and labour market participation record is reasonably good, but it lags behind that in some other OECD countries, suggesting that it could be improved. Unemployment rates of Māori and Pacific Island populations are significantly higher.

One of the keys to high employment is steady and predictable economic growth. However, cross-country evidence suggests that several types of micro-level policy interventions – wage setting regulations, tax-benefit policies, benefit administration and some active labour market policies – are also potentially effective in combination in generating improved labour market outcomes. There is a need to ensure that the current balance of effort is correct.

In addition, policy should focus on barriers facing particularly disadvantaged groups, and the impact of more work on the time people have available for effective parenting and family life.

## Geography

Geography – or the location of activity and people – is another important consideration.

While increasing urbanisation and globalisation are vital for economic growth and productivity, there may also be downsides. The benefits of urbanisation may be reduced by problems with low well-being neighbourhoods arising from so-called “neighbourhood effects” (where there are negative spillovers caused by groups of less well-off people living together) and the high adjustment costs often involved in moving from a declining region to a growing one. The predominance of Māori and Pacific Island people in these neighbourhoods is also a concern.

Government can intervene in three ways. First it can implement national policies that do not have a regional intent, but do have a regional impact. The key concern here is to ensure that these policies do not have a dysfunctional effect when viewed from a regional perspective.

Second, it can intervene through place-based policies (policies aimed directly at assisting particular locations). While some such policies can be effective, there is a need to be cautious, particularly with any that require significant funding. The costs of supporting any such policies are a drag on those regions not being assisted.

Typically, a better approach is through people-based policies aimed at helping people to adjust to regional disparities. In deprived regions it is crucial to enhance choices by facilitating mobility – policy should focus on initiatives such as job search assistance and relocation assistance. Currently there are no significant such schemes in New Zealand.

Emphasis might also be placed on policies with both a people and a place component such as education, including the better governance of local schools, skills development, or low-cost policies that enhance community participation and inter-relationships.

While connectedness with the rest of the world is crucial for maintaining high standards of living, it has also posed major challenges, such as:

- The impact of increasing international competition for skilled labour on the wages earned in New Zealand by such labour.

- The limits thereby placed on the ability of government to undertake tax-benefit redistribution.
- The strains globalisation places on perceptions of national identity and economic sovereignty.

## Institutions and values

Public institutions (such as the parliamentary system or the school system) provide the broad framework within which politics, society and the economy function, and therefore have major impacts on the well-being of New Zealanders. Shared or mutually respected values (such as tolerance and trust) can also impact positively on both social and economic relations. Institutions and values interact – for instance, voluntary compliance with the law supports the institutions that define and enforce the law, and vice versa.

While New Zealand enjoys a good reputation internationally for the quality of its public sector governance, there are a number of risks in this area that have implications for the economy and democracy. These include the increasing international exposure of society and the economy to countries in which corruption is the norm or widely tolerated; the absence of some safeguards against self-serving behaviour within government; and the scope for conflicts of interest given our small size.

Greater accountability is also needed for the outcomes of government spending with regard to effectiveness and cost-effectiveness.

There are potential gains to be made in social capability, economic growth and well-being by focusing on Māori governance and on capacity building to complement the existing Treaty of Waitangi settlements process.

The current review of the Local Government Act (LGA) 1974 raises important questions about the degree of centralisation in the administration of the country's affairs and the relative benefits of decentralisation and devolution. Any fundamental change in the powers, accountability and funding of local government should be preceded by an in-depth comparative review of recent experiences in New Zealand with devolution and decentralisation.

The importance of maintaining ethical standards suggests the possible introduction of a code of conduct for Parliamentarians, covering issues such as conflicts of interest, public disclosure of private interests, and acceptance of gifts and hospitality. Similar provisions might apply in local government.

Given the relative size of the assets and funding under control of statutory bodies in New Zealand and the consequent importance of technical competency of board members, it would be timely to strengthen procedures requiring appointment on merit.

There is also growing recognition that the effective functioning of politics, the economy and society depends to some extent on the existence of a core set of mutually respected values, which in turn suggests further consideration should be given to what role governments should have in fostering and reinforcing these social norms.

The compulsory education curriculum is one of the few mechanisms by which government may influence the formation of social norms and values. Greater emphasis on values important for New Zealand's social capability and economic performance, and on key elements of New Zealand's institutional environment could be considered.

## Conclusions

It is not the purpose of this report to develop detailed policy recommendations. However, our research and analysis indicate a clear objective for government – raising well-being for all – and a high-level plan for how to go about it:

- Growth is very important and policy should take care not to undermine the productivity and dynamism of a healthy market economy. But the need for social cohesion means that the social consequences of growth should be predicted and built into policy thinking.
- Many of the problems we want to solve through moving towards a more inclusive economy are a result of individuals and households having low absolute levels of income. Low skills and levels of education typically drive this. New Zealand has a poor comparative record in education outcomes in the lower part of the distribution, particularly among Māori and Pacific people, compared to its generally good performance in the upper half. This needs to be remedied.
- While necessary as a short-term safety net, the tax-benefit transfer system is not a realistic or desirable option to tackle in a sustainable way the problem of low absolute levels of income.
- An “active” approach to raising low incomes through policies that improve education and labour market opportunities in the lower part of the distribution offers the best prospect to make a difference to distributional outcomes over the medium term, and should be given a high priority – particularly as they have the potential to increase both economic growth and social participation.
- Identifying specific education and labour market policies as strategic priorities would enable the Government to rank the demands on its scarce fiscal resources, and, in the medium term, to articulate an agenda of steady progress to increasing well-being for all.
- There is a range of institutional reforms that offer the prospect of sound returns, at little cost. They include: improving accountability for the results of government activities; strengthening Māori institutions and governance; and initiatives to strengthen ethical safeguards in public institutions.

- One issue that has emerged as important across a range of areas is improved understanding of the effects of government policies. Improving the evidence base for government policy will require improving the effectiveness of research and evaluation activities across the public sector.
- There are a number of areas that are suggested for further investigation. These include improving our understanding of the causes and obstacles to regional migration in New Zealand, together with the right mix of people-based and place-based interventions to deal with regional disparities; a review of recent New Zealand experience with devolution of decision making and decentralisation of public services' delivery, as a precursor to any decisions on fundamental changes in the role of local government in New Zealand; and the possible value of further emphasising mutually respected values through the education curriculum.

Finally, a key insight of this project is that there are a small number of crucial policy areas where there appear to be opportunities for significant gains in equity and participation, while being neutral or even positive for growth. The areas are education and jobs in the lower part of the distributions of attainment and skills; Māori institutions and governance; and improving understanding and reporting of the results of government action. These areas should receive increased government attention.

# 1 Introduction

This paper forms part of Treasury's reporting on its Key Priority 3, "An Inclusive Economy", one of four key priority areas for 2000/01. It presents a framework for considering broad policy options in terms of their potential for positive and mutually reinforcing linkages between a productive economy and various characteristics of society, with the ultimate objective of improving the well-being of all New Zealanders.

Three other Treasury papers enlarge on particular aspects of our inclusive economy work: Treasury (2001a) *Human Capital and the Inclusive Economy*, Treasury (2001b) *Geography and the Inclusive Economy: A Regional Perspective* and Treasury (2000) *Framework for Closing the Gaps*.

An inclusive economy provides well-being to New Zealanders by ensuring there are broad-based opportunities for people to participate in society and the economy – thereby opening up the key routes to improved well-being. The objective of the government in such an economy is to improve well-being by ensuring that policy is directed to these ends.

The focus on "inclusiveness" derives from the importance, as both an end and a means, of that participation. The desired end is encapsulated in one of the Government's stated goals – **to grow an inclusive, innovative economy for the benefit of all**.

In terms of means, there is no doubt that economic participation is a key channel through which individuals achieve well-being. Higher incomes expand opportunities and choice, and provide the basis for participation in society. Having a job also contributes directly to well-being through the sense of self-esteem and sociability that it provides.

There is equally no doubt that individual well-being derives from a number of factors in addition to income. People's participation in social networks, community life, political choices and civil society are also key means through which they achieve well-being. Survey evidence suggests that both happy family relationships and material resources are important to individual well-being. The quality of the natural environment is also important.

The social cohesion and connectedness that arise from participation in turn impact favourably on economic performance. A society of people that enjoys high levels of participation, interconnection and cohesion is defined in this project as possessing a high level of "social capability". Social capability can be thought of as the ability of a society to co-operate towards the attainment of socially beneficial outcomes. Social capability depends on the effective functioning of institutions that span the realm of

the coercive institutions of the state, the voluntary institutions of civil society, the affection-based institutions of the family, and the informal co-ordinating “institutions” of social mores and values.

An important aspect of inclusion is the way that society behaves towards potentially disadvantaged groups. An inclusive economy is one that facilitates the participation of people with physical and mental disabilities, ethnic minorities, immigrants etc in work, in the community and in other ways. When individuals or groups face barriers to participation, a key policy issue is whether, how and how much the Government can play a useful role in providing opportunities to overcome these barriers.

Inclusiveness does not mean a dull uniformity. Diversity is important both as freedom for people to express their individuality or cultural aspirations, and instrumentally to make New Zealand a more interesting and stimulating place to live, facilitate new ideas and innovative behaviour, foster competition, raise productivity, and open new markets. However a core of overarching community norms is needed, for example respecting the values and rights of others.

A fundamental insight of our inclusive economy work is that it is important to take full account of the *rich and complex set of linkages* between the social capability elements of well-being and the economic growth elements. But the work also needs to recognise that social capability literature is in its infancy, with many challenges ahead for concept development, measurement, data collection and hypothesis testing. Some conclusions drawn from this literature are therefore tentative and we emphasise the more robust of these in what follows.

This paper concentrates on identifying and illustrating the key linkages, and on analysing their application to New Zealand’s current economy and society. The approach is based on combining standard economic knowledge about the causes of growth with insights based on the much newer literature on social capital and capability<sup>1</sup>.

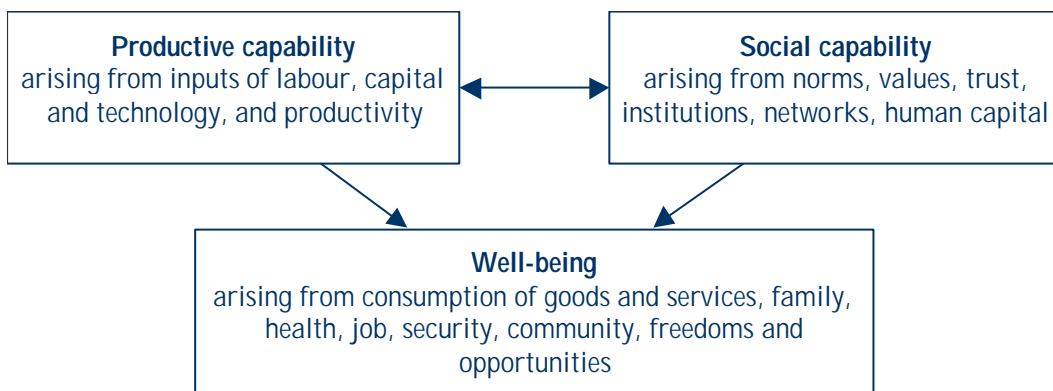
Section 2 of the paper outlines our inclusive economy framework and describes the key linkages. Section 3 draws out some key messages based on the policy interventions that evidence shows can influence well-being, taking into account New Zealand’s current situation. These messages are grouped within several broad themes. In section 4, the paper reaches conclusions about the broad policy direction that emerges from the framework and these themes. It also identifies where further work would be likely to pay off.

<sup>1</sup> This literature includes contributions from sociology, political science, anthropology and psychology as well as economics. The 1988 article by American sociologist James Coleman, “Social Capital in the Creation of Human Capital” (Coleman (1988) is widely credited with initiating the recent literature on social capital.



## 2 A Basic Framework for an Inclusive Economy

The following diagram depicts the three main components of our inclusive economy framework and the linkages between them:



The framework represents a simplification of the complex set of factors that combine and interact to produce people's well-being. For example, although the arrows run in only one direction from the upper two boxes to the well-being box, in reality well-being to some extent impacts back on productive and social capability. A more detailed diagram that reproduces more of the subtlety of the complex underlying reality can be found in Annex A.

The key simplifications and insights afforded by the framework are:

- Social capability influences economic performance through values, trust, interpersonal skills, networks and institutions, and their impacts on contracting, risk-taking, incentives, innovation and economic participation.
- Economic performance – in the form of output of goods and services – in turn influences social capability through the impact of economic change on cohesion, institutions and values, opportunities for participation, learning from experience, and increased public and private spending.
- The two-way nature of the linkages between social capability and economic performance alerts us to the possibility of feedback loops, virtuous or vicious circles, and multiple equilibria (in the simplest case “good” versus “bad” equilibria). A simple example is trust leading to voluntary exchanges and good economic outcomes that in turn reinforce the original trust.

- A policy initiative can potentially influence well-being via a number of different channels and mechanisms, some more direct than others. To give a full picture, an analysis of the initiative needs to examine the most important of these<sup>2</sup>.

We have examined the contents of each “box” in the framework and the nature of the linkages between the boxes. The following summarises the key findings.

## 2.1 Productive capability

The economy’s productive capability generates a flow of goods and services that are the key determinant of a country’s average material standard of living. The distribution of these goods and services (and income) across households is also an important influence on overall well-being.

The level and rate of growth of aggregate production, income and wealth are determined by the normal factors of production, by the incentives that participants in the economy face, and by the capability of the economy to take advantage of new opportunities and manage shocks.

There is much international evidence on what drives good economic performance. This shows that New Zealand starts with the disadvantages of small population size, geographical isolation and a resource-based economy. These features tend to be associated with below-average economic performance. There are a number of things New Zealand can try to do to offset these disadvantages. Sound economic performance rests on getting a lot of things right. The list of key ingredients that policy can influence includes:

- Availability of resources: labour, skills, capital (education, training, immigration, raising participation, reducing unemployment).
- Conditions that facilitate well-informed and secure contracting (macro-economic stability, property rights, rule of law, good governance, flexible markets).
- Conditions that facilitate and encourage innovation, technology transfer, entrepreneurship, efficiency and responsiveness to change (openness, competition, and regulation that facilitates but does not stultify competition and market exchanges).
- Regional, trade and foreign policies that facilitate access to the benefits of large population and markets elsewhere in the world and limit the disadvantages of isolation.
- Conditions conducive to increased savings and high-quality investment.
- Fiscal responsibility (sound finances, moderate size of public sector, high-quality spending).

<sup>2</sup> Annex B contains examples of using the framework to conduct this sort of multi-channel analysis.

## 2.2 Social capability

A country's social capability refers to its collection of skills, values, community characteristics and networks, norms, institutions etc that not only contribute directly to well-being but also influence the output of goods and services, for example, by reducing the costs of business transactions. We use social capability as an overarching concept that depends positively on levels of human capital, well functioning institutions, social cohesion and connectedness, and negatively on the extent of social exclusion of particular individuals and groups. Some aspects of social capability are captured in the increasingly popular term "social capital". However, there are varying interpretations and variants of social capital. Coleman (1988), for example, identifies a number of forms including:

- Obligations, expectations and trustworthiness of structures. The existence of informal reciprocal obligations between people creates an asset that can be drawn on when needed.
- Information channels. Individuals can obtain valuable information as a by-product of participation in social activities.
- Norms and effective sanctions. By encouraging certain types of behaviour and discouraging others, norms make possible some sorts of (generally socially valuable) activities such as voluntary compliance with paying taxes or meeting the responsibilities that go with receiving cash and in-kind benefits from the community.

Woolcock (1998) identifies another dimension of social capital according to the "reach" of the social relationships that individuals experience. People have expanding and overlapping layers of relationships and networks, starting with family and extending out to include the local community and community groups, iwi and hāpu, broader cultural or ethnic groups, civil society organisations, and the formal institutions of the state.

People typically have "strong ties" within family, or other cohesive, tightly knit groups to which they belong (kin groups, clan, gang) and "weak ties" with broader community or work-related groups (iwi, voluntary organisations, trade unions, professional groups). Strong ties contribute to well-being via support and sense of identity ("bonding" social capital). They can also foster smaller-scale commercial activities. Weak ties ("bridging" social capital) foster broader community links and provide information channels for more broadly based economic opportunities and co-operation.

The presence of bonding social capital may add to or detract from bridging social capital. The latter occurs when the strong ties are exclusive in character and do not encourage or even allow participation outside the close-knit group, therefore damaging overall social capability. A specific example is that in some cases a traditional family structure will inhibit innovation and personal development of, say, its female members. Other instances of social capital can also have negative effects e.g. the anti-social culture of a criminal gang, or the exclusion of outsiders by a closed organisation.

Part of the negative impact on social capability of a group like a gang is that it feels no allegiance to, and may explicitly reject, the broader society within which it exists. Etzioni (2000) uses the term “community of communities” to describe the opposite situation where shared “core values” across society mean that a diverse collection of smaller groups – including different ethnic and cultural groups – is all part of a broader national (and international) community. This nesting of smaller groups within an overarching “community” contributes to social cohesion and capability.

“Human capital” is “acquired human capabilities, which are durable traits, yielding some positive effects upon performance in socially valued activities” (David, 2001). We have included it in the social capability “box” for two reasons:

- 1) People’s values, social knowledge and social skills are a component of their human capital and these things clearly contribute to social capability.
- 2) Education has a strong empirical association with trust, networks and various forms of social participation.

On the other hand, vocational skills and technical knowledge – also important aspects of human capital – fit better in the box relating to goods and services output. A fuller representation of the framework would bring out more clearly this dual nature of human capital.

### 2.3 Well-being

Economic participation is a key channel through which individuals achieve well-being. Increased income and assets expand opportunities and choice towards whatever ends people may desire, such as recreational activities, maintaining personal relationships, or development of spirituality or cultural identity. Income also provides the means to purchase those goods and services that are needed for participation in society. An inability to do so is a key characteristic of poverty and social exclusion. Economic participation also contributes directly to well-being through the sense of self-esteem, identity, self-confidence and sociability that it provides. In addition, the ability to participate in voluntary economic exchanges is widely seen as an important individual right.

However, well-being derives from a number of factors in addition to income<sup>3</sup>. These include:

- Family and community ties.
- Health, education and employment.

3 For example, Oswald (1997) shows that increases in income, on average, yield small increases in people’s reported happiness or life satisfaction in industrial societies. However, those in the top income quartile across Europe are significantly more likely to report being “very happy” than those in the bottom quartile (Di Tella, MacCulloch and Oswald, 2001). Being in work, happily married, healthy and well educated appear to be strongly associated with happiness (Blanchflower and Oswald, 2000).

- Security.
- Freedom and ability to pursue the things that people have reason to value.
- Social and cultural participation and identity.
- Quality of the physical environment<sup>4</sup>.

An individual's well-being also depends on the state of the wider society in which they live. It is likely to depend on factors such as:

- Social cohesion and inclusion.
- Widely available opportunities.
- Trust among people and groups.
- Shared and/or mutually respected sets of values.
- Absence of significant poverty.
- A rich culture.
- Good governance structures – democracy, accountability, transparency, rule of law.
- High-quality public goods and services.

The above description of well-being emphasises both the processes (such as democracy) and the desirable outcomes that people hope to attain in their lives<sup>5</sup>. The Nobel laureate Amartya Sen has recently set out an influential exposition of this type of approach to well-being in his book *Development as Freedom* (Sen, 1999). Essentially Sen proposes that well-being should be judged by the extent to which individuals possess various kinds of "freedoms". These are people's opportunities and capabilities to live the kind of life they have reason to value.

The focus is not just on particular end-states or outcomes. Neither is it about people being passive recipients of those outcomes. Rather, it is about individuals acting and bringing about change, where the achievement can be judged in terms of their own values and objectives. The freedoms are important ends in themselves: for Sen, long-asked questions such as "are political and civil liberties conducive to development?" are misconceived. They constrain "development" to a narrow focus on material output. Such liberties should be seen as ends in themselves, not requiring any further justification on the basis of their instrumental effects on other outcomes, such as economic growth.

4 Environmental quality is an important element of well-being. For example, clean air, clean water and the absence of toxic emissions contribute directly to the quality of life. In addition, environmental resources contribute indirectly to well-being through their value as inputs to production. The complex linkages between the environment, economic output, social capability and well-being are beyond the scope of this report – they are being covered in separate work across the government on sustainable development. In very general terms, however, while there appears to be some scope for policies that aim at both enhanced environmental quality and higher economic output, trade-offs will often be required. The degree of uncertainty often present about environmental impacts and the long time horizons involved make this a particularly difficult area of policy, involving issues of inter-generational fairness and concerns about the possibility of irreversible environmental effects.

5 A similar approach relating specifically to New Zealand can be found in Royal Commission on Social Policy (1988), Vol. II, p.450.

Sen identifies five different freedoms:

- 1) Political freedoms – democratic systems with freedom of expression and organisation, and a free media.
- 2) Economic facilities – the opportunities that individuals enjoy to utilise economic resources for consumption, production or exchange.
- 3) Social opportunities – social arrangements for education, health care and so on which influence individuals' substantive freedom to live better lives.
- 4) Transparency guarantees – the freedom to deal with one another under guarantees of disclosure and lucidity (important to preventing corruption and other underhand dealings).
- 5) Protective security – a social safety net for the poor and vulnerable, comprising on-going institutions and ad hoc emergency measures.

Sen also demonstrates that such freedoms are also critically important as means to the achievement of social development, in the form of economic growth and improvements in the quality of life. He assembles empirical evidence on the connections between freedoms of various kinds, and a variety of social outcomes.

“Political freedoms (in the form of free speech and elections) help to promote economic security. Social opportunities (in the form of education and health facilities) facilitate economic participation. Economic facilities (in the form of opportunities for participation in trade and production) can help to generate personal abundance as well as public resources for social facilities. Freedoms of different kinds can strengthen one another.” (Sen, 1999, p.11).

Our approach is similar to Sen's although the vocabulary is different. The key ideas are that well-being is more than material living standards, certain freedoms are intrinsically valuable, and these freedoms are also instrumentally powerful, via their linkages with each other, in producing desirable development outcomes.

## 2.4 Linkages between social capability, economic performance and well-being

There are direct linkages between social capability, economic performance and material and social well-being. As previously mentioned, the effects are often mutually reinforcing or involve feedback loops. This raises the possibility of virtuous or vicious circles, and the possibility of good and bad equilibria. Good understanding of the nature of the linkages is therefore important. The following paragraphs illustrate some of the links in each direction between social capability and economic performance (goods and services output).

Social capability and economic performance impact on each other

- Social capability directly affects economic performance. For example:
  - The ability to adjust to economic shocks decreases with social division (Rodrik, 1999).

- The effective rule of law increases investment by improving the incentives to invest and save (World Bank, 2000).
  - Transparency and good public sector governance improve resource allocation, reduce resources being wasted on lobbying, reduce the incidence of poor public policy, and promote earlier adjustments to emerging problems (Kaufmann, Kraay and Zoido-Lobaton, 2000).
  - Trust and co-operation (positive reciprocity) ease the burden on the institutional structure and reduce transaction costs (Knack and Keefer, 1997; La Porta et al, 1997).
  - Interpersonal linkages facilitate labour market participation and matching, innovation, and diffusion of knowledge and best practice (Saxenian, 1994; Fountain, 1997).
  - "Strong ties" can contribute to or detract from "weak ties" that are important for economic development. For example, immigrants from the Pacific Islands (particularly the older generation) tend to have extensive "strong ties" but almost nonexistent "weak ties" into other communities (personal communication D. Robinson, May 2001).
  - The degree of income inequality can be negative or positive for growth depending on a number of factors such as its impact on incentives, education and fertility decisions and political support for reforms (OECD, 2001b; Annex B).
- Economic performance affects social capability both positively and negatively. For example:
    - Economic growth generally increases opportunities for active participation in the economy, mainly via the labour market. Relationships formed at and through work are an important element of people's social networks.
    - Economic growth tends to generate a constituency of support for the institutions and policies responsible for growth, and thereby helps build social cohesion (Galt, 2000).
    - Participation in voluntary market exchanges can promote the development of important social norms (trust, reliability, honesty) that smooth broader social interactions (Sen, 1999).
    - Economic growth generates additional tax revenues that fund public expenditure on things like education and social protection that promote social capability.
    - Growth often creates winners and losers as resources shift from declining to expanding sectors, skill categories or regions. This means that the fruits of growth can turn out to be unevenly distributed, with particular individuals and groups suffering relative or absolute losses alongside others who experience

rapidly improving fortunes. This can cause social tension and divisions. Unless governments manage these changes well, this can lead to opposition to further change and policy reversals (Rodrik, 2000).

- Globalisation and greater openness (important drivers of growth) tend to place strains on the social fabric via increased volatility (e.g. in the demand for certain types of labour) and via the challenge that foreign norms and ownership of businesses create for local culture and norms (Rodrik, 2000). Globalisation and openness increase the mobility of capital and skilled labour and so limit government efforts to enhance social capability.
- Globalisation and greater openness may also have positive social impacts such as more tolerance of diversity and a more dynamic culture (Fukuyama, 1999).

Thus, social capability and economic performance impact on each other. In addition, both impact on well-being. Positive linkages in each direction clearly have the potential to generate virtuous (or vicious) circles, and win-win opportunities for policy. This insight is a distinctive and novel part of the “inclusive economy” framework and leads to a wider focus for policy analysis – as the next section will illustrate. On the other hand, the negative linkages imply potential trade-offs so that, for example, a policy that boosted growth might be at the expense of some aspect of social capability. In turn there would be both positive and negative effects on well-being with the net effect depending on their relative sizes. So it is important to consider the factors that influence economic performance, and their positive or negative impacts on social capability, and vice versa.



### **Box 2.1: Health outcomes in an inclusive economy**

Health is an important contributor to, and element in, most definitions of well-being both at the individual and societal level. For this reason, most of the policy themes discussed later in this paper which are articulated in terms of their positive contribution to overall well-being are likely to have more specific positive impacts on health. For example, there is strong evidence of positive effects on mental health for individuals who obtain a job after a period of unemployment (Jenkins, 2001).

Research on the determinants of the relative healthiness of populations has long recognised the complex causal interplay between social capability and material living standards in influencing health outcomes. It is recognised that many of the most important factors shaping the health of communities lie far outside the domain of the health services delivery system. Rather they lie in the socio-economic circumstances of people, including the characteristics of the areas where they live (Marmot and Wilkinson, 1999). Therefore, effective health-promoting policy should focus at least as much on the material living standards of the least well off, particularly their children, their level of educational attainment and the social networks and supports present in communities, as on improving access to timely and appropriate preventive and curative health services.

That said, there is also evidence that well-organised public services (not just health services) and infrastructure can improve health even in poor areas and complement other policies. For example, the Kerala state in India has far better health outcomes than its per capita income would predict. This is generally attributed to the province's strong commitment over many years to public health, basic primary health services and mass education, including an emphasis on women's literacy (Sen, 1999).

A similar example is provided by Britain's health experience during two World Wars. Mortality rates among non-combatants fell sharply despite a reduction in the per capita availability of many resources including food. The most likely explanation relates to the noticeable increase in public provision of universal social services and a more equitable distribution of basic commodities, especially food, reducing under-nourishment among the poorest (Sen, 1999). This suggests that improving the prospects and living standards of the least well off is likely to be positive for health and wider well-being.

## Box 2.2: Housing in an inclusive economy

In an inclusive economy, housing policy is concerned with more than simply ensuring that people have access to an adequate, sheltering physical space, since it is apparent that housing has important consequences for both social capability and well-being, and the economy.

For example:

- Damp and cold housing is associated with poor respiratory health, especially among children (Howden-Chapman et al, 1996).
- Overcrowding is associated with higher rates of a number of infectious diseases in childhood (Howden-Chapman et al, 1996; McNicholas, Lennon et al, 2000).
- Overcrowding has been put forward as a contributory factor in some children's poor educational attainment, because of its effect on the ability to find quiet space for homework.
- Different types of housing (single dwellings in streets, apartment buildings etc) have been found to be associated with different patterns of social interaction and sociability in neighbourhoods (Glaeser and Sacerdote, 2001).
- Different types of housing have been found to be associated with different levels of crime in neighbourhoods because of the opportunities which different physical lay-outs offer for undetected criminal behaviour.
- Owner occupied housing has been identified as positively associated with a higher level of civic participation on the grounds that owner occupiers have a "stake" in their community (Glaeser and Sacerdote, 2001).
- Home owning as against renting may lead to greater inflexibility in the labour market if workers find it difficult to sell their homes in order to be able to move to places where jobs are available.
- House design and home amenities can have a major bearing on whether disabled or frail older people are able to live in the community and remain integrated with the rest of society.

Viewed in the light of these examples, housing policy is another domain in which economic and social policy concerns are best analysed in an integrated, inclusive way. Poor housing is likely to be caused by prior disadvantage – for instance low skills and low earnings capacity – that, at the same time and independently, leads to other poor outcomes. Thus, problems that are associated with poor housing may be due to other causes, and improved housing may not solve the problem (Mayer, 1997). Also, even when poor housing contributes to poor outcomes, other policies, such as immunisation and homework centres, may be more effective as solutions.

In the next section we discuss what we think are the more important areas of policy opportunity based on empirical evidence of what is most likely to work to promote inclusive economy goals, and relevance to New Zealand's current situation.

## 3 Key Messages for Shaping Policy on the Inclusive Economy

In this section we group key messages for shaping policy on the inclusive economy under a number of themes. They represent broad policy areas that theory and evidence taken together strongly indicate are important in building a more inclusive economy, taking New Zealand's current situation as a starting point. We discuss the themes in the context of our framework in order to bring out how their relationship to well-being works through both economic and social mechanisms and the interactions between them. The themes are:

- Growth and distribution.
- Human capital.
- Jobs.
- Geography.
- Institutions and values.

### 3.1 Growth and distribution

The well-being of New Zealanders is vitally linked to our ability to achieve and sustain a steady rate of growth in our national income<sup>6</sup>. A continuously rising level of national income per head:

- Represents additional purchasing power that is available to acquire goods and services to consume (a central component of material well-being), and to save and invest to provide future growth.
- Seems to be associated with a similar rate of increase in incomes of the poor (Dollar and Kraay, 2001).
- Creates additional jobs, expanding the opportunities for fuller employment and greater participation particularly of poorer people (Freeman, 2001).
- Can help avoid New Zealanders' living standards slipping relative to those of other comparable countries, thus avoiding the risk that too many people will choose to emigrate.
- Provides revenue to support important social expenditures without placing additional strain on the rates of tax.

<sup>6</sup> For the reasons discussed in **Box 3.1**, a better aggregate measure of the economy's performance in delivering improved material well-being is growth in Gross National Income per head.

- Provides greater room for policy and economic flexibility by permitting structural improvements and relative price changes to occur without those adversely affected necessarily having to take a drop in real income.

Thus, in looking for new and more effective ways to enhance well-being, we cannot afford to overlook the basics – those elements of fiscal, monetary and regulatory policy that are important for growth, stability and the efficient functioning of key markets.

### Box 3.1: GDP, GDP per head, and GNI per head

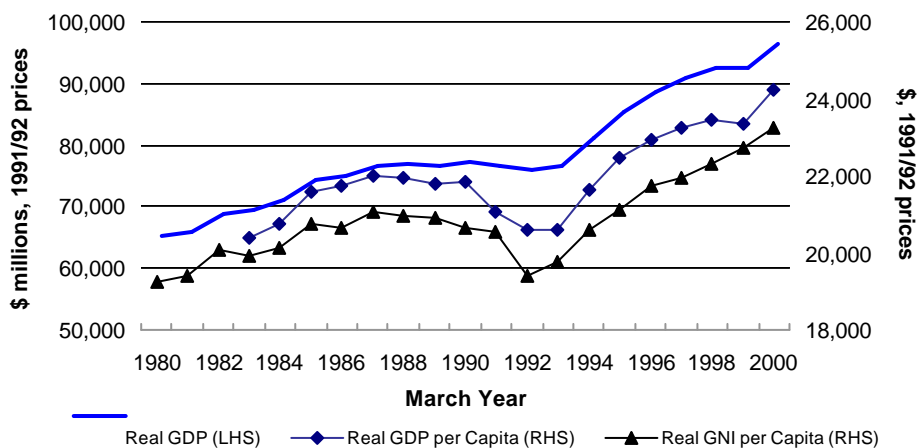
The most commonly used economic aggregates are Gross Domestic Product (GDP) and its growth rate. These are not always good measures of material well-being, even on average, because they ignore changes in population. GDP per head and its growth rate are therefore better measures. However, GDP measures economic activity in New Zealand whether the activity is “owned” by foreigners or residents. Likewise it ignores any income earned from offshore activities that are owned by New Zealand residents. A measure that better reflects the income accruing on average to each New Zealand resident is therefore Gross National Income (GNI) per head.

Fig 3.1 below shows the tracks of the three series over the past two decades and illustrates how they have differed considerably from each other. For example the two “per head” series dipped sharply in the early 1990s whereas GDP did not. This was due to an increased population growth rate coinciding with low or slightly negative GDP growth at the time. Currently available statistics do not capture the incomes of New Zealanders resident overseas (except partially and indirectly via transfers from or to them). Whilst arguable, it seems unlikely that such incomes would be a policy concern for the New Zealand Government.

The challenge is to draw on the insights of the best available theories and evidence on what improves economic and social outcomes overall, rather than improving one at excessive cost to the other. This process needs to take account of New Zealand’s particular institutions, values and history.

A good example of the challenge lies in the issue of income inequality.

Fig 3.1: Real GDP, real GDP per capita and real GNI per capita



Along with a number of other developed countries, New Zealand has experienced widening pre-tax incomes over the past two decades or so, mainly because technological change has increased the demand for, and therefore the wages of, skilled labour relative to unskilled (David, 2001; Acemoglu, 2001).

It has been conventionally believed that, while less income inequality might be socially desirable, attempting to narrow the post-tax distribution of incomes is bad for economic efficiency and growth. Thus it seemed necessary to make a difficult trade-off between the two desirable goals of economic growth and improving outcomes for the worst off. However, the linkages between income inequality and economic growth have recently been the subject of considerable debate. A number of theories and empirical studies have been advanced that indicate that wide dispersion of incomes is not necessarily good for growth and that a more equal distribution can be beneficial (OECD, 2001b)<sup>7</sup>.

In light of this more recent evidence, it is tempting to conclude that one can achieve both reduced inequality and growth without having to trade one against the other. However, it is a serious over-simplification to believe that, where there is a large disparity in people's incomes, the tax and transfer system can be used to redistribute from rich to poor without undermining the country's growth prospects. There are several problems with this over-simplification:

**“Passive” social spending, via taxes, income transfers and some social services, is likely to harm incentives and jeopardise growth**

The evidence from a recent cross-country study indicates that high levels of taxes, transfers and social spending are associated with lower growth rates in OECD countries (see Box 3.2). Lower growth is bad for well-being because it is associated with slower job growth and, in an open economy, a worsening pre-tax income distribution (see discussion of globalisation below).

**“Passive” income transfers alone are not sufficient to enhance well-being**

As discussed earlier, the concept of well-being relates to having a set of freedoms and capabilities. An increase in current transfer income provides a means by which some choice can be exercised for the moment, but well-being is multi-faceted and path-dependent. In other words, it is influenced by people and events around us and tends to evolve with us over our life as we exercise choices, relate to others, gain skills, experience and other assets, or suffer personal, family or financial losses.

Income-tested benefits are a key feature of our social security system since they provide collective social insurance against adverse events. However, income transfers do not by themselves guarantee that those affected by adverse events are back on a trajectory of evolving positive well-being. For some, that is likely

7 Annex B highlights some of the different mechanisms linking inequality and growth.

to require much more: medical treatment; a network of supportive and stable relationships; realistic options for achieving, and encouragement to achieve, stable employment; and the contacts, motivation, knowledge and skills to pursue them.

The availability of “passive” benefits without a well-designed gate-keeping system leads to growth in numbers of welfare-dependent individuals and families. In addition, long periods of benefit receipt are associated with a range of poor outcomes for both adults and their children<sup>8</sup>. Finally, social cohesion will suffer if taxpayers feel they are being asked unreasonably to support a growing number of recipients of “passive” transfers.

### Box 3.2: Linkages between growth, inequality and social protection

The most recent OECD study (OECD 2001b) on this topic reveals how complex are the linkages and how difficult it is to interpret the empirical evidence.

The OECD started with a fairly standard model of the major determinants of growth for OECD countries – human capital, investment in physical capital, population growth and a “catch-up” factor for countries with lower initial incomes. They then tested whether the degree of income inequality (after taxes and transfers) could add further explanatory power. The evidence was inconclusive, so they could not say whether a wide distribution of final income was good or bad for growth.

Despite this inconclusive result regarding income distribution, the OECD found that greater levels of government spending on social protection were associated with a poorer growth performance. However, they also found that it made a difference whether the social protection spending was “active” or “passive”. “Active” policies they defined as those introduced to encourage increased employment by the beneficiaries of such policies. They could therefore include a range of “active” labour market policies as well as policies designed to reduce barriers to participation, such as child care assistance, tax credits for low-income working families, and some forms of health protection. “Passive” policies were defined as pure transfers of consumption from one group in society to another<sup>9</sup>. Using this distinction the OECD found that “active” social spending tended to promote growth, while “passive” spending inhibited growth.

<sup>8</sup> While there are strong associations between benefit receipt and a range of poor outcomes, it is less clear that benefit receipt itself is an independent factor contributing to these. See Boggess, Corcoran and Jenkins (1999).

<sup>9</sup> Passive transfers include cash transfers and elements of health and other social services spending. Any division of social protection policies into active and passive will be imprecise. Some mostly passive programmes have an active component – for example, job search requirements for unemployment beneficiaries. In addition, the recipients may use some of the transfer for active purposes, such as investing in job search. Recent empirical research has found that when average incomes rise, the average incomes of the poorest fifth rise proportionately. This result holds across regions, periods, income levels and growth rates (Dollar and Kraay, 2001). The focus should therefore be on helping the poor while avoiding undermining the incentives for economic growth.

The pre-tax distribution of market incomes largely depends on the distribution of skills in the population and the rate of non-employment. “Active” policies aimed at increasing skills and employment offer the best prospects for improving both distributional and growth outcomes over time

As the next two sections discuss in more detail, the evidence shows that the major influences on the pre-tax distribution of income are the distribution of skills among the population, the differences in wage rates between skilled and unskilled work (the skill premium), and the incidence of paid employment (Acemoglu, 2001; O’Dea, 2000). This suggests that a focus on education, training and promoting participation in the labour market are the best routes to reduce deprivation and poverty, without incurring the downsides of passive tax-benefit redistribution. OECD work (see Box 3.2) confirms that such “active” forms of assistance are effective and do indeed promote rather than diminish a country’s growth prospects.

An inclusive economy needs to produce fair outcomes, as judged from several perspectives

There is a tendency to focus too much on the static distribution of after-tax incomes and to infer that any increase in inequality measured that way is bad, and any decrease good, for social equity. However, income inequality measures confuse two issues: improving income for the poor; and reducing income for the rich. A dynamic economy depends on rewarding individuals for innovating and meeting consumer needs. An economy that grows rapidly is likely to provide benefits to the poor as well as the rest of society.

A more complete assessment should also take into account how incomes translate into longer-term outcomes for people, families, population subgroups and the nation as a whole. It also needs to recognise that it is not wise to use comparisons of current income as a proxy for comparisons of living standards, because the former does not take into account factors like home ownership, the opportunities people have and the different stages of life different people are at.

The above considerations require us to think carefully about how best to address distributional and growth concerns. We need to deal with the immediate concern for social protection of today’s vulnerable people. At the same time, we need to recognise that providing opportunities of training and jobs – and expecting those getting welfare benefits to take them – is as important as providing current income. We need to recognise that there is a trade-off between providing income support through “passive” income transfers, and fostering the economic growth that will provide better living standards for today’s poor tomorrow. We also need to recognise that growth depends on entrepreneurship, and accept high incomes justly earned.

Greater consensus among voters and taxpayers is needed on where to strike the balance across these sometimes competing ends. This inevitably requires value judgements to be made. However, these judgements need to be well informed, and based on a better understanding of the costs and probabilities of success of different interventions. Improving public awareness of what works through better information

and public debate should lead to a clearer sense of what constitutes desirable outcomes and the best means to achieve them. This in turn should provide a stronger mandate for policy settings that can be sustained over an extended period.

### 3.2 Human capital

Human capital is positively linked to well-being

There is strong and consistent evidence that human capital is positively associated with well-being, both directly, and through raising economic performance and social capability. Across developed countries, an extra year of education is associated with increased individual earnings of between 5% and 15% (Krueger and Lindahl, 2000). The most recent OECD evidence (OECD, 2000b) shows that a one-year increase in average years of schooling in the working-age population is associated with an increase in output per capita of 6%<sup>10</sup>. While there are thorny empirical issues affecting the interpretation of these findings, there is a growing (but not universal) consensus amongst economists that these associations mostly reflect a causal link from education to productivity, income and growth (Temple, 2000).

In addition, evidence shows a positive association between education and a wide range of other outcomes – including health, lower criminal offending, participation in voluntary community activity, giving to charity, concern about equality of opportunity, political participation, trust and direct measures of happiness. Moreover, improving human capital in one generation appears to have positive flow-on effects to the next; and raising the general level of education in a community provides benefits to individuals in addition to those gained from their own education (OECD, 2001b). Again causal relationships are not always clear, but these probable additional benefits should be taken into account in evaluating the contribution of human capital policies to well-being.

Many important questions remain for policy

Within these very broad relationships many important questions remain for policy. Human capital has many different dimensions, and is acquired in a wide variety of settings – families, school, tertiary sector, on the job and in the community – and through different means. Empirical evidence often captures only a small part of this complexity, or does so in a way that makes generalisation for broad national policy difficult. Particular questions include:

- Are the best human capital policies to increase economic growth also the best to increase well-being on other dimensions, or is there a trade-off, particularly in competing demands for society's and government resources? If so, can the trade-off be evaluated to assist policy choices?

<sup>10</sup> This is an average relationship across OECD countries. Countries that already have high levels of education in the working-age population have less scope to add years of education, and there are diminishing returns to extra education for such countries.



- Which level of education – early childhood, primary, secondary, post-compulsory – should receive the most attention henceforth, and why? What is the relative importance of formal education, compared to other influences on human capital formation – families, workplaces and community – and what does this suggest for policy design and implementation?
- Given a strong role for private decisions by families, individual students, education providers and firms, what is the appropriate role for governments? What problems should government involvement address? What problems does that involvement entail? What sort of institutions and what regulatory, funding and financing arrangements are best?

A companion paper, *Human Capital and the Inclusive Economy* (Treasury, 2001a), aims to improve the basis for reasonable judgements on a number of these issues, in the New Zealand context.

Economic growth is driven by technological innovation, creating an increasing demand for skill, and, in many countries, a widening dispersion of incomes

As noted above, economists view economic growth as being driven primarily by technological innovation<sup>11</sup> – finding new and more efficient ways of producing existing goods and services, and producing new types. There is reasonably firm evidence that over the last 80 years and particularly over the last 25, this technological progress has created an increasing demand for skills (David, 2001). It is the response to this demand that has been primarily responsible for rising levels of education in OECD countries. Particularly over the last 25 years, this has played a significant role in the widening of the distribution of income in a number of countries (Acemoglu, 2001).

However, there is no simple relationship between economic growth and earnings inequality. Much will depend on the circumstances of particular countries: the way in which their industries are organised; labour market regulation and welfare policies; the nature of formal and informal education and their linkages to industry; and the quality and distribution of the existing stock of human capital. In addition, increased supply of skilled labour may, itself, induce further technological change. Countries show marked differences in both growth patterns and the trajectory of income inequality over time<sup>12</sup>.

Nevertheless, it is likely that the faster the pace of skill-biased technological change, the more likely there will be a widening dispersion of earnings. Countries such as the United States (and, apparently, New Zealand) that utilise a high-skill/low-skill mix of labour inputs rather than a more uniform skill mix (Broadberry, 2000) are likely to be more vulnerable to a widening dispersion in the face of rapid skill-biased technological change. This is partly because the current level of human capital in families and communities has a strong effect on formation of human capital in the

11 In the broad sense, including organisational innovation.

12 See the previous section on *Growth and distribution*, and OECD (2001b).

next generation. Moreover, much human capital is formed “on-the-job” – people who have worked only in low-skilled jobs will find it more difficult to adapt to new skill-biased technologies.

Human capital policies for growth or improved distributional outcomes?

Technological progress drives growth, and seems to require at least the following types of capabilities (aspects of which are not acquired through formal education):

- People who have the high technical skills (in the appropriate areas) and creativity to create or adopt new technologies – and behind this, people who have high levels of generic skills that will enable them to learn efficiently specific technical skills demanded by emerging technologies.
- People with the required entrepreneurial and management skills to identify opportunities, organise the financing of investments, and design and manage new ways of organising to make optimal use of new technologies.
- People with the skills to operate the new technology and to work effectively in the new forms of organisation. (While there is evidence that cognitive skills have become more important, a range of other skills and qualities are also important, including the ability to work in teams, to problem solve, and to adapt.)

On the other hand, the most effective human capital policies to address income adequacy and income distribution concerns are likely to be aimed at raising the skills of people in the bottom quintile of the distribution (Acemoglu, 2001). This conclusion is likely to be reinforced when considering other channels by which human capital affects well-being. For instance, the biggest effects on improving outcomes in health, reducing crime, raising attainment in disadvantaged communities, increasing community and political involvement and raising trust are also likely to be gained by raising achievement in the bottom part of the distribution.

Improving skills on the bottom rungs of the distribution to address distributional concerns will reduce the need to use other instruments (such as income transfers, labour market regulation, and taxation) that, as we have seen, are likely to have continuing adverse effects on economic growth<sup>13</sup>.

If the best human capital policies to improve the production of skills for growth are different from those to raise incomes at the bottom of the distribution, and each requires large amounts of extra resources, then clearly there will be a trade-off. The trade-off might be evaluated in terms of contributions to productivity and economic growth, but other effects on well-being need to be taken into account, and, in the end, equity objectives also need to be considered. One guide to evaluating this potential conflict is to compare the levels and distributions of human capital in similarly developed countries.

<sup>13</sup> See the previous section on *Growth and distribution*, and OECD (2001b).

New Zealand's ranking in educational attainment and skills is mixed

New Zealand currently has very high rates of tertiary enrolment, and ranks fifth in the OECD in terms of 17 year olds' expected years of tertiary education. On the other hand, along with the United States and the United Kingdom, it ranks in the bottom third for rates of participation in education of young people aged 16 through 18. On a range of internationally comparable measures of achievement, New Zealand (along with other English speaking countries<sup>14</sup>) has a comparatively large proportion of low-skilled people – both at school and in the adult population. On the other hand, New Zealand often ranks well in skill levels in the top half of the distribution.

This suggests that there is more scope to increase average years of education, and to improve well-being directly, by focusing attention on the roughly 20% of young people who leave school without a recognised qualification of any sort, and, in particular, the roughly 15% of young people who leave school in the year that they turn 16. (OECD and Statistics Canada, 1997 and OECD, 2001a reach similar conclusions more generally. They point out that variations in skills and attainment across OECD countries are much greater in the bottom part of the distribution than in the top.)

A further important dimension is the over-representation of Māori and Pacific people amongst those with low skills. This increases the risk of damaging social fragmentation, particularly to the extent that this is seen to be caused by social and economic processes that unfairly disadvantage them.

Early interventions are likely to be the most cost-effective in the long run

There are two issues here – how to reduce the numbers of young people leaving education without sufficient skills to secure stable employment, and how to improve skills for those already in the workforce. Because of the cumulative nature of educational investments, early interventions in pre-school and primary education are likely to be most cost-effective in the long run.

The period from birth (even pre-birth) to school age is a critical development phase with life-long effects on well-being. Intensive early childhood interventions can be effective in improving a range of both short- and long-term outcomes for disadvantaged children (Waldfogel, 1999). Given that they are relatively expensive (compared to regular early-childhood education), such interventions need to be carefully designed in terms of the age of the child, their targeting on risk factors and their mix of child-focused and parent-focused elements. Intensive very early interventions for children most at risk may be important, given the rapid brain development that takes place in these years. Targeting instruments are not perfect, and it may be difficult to engage the most disadvantaged families. Good quality standard early childhood education also appears to have a beneficial effect, in particular for disadvantaged children, but again it is difficult to ensure that the most disadvantaged children access provision. In addition, there is evidence that some of the benefits – particularly in terms of cognitive skills – are lost, if subsequent primary education is of insufficient quality (Nechyba et al, 1999). Given this, primary schooling is a key stage at which to address the risk of low achievement.

14 Although Australia recently has been doing better (Treasury, 2001a).

Of particular importance are foundation skills in literacy and numeracy that provide the platform for later learning both in school and the workforce. Such skills have been shown to have a strong link with labour market success independent of levels of education (OECD and Statistics Canada, 1997).

Many jurisdictions – for instance the United Kingdom, and many states in the United States – have put increasing emphasis on the acquisition of literacy and numeracy skills during elementary schooling. For example, they have put in place standardised measures of progress, at individual, school and national level. A range of interventions may be effective. By and large, these will need to engage families and communities in pursuing meaningful objectives for their children, recognising the important contribution that each makes to children’s outcomes. The Strengthening Education in Mangere and Otara (SEMO) initiative is a promising recent New Zealand example of such an approach (see Box 3.3). A key issue is how to export such an approach to other disadvantaged communities, given scarcity of skilled human resources, and the costs involved.

Labour market and basic skills training for adults may also be useful

Addressing low levels of human capital in the adult population raises different issues. First there is not strong evidence that pre-employment labour market training (such as the New Zealand Training Opportunities Programme) is particularly effective in securing better labour market and earnings outcomes. In the short to medium term, evidence supports concentrating on getting persistently unemployed people into work as a first priority. On the other hand, policies that concentrate on human capital accumulation may eventually match “work first” policies in effectiveness, over the longer term (Hotz, Imbens and Klerman, 2000). In addition, human capital policies may have important benefits both for individuals and their families, other than improving labour market outcomes. These need to be taken into account.

There may also be an increased role for improving the quality of training available for the low skilled while they are in employment (Acemoglu, 2001<sup>15</sup>).

More generally, people in the bottom 20% of the distribution of skills vary widely in the characteristics that are associated with their low skills. Some will not be able to benefit from human capital policies in terms of improved labour market attachment, but may nevertheless benefit for other reasons.

Overall, there is a need to get a better understanding of what policies are effective in which circumstances and for whom. This can only be achieved through experimentation and good evaluation of policies as they are implemented in New Zealand, and drawing on learning from other jurisdictions.

<sup>15</sup> New Zealand appears to have very high rates of adult education and training, including that provided or financed by employers. The questions then are who benefits from such training, and what is the scope for policies to shift provision more to the initially unskilled, without impairing efficiency?

### Box 3.3: Strengthening Education in Mangere and Otara

The Strengthening Education in Mangere and Otara (SEMO) initiative began in 1997 in response to an Education Review Office (ERO) report criticising the quality of education in many South Auckland schools. It aims to strengthen schools in Mangere and Otara by improving their capacity to manage themselves. The Ministry of Education provides extra assistance to this end. SEMO's design reflected recent research on school improvement that emphasised the importance for sustained gains of involving both schools and community groups. Relevant resources (aspirations for children, understanding what is needed to reach them and the skills to do so) are more likely to be identified and aligned through such an approach. The initiative worked within national education policy parameters, and the culture, politics and recent educational history of Mangere and Otara. It thus aimed to be a partnership between the state and the local communities, families and schools. Evaluation (Robinson et al, 2000) showed that considerable obstacles (the historical pattern of relationships and expectations, suspicion of state interventions, expectations of management autonomy, community loss of confidence in the local schools) stood in the path of achieving partnership. Over time, through learning from the feedback of the various communities, schools and evaluators many of these obstacles have been overcome, resulting in the establishment of effective partnerships. The evaluators note the importance of SEMO activities (which are complex and diverse) focusing on the central objective of sustainable improvement in students' achievement. Activities not so focused can wittingly or unwittingly divert the attention and effort that is needed to achieve this goal. SEMO has been successful in gaining community and schools' support for this goal. A current activity in 13 schools is a programme of teacher professional development on the analysis and use of student achievement data. An evaluation of another component of SEMO, a teacher development programme focused on teaching new entrants, indicated that it substantially improved the chances of children from low-income families reaching national standards of literacy achievement.

### New Zealand should improve selected areas of tertiary education

Empirical evidence lends support to models in which the tertiary sector plays a crucial role in economic growth in developed economies, through the production of highly skilled technical specialists, and top class managers. Effective linkages between tertiary education research, and research and development in industry, are also important for economically relevant technology creation and adoption. Much of the knowledge and skills required are learned by "doing", are "tacit", and to a significant extent are disseminated only through personal interactions. Linkages between New Zealand and international centres are important, for the same reason.

In addition, some economists (David, 2001) argue that there are important investment co-ordination problems that create an opportunity for government intervention to improve outcomes. Skilled graduates and new technologies are complementary. The investments by students in time, by the tertiary sector in creating capacity for producing graduates, and by firms in research and development and adoption of technologies, all require each other in order to reap good economic returns. This suggests that a key government role is providing an environment that encourages students, tertiary providers and industries to make complementary investments.

New Zealand has high rates of participation in tertiary education

New Zealand has been remarkably successful in rapidly increasing output of tertiary graduates over the last 15 years, while keeping real government outlays tightly constrained. This has been achieved through funding tertiary institutions almost entirely on the basis of student numbers, with students expected to contribute a part of tuition costs (able to be financed through student loans). The funding includes a national element to cover research – but does not provide strong incentives for excellence in research.

Quality assurance systems are designed to ensure tertiary providers exceed minimum standards. The main mechanism that mediates responsiveness of provision to the needs of the economy is student demand for courses, which in turn is dependent, at least to an extent, on differences in labour market returns to educational investments. Certainly high private rates of return to tertiary education appear to have been a significant driver of increased participation in New Zealand.

New Zealand competes in an international labour market for the most skilled academic workers

However, New Zealand is a small, remote, open economy that operates in an international labour market for the most skilled workers. It is competing with a number of higher-income countries for the best academic workers. It is very unlikely that policies that aim at a uniform standard across the tertiary system will reliably produce world-class centres of research and teaching – no country has the resources to afford a uniformly world-class standard of provision in its universities.

Thus the challenge for tertiary education in its contribution to growth in New Zealand is not one of further raising participation rates, but of improving quality and relevance to the needs of the economy. It is important to be cautious on this point – the New Zealand economy is very different in its structure to other OECD economies – particularly in its reliance on agricultural commodities. It does not follow that producing science and engineering graduates, for instance, in the same proportions as in Germany, the United States or the United Kingdom would be beneficial for growth<sup>16</sup>.

Careful funding and institutional design are required to increase the incidence of world-class tertiary research and teaching in an affordable way

While some recognised centres of excellence in research and training do exist, it is possible that a careful choice of funding and institutional arrangements could lead to the emergence of more, in areas of particular relevance to economic growth. Encouraging selected areas of world-class provision requires internationally competitive salaries and levels of funding. Building on emerging centres of excellence, particularly where they can demonstrate effective linkages with

<sup>16</sup> It is worth noting, however, that, at least in the broad data, New Zealand appears to produce science and engineering graduates at a comparable rate to Australia, Canada, the United States and the United Kingdom (OECD 2000c, Tables C4.2 and C4.3a). At the same time, starting salaries for engineering and science graduates in New Zealand are considerably lower than for commerce graduates, for instance.

relevant industries, could reduce the risk of wasted resources. Internationally, it is not uncommon for research centres (often associated with teaching) to be funded through a tendering process that provides sufficient continuity to allow strategic investments to be made, but which also provides strong incentives for performance.

New Zealand can support only a limited number of such centres. However, they could play a significant role in the identification and adoption of new technologies (and, in some areas, the creation of new technologies) by attracting and retaining top staff and students, and building linkages with industry across which knowledge can be transferred<sup>17</sup>. The particular design of institutions and funding arrangements are likely to be important for giving industry, students and tertiary staff the confidence to make the investments that will yield productivity gains in the longer term. A degree of experimentation may be required to find the best policies.

### Summary

Policies aiming to increase the incidence of world-class tertiary education and research relevant to industry need not require large additions to existing publicly provided resources. The policies involve only a small part of all tertiary provision, and high private rates of return provide strong incentives for individual students to contribute their own resources (assisted by the student loan scheme). More selective funding, coupled with suitable institutional arrangements, could lead to significant improvements<sup>18</sup>.

On the other hand, determined efforts to reduce the incidence of low skills among new entrants to the working-age population are likely to require significant additional resources – but again careful work is required to identify the most cost-effective policies. There is substantial evidence that interventions during childhood and adolescence can be very effective in raising skills. Much less is known about the capacity to raise basic skills in the adult population – suggesting a cautious approach, with expansion dependent on successful evaluation. Recent work in the United Kingdom (Bynner et al, 2001) suggests that where these interventions raise skills, they are likely to have substantial benefits not only for the individuals concerned, but also for social outcomes, productivity, economic growth and requirements for public spending.

## 3.3 Jobs

Having a job is important for well-being

Job loss and the experience of unemployment are known from many studies to have a strongly negative impact on personal well-being, particularly their impact on mental health and adverse psychosocial outcomes (e.g. drug and alcohol abuse). These effects are independent of, and often larger than, the direct impact of reduced income on well-being. Where job losses are widespread in particular communities, whole

<sup>17</sup> While further analysis is required, more differentiated levels of tuition subsidy may also promote concentrations of excellence.

<sup>18</sup> New Zealand's ratio of per student expenditure in tertiary education compared to primary (or secondary) is still comparatively high among OECD countries.

communities can also be disrupted<sup>19</sup>. For most prime-age adults, having a satisfying job is directly important to well-being (e.g. people who get jobs report significantly improved satisfaction with their lives (Jenkins, 2001)), though as jobs become more demanding, the impact on parenting, family life and work-related stress cannot be ignored.

From a national rather than an individual focus, increased paid employment (through reducing unemployment and raising participation) yields a long list of benefits:

- It is a key means of raising national economic output and thereby well-being via higher income per head (although there is some offset from the loss of home production, including possibly the care of children and other dependent people).
- Work experience helps improve human capital – and so the earnings potential – of the working-age population.
- Since many non-workers are poor, it contributes to reducing income inequality, and taking people out of poverty<sup>20</sup>.
- It is positive for fiscal outcomes on both the tax and expenditure sides of the budget (generating or releasing funds for higher priority expenditure, debt reduction or tax cuts).
- It can contribute to social cohesion as the number of people on benefits paid for by others reduces.
- Participation in work widens social networks which is an important asset for economic development and social capability in the longer term.
- As the population ages, it will become increasingly important to raise participation rates among people of working age and those past current retirement age in order to maintain fiscal health and economic growth.

Unpaid work has many but not all of these benefits. Job quality of course varies a lot and can affect the extent of benefits accordingly. But even low-wage, low-skill jobs are usually better for individuals in a position to take paid work, and for society, than no jobs.

Good policy can deliver higher employment

One of the keys to high employment is steady and predictable economic growth. Recessions are not bad simply because they reduce the number of jobs at the time the recession is happening. They also create a damaging longer-term increase in the minimum level of unemployment that is sustainable without creating rising inflation<sup>21</sup>.

This happens because many of those thrown out of work in a bad recession tend to lose their attachment to the labour market – a result of loss of skills, work habits and

<sup>19</sup> This occurred in New Zealand during the period after 1984, for example.

<sup>20</sup> Jenkins (2001) finds the probability of poor people who get full-time work exiting poverty to be of the order of 70% to 80%.

<sup>21</sup> Economists often refer to this “equilibrium” level of unemployment as the Non-Accelerating Inflation Rate of Unemployment, or NAIRU.



motivation. As the economy recovers from recession, these discouraged workers do not flow back to fill the new jobs and this limits how much unemployment can be reduced before the tightness of the labour market starts to cause rapidly accelerating inflation. Hence there is likely to be a prolonged adjustment period in which trying to reduce unemployment to its original level too fast will be unsustainable.

In addition to stable macro-economic policy, other policies are important. Policies to promote competition between firms in the supply of products and between workers (particularly skilled workers) in the supply of their labour reduce their ability to demand price increases and wage increases respectively. They thereby allow the Reserve Bank to be more relaxed about running the economy closer to full capacity and at a lower level of unemployment.

Policies targeted specifically at the long-term unemployed (and people without jobs in regions of high unemployment) can also reduce the minimum sustainable level of unemployment. This follows from the fact that these unemployed people do not provide effective downward wage pressure via search activity or by providing a credible source of labour supply in the eyes of employers. Therefore getting more of them into jobs does not raise inflation risks. In addition, improving the employment opportunities and job experience of these groups is particularly important for reducing poverty and a range of longer-term risks to well-being.

New Zealand compares favourably with average OECD performance on standardised unemployment and participation rates. But as Table 3.1 indicates, evidence from countries such as the US, the UK and Denmark suggests that it is possible to achieve lower unemployment and higher participation than we have currently in New Zealand.

Table 3.1 Unemployment and labour market participation rates				
	NZ	US	UK	Denmark
Unemployment rate (ratio of unemployed to workforce, ILO definition, 2000)	6.0%	4.0%	5.5%	4.8%
Participation rate (ratio of workforce to working-age population, 15-64 years, 1999)	75.2%	77.2%	76.3%	80.6%

Source: *OECD Employment Outlook*, June 2000 and *OECD Labour Force Statistics*, 1979-99, part III.

The experience of these countries is that a generalised lack of jobs (insufficient labour demand) is not a problem in most settings though there may be instances of regional or skill imbalance (sections 3.2 and 3.4, on Human capital and Geography, deal with these issues). In New Zealand the policies of the Reserve Bank ensure enough overall demand to create as many jobs as possible consistent with achieving an inflation rate within the target band. The mechanism is that, if unemployment rises and inflation falls too much, the Reserve Bank will reduce interest rates to increase aggregate demand to the point that inflation will move back into its target band.

The benefits of low unemployment for well-being are illustrated by the United States' economic boom of the 1990s and early 2000s. Freeman (2001) showed that the long period of economic growth significantly improved the well-being of people on the lower rungs of the income distribution via lower unemployment and higher earnings. The tight labour market in the United States reduced poverty substantively. But this occurred at an unemployment rate of 4% to 5%, not at 6% to 6.5%, the rate once viewed as the sustainable equilibrium for the United States. Freeman also found a reduction in socially undesirable behaviours such as crime and teenage motherhood associated with the rise in employment and reduction in poverty.

Alongside macro-economic stability and growth, cross-country evidence indicates that several types of micro-level policy settings are important in generating better labour market outcomes (Blanchard and Wolfers, 2000; Nickell and Layard, 1998). We can label these as wage-setting arrangements, tax-benefit policies ("making work pay"), benefit administration and "active" labour market policies (including relocation assistance). Programmes involving combinations of the last three of these are sometimes referred to as "welfare-to-work" strategies.

Wage-setting arrangements affect the minimum sustainable unemployment rate

Evidence suggests that the wage-setting structures that work best to minimise unemployment are either centralised, highly co-ordinated bargaining between labour unions and employers, or decentralised, independent work-place bargains (Blanchard and Wolfers, 2000; Nickell and Layard, 1998). Historically New Zealand has shifted from an approach largely based on the former (seen in the operation of the Arbitration Court and national wage awards up to the 1960s) to a position close to the latter in the 1990s. Systems that sit in the middle between centralised and decentralised bargaining perform poorly. They raise the sustainable equilibrium rate of unemployment by several percentage points by encouraging unco-ordinated wage leapfrogging by "insiders" with jobs at the expense of unemployed "outsiders". New Zealand's recent shift from the Employment Contracts Act to the Employment Relations Act appears, at least so far, not to have disturbed significantly the system's basically decentralised character.

Wage-setting arrangements are a form of labour market regulation. Other labour market regulations such as minimum codes and wages, paid parental leave and employment protection laws generally aim to increase the quality rather than the quantity of jobs. But they can quite easily have the undesirable side effect of raising unemployment. Their design therefore needs to strike the right balance between protecting workers against exploitation and getting vulnerable unemployed people (whether due to lack of education, low skills or discrimination) into jobs. Sen (1999) is particularly critical of the high-wage/high-unemployment path taken by some European countries, because of its adverse impact on people's well-being through curtailing their freedom to find work.

“Making work pay” may encourage people into jobs

There is a long tradition both in New Zealand and overseas of using reforms to the tax-benefit system to try to alleviate both the “unemployment trap” and the “poverty trap”. These traps relate, respectively, to the lack of incentive to take a job over remaining on benefit, and the disincentive to work extra hours in the face of high effective marginal rates of tax caused largely by the withdrawal of benefits as incomes rise. Reducing either trap improves the monetary rewards of working relative to not working. Hence reforms that do this are sometimes referred to as “making work pay”.

A key problem with “making-work-pay” reforms is that it is impossible to improve one of the traps without worsening the other, except by reducing benefit levels relative to wages. The alternative of raising the after-tax wages of the unskilled relative to benefits is fiscally expensive and moves the incentive problem further up the income scale in the form of higher marginal tax rates. Current New Zealand policy settings appear to offer a reasonable compromise and this is supported by recent steady falls in the number of those receiving unemployment benefit.

There is overseas evidence that wage subsidy schemes may offer benefits, particularly in the long run, in the case of considerably disadvantaged potential workers. The schemes involve paying wage subsidies to employers who hire particular types of workers (e.g. those who have been out of work for an extended period and/or who have few skills). Some schemes of this type exist in New Zealand. But these schemes are costly and can displace existing workers as well as causing job “churning” as successive groups of disadvantaged workers replace one another, when the time limit on subsidies runs out. Nevertheless, there may still be a net gain if the newly employed displaces an existing employee who is less likely to drift into long-term exclusion from the labour market.

“Making-work-pay” schemes in which the government makes direct payments to disadvantaged groups may be a more efficient way of encouraging labour market participation in situations where low wages are regarded as a major barrier to taking a job. An intensively studied example of such a scheme is the Canadian “Self-Sufficiency Project” aimed at getting sole parents into full-time work (see Box 3.4). The findings from its interim evaluation suggest that a generous payment to sole-parent welfare recipients who obtain full-time work can bring multiple benefits – increased employment and higher incomes for low-income people, with little or no net increase in the cost of government transfers (Greenwood and Voyer, 1999; Michalopoulos, Card, Gennetian, Harknett and Robins, 2000). The approach might be even more effective if combined with other policies to overcome barriers to work such as child care and transport problems<sup>22</sup>.

22 The interim results look very promising. However, there are some grounds for caution: the project appears to have high “deadweight” costs (payments going to people who would have worked anyway); we have yet to see what happens when the three-year period of assistance comes to an end; and there is the usual proviso about transferability of an overseas project into the New Zealand context. Nevertheless, the scheme illustrates that targeted financial assistance is potentially effective in moving individuals from welfare to work.

### Box 3.4: Key interim findings from the Canadian “ Self-Sufficiency Project”

- The programme – a randomised trial of a substantial financial incentive to work (payment of half the difference between actual earnings and an earnings “ reference level” , usually double the earnings from a minimum wage job or from social welfare). Targeted at single-parent, longer-term (over 12 months) recipients of welfare. Payments for taking a job available for 12 months after enrolment and paid for three years as long as participants continue to work full-time. Full-time work required. Relatively low tax rate for those who earn more while receiving the wage supplement.
- The effects – 35.2% of 9,000 enrolled in two provinces left welfare for full-time work in the 12-month eligibility period, but two-thirds did not, mainly on the grounds that they could not find a full-time job or could not overcome other barriers to work.
- Providing an additional, modest package of employment-related support increased the likelihood of take-up from one in three to one in two.
- At its peak, 29% of programme members were working full-time versus 14% of the control group.
- The work-conditioned financial incentive not only increased stable work among the target population, it also significantly raised incomes and reduced receipt of social assistance compared with controls, thereby reducing the net cost to government to a very low level. Poverty also reduced significantly.
- Although most of the jobs that people got paid close to the minimum wage, wages grew over time for those who worked full-time.
- There appeared to be no adverse effects on young children, possible positive benefits for school-age children and possible negative behavioural effects on adolescent children of participants (Morris and Michalopoulos, 2000).

More rigorous benefit administration is important

Becoming unemployed often de-motivates people and damages their self-esteem. Creating an expectation that those in a position to work should seek it can help people overcome these barriers and facilitate their return to work. In addition, creating such an expectation meets the reasonable expectation of taxpayers that those who can work should do so. This helps to maintain the legitimacy of the benefit system<sup>23</sup>. For both reasons, the administration of the benefit system should support and be part of an overall “ welfare-to-work” strategy<sup>24</sup>.

<sup>23</sup> A survey conducted for the New Zealand Royal Commission on Social Policy (1988) found there was a strong sense of community responsibility for the less well off, but also a strong belief in the importance of individual responsibility.

<sup>24</sup> OECD (2000d) surveys the variety of approaches across countries and draws some conclusions.

Unemployment beneficiaries are rightly required to attend regular interviews and prepare return-to-work plans with the help of job counsellors. Areas where improvements could still be made are more detailed job-search requirements, more active monitoring by Department of Work and Income (DWI) staff, and greater preparedness to use available sanctions. OECD work suggests that the New Zealand work test is administered in a relatively gentle way compared to other countries and that a tougher approach is effective (OECD, 2000d). Beneficiaries should be required to take jobs on offer even if they are not ideal in terms of job type or location, subject to criteria that the taxpayers funding the benefits would regard as reasonable.

Having a single agency responsible for job placement, benefit payments and “active” labour market policies (e.g. training) as in New Zealand has the potential to offer considerable advantages in overcoming the “unemployment trap” and in ensuring that those receiving benefits and engaged on “active” programmes continue to follow the agreed steps to raise their employability and secure a job. Nonetheless, there could be value in reviewing the DWI’s case management systems to evaluate whether the balance between getting people into jobs and meeting their income and training needs should be moved more in favour of the former. Training could then continue during employment with the aim to increase the duration of job tenure and foster career progression.

“Active” labour market policies can also help, but are tricky to get right

“Active” labour market policies are measures that attempt to integrate unemployed or economically disadvantaged potential workers into the workforce by helping them with searching for a job, improving their skills or developing work-related habits such as punctuality. They can be contrasted with “passive” policies that focus on meeting the financial needs of those not in work until such time as they can find work unassisted. The evidence on the effectiveness of “active” labour market policies suggests that most approaches struggle to help the most disadvantaged (e.g. older unskilled workers) get into satisfactory work but that carefully targeted and relatively intensive (and costly) interventions can be effective.

A variant of “active” labour market policy is the so-called “work first” approach that promotes immediate job entry (usually buttressed by some initial training) rather than more expensive human capital-oriented programmes. Work-first programmes may also offer training whilst in work. (In contrast, human capital-oriented programmes focus on improving beneficiaries’ education and skills before encouraging them to seek work.)

The Riverside County, California GAIN (“Greater Avenues to Independence”) programme is a successful example of the “work first” approach. Over the first three years of evaluation the “work first” approach in Riverside was superior to the human capital approach followed in two matched programmes in other counties in terms of employment, earnings and reduction in welfare spending. The Riverside programme cost was also significantly lower (Hotz, Imbens and Klerman, 2000)<sup>25</sup>.

25 However, seven to nine years after commencement, the human capital approach turned in better results than the Riverside approach although the difference was not significant.

The difficulty in assessing what works and what does not suggests that the approach of basing funding on achieved outcomes, currently being developed for piloting by New Zealand officials, holds considerable promise. Under it, the Government would pay by results. This would give participating non-governmental organisations the incentive to match their interventions to the particular needs of the unemployed. Preliminary evidence from Australia suggests such schemes can be quite effective (DEWRSB, 2000).

In regions with low demand for labour, it may be necessary to consider schemes to help those who wish to relocate to move to places where the likelihood of finding work is greater (see Geography section below). By shifting workers from areas of high unemployment to low unemployment, such schemes may reduce inflationary pressures caused by tight labour markets and lower the equilibrium rate of unemployment. They could comprise one or more forms of assistance including housing assistance, or a subsidy to employer or employee. Currently, no substantial schemes explicitly designed to support such moves exist in New Zealand.

In our discussion of micro-level policies, the main focus has been on getting the unemployed into jobs. But most of the approaches also have the potential to raise participation rates: “making work pay” would persuade some previously inactive people to enter the labour market; “active” labour market policies can be tailored to groups with high levels of inactivity such as older unskilled men, or the disabled; and tighter benefit administration with a selective “work first” focus could apply to other types of beneficiary in addition to the unemployed. This is an area for further work.

### Summary

Because low-income, low-skilled individuals suffer high rates of unemployment and non-participation, and getting a job can increase well-being across a number of dimensions, policies to reduce unemployment and non-participation should be a priority. While education holds the key to improving skills on the lower rungs of the distribution, it will take time. Getting current cohorts of low-income, low-skilled adults into jobs is the next-best approach. Micro-policies should aim to enhance competition in both the product and the labour markets. They should also assist and encourage people into work, particularly the long-term unemployed. This will lower the equilibrium rate of unemployment and enable the Reserve Bank to allow increased demand and reduced unemployment without creating inflation. The evidence is that this benefits those on the lowest incomes (Dollar and Kraay, 2001; Freeman, 2001).

The design of specific labour market policies to achieve this is tricky, but there is evidence that supports the effectiveness of certain schemes. These include some “make work pay” schemes, some “active” labour market policies and a tighter approach to benefit administration including increased emphasis on the “work first” approach. Policy development also needs to focus on barriers facing particular groups such as the disabled and single parents (e.g. the child care costs of work)<sup>26</sup>, and the impact of more work on the time available for effective parenting and family life.

<sup>26</sup> The evidence is mixed on whether it is good or bad for young children to be placed in child care so their parent(s) can work. As pointed out in the Human capital section, early childhood is a critical period for development.

While the focus of this section has been largely on getting those on unemployment benefit into work, most of the policies would also raise participation rates – “making work pay” would persuade some previously inactive people to enter the labour market, “active” labour market policies could be tailored to groups with high levels of inactivity such as older unskilled men, and tighter benefit administration with a selective “work first” focus could be applied to beneficiary types other than the unemployed.

### 3.4 Geography

Both within New Zealand and internationally, people and activity are increasingly drawn to dense urban areas. In general, agglomeration of activity within New Zealand – such as in cities – is good for economic growth. However, it also brings risks. The government may be concerned about low well-being neighbourhoods and regions in themselves, as opposed to low well-being individuals and families, if negative spillovers lead to cycles of deprivation, or if people become stuck in declining areas.

From an international perspective, although integration with the rest of the world is good for New Zealand’s productivity, globalisation and the international mobility of skilled labour have implications for domestic policy, particularly in the areas of income distribution and social capability.

Concentration of economic activity helps economic growth, but can cause problems

Many of the differences in geographical concentration of people and well-being result from choices made by people and firms in response to varying personal and regional characteristics, and so constitute the best outcomes that people can achieve for themselves. Other differences represent points in a process of regional adjustment. Adjustment is a natural and necessary process; it is what happened when people moved from former West Coast gold-rush towns to areas with greater opportunities, for example.

Some regional differences are good for New Zealand. Cities provide benefits to both producers and consumers, and are important for New Zealand’s economic performance. United States evidence has shown that if the population density of an area doubles, labour productivity increases by 6% and total factor productivity by 4% (Ciccone and Hall, 1996). Furthermore, there is a wage premium of over 20% in United States cities and there is evidence that this is related to higher human capital accumulation (Glaeser and Mare, 2001). Recent New Zealand evidence (Kerr and Timmins, 2000) suggests that internal migration patterns reflect a similar mechanism operating here.

This evidence suggests that increasing agglomeration has positive benefits up to a city size well in excess of Auckland’s. Increasing agglomeration could also be important for our smaller cities – if for example there are industry-specific factors associated with New Zealand’s relatively high reliance on primary production. We conclude that the larger cities, and Auckland in particular, are likely to be a critical force in New Zealand’s long-term economic development<sup>27</sup>.

27 Such things as the business cycle, changes in relative prices etc can mean that cities do not grow more rapidly than other parts of the country for extended periods of time.

Regional differences, however, are of particular concern in two cases: when there are negative “neighbourhood effects”, and when there are high costs of adjustment. Similar sorts of people tend to choose to live in similar sorts of places because, for example, they can afford similar housing, need similar social services, identify personally or culturally with others in the area, or can provide each other with community support. However, when groups of low well-being people live together, there may be negative spillovers or “neighbourhood effects” that perpetuate social problems and result in even poorer outcomes for these groups. There are likely to be fewer educational opportunities, poorer quality of education, poor local infrastructure, difficulty in establishing businesses, and lack of access to information-rich networks. It is these sorts of interactions that may lead to cycles of disadvantage, urban ghettos and dysfunction in remote communities.

Despite the intuitive appeal of “neighbourhood effects”, research has found it very difficult to document empirically, in large part because of the difficulty of working out whether disadvantaged communities arise because disadvantaged people choose to live together, or because living together also worsens their prospects. While this makes it difficult to prove that spillovers exist, their possible existence suggests policy for the disadvantaged should focus at least partly on deprived neighbourhoods. Even in the absence of “neighbourhood effects”, the existence of deprived communities may allow the government to use communities as a marker for targeting individuals and families, for example in the delivery of health services. The preponderance of Māori and Pacific Island people in these communities and neighbourhoods constitutes a key dimension for policy attention.

The second reason government may be concerned about regional differences is when people who are unable to find work locally do not relocate to areas where there are jobs because the costs of adjustment are so high. Differences in house prices or rents between regions, for example, may mean people become stuck in declining rural regions<sup>28</sup>. There are, of course, some who are not stuck, but choose to remain in deprived regions for non-economic reasons. These people face a difficult trade-off between the well-being gained from moving (the benefits of income and a job) and the well-being gained from staying (existing social ties and connections to place).

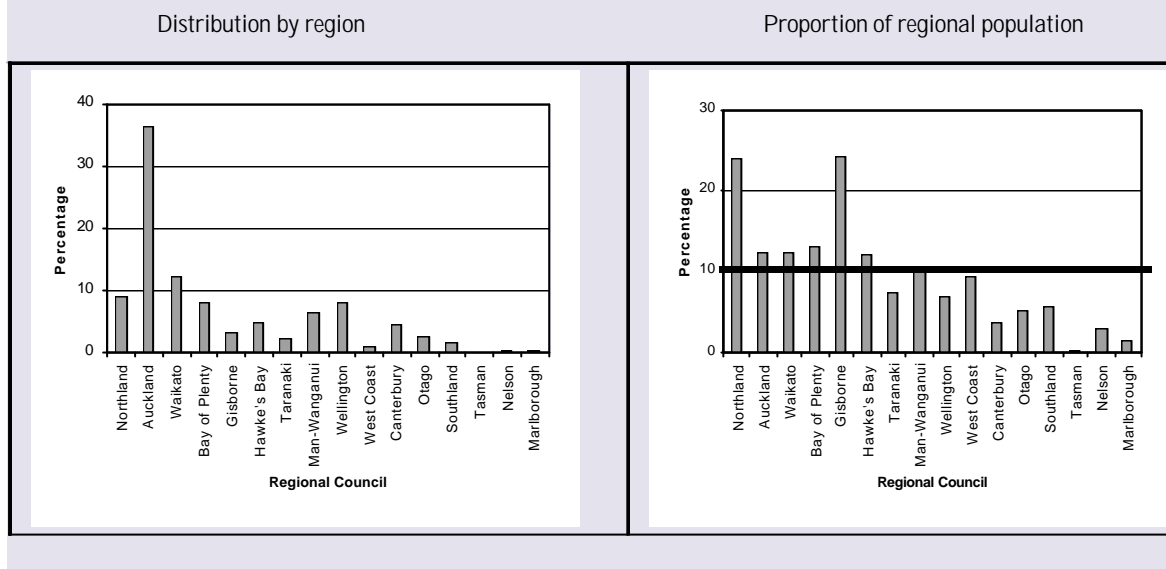
As Box 3.5 below illustrates, when we look at deprivation in New Zealand<sup>29</sup> we see that Auckland contains by far the largest number of people in deprived neighbourhoods (36.5%), followed by the Waikato (Treasury, 2001b). Furthermore, the proportion of Auckland’s population living in deprived neighbourhoods has also increased between 1986 and 1996. We have discussed the importance of cities for economic performance. Given the concentration of deprived neighbourhoods in South Auckland, negative spillovers are likely to be a particular problem here. Anecdotal evidence also suggests that, despite geographical proximity, deprived Aucklanders are not very well connected to the rest of the metropolitan region. For all these reasons, Auckland is a crucial focus.

<sup>28</sup> A related factor may be some people’s reluctance to crystallise capital losses by selling assets that have declined in value.

<sup>29</sup> This work on deprivation looked at the location of the 10% of the population living in the most deprived meshblocks (neighbourhoods of about 100 people) based on an index of income, employment and education.



Box 3.5: Location of the 10% of New Zealand's population who live in the most deprived meshblocks in 1996



Relative to heavily populated areas such as Auckland, rural regions are less of a policy concern because they have far fewer deprived neighbourhoods. Nevertheless, they warrant attention if many people have no local options and face real barriers to relocation. As job opportunities reduce in non-urban areas, and those who can relocate do so, the risks of negative “neighbourhood effects” in the communities that remain increase. When community functioning is impaired the region concerned suffers and, in serious cases, there may be spillovers affecting the social cohesion of New Zealand as a whole. As Box 3.5 shows, Gisborne and Northland have the highest proportion of their populations living in deprived neighbourhoods (around 24%).

Whilst Gisborne has been persistently deprived, it is in fact improving, whereas Northland has declined significantly. In 1986 only 10% of Northlanders lived in the most deprived neighbourhoods – by 1996 that figure had risen to almost 24%. Furthermore, the association between ethnicity and deprivation whether in urban centres or regional areas, suggests a focus for policy analysis.

Government can affect deprived areas through its policies in three ways. It can inadvertently affect them by national policies that are non-spatial, but have spatial impacts. It can affect people through policies directly aimed at particular locations. It can affect people through policies aimed to help people in particular locations.

#### National policies can have unintended regional effects

Non-spatial policies, including minimum wages, benefit levels, industry policy and infrastructure policy, may have a spatial impact. There is a danger that policies that seem fair at a national level may have dysfunctional effects when considered regionally. For example, since the unemployment benefit is fixed nationally, it may

encourage people to live where the cost of living is low rather than where the jobs are. This may not be in their long-term best interests. Further work needs to be undertaken in this area to ascertain what the policy implications might be.

Governments should be cautious about policies aimed at particular locations

Central government may be able to contribute to regional development by assisting local interests to work together. Better co-ordination, facilitation and provision of information are sensible, low-cost ways of helping regions to identify their potential areas of economic development and do something positive to develop them. Local government, local business, and community and Māori interests can all play an important co-operative role in improving a region's capability. Some of the recent initiatives outlined in Box 3.6 such as the 'Heartland Services Initiative' offer ways to focus local efforts, potentially adding to both growth and well-being. Promoting social and informational networks may contribute to building social capability and enhancing productive capacity. Worthwhile areas for investigation include supporting the role of "social entrepreneurs" in selected communities, access to the internet and telephone services, and the interface between people and government services, both local and central.

However, the Government should be cautious in promoting regional or place-based policies. While some such policies – like those mentioned above – can be worthwhile, place-based policies are often less effective than helping disadvantaged people to adjust. Large-scale expenditure by central government to selected recipient regions is likely to involve significant costs to contributing regions and the benefits to the wider economy are unlikely to outweigh their costs. Place-based policies therefore need to be selective. As the next section makes clear, cities are likely to be an important source of growth for New Zealand. These cities compete with other urban agglomerations, notably Sydney, in providing residence for workers and firms. One of the costs of assisting struggling non-urban regions may be that it promotes overseas cities at New Zealand's expense.

### Box 3.6: Policy initiatives in rural deprived regions

In 2000 the Government identified Northland, Eastern Bay of Plenty and South Waikato as priorities for regional development assistance.

In May 2000 the Tairāwhiti (East Cape) Taskforce was launched “to provide leadership and direction” to support the Tairāwhiti community by:

- Creating a partnership between central and local government, local runanga and industry.
- Putting in place a development strategy, creating sustainable jobs and “delivering a better life”.

In November 2000 the Government announced:

- 2000 surplus computers to be placed in local schools with appropriate software and training.
- A joint venture with Telecom to create 13 computer hubs in local facilities to enable access to the internet.
- Placement of Ministry of Agriculture and Forestry advisor on use of Māori land in Tairāwhiti.
- Commitment to process 60% of logs in the region.
- Review of the road, port and rail infrastructure of the East Cape region.

In December 2000 the “Heartland Services Initiative” was launched. Key government departments developed an “outreach” programme to:

- Establish joint service centres in some provincial towns.
- Collaborate and synchronise their business in isolated communities and to make regular visits at least monthly.

In March 2001 the Government approved a national operational framework for government’s engagement with regions with acute needs. It identified forestry, infrastructure, land use, and building strong regional partnerships as priority issues.

In June 2001 the Department of Labour prepared a report on the employment, skills and training needs for the wood processing industries, with particular reference to the Tairāwhiti region.

In April 2001 the Government endorsed a national wood-processing strategy to co-ordinate forest industry development issues in new forestry growth regions including Tairāwhiti/Hawkes Bay, Northland, and the southern North Island.

The strategy includes:

- The establishment of a steering group with central and local government, industry, community and Māori representation.
- Working groups to address biosecurity; research, science and technology; trade access; trade enhancement; certification; investment; climate change.

Goals include:

- Developing a transport network in new forest regions.
- A 20% increase in industry-related employment by 2005.
- Attracting at least \$3 billion investment by 2010.
- Processing at least half of new logs in New Zealand by 2015.

## People-based policies are more promising

In terms of policies that target deprived areas, policies that help deprived people within regions seem more promising. In particular, there is a potential role for government in helping people in declining regions to overcome costly barriers to taking up new jobs in other parts of the country. Policy should focus on initiatives such as job-search assistance, and relocation assistance for those who would like to move but face barriers to doing so. These policies would have a double benefit of helping people in deprived regions get jobs, and helping employers in growing regions fill vacancies. The downside is that outcomes may be even worse for those left behind.

Of the other options, focusing on education seems promising. Firstly, it has the direct effect of raising earnings prospects for those in the area. Secondly, improving the quality of schooling is probably the best way to address “neighbourhood effects” – better local schools promote positive spillovers, attract to or retain in the area higher well-being families, and improve social capability. By providing people in isolated deprived regions with skills, education can also facilitate people moving to jobs in high-growth areas. In both deprived city neighbourhoods and deprived isolated areas, investment in the quality of governance and leadership of local schools, and particularly the school-parent partnership, is likely to be important<sup>30</sup>.

Building connections (“bridging” social capital) between deprived areas and wider New Zealand society may also help address neighbourhood effects, by exposing deprived individuals to more positive interactions and encouraging beneficial spillovers.

Finally, the best mix of policy levers to achieve spatial policy goals will only become clear as a result of careful evaluation of current policies. Such evaluation ought to be a key component of any people- or place-based interventions.

## Globalisation helps growth but also presents challenges for New Zealand

Economic integration with other countries, in goods, services, capital and labour, has important benefits for New Zealand. It improves productivity through allowing us to allocate our resources better and specialise in what we do best. Flows of ideas and people from overseas help New Zealanders become more skilled, educated and innovative, and help New Zealand businesses learn about and adopt cutting-edge technology and management practices. The message for policy is: just as connectedness is vital for regions within New Zealand, our connectedness with the rest of the world is crucial in maintaining high standards of living.

Globalisation also presents challenges for New Zealand. Inward flows of people enrich New Zealand socially and economically by bringing new skills and perspectives, making us more cosmopolitan and, we hope, more open-minded and tolerant. However in the short term immigration may also have costs, both

<sup>30</sup> For example, Box 3.3 in the Human capital section describes the SEMO initiative to foster parent-school-community partnerships that focus on improving children’s education achievement in Mangere and Otara.

economically (immigrants earn less initially, and often struggle to have their qualifications recognised) and socially (as current New Zealanders adjust to new citizens and the change they bring to national identity).

A more serious future issue may be emigration. To date New Zealand has experienced a “brain exchange” rather than a “brain drain”, the skills of emigrants largely being replaced by skilled immigrants. Since the forces of agglomeration operate across national borders as well as within them, and New Zealand is small and remote in world terms, we face the risk that other locations will become more desirable, both to New Zealanders and would-be immigrants. In particular, the departure of young, highly educated New Zealanders would be a fiscal loss because of the cost of their expensive education and foregone taxes (exacerbated in some cases by unpaid student loans); an economic loss of potential innovators, technicians, managers and leaders; and an obvious social loss.

We are starting to see increasing international competition for skilled labour. The United States and the United Kingdom, for example, have recently relaxed their immigration rules for IT specialists and other skills in short supply. In the future some European countries may open their doors in an effort to combat low birth rates and offset the fiscal strain of their ageing populations. In addition, we will probably continue to lose people of all skill levels to Australia.

To the extent that this scenario occurs, there are several implications for policy:

- The Government needs to strive to make New Zealand an attractive location to which people wish to remain connected. Economic conditions and prospects are a key determinant of flows particularly between New Zealand and Australia.
- The Government also needs to recognise other factors that pull people and companies overseas, such as more challenging opportunities, and do what it can to match these things at home. It has an important role in making New Zealand a clean, “green”, safe, vibrant, dynamic place in which New Zealanders want to live, work and educate their children.
- After-tax wages for skilled labour and the cost of capital are likely to be increasingly linked to world rates. Income taxes imposed on skilled labour and capital will in fact be borne by landowners and less skilled labour, through lower land prices and lower real wages. Therefore the only realistic way to reduce income dispersion in a sustainable way will be to increase per capita income growth by improving the education and skills of those on the lower rungs of the income distribution.
- The ability of government to raise taxes from individuals and companies is likely to depend increasingly on its ability to deliver value to those same individuals and companies. In particular, income redistribution that does not have widespread support from those paying the taxes may become increasingly difficult and increasingly lead to migration of those subject to what they see as unjustified taxation.

- The availability of an exit option for an important group in the population may reduce their incentive to engage in normal political processes, leading to greater social fragmentation.
- In an environment of global competition for immigrants, settlement policy is crucial. English-language training and occupational regulation that balances the risk of inadequate skills with the risk of under-utilised qualifications and compliance costs are particularly important areas.
- In a global, integrated world of people flowing more freely between countries, the idea of being a New Zealander will become less linked to residence in New Zealand. The worldwide community of New Zealanders should be viewed as an opportunity as well as a threat. Policy could explore ways to enhance connections with offshore New Zealanders and exploit the diaspora.

### Summary

Both within New Zealand and internationally, there are major economic forces driving location of people and activity. The Government is largely in the position of responding to the effects of these location choices. It can ease adjustment and change, but it cannot stop it.

A key lesson from the consideration of New Zealand's economic geography is the importance of concentration of economic activity – particularly cities like Auckland – to New Zealand's future prospects. It is these locations that will provide the best chance of providing satisfying jobs and rewarding lives to skilled New Zealanders, so encouraging them to live here rather than overseas. Policy should facilitate people in adjusting to take advantage of these benefits, while managing the risks associated with concentration. However, it is also important that government consider appropriate policies towards those that remain in regional communities.

## 3.5 Institutions and values

Public institutions<sup>31</sup> provide the broad framework within which politics, society and the economy function. They have major impacts on the well-being of New Zealanders, both directly through opportunities for democratic participation and the protection of important individual freedoms, and indirectly through their impact on the functioning of society and the economy.

The governance of public institutions, defined broadly as the formal and informal ways in which power and authority are exercised in these institutions, affects their performance – and so their contribution to well-being.

The quality of governance of public institutions affects well-being first through their success in protecting the intrinsically important individual freedoms that Sen (1999) articulates, as outlined above in section 2.

<sup>31</sup> Public institutions include, for example, Parliament, government departments, Crown agencies, local government and the activities of all of these.

A second tier of benefits from good governance arises from their instrumental value in promoting social capability and economic performance. Annex B.3 details the channels, mechanisms and the evidence for a variety of both the intrinsic (direct) and instrumental (indirect) effects of good governance on well-being.

Shared or mutually respected values – such as trust and respect for the law – can also impact positively on both social and economic relations, lowering barriers to all forms of social and economic interactions.

New Zealand faces risks that good governance can reduce

New Zealand generally scores well in international surveys of its governance (World Economic Forum, 1999; Transparency International, 2000).

However, certain features of our economy – such as a large and chronic current account deficit and one of the highest external debt to GDP ratios among OECD countries – make us vulnerable to international sentiment about the quality of the business environment, including the quality and integrity of public sector governance. Good governance is also important for New Zealand because of the particular challenge of establishing a more solid basis for inter-group and inter-ethnic co-operation and cohesion in New Zealand.

More generally, the increasing complexity facing policy-makers from the need to form judgements about the causes of outcomes that cut across sectors and are long-term in nature poses a challenge to public sector governance.

Some specific risks to the quality of governance in New Zealand include:

- The potential for incidents of corruption and mal-administration in government agencies, which, if they occur, are likely to reduce public confidence in the state sector.
- Excessive unjustified criticism of the probity of the state sector, which could undermine public confidence in the state sector.
- The scope for and inevitability of conflicts of interest, given our small size.
- The increasing international exposure of our society and economy, including the higher levels of interaction of New Zealanders with people from countries in which corruption is the norm or at least widely tolerated.

Other factors in New Zealand reinforce the need to strengthen opportunities for democratic participation and assure institutional integrity. Public surveys of New Zealanders' values and attitudes reveal a lack of trust in public institutions such as Parliament (and Mixed Member Proportional Representation (MMP) in particular), and a concern that the country is run for the benefit of narrow interests rather than the public interest (New Zealand Study of Values, 1985; 1989; 1998 – see Perry and Webster, 1999). The surveys also indicate wide individual and group differences of view on important issues such as the Treaty of Waitangi and the nature and extent of a taxpayer-funded social safety net.

## Broader consensus on what works would help policy stability

A number of commentators have expressed concern over recent years about policy shifts being driven by one side or the other of the political spectrum rather than broader consensus, e.g. on health policy or retirement income policy. It would therefore be desirable to find ways of adopting a broader consensus on policy to either inhibit abrupt changes when they are not justified by circumstances, or promote early, smaller changes when they are. For example, it is arguable that the 1980s reforms could have been less radical and disruptive if there had been earlier adjustments to the changes in New Zealand's economic circumstances in the 1970s.

One way to foster broader consensus would be for politicians to lead reasoned public debate about ends and means. Another is to improve our knowledge of what works best to achieve given objectives. This is likely to follow from more and better evaluation and greater scrutiny of government programmes, together with greater accountability for them.

## Accountability should focus on the results of government activities

Accountability for the results achieved by government action is fundamental to good governance. The Public Finance and Fiscal Responsibility Acts have delivered some real gains in New Zealand, particularly in terms of greater transparency. But accountability for the outcomes of government activities is widely acknowledged to have proved a weak part of our public management system (Petrie and Webber, 2001). Among the initiatives that could be considered are:

- Obtaining better information on outcomes by sector or major portfolio area, and comprehensive reporting of these at a whole-of-government level. The importance of comprehensive outcome reporting, together with better research and evaluation, is being increasingly recognised as a means of achieving more integrated and coherent policies<sup>32</sup>.
- Generating a greater focus on results at the individual departmental level by driving strategic plans off an outcome focus, and measuring value for money more in outcome terms.
- Adding to tax information already furnished in the Budget Policy Statement by requiring governments to publish their desired tax policy outcomes, progress in achieving them, and regular statements of tax expenditures.
- Increasing the use of independent policy analysis in technical areas such as business taxation.

Together, these measures would facilitate improved scrutiny of the results of government actions.

Further discussion of these proposals is included in Annex C.

<sup>32</sup> For instance, the OECD's current work on sustainable development suggests this (OECD 2001c).



There is a case for strengthening ethical safeguards in public institutions...

Parliament is the supreme authority in New Zealand. Social cohesion ultimately rests on faith in the integrity of Parliament. In Parliament, as in law, justice must be seen to be done.

The introduction of MMP may lead to an increase in lobbying of Members of Parliament. A change that might be considered, therefore, is the introduction of a code of conduct for Parliamentarians, covering issues such as conflicts of interest, public disclosure of private interests, and acceptance of gifts and hospitality, similar to that which exists now for Cabinet Ministers<sup>33</sup>. A similar gap exists at the local government level.

Incidents in recent years have heightened awareness of risks to public confidence in the integrity of the Public Service. One response would be for government to consider commissioning a survey of public servant understanding of, and attitudes towards, standards and integrity. International experience suggests that surveys of public officials can be an effective means of identifying areas of vulnerability in public institutions (Kaufmann et al, 2000). This may help focus any remedial efforts on priority areas, and it could establish a benchmark for subsequent monitoring.

...and improving the transparency of public appointments

Given the size of the assets and funding under the control of statutory bodies in New Zealand, and so the importance of having technically competent as well as representative boards, the Government should strengthen the procedures requiring appointment on merit, and buttress them with legislation. For example, the Cabinet Office appointment procedures could be codified in law. This would increase their visibility and status. Desirably, the change would also establish the responsibility of an independent party to audit and report to Parliament on compliance with the procedures.

Strengthening Māori institutions and governance should yield gains

There are important potential gains in Māori social and economic capability to be made from a careful linking of areas of government activity. These are facilitating the Treaty of Waitangi process; the strengthening of Māori governance; more general capacity building in Māori society; and decentralisation of government service delivery.

The Treaty of Waitangi process

For reasons of both good governance and social cohesion, the resolution of historical Treaty claims is an area of critical strategic importance to any New Zealand Government<sup>34</sup>. The settlement process provides an opportunity to heal grievances and build Māori capability – but also risks exacerbating existing tensions or creating new social divisions. The claims process remains an inherently complex, contested and politicised one – better outcomes will not be easily achieved.

<sup>33</sup> Sir Geoffrey and Matthew Palmer propose a register of MPs' interests (and a register of lobbyists) in their book *Bridled power* (1997), page 201. They argue – rightly in our view – that it might be prudent to take action now in this area before an incident presses home its necessity.

<sup>34</sup> The Crown's objective for the Treaty settlement process is to provide full and final redress for past injustices. Redress focuses on the restoration of rights and the Crown seeks no conditions on how Māori use any settlement assets.

Among the issues that warrant consideration are:

- The continued apparent preference by many claimants for a Waitangi Tribunal report over direct negotiations with the Crown.
- The consequent demand on the Tribunal's capacity (both funding and membership) and the need to produce consistently high-quality reports.
- The respective roles of Parliament and the Executive in the Treaty process.
- The declining public constituency for the settlements process.

These issues are discussed in greater detail in Annex C.

### Strengthening Māori social capability and governance

Good governance and stronger social capability are closely linked. Developing both of these in the Māori community is problematic, as it involves facilitating the participation of very broad communities of interest, where members may not be aware of their standing (see Box 3.7).

Key issues for both Māori and the Crown are to create structures that reflect the fluidity of Māori social processes, and that span and link internal interests rather than compartmentalise them. These structures should also enable efficient allocative decision-making and fair distributional processes. It will be desirable to reshape governance arrangements to reflect changing circumstances, and to further develop key "bridging" capacities, such as high-quality executive skills, strategic links, effective leadership, and broad participation of group members.

Possible actions by government to help strengthen Māori governance, and so social capability, are:

- Facilitating the "enabling environment" for Māori civil society by reviving work on an area of public law important to Māori governance: the reform of the Māori Trust Boards Act 1955 and the review of the Māori Community Development Act 1962.
- Building the constituency for good governance, through such things as facilitating the availability of "best practice" models and better linking with relevant agencies in the Māori governance area.
- Encouraging those Māori institutions that receive public funding to investigate ways to collaborate and build links with each other at the strategic and human (including cultural) capital development levels. This sharing should extend to the private sector and internationally.
- Considering how to unlock the productive potential of multiply owned Māori land through on-going reform of the land tenure system.

These actions are discussed in greater detail in Annex C.

Beyond the general enabling environment for Māori civil society, more specific capacity building is also important. One general initiative that offers a range of potential pay-offs with respect to Māori social capability is the Māori Registration Service (MRS), which will assist groups to compile accurate and comprehensive registers of their members – see Box 3.8.

### Box 3.7: Building Māori social capability

Building social capability among Māori interests requires, at the least, that policies be based on an accurate conceptualisation of Māori social dynamics.

Major elements of this are a recognition that:

- Traditional forms of Māori governance have fundamentally changed, heralding changes in notions of identity and how common interests may be articulated and expressed.
- Social capability exists both in and outside of the traditional kinship-based social structures. The outside structures include the many voluntary and informal networks and relationships that prevail in Māori (as in other) communities.
- Non-tribal and pan-tribal forms of affiliation have become more pronounced, and it is likely that in some cases they are the preferred basis for expression of Māori community aspirations.

Nevertheless, kinship-based organisations remain extremely important to Māori social and economic development. Iwi governance must accommodate a unique set of circumstances including:

- Mixed social, economic and cultural/political objectives.
- Dispersed members whose entitlements may not yet be specified.
- Distributing benefits derived from collective rights.
- Rebuilding communities of interest or creating them de novo.
- Specifying appropriate internal levels of responsibility and accountability that reflect the make-up and history of internal constituencies – for example, reflecting any rights exercised at the hapū or whānau level, and any incumbent obligations.
- Evolving new forms of governance that reflect norms of both tikanga and Western democratic practice.

### Box 3.8: The Māori Registration Service

One general initiative that offers a range of potential pay-offs with respect to Māori social capability is the Māori Registration Service (MRS), which will assist groups to compile accurate and comprehensive registers of their members. This would give Māori organisations a valuable administrative tool for the running of their affairs. In return, the Crown could expect:

- Increased momentum for the Treaty settlements process, since claimant groups would have to devote less time and fewer resources to building registers.
- Greater assurance that Māori organisations would be accountable for the management of their resources.
- Enhanced ability of Māori organisations to distribute benefits widely amongst their members, including those living outside their traditional tribal rohe.

The MRS will also assist Māori to research their tribal affiliations, and to link with other Māori organisations. It may also benefit economic development through the more effective administration and utilisation of Māori land.

### Decentralisation and service delivery

Decentralisation of service delivery is likely to be a key issue in Crown-Māori relationships, as Māori aspirations for autonomous institutions build<sup>35</sup>. There has been worthwhile progress in this area but some problems have surfaced. The following would help to address these and better manage risks for all parties: improved community and iwi governance, developing managerial skills and culture for meeting contracted outputs and achieving desired outcomes. Widespread decentralisation will also give rise to issues such as managing people's entitlement to services from different providers and lines of accountability that will require close consideration.

It is very important that current initiatives in capacity building, and the decentralisation of service delivery to Māori organisations, are properly evaluated. This concern arises not least because the speed of implementation of initiatives has limited the opportunity to co-ordinate approaches across government departments. Welcome as it is, evaluation of these initiatives is only now under preparation.

### Changes in local government need to address some key questions

The current review of the Local Government Act (LGA) 1974 is considering important changes to the powers and accountability of local government in New Zealand. These contemplate providing local government with some form of power of general competence to undertake a wider range of discretionary activities, while continuing to prescribe coercive and regulatory powers.

<sup>35</sup> The current wide-ranging debate on Māori self-determination and shared sovereignty is likely to continue and to influence these aspirations. We do not investigate these issues here.

A virtue of current arrangements is the relatively clear separation between central and sub-national roles and responsibilities. With one or two exceptions such as roads, local governments raise their revenues from their own dedicated tax base, and expenditure responsibilities are clearly allocated to either central or sub-national levels.

It will be important to ensure that the advantages of current arrangements, in terms of clear accountability associated with separation of roles, are not lost sight of. A “partnership approach” between central and local government, or between government and the voluntary sector and/or Māori organisations, can mean many different things. It is very important to be clear about precisely what is involved, and what the implications of the different approaches are. There are accountability risks, policy and effectiveness risks, and fiscal risks in this area.

Key questions that need to be addressed are:

- What functions should be centralised and what should be delegated?
- What are the relative benefits and costs of decentralisation versus devolution<sup>36</sup>?
- Under a decentralisation approach, what are the different ways in which local community views can be brought to bear in the decisions of central government agencies?
- If Parliament devolves additional power to local government, how can it ensure that local government acts in accordance with the wishes of those who provide it with funding and for whom its powers are exercised? Local government elections are part of this, but by themselves are insufficient.

These issues are being explored in the current LGA review.

It would also be highly desirable for any fundamental changes in the powers, accountability and funding of local government in New Zealand to be preceded by some in-depth comparative review of recent experiences in New Zealand and elsewhere with devolution and decentralisation.

New Zealanders’ values and attitudes affect politics, society and the economy

There is growing recognition that the effective functioning of politics, the economy and society depends to some extent on the existence of a core set of values that promote social cohesion and facilitate social and economic exchanges. The recently initiated *NZ Herald* “Common core debate” (<http://www.nzherald.co.nz>) suggests a need to pay more attention to the articulation and fostering of core values in New Zealand. Core values for social cohesion do not imply uniformly shared values but would include mutual respect and tolerance for the values and life-styles of others.

36 Decentralisation involves delegating decision-making powers within central government agencies to managers in local offices, for example the Regional Employment Commissioners in DWI. Devolution involves the transfer of decision-making powers to sub-national government, for example as occurred under the Resource Management Act; or to locally elected Boards, as occurred under the Tomorrow’s Schools initiative.

One of the few mechanisms available to the Government to influence directly the formation of social norms and values is the compulsory education curriculum. Bicultural awareness has for some time been an important part of the curriculum. Greater emphasis to values important for New Zealand's social capability and economic performance and to key elements of New Zealand's institutional environment could be considered. Given the key contribution of human capital to well-being, it would also be desirable to promote a consensus on the importance of educational achievement for the individual and society.

The family is important to the well-being of children, and in particular to human capital formation and the fostering of social values (Ormerod and Rowthorn, 2001). Given this, there would be value in investigating further the impact of family law on well-being, in particular through its impact on family formation, dissolution and the life chances of children.

There is further discussion in Annex C of the effects of changes in divorce law on outcomes for children.

### Conclusions

While New Zealand enjoys a good reputation internationally for the quality of its public sector governance, there are a number of factors that suggest further strengthening of governance is needed in the following areas:

- Greater accountability for the outcomes of government activities.
- Strengthening Māori institutions and governance to complement the existing Treaty settlements process.
- A review of recent experiences in New Zealand and elsewhere with devolution and decentralisation before any fundamental changes are made to the powers, accountability and funding of local government, or any significant initiatives are taken on a "partnership" between government and non-government organisations.
- Strengthening systems to reinforce ethical behaviour in public institutions, particularly Parliament.
- Additional transparency in the process for public appointments.

There are few means available to government to influence the evolution of social norms. One is the compulsory education curriculum, where consideration could be given to further emphasising mutually respected values. Officials should also assess the effects of different approaches to family law in terms of social outcomes for children.

Issues of institutions and values are core areas of government action. They have major impacts on the well-being of New Zealanders, both directly through opportunities for democratic participation and the protection of important individual freedoms, and indirectly through their impact on the functioning of society and on economic growth.

There are also important links between the functioning of government institutions and the other elements in the Inclusive Economy framework. For instance, improved understanding and reporting of the results of government action contribute to better policy and more effective implementation across the whole of government, including education, labour market, regional development and macro-economic policies.

Government initiatives in the areas of institutions and values need not necessarily involve significant direct fiscal costs. Their main cost would be the opportunity cost of Ministers' and officials' time.

These factors suggest that initiatives to strengthen governance and further consider the role of government in fostering social norms should be seen as an important component of a mixed strategy in creating a more inclusive economy.

## 4 Conclusions

An inclusive economy is about directing policy at ensuring opportunities for people's broad-based participation in society and the economy, with the ultimate objective of improving the well-being of all New Zealanders. The focus on inclusiveness derives from the importance – both as an end and a means – of broad participation of people in the economy and society.

This report is not intended to develop detailed policy recommendations. The inclusive economy framework and the key messages and themes that have emerged from our review of theory, evidence and their application to New Zealand's current situation point to a general policy direction to inform and guide detailed policy.

At the heart of this is a clear objective – raising well-being for all – and a high-level plan of attack for how to go about achieving it. The plan would couch policy in terms of our inclusive economy framework by recognising the multi-faceted nature of well-being, the role of economic performance and social capability as drivers of well-being, and the potential for mutually reinforcing inter-relationships between economic performance and social capability.

While acknowledging New Zealand's strengths, it is not difficult to point to areas in which New Zealand currently falls short. Average material living standards have fallen relative to most other OECD countries; income inequality increased particularly in the late 1980s; the incidence of household poverty is too high; there are wide gaps in ethnic averages across a range of social indicators<sup>37</sup>, there are poor outcomes in health and education among lower socio-economic groups; there are quite sharp divisions in values and attitudes on key socio-economic issues; and there are institutional weaknesses that trouble Crown-Māori aspirations and our levels of social capability more generally.

Added to this is a regional picture of increasing deprivation in Northland and parts of Auckland, and stagnation in East Cape. Finally, there is the threat of more skilled young New Zealanders leaving for what they see as more prosperous foreign countries that are putting out the welcome mat for them.

Making use of our report's themes and key messages for shaping policy on the inclusive economy, it is possible to construct a high-level plan of action to address these problems. It would have a distinctive logic and a number of features as follows:

- Growth is still very important and policy should take care not to undermine the productivity and dynamism of a healthy market economy. Growth helps the poor as well. The need for social cohesion means taking account of the social consequences of growth (e.g. as far as possible avoiding the creation of new groups of disadvantage and/or exclusion).

<sup>37</sup> The work of Chapple (2000) shows that the distributions of individual outcomes behind the ethnic averages overlap each other significantly.



- Many of the problems referred to above are a result of individuals and households having low absolute levels of income. Low skills and levels of education typically drive this. New Zealand has a poor comparative record in outcomes in the lower part of the distribution of educational achievement compared to its generally good performance in the upper half. Early interventions, aimed at increasing the literacy and numeracy skills of the bottom quintile will be most cost-effective in the long term. Carefully targeted, intensive pre-school interventions can be effective for the most disadvantaged, but ensuring basic skills acquisition during primary schooling is of particular importance.
- While necessary as a short-term safety net, the tax-benefit transfer system is not a realistic or desirable option to tackle in a sustainable way the problem of low absolute levels of income. Limits on the effectiveness of “passive” tax-benefit redistribution arise from the costs to growth of high marginal rates of tax, the international mobility of high-skill, high-income people, and the risks to social cohesion from having a large and expensive group of taxpayer-funded beneficiaries.
- An “active” approach to raising low incomes through policies that improve education and labour-market opportunities in the lower part of the distribution offers the best prospect to make a difference to distributional outcomes over the medium term. This is supported by a considerable weight of empirical evidence. Moreover investing in education and increasing labour-market participation are robust ways to improve social capability in dimensions such as increasing economic and social participation, increasing trust, improving health and reducing crime and victimisation. This win-win character of active policies makes them particularly attractive.
- Identifying as priorities education and jobs to improve outcomes for the less well off would enable the Government to rank demands on its scarce fiscal resources. Followed consistently over the medium term, such an approach would enable it to demonstrate steady progress towards increasing well-being for all. These policies should be funded first from better use of existing resources. However, additional resources may be necessary.
- Tertiary education is an important instrument for promoting economic growth and, through that, well-being. New Zealand has high levels of participation, but there is room to increase the numbers of centres with world-class research and teaching, and that facilitate technology transfer to industry. This is likely to be more about good institutional design than funding.
- There is also a range of institutional reforms that offer the prospect of sound returns in terms of well-being, at little fiscal cost. Those institutional reforms that would improve transparency, trust, voice and participation in decision making are good for well-being not only directly (because they are intrinsically part of that concept), but also through increased social capability and, to a lesser extent, improved economic performance. They include improving accountability for the results of government activities; strengthening Māori institutions and governance; and initiatives to strengthen ethical safeguards in public institutions.

- One issue that has emerged as important across a range of areas is improved understanding of the effects of government policies. Improving the evidence base for government policy will require improving the effectiveness of research and evaluation activities across the public sector.
- There are a number of areas that are suggested for further assessment. These include improving our understanding of regional migration in New Zealand, and the best mix of people-based and place-based interventions; a review of recent New Zealand experience with devolution and decentralisation as a precursor to any decisions on changes in the role of local government in New Zealand; the adequacy of Parliament's access to independent expert advice to fulfil its review functions; the possible value of reinforcing mutually respected values in the education curriculum; and investigating the impact of family law on well-being, particularly its effects on families and the life chances of children.

Finally, a key insight of this project is that there is a small number of key areas where there appear to be opportunities for significant gains for equity and participation, while being neutral or even positive for growth. The areas are education and jobs in the lower parts of the distributions of attainment and skills; Māori institutions and governance; and improving understanding, and reporting, of the results of government action. These areas should receive increased government attention.

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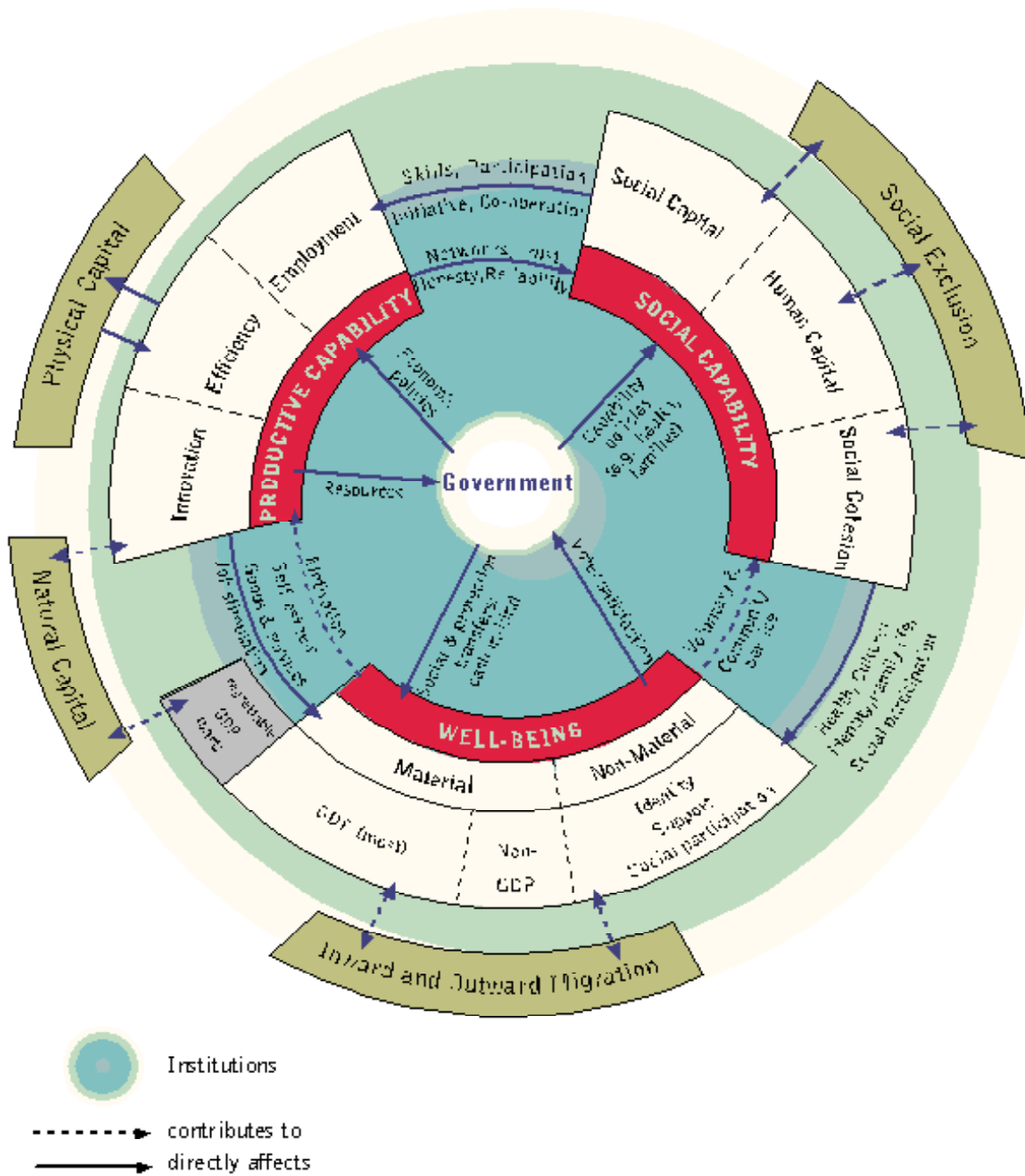
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Annex A: Inclusive economy components and linkages



## Annex B: Tables summarising channels and mechanisms linking selected policy “ themes” with well-being in an inclusive economy

This Annex sets out in greater detail the many possible channels and mechanisms that can operate to influence behaviours and outcomes. The information is presented in five tables that cover most of the key themes in the paper. The tables describe the linkages between:

- B1 Jobs and well-being
- B2 Growth and income distribution and well-being
- B3 Good governance and well-being
- B4 Shared values and well-being
- B5 Human capital and well-being

Each table shows separately those channels of influence that can be considered as relatively direct and those that are indirect, for example by operating through some intermediate component. Some tables also identify the presence of vicious or virtuous circles to highlight the dynamic nature of many processes.

In order to present a full picture, cost-benefit appraisals of policy proposals ought to take account of all the various channels through which benefits and costs can affect well-being. This can be difficult in practice where quantitative estimates of impacts are unavailable. In these cases, the likely influence based on the best available evidence should nevertheless be taken into account in the overall qualitative judgement about the value of the proposal.

Table B.1: Summary of linkages between jobs and well-being

Channel	Mechanism	Evidence
<i>Direct channels</i>		
1. Psychological and health effects of employment	Having a job = greater satisfaction + higher self-esteem irrespective of income gains or losses Losing a job or anticipating loss of a job associated with poorer mental and physical health	Old argument in terms of the “dignity of labour” (Jaboda, 1979). Strong evidence that having a job is positive for well-being for most people, particularly overall life satisfaction and mental health (Wadsworth, 1991; Jenkins, 2001). However, hints that some sub-groups can lose “work ethic” so joblessness ceases to reduce well-being in the same way as formerly. This may depend on scope for participation in the informal economy
2. Effects through greater social participation, less exclusion, higher social cohesion	Being in work leads to richer set of social relationships/networks. Work habits (e.g. punctuality, responsibility) are generally pro-social and build trust. Less welfare dependence builds social cohesion	Increasingly large proportion of social contacts derived via work so work assumes greater significance for social connection, Putnam (2000)
<i>Indirect channels</i>		
3. More people in paid work increases well-being via higher material output and growth and higher average material living standards	Higher labour market participation, lower unemployment, and lower likelihood of needing to use cash benefits	Abundant evidence since this is the orthodox position. Most evaluations of labour market interventions look at this channel exclusively. Getting the long-term unemployed into jobs does not significantly increase upward wage pressures. Some active labour market policies reduce benefit costs, paying for themselves (see below) (Michalopoulos et al 2000)
4. Higher human capital	People in work add to or at least maintain their human capital through on-the-job experience/training. Increases in skills lead to increases in productivity, leading to increase in supply of employment	
5. Through less poverty and inequality	Less poverty and inequality associated with increased sense of fairness, better health, crime etc outcomes	Effects depend on wage levels of jobs which people take and proportion of the poor who find jobs. Full-time work seems effective in taking poor people out of poverty Freeman (2001; Jenkins 2001)
6. Via impact on crime, drug abuse, etc	Young males in employment generally found to exhibit lower likelihood of criminal behaviour	Old idea of “the Devil finds work for idle hands”
7. Stimulating disadvantaged communities	Getting more people into work in a socially and economically lagging community can help break mutually reinforcing patterns of deprivation	
8. Through impact on child care and the quality of family life	Getting single parents into jobs could increase or decrease quality of child care	Effects likely to depend on other supportive policies (e.g. subsidised, affordable child care) (Duncan and Chase-Lansdale, 2001)

Table B.1: Summary of linkages between jobs and well-being (continued)

Channel	Mechanism	Evidence
<i>Virtuous circles</i>		
9. Interactions between material output and social capability	More people in jobs leading to higher social capital (better social skills, health, trust, networks) gives better economic performance and vice versa	Evidence is accumulating rapidly, but is relatively new and can be challenged
10. Inter-generational transmission	Households with children in which at least one adult is in work associated with better outcomes for pre-adolescent children; limited evidence of increases in school problems and risky behaviour in adolescents	Likely to be income effects and role modelling, (Duncan and Chase-Lansdale, 2001)

Table B.2: Summary of linkages between growth and income distribution and well-being

Link codes: + greater equality and growth are complementary  
 ~ greater equality and growth are in opposition  
 ? inconclusive

Link	Channel	Mechanism	Evidence
	<i>Indirect channels</i>		
?	1. Adaptation to cross-sector differences in productivity	Growth causes the earnings distribution to widen initially and then narrow as people progressively move from low to higher productivity sectors	Industrialised countries' income inequality declined over the longer term (to 1970s) (Kuznets, 1955; Barro, 2000)
~	2. Effect on savings propensity	A wider market income distribution raises the average savings propensity and hence investment and growth	Lewis (1954), Kaldor (1956,1957), Stiglitz (1969)
+	3. Capital market imperfections	A wider income distribution associated with capital market imperfections prevents poor families from investing in human capital improvement, which inhibits growth	Galor and Zeira (1993), Perotti (1993)
+	4. Fertility and human capital investment decisions	A more equal income distribution shifts the balance of advantage between having children and investing in human capital towards the latter, suggesting that greater income equality has a positive effect on growth	Negative correlation between income inequality and secondary school enrolment rates (Galor and Zang, 1993, Becker, Murphy and Tamura, 1990)
~	5. Redistribution through taxes and transfers	Social protection policies can harm incentives and allocative efficiency	Mirlees (1971)
~	6. Wage compression	Artificial wage compression can reduce growth, since skilled workers in an open economy can migrate, lowering the average skill level and growth potential	Bowles (2000)
?	7. Some forms of egalitarian redistribution can work without harming growth	Eliminating wage disparities among similar workers puts pressure on low productivity firms	Bowles (2000)



Table B.2: Summary of linkages between growth and income distribution and well-being (continued)

Link	Channel	Mechanism	Evidence
	<i>Indirect channels (cont'd)</i>		
~	8. Lobbying for assistance	Extensive social protection can reduce growth since it rewards efforts to lobby for allocation of funds, distracts people from wealth creation and erodes innovative capacity	Lindbeck (1995)
~	9. Income inequality shapes the level and time path of demand for an innovator's product	Innovation and hence growth will be encouraged if there are plenty of middle-income earners who can afford to buy newly developed products	Zweimuller (2000)
+	10. Addressing people who lose out from growth reforms	Social protection investments that pay attention to people who potentially adversely affected, promotes political support for undertaking growth-promoting reforms	Rodrik (1997)
+	11. Social cohesion and room to manoeuvre	A relatively equal distribution of income can facilitate growth when it is associated with an absence of social divisions and ethnic heterogeneity. Social cohesion and strong institutions give politicians greater room to manoeuvre	Ritzen, Easterley and Woolcock (2000)
+	12. Social unrest	Excessive income inequality can cause social and political unrest, which inhibits investment and growth	Perotti (1996), Latin American literature
+	13. Political reaction to extreme disparities	Excessively wide market income distribution can give rise to political support for extensive redistribution, the fiscal effects of which can inhibit growth performance	Higher income inequality at the start of an earlier year had a negative impact on growth in the subsequent period. (Persson and Tabellini, 1994; Alesina and Rodrik, 1994), political economy literature

Table B.3: Summary of linkages between good governance and well-being

Channel	Mechanism	Evidence
<i>Direct channels</i>		
1. Through protecting important political, civil and individual freedoms that are themselves constitutive of well-being	Enabling institutions such as free democratic elections, an independent judiciary, legal protections for free speech and human rights; protection of minority rights	Well-being <i>entails</i> the protection of political, civil and individual freedoms
2. Through enabling greater democratic participation	Access to official information; explicit consultative mechanisms Appropriate decentralisation of expenditure responsibilities to sub-national governments.	Well-being <i>entails</i> providing for democratic participation, (Huther and Shah, 1998)
3. Through facilitating social interactions and economic exchange	Enabling environment for economic exchange, such as secure property rights, security of contract Enabling environment for civil society, such as legal framework for civil society organisations, freedom of expression, a free press, open government	Well-being <i>entails</i> facilitating social interactions and economic exchange. For evidence on the instrumental effect of good governance on economic exchange see channel 5 below

Table B.3: Summary of linkages between good governance and well-being (continued)

Channel	Mechanism	Evidence
<i>Direct channels (cont'd)</i>		
4. Through contributing directly to better outcomes, such as life expectancy, literacy, and the quality of the physical environment.	<p>Impact of improved "citizen voice" via a free press on equity of government policies</p> <p>Less corrupt, more open public sector governance</p> <p>Decentralisation of expenditure responsibilities to sub-national governments</p>	<p>Dreze and Sen (1989)</p> <p>World Economic Forum (2001)</p> <p>Huther and Shah (1998)</p>
<i>Indirect channels</i>		
5. Through higher economic output	<p>Effective protection of property rights increases investment and incentives to produce and save</p> <p>Political and civil freedoms facilitate the emergence of shared norms, such as trust and tolerance, and social values such as the importance of education or attitudes toward the environment. Shared norms in turn facilitate the achievement of social consensus (i.e. the reduction of transactions costs) that facilitates more efficient collective action and economic exchange</p> <p>Corruption lowers incentives to invest by both domestic and foreign investors, by acting as an at times highly uncertain and risky tax on productive activity</p> <p>Corruption distorts the composition of government spending, away from education and towards large-scale capital projects where it is easier to extract bribes</p> <p>Basic civil liberties facilitate greater citizen voice and hence more effective government</p> <p>A more extensive and effective civil society is associated with higher economic output</p> <p>Central bank independence leads to lower inflation and higher growth</p> <p>Greater transparency and accountability strengthen incentives for earlier policy adjustments, and prevent the costly accumulation of problems (the post-Asia crisis Washington consensus)</p>	<p>Kaufmann, Kraay and Zoido-Lobaton (1999)</p> <p>Mauro (1996)</p> <p>Wei (1997)</p> <p>Mauro (1996)</p> <p>Tanzi and Davoodi (1997)</p> <p>Isham, Kaufman and Pritchett (1997)</p> <p>Putnam (1993)</p> <p>Cukierman, Webb and Neyapti (1992)</p>
6. Through strengthening state capability	Corruption and the absence of the rule of law are correlated with a larger share of the unofficial economy in GDP	Johnson, Kaufmann and Zoido-Lobaton (1998)

Table B.3: Summary of linkages between good governance and well-being (continued)

Channel	Mechanism	Evidence
<i>Virtuous and vicious circles</i>		
7. Interactions between political and civil freedoms, and the evolution of shared norms	The exercise of freedom is mediated by values, but the values in turn are influenced by public discussions and social interactions, which are themselves influenced by participatory freedoms (Sen 1999)	See Table B.4 for discussion of the channels through which shared norms impact on well-being
8. Interactions between declining state capability and the extent of the unofficial economy	As state capability declines, taxpayers receive lower quality public services (e.g. poor contract enforcement, protection of private property) and shift activities underground, further weakening state capability. Process can work in reverse, although many states appear trapped in a low-level equilibrium	Kaufmann, Kraay and Zoido-Lobaton (1999)
9. Interactions between participatory democracy and basic education skills	Democratic participation requires basic education skills such as literacy and numeracy; widespread democratic participation in turn is correlated with higher education spending	Mauro (1996)

Table B.4: Summary of linkages between shared values and well-being

Channel	Mechanism	Evidence
<i>Indirect channels</i>		
1. Through higher economic output	Social divisions, in terms of ethnicity and income (and corrupt public institutions) result in an inability to generate social consensus, reducing the ability to adjust to economic shocks Trust and shared values reduce transaction costs in the private sector; may encourage investment Trust and shared values increase state effectiveness through voluntary compliance with laws, taxes and regulations	Rodrik (1999 and 2000) Easterly (1999) Easterly (2000) Knack and Keefer (1997) La Porta et al (1997)
<i>Virtuous and vicious circles</i>		
2. Interactions between trust, social and economic interactions, and the effectiveness of institutions	Trust facilitates social and economic interactions, and enhances the effectiveness of institutions. Effective institutions in turn further build trust	La Porta et al (1997)
3. Interactions between shared values and economic growth	Social cohesion may contribute to higher economic output (as above); and economic growth may in turn contribute to social cohesion by changing individuals' subjective feelings about the degree of well-being they derive from belonging to their society	Bates (1996)

Table B.4: Summary of linkages between shared values and well-being (continued)

Channel	Mechanism	Evidence
<i>Virtuous and vicious circles</i>		
4. Lack of trust can be very difficult to break down	A lack of generalised interpersonal trust is associated with lack of social and economic interactions. In the absence of such interactions, it is difficult to revise one's view of the trustworthiness of others. In a low trust society it is rational to exploit others rather than to trust them	Putnam (1993)

Table B.5: Summary of linkages between human capital and well-being

Channel	Mechanism	Evidence
<i>Direct channels</i>		
1. Exercise of freedom and choice	More education = more freedom and happiness	Blanchflower and Oswald (2000)
2. Via impact on health-related habits and lifestyles	More educated people found to have healthier habits and lifestyles (not just effect of greater knowledge, but independent effect of educational level); e.g. lower smoking, lower obesity and higher exercise levels	Wolfe and Haveman (2001)
<i>Indirect channels</i>		
3. Through higher income and growth	Higher labour-market participation, lower unemployment, higher productivity, and lower likelihood of needing to use cash benefits	Temple (2000); Wolfe and Haveman (2001); OECD (2000)
4. Through greater social participation, less exclusion, higher social cohesion	Being in work, or just being more educated leads to richer set of social relationships/networks. Higher social and political participation, higher trust and more volunteering associated with higher levels of education	Helliwell and Putnam (1999); Verba, Scholzman and Brady (1995)
5. Through less poverty	Human capital investment can raise earnings prospects for disadvantaged children. Less poverty is associated with an increased sense of fairness, better health, crime etc outcomes	Comer, J.P. (1988)
6. Via impact on crime	Better educated people are generally found to exhibit lower likelihood of criminal behaviour. More education associated with lower costs of crime (e.g. lower law enforcement and victim costs)	Wolfe and Haveman (2001); Behrman and Stacey (1997)
7. Through tackling disadvantaged communities	Installing a high-quality education infrastructure in a socially and economically lagging community can help overcome negative neighbourhood effects	Strengthening Education in Mangere and Otara (SEMO) initiative

Table B.5: Summary of linkages between human capital and well-being (continued)

Channel	Mechanism	Evidence
<i>Virtuous circles</i>		
8. Interactions between material output and social capability	Education leading to higher social capital (health, trust, networks) through social skills, gives better economic performance and vice versa. Number of years of schooling is the most robust correlate of social capital variables	Glaeser, Laibson and Sacerdote (2000); Glaeser (2001)
9. Inter-generational transmission	Higher human capital in one generation is associated with higher human capital in the next	Sandefur, McLanahan and Wotjtkiewicz (1989)

## Annex C: Institutions and Values

### Strengthening governance, institutions and values in New Zealand

Attention to the quality of governance in New Zealand is likely to have significant pay-offs for the quality of democracy and to a lesser extent for economic performance. Some concrete proposals for strengthening institutions and values in New Zealand are raised below that may make a sizeable impact and that the Government is well placed to attend to. There are also other areas where further work may be worthwhile because they may help identify additional opportunities for effective reform and/or managing emerging risks.

### Greater accountability for the results of government activities

Accountability for the results achieved by government action is fundamental to good governance. There is reason to be concerned that in some areas New Zealand lags behind other developed countries in this respect. In particular, accountability for the outcomes of government spending, taxation, and the operation of monetary policy needs to be strengthened.

Accountability for the outcomes of government spending is widely acknowledged to have proven a weak part of our public management system (Petrie and Webber, 2001). A necessary condition for this accountability is good quality information. There is a lack of adequate information on the effectiveness and cost-effectiveness of government spending – even allowing for New Zealand’s small size and the high cost of good research and evaluation. Access to such information would also contribute directly to well-being in Sen’s view (Sen, 1999).

Citizens’ charters, like those implemented in the United Kingdom, could inform the public about the service they can reasonably expect from departments and similar agencies, as well as strengthening departments’ accountability for the services they provide to the public.

### Public expenditure

An initiative towards the goal of better information about the results of public spending might be moves towards publishing outcome statements by broad sector or major portfolio area, and comprehensive reporting of these at a whole-of-government level. These could contain carefully selected outcome indicators, including both “state-of-the-nation” statistics and the outcomes achieved by major interventions. This may help to prompt more informed debate about the effectiveness of government policies and programmes. The importance of comprehensive outcome reporting, together with better research and evaluation, is being increasingly recognised as a means of achieving more integrated and coherent policies<sup>38</sup>.

At the same time initiatives could be taken to generate a greater focus on results at the individual departmental level. This could be done by driving strategic plans off an outcome focus, and measuring value for money in outcome terms. Treasury is currently discussing this sort of approach with the State Services Commission with a view to piloting it with interested departments.

<sup>38</sup> For instance, the OECD’s current work on sustainable development (OECD 2001c).

## Tax policy and the conduct of monetary policy

There are also weaknesses on the tax side. While the Generic Tax Policy Process (GTPP) has been developed to improve the operational and legislative phases, there is little transparency or attention given to desired tax policy outcomes at an aggregate level. There is also a lack of information on tax expenditures, limited (and non-independent) post-implementation reviews of new tax policies, and a lack of disinterested, independent policy analysis of tax policy. Remedies that could be considered include requirements for governments to publish a statement of their desired tax policy outcomes and progress in achieving them; regular publication of tax expenditure statements; and increased resourcing and involvement of independent policy analysts.

In a parliamentary system, particularly one with a unicameral House, significant power is vested in the hands of a government that can command a majority in Parliament. An important check on the effectiveness of the executive is exercised through the scrutiny activities of select committees of Parliament.

The recent Monetary Policy Review recommended greater resourcing of Parliament's Finance and Expenditure Committee (FEC) to enable it to review the effectiveness of monetary policy more effectively<sup>39</sup>.

Enabling adequate parliamentary scrutiny of tax law is a particularly thorny issue. The complexity of tax policy and law is such that current knowledge of tax policy principles and tax practice is vital to understanding tax law. The problem is the stakes are high and that every person with this knowledge is conflicted, either by being an advisor to the Government or to business. In addition competent advisors are very expensive. Providing adequate scrutiny may require an independent advisory body to be established.

These are specific instances of a much more general issue. Adequate scrutiny by Parliament is one with a potentially high pay-off in terms of the quality of governance. It is worthy of further in-depth consideration.

Initiatives to strengthen accountability for the results of government activities in areas such as spending, taxation and monetary policy could result over time in somewhat less policy instability, as improved evidence and knowledge about "what works" narrows the scope for hasty or ill-considered policy change.

## The role of local government

The current review of the Local Government Act (LGA) 1974 is considering important changes to the powers and accountability of local government in New Zealand.

A virtue of current arrangements is the relatively clear separation between central and sub-national roles and responsibilities. With one or two exceptions such as roads, local governments raise their revenues from their own dedicated tax base, and expenditure responsibilities are clearly allocated to either central or sub-national levels.

<sup>39</sup> The Review also recommended a number of changes to current accountability arrangements for the implementation of monetary policy (Svensson, 2001).

Key questions that the current arrangements raise, however, are:

- Are we too centralised?
- What are the relative benefits and costs of decentralisation versus devolution? Decentralisation involves delegating decision-making powers within central government agencies to managers in local offices, for example the Regional Employment Commissioners in the Department of Work and Income. Devolution involves the transfer of decision-making powers to sub-national government, for example as occurred under the Resource Management Act 1991; or to locally elected Boards, as occurred under Tomorrow's Schools.
- Under a decentralisation approach, what are the different ways in which local community views can be brought to bear in the decisions of central government agencies? One example is the Local Management Group structure set up under the Strengthening Families initiative, which brings together representatives of central government agencies, local government, and the non-government sector in discussions about local needs and service priorities for children at risk. Other approaches being considered in the current review of the LGA include formal joint strategic planning exercises between central and local government.

If Parliament devolves additional power to local government, how can it ensure that local government acts in accordance with the wishes of those who provide it with funding and on whom those powers are exercised? Local government elections are part of this, but by themselves insufficient.

It would be highly desirable for any fundamental changes in the powers, accountability and funding of local government in New Zealand to be preceded by some in-depth comparative review of recent experiences in New Zealand with devolution and decentralisation. An investigation of experience with the Resource Management Act (devolution), the current framework for roading (overlapping roles and mixed funding), and the Strengthening Families initiative and Regional Employment Commissioners (decentralisation) could highlight interesting features of these very different approaches, and provide important insights for policy. This could usefully be combined with some careful assessment of arrangements in selected relevant countries.

It will also be important to ensure that the advantages of current arrangements, in terms of clear accountability associated with separation of roles, are not lost sight of. A "partnership approach" between central and local government, or between government and the voluntary sector and/or Māori organisations, can mean many different things. It is very important to be clear about precisely what is involved, and what the implications of the different approaches are. There are accountability risks, policy and effectiveness risks, and fiscal risks in this area. These issues are being explored in the current LGA review.



## New Zealanders' values and attitudes

There is a growing recognition that the effective functioning of politics, the economy and society depends to some extent on the existence of a core set of common values that promote social cohesion and facilitate social and economic exchanges. The recently initiated *NZ Herald* "Common Core Debate" (<http://www.nzherald.co.nz>) is suggestive of a need to pay more attention to the articulation and fostering of core values in New Zealand.

One of the few mechanisms the Government has to directly influence the formation of social norms and values is the compulsory education curriculum. Bi-cultural awareness has for some time been an important part of the curriculum. Greater emphasis on values important for New Zealand's social capability and economic performance, and on key elements of New Zealand's institutional environment could be considered. More productive school/family links may be a way to strengthen a consensus on the importance of educational achievement for the individual and society.

The importance of the family for the fostering of social values is widely acknowledged in public discourse in New Zealand. However, relatively little emphasis appears to have been given to analysis of the potential effects of different approaches to family law on family formation and dissolution, and the life chances for children. Recent debates on the law regulating de facto and legal marriages, for instance, appear to have focused on a rights-based approach, instead of considering empirical evidence on the impact of different approaches on well-being. For example, a recent article by Gruber (2000) finds that adults who were exposed to unilateral divorce laws as children are less well educated, have lower family incomes, are more likely to be married earlier and are more likely to separate.

Given the importance of the family to the well-being of children, and in particular to human capital formation and the fostering of social values, there would be value in investigating further the impact of family law on well-being, in particular through its impact on family formation, dissolution and the life chances of children.

## Māori institutions and values

### Treaty of Waitangi process

From 1990, the inception of the direct negotiations process increased the incentives for claimants to enter into negotiations with the Crown without first going through a lengthy Waitangi Tribunal inquiry process.

Despite this, claimants strongly prefer the Tribunal process, reportedly because the research and hearing processes are important catalysts to rebuild their communities and because a Tribunal report will enhance the validity of their claim. Those with claims implicating Crown Forest and SOE assets also have an incentive to seek remedies hearings by the Tribunal, contributing to a lengthy list of "claims in waiting". This has placed major demands upon the Tribunal's capacity, both its funding and its membership, despite its adoption of procedures to streamline its

inquiry processes by requiring claimants to resolve cross-claim issues, have all necessary research completed and encourage Crown and claimant counsel to identify common issues as early as possible.

A recent High Court decision on litigation between claimants and the Waitangi Tribunal also suggests that resourcing issues may need reconsideration by government. This decision expressed the judiciary's concern about the "inadequacy of the Tribunal's resources" and that "systemic delays on the present scale prevent proper discharge of (the Waitangi Tribunal's) function" (McGechan, *J. Te Runanga o Ngai Tahu vs Waitangi Tribunal*, April 2001).

For the decisions of the Tribunal to contribute to social cohesion, they must be seen to be just by all sections of society. Consideration of resourcing issues should therefore also include the appointments process to the Tribunal, including access to sufficient expertise to prepare consistently high-quality reports on matters likely to come before it. This consideration of resourcing issues should also consider the knock-on effect that a larger Tribunal output will have for the Crown's negotiations programme.

An issue that needs attention is agreement over the role of Parliament in the settlements process. Recent experience suggests that some Parliamentarians see the select committee process as an opportunity to revise negotiated settlements. Parliamentary oversight of the settlements process is of course fundamental. The issue, however, is to obtain the most effective division of roles between Parliament and the Executive. As with international treaties, this is likely to be an area where good public policy requires delegation of negotiating authority by Parliament to the Executive, within clearly prescribed limits. This is an important area where clarification of respective roles could strengthen both effectiveness and accountability.

A more narrow but difficult issue that needs to be addressed is the relatively weak and probably declining public constituency for the settlements process (NZ Values Survey 1998, 1989 – see Perry and Webster, 1999) and the perception that the Waitangi Tribunal is the direct source of unsustainable Māori demands on the public purse. Refining Tribunal processes as discussed above, and improving governance as outlined below, should help. The Government could also consider what it could do best to improve the climate of public opinion on Treaty of Waitangi issues.

#### Strengthening Māori social capability and governance

Good governance is important for Māori asset management and in turn for participation in the "inclusive economy". Strengthening Māori social capability and governance is a problematic process. An attempt over a decade ago to create a statutory basis for Māori legal personality – in the form of the Iwi Runanga Act 1990 – proved contentious and short-lived as concern developed over the degree to which such structures institutionalised the "authoritative voice" of iwi.

Other developments, such as the politicisation of the urban-rural Māori debate, particularly in the context of the Māori fisheries litigation, highlight the contribution that good governance arrangements can make to social capability through, for example, developing trust between the parties and a constituency for disputes resolution processes. In the Treaty claims area a question for government is whether,

in requiring that assets be transferred to accountable asset management structures, it has the balance right between a structured permissive approach with very general governance criteria, and a somewhat more delineated approach.

The disparity in Crown and Māori capacities in this area adds salience to this issue. Greater Māori social capability would minimise the need for greater prescription. For example, a capacity for “share-holder participation” by tribal members is an important element in ensuring the function of iwi governance structures and the accountability of leadership.

Another key governance issue is whether or not the current Māori land-tenure framework achieves a balance between protecting land from alienation and enabling land to be managed as a commodity for sustainable economic development.

At a more specific level, good governance arrangements are important for enabling distributive questions to be addressed, such as creating distributive mechanisms for benefits from collectively owned assets.

Possible areas for further attention are:

- Facilitating the “enabling environment” for Māori civil society. Two streams of public law work important to Māori governance are the reform of the Māori Trust Boards Act 1955 and the review of the Māori Community Development Act 1962. Together these statutes address community, tribal, regional and national structures and their review would provide the basis for a systematic consideration of governance and community (including family) development in Māori society. Work on these should be revived.
- Building the constituency for good governance, through such things as facilitating the availability of “best practice” models and better links with relevant agencies in the Māori governance area. This might drive off the work of the Treaty of Waitangi Fisheries Commission on iwi governance or the recent interest of the Law Commission on asset management structures.
- Encouraging those Māori institutions that receive public funding to investigate ways to collaborate and build links with each other at the strategic and human (including cultural) capital development levels. This sharing should extend to the private sector and internationally.
- Considering how to unlock the productive potential of multiply owned Māori land through on-going reform of the land tenure system.