

SUBJECTIVE WELLBEING IMPACTS OF NATIONAL AND SUB-NATIONAL FISCAL POLICIES

An Executive Summary

Arthur Grimes, Judd Ormsby, Anna Robinson, Siu Yuat Wong

Motu Economic and Public Policy Research
arthur.grimes@motu.org.nz



INTRODUCTION

Fiscal policy
balances growth, wellbeing.
What is best for whom?

The optimal mix of fiscal policy is vital for good government, including which combination of expenditure and tax policies are best for constituents. Much empirical research has focused on the effects of fiscal policy on growth. Ultimately, however, growth is a means to an end – greater utility or wellbeing. This study looks at the relationship between subjective wellbeing and fiscal policy.

This study is the first to explicitly consider the relationship of fiscal policies with subjective wellbeing taking into account:

- the government's budget constraint,
- the context of endogenous growth theory,
- regional and subnational dimensions, and
- general rather than solely central government datasets.

The working paper "*Subjective wellbeing impacts of national and sub-national fiscal policies*" examined over 30 years of fiscal data from 35 countries, cross-referenced with subjective wellbeing scores from more than 170,000 people.

The research found that 'distortionary' taxes (like income tax) are associated with better subjective wellbeing outcomes than 'non-distortionary' taxes (like GST/VAT). This is particularly true for the poor. In contrast, the empirical growth literature has found that non-distortionary taxes are associated with stronger growth than distortionary taxes.

This paper shows that the relationships do not depend on people's political ideology, supporting the idea that fiscal policies affect subjective wellbeing through effects on the real economy.

METHODOLOGY

The researchers used fiscal data from the IMF Government Finance Statistics and the OECD, spanning up to 35 countries and over 130 country-years from 1981 to 2012. They combined this fiscal data with over 170,000 individual responses from the World Values Survey and European Values Study and with macroeconomic data from various sources.

Mean subjective wellbeing is about 7.3 (on a 0-10 scale) with a standard deviation of about 2 across all the individuals in our analysis. Because of subjective wellbeing's tight distribution, even numerically small changes can be economically meaningful.

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Following the Barro endogenous growth model, the researchers split expenditure and taxation into two main categories:

- distortionary and non-distortionary taxation, and
- productive and unproductive expenditure.

Based on papers examining fiscal policy and growth, non-distortionary taxation is defined as sales and value added taxes (i.e. GST), while distortionary taxation, is taxation on income, social security contributions, and property taxes. Productive expenditures include education, health, housing, transport, defence and general public services. Unproductive expenditures include social security and welfare, recreation and economic services.

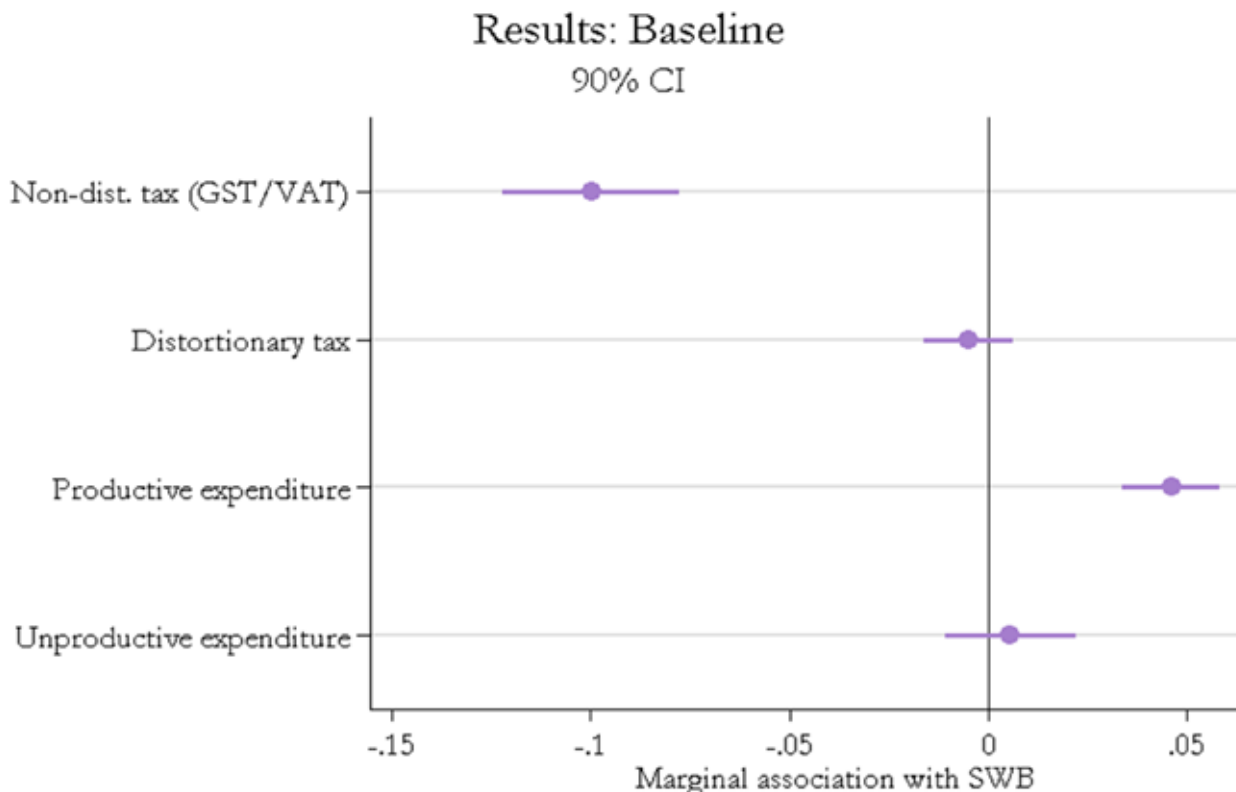
Unlike most previous studies, we tested our results using different fiscal measures in our regressions. General, including ‘subnational’, government data provides a more complete picture of a nation’s fiscal policy settings, while central government has better coverage. Subnational government is taken to comprise all levels of government below central government (i.e. including both state and municipal governments). The use of both datasets together allows the researchers to explore the associations between fiscal decentralisation and subjective wellbeing.

Our methodology reflects assumptions that once our suite of personal and macroeconomic controls is included, there is no reverse causality from individuals’ subjective wellbeing to the fiscal variables and no omitted variable bias. This is a strong assumption: it is possible that a shock to individuals’ subjective wellbeing could be caused by something unobserved that also changed one or more fiscal variables. For instance, even in the absence of any macroeconomic effects, a terrorist attack may lower subjective wellbeing while raising defence expenditure. Given this possibility, we are careful to talk of associations rather than of causal relationships between the variables.

RESULTS

In all our regressions, distortionary taxes are associated with higher subjective wellbeing than non-distortionary taxation, and productive expenditures are associated with higher subjective wellbeing than unproductive expenditures. Adding macro controls makes very little difference to the results.

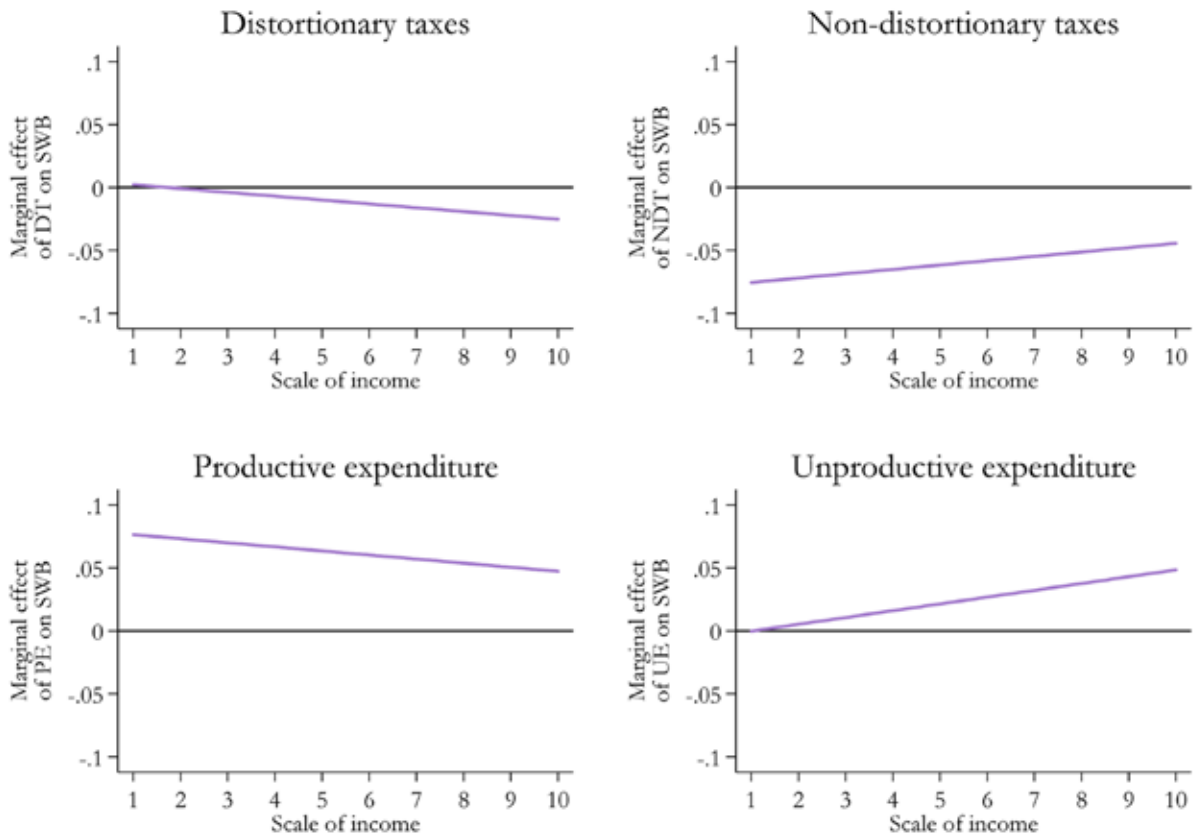
Figure 1: Baseline estimates (90% confidence intervals)



The differences between different tax and expenditure estimates are economically meaningful. For example, reducing distortionary taxation by 10 percent of GDP funded by a same sized rise in non-distortionary taxation is associated with an approximate 0.6 unit rise in subjective wellbeing or about 25% of a standard deviation – an effect larger than the often cited but transitory positive effect of getting married.

We explore whether people at different parts of the income spectrum have different subjective wellbeing responses to the various fiscal categories. Our results indicate that distortionary taxation has a more negative effect for higher income earners, and non-distortionary taxation has a more negative effect on lower income earners. Productive expenditure also appears to be favoured by poorer individuals. The results for unproductive expenditure, which mainly comprises social welfare spending, is found to have most benefit for the middle class and least benefit for poorer people, possibly reflecting ‘middle class capture’.

Figure 2: Marginal effects by income group



Fiscal policies do not appear to affect people of opposing political orientations differently: none of the slope estimates are significant at the 5% level.

We find little variation when we interact fiscal policies with town size variables. There appears to be some slight downward association between distortionary taxation and subjective wellbeing and some slight upward association between non-distortionary taxation and subjective wellbeing. However, this result may reflect only that people living in cities tend to be wealthier than those in rural areas.

We examine the differences in the degree to which fiscal expenditures and revenues are centralised or decentralised to subnational government. We find a positive association, up to a point, between subjective wellbeing and an increase in the share of expenditures that are spent sub-nationally. Additionally, we find a negative association between subjective wellbeing and an increase in the share of tax revenue raised sub-nationally. Thus our findings support taxation being a central government function while fiscal expenditures appear to be best provided by a combination of central and subnational governments. One caveat to these results is that the available data on subnational fiscal categories is not as strong as that for central government.

CONCLUSIONS

The small prior literature relating to fiscal policy and wellbeing has focussed on the overall size of government, without addressing how government is financed. We explicitly control for the government budget constraint, estimating the wellbeing associations of changes in taxation and expenditure when financed by increases or decreases in the budget surplus.

We find a number of important associations, even after including country fixed effects and a suite of macroeconomic and personal controls. We find:

- distortionary taxes appear better, on average, for subjective wellbeing than non-distortionary taxation.
- productive expenditures appear better for subjective wellbeing than unproductive expenditures.
- there are no material differences across the political spectrum,
- there are differences in associations across people of different incomes.

Richer people are hurt more by distortionary taxes and less by non-distortionary taxes (like GST) than poorer people. They also benefit less than poorer people from productive expenditures. The middle class appear to benefit the most from unproductive expenditures, consistent with either middle class capture or omitted variables that hurt the poor and drive up welfare payments.

In examining regional issues, we find no material differences in the effects of fiscal policy across people living in different-sized settlements. However, when examining central and subnational government fiscal policies our results suggest that taxation is best done centrally, while expenditure is best done by a combination of central and subnational government. This is consistent with economies of scale being important for revenue raising, and with local knowledge being important for expenditure.

We see no strong reason to expect material reverse causality from subjective wellbeing to fiscal policies or to expect any major sources of omitted variables bias, especially given that we have controlled for macroeconomic conditions. Nevertheless, other elements than subjective wellbeing are important in setting government policy. Future research could examine the extent to which the relationships that we establish are causal and examine the causal pathways through which these relationships act. In particular, our findings regarding the optimal roles for subnational versus central government fiscal policies could prove a fruitful area for further research with an emphasis on uncovering particular categories of expenditures (and taxes) that are best retained at the central government level and those that are best devolved to subnational government.