INCLUSIVE PROSPERITY
COMMISSION

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Message from the co-chairs

Inclusive Prosperity: Australia's record and the road ahead is the first Discussion Paper to be released by the Chifley Research Centre's Inclusive Prosperity Commission. This is a first phase in our project to deliver a high-level economic analysis charting the path to a high pay, high productivity economy. It is designed to put forward some of the facts which Australia must confront - and pose some of the questions which Australian leaders must answer - in order to secure future economic growth.

The argument of this paper is very simple: a new level of inequality is emerging in Australia and this is a serious threat to our future economic growth.

Our past performance is a strong platform and Australia is one of the few countries to have resisted the trend to a shrinking middle-class up until now, as the IMF has recently observed. But the evidence of this paper is worrying:

- income inequality in Australia has been rising and we are now in the bottom half of the equality ladder
- those at the top have been taking a greater share of Australia's income – this isn't yet as bad as in the United States, but it's getting worse
- the gender pay gap is widening
- Australians with disadvantage are being left behind
- wealth inequality, especially driven by housing, is far worse than income inequality

Most worrying, since the mid-2000s, wages have failed to keep pace with productivity improvements.

This means workers are benefitting less from better productivity and the labour share of income is falling even faster than before. This appears as a direct consequence of weakening labour market institutions and a decline in union representation and employee voice in the workplace.

This bad news for equality in Australia comes at precisely the time when we see widespread understanding of the link between rising inequality and slowing growth worldwide. IMF Managing Director Christine Lagarde recently put it starkly, noting that the world's 85 richest people control more wealth than the world's 3.5 billion poorest people, and that this degree of inequality is casting a "dark shadow" over the global economy.
New analysis from the IMF, World Bank and the OECD, along with influential publications such as Thomas Piketty's 'Capital in the Twenty-First Century', point to this as well.

Greater government involvement and regulation in many parts of the world is needed to respond to this, particularly through stabilising labour markets and restoring progressive taxation. This Commission will build on the trans-Atlantic report of the Center for American Progress (CAP), which is a project partner with the Chifley Research Centre. The CAP report concluded:

"Left to their own devices, unfettered markets and trickle-down economics will lead to increasing levels of inequality, stagnating wages, and a hollowing out of decent, middle-income jobs. This outcome is morally wrong, economically myopic, and at fundamental odds with a democracy in which everyone quite reasonably asks for an equal chance to succeed."

Our American and European friends know this, because they have lived it in their own economies. Australia is fortunate to have the opportunity to learn not from bitter experience of our own, but from observation of the evidence from overseas.

How? The powerful forces leading to concentration of wealth and inequality of income in advanced industrial economies can't be countered simply through market competition, incentives for workforce participation and education and training. Rather, a much more muscular mix of healthy labour market institutions, prudential design of financial markets and corporate governance, and job-biased growth across all the sectors of the economy is required. This demands very new government policies, but also very different capital and financial market incentives for the leaders of public and private firms.

So our argument is simple – rising inequality threatens Australia's growth – and the conclusion we draw is equally stark.

Australia must not go down the American road of cuts and shrinking government, leading to an army of working poor, a crunch on living standards for the middle class, and concentration of wealth.

We must pursue policies designed to limit inequality if we are to achieve wealth creation, job growth and economic growth in a globalized economy characterized by profound technological change.

That is the key to inclusive prosperity for Australia in the coming years.

Wayne Swan MP **Michael Cooney**
20 July 2015

Inclusive prosperity:

Australia's record and the road ahead

A new vision for Australia – a growing economy with growing equality

Australia's economy is changing. We can no longer rely on a decades-old reform dividend or a commodities boom; we must look to new sources of economic growth to lift living standards.

Australia's strong economic performance over the past two decades is a strong platform. The record terms of trade boom was not wasted – combined with sound policy settings and institutions it led to average incomes rising across the board. Our experience has been very different to several other advanced economies: flat middle-income growth for decades and the fallout from the global financial crisis today.

However, the economic circumstances of many Australians are insecure and our country's prosperity is fragile. Inequality is on the rise here and political and economic pressures are emerging which would make inequality much worse. This is a threat to social justice and fairness in itself, and there is also a growing body of evidence that it threatens economic stability and growth.

This is why Australia needs a new policy conversation. It is becoming increasingly clear around the world that inequality is an economic problem. The fundamental assumption of much domestic economic and policy debate, that we face a 'tough trade-off' between future growth and protecting fairness, is a false one. The core principle of the Inclusive Prosperity Commission is that equality is a driving force for a strong, stable and growing economy, while inequality threatens economic growth.

This discussion paper reviews Australia's performance on inclusion and growth over the past 30 years, noting the success of our long-run economic and social model. At the same time, the paper identifies emerging trends in economic inequality and new threats. This extends far beyond the exclusion of Australians with disadvantage from the workforce.

We see a potential squeeze on 'middle Australia', the middle-income households who have been a crucial driver of growth and rising living standards in the past. Significant economic problems could result from this.

In particular, we find emerging evidence of a new threat to equality in the short term and economic growth in the long term: a 'wages disconnect' where productivity growth is not matched by increases in real wages. This threat to incentives for labour productivity, so important to long-term economic growth, has emerged gradually in the past fifteen years and is a major challenge to our markets and institutions.

This is a complicated story to tell. The common assumption that everyone is better off now than two decades ago masks the complexities of analysing income trends and wealth distribution. A closer analysis shows the growth decades have not lifted incomes for all households and points to cause for concern should we fail to pursue sources of inclusive growth and retain an effective social safety net.

Why does inequality matter?

The social cost of inequality is widely understood: it undercuts the social consensus required to adjust in the faces of shocks, causes investment reducing political and economic instability and undermines progress in education and health. 'Opportunities to rise' do not redress these bad effects – indeed, inequality harms social mobility and makes it harder for people to improve themselves. In the past, relatively equal Australia has been considered one of the more socially mobile countries in the OECD. Public investment in education has been an important equaliser and enabled mobility. (Today however, increased school choice - in the context of growing spatial inequality between suburbs and unreformed funding - appears to be leading to divergences in student performance.) High inequality means less mobility across generations - when income is less equally distributed, the income of parents makes an even bigger difference to the life chances of a child.

It is now also increasingly clear that inequality is an economic as much as a social problem. This is a major shift in the global political and economic debate with big implications for Australia.

The OECD finds rising income inequality drags down long-term economic growth and harms opportunities. (The main transmission mechanism is under-investment in human capital as disadvantaged households struggle to obtain quality education.) The OECD also finds high wealth concentration limits investment opportunities and weakens potential growth. International Monetary Fund (IMF) staff agree income inequality - specifically the distribution of income to middle- and low-income earners - matters for growth and its sustainability.

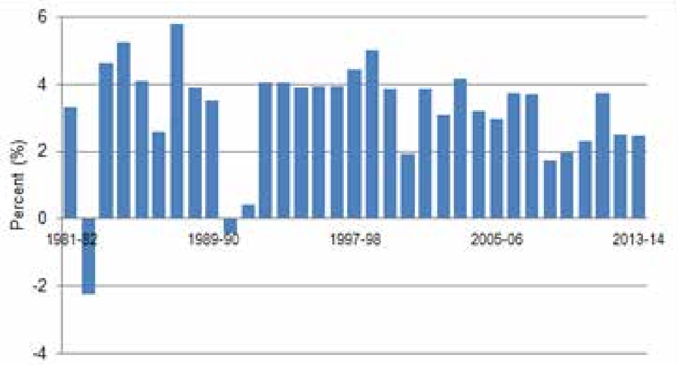
Rising inequality squeezes living standards in middle Australia, exacerbates disadvantage, limits social mobility – and threatens future economic growth.

Australia's past performance – our strong platform

Australia has benefited from a once in a lifetime commodities boom.
Australia's last recession ended in 1991 and over the past 23 years, the Australian economy grew strongly at an average annual rate of 3¼ percent (see Figure 1). In the 2000s, ongoing rapid industrialisation in China and other emerging markets generated a massive increase in Australian commodity export income. At the same time, Australian consumers and businesses benefited from access to cheaper manufactured goods from Asia. The combined effect was to boost real incomes in Australia.

We have grown the economy

Figure 1: Real GDP growth



Source: ABS National Accounts, Cat. No. 5206.0

Australia achieved low inflation, rising real wages, and low unemployment

A vital aspect of the current prolonged expansion phase has been the containment of inflation to an average rate of 2.5 percent, exactly the mid-point of the Reserve Bank of Australia's target band of inflation of 2 to 3 percent. At the same time, annual wages growth has averaged around 3.5 percent, which means that workers had their purchasing power increasing by 1 percent per annum. Businesses have also flourished with strong profits and returns on investment. As just one indicator of business health, the ASX200 index in 2011 was 130 percent higher than the mid-1990s .

Sustained economic growth delivered ongoing job creation and the unemployment rate remains low compared to the 1980s and early 1990s (see Figure 2). The structurally lower unemployment rate boosted household incomes and complemented the rise in real wages to the point where there has been a broad-based increase in living standards.

Over the same period, the workforce participation rate also increased, from around 61 percent of the workforce in the 1980s to around 65 percent today. Most striking has been the lift in female participation, which has risen from 45 percent to around 58 percent of the workforce over the same period (see Figure 3).

We have grown jobs, especially for women

Figure 2: Unemployment rate

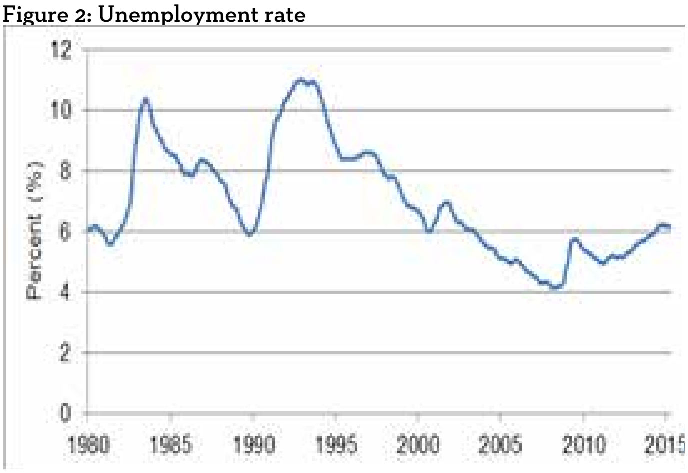
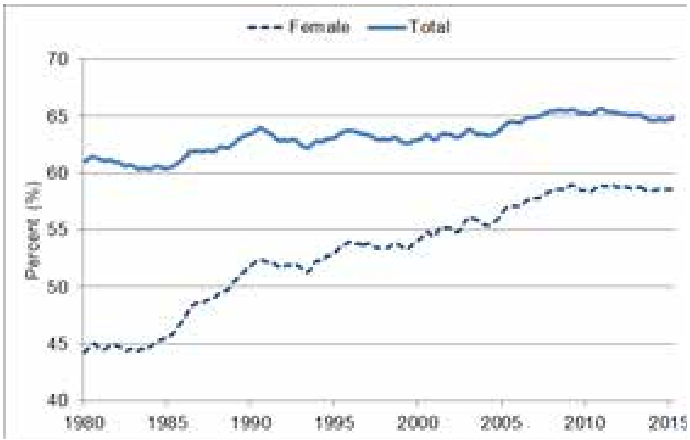


Figure 3: Participation rate



Source: ABS Labour Force Australia, Cat. No 6202.0

Australia avoided several cyclical downturns

Over the past 25 years, fiscal and monetary policy in Australia have adjusted well to risks to the economy, including the Asian financial crisis of 1997-98 and the tech bubble in the United States in 2000-01. The strongest test of Australia's economic settings was the global financial crisis of 2007-08.

The bursting of the US housing bubble and subsequent banking crisis was the catalyst for the most serious and widespread global financial crisis in generations. Policy makers in Australia reacted swiftly. The Australian Government banned short selling of stock and introduced a residential mortgage backed securities investment program. With growing nervousness among depositors, the Australian Government extended the guarantee arrangements to deposits. The Government also guaranteed the wholesale funding of banks.

These decisions were followed by a fiscal stimulus program and significant cuts to interest rates by the Reserve Bank.

Several international commentators have identified rising inequality in those nations as one of the key drivers of the financial crisis. High wealth concentration was a destabilising factor in extremely deregulated financial markets. The Australian story was very different. There was a rise in inequality in Australia over the same period, but it was more moderate, while stronger regulation prevented the build up of extreme financial risks in Australia – and this was matched by a better policy response when the crisis hit. As a result, Australia largely avoided the global downturn in 2009 and sharp rise in unemployment experienced by other advanced nations (see Figures 4 and 5).

We have stayed out of recession

Figure 4: Real GDP growth

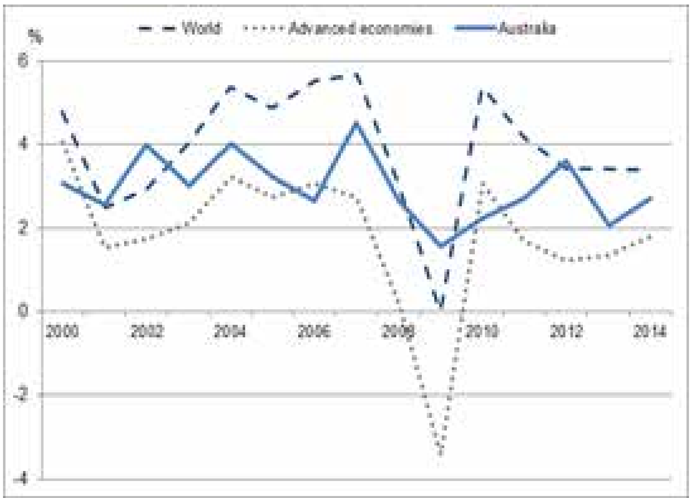
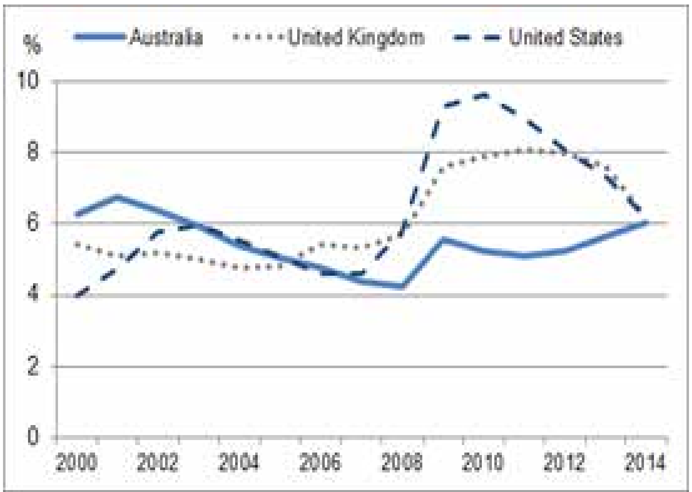


Figure 5: Unemployment rate



Source: IMF World Economic Outlook, April 2015

What is inclusive prosperity?

Inclusive prosperity is a new way of thinking about Australia's economy. At the heart of the matter is a simple premise: economies grow faster when everyone shares in the growth. More and more evidence now suggests that rising inequality is a threat to economic growth while only broadly shared prosperity can be sustained in the long-term. Inclusive prosperity means embracing the economic opportunities of our time and finding ways to ensure they serve the vast majority of society.

Australia is one of the few advanced countries with incomes rising on average across the board

Australia's recent growth experience has been one where households across the income distribution have benefited on average. Strong growth across the distribution sets Australia apart from many other OECD countries.

One illustration is Figure 6, which shows major economies experiencing slow growth or a fall in middle incomes over the 2000s, while Australia achieved a large increase.

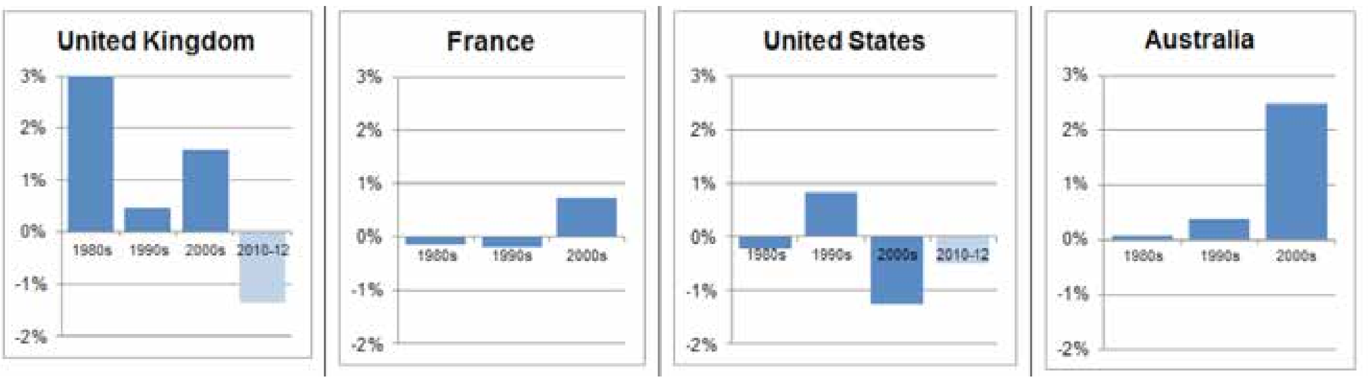
We have shared the benefits of growth

Figure 6: Average real income growth of those outside the top 10 percent, by decade

At the lower end of the income distribution, Australian households experienced rising incomes as workers benefited from growth following recovery from the 1990s recession. People in middle and lower income households were more likely to work, and part-time workers took on more hours.

It is no coincidence that we have grown more strongly than many countries while making sure more of our people benefit from our growth.

Rising living standards in middle Australia have strengthened our economy in a period when run-away inequality and wealth concentration destabilised the US and much of Europe.



Source: The World Top Incomes Database http://topincomes.g-mond.parisschoolofeconomics.eu

Bottom 90 percent average income, Accessed July 2015

Lighter shading indicates less than a full decade of data available

Looking more closely – there are emerging threats

Australia's egalitarian economy, supported by sound policy and natural endowments, has performed strongly for twenty-five years. However even through this period, threats to equality have been emerging, limited in some cases by effective public policy but real nevertheless. Australians need to understand these emerging threats to our equality if we are to prevent them from threatening the future of our economic growth.

Income inequality in Australia has been rising

Although there have been periods where inequality has risen and fallen over the past 30 years, the overall trend is an increase in inequality. According to the most commonly used measure of income inequality, the Gini coefficient, inequality in Australia has risen from 0.27 in 1980-81 to 0.32 in 2011-12. Australia stands at around the OECD average in terms of income inequality (see Figure 7) and well behind major trading partners like Germany and Korea. This is during a period of increasing inequality amongst almost all OECD countries, including those that traditionally had low inequality (e.g. Denmark, Norway, Sweden).

Overall, Australia's strong growth and employment record, matched with policy and institutional settings, has acted to slow the growth of income inequality experienced in countries such as the United States and United Kingdom. These settings include: a strong social safety net, including means-tested welfare, universal healthcare, and universal superannuation scheme; high public investment in education; a solid minimum wage; employment standards; and discrimination protection. There is also an argument that comparing Australia to other countries on measures of the relationship between 'the top' and 'the bottom' understate our relatively strong performance in 'the middle'. Market inequality is relatively low in Australia, and middle-income earners have had better growth in living standards than in many countries, notably the United States.

We are now in the bottom half of the equality ladder
Figure 7: Select OECD nations ranked from lowest to highest inequality, 2013

Country	Gini
Denmark	0.25
Norway	0.25
Finland	0.26
Sweden	0.27
Netherlands	0.28
Switzerland	0.29
Germany	0.29
Luxembourg	0.30
Korea	0.30
Ireland	0.30
France	0.31
Canada	0.32
OECD average	**0.32**
Australia	**0.33**
Italy	0.33
New Zealand	0.33
Spain	0.34
Japan	0.34
Portugal	0.34
Greece	0.34
United Kingdom	0.35
Israel	0.36
United States	0.40
Turkey	0.41

Source: OECD Income Distribution Database

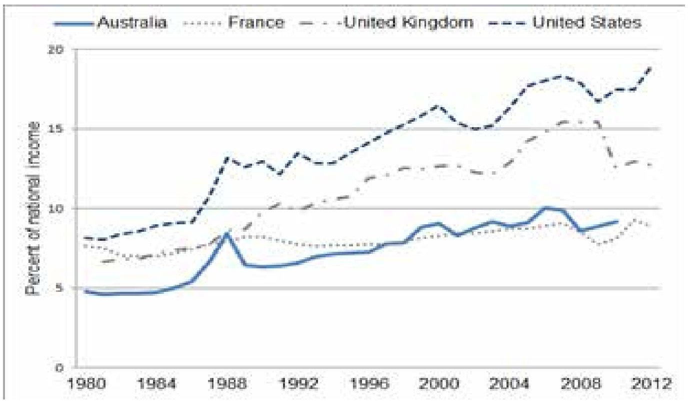
Australia also has a distinctive, indeed close to unique, welfare and tax system; this has acted to moderate our growth in income inequality. In particular, Australia relies more heavily on income testing and directs a higher share of benefits to lower income groups than any other OECD country. The 2009 increase in the Age Pension for example sharply reduced income inequality amongst older people. However, there is evidence that the egalitarian impact of the social security system has reduced over time; this is mainly due to its smaller relative scope in a period of strong employment and income growth, but also due to the effect of continuing income tax cuts which have reduced the overall tax take and due to the delinking of benefits levels from wages growth.

Since the 1980s, those at the top have been taking a greater share of Australia's income

Over the past 30 years, those at the top of Australia's income distribution have experienced stronger gains in earnings and investment income. This is most starkly illustrated by the rising income share of the top one percent (see Figure 8). Although Australia is starting from a lower base compared to other countries such as the United Kingdom and the United States, the proportionate increase is about the same.

Income concentration is not as bad as the US, but it's not good and it's getting worse

Figure 8: Top one percent share of national income



Source: The World Top Incomes Database http://topincomes.g-mond.parisschoolofeconomics.eu

Since the mid-2000s, wages have failed to keep pace with productivity improvements

Labour earnings are the largest component of income for most Australians, and therefore the most important driver of income inequality. Average wages today are growing more slowly than productivity, contributing to inequality in the short term and threatening future productivity growth.

In the past there have been concerns over 'wage breakouts' threatening inflation and competitiveness. The evidence indicates our record terms of trade boom did not lead to a wage breakout.

In fact, wages have now become disconnected from productivity growth.

Figure 9 maps the relationship between labour income and productivity since the 1960s and shows several distinct phases. In the 1970s, real wages growth in Australia exceeded productivity growth leading to the 1980s Prices and Incomes Accord. As part of this Accord, unions agreed to restrain their claims for wage increases in return for changes to public policy that aimed to increase workers' standard of living through other means, including Medicare and superannuation. In the 1990s, rapid productivity growth was evenly shared between labour and capital, but since 2000, there has been a significant 'decoupling' where wages have failed to keep pace with productivity improvements.

Decoupling does not necessarily imply declining living standards for workers – average real wages grew solidly in Australia up until 2012 – but it does imply rising inequality with middle Australia missing out on a growing share of income growth, and it does pose risks to future productivity improvements. Figure 10 shows that labour's share of national income has been steadily declining since the 1980s. This is consistent with the experience of most other advanced economies.

Workers are benefiting less from increased productivity

figure 9: Labour income and productivity in Australia

Source: ACTU calculations based on ABS 5204, ABS 6291.0.55.001, and Butlin (1977) A Preliminary Annual Database 1900 01 to 1973-74 RBA Research Discussion Paper 7701

The fall in the labour share of income has accelerated since mid-2000

Figure 10: Labour share of national income

Source: ACTU calculations based on ABS 5204, ABS 6291.0.55.001, and Butlin (1977) A Preliminary Annual Database 1900 01 to 1973-74 RBA Research Discussion Paper 7701

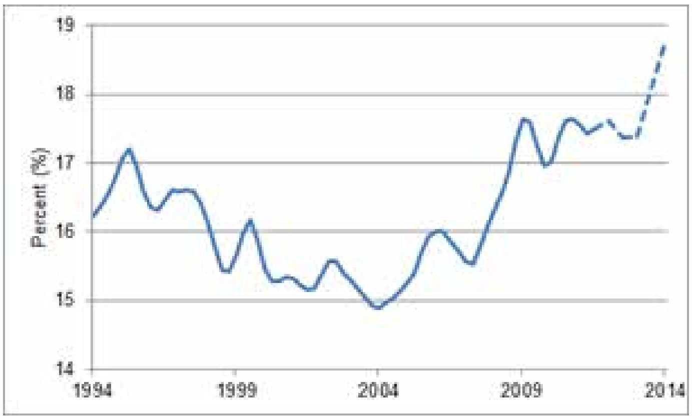
Alongside the emerging disconnect between labour income and productivity, we identify other worrying trends.

The gender pay gap is also widening

Around the world, increased female participation in the workforce, a higher share of women working full-time and higher relative wages for women have acted to put a brake on rising inequality. Of concern for Australia is that since mid-2000, the gender pay gap has increased significantly (see Figure 11). Several factors contributing to this gap include: female dominated industries and jobs tending to attract lower wages; relatively fewer women in senior positions; workforce absences due to caring responsibilities; and discrimination. Other factors include: low wages and job security in the government funded services sector impacting social and community work mainly performed by women; and the tendency for more women to be employed in part-time and casual positions reliant on a safety net which has diminished over time.

Women are particularly missing out

Figure 11: Gender Pay Gap



Source: ABS Average Weekly Earnings Cat. No. 6302 (Full-time ordinary adult earnings)
Data frequency changed from quarterly to bi-annual in 2012

Some Australians are still being left behind

Despite decades of strong economic growth, an estimated 4-6 percent of Australian society continues to experience chronic poverty and deprivation. The Committee for Economic Development of Australia notes that the people who find it hardest to escape from disadvantage appear to fall into six main categories: older people; less educated people; households with no employed members; particular geographic areas; indigenous Australians; and those with chronic health problems.

Moreover, the conclusion that everyone is better off now than two decades ago masks the complexities of analysing income trends. The rising tide of prosperity has not lifted incomes for all households: averages for income groups mask changes within those groups, while excluding the effect of households whose own income declines and moves them into a lower category. Policy also matters: indexing allowances for the unemployed and the sick to prices rather than community-wide incomes has led to households reliant on these payments slipping down the income ladder for the last two decades.

Wealth is far more unequally distributed than income

Wealth is an important source of economic security. Wealth enables a household to tide over bad times when the normal flow of income is reduced. Wealth also enables households to invest for the future. In Australia, wealth is far more unequally distributed than income and wealth concentration has been rising over time. In 2003-04, the net worth of the wealthiest 20 percent was 57 times as high as the least wealthy 20 percent. By 2011-12, the wealthiest Australian households had 71 times the net worth of the least wealthy.

Comparing wealth distributions across countries is difficult due to different methods in valuing wealth. The 2014 Credit Suisse Global Wealth report places Australia in the 'medium inequality' group, countries with the top 10 percent holding over 50 percent of the nation's wealth. Very high inequality countries (top 10 percent holds over 70 percent total wealth) include Switzerland and the United States.

The relatively less unequal distribution of wealth in Australia reflects high levels of home ownership, particularly among those of Age Pension age. This is because people accumulate wealth over their life course. As a result, older people have much higher average wealth, but generally have lower incomes, than younger people.

A key challenge for Australia is that families unable to access the housing market miss out on an important store of wealth and economic security. For example, single-parent households have only half the rate of home ownership as two-parent families (37 percent compared to 75 percent).

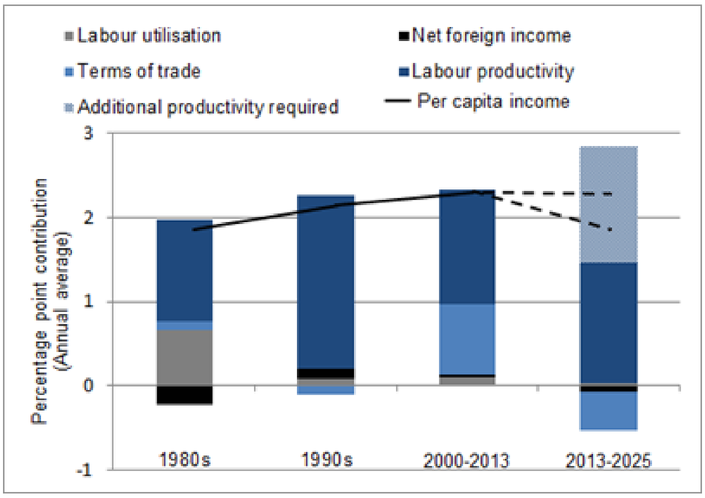
Which road ahead?

Australia's impressive run of economic growth has translated to improved living standards for many Australians, but this cannot be taken for granted in the decades ahead. Inequality is rising and this poses a threat to growth.

As shown in the Treasury representation below (Figure 12), Australia's national income grew in the 1980s as a result of increased labour utilisation (participation of women) and improved productivity. In the 1990s productivity contributed most to income growth. Reforms including internationalising the economy, expanding school and university achievement, increased competition in utilities and productivity-based enterprise bargaining led to increased productivity. The adoption of new information and communications technologies also helped workers to undertake existing tasks more efficiently. In the 2000s, declining productivity growth was offset by the terms of trade boost but in the years ahead, this trend is expected to reverse.

The future of growth?

Figure 12: Contribution to national income growth



Source: Treasury (2014) Budget Paper 1. Lighter shading represents additional labour productivity growth to achieve long run average growth in real national income per capita

Increasing productivity is key to improving living standards but cannot be a cover for reductions in jobs and wages. Productivity and competition should always be seen as means to an end, and subject to important caveats including economic equality and financial stability, not as policy goals in isolation. The link which was forged between wages and productivity ended the era of the 'wage breakout' – restoring that link is important to restoring incentives for productivity growth and reviving living standards in middle Australia.

In coming decades, Australia must adapt to the 'third wave industrial revolution'. That is, disruptive technological change that is allowing machines to replace even complex forms of human work. This changed environment offers a host of new opportunities. Technological change brings the possibility of new products and services and opportunities for workers to enter new, potentially higher-paid forms of work. At the same time, these changes could put immense pressure on middle Australia.

A great divide is emerging between skilled and unskilled labour; capital owners and workers. New jobs are being generated that privilege people with skills, qualifications and experience. Already Australia has seen the number of long-term unemployed (out of work for more than 12 months) climb to 190,000, the highest level for 16 years. One in every four Australians now looking for a job is long-term unemployed.

Spatial inequalities are also arising in the way Australia's major cities are evolving. Equity and growth depend on the availability of jobs and housing. The outskirts of major metropolitan areas often have higher levels of unemployment, lower levels of education, poorer health outcomes and availability of infrastructure. Demographic change creates great social goods and complex opportunities for a new kind of society in which many Australians live much longer.

Amongst these challenges there is reason for optimism if we make good policy choices.

Among advanced economies, Australia is almost uniquely well-placed to take advantage of the continued rise of China, India and the rest of Asia. Australia has a legacy of delivering successful structural reform and responding to global shocks. Our established social preferences for good wages, quality housing, excellent education, universal health and secure retirement are also now the building blocks for wealth creation and economic growth. What is needed is a deeper conversation about the future sources of growth in Australia and policies that support the inclusion of all Australians in that growth. There is nothing wise about seeking faster growth by leaving some Australians behind and squeezing living standards for the many.

Policy changes which lift inequality are not necessary or tough - they damage our prospects.

Inequality is not a necessary evil or the price of progress, it undermines our strength, destabilises our economy and threatens future growth.

There are steps that can be taken by policymakers to drive equitable growth, to build on our history as an open, prosperous economy, and deliver improved living standards for all.

In the next phase of the Commission's work, we will explore some of the ways this can be done.

The Chifley Research Centre is the think tank of the Australian Labor Party. The Inclusive Prosperity Commission is a major Chifley project exploring the threat to Australia's future economic growth presented by growing inequality – and new policies to respond.

The Inclusive Prosperity Commission is co-chaired by Hon. Wayne Swan MP (Federal Member for Lilley, former Deputy Prime Minister and Treasurer of Australia) and Michael Cooney (Executive Director of the Chifley Research Centre). The Commission's membership is broad with high profile and credentialed policy makers from across the spectrum. The commissioners are Cameron Clyne, David Hetherington, Dave Oliver, Peter Whiteford, Rebecca Huntley, Stephen Koukoulas and Tony Nicholson. Amanda Robbins of Equity Economics leads the Commission's staff. (Biographical details for Commissioners are at http://www.chifley.org.au/federal-labors-think-tank-launches-inclusive-prosperity-commission)

The Commission's task is to develop a new economic policy framework to guide Australia beyond the global financial crisis and the peak of the commodities boom. The Commission will conduct public meetings and hearings, conduct and release research and recommendations, through 2015 and 2016. The project will culminate in a formal public report, to be released in 2016.

Have your say:

This is the start of a new conversation about ensuring new economic opportunities benefit all Australians. Over 2015, the Chifley Research Centre will be consulting with stakeholders around the country. We encourage you to engage in the discussion:

- What does inclusive prosperity mean to you?
- How can we work together to improve living standards for all Australians?
- What can the government do to create a strong and fair economy?

Visit us at:
www.chifley.org.au/futureofgrowth

Note from the authors:

As in any collaborative process, there has been much give and take among the participants in developing this paper. We all subscribe to the broad analysis and principles articulated here. There may be specific matters, however, on which some of us have different views.

The Chifley Research Centre is the official think tank of the Australian Labor Party. This paper has been prepared with the assistance of Equity Economics and Development Partners Pty Ltd.