THE UNIVERSITY OF MELBOURNE

Inequality

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In 2002, in the opening presentation to the first conference of this Melbourne Institute-The Australian series, I said that Australia in the twenty first century would have all of productivity-raising economic reform, economic growth and equity in income distribution, or none of them (Garnaut 2002).

This statement was made after a decade in which Australia had had all of reform, growth and equity to an unusual degree.

In the Twenty First Century so far we have had none of them. Since 2004 I have been calling this period The Great Australian Complacency of the Early Twenty First Century. There has been no substantial and sustained productivity-raising reform, as policy-making has come to be dominated by pressures from vested interests and short-term calculations about political survival. Total Factor Productivity growth languished and then disappeared. Total Factor Productivity is about the same now as a decade ago. Real income growth per person was spurred for a while by the sugar hit of a housing and consumption boom, and then by the China resources boom, but since 2011 has stopped. It seems that we are in the early or middle stages of the lowest average growth in real incomes over an extended period since the Great Depression. Meanwhile, the corrosion of the corporate and personal income tax base since the turn of the century, with the cut in the capital gains tax rate, the changes in superannuation taxation arrangements and the blind eye to transfers of taxable income outside Australia, have contributed to widening dispersion in the distribution of domestic incomes and wealth. These domestic policy developments have exacerbated tendencies to greater inequality in the distribution of Australian incomes emerging from the international economy.

I told this story in *Dog Days: Australia After the Boom* (Garnaut 2013). I laid out two possible futures for Australia. In one, Australians recognise the deterioration in their political culture and a new Australian leadership sets about building a new era of productivity-raising reform, economic growth and equity. This would require a new Australian leadership to govern from the centre of the polity, and to resist pressures from sectional interests to the extent of disappointing its strongest supporters. In the alternative future, we live with business as usual, stagnation of real incomes and rising inequality.

In the two years after Dog Days, Australians chose business as usual.

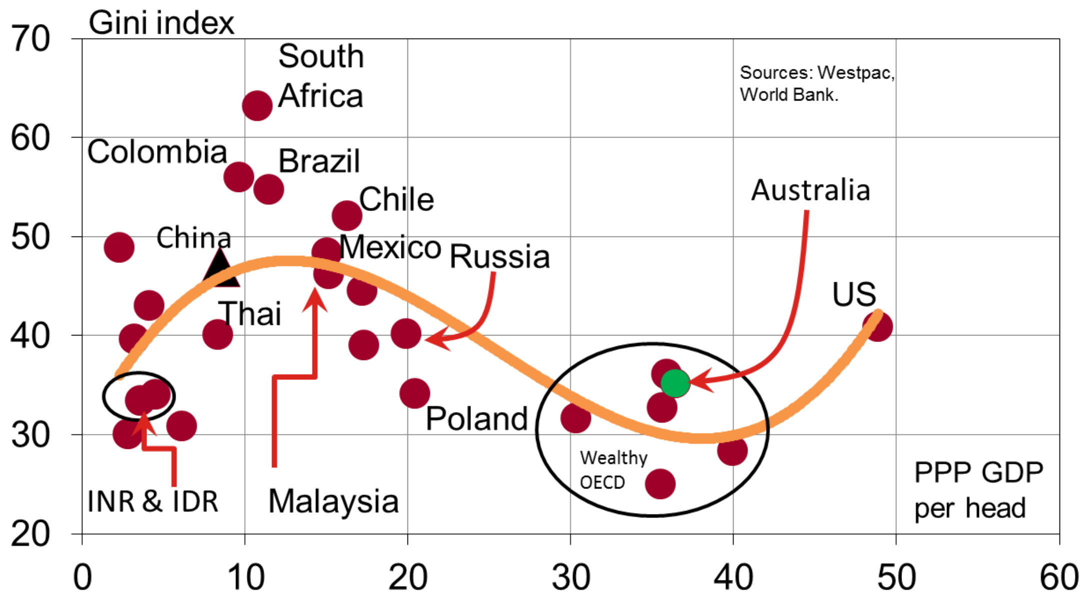
Malcolm Turnbull launched Dog Days two years ago. His emergence as Prime Minister provides another chance for Australians to choose reform, sustainable growth in incomes and equity.

I will say more about the pressures from the international economy, before returning to domestic income distribution.

The story of income distribution is different in developed countries including Australia than in the world as a whole.

Chart 1, extracted from World Bank data by Huw McKay, suggests a general tendency for the dispersion of income distribution to increase—that is, for inequality to grow—in the early and intermediate stages of economic development. This tendency may continue from the early years of modern economic development to somewhere near China's average income level today. After the "turning point in economic development", when labour becomes scarce and more valuable and wages rise more rapidly than the value of output, inequality seems to fall.

Chart 1: Income level per capita & its distribution



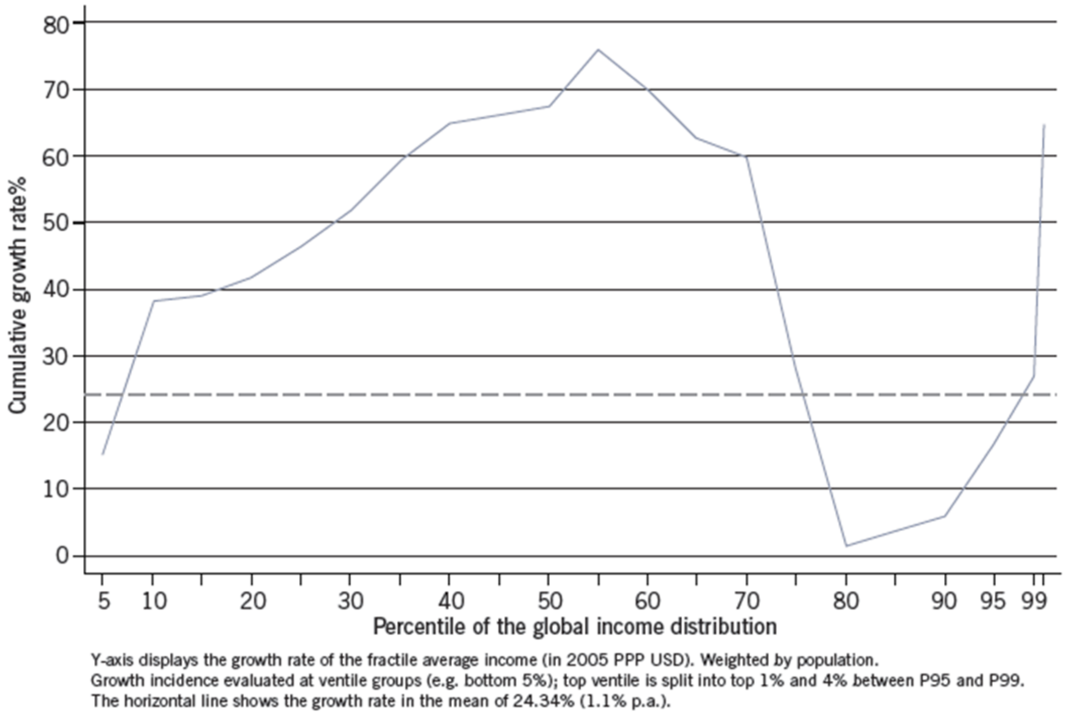
In Chart 1, the US is an outlier in average incomes and inequality amongst developed countries. Does the US data suggest that inequality increases again at very high levels of incomes? So much is special about income distribution in the United States that we should be careful about drawing conclusions from this single observation. That requires us to be careful about the right hand end of the trend line that Huw has drawn through the data in Chart 1.

Chart 2, from a World Bank Working Paper a couple of years ago, looks at the international distribution of the growth in income over recent decades. It reveals two groups of big winners: the highest income "one percent"; and several deciles in the middle of the global distribution. (The graph is not fine enough to reveal that much of the gain of the one percent accrues to a tenth or less of the category). It identifies two groups that have fared poorly: one corresponding to the "bottom billion"—the seventh of humanity who have not yet entered modern economic development. The other-set of losers—those who have done most poorly in recent decades, with almost no increase in real incomes—are around the second highest decile, corresponding to ordinary people in the developed countries.

The second set of observations reported in Chart 2 ends with the global financial crisis. Since then, ordinary people in the developed countries have generally experienced static or falling real incomes. Since then, large numbers of people in the developing countries have experienced substantial incomes growth. Ordinary people in China at least have seen their incomes rise more rapidly than those of the richer Chinese after many years of relative decline.

The story of standards of living for ordinary Australians over the period covered by Chart 2 is better than for their counterparts in the rest of the developed world. From 2011, they have joined the rest of the world in stagnation and falls in average incomes.

Chart 2: Global growth incidence curve 1988 to 2008



How should we interpret this tendency for the general run of citizens in much of the developing world to do well, while ordinary citizens in developed countries fare poorly?

Piketty's celebrated book *Capital in the Twenty First Century* (2014) has encouraged more serious discussion of inequality. Piketty's focus is mainly on income and wealth distribution in the developed countries and not in the world as a whole.

It is worth standing back to examine some of the large forces affecting global income distribution, and linking standards of living of ordinary people in the old developed countries, and in the economically successful developing countries led by China.

Piketty's book contains an analytic core and an eclectic periphery.

The analytic core is built around what Piketty says is a long-term tendency for the rate of return on capital to exceed the growth rate—giving rise to a tendency for the share of capital in total income to rise over time. He is talking about the return on low-risk capital, like real estate and government bonds. The large and increasing concentration of capital incomes makes this the cause of rising inequality.

Piketty's eclectic periphery contains important insights. He identifies powerful tendencies for policy to exacerbate tendencies to greater inequality in the developed countries in the twenty first century. Democracy holds the key to correction of the unnecessary elements of the tendency to inequality.

On the core argument, Piketty's stylized facts do not fit contemporary reality.

Let me make the point by highlighting some important broad tendencies.

In the early twenty first century, there is a powerful tendency for the desired rate of savings in the world as a whole to exceed the desired rate of investment. Low rates of business investment seem to be associated with an historic decline in productivity growth in the developed countries and with falls in the costs of capital goods. We don't know much about the decline in total factor productivity growth, but it is persistent and it would be unwise to assume an early restoration of old performance. The tendency for savings to grow faster than investment creates an abundance of capital. Real long term interest rates, determined in the market, as well as short-term rates determined by policy are the lowest ever in real terms. There is no sign of this changing for long-term rates, and not much for policy rates.

The fall in the cost of capital reduces business investment expenditure. We would expect it also to be associated with a bias towards capital saving in technological change, which over time would favour increases in labour over capital incomes.

The global abundance of capital is highly favourable to rapid economic growth in developing economies which have the institutions and policies to absorb it in large quantities and to put it to productive use. This is part of the background to historically high rates of economic growth in developing countries so far in the twenty first century.

The tendency towards abundance of capital is accompanied by a decline in global fertility and a deceleration of growth in global population and labour force. The decline in fertility is apparent in all regions, but is much weaker amongst the bottom billion who are yet to participate intensively in modern economic development than amongst the six sevenths of humanity who have experienced increases in living standards to levels well below those before modern economic growth.

Strong expansion of output and declining labour force growth in China and some other developing countries are generating increasing scarcity of labour and rising wages. Immobility of labour across national borders means that declining fertility and strong economic growth are associated with scarcity of labour and rising wages in some economies but not in others, depending on rates and stages of economic and demographic development. Over time, labour will tend to become scarce and valuable in the world as a whole so long as there is successful development amongst the bottom billion.

I have painted with the broadest of brushes the most powerful forces causing global development to influence the distribution of income in the twenty first century. We are likely to see continued abundance of capital, with low rates of return on competitive investment.

High returns will be available only to genuine entrepreneurship and to the capture of regulatory, market, resource and other rents through the exercise of monopoly power. In these circumstances, there are large rewards from exercise of corporate influence over policy to create monopolistic positions that generate rent. This has been part of the story of the decline in Australian total factor productivity growth in the twenty first century so far, and is a barrier to restoration of productivity growth.

Depending on the success of development in the bottom billion, continued global development is likely eventually to enhance all labour incomes, in developed and developing countries alike. Low returns on capital accompanied by rising wages should be favourable to equitable distribution of global incomes.

How then should we understand the widening dispersion of incomes in the developed countries so far in the twenty first century?

Part of the sharp increase in inequality since the turn of the century that is observed by Piketty is simply a reflection of the increase in the value of assets associated with the historic decline in interest rates. This is a once-for-all adjustment. When interest rates stop falling, the contribution of rising asset values to high incomes will decline markedly and perhaps cease.

Several factors seem to have depressed incomes of ordinary people in the developed countries. One is the effect of globalization of production and consumption of goods and services in depressing returns to labour in developed and enhancing them in developing countries. A second is the tendency for growth in demand to remain below sustainable rates of growth—despite the latter being curtailed by lower productivity growth. A third is the increasing influence of corporate pressure on the policy process in the developed countries—reflected, for example, in the Australian taxation changes noted earlier in this presentation.

The first of these three factors is transitional—although the transition is difficult, uncertain and long, extending over decades and possibly generations. The second is the result of a mistake in economic policy. The third is amenable in principle to change in a democratic polity but entrenched if not intractable in practice.

Does increasing inequality and stagnant or declining real incomes of ordinary people in the developed countries matter if it occurs alongside rising incomes in the developing world? To the extent that rising inequality is the result of the first consideration, does it matter if it is merely transitional, pending the maturation of global development and the associated global increase in labour incomes?

I think it does. Stagnant incomes for most people place great strain on a democratic polity. Governments tend to be nasty, brutish and short. As I observed in the first conference in this series, the absence of equity makes it unlikely that we will experience economic reform or economic growth. If there were any doubt about this simple reality, it was removed through observation of the fate of the Abbott government. We have no experience of democracy flourishing with stagnant or declining living standards for most people. And we need democracy to flourish in its original homes, at this time when the entry of China into high income status relegates to a minority the citizens in high-income countries living within democratic political systems. The success of democracy in its original homes in the period ahead is likely to determine its attractions for the majority of the world's people who are making up their minds about the merits of alternative political systems.

So it is especially important in the period ahead to remove the avoidable contributions to growing inequality in Australia. We can remove the second of the three factors described above through combinations of fiscal and monetary policy that allow early return to full employment. The policies discussed in Dog Days remain relevant.

In selecting such policies, sustained growth in employment and living standards requires us to deal with the long term budget problem. We have been kidding ourselves by writing into revenue forecasts an unlikely early return to fondly remembered levels of productivity and incomes growth. Meeting the long term budget challenge is the first priority for policy directed at sustained reduction of inequality as well as sustained increases in average living standards. Pending that correction, Australians are vulnerable to a range of possible shocks from the domestic and international economy. The more we can do to lift productivity, the less our vulnerability. But raising productivity growth to anything like the levels to which we became accustomed in the second half of the twentieth century, let alone the late twentieth century, will be difficult, and in the best of circumstances will take many years.

The third factor is avoidable in principle, but its removal is more easily wished than done. The third factor has emerged from elements of contemporary political culture that are now deeply entrenched. The essential part of a solution is to rebuild an independent centre of the Australian polity, seeking better outcomes for their country and society independently of sectional business or partisan political interests.

This is a time to be rigorously analytic about changes in taxation and public expenditure policy that are pushed by corporate interests for their supposed contribution to higher productivity and economic growth. It is a time to apply policies that generate more equitable income distribution without damaging economic growth. And it is a time to avoid policies that widen the dispersion if income distribution without substantially lifting prospects for stronger economic growth.

I will conclude with a particular call to be analytic about the effects of a cut in corporate income tax on labour productivity and labour incomes. There is currently a great deal of momentum from the business lobbies and parts of the media for a general reduction in corporate income tax rates. A bit of theory in Treasury papers premised on perfect competition in capital, goods and services markets has been used to draw conclusions about the effects of a cut in company tax rates in the real world. The cautions are there in the fine print of the Treasury documents, but the unqualified conclusions are so attractive that we are urged to sign up before putting on our glasses to read them. Too much is at stake for us to shirk the analysis.

Note: Many of the arguments set out in this paper were set out in greater detail in my 2015 Holmes Lecture "Global Development in the Twenty First Century", at Victoria University in Wellington in February 2015. This paper, along with three critiques, was published in Policy Quarterly in May 2015. My response to the critiques appears in Policy Quarterly, November 2015. An early version of some of the argument is in "Capitalism, Socialism and Democracy in the Twenty First Century", the Second London School of Economics-University of Melbourne Lecture, London, October 2014.

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