Submission to Senate Community Affairs References Committee inquiry into the extent of income inequality in Australia

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The primary purpose of my submission is to provide information to the Committee on recent income inequality trends in Australia, largely drawing on my own research (undertaken in my capacity as an applied economics researcher at The University of Melbourne). I am not, therefore, providing a comprehensive submission addressing all of the Inquiry terms of reference. However, I do provide some additional comments on the concept of inequality, the appropriate target of policy in relation to inequality, and the policy levers available to government to affect income inequality.

1. Why inequality matters

My submission does not discuss the effects of inequality (term of reference (b) and (c)), but I would draw the Committee's attention to the fact that this is an area of much contention among researchers in the field. For example, adverse health effects of inequality have been asserted by many researchers, but no robust evidence in support of this assertion has been produced (Leigh et al., 2009). My own view is that the primary argument against inequality is that it directly lowers social welfare—that is, reduces the overall subjective wellbeing of the population. A number of studies have produced compelling evidence of this direct adverse effect of inequality. It is therefore not essential to advance 'instrumental' arguments that inequality is undesirable because it has adverse effects on other outcomes, such as health, crime and even economic efficiency. (But of course, these potential adverse effects are relevant to deciding how much inequality matters, and how much inequality we should have.)

2. Inequality of opportunity versus inequality of outcomes

Often, people will argue for equality of opportunity, which I believe is a thinly veiled argument for allowing large inequality of outcomes. Equality of opportunity is a noble aspiration, but it is almost as meaningless as advocating for equality of height. We quite simply do not have the power to create equality of opportunity; indeed, we don't even have the ability to recognize when equality of opportunity has been achieved. Individuals are born endowed with genes and parents and into an economic and social context beyond their control. To completely correct for these inequities in starting points is not possible; to give a somewhat extreme example, what would be required to give a child born with Down syndrome the same opportunities as a healthy child?

Discussion of inequality therefore rightly focuses on inequality of outcomes—after all, this is what ultimately matters. But—and this is perhaps a motivation for advocating a focus on equality of opportunity—any discussion of inequality should have due regard to adverse effects on incentives (for example, to work or to start a business). To put it another way, the optimal level of inequality is not zero. In fact, it is a long way short of that. But equally certain is that the degree of inequality produced by the free market is not optimal—redistribution by government can substantially raise aggregate wellbeing.

3. Measuring income inequality

The income measure

The income measure on which most studies of income inequality focus is income after payment of income taxes and receipt of government benefits, measured at the household level and adjusted for household size and composition using an 'equivalence scale'. For example, the commonly-used 'modified OECD' scale equals 1 for the first household member, plus 0.5 for each additional household member aged 15 and over, plus 0.3 for each child aged under 15. 'Equivalised' income is the household income divided by the equivalence scale, producing a 'per-adult equivalent' measure of income. For example, using the modified OECD scale, household disposable income is divided by 2.1 for a family of two adults and two children aged under 15.

Cash income is only one (albeit very important) component contributing to an individual's economic wellbeing, which depends on a broader range of factors, including non-cash income, indirect taxes, wealth and living costs. It is particularly important to consider the effects of 'social transfers in-kind' from government, which include health and education services, among other things. These can be very important to economic wellbeing and, moreover, when included in the definition of income tend to reduce measured inequality. Less information is available on these transfers (and other components of economic wellbeing), and so studies typically restrict focus to cash incomes, but one needs to be cognisant of these other components of economic wellbeing when interpreting estimates of inequality in cash incomes. For example, an increase in income support payments accompanied by cuts to public health expenditures will reduce measured inequality in cash incomes, but may in fact lead to greater inequality in a broader measure of income that includes social transfers in-kind.

Inequality measures

There is a variety of summary measures of inequality, including ratios of incomes at different ranks in the income distribution (for example, the ratio of the income at the 90th percentile to the income at the median), income shares (for example, the share of total income going to the top 1%) and summary measures of overall inequality, such as the Gini coefficient, coefficient of variation and Theil Indices. Each measure provides different information on the income distribution, and ideally any study of inequality will examine a battery of measures. To obtain a complete picture of the income distribution, it is also useful to examine density graphs, which are essentially smoothed histograms showing the proportion of people at each income level. Finally, Lorenz curves are also commonly used in studies of income inequality, graphing the cumulative proportion of total income against the cumulative proportion of the population ordered from lowest to highest income. (A Lorenz curve always starts at 0 and reaches a maximum of 1. It is a straight line if everyone has the same income, and is otherwise a convex function.)

4. Trends in income inequality

As the Committee is no doubt aware, ABS income survey data show a trend rise in income inequality in Australia over the last three decades. Top income shares derived from Australian Taxation Office (ATO) tax data combined with National Accounts data confirm this longer-term trend (Burkhauser et al., 2014).

However, it should be noted that changes in ABS survey methods and income concept create some ambiguity about the magnitude of increase over the early-to-mid 2000s (especially 2003-04 to 2007-08). My own work suggests the ABS data overstate the magnitude of increase in inequality over this period (Wilkins, 2014). Moreover, there are signs from both the ABS income survey data and the ATO/National Accounts data that inequality ceased growing around 2009, and has in fact slightly declined since then. The aftermath of the GFC is likely to be a factor in this, and it of course remains to be seen whether it is temporary or sustained. **Nonetheless, it is important that the Committee is aware that the most up-to-date evidence we have is that income inequality is not currently rising in Australia.**

Having said that, current inequality appears to be relatively high by recent historical standards. For example, the ABS income survey data show that the Gini coefficient for household-size adjusted disposable income has been 0.32 or higher since 2007-08, compared with 0.30 or lower in the 1990s, and 0.27 in 1981-82. In Wilkins (2014), I show that the growth in measured inequality since 1993-94 is attributable to increased earnings inequality among employed people, increased inequality in business and investment income, and a reduction in the extent to which income taxes and transfers redistribute income. Growth in employment over the last two decades has acted to decrease income inequality. (This employment growth has also helped reduce welfare receipt, in turn acting to reduce the role of transfers in reducing inequality.)

International comparisons of inequality levels are difficult because of the multitude of differences across countries in how income is defined and measured, and in institutional contexts. Restricting to developed OECD countries, for which data is relatively more comparable, OECD (2011) shows that income inequality in Australia is higher than in most European countries, similar to that in the UK, New Zealand, Japan and Canada, and lower than in the US. Most developed countries have experienced growth in inequality in the last 2-3 decades, and indeed a number of countries have experienced greater growth than Australia.

5. Effects of government policies on income inequality

The main direct channels by which government affects income inequality in cash incomes are income taxes and transfers. As noted above, the redistributive effect of income taxes and cash transfers reduced between 1993-94 and 2011-12, although it would be wrong to infer that this was entirely due to active changes in government policies. A significant fraction of the reduction in redistribution is attributable to the employment growth over the period, which has seen a decline in welfare reliance and therefore a reduction in the redistributive role of the welfare system (Azpitarte and Herault, 2014).

Government social transfers in-kind (especially health and education) and indirect taxes are also very important to the distribution of income if a broader income measure is adopted (in-kind transfers tending to reduce inequality, and indirect taxes tending to increase inequality). The effects of changes to indirect taxes and social transfers in-kind in recent decades are not clear, although in principle they should be identifiable. The ABS produces a 'fiscal incidence study' each time it conducts the Household Expenditure Survey (every six years), which allows examination of the distribution of income net of indirect taxes and inclusive of social transfers in-kind. However, my research using this data is still in progress (and I'm unaware of any recent analysis of this data by other researchers).

Governments affect income inequality in many other indirect ways, including via wage setting institutions (the legal framework), tax policies beyond the tax rates applied to income and expenditures (tax exemptions and discounts, allowable deductions, compliance enforcement, etc.), housing policy, transport policy, and even policies relating to competition law, business regulation, trade and so on. Indeed, there is the potential for (indirect) impacts on income inequality in most policy domains. These indirect effects are inherently very difficult to quantify, but are nonetheless very important and therefore need to be part of any discussion of the impact of government on inequality and what can be done to reduce inequality. (Arguably, distributional implications of all major policy initiatives should be assessed prior to legislation and implementation.)

Regarding the effects of the measures proposed in the 2014-15 Budget, there can be little doubt they will act to increase inequality. I have not estimated the magnitude of the effects, although I note that others have attempted to do so. I raise the question of why this is not a task undertaken as a matter of course by the Australian Treasury (for example, producing estimated net impacts by quintile of the income distribution).

6. Looking forward: Policies to reduce income inequality

The key levers for reducing income inequality are income taxes and transfers. Increasing the progressivity of the income tax system is certainly viable, although adverse incentive effects may result from any further increase in top marginal tax rates. Increasing income support payments is also viable, but adverse incentive effects are inevitable, and problems are compounded by the increased fiscal demands of such a strategy.

Indeed, while maintenance of adequate benefits for the most disadvantaged is an important component of a strategy for reducing income inequality, as a general proposition, increasing income support payments is not the best way to reduce income inequality. The experience of the last two decades illustrates that, for working-age people, increasing employment participation is the most effective way to reduce inequality. Increasing in-work benefits, such as through an earned income tax credit, is likely to be a relatively low-cost way to increase labour supply while simultaneously boosting the incomes of lower-income households. On the demand side, consideration should be given to reducing minimum wages, especially those that are above the national minimum wage.

Policies to improve productivity, including policies increasing the skills of the population through education, will also increase employment and wages. This includes directing more funding to early-childhood learning and schools (especially in disadvantaged areas), and steps to increase post-school education and training. Other 'growth-friendly' policies, for example policies to correct market failures and reduce government-created market distortions, will not only make it easier to achieve employment and productivity growth, but are also likely to help reduce inequality in other ways—for example, by eliminating monopoly rents accruing to high-income earners.

For retired people, in the short-term, continued indexation of the Age Pension to male average weekly earnings will help constrain income inequality growth. Over the medium- to long-term, moves to increase reliance on superannuation in retirement (potentially involving requirements for retirees to convert superannuation into an income stream), combined with tighter means tests for the Age Pension (such as eliminating the exemption for the family home), can reduce inequality while keeping the Age Pension fiscally sustainable.

Tightening the Age Pension means tests should in fact be considered part of a broader effort to better target cash benefits on the most disadvantaged. Australia has done a good job of this by international standards, but we could do better still. The same principle applies to social transfers in-kind, although the need for targeting is less pressing given these transfers will generally have additional functions beyond redistribution. Reduction of tax expenditures (such as for superannuation and capital gains), which tend to be regressive, will also reduce income inequality—although again, other policy goals of these expenditures may make such reductions undesirable.

Finally, consideration could be given to introducing a wealth tax, or at least a federal property tax. An inheritance tax (levied on the recipient of the bequest rather than the estate) would also act to reduce inequality (primarily of wealth, but also of income).

References

Azpitarte, Francisco and Nicolas Herault (2014) 'Recent Trends in Income Redistribution in Australia: Can Changes in the Tax-Transfer System Account for the Decline in Redistribution?' Melbourne Institute of Applied Economic and Social Research, University of Melbourne, Working Paper No. 2/14.

Burkhauser, Richard V., Markus Hahn and Roger Wilkins (forthcoming, 2014) 'Measuring Top Incomes Using Tax Record Data: A Cautionary Tale from Australia', *Journal of Economic Inequality*.

Leigh, Andrew, Christopher Jencks and Timothy M. Smeeding (2009) 'Health and Economic Inequality', in Wiemer Salverda, Brian Nolan and Timothy M. Smeeding (ed.s) *The Oxford Handbook of Economic Inequality*, Oxford University Press: Oxford.

OECD (2011) *Divided We Stand: Why Inequality Keeps Rising*, OECD Publishing, <http://dx.doi.org/10.1787/9789264119536-en>.

Wilkins, Roger (2014) 'Evaluating the Evidence on Income Inequality in Australia in the 2000s', *The Economic Record*, Vol. 90, No. 288, pp. 63-89.

Attachments

The following two attachments are working papers, which are extended versions of Burkhauser et al. (2014) and Wilkins (2014). (These working papers are freely distributable, whereas the articles themselves are not.)

1. Wilkins, Roger (2013) 'Evaluating the Evidence on Income Inequality in Australia in the 2000s', Melbourne Institute of Applied Economic and Social Research, University of Melbourne, Working Paper No. 26/13.
2. Burkhauser, Richard, Markus Hahn and Roger Wilkins (2013) 'Measuring Top Incomes Using Tax Record Data: A Cautionary Tale from Australia', NBER Working Paper 19121, NBER, Cambridge, Massachusetts.