Distribution matters

(Article by Saul Eslake, Director of the Productivity Growth Program at the Grattan Institute, published in the Melbourne Age*, and in the online edition of the* Sydney Morning Herald*, on Saturday 29th October 2011)*

Among the often inchoate complaints of those who have been 'Occupying' public spaces in almost 1000 cities around the world over the past couple of months (including Melbourne and Sydney), one common theme appears to be resentment at the share of income and wealth controlled by, and the degree of political influence exercised by, the richest citizens of each nation.

In the United States, at least, these concerns are quite well-founded. According to data published in the Paris School of Economics' *World Top Incomes* Database, the share of total household income accruing to the top 10% of the income distribution in the US rose from 34.6% in 1980 to 48.2% in 2008, an increase of 13.6 percentage points. The share accruing to the top 1% of the income distribution *more than doubled*, from 10.0% to 21.0%, over the same period; while the share accruing to the top 0.01% of US households ranked by income increased *almost fourfold*, from 1.3% to 5.0%. The average gross income of the richest 1% of American households rose by 172% in real terms between 1980 and 2008; over the same period the average real incomes of the 'bottom 90%' of American households rose by just 2%. Indeed (and staggeringly), the average gross income of households in the 'bottom 90%' of the income distribution was, in real terms, lower in 2008 than it had been in the early 1970s.

The situation hasn't been much different in Britain. There, the share of total household income accruing to the richest 10% of households rose from 31.0% to 40.3% between 1980 and 2007, while the share accruing to the top 1% more than doubled from 6.7% to 14.6% over the same period. The 'bottom 90%' of British workers experienced real income increases of 17%, on average, which was a lot more than their American counterparts, but well short of the 103% increase in the real incomes of the top 1% of British adults.

Of course these trends aren't confined to the purportedly *über-liberal* societies of the United States and Britain. In traditionally egalitarian Sweden, the richest 10% of households' share of total income rose by 5.2 percentage points between 1980 and 2009, while the share of the top 1% rose by 2.7 percentage points (although those shares were, at 27.9% and 6.7%, respectively in 2009, a lot smaller than the corresponding shares of the richest 10% and 1% in America and Britain). In the People's Republic of China, a communist dictatorship, the share of household income accruing to the richest 10% of households increased by more than 10 percentage points, from 17.4% to 27.9%, between 1986 and 2003 (the latest year for which figures are available). That's a bigger increase than in either the US or the UK over the same period. The income share of the top 1% of Chinese households more than doubled, from 2.7% to 3.9%.

Here in Australia, the distribution of income hasn't widened as much as in the US or Britain. According to data compiled by Andrew Leigh (who was a Professor of Economics at the Australian National University before entering Parliament as a Labor MP at the last Federal election), the share of gross household income accruing to the top 10% of Australian households rose by 'only' 6.1 percentage points, from 25.4% to 31.5%, between 1980 and 2007; while the share accruing to the top 1% of Australian households rose by 5 percentage points, from 4.8% to 9.8%.

In each case both the share accruing to the top 10% and 1% of Australian households, and the increase in those shares over the past three decades, was smaller than in either the US or the UK.

The real income of households in the 'bottom 90%' of Australian households rose by 30% between 1980 and 2007 – although, interestingly, all of that increase occurred after 1997: real income of the 'bottom' 90% actually fell by 8% between 1980 and 1993. However the real income of the richest 1% of Australian households rose by 189% between 1980 and 2007 – about the same as in the United States.

All of these figures are based on gross income, that is, before taking into account the impact of the taxation and social security systems. In Australia's case, these have reduced the extent to which the distribution of income generated by the market has become more polarized. Australia has a highly progressive social security system, largely reflecting the fact that most social security payments in Australia are means-tested. According to the University of New South Wales' Professor Peter Whiteford, the pensions and benefits received by the poorest 20% of Australian households are more than 12 times those received by the richest 20% of households, a higher ratio than for any other OECD country (and almost six times the OECD average). The Australian personal income tax system is also progressive: the richest 20% of households pay twice as much of their gross income in tax as the poorest 20%.

Nonetheless, even after allowing for the impact of the tax and transfer systems, the distribution of income and wealth in Australia has become less egalitarian over the past two decades. According to recently-released ABS data, the share of household disposable income accruing to the richest 20% of Australians has increased from 37.8% in 1994-95 to 40.2% in 2009-10, while that of each of the four lowest 'quintiles' (fifths) has fallen over the same period. (In the United States, according to a study published this week by the Congressional Budget Office, the share of household disposable income accruing to the richest 20% of American households was more than 52% in 2007).

And although Australia's income tax system *is* progressive, it has become less so over the past decade. Reflecting the significant increases in the thresholds at which the top rates of income tax have become payable since 2004, and the halving of the tax rates on capital gains since 1999, the proportion of gross income paid in income tax by the richest 20% of households has fallen by 4.2 percentage points since 2003-04, more than for any other group of households.

Wealth is even less equally distributed than income, in part because wealth (and the income generated by it) is much less lightly taxed than wage and salary income. The share of household net worth owned by the richest 20% of Australian households has risen from 58.6% in 2003-04 to 62.2% in 2009-10.

One doesn't need to be a socialist (and I'm certainly not) to be concerned about trends such as these. An increasingly polarized distribution of income and wealth can have adverse consequences for economic performance. The stagnation in ordinary Americans' real incomes over such a long period of time undoubtedly prompted many of them to accumulate what eventually turned out to be unsustainable levels of debt in order to maintain their lifestyles, and was thus one of the underlying causes of the global financial crisis.

By contrast, in Australia – where real incomes have continued to rise, albeit far from equally, across almost all parts of the income distribution – most of the increase in household debt has been incurred by households in the top 40% of the income distribution, who are more capable of servicing it, and who have used it mainly in order to acquire assets, rather than to sustain consumption spending. That's a major reason why Australia has avoided the degree of household financial distress seen in the United States. But it's also a reason why we should be concerned to prevent an American-style polarization in the distribution of income and wealth from occurring here.

More generally, the fact that the economic gains resulting from the policy agenda pursued, to varying degrees, around the world over the last three decades have accrued so disproportionately to upper income groups has undermined political acceptance of (let alone support for) the key elements of that agenda – including deregulation of financial and other markets, reductions in barriers to cross-border trade and investment, and lower rates of corporate and personal income tax.

There is, instead, increasing support around the world (including in Australia) for more stringent regulation of financial markets, new barriers to cross-border trade and investment, greater government involvement in setting executive salaries, and new or higher taxes. Except for more stringent regulation of financial markets and institutions (for which, in many instances, the weaknesses and excesses exposed by the financial crisis have made a strong case), most of these things would have harmful effects on economic activity, income, investment and employment.

I'm *not* in favour of higher marginal tax rates, on top income earners or anyone else. Nor do I support lowering the thresholds at which the top tax rates become payable. But I do think there's a strong case for curtailing the various avenues which are disproportionately by upper income taxpayers to reduce their tax bills, including 'negative gearing', the concessional tax treatment of capital gains, and the use of trusts. Curtailing or eliminating these tax privileges would not only improve the fairness of the tax system (and the resulting distribution of income): it would also reduce the complexity of the tax system, and the extent to which the tax system distorts investment decisions.

More broadly, those who want to see a more open and less-intrusively regulated economy (as I do) need to be aware of the consequences of what they propose for the distribution of income and wealth, and hence for public acceptance of those proposals.

To paraphrase something Winston Churchill said in a different context, markets provide (in most cases) the worst mechanism we have for determining what gets produced, by whom, how, where, for what price, and for sale to whom – except for every other one that's ever been tried. (That's why, like almost every other economist I know, or know of, I think 'putting a price on carbon' is preferable to 'direct action' as a way of responding to climate change).

But there's absolutely no guarantee that the distribution of income and wealth produced by markets will be socially desirable, or politically sustainable; indeed, there's plenty of evidence to suggest that more often than not, it won't be.

Thus, if there's to be less government intervention in the means by which incomes are generated by the operation of 'market forces', based on the belief that the result will be a higher aggregate level of income, there may well need to be more government intervention in the way in which that higher level of income is distributed, in order that the end result is socially and politically sustainable.

For much the same reason, those who want to see productivity-enhancing structural change in the economy, and productivity-enhancing organizational change in individual workplaces, also need to think about the distributional consequences of what they propose.

It may not be illegal for executives of companies to award themselves large salary increases or bonuses, or to put their hands up for large options packages with undemanding performance hurdles, whilst simultaneously sacking large numbers of their employees (or arguing for greater freedom to do so).

But the ‘optics’ of it are dreadful. That kind of behaviour does nothing to enhance public understanding or acceptance of the occasional need for painful and unpleasant changes in the way work is organized, or the number of people who do it, in individual workplaces. It does terrible things to the loyalty and morale of the staff who remain after ‘restructurings’ have been undertaken. It exacerbates trends in the distribution of income and wealth which, if taken too far, threaten to undermine public support for a market economy. And, to my mind at least, it’s morally, and ethically, wrong.

Saul Eslake is a Program Director with the Grattan Institute. However the views expressed here are entirely his own.