Oliver's INSIGHTS

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Australia's falling living standards – what's driving it and how to fix it

Key points

- Falling real wages and a surge in tax and interest payments have led to a slump in Australian living standards.
- But a broader driver of the malaise in living standards has been a slump in productivity growth from over 2% pa in the 1990s to near zero since 2016.
- Key policies to boost productivity growth include: tax reform; a cap on public spending as a share of the economy, deregulation; greater incentives to invest; and competition reforms.

"Productivity isn't everything, but, in the long run, it is almost everything". Paul Krugman, Economist

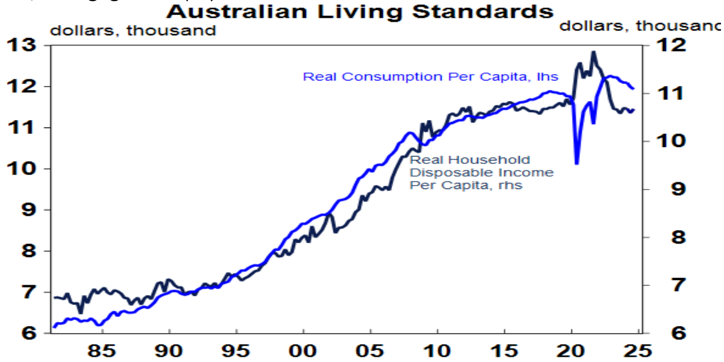
Introduction

Decades ago, the Australian economist Dr Don Stammer observed that while Australia may manage a boom poorly it manages crises well. This was certainly evident in the 1980s when a terms of trade shock after years of stagflation galvanised the Hawke/Keating Labor Government to undertake more supply side productivity enhancing economic reforms to get the economy back on track. These were continued in the Howard/Costello years and Australians saw rapidly rising material living standards.

But since then, the wheels seem to have fallen off the reform agenda and productivity has suffered. Numerous economists have been pointing this out for years but with the problem masked by strong export earnings no one really worried. Maybe until now. The past few weeks have seen increasing coverage of Australia's falling living standards with headlines like "plunging living standards hit households harder than recessions" and "how Australia became world's cost-of-living loser". So, what's driving it? And is it the sort of crisis that sees Australia reinvent itself again?

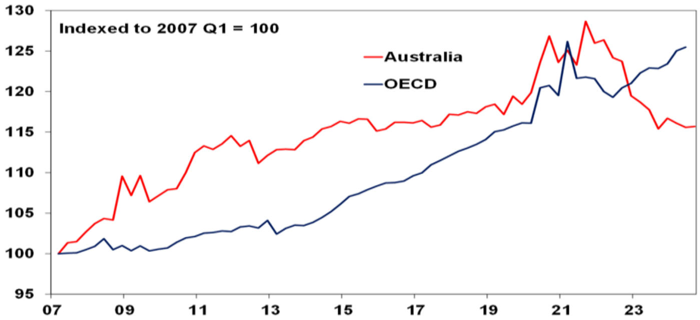
Falling living standards

The deterioration in living standards can be seen in various indicators. Often referred to lately is the slump in real household disposable income per capita which shows the value of incomes per person after allowing for tax, mortgage debt payments and inflation.



Source: Macrobond, AMP

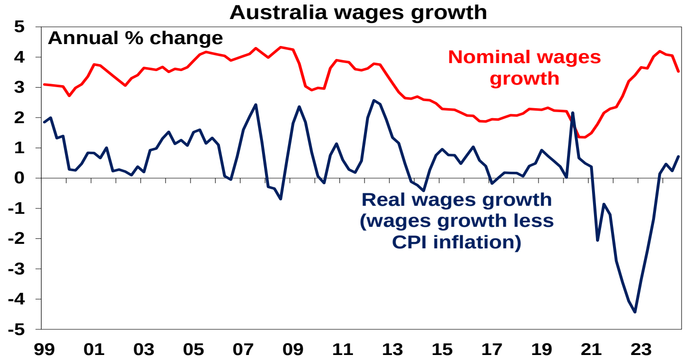
Since its high point in 2021, it has fallen around 10%. Of course, as evident in the last chart this slump is exaggerated because it comes off the back of a surge through the pandemic due to payments like Job Keeper. But even allowing for that, real disposable income per person has been stagnant for a decade. The problem is also evident in falling per capita consumer spending which is down 2.8% from its 2022 high. It's also evident in the "per capita recession" with per person GDP down 2.1% from its 2022 high. Outside of the pandemic this is its biggest fall since the early 1990s. And the fall in real disposable income has been worse here than across OECD countries where the trend has remained up.



September quarter data for Australia is estimated from ABS data. Source: ABS, OECD, AMP

So, what's the problem?

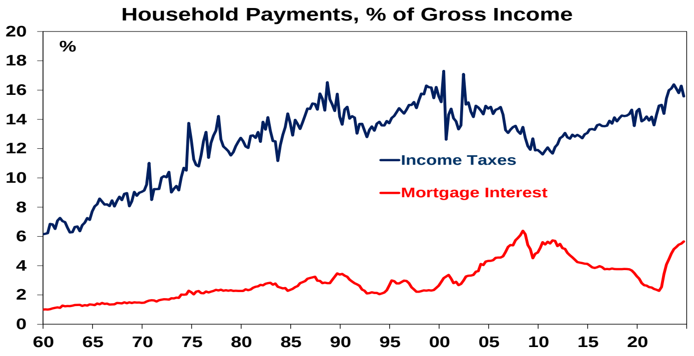
The poor performance in real household disposable income reflects a combination of factors. First, wages growth has generally been weaker in Australia, such that wages have not kept up with inflation. For example, since the end of 2020 average consumer prices are up 18.7%, but average wages have only gone up 12.9%. This means real wages have fallen 4.8%. Recently real wages have started to rise but it hasn't made up for the gap.



Source: ABS, AMP

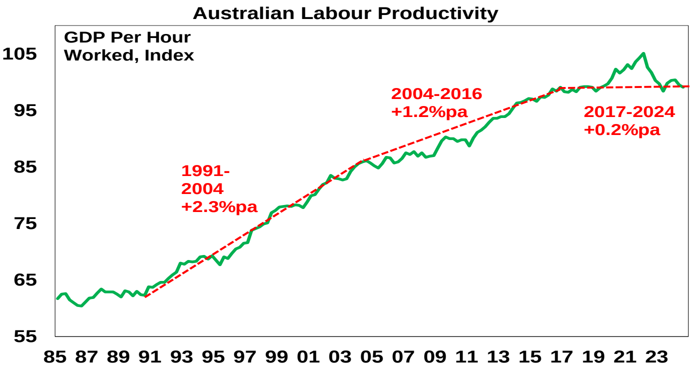
Second, the rise in interest rates have seen a bigger rise in mortgage interest payments in Australia reflecting the high preponderance of variable rates and our relatively high household debt to income ratio.

Thirdly, bracket creep has driven income tax payments to a record high as a share of income further reducing disposable income. Tax and interest payments are taking up an extra 5% of income compared to 3 years ago.



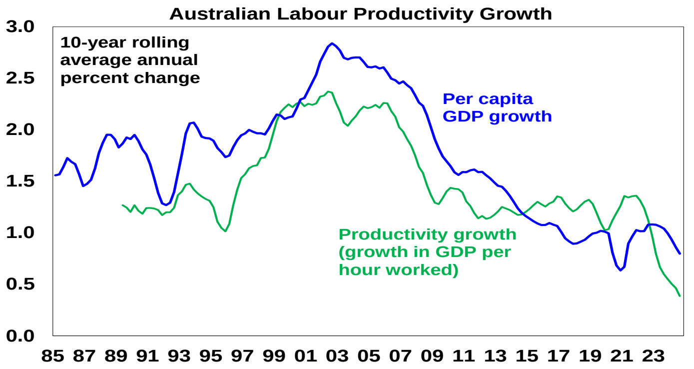
Source: ABS, AMP

Of course, as inflation and interest rates fall we will see some improvement in real disposable incomes. However, a more fundamental driver of the slump is poor productivity. Productivity is often thought of in terms of labour productivity, i.e. GDP per hour worked. See the next chart. While productivity growth was strong in the 1990s and into the 2000s it slowed from the mid-2000s and has stalled since 2016. Just like real incomes! And our productivity growth has dropped to the low end of OECD countries.



Source: ABS, AMP

Productivity growth is the main driver of material living standards over long periods. As can be seen in the next chart, the slowdown in productivity points to ongoing softness in per capita GDP and hence consumer spending. If sustained it will start to impact Australian asset class returns.

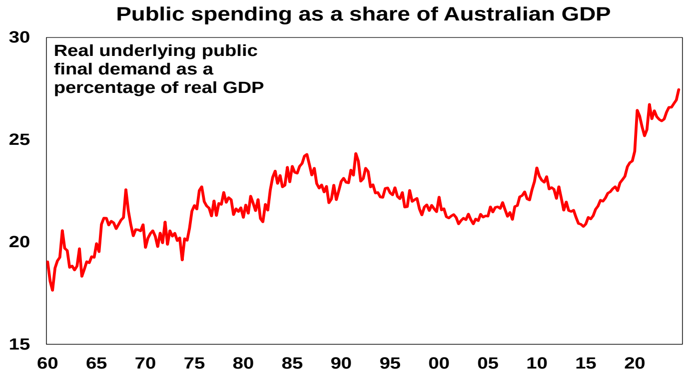


Source: ABS, AMP

We can make up for this by faster population growth but this doesn't help living standards per person. Likewise, it can be masked by strong commodity prices and hence national income but medium-term threats to Chinese growth mean we cannot rely on that. Lower productivity growth makes it harder to boost the supply side of the economy to keep inflation down and results in lower real wages growth, slower growth in profits and a reduced ability for the government to provide services.

So why the slump in productivity growth?

After the malaise of the 1970s, there was a focus in the 1980s on supply side economic reforms designed to improve productivity growth by making the economy more flexible and competitive, improving incentives and improving skills. This saw productivity growth surge through the 1990s into the 2000s. But since then, a range of factors have contributed to slower productivity growth, including: no big new reforms since the GST and some backsliding; very strong population growth has led to urban congestion and poor housing affordability; growth in business investment stalled in the 2010s; market concentration has increased, reducing competition; confusion regarding climate policies has contributed to underinvestment in power supply and energy costs; and a huge expansion in public spending.



Source: ABS, AMP

The latter is particularly significant as the shift in resources from the private sector to the public sector has been bad news for productivity because public (or non-market) sector productivity is invariably lower than that in the private (or market) sector and because public spending has been squeezing out private business investment which has weakened private sector productivity. The boom in public sector spending by depressing productivity and keeping demand higher than it otherwise would have been has in turn meant higher for longer RBA interest rates.

How to sustainably boost growth in living standards?

The key is to boost productivity but there are no quick fixes. Fortunately, there are plenty of good ideas, including these seven key measures:

1. Tax reform to rebalance from direct tax to a broader GST, compensate those adversely affected, and remove nuisance taxes like stamp duty to incentivise work effort and investment & better allocate resources.
2. Put a limit on the size of government spending below 25% of GDP. If we want more government services, we need to find others to cut.
3. Deregulate product and labour markets to remove red tape and boost labour market flexibility.
4. Provide more incentives to boost investment & adopt new technology.
5. Undertake competition reforms to reduce market concentration.
6. Match population growth to the ability to supply new homes and make it easier for people to live away from congested cities.
7. Reduce climate policy uncertainty and rely more on market signals as to how best to transition to net zero.

For a deeper look at the productivity malaise and solutions see here.

So, what's stopping us?

While Australian governments appear to be keen to do reforms that boost the size and power of government, support for the hardnosed supply side reforms needed is low. Two things may change this. First, Trump proposing an even lower US corporate tax rate, and a DOGE focussed on reducing the size of government and regulation may put intense competitive pressure on Australia. Like Reagan's and Thatcher's reforms did in the 1980s. And the living standards malaise may start to drive support for more serious reform. We may have a way to go yet though!

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