

# BRIDGING THE DIVIDE

How reform consensus can unite Australia's three economies

Daniel Mookhey



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## About the author

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## Introduction


The notion of a multitrack economy in Australia has become clichéd: ‘two-speed’, ‘patchwork’ – there’s no end to the labels bandied around. But what do any of these economies actually look like? Let’s borrow a taxonomy from Melbourne University’s Max Corden. Corden describes three economies in Australia: the Booming Tradable Sector, the Lagging Tradable Sector and the Non-Tradable Sector. The Tradable Sector produces goods and services that can be produced or consumed anywhere. Think of Apple’s iPad: it is designed in Cupertino, California; manufactured in Guangdong, China; but used everywhere. In contrast, the Non-Tradable Sector produces goods or services that must be both produced and consumed domestically. Think of your local hospital: its services can only be produced and consumed on site.

Using this taxonomy, we’ve set out to analyse who works in which sector, and how fast each is growing – in aggregate, employment numbers, and wages. We have found that over the ten years to 2011, output and wages grew faster in most parts of the Tradable Sector, but employment grew faster in the Non-Tradable Sector. This means that an already unbalanced economy became even more unbalanced: the Booming Tradable Sector created more wealth but split it amongst fewer people, while the Non-Tradable Sector produced comparatively less new wealth but shared it amongst many more people. This partially explains why Australians read about record profits in some sectors, but job losses in others; record investments in production, but parsimonious spending on consumption; fast economic growth in the mining states, but slower economic growth in the other states. They are reading about three different economies.

Participants in the three sectors disagree over how to manage these different economies. The Lagging sector blames its declining profits and stagnant wages on the same factors that drive the success of the Booming sector: global markets. Absent intervention, these market forces are hollowing out the Australian economy, leaving it totally dependent on few ‘booming’ industries like mining. Predictably, the Booming sector disagrees: industries lacking comparative advantage must shrink so they can expand. Economic restructuring, job losses and capital withdrawal are the price of expanding internationally competitive industries. The Booming sector argues that Australia should adapt to these pressures, letting the Lagging sector contract, which will be made much less painful by strong growth in the other two sectors. Meanwhile, the Non-Tradable Sector is caught between the two positions – fearful of the forces of globalisation, but dependent on the Booming sector’s success for its own demand.

If these fault-lines are to be prevented from deepening further, Australians will need to choose a new economic strategy. I argue that instead of pitting the three economies against each other, it is better to orientate all three sectors toward recognising their shared interest: a symbiosis that sees productivity gains in the Non-Tradable Sector lift the international competitiveness of the Booming Tradable Sector, while easing the adjustment of the Lagging Tradable Sector - releasing the state from the responsibility of compensating those left behind.

This is a complex economic rebalancing task. It requires a reform model that channels all three sectors’ market interactions into higher overall living standards. In this paper I discuss two models: model one, The ‘Consensus model’, is the reform model of the 1980s and 1990s, the model that relied upon agreement among economic actors to redesign markets and boost productivity growth and living standards. Model Two is what I dub The E‘ntitlement model’ - the reform model of the 2000s - the model that freed markets from responsibility for



equitable rises in living standards, instead using the Federal Budget to subsidise middle class living standards. This paper argues that the Consensus Model is the reform approach most able to undertake a necessary rebalancing of the three sectors, while smoothing the overall distribution of wealth. This is because it replaces a conflict culture with a political environment centred on sharing risks, sacrifices and benefits.

The paper is organised as follows. Section One details the current gaps between the three sectors: the Booming Tradable Sector is enjoying faster GDP and wage growth, but slower employment growth than the Non-Tradable Sector. Unsurprisingly, the Lagging sector lags on all three indicators. Section Two shows how this disjuncture is enriching capital over labour, and managers and professionals over the other occupational groups. Governments have responded by converting tax receipts into lifestyle subsidies for favoured social groups, perceived to be 'middle class' and 'aspirational'. Section Three explains why this is harmful for economic reform: it encourages actors to fight over the division of spoils, not cooperate for their mutual benefit. The final section sets out how this conflict culture can be replaced by a consensus culture centred on the principles of a shared fate, shared risk and shared sacrifice for shared benefits.

## Section I: Australia's Three Economies

Characterising Australia as a 'two-speed economy' is clichéd. The Federal Government, the Reserve Bank of Australia, peak business organisations and many of Australia's leading trade unions point to uneven rates of industry growth, State growth, wage growth and employment growth as incidences of the 'two-speed' economy phenomenon. A more useful distinction is offered by Max Corden (2012) who analyses the Australian economy in three separate blocs: 1) the Booming Tradable Sector – those industries exposed to global trade in which Australia enjoys a comparative advantage; 2) the Lagging Tradable Sector – trade-exposed industries with little comparative advantage; and 3) the Non-Tradable Sector – industries that do not compete in global markets.

The gaps between these three sectors occupy less attention than the standard two-speed economy approach. This is unfortunate. Globally, the widening chasm between the Tradable and Non-Tradable Sectors features heavily in analysis of the American, Chinese, Indian and the European economies. It is posited that in these advanced economies the competitive tradable sectors disproportionately benefit from global market integration because they are able to produce in the most cost-effective geographies, and sell in the most profitable markets. Uncompetitive trade-exposed sectors gradually decline, while the health of the Non-Tradable Sectors depends on the continued existence of strong competitive trade-exposed industries (Spence, 2011).

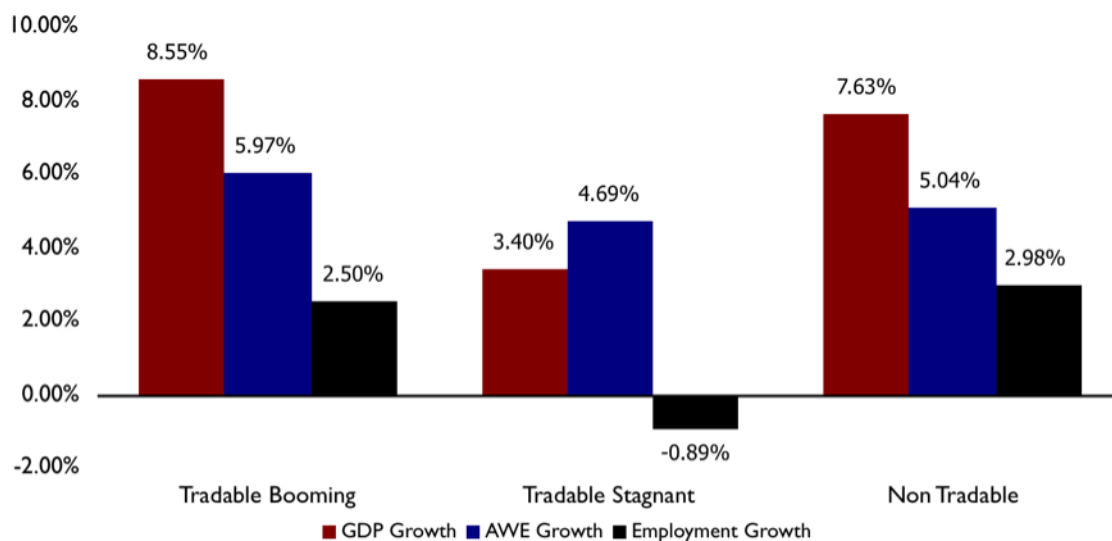
### The Cochlear Implant System

An example of a booming Australian tradable product is the 'Cochlear Implant System' for the hearing impaired. Graeme Clark, a PHD student at the University of Sydney, extended some research completed in the United States and published his theory of electrical stimulation of the auditory nerve in 1969. Nine years later, his prototype restored a person's hearing. Seized of the possibilities presented by this breakthrough, the Federal Government, the private sector and the University of Melbourne worked together to perfect the product's design. They eventually brought the product to market in 1983. This Australian-designed product is now used in over 50 countries. Over 83.4% of Cochlear's revenue is currently earned overseas.

### *The Australian Tradable & Non-Tradable Sectors*

For the purposes of this paper, we have classified the three sectors using Australian Bureau of Statistics (ABS) data as follows: in the Booming Tradable sector, we have included mining, professional services, agriculture and information, media and technology; in the Lagging Tradable sector, we've included manufacturing; and the remainder of the economy we have included in the Non-Tradable sector. The presence of a macroeconomic gap between the three sectors in Australia is signalled in comparative sector, wage and employment growth data. Figure 2.1 shows that over the past ten years, the Booming Tradable Sector has experienced a higher GDP growth rate, a higher rate of wage growth, but a lower rate of employment growth than the Non-Tradable Sector. The Lagging Tradable sector has experienced the lowest sector, wage and employment growth of all three (ABS, 2001-2012a).

Figure 1.1 Annual Sector/AWE/Employment Growth By Economy Type



SOURCE: Per Capita Analysis

The performance of all these industries has been affected by Australia's terms of trade. Since 2003, prices for non-rural commodities have risen by approximately 315%, while prices for rural commodities have risen by 65%. This has sparked the terms of trade boom that reached its peak in the June quarter of 2011 - the highest level in at least 140 years (Gruen, 2011).

Figure 1.2 Australian Terms of Trade (1869-2011)

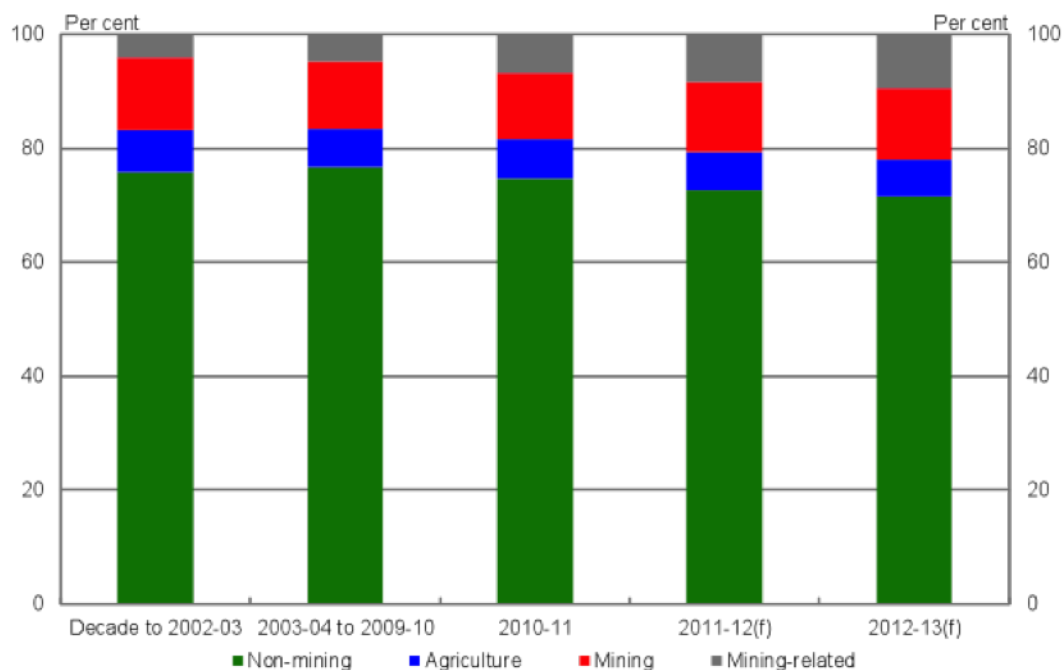


SOURCE: Commonwealth Treasury

Asian urbanisation, especially China's, but also India's and Indonesia's, is fuelling demand for resources abundant in Australia: coal and iron ore and, increasingly, liquefied natural gas. Coal production has risen 25% since 2003-2004, and iron ore production has doubled. This explosive growth in mining volumes has reconfigured the structure of the Australian economy, privileging mining above all other industries.

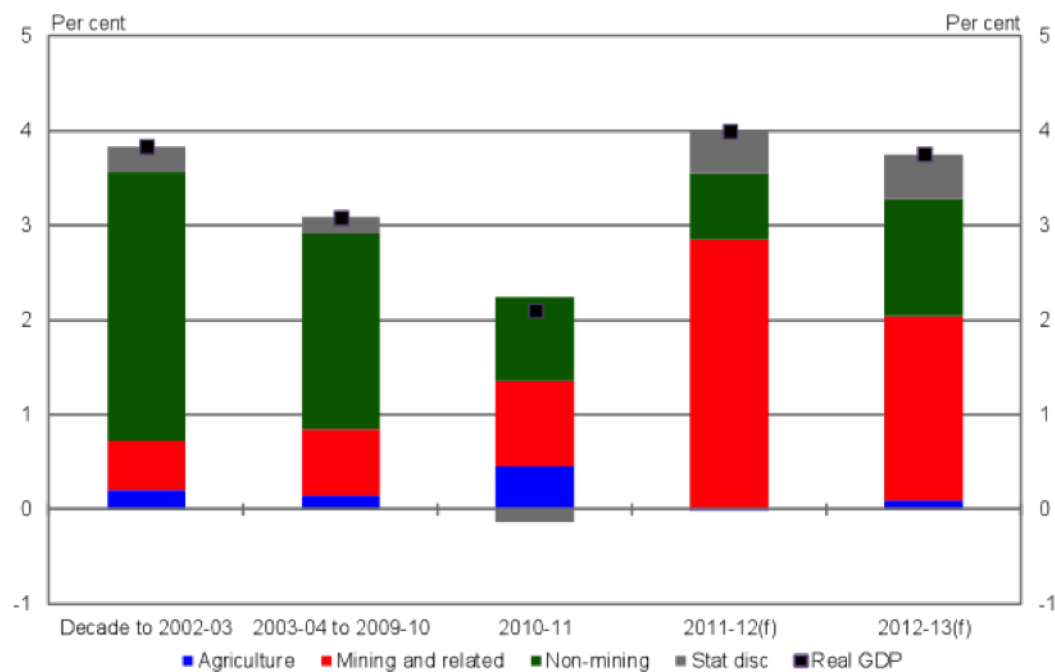
Figures 2.3 and 2.4 show how the gap between the tradable and non-tradable sector growth is increasingly the same as the gap between mining and mining related production, and the rest of the Australian economy.

Figure 1.3 - Sectoral Shares of the Australian Economy



SOURCE: Commonwealth Treasury

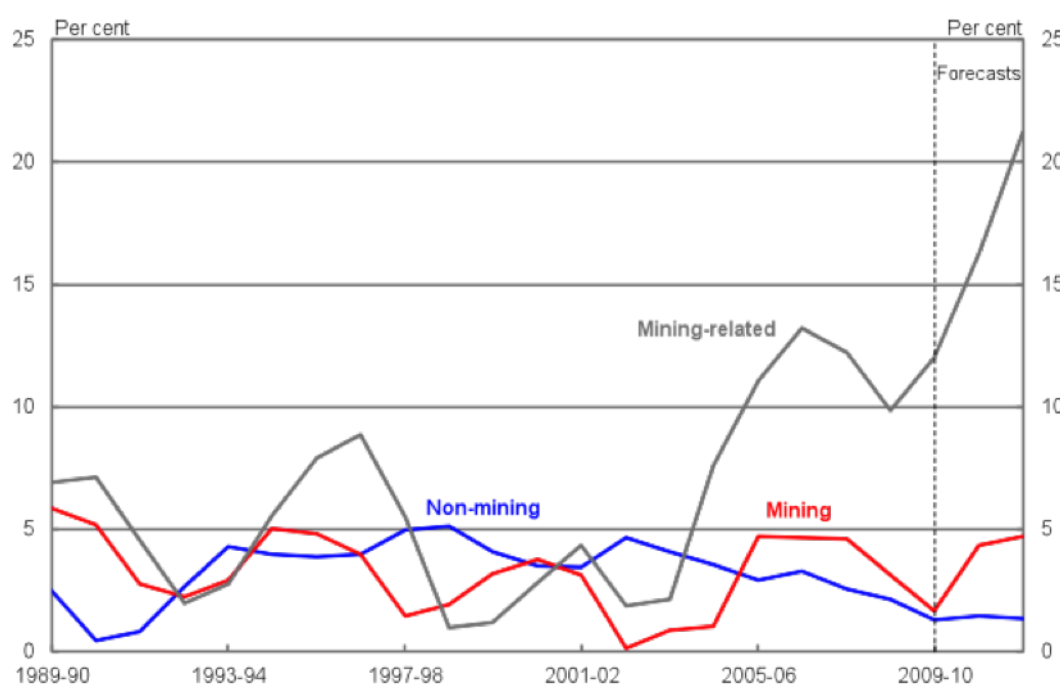
Figure 1.4 - Sectoral Contribution to Australian GDP Growth - Percentage



SOURCE: Commonwealth Treasury

Treasury expects this gap to continue. It forecasts 5% annual growth in mining output and 20% annual growth in mining related output in the three years from 2010-2011 to 2012-2013, but only 1% growth for the rest of the Australian economy (Gruen, 2011).

Figure 1.5 - Sectoral Growth Rates - Mining/Mining Related & Non-Mining



SOURCE: Commonwealth Treasury

This forecast means the non-mining portion of the Australian economy - 70% of the total economy - will grow by an anaemic 1%. Barring unforeseen events, Treasury expects the current three-speed economy phenomenon to be an enduring feature of the Australian economy.

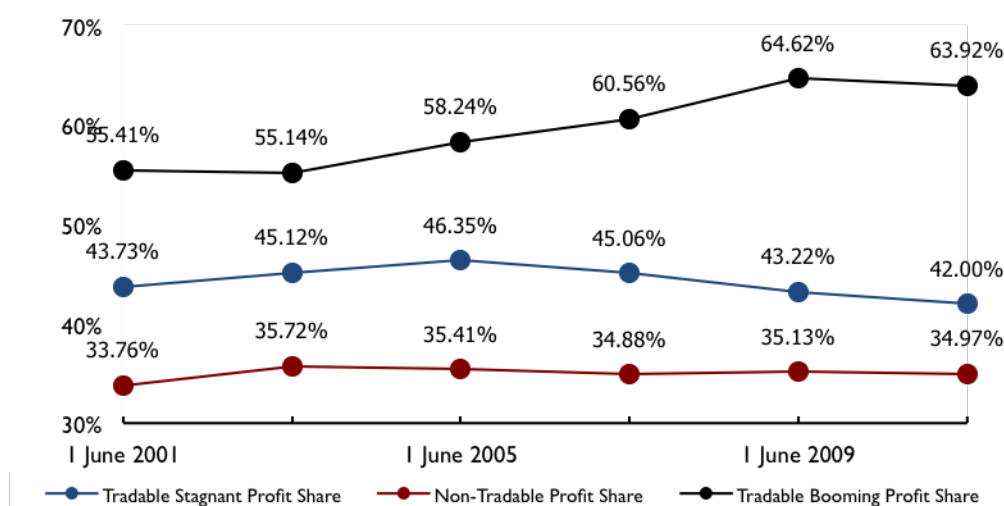
#### The Australian Mining Industry & The Non-Tradable Sector

The relationship between the Australian mining and transport industries is illustrative of how a successful tradable industry has affected the Non-Tradable Sector. Mining is, overwhelmingly, an export industry: China, Japan, South Korea and the United States are Australian mining's key export markets. To meet international demand, Australian miners must closely coordinate their mining operations with their transport operations. Currently, massive investment programmes in ports and railways are planned in Gladstone, Port Headland and Darwin - three cities proximate to major mining locations. Companies like Linfox, Toll and QR National are reallocating capital to meet growing demand for road transport services in major mining regions. They expect the growth in the mining industry to have a major effect on their business plans.

## Section II: Dividing the Spoils

The three-sector economy structure advantages some actors over others: 1) generally, capital is better off than labour; 2) managers and professionals are the most privileged occupational group; and increasingly 3), risk is passing to the Non-Tradable Sector. The first trend - the relative privilege of capital over labour - is visible in data on profit share by sector. Figure 2.6 shows fluctuations in profit share starting from 2001 (ABS, 2001-2012a).

Figure 2.1 Profit Share By Tradability (2001-2010)

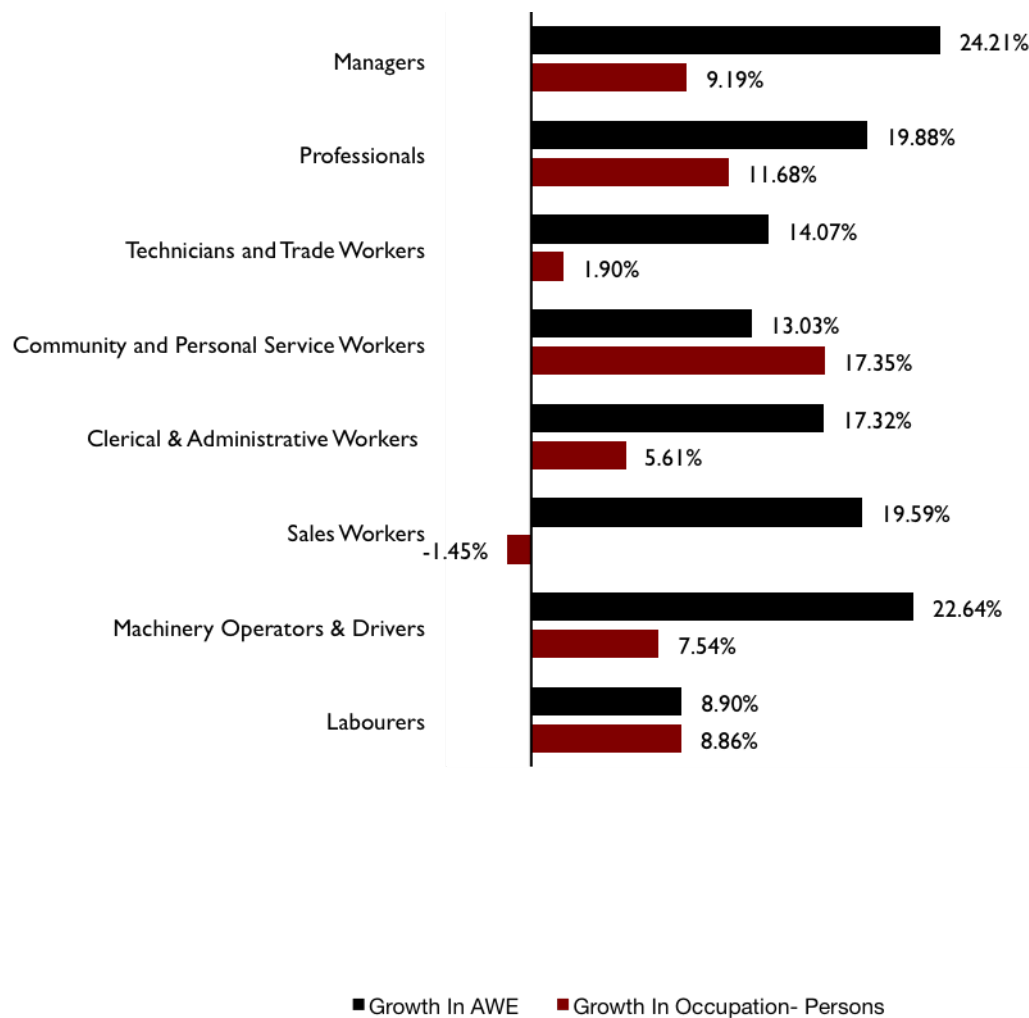


SOURCE: Per Capita Analysis

In the Booming Tradable Sector, profit share has risen dramatically while in the Lagging Tradable Sector, capital's fortune has been reversed. The Non-Tradable sector's trifecta of higher employment growth, positive wage growth but slower GDP growth has been financed from its much lower profit share.

The second trend, the enrichment of managers and professionals, is visible by comparing the rate of wage growth by occupation compared to the level of employment growth by occupation. Figure 2.8 shows that more wealth is concentrating in the smallest occupational class, the managerial class, and its income is rising faster than before, and faster than other occupational groups (ABS, 2006-2012b).

Figure 2. 2 Growth In AWE vs Growth In Occupation- 2006-2012



SOURCE: Per Capita Analysis

Between 2006 and 2010, manager earnings grew 0.39% faster per annum than between 2000 and 2004, and aggregate managerial income rose by 19.49%. In aggregate, this is 4% faster than the earnings growth of the other occupational groups.



### The Nurse & the Mining Executive

If you compare how a nurse is paid with how an advertising executive is paid, the differences between the Tradable and Non-Tradable Sectors become stark. A public hospital nurse is classified as 'community and personal service worker'; they are employed in the 'health care and social assistance' sector of the economy, a non-tradable industry. A mining executive is a 'manager in the mining industry', a sector which is tradable. The nurse is employed in the fastest growing industry by employment growth; the mining executive works in fastest growing industry by GDP growth. Currently, there is a shortage of both nurses and mining executives.

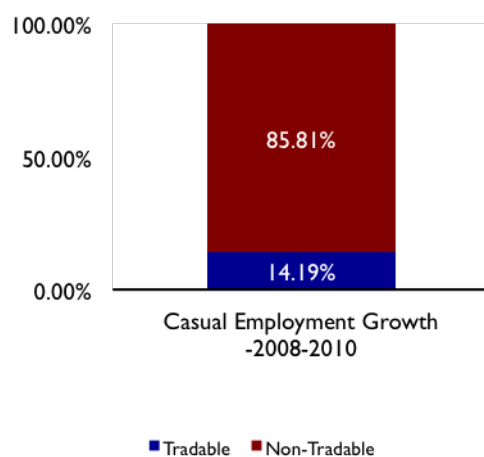
The nurse is unlikely to negotiate their remuneration directly with their employer, they are probably award dependent. This means that any pay increase will result from the decision of an industrial tribunal. That tribunal will take into consideration the employer's ability to pay before granting a pay increase. The nurse's ultimate employer, even in the private sector, is the state, meaning the nurse's pay increase depends on the Government's revenue base. Assuming the state's fiscal strategy can sustain pay increases, it is common for remuneration to be set triennially, meaning, for good or ill, nurse's remuneration is not necessarily correlated with the economic cycle.

The mining executive is different: they are likely to negotiate their pay directly with their employer, concluding a common law individual contract. Their employer's income is market derived, meaning the mining executive's remuneration will probably depend on forecast market conditions. In times of plenty, the mining executive can use their market power to extract higher pay by varying their contract; but during downturns their pay can be cut easier than an award dependent worker.

This difference highlights the benefit of being employed directly in the booming sector (the mining executive) as opposed to being indirectly reliant upon it (the nurse.)

The final trend, the transfer of economic risk to the Non-Tradable Sector, is visible by examining the changing levels of casual employment by tradability. Casual employment is a useful proxy for economic risk because companies prone to sudden fluctuations in demand try to disperse that risk away over as many actors as possible, including their labour forces. Shedding labour - a typical response to an economic downturn - is easier with a casual employment contract than a permanent employment contract; hence its appeal to industries prone to sudden economic downturns. Figure 2.8 reveals that the Non-Tradable Sector experienced an astonishing 85.81% share of casual employment growth between 2008 and 2010 (ABS, 2008-2012).

Figure 2.3 Share of Casual Employment Growth By Tradability - 2008-2010



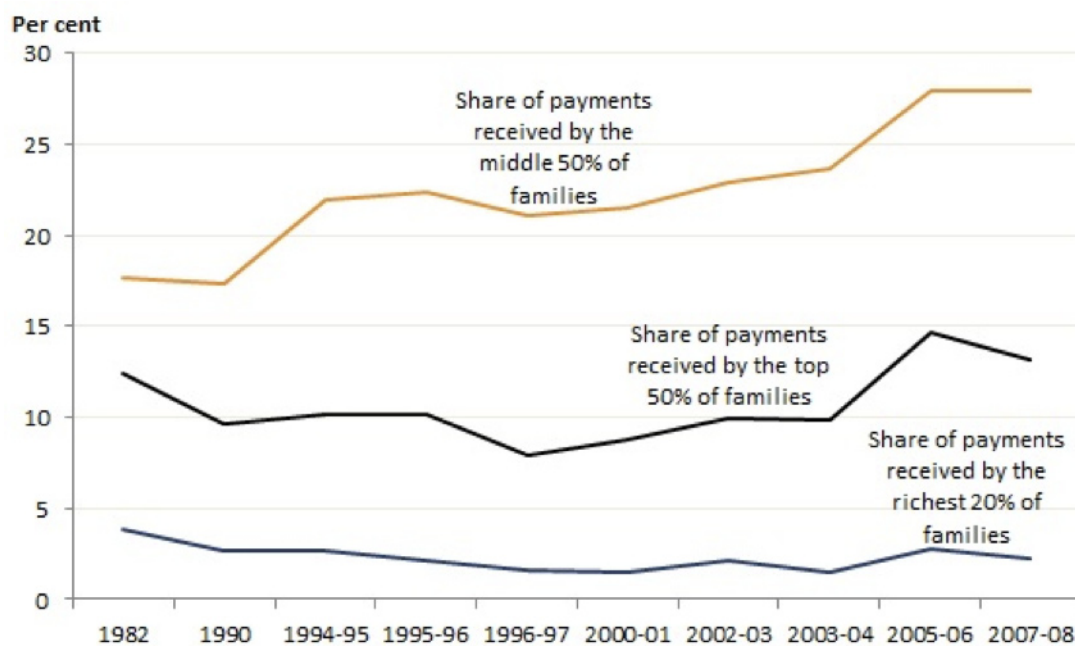
SOURCE: Per Capita Analysis

### ***Compensating The Losers - The Rise of the 'Entitlement Mentality'***

The sharing of spoils across Australia's three economies results in an overarching social condition: more wealth is accruing to less people. Governments have responded by offering more compensation to the middle class. This was Australia's experience in the 2000s - an era that saw the rise of a tax-and-transfer mentality that freed markets from responsibility for social mobility. Instead social mobility relied on the Federal Government using its share of the terms-of-trade boom to subsidise rising living standards amongst those who did not directly benefit from the Booming Tradable Sector.

From 2001 onwards, the Federal Government ended fuel indexation, created the 'Family Benefits' payment system, paid a 'Baby Bonus', a 'First Home Owner's Grant' and a private health care rebate, while massively increasing grants to private schools. These policies targeted the middle classes, a social strata overwhelmingly employed in the Non-Tradable Sector, who are mostly excluded from the capital owning/managerial class, and are caught in the squeeze between the tradable and non-tradable sectors (Cowgill, 2012).

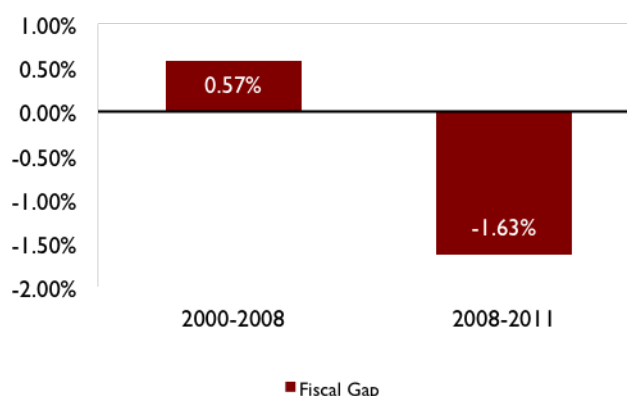
SOURCE: Per Capita Analysis



SOURCE:Whitford, Redmond & Adamson, 2011

The weakness of the entitlement model is that it depends on the continued expansion of the Commonwealth's revenue base. Put simply, if growth in tax receipts is less than growth in outlays, the gap results in a deficit which eventually precludes the Federal Government from offering more subsidies. This was Australia's experience after the Global Financial Crisis (GFC). Figure 2.10 shows Australia's 'Fiscal Gap' - the difference between the rate of growth in government revenue and the rate of growth in government expenditure, before and after the GFC (Treasury, 2000-2011).

Figure 2.4: Australian Fiscal Gap (2000-2011)



SOURCE: Per Capita Analysis

In the 2000s, the consumption boom, the boom in financial services and the mining boom meant that in the eight fiscal years leading into the Global Financial Crisis, the Federal Government could inaugurate all the new spending programmes described above and still significantly cut personal taxes, because average annual growth in the revenue base exceeded average annual growth in expenditures by 0.57%. After the GFC sapped household consumption and tax receipts from the finance industry, growth in expenditure exceeded growth in revenue by 1.63% p.a., resulting in budget deficits.

Treasurer Wayne Swan has recently pointed out that even with economic recovery after the GFC, the shift to investment-centric economic growth, particularly in the mining industry, means the revenue base is unlikely to return to pre GFC growth rates (Swan, 2012). Treasury forecasts imply a 0.94% fiscal gap over the budget estimates, assuming all promised expenditure reforms are implemented. This means that, absent the political tolerance of a structural budget deficit - unlikely given both Parties strenuously oppose them - the entitlement model of the 2000s is obsolete. The Federal Government can no longer expand middle class subsidies to compensate for the gap in living standards between the Tradable and Non-Tradable sectors.

For middle class living standards to rise, the main structural weakness of Australia's three economies - wealth accruing in the Booming Tradable Sector, but employment residing overwhelmingly in the Lagging Tradable and Non-Tradable Sector - requires redress. In future, markets, not governments, must deliver more wealth to more people. This means a reform model is needed that converts the economic growth of the Booming Tradable sector into higher overall living standards.

## Section III: The 'Consensus' Reform Model

The reform model most likely to succeed in rebalancing our economy is one akin to the model which created Australia's 'three-economy' structure - the 'consensus' reform model of the 1980s and 1990s. This model replaced the economic insularity of the 'Australian Settlement' (Kelly, 1994) with a growth strategy centred on the symbiotic relationship between the Tradable and Non-Tradable Sectors: productivity increases in the Non-Tradable Sector boosted the international competitiveness of the Tradable Sector. In turn, the Tradable Sector funded the Non-Tradable Sector's growth.

Both sectors benefited from a virtuous cycle of productivity reforms which led to economic restructuring, to greater international competitiveness, and to more economic activity, allowing for reform's victims to be reabsorbed into the economy, preventing the emergence of a underclass that undermined the consensus favouring global market integration. Today, a similar architecture is needed that rebalances the relationship between Australia's different economies by appealing to their symbiosis, the fact that for each to expand, they need the other to be productive. Even for the Lagging Tradable Sector, an improvement in the productivity of the Non-Tradable Sector will slow the decline and allow some businesses to remain operating where they otherwise would have failed. This mutual reliance is the point of coincidence between the interests of actors in all three economies; it is the means to mobilise them to support long-term reform.

The reform era stemmed directly from the palpable sense of economic failure that stalked Australia from the OPEC Oil Shock of 1973 until the recession of 1982. Then a 'boom and bust' cycle reigned that saw the economy rapidly veer from expansion to contraction following the release of inflationary pressures. Without a floating dollar or enterprise bargaining, inflation quickly dispersed throughout the national economy, leading to recession. Repeated booms and busts induced a reform consensus inside the Australian political order. Notwithstanding significant internal opposition that made reform hard, farmer organisations, trade unions, economic agencies, State Governments, the media, business organisations and academics agreed on the importance of addressing the poorly designed structure of the Australian economy - namely its insularity from international markets. This meant Governments could implement reforms free from the fear of general opposition, even though individual actors opposed individual reforms. Over time, every actor lost a benefit important to them. In exchange every actor benefitted from greater international competitiveness: labour received the 'social wage' and real wage growth; capital enjoyed a higher profit share; savers benefitted from lower inflation; borrowers benefited from greater access to finance; farmers benefited from more international markets, and State Governments benefited from their own autonomous revenue stream, the GST (Kelly, 1994).

Widely dispersed gains made the reform consensus enduring. Over twenty years, the Australian dollar was floated, tariff protection was removed, enterprise bargaining was introduced, the Capital Gains Tax, the Fringe Benefits Tax, the Petroleum Rent Resource Tax, and the Goods and Services Tax were all legislated, competition policy was agreed and the Reserve Bank was given its independence. All these reforms faced significant opposition from some powerful actors, but no actor succeeded in breaking the strategy that underpinned them all: that productivity increases would lead to greater competitiveness in international markets; international markets would then enable Australia's long term growth.



The reform era ended when the Australian political order fell prey to our own 'resource curse' - the phenomenon that sees nations flushed with resource wealth descend into social conflict as different actors manoeuvre for a share of the spoils (Stiglitz, 2005). During the terms of trade boom powerful actors have been engaged in a circular series of contests over the spoils of growth. Labour has resented capital's higher profit share, fighting torrid battles over industrial relations; the manufacturing sector laments its relegation to second class status, angry about the high Australian dollar; the Federal Government is envious of the mining sector's 'super profits', skirmishing over mining taxation; and all parties have fought over the economic risk, especially in complicated debates like the one over carbon pricing. Consensus, shared sacrifice and shared benefit - the key principles of the reform model - have been replaced by the entitlement mentality that rejects the notion of a shared fate. Instead, the zeitgeist is for each actor to claim that Australia's interest is indivisible from their own, thus harming them is the same as harming Australia. In recent times, the mining, manufacturing, gaming, tobacco and liquor industries have all made this claim, campaigning against reforms that are presented as being for the collective interest. If this culture continues, self interest will dominate public debate - making the task of rebalancing the relationship between Australia's two economies politically fraught (Megalogenis, 2012).

## Section IV: Rebalancing By Returning To Consensus

The difficulty in returning to consensus is contextual. Unlike the first reform era, there is no immediate sense of economic failure that pressures enough actors into supporting reform. Some game theory offers a useful perspective here. In the absence of a widely felt dissatisfaction with the status quo, supporting long-term reform requires an actor to unilaterally risk their immediate interests for a potential benefit that might not be proportionate to their original sacrifice. Calculating, rational actors will not make that decision, especially when competitors are eschewing any responsibility to the collective interest, instead acting out of self-interest. This means the first requirement of a renewed consensus model is an external environment that makes support for the status quo the riskiest option for enough actors. Already some actors are showing signs of exhaustion from the perpetual conflict and uncertainty associated with our economic imbalance. Governments should encourage this trend, offering clarity of intent to actors prepared to work together in pursuit of their collective interest. In the contested environment that currently reigns, clarity is at a premium.

Governments also need to encourage the shared taking of risk. No reform can have guaranteed certainty; all reforms have unintended consequences. In a contested environment, unintended consequences that adversely affect a series of economic actors can be used to scupper a reform consensus. Parties need to have confidence that the risk associated with reform will be equally shared. Practically this means each party needs confidence that other actors are participating in the reform project, and that those actors are equally as reliant on reform's success, that all actors are making sacrifice for reform, that no party is being asked to make sacrifices disproportionate to their power, and all actors are receiving benefits commensurate with their contribution. These are the 'shared risk, shared sacrifice, shared benefit' principles that underpinned the first reform era. They are vital for starting a second reform era because they endow actors with confidence that a clear framework is in place to manage the tensions that always arise in mediating competing interests. Take away this confidence and actors will distrust the collective decision making apparatus, refusing to transfer any of their individual prerogatives and power to the reforming centre.



## 'The New Commons

Reconstructing the relationship between the tradable and non-tradable economies requires addressing the economic systems that epitomise their symbiosis: the systems they both rely upon for their productivity and growth. This is the 21st Century equivalent of 'the commons' - resources that are owned in common, or shared amongst communities. Modernising the commons is an ideal project for breaking the conflict culture and returning to consensus because all sectors rely on these systems for their long-term expansion. The following three suggestions extend the 'shared risk, shared sacrifice, shared benefit' principles to the task of modernising the commons. Modernising the spaces that foster cross-pollination and exchange between the disparate economies renews the ties between them. Over time, the mutual benefit and trust that results encourages both sectors to recognise their mutual dependence and joint fate.

### 1. Embrace The People

The resource that powers competitive advantage in advanced economies is people. Skilled people add value regardless of economic sector. Hence both the tradable and non-tradable sector have an interest in maintaining a high supply of skilled people, and then ensuring their workforce participation over their working lives. This is their point of shared interest - the social systems that train people and ensure workforce participation: the higher education system and - increasingly - the childcare/social support systems. An agenda could be designed that mobilises both sectors to support the expansion of schemes like HECS-Help and PELS, TAFE and vocational training, as well as the childcare system, crucial for encouraging female workforce participation.

### 2. Embrace Innovation

Maintaining competitive advantage is typically a function of developing new ideas or variations that extend an existing body of knowledge. Such innovations can transform an industry, regardless of economic sector. Hence both the tradable and non-tradable sector share an interest in the public and private sector innovation systems. An agenda could be designed that mobilises more public and private investment and collaboration with public sector research institutes, especially universities. Equally, schemes that foster private sector innovation, like the research and development tax credit, could also be expanded.

### 3. Embrace Investment

Certain systems - road networks, energy markets, communication facilities, public transport systems - remain sources of competitive advantage, regardless of sector. This is the third system that reflects a shared interest between the tradable and non-tradable sectors, renewing the infrastructure that sustains both sectors. An agenda could be designed to lift collective investment in the expansion of these systems. Public levies, greater private sector investment in energy and transport markets - these initiatives could be expanded to accelerate the modernisation of these infrastructure systems.



## Conclusion

Popular frustration with Australia's economic cleavages is rising, as is popular frustration with the self-interest that currently dominates Australian economic debate. These are related events, reflecting anger with the status quo and anger with the Australian political order for failing to act in the common interest. Rather than treating each event separately from the other, it has been argued that the solution to both lies in recognising their point of coincidence: that they stem from a refusal to acknowledge a 'shared fate,' the idea that one sector's and one actor's destiny is inextricably tied to another's, and therefore improving one's own position means cooperation, not conflict.

It should be recognised that consensus will not free Australia from all political conflict. Rather, consensus provides a framework for resolution centred on the public interest - namely, the need for a mutual benefit. This becomes the role of the state: enforcing the public's interest over the self interest of whichever actor is perverting public discourse. Constant enforcement of the 'shared risk, shared sacrifice, shared benefit' principles creates reform momentum, and, over time, those reforms encourage equality between all sectors and a greater measure of equality for their participants.

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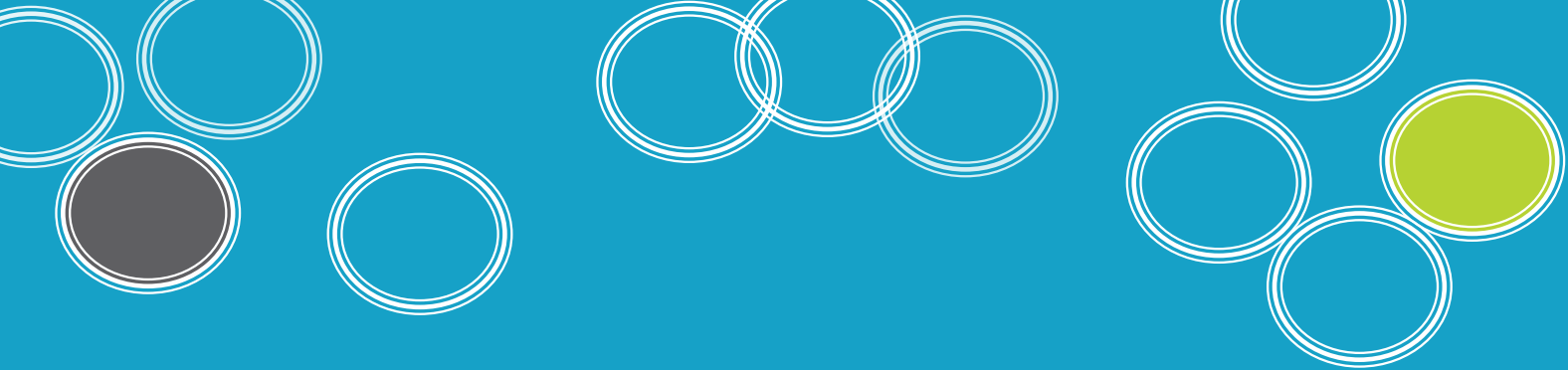
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