Select Committee on Cost of Living

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A. The cost-of-living pressures facing Australians

Following the initial COVID-19 pandemic of 2020-2022, the global economy faced supply-side shocks as global value chains were disrupted, particularly in electronic component exports. Border closures also reduced immigration rates, and the Ukraine war led to an energy crisis. Finally, Australia also faced punitive tariffs from China, which affected some sectors.

These events pushed up costs and reduced real incomes and profits, that are perceived by consumers and firms as "increased costs of living", "input costs increases", and "labour shortages".

The cost increases have an impact similar to a decline in productivity. In the long run, energy price shocks induce substitution to alternative sources and more efficient technology, but in the short run, the increase in costs cannot be avoided. This means that producers will be able to supply less so that output and incomes contract and final goods and services prices increase. There is no way to restore real incomes except through: (i) a reversal of these events, such as the end of the pandemic, the opening of borders, and the end of the Ukraine-Russia war, or; (ii) productivity growth.

The cost-of-living pressures vary across the Australian population with many vulnerable groups. Some such groups are the subjects individual submissions from members of UWA Business School.

B. The Government's fiscal policy response to the cost of living

Context to the Current Macroeconomic Situation

Governments responded to the pandemic with programs to support incomes during lockdowns. Globally central banks also increased liquidity.

This fiscal stimulus and monetary expansion followed a decade of monetary expansion in the face of declining interest rates.

This occurred in a setting where there were no expectations of inflation and households were willing to hold cash. Following the Ukraine war and Covid supply shocks however, expectations quickly changed.

With the change in expectations the RBA and global monetary expansion put Australia in a similar position as had occurred the early 1970s when a substantial increase in the money supply, following the oil and food price shocks in 1973/74, also resulted in inflation.

Nevertheless, the environment was ripe for inflation to occur if something occurred to induce a change in expectations. As in the 1970s and 1980, it is likely that monetary expansions have to be paid back in terms of recessionary contractions at a later stage. The supply side shocks can thus be thought of as the sparks that lit the dry tinder.

The Impact of Vaccinations That Mitigated Cost of the Pandemic

With hindsight the massive monetary expansion over the past decade could be seen as a mistake in monetary policy. At some stage, the likely result in inflation.

But this occurred in a situation where the RBA was consistently below its inflationary target. It is difficult to know how the economy would have fared through the pandemic without monetary expansion. There was also much mainstream commentary suggesting that inflation was very low risk.

The COVID-19 fiscal and monetary responses were thus risk management strategies and arguably appropriate. In the end, however, vaccinations proved successful, which meant that the global economy was able to quickly bounce back and avoid the likely deep recession that would have occurred due to either extended lockdowns or a much worse health crisis.

Hence the return of inflation is due to:

- The worst recessionary fears were not realized due to vaccinations which dramatically reduced the cost of COVID management.
- As such households were able to make significant savings during the pandemic. For example, demand for luxury goods rose as the availability of tourism fell.
- Initial expectations of only temporary inflation became embedded once energy prices increased and the war became a quagmire.

These expectations of inflation feed into wage contracts. In our view, this ensures inflation will persist until such time as there is some shock to reverse these expectations. For example, in the 1980s and 1970s, inflationary expectations were only reset with severe economic downturns manufactured by governments through tight monetary policy. Increased interest rates eventually induced recessions and increased unemployment that then reset firm employee expectations about wage contracts.

While we may hope that expectations can be more gradually eased this time, there is no clear mechanism for doing so. There is no agreed policy prescription for avoiding the hard crashes experienced in the 1980s.

The need for policy coordination

Contractionary monetary policy (higher interest rates) can be effective in decreasing demand from the private sector, which includes households and businesses. However, government spending and taxation also affects aggregate demand. To align inflationary expectations in the right direction, it is important for the government to curtail excess government spending.

Government spending, particularly deficit-funded spending, will generally increase income and inflationary expectations. Thus, increasing spending to avoid a recession will work in opposition to attempts by the RBA to reduce inflationary expectations by raising interest rates. In other words, the lower is government spending, the less likely are future interest rate increases. The RBA can use monetary policy to bring inflation back to normal by stifling demand, but not without severely hurting mortgage holders and borrowers and ultimately recessionary risks through increased borrowing costs and too little liquidity.

Further, the increasing debt-GDP ratio that results from an expansive fiscal policy will lead to an increasing structural deficit because of an increasing interest burden and a higher risk premium on interests. With the combined aging world population and increasing global government debt, the world interest rates are deemed to increase significantly in the future and put extra pressure on government finances.

Over-reliance on increasing cash rates to tackle inflation also goes directly against the RBA's own mandate of maintaining price stability and full employment. Increasing cash rates beyond a certain threshold may lead to a discontinuous drop in employment and output as cashflow issues in households and businesses cascade into a sector-wide crisis.

It is, therefore, important to look at fiscal policy restraint to maintain price stability in Australia.

C. Ways to ease the cost-of-living pressures through the tax and transfer system

Cost pressures will remain despite the easing of the pandemic

The supply-side shocks experienced during the pandemic are likely to be temporary because supply chains are being restored. However:

- There is increased geopolitical uncertainty following China's threats to Taiwan and the Ukraine war, and Australian initiatives such as AUKUS and the QUAD
- The Trump-era has accelerated the rise of nationalist protection that is likely to see increased trade costs with "non-friendly" countries.
- Increased energy costs are likely to persist in the future, especially as governments push an energy transition and tax fossil fuels, and there is no end in sight to conflict in Ukraine
- Health concerns and a new need for national capabilities to supply strategic goods, such as PPE equipment, pharmaceuticals, and essential foods, are likely to also increase costs in these areas

Because of these factors, it is expected that some supply-side pressure will remain on costs even as the pandemic eases and supply chains are restored. Specifically

- Governments cannot reverse the rise in costs through fiscal policy.
- Real incomes will decline, and a key question is who will bear the burden of this decline – i.e., which sectors and which types of households.
- Government policy, therefore, needs to focus on managing inflation and its effects on income distribution.
- Government spending needs to be targeted toward only those most in need
- Government spending also needs to be prioritized toward increasing productivity growth.

Government spending thus needs to be targeted and avoid middle-class welfare. Productivity growth can be achieved through tax reform and ensuring innovation is not stifled through excessive market regulation and policies to support human capital (including taxation).

A Global inflationary environment will limit options to reduce inflation

It is also likely that the US will allow inflation to persist thereby reducing its real overseas debt burden. In this case, Australia will face a rising exchange rate and pressure to ease off on interest rate increases.

In a global inflationary environment Australia may import inflation. Equivalently Australia may face pressure align interest rates with global rates to prevent an exchange rate appreciation.

In such a global inflationary environment, an aggressive fiscal contraction to try and prevent inflation, may also be counter-productive.

D. Measures to ease the cost of living through the provision of Government services

While costs of living have increased it is important to note that oil prices today (February 2023) in real terms are lower than in the 1970s and the 1980. Consumers have enjoyed large income gains from lower real prices of imports over the past few decades and have also faced the lowest interest rates ever seen in history.

Moreover, the inflation we have today has been the norm since the Gold Standard was abandoned in 1913. Rather it is the low inflation environment over the past two decades that are abnormal.

Thus, there is a real sense that the current inflationary environment is not historically abnormal, and the low interest rates of recent decades are unusual. Potential explanations for these historical anomalies are: the emergence of China as a global manufacturing hub; the long phase of post-war globalisation, and falling trade costs.

Rising inequality and geopolitical issues, however, suggest a pessimistic outlook for a return to price stability. Geopolitical uncertainty is increasing, especially in our region, and there has been a strong retreat from globalisation due to rising inequality, a retreat from globalisation, and populist political backlash.

This context suggests some caution is warranted in how price stability is managed Specifically

- In a global inflationary environment, the government needs to manage inflation rather than fight it. This means ensuring that those on government fixed incomes have appropriate wage/welfare indexation, e.g., pensioners and students.
- The government can support income through tax breaks if real efficiencies can be found within government services. This will be anti-inflationary and increase real incomes.
- The government needs to focus on enablers of long term productivity growth such as infrastructure and education, to ensure such contractionary budgets do not stifle prospects for ongoing productivity growth.

E. Any other related matter.

Looking forward, the government should consider reducing income taxes to give higher work incentives and, to finance the income shortfall, increase GST and exercise taxes on petrol. In other words, it is consumption that needs to be taxed, not income. Compensating transfers to low-income earners could be implemented.

To meet a potential need for rising transfer payments, the government could also consider adjustments in applicable tax rates and different tax types in mining and petroleum sectors. Resources taxes are typically less distortionary than other taxes in the government's toolbox.

Given the high profitability of the mining and petroleum sectors in Australia, resources taxes are also justifiable for transfer and redistribution purpose. Such taxes however should not be retrospective and should avoid any creation of sovereign risk.

In the long run, it is productivity that determines the income level and the production costs. The current fiscal status allows Australian government to offer more generous R&D tax credit to a wider range of companies for high power incentives to their R&D investments. The R&D tax credit can be simplified so that it is more accessible to small and medium-sized enterprises.

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