

“Active social investment and equality of opportunity” – Address by Fred Argy to the Fabian Society, ACT Branch, June 13 2006

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It is often said that the Left no longer has a distinctive, well-defined set of political values or big new policy ideas to offer and that it is rapidly becoming the conservative side of politics.

I understand this sentiment but I think social democrats worry too much. It is true that on issues like free trade, industry assistance, competition policies and public ownership, the gap between Left and Right has narrowed considerably. This is nothing to commiserate about. Hawke and Keating realised long ago that economic liberalism can be a force for social good - provided it is driven by efficiency concerns rather than small government ideology and matched by appropriate social policies.

Throwing out protectionism has not robbed the Left of identity. The distinctive hallmark of social democracy has always been its concern to ensure that the fruits of productivity growth are widely spread. This belief in a fair distribution (of both material wealth and quality of life) remains its main *raison d'être*. But if social democrats want to win elections, this egalitarian goal now needs to be redefined and redirected.

Rising affluence with stable distribution

Australia has enjoyed some 15 years of strong and sustained productivity growth, buoyant export prices, rising real wages and expanding job opportunities. And the good times seem set to continue, apart from an occasional glitch.

While the gains in gross earnings have been skewed towards the top end, our progressive tax and social security system has done an excellent job of redistributing market incomes to the poorest 20% of households. As a result, and helped along by falling unemployment, the distribution of net disposable incomes has remained remarkably stable. And low-income families are appreciably better off than they were 15 years ago.

Backlash against passive welfare

This relatively benign economic and social climate, and our growing exposure to global competition from low-wage countries, has led to a hardening of community attitudes to certain kinds of welfare and an increasing tendency for mainstream Australia to blame the jobless and under-employed for their plight. Some economists have added their voice

against passive redistribution by warning that it encourages a culture of welfare dependence.

In my 2003 book¹, I rejected such generalized attacks on our social security system. I hope social democrats continue to fight hard for decent welfare benefits: in my view, Newstart Allowance has slipped too far relative to community standards. And I hope they continue to defend our progressive tax system, which is steadily eroding.

But we all know that passive redistribution has one big limitation: it does nothing per se to develop human capabilities. In particular it does nothing to correct the underlying *structural* inequalities of education, health, employment, housing and location - or the distortions these create in the distribution of market incomes from work.

My new discussion paper for the Australia Institute² analyses these structural inequalities and distortions and questions the widely held view of hard line liberals that in a fully open and competitive economy, the distribution of market income (before taxes and transfers) is predominantly merit-based. I contend that it is in good part a product of unequal opportunities.

Social mobility in Australia

How does one gauge the extent of equality of opportunity in a society? The usual way is through longitudinal studies - following the same group of individuals over a long period of time and observing the ease or difficulty with which they move up the social hierarchy. What these studies seek to assess is the degree of “income mobility” and how it differs between social groups.

Most longitudinal studies in Australia like HILDA have only a short history. But, taken with other recent academic work, and in particular that of Andrew Leigh, we can confidently say that Australia is a fairly mobile society (i.e. it has less inequality of opportunity) - at least relative to “older” countries like the US, UK and Germany.

What of the the outlook for income mobility in Australia? To answer this question my paper draws on two pieces of evidence – first the international literature; and secondly, the changes in social and human capital occurring in Australia, such as in health and education, which have a bearing on future movements in income mobility.

The international experience: what does it tell us?

International studies are a useful guide for Australia because they help us understand the factors driving income mobility - and why some countries perform better than others on this criterion. These studies confirm that freeing up markets generally enhances income

¹ “Where to from here? Australian egalitarianism under threat,” Allen and Unwin Sydney 2003

² “Equality of Opportunity in Australia: myth and reality”, Discussion Paper no. 85, The Australia Institute April 2006

mobility but that *this alone does not produce the best results*. The other, even more important, ingredient is high levels of what is often called “active social intervention”.

“Active” social intervention differs in three ways from “passive” redistribution (unconditional cash transfers). First, the active variety makes cash social security benefits to able-bodied persons more work-conditional – using a mix of incentives and penalties. Secondly, active social intervention includes a sufficient core of social regulation to ensure that vulnerable workers (those without individual bargaining power) have meaningful work choices.

Thirdly, and most importantly, active social intervention is about a strong government commitment to human capital development, targeting in particular those at the lower end of the income spectrum. This is what I call ‘social investment’. It includes government spending – both ‘soft’ and ‘hard’ - on the provision of *benefits-in kind* like parental support, public education, training, job creation and placement, public housing, public transport and health care.

The literature tells us that free markets help create more economic opportunities but without adequate and well targeted social investment, it is mainly those born to rich, well-educated and motivated parents that will be best able to take up the better economic opportunities. The US experience illustrates this well: it has the freest and most productive economy in the world with abundant employment opportunities - but because of its relatively low rates of social investment it does not rate well on social mobility in world rankings. And the countries which rate highest – the Nordic countries and smaller European countries like the Netherlands – put considerable resources into social investment.

Implications of international evidence for future social mobility in Australia

This international analysis sends an important warning signal to Australia. While we have invested heavily in our people in the past, *we now seem to be relying too heavily on economic freedom and welfare penalties to increase labour participation and equalise opportunities. We are not doing enough on three other policy fronts: work incentives, workplace choice for everyone and social investment.*

On the first two it is worth noting that the Howard Government’s recent reforms will give us a workplace and welfare regime that in some respects is even harsher than in the USA, both in terms of how we treat trade unions and how we reward welfare to work.

But it is the third ingredient, social investment, which poses the greatest challenge. And I believe that here, Australia is falling short. Sure, total government outlays on things like health, education, housing and child care have continued to increase strongly over the last decade or so and have become increasingly important influences on families’ final incomes.

However, health accounts for a good part of the increase in benefits in kind, reflecting the ageing of the population and technological changes – and even in health there is evidence of services under pressure. More importantly, the increased government spending on benefits in kind has not been well targeted. Over the last decade, the share going to the poorest 20 per cent has been tending to decline appreciably. This is especially true of health and school education,

If this trend in social investment continues, there is a strong risk - *prima facie* at least - that we will follow the US down the road of diminishing equality of opportunity relative to the leading countries.

The growing barriers to mobility in Australia

Such concerns are reinforced when one looks closely at the specific barriers to upward mobility faced by Australians from low income backgrounds over their lifetimes - and how these are changing.

It is clear that many Australians are impeded by childhood experiences (such as dysfunctional home environments, low parental incomes and aspirations and poor networking). These experiences perpetuate disadvantage in adulthood and are compounded by a range of access barriers to employment, health, education, adult training, low-cost housing and public transport. The barriers, which are outlined in detail in my paper, prevent many Australians from competing on an equal footing in the labour market.

Some of the access barriers are producing widening inequalities of *outcomes* in areas such as education, health and housing. And I fear the new welfare and workplace regime will further compound the problem. It may well help create new jobs for low productivity unskilled workers and, to that extent, facilitate the transfer from welfare to work. But it will also lead to wider earnings differentials and make it more likely that Australia will end up with a US-style population of ‘working poor’ – thus creating a bigger starting hurdle for many. Moreover the tougher welfare regime will reduce job search capability and make it harder to plan careers and undertake training. And, by reducing workers’ control over their working hours and opportunities for family life, it could increase the risk of generational transmission of income poverty. Thus, one or two barriers to income mobility will come down but many more will increase.

Summing up what I have said so far, there are many Australians “stuck in the basement” who are there not through lack of ability, effort or motivation but through lack of opportunity - and life could get even harder for them in the new policy environment. To put it differently, the distribution of market incomes might be merit-based *at a point in time* - but *over people’s lifetimes* it is at least as much a product of unequal opportunities as of relative merit.

New policy directions needed

The lessons for social democrats are clear: refocus the goals from income inequality *per se* to the underlying structural inequalities of opportunity – and from passive welfare methods of redistribution to “active” social investment.

Realistically, inherited wealth and parental skills will always be unequally distributed. And no one wants a nanny society. So we will never achieve perfect equality of opportunity - and trying to achieve it would be too disruptive. But we should be able to get much closer to the optimal than we are. I say this for three reasons. (1) International research indicates that genes account for less than half the observed correlation of adult earnings with parents’ economic status. (2) Some countries achieve better mobility results than Australia and do so by putting more resources into social investment. (3) The sectoral evidence I have put together in my discussion paper shows there are major and often growing barriers to mobility in Australia.

My paper outlines the broad kind of strategy that is needed to address the areas of greatest opportunity deficiency faced by disadvantaged Australians over their life cycle. Its aims should be:

- to break the vicious circle of inter-generational poverty and welfare dependence³;
- improve access to high quality public services⁴ ;
- enhance the job readiness of disadvantaged teenagers and young adults⁵);
- reduce geographic disadvantage⁶;
- minimise work disincentives;
- increase the capacity of the poor to save and borrow⁷;
- ensure workers have better control of their working hours; and
- help overcome the special location and cultural barriers faced by indigenous Australians⁸.

My paper argues that a system of reciprocal obligations (compassionate but hard-nosed) is necessary to make such a program acceptable to middle-class Australian values. Even so, I am too long in the tooth to believe that it will be readily accepted by the electorate. There are at least three major political obstacles. One is public apathy and complacency. A second is public cynicism about governments’ ability to deliver. And a third is concern about the financial and economic cost. Let me deal with each in turn.

Overcoming complacency and apathy

³ Through early intervention to protect vulnerable children e.g. by improving and supplementing parental skills and living conditions, providing better pre- and primary schooling, child and health care services, regular home visits supported by mentors etc. Paid maternity leave could also help.

⁴ Through better public schools, life long learning facilities, better access to information, preventative health care, affordable housing, improved public transport etc.

⁵ Make them better equipped for the demands of the labour market by improving the job-matching process, counselling and training facilities, providing training and selective employer subsidies, creating or encouraging suitable jobs in job-poor areas, including jobs for low-skill ancillary workers in community services, and where the area is not viable offering generous relocation incentives.

⁶ Building up the capacities of local communities through counseling, regional infrastructure, tax incentives and government-community partnerships Regional social infrastructure (in housing, health, recreation, public transport and education) is an often neglected cause of economic malaise such as in Macquarie Fields.

⁷ Through special savings accounts with matching government contributions similar to the co-contribution super but better targeted

⁸ For those attached to the land, local job creation and for those willing to move, generous relocation assistance and affirmative employment action. In both cases, improved access to training, work experience, education and health care are essential.

As a social ideal, equality of opportunity strikes a strong chord with most Australians. It is the essence of what we all mean by a “fair go”.

But a good many of us think that today’s Australia is already a land of opportunity for all - that anyone with a bit of go can move up the social hierarchy, irrespective of their social backgrounds. The community is aware of barriers to income mobility but it is not fired up about it.

This apathy and complacency is a very real political obstacle to social reform. But right-wing think tanks try hard to frighten the politicians even more by exaggerating the public’s hostility to social intervention. For example, the Centre for Independent Studies ran a survey with AC Nielsen in 2003 which asked Australians if they saw a society based on classical liberalism as “fairer” than a society based on egalitarianism. For purposes of that survey, a classical liberal society was defined as one “where people’s incomes depended on how much other people valued the services they provided” – a reasonable definition. But an egalitarian society was defined as one where “nobody gets an income bigger or smaller than anybody else gets”. Since only out-and-out communists would opt for such extreme egalitarianism, it is hardly surprising that most respondents said they preferred the classical liberal option.

If egalitarianism is defined sensibly, you get a very different response in polls. For example, when Australians are asked if present inequalities of incomes are “too high”, the question elicits a resounding ‘yes’.

This suggests to me that Australians generally have a much broader vision of equality of opportunity than the classical liberal one. The classical perspective doesn’t look beyond the labour market starting gate, so to speak. It focuses only on the attributes people bring to the labour market **at any point in time** and the values employers assign to these attributes. But my reading of the polls - admittedly still inconclusive and requiring much more work – is that the social ideal most Australians have in mind is one where people with the same innate capacities have an equal chance to achieve their potential to the full **over their lifetimes**, irrespective of their social backgrounds.

Opinion surveys also reveal a pervasive sense of unease that Australia is becoming a “less fair society” – an unease which is bound to grow if governments continue to embrace American social policy norms.

Surveys also show a widespread willingness “to pay higher taxes to pay for better community and public services”. But I suspect that when Australians say they want more spent on community services, they have in mind more **universal** provision – not just improving access to the disadvantaged through **targeted** social investment initiatives. It will require very strong and committed political leadership to win the public over to the kinds of targeted policies I advocate in my paper. .

Can active social investment deliver the goods?

A second political obstacle for social democrats is that mainstream Australia distrusts governments' ability to deliver social reform. Apart from the usual fear of stuff-ups, they are concerned that social spending encourages so-called 'bludgers' and 'cruisers'. This concern has been deliberately incited by wildly exaggerated claims from "small government" exponents and some politicians about the perverse effects of welfare on human behaviour and the growing culture of welfare dependence.

Anyhow, whatever its merits, this argument is not relevant to social investment. The empirical evidence indicates that such investment has the capacity to greatly improve income mobility and *reduce* welfare dependence in the long term.

The alternative way to increase work participation, adopted by the Howard Government, is through punitive measures like downward wage flexibility, destruction of trade unions and tougher welfare measures. As I said earlier, this is at least as likely to reduce as to increase income mobility. But even if the Howard strategy is successful, there is little doubt that active social investment can achieve equal or better outcomes for income mobility *at much less social cost*.

The economic benefits of active social investment

But won't an expanded program of social investment damage the economy? One could simply shrug such concerns aside: after all, the economy is supposed to serve society, not the other way round. But it is clear that when voters go to the ballot box they have prominently in their minds things like jobs, interest rates and real wage growth. So the economic issues cannot be shirked.

And there is no need to shirk them. Social democrats should be happy to debate the issues with economists on their own favourite stalking ground – level playing fields, cost-effectiveness, productivity and economic growth.

The truth is that increased social investment has the potential to generate considerable economic as well as social rewards because it addresses market failure - helps markets to work better. Let me explain.

Market failure occurs in a situation where markets, left on their own, fail to allocate resources efficiently. In the static world of microeconomics, it arises because of externalities (impact of market transactions on third parties), excessive market power and inadequate or asymmetric information. Even within the narrow confines of such a static model, inequalities of opportunity can be viewed as a form of market failure⁹.

⁹ For example, labour and capital markets are affected by information deficiencies and discrimination and labour markets are also affected by unequal bargaining power as well as unavoidable rigidities in wage adjustments and in labour mobility. Inequalities of opportunity can also have negative external spin-offs. For example, they worsen the tendency for free markets to under-spend on merit goods and create a more unstable social environment and a negative climate for further structural change.

The market failure argument is greatly strengthened when we move away from the confines of a static, ‘snapshot’ model (with fixed variables) and take a more dynamic, long term perspective, which allows for behavioural responses *over people’s lifetimes*. From that dynamic perspective, it is arguable that the many barriers to occupational and income mobility faced by people of low socio-economic background over their lifetimes prevent society from making the best use of all its citizens and lead to a waste of human potential. They lead to sub-optimal economic outcomes.

By correcting market imperfections, social investment has very similar economic effects as other forms of microeconomic reform such as competition policy and labour market deregulation. And the evidence of high economic returns from social investment is no less persuasive.

I have seen credible studies showing national economic returns (in terms of real incomes per head) of between \$2 and \$5 per dollar of government outlay on programs which address early childhood disadvantage, improve work incentives, widen employment opportunities and broaden access to health, education, housing and transport¹⁰.

These economic returns come in the form of a better educated and skilled workforce, greater geographic and occupational mobility of labour, less waste of potentially successful entrepreneurs, higher employment (participation) rates, diminished health costs, lower imprisonment rates and less spending on juvenile delinquency. There are also external economic benefits from increased community trust and harmony and a reduced resistance to future structural reforms.

The economic risks

So far I have focused only on the positive - spending - side of social investment. But critics rightly remind us that social spending of any kind needs to be financed. And higher taxes can alter people’s behaviour in undesirable ways and in particular blunt economic incentives (to work, save, innovate etc).

Mitigating the risks

Governments can minimize such efficiency costs in a number of ways.

One is by ensuring that the tax system does not unnecessarily distort economic choices or economic incentives. This principle is well understood but not always applied in practice.

Another way for governments to minimise the economic risks of increased taxation is to make greater use of income-contingent loans like HECS in lieu of grants and of government borrowing in lieu of recurrent revenue. These are ideal methods of financing

¹⁰ On early education, there are studies by the Washington State Institute for Public Policy and the Rand Corporation. On community services and their effect on health outcomes there is a UK study by Marmot and Wilkinson. See also references in my discussion paper to Byneer, Vimpani and Heckman.

social programs that are expected to yield good societal returns in the longer term. Social investment fills the bill perfectly.

In this context, what is one to make of the latest ALP fiscal policy statement (Labor's Budget Rules)? It outlines a medium-term budget strategy which, in some respects is more stringent than the Coalition's. It promises that a Labor Government will "keep the budget *in surplus* on average over the cycle". I presume it is the cash account that will be in surplus – not just the operating account (and perhaps Tim can throw light on this). If so, this leaves no room for net borrowing for long term infrastructure.

Some State Governments are timidly rethinking their public debt stance but any big initiatives in social investment can only come from the Federal Government. Without it, any brave new words about delivering "quality services" lack credibility. Rigid safeguards against fiscal extravagance are clearly needed but the ALP seems to be throwing out the baby with the bathwater

[And how long is the ALP going to turn the other cheek whenever the utterly false "Beazley black hole" claim is made? And how long is it going to accept an economically irrational policy stance just to avoid the sharp tongue of Peter Costello?]

There is yet another way social democrats can ease the burden on taxpayers – and here the ALP has got it right. It is to resist this mad craze for further and further deregulation of the labour market. I may be at odds here with many of my fellow economists, but I believe it no longer makes *economic* sense - much less social sense - to keep retreating from worker protection and then relying on budgetary measures to ease the pain down the road.

Economists never tire of warning that regulation is a less efficient method of social protection than direct taxes and transfers. And it is true that regulation, apart from being less transparent and less well targeted, has more by-product efficiency costs than direct budget transfers because it interferes more with the price mechanism (shifting the relative prices of various goods and services in ways which are unrelated to the social opportunity cost of producing those goods and services). I have put this argument up myself endless times (starting with the 1981 Campbell Committee report).

But these days it needs substantial qualifications.

To begin with, after the major changes of the past three decades, levels of worker protection regulation in Australia are among the very lowest in the developed world. Starting from such a low base, the potential economic returns (in terms of employer flexibility and efficiency) from further labour market deregulation are much smaller than when Hawke and Keating began to reform the IR system. I believe that by the end of the 1990's, most of the "low hanging fruit" had already been picked.

Secondly, having gone as far as we have down the deregulation route, reductions in worker protection are actually starting to generate efficiency costs by making the playing field between employers and employees much more uneven and increasing the potential severity of the short term economic adjustment costs.

Thirdly, with the ageing of the population, a primary economic policy goal should be to increase workforce participation. But this goal will be impeded if fiscal policy is asked to take an ever-increasing role in social protection to offset the effects of deregulation because it means higher taxes. This does not matter at the higher end of the income spectrum, where tax disincentive effects are small, but the level of taxes and transfers does matter at the lower end where the work disincentive effects can be considerable.

In short, the *economic* advantages of using fiscal measures rather than labour market regulation to advance social goals have now largely disappeared in Australia¹¹.

The economic bottom line

I have put to you that governments can minimize the economic efficiency costs of higher taxation (through tax reform, increased reliance on borrowing and HECS schemes and, up to a point, through IR regulation). But these costs cannot be avoided altogether and need to be weighed against the long term economic benefits of social investment.

So what's the economic bottom line? Theory is no help. We must rely largely on the cross-country empirical evidence.

I have studied the mix of social policies in different countries and found that the social model favoured by the Nordic countries and some of the smaller Europeans (such as the Netherlands and Austria) not only produces the lowest levels of inequality and highest rates of social mobility but also has the most benign effect on economic outcomes.

And the reason is the one I have stressed throughout my talk – that, although the Nordic model redistributes on a large scale, it does so predominantly through work-conditional income support and through social investment. For example, governments in Denmark, Norway, Sweden and the Netherlands spend much more than the English speaking countries on education and health, both universally and specifically for the disadvantaged, and they invest about four times more (relative to GDP) on active labour market programs – job placement, training, employment incentives, integration of the disabled, direct job creation and start-up incentives.

The success of the Nordic model indicates that putting more resources into social investment is the best means of promoting equality of opportunity without economic pain.

¹¹ The Nordic countries got it right: they realised that the kind of worker protection regulation in place in the older European countries was too constraining. So they freed up the labour market up to a point but decided to stop well short of Australia. This half way house has not harmed their economies at all. All this is not to deny that further downward wage flexibility will yield additional employment gains but they will be small and in other areas of worker protection the gains are likely to be even smaller.

Australia could never fully embrace such a 'big government' model, but does it make sense for us to be moving in the opposite direction – towards the American 'small government' model? On my analysis, the net economic returns from additional US-style economic freedom are likely to be small. Yet we risk ending up with a 30/40/30 society - where 30% are extremely prosperous and influential; another 40% are apathetic; and the remaining 30% are angry, frustrated and overwhelmed with a sense of utter helplessness.

I fear Australia has taken the wrong turn.

The lessons for social democrats

Let me end by asking: what does all this argy-bargy mean for social democratic parties in Australia, and in particular for the ALP?

The first lesson is that while social democrats should maintain their rage on many of the recent welfare and workplace reforms, they should make inequalities of opportunity, as well as quality of life, the main target of their social policies – and not just in their rhetoric.

The second lesson is that social investment should be the key pillar of their equal opportunity agenda.

The third is that slowly and gradually the ALP should throw out the financial straightjacket it has encased itself in and look seriously at some of its present fiscal strictures – no tax increases, no net borrowing or HECS-like schemes and no retreat from middle-class welfare.

I accept that all this won't be easy to sell. But it's amazing what patience and political leadership can do. Look at John Howard.

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