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Australian Government
The Treasury

Ministerial Submission

MS23-000531

FOR INFORMATION – Profits, input costs and inflation

TO: Treasurer - The Hon Jim Chalmers MP
CC: Assistant Minister for Competition, Charities and Treasury - The Hon Dr Andrew Leigh MP

KEY POINTS

- The Australia Institute published a paper on 24 February concluding that profits have been the major driver of above-target inflation in Australia since the pandemic.
  - In Treasury's view, the analysis significantly overstated the role of profits in driving inflation. The paper implicitly assumes that the distribution of corporate profits by sector is the same as the distribution of household spending across goods and services.
  - This is not the case, primarily because mining sector revenue accounts for a significantly larger share of business revenue compared to the consumption of commodities within household spending.
- A follow-up paper in April further argued that mining sector profit is not the only factor driving profits in Australia, citing increased profits in wholesale trade, manufacturing and transport.
  - The paper measured gross profits, which reflects both output and inflation and a return on equity and debt for investments.
  - Profit margins more closely relate to inflation and, while increasing in some sectors (Figure 1), there is no systemic evidence of margins or the capital share of income increasing once the mining sector is excluded.
- Neither paper adequately accounted for the role of mining export values in driving higher profits following Russia's invasion of Ukraine or the knock-on effect of global supply shocks that constrained output, raised import prices and created cost increases for firms.
  - RBA analysis found that at least half of the recent increase in inflation is attributable to supply shocks, including commodity price shocks. The current run up in inflation can largely be explained by accounting for a handful of sector-specific cost shocks.
  - It is appropriate to exclude mining, as local consumption of domestic mining production is limited and so the impact on CPI inflation would be much more limited than mining profits would suggest.

        - In recent years, approximately three quarters of Australian mining production was exported. Most of the remainder is further processed prior to export.

- Demand has also interacted with supply constraints and increased opportunities for firms to pass on costs and increase margins in some global markets.
    - The IMF recently outlined four key drivers of high global inflation: overstimulation of demand from fiscal and monetary policy in the initial recovery phase from the pandemic; supply chain bottlenecks; the shift in demand from services to goods; and unprecedented labour market tightness.
    - The passthrough of higher costs occurred more readily in sectors experiencing a temporary mismatch between supply and demand and large cost increases.
    - With a few exceptions, consumer prices do not typically fall, including in instances where input cost inflation is easing but demand remains robust.
- Unlike other advanced economies, an increase in labour supply in Australia meant that wages growth did not contribute to above target inflation.
    - Australia's participation rate is 0.9 percentage points higher than its pre-pandemic level. In contrast, participation remains 0.7 percentage points below pre-pandemic levels in the United States.
    - As supply shocks subside and inflation dynamics normalise, wages growth will again become the main driver of inflation, given that labour costs are, ordinarily, the largest cost for business.
- Attention should be paid to firm pricing behaviour to ensure that inflation moderates appropriately as input cost inflation normalises.
    - Cyclical changes in income shares as markets adjust to supply and demand conditions are not themselves indicative of an increase in monopoly profits.
    - Profits can rise temporarily until demand responds to prices or capacity expands. The forecast economic headwinds will limit profits in most industries.
        - In some industries, such as construction, rising costs and labour shortages have contributed to squeezed profit margins. Construction insolvencies in the 12 months to March are about 25 per cent above their pre-pandemic average.
    - The ACCC can, at the Treasurer's direction, undertake price surveillance in specific markets where competitive pressures may be insufficient to achieve efficient prices.

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ATTACHMENTS

A: Australia Institute analysis
B: Profit share of income
C: Drivers of inflation in Australia
D: Firm profit margins and the role of the ACCC

ATTACHMENT A – AUSTRALIA INSTITUTE ANALYSIS

The Australia Institute recently concluded that excess profits are responsible for 69 per cent of additional inflation above the RBA's target.

- The Australia Institute papers use national accounts data on the distribution of income to labour and capital to assert a causal relationship between profits and inflation.

Parts of the analysis were flawed and Treasury analysis does not support the strength of the conclusions.

- The papers assert a causal relationship between profits and inflation, without an assessment of the reason why profits have changed.
  - Changes in both profits and inflation are typically a consequence of demand and supply imbalances in the economy. Profits themselves are not a cause of domestic inflation, particularly where products are exported.
    - Profits can increase due to higher volumes of sales with no change in prices or inflation.
  - To the extent that firms raise prices when the demand for their products is greater than its supply, the risk of high growth in profits should be temporary.
    - High returns will provide an incentive for firms to enter or lift production which, over time, should increase supply and normalise returns in an industry.
    - Monetary policy is the primary tool used to reduce any excess aggregate demand and stabilise inflation.
  - Cyclical changes in income shares themselves are not indicative of an increase in monopoly profits. Further information is at Attachment D.
- The paper overstates the role of increased mining prices and profits in driving domestic inflation.
  - Higher global commodity prices played a role in pushing up retail energy prices in combination with other extraordinary supply issues in the energy sector.
  - Treasury estimates that energy prices directly contributed ½ of a percentage point to the 7.8 per cent peak in inflation in the December quarter 2022, far less than the Australia Institute attributes to mining profits. See Attachment C.
  - In recent years, Australian fossil fuels have been largely exported. From 2018-19 to 2020-21, 92 to 95 per cent of coal, and 65 to 70 per cent of oil and gas production has been exported.
- The papers do not use an appropriate measure of prices to measure domestic inflation.

- The papers use the GDP deflator (a measure of the price of production) rather than the Consumer Price Index (CPI, a measure of the price of goods and services consumed by households) to attribute drivers of inflation.
  - The CPI is designed to reflect changes in the cost of a representative basket of goods and services purchased by households. The products included are weighted to reflect their relative importance to household budgets. Imports are included, while exports do not directly affect the CPI.
  - The GDP deflator's weights reflect the composition of GDP, not just household consumption, and includes items such as mining (14 per cent) and agriculture (2 per cent). Import prices are subtracted from the GDP deflator.

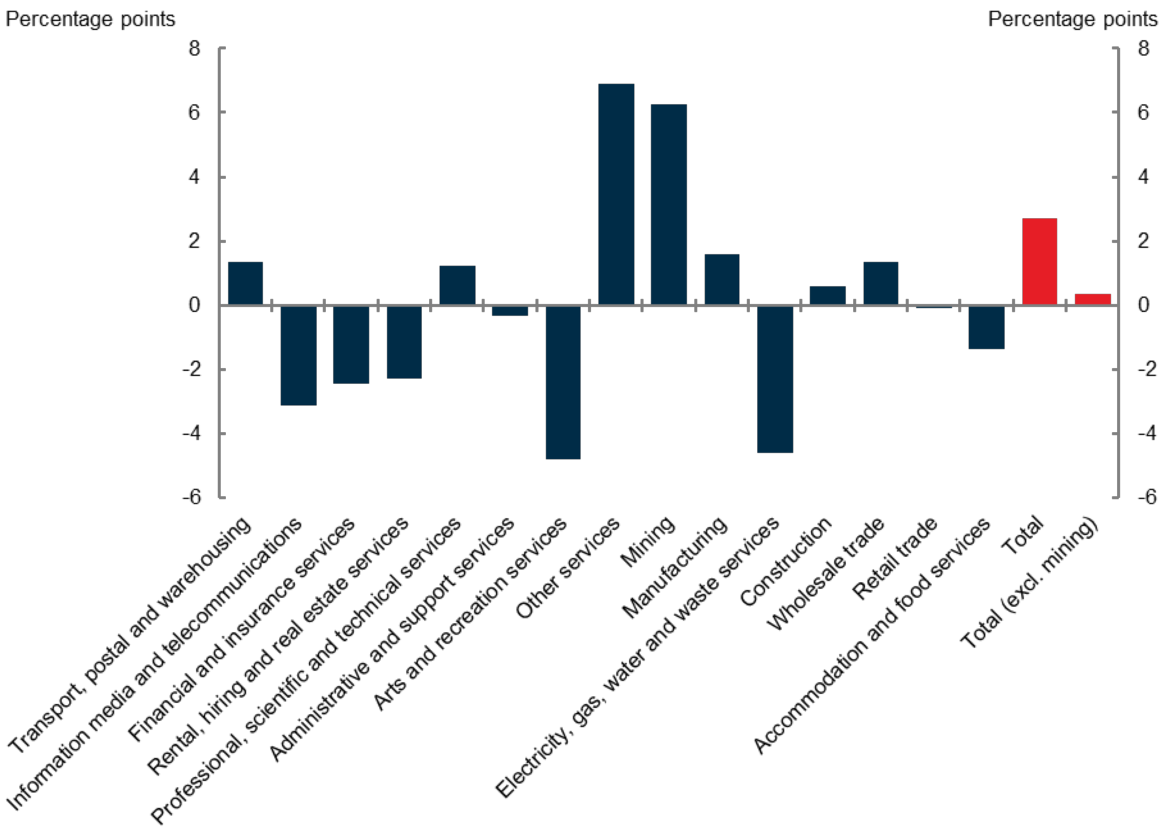
- The papers do not accurately measure firm profits.
  - Gross operating profit (GOP) is not equivalent to firm profits. GOP does not account for taxes, interest, or depreciation. Firm profits are earnings after all expenses are deducted, and more accurately capture the financial health of firms.

ATTACHMENT B – PROFIT SHARE OF INCOME

Excluding mining, profit margins have increased only slightly since December 2019.

- It would be appropriate for the paper to exclude mining from its analysis. This is because increases in mining export values have been a key driver of higher aggregate profits, but have had less impact on CPI inflation as local consumption of domestic mining production is limited.
- In the aggregate, implied profit margins for non-mining industries were only 0.4 percentage points per cent higher in the December quarter of 2022 than the December quarter of 2019 (Figure 1).
  - While there have been changes at the industry level, this small aggregate increase is inconsistent with the narrative that profit-taking has driven the CPI. The CPI is 12.6 per cent higher in the December quarter of 2022 than in the December quarter of 2019.

Figure 1 - Implied industry margins, change from Dec-19 to Dec-22:

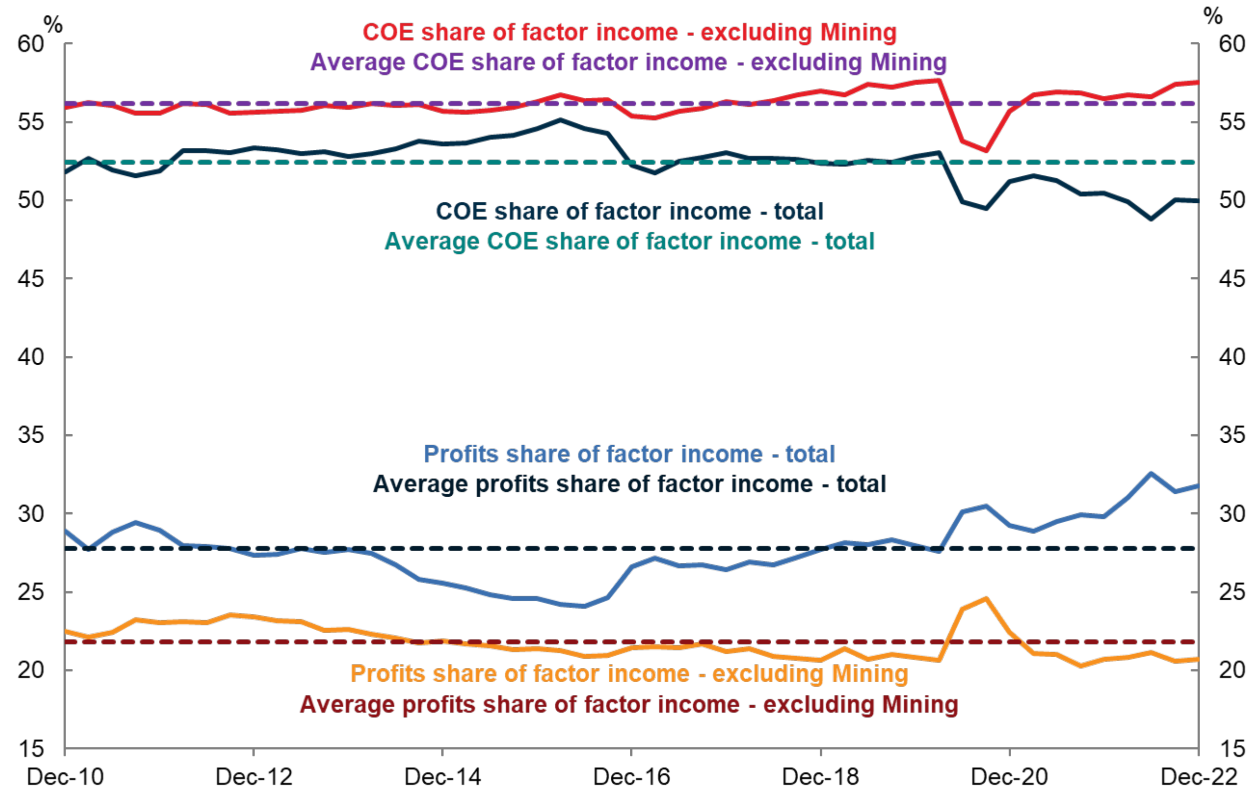


Source: ABS Business Indicators. Implied margin = gross operating profit/income from sales.

Excluding mining, the profit share of income has remained relatively stable.

- The profit share of factor income (including mining) increased from 27.9 per cent in December 2019 to 31.8 per cent in December 2022. However, this result is driven by mining profits on the back of persistently high commodity prices.
- The profit share of factor income excluding mining is 0.1 per cent lower than in the December quarter of 2019 and the labour share of factor income remains stable, once mining sector activity is excluded (Figure 2).
- While not a precise guide to firm profits, this measure provides an indication of the distribution of income between factors of production and is inconsistent with margins increasing significantly outside of the mining sector.

Figure 2 - COE and Profits as shares of factor income



ATTACHMENT C – DRIVERS OF INFLATION IN AUSTRALIA

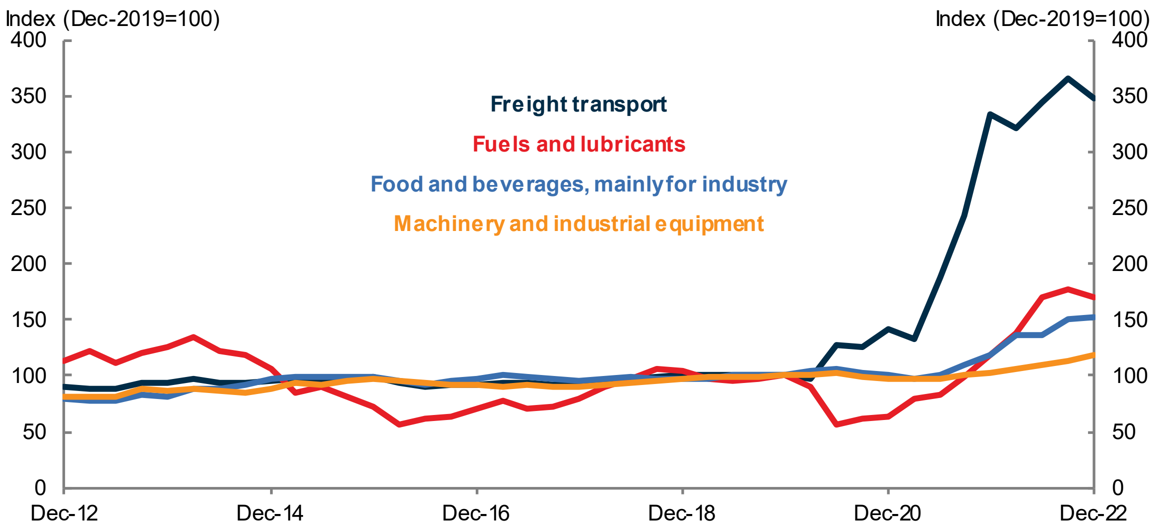
The run up of inflation in Australia can largely be explained by the direct and indirect impact of known cost increases and sectoral shocks.

- High inflation in Australia reflects a range of developments, including large consecutive and compounding supply shocks. These shocks include:
  - The impacts of the pandemic, which interrupted the flow of goods and generated significant price increases for freight.

- The invasion of Ukraine, which drove price increases for fuel, energy and food.
- Severe weather events that have interrupted domestic supply.

- Reflecting the global nature of many of these shocks, import prices have increased by 26.4 per cent since prior to the pandemic. This aggregate figure includes significant increases in prices for key business inputs (Figure 3), including:
  - Fuel (up 74.2 per cent),
  - Freight (up 247.1 per cent),
  - Food and beverages for industry (up 52.7 per cent), and
  - Machinery and equipment (up 19.8 per cent).

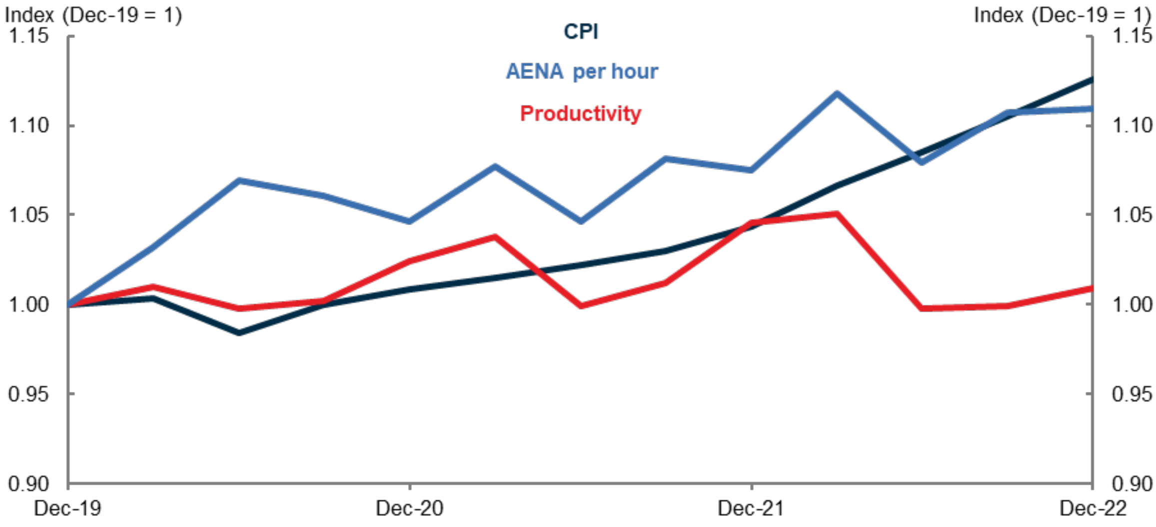
Figure 3 - Imports implicit price deflators, select components



- Further to these supply shocks, labour costs have also risen.
- Compensation of employees increased 10.4 per cent through the year to the December quarter of 2022.
- Since December 2019, nominal wages, as measured by average earnings per hour in the National Accounts, have risen in line with CPI (Figure 4). Weak productivity growth since the onset of the pandemic has exacerbated the cost of labour per unit of output facing firms. Over the same period, there was an increase of 5.6 per cent in non-mining gross operating surplus and mixed income.[1]

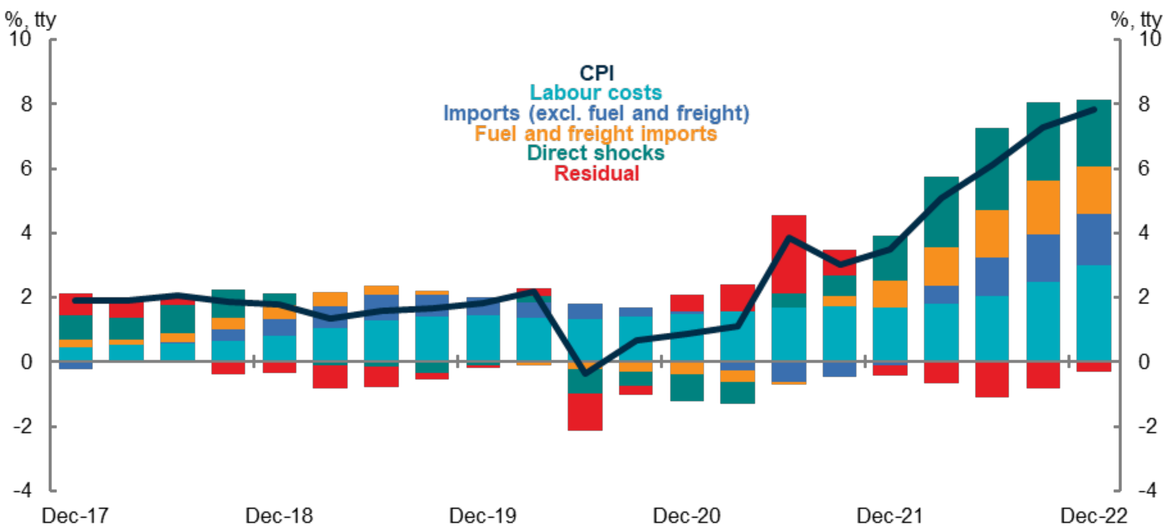
[1] Gross Mixed Income (GMI) refers to unincorporated enterprises and is the product of both labour and capital subsumed into one national accounts aggregate. This differs from Gross Operating Surplus which does not include labour income

Figure 4 - CPI, Average earnings, and productivity



- Treasury analysis of the drivers of inflation provides a stylised decomposition of the drivers of inflation resulting from labour costs, import prices and specific sectoral shocks (Figure 5).
  - Estimating the pass-through to consumer prices from labour costs and import prices (excluding fuel and freight imports), accounts for around 60 per cent of the 7.8 per cent peak in inflation through-the-year to the December quarter of 2022.
  - Fuel and freight imports, in addition to the direct contributions to inflation from the construction sector, energy, rents, and fruit and vegetables can explain the remainder.

Figure 5 - Decomposition of inflation



Source: ABS and Treasury. Direct shocks include the contributions to inflation from dwelling construction, energy, rent, and fruit and vegetables.

- This stylised decomposition uses an econometric model to estimate the long run pass through of labour costs and imports prices to CPI inflation:

– Labour costs are the single largest cost to firms, and historically have usually been the single greatest contributor to inflation as a result.

– Based on the long run pass through from changes in aggregate imports prices to CPI inflation, we estimate the portion of consumption which is imported as 18 per cent.

– Other input costs includes a range of other drivers including domestic food price inflation, domestic energy costs and rents.

Input costs to Australian businesses have increased significantly.

- While many of these shocks have impacted the CPI directly, they have also increased input costs for businesses.

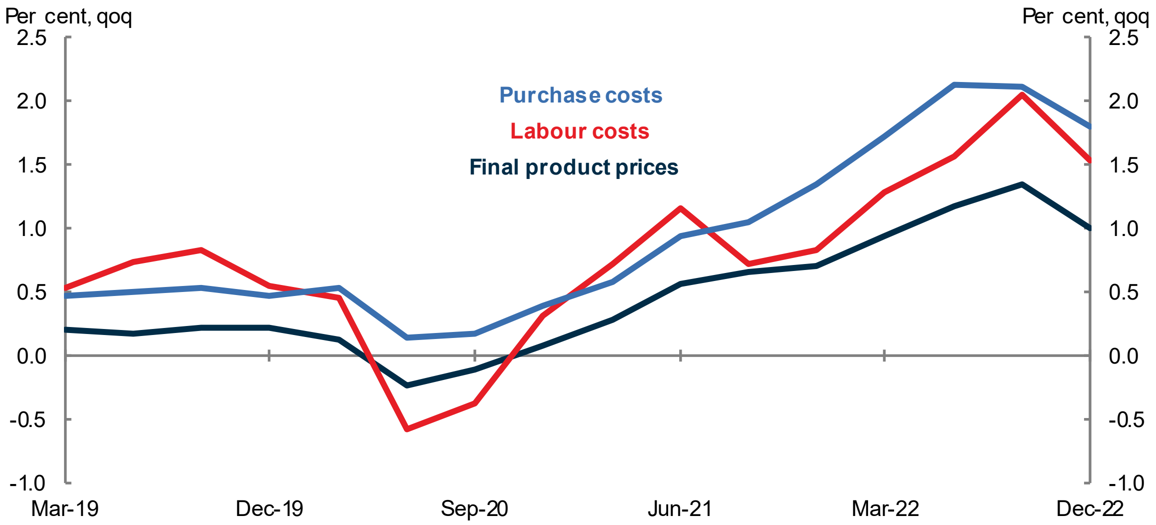
  – To maintain existing margins, cost increases can be passed through to final consumer prices. Strong demand conditions increase the capacity of firms to pass on cost increases.

- Firms have consistently reported large increases in input costs over the current inflationary period. According to the NAB Quarterly Business Survey, purchase costs for firms have increased 12.9 per cent since pre-COVID.

  – Labour cost growth has also accelerated, growing 9.7 per cent over this period.

  – Final product prices have increased 6.5 per cent, noting that this measure represents a survey of firms' views and is not a weighted average of final consumption prices like the CPI.

Figure 6 - Costs and price growth



Source: NAB Quarterly Business Survey

ATTACHMENT D – FIRM PROFIT MARGINS AND THE ROLE OF THE ACCC

As input cost inflation moderates, attention should be paid to whether this moderation is appropriately reflected in final prices.

- As supply constraints ease globally, the pace of growth in non-labour costs should ease, or even fall in some industries, and put downwards pressure on inflation.
  - Increases in purchase costs for firms decelerated to 1.8 per cent in December quarter 2022, from 2.1 per cent in the September quarter, according to the Quarterly NAB Business Survey.
- The extent to which a moderation in input cost inflation is passed through to final prices will be a critical influence on the speed at which inflation returns to target.
  - Furniture and clothing and footwear prices all decreased in the March quarter CPI.

There is evidence of declining dynamism in Australian markets over a multi-year period prior to COVID.

- The extent of competition in Australian markets is a key structural driver of prices over the longer term, including productivity and profits.
- A Treasury working paper using firm-level data found that average firm mark-ups increased by around 5 per cent between 2003–04 and 2016–17 (Hambur, 2021). However, this increase was smaller than those observed on average across advanced economies
  - These findings are based on a Treasury working paper that was published in June 2021, using pre-Covid data.
  - The working paper's estimated increase in mark-ups was more modest than earlier Australian estimates.
  - Digitally intensive firms and firms that controlled large market shares increased their mark-ups the most.
  - Excluding mining, estimated mark-ups were relatively higher in the Information, Media and Telecommunications sector, and lower in Retail Trade. Digitally intensive sectors may rely more heavily on intangible investments, such as research and development, or on platform or network effects.
  - Firms with high mark-ups relative to other firms in their industries appeared to account for a disproportionate share of output, suggesting that they are larger. This finding is consistent with other findings that mark ups are directly related to the share of the market held by the firm.

The role of the ACCC

- While the ACCC does not examine broader inflationary drivers or price increases across the economy, the ACCC can, at the Treasurer's direction, undertake price surveillance in relation to specific markets, where competitive pressures are not considered sufficient to achieve efficient prices and protect consumers.

- The ACCC is currently undertaking price inquiries into gas, electricity, childcare and digital platforms markets. As part of these in-depth inquiries, the ACCC can use its compulsory information-gathering powers, and may identify issues it considers require a regulatory response.
- The ACCC is also monitoring prices in other sectors, including petrol and domestic airline prices.
- Except where specifically given statutory powers to regulate prices in a market, the ACCC does not have general powers to set or otherwise regulate prices, and its investigative and enforcement powers are limited to breaches of the competition and consumer law.