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The spending reforms we have to have

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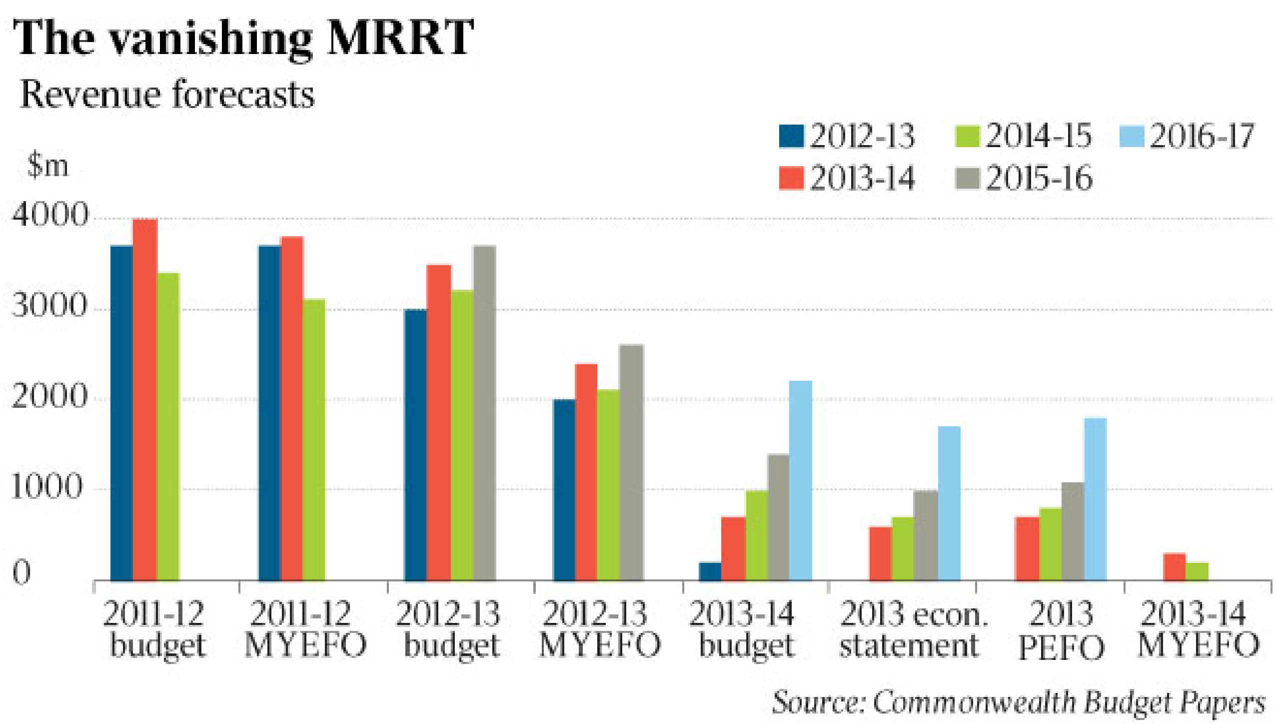

EXACTLY a year ago, Wayne Swan conceded that the Labor government would not achieve its much touted budget surplus. Since then, the $5.4 billion surplus Swan promised in 2010-11 for 2012-13 has melted into a $47bn deficit. As for the benign outlook Swan's 2012-13 budget projected, its cumulative surplus of $16.3bn to 2015-16 has become a $123.8bn sea of red ink.

Nor is the bad news over. From spending on children to retirement incomes, the pressures on public expenditure keep rising. Labor committed to increase outlays by no more than 2 per cent annually in real terms; in fact, they have been growing at about 3.5 per cent.

Even with bracket creep raising effective tax rates, restoring fiscal sustainability therefore seems to require swingeing cuts to public expenditure.

Austerity, however, is no panacea. Yes, tightening the taps can bring crucial relief from budget blowouts; but the underlying momentum reasserts itself as soon as circumstances permit. In the process, high social and economic costs are imposed on the community for little enduring benefit.

Instead, for the nation's finances to be placed on a sustainable basis, public expenditure needs to be reshaped fundamentally, in ways that achieve valued social goals but do so within our means.

Luckily, what remains of the resource boom, coming on top of the strong fiscal position the Howard government left, gives us time to make such a reorientation. However dire the outlook, we are not France or Britain, much less Greece or Spain.

But as Prussian military theorist Carl von Clausewitz said about war, fiscal consolidation is an endeavour in which everything is simple yet nothing is easy. And a primary exporter's terms of trade are the economic equivalent of the Grand Old Duke of York: when they are up, they are up, but once they are down, they are most definitely down. The fun part of that roller-coaster ride is largely behind us; and with the Audit Commission's initial report due late next month, reforming public spending must be at the heart of next year's agenda.

That opportunities for making better use of the public's resources are hardly lacking only makes that imperative greater.

Under normal politics, programs develop by accretion, while savings are achieved by nips and tucks. Muddling through eventually results in policies that are costly and not fit for purpose.

Yet even the most obsolete programs never die of old age: to paraphrase US president Ronald Reagan, poorly designed policies are the nearest thing to eternal life to be found on earth. So the day must come when it is best to consider euthanasia for some and a fresh start for others.

Inevitably, the focus then falls on the programs that make the greatest contribution to spending growth. Bringing those programs under control helps stabilise outlays, leaving time for revenues to catch up. That shouldn't mean, however, that other programs escape scrutiny. And in all cases sensible reform requires restating objectives and considering how they are best achieved.

The guiding principles for spending reform are clear: promoting individual and family responsibility while helping those who cannot help themselves; ensuring efficient program delivery, including by decentralisation and contestability; and, crucially, making current and future costs apparent to the community, thus improving accountability and tempering pressures for unchecked expansion.

Set against those principles, a natural place to start is the aged pension, which accounts for almost $40bn of commonwealth outlays, with those outlays rising at an annual average real growth rate of 4.6 per cent across the past decade. Population ageing will not only add directly to that growth rate but also make pensioners an ever more powerful electoral force, increasing the political attractiveness of redistributing income from the young to the old.

In 1974, there were three voters with children under 18 for every voter at least 65; by 2040, there will be as many voters aged 65 and older as those with young families.

And the rise in the numbers over 80 is even more pronounced, with their share of the electorate rising from one in 50 in 1974 to one in 10 in 2040. The longer pension reform is postponed, the harder its politics will be.

But that reform should not compromise the system's twofold purpose: to help individuals smooth income and consumption across their lifetimes; and to alleviate poverty in old age. Both objectives would be better served by treating the system as a notional defined benefit scheme, that supplements, but does not replace, individual savings.

More explicitly, accounting for the scheme, including annual reporting on the quantum and financing of its expected future liabilities, would help the community keep tabs on its costs. So would vesting its management in a separate entity, whose board administered a formula that linked the age of eligibility to life expectancy. At the same time, the pension amount should be indexed to consumer price index, with a public review every two years of its adequacy. And any changes in future liabilities arising from that review, as well as from other factors, should be immediately reflected in the government's balance sheet.

That is not to dismiss other changes, such as extending the means test to capture the family home. But even were that politically feasible, its long-run savings can be exaggerated, as housing prices and individual investment behaviour would adjust.

And if Australians have less wealth and income in old age from housing, the impetus to increase the pension will be only greater.

Instead, the focus should be on complementing changes to the pension system with reforms to superannuation.

Particularly important is mandating that part of retirees' superannuation be converted into an annuity at preservation age, reducing the incentive the aged pension creates for savings to be run down unduly quickly.

Improving the annuities market, if necessary by the commonwealth wholesaling annuities to retail funds, would make such a reform easier.

There are obvious parallels between these reforms and those required in healthcare, which costs the commonwealth and the states nearly $100bn a year and on which outlays have grown by 4.8 per cent annually in real terms in the past decade. The goals of our healthcare system are to ensure all Australians have access to high quality, efficient and effective health services, are properly covered against the costs serious illness can bring, and have incentives to make wise use of the health system's resources. As in retirement incomes, those goals are pursued through a mix of public and private providers.

But whatever our system's strengths, it fails to meet its objectives. In theory, it provides insurance; in practice, it does not manage risks but dispenses benefits. The payers, such as Medicare, are largely passive bearers of the system's financial risk, with their main activity consisting of setting fees and processing payments. Neither they nor anyone else takes overall responsibility for monitoring and controlling individual health outcomes, along with the costs involved in achieving them.

Fiddling within each of the system's silos will not solve the problems that creates; rather, what is needed is a move to a model in which there is a real insurer, who not only bears the full range of financial risks associated with its clients but also has the instruments to manage those risks.

Moreover, all Australians, and not only those who are better off, should have a choice of who that insurer is.

Managed competition, in which consumers can vote with their feet, would be one way of implementing such an insurance model. As part of the transition to such a system, the vast subsidies built into the present arrangements could be gradually pared back and targeted to those with low incomes or whose health condition makes them especially costly to insure.

Mandatory universal coverage would remain; ultimately, however, most consumers would pay their own way, while still being fully protected from the costs of severe illness. That is not to downplay the myriad difficulties such a reform involves; but shifting from an open-ended, poorly specified entitlement to a market contract would at least make costs more transparent, to consumers and taxpayers, while clarifying whose responsibility it was to keep them within reasonable bounds.

Similar issues loom with the National Disability Insurance Scheme. The overwhelming support this scheme has received is fully understandable: if we cannot provide adequate insurance against the risk of severe disability, we are not half the society we think we are.

But it is also obvious that the scheme faces serious dangers of eligibility creep. No magic formula can entirely avert those dangers. But effective spending limits on the scheme's administrators would be a good place to start.

The NDIS could be operated, for example, as a genuine insurance scheme for which all Australians paid a legislated premium, with the premium revenue being the maximum amount the scheme was allowed to spend. If the scheme's administrators wanted to expand coverage, they would face a choice: seek parliament's approval for a premium increase or reduce the amount spent on current beneficiaries. Such a hard budget constraint would make the scheme more accountable to the community, while limiting the temptation to extend the scheme away from its purpose.

Improving the disciplines on, and effectiveness of, assistance to parents is a third crucial area. Together, these programs, which include family benefits, childcare and parental leave, account for $34.4bn in commonwealth expenditures.

That amount will rise with the Coalition's parental leave scheme and as pauses on family benefits indexation come unstuck.

Underpinning this spending is recognition of the cost of children. In turn, that leads to three goals: to provide targeted income support for families in which children are especially vulnerable to poverty, notably those with single mothers; for other families, to recognise that all else equal, the real income of a household with dependent children is less than that of one without; and to at least partly reimburse specific expenditures, such as childcare, where there is a wider gain to the community from doing so.

There are, however, many options for improving the means used to pursue these goals. For example, transfers to low-income families with children should be less distorting of single mothers' incentives to work and find a spouse.

Recognising the cost of children in assessing households' real income might be done more efficiently in the tax system than through benefits. And payments for specific services - ranging from childcare to paid parental leave - could be streamlined into a single capped grant, with parents having greater flexibility over its use.

But even all those changes, together affecting about $150bn in commonwealth expenditure, barely scratch the surface of the scope for spending reform.

For transport infrastructure, for example, why not put the allocation of the commonwealth's $7bn funding to the states on a formula-driven basis, as it once was, reducing the incentive for states to give priority to the mega-projects they know both sides of politics invariably will be forced to endorse? Not only are those mega-projects extremely vulnerable to cost and schedule blowouts but they come at the expense of smaller-scale projects that would do far more to alleviate infrastructure constraints.

And for defence, instead of a target for funding based on an arbitrary share of GDP, why not have a process that sensibly relates spending, strategic risks and required capabilities?

But one reform is especially important: telling it like it is. Swan's forecasts were not errors; they were fictions. As the most cursory review of his estimates for the carbon tax and the minerals resource rent tax would show, those promises had no more reason to eventuate than the fantasies of Dr Seuss. Claims built on a marsh of unreality, they only hid facts to which the community must now adjust.

No one can legislate honesty. But already Joe Hockey's economic statement does more for disclosure than Labor's budgets ever did. Swan and Julia Gillard thought Christmas would distract from their admission of fiscal defeat; if the Coalition genuinely wants spending reform, its Christmas present to the nation must be the gift of truth.