THE AUSTRALIAN

Government must tackle ever-rising expenditure

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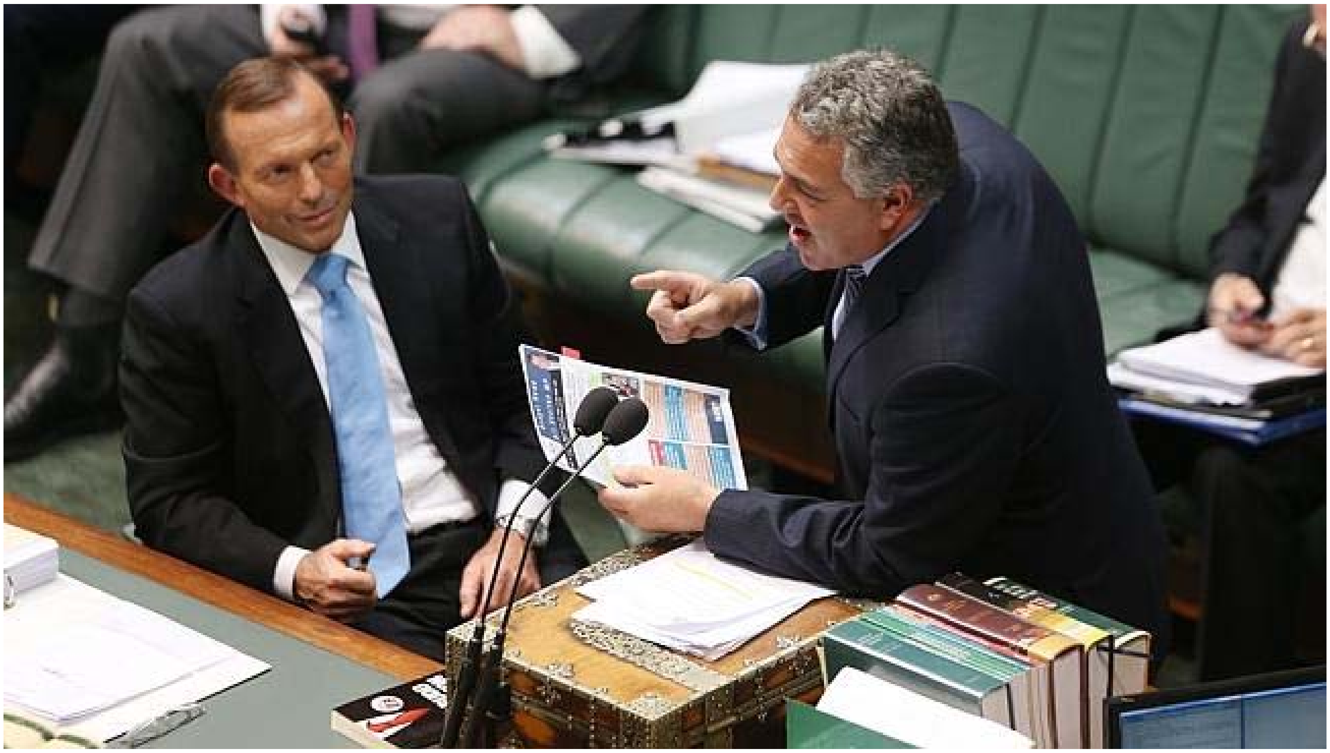


The Prime Minister Tony Abbott with Treasurer Joe Hockey during Question Time in the House of Representatives. Source: News Corp Australia

AS the Abbott government prepares its first budget, it faces some stark realities. This year will see our sixth budget deficit in a row. And although there may be some short-term improvements, the time bombs Labor left will result in deficits for years to come. Without fundamental change, the country's fiscal position risks becoming unsustainable.

The causes of the problem are obvious. Commonwealth payments are running at just less than 26 per cent of GDP, 1.4 percentage points above their 20- year average and close to the peak Kevin Rudd and Wayne Swan achieved in 2009-10.

Commonwealth receipts, on the other hand, are projected to be about 23.1 per cent of GDP this year, with tax collections running 0.6 percentage points of GDP below their average level.

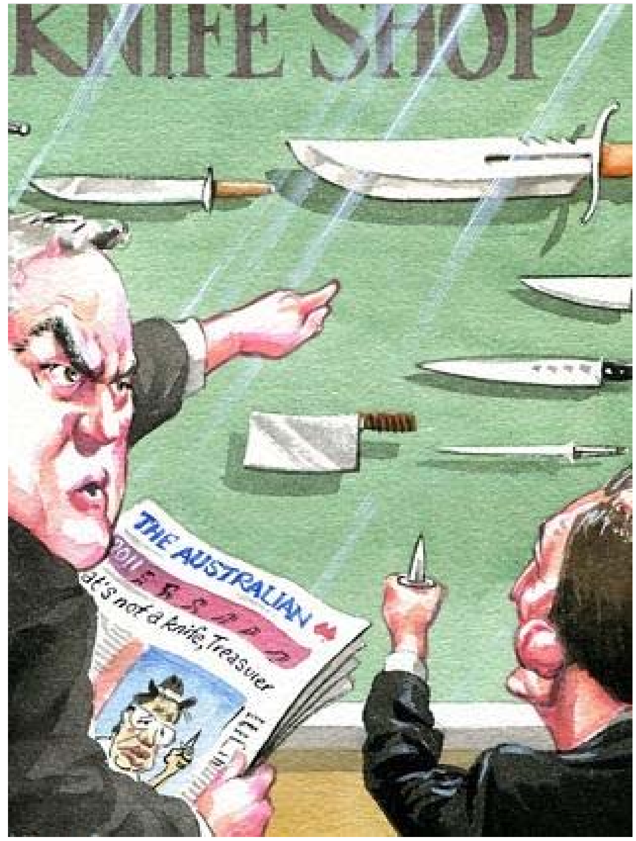
Combined, spending that is far above trend and revenues that are slightly below trend translate into persistent red ink, with Labor's last budget statement projecting a cumulative deficit of $123 billion to 2016-17.

But even more worrying than the immediate prospect is the longer-term outlook. Labor took public expenditure to historic highs, as spending per head of population rose in real terms from barely $6000 before the Whitlam government to about $12,000 by 1998-99, and more than $15,000 today.

And that growth seems set to continue, with a slew of programs increasing the outlays-to-GDP ratio over the next decade to a peacetime record while pushing real commonwealth spending in 2023-24 to an extraordinary $20,000 per Australian man, woman and child.

Yes, with rising incomes and ongoing inflation, commonwealth tax revenues will grow too. But "bracket creep" is difficult to sustain politically; and even if it could be sustained, allowing inflation to force ever greater numbers of income earners to face marginal tax rates of 37 per cent or more would impose high economic costs. Rather, bracket creep can and should be offset by tax reductions, meaning that revenues won't rise to much more than 25 per cent of GDP.

The result is an annual shortfall of 1.5 per cent of GDP, plunging the commonwealth, which had positive net assets of $44bn at the end of the Howard years, into more than $400bn of net debt by the early 2020s.



Picture: Sturt Krygsman Source: News Corp Australia

As the ratio of net debt to GDP marches towards 20 per cent, the government's interest costs will rise while its scope to increase borrowings so as to sustain spending when serious shocks hit will dwindle. With our economy increasingly exposed to terms-of-trade fluctuations, the effect could be severe instability, with all the economic, social and political pain that entails.

Averting that danger requires a dramatic improvement in budget outcomes, in the order of 2 per cent of national income, allowing net debt to fall from 12 per cent of GDP today to no more than 5- 6 per cent of GDP within a decade. But no miracle cure can achieve that turnaround.

For sure, nostrums such as drastically curtailing superannuation tax concessions for higher-income earners always get a good run, but they merely show a lack of understanding of just how punitive effective tax rates on retirement savings would be were those concessions removed.

Rather, the answer must lie in tackling the programs that are taking public spending ever higher. Those programs are readily identified; and so too are options that could slow their growth. But, for those options to result in durable fiscal consolidation, they must be associated with comprehensive policy reform.

The age pension is a case in point. With outlays of just less than $40bn growing at a trend annual rate of about 6.5-7 per cent, it represents the largest single source of future spending pressures.

That growth rate could be halved by expanding the means test to include at least some part of the value of the family home; changing the base on which the pension is set, from a proportion of average weekly earnings for males to those for both men and women, while revisiting the indexation arrangements; and further raising the pension age in line with increases in life expectancy and in the reasonable duration of working life.

But making those changes achievable and politically sustainable is hardly easy. In 1974, voters aged 65 and older accounted for 13 per cent of the electorate; that share is now more than 20 per cent and by 2050 it will have increased to more than 30 per cent. Unless those voters have adequate savings, the clamour to increase the age pension will prove irresistible; so changes to the pension must be accompanied by reforms which help provide income security to older Australians, for instance by greatly expanding access to privately funded defined-benefit streams.

Tinkering with eligibility rules is therefore far from being sufficient to durably reduce the fiscal risks associated with the public pension. Rather, the government needs to define and implement a retirement-incomes strategy that ensures efficient and socially acceptable alternatives are in place.

Similar issues arise with healthcare costs, the second largest source of spending pressures. Indeed, commonwealth outlays on the entire complex of health, aged and disability care are rising more than twice as rapidly as per capita GDP, increasing overall commonwealth spending on those forms of care from about $2600 per head today to $4100 in real terms in 10 years' time.

Here too, there is plenty of scope to trim expenditure through a cocktail of firm spending caps on individual programs (such as the Pharmaceutical Benefits Scheme and national disability insurance scheme), wider use of co-payments, pared-back safety net provisions, more stringent means tests and tougher eligibility restrictions on concessions.

But imposing those changes doesn't mean they would endure. For example, under the Rudd government's hospital-funding agreements with the states, the commonwealth's share of the growth in efficiently incurred public hospital costs will rise from 45 per cent in 2014-15 to 50 per cent from 2017-18 on. The Abbott government could seek to freeze that share at 45 per cent but it would then face a campaign on hospital cuts as fierce as that Howard faced in 2007, when nearly half of all voters judged Labor clearly superior on health issues.

Nor is it obviously efficient to shift healthcare risks back on to individuals and families, as greater co-payments, tighter means-testing and pared-back safety net provisions would all tend to do. On the contrary, if consumers are exposed to much greater risk, they will understandably resist and ultimately reverse the moves to bring public healthcare costs under control.

As a result, for those moves to be sustainable, they must be paralleled by reforms which ensure that an efficient privately funded alternative to publicly provided insurance is available. There should, in other words, be a credible transition path to an insurance model that offers both comprehensive cover and choice to all Australians, while subsidising those, and only those, who cannot pay for themselves.

The complex of outlays associated with families also cries out for reform. Together, family tax benefits, childcare payments and outlays on paid parental leave are likely to rise in real terms from about $7000 annually per family with children in 2013-14 to more than $9000 in 10 years. Yet there is no shortage of problems with that spending, including great administrative complexity, questionable cost-effectiveness (especially for the childcare payments) and the potential of family payments to inefficiently reduce labour-force participation.

Those problems, however, cannot justify simply taking an axe to the programs, as vocal critics of "middle-class welfare'' invariably contend. After all, a family with a combined income of $110,000 and two children does have a significantly lower ability to bear taxes than one with the same income but no children; and any equitable tax/benefit system will take that into account. But it is possible to support families far more efficiently than we do now.

For example, all the programs, including Abbott's proposed parental leave scheme, could be combined into a more flexible, voucher-like payment. The much greater value that would give families would create the political room to reduce both the amount and the growth rate of payments, pegging that growth more closely to increases in tax collections.

None of that is to underestimate the difficulties involved in linking serious expenditure curbs in each of these areas to reforms that deliver more for less. But tackling those difficulties is especially crucial for the Abbott government.

The government came to office promising to redress the nation's finances; but an unavoidable emphasis on far stricter means tests and narrower eligibility criteria for public programs will put the pain of achieving that goal on precisely the voters it needs to attract and retain. Political survival depends on the Coalition offering those voters something in return.

That something should be a way of meeting those programs' goals both at lower cost to taxpayers and with greater benefit to recipients. For example, families might well accept slower growth in education spending if it was accompanied by a shift to a voucher system which gave all Australian children a genuine choice of schools.

But that hardly means we can have expenditure restraint without tears. The fact of the matter is that Labor promised, time and again, what it knew could not be delivered; and then did everything it could to lock those promises in, all the more so as they transferred taxpayers' money to its supporters in the public sector unions.

The result is that we face a historically unprecedented run of budget deficits, stretching from 2008-09 to 2023-24 and perhaps beyond, shifting an enormous burden on to future generations. All the options for righting that situation involve painful choices.

Yet Australians have considerable confidence in the Coalition, with the 2013 Australian Election Study showing the proportion of voters expecting the government's decisions to improve the country's economy standing at an unprecedented high. The challenge for Abbott and Hockey, as they struggle with those painful choices, is to carry that confidence into the land of 1000 cuts.