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Herculean effort but more to do

HENRY ERGAS THE AUSTRALIAN MAY 14, 2014 12:00AM

ONE thing is clear: this budget is a herculean effort. But while it has put our fiscal position on the right track, we still have miles to go, and the path is fraught with risks.

The government's problem is simple. Despite all claims to the contrary, Labor left an unsustainable inheritance.

With spending growth primed to explode as one IOU after the other came due, gross debt was set to rise to \$667 billion by 2023-24, at which time we would be spending more on interest payments than on aged care.

To make matters worse, much of the expenditure growth was locked in, especially in education and health, limiting Joe Hockey's room for manoeuvre; and a weakening economy, with considerable uncertainty about the economic outlook, will only have added to the difficulties.

An extraordinary number of hard decisions have therefore needed to be taken merely to stabilise the situation, creating the conditions for an eventual return to surplus.

No doubt, there will be controversy over just how large the turnaround is, relative to what would otherwise have occurred: a reasonable estimate is that the total deficits over the four years to 2017-18 have been reduced by some \$35bn to \$45bn.

On any measure, it is spending cuts that are doing the heavy lifting, with policy decisions reducing spending by \$28bn (relative to the 2013-14 MYEFO) over the period to 2017-18.

That means spending reductions, rather than tax increases, account for 77 per cent of the fiscal effort, which compares well with the Howard-Costello consolidation of 1996-99.

But the job is far from done. For starters, sustaining the spending cuts will hardly be easy. In the initial years, they rely heavily on freezing benefits, reducing thresholds at which payments are phased out and tightening eligibility rules: the fiscal physician's favourite slimming diet, but also that most readily relaxed as an election approaches. Moreover, it is in 2017-18 that the axe really falls, as the government tears up Labor's Gonski and hospital funding IOUs.

That helps reduce spending growth in 2017-18 from the 5.9 per cent in real terms that retaining those commitments would have entailed to a more manageable 2.6 per cent; but sensible though that decision is, it promises a political firestorm.

After all, by walking away from those agreements, the government is both setting up a massive conflict with the states and aggravating its vulnerability just where the Coalition is weakest: health and education. As a result, it must be likely that as the election looms, the government will negotiate alternatives, with some part of the savings coming undone.

And there are uncertainties on the revenue side too. The "budget repair levy" looks like small change, but it is projected to raise \$1.9bn in the three years to 2016-17. That estimate, however, takes very little account of the changes in behaviour the levy is likely to cause, especially given the very large gap between the top personal income tax rate and the tax rate on company income, and so probably overstates the revenue the levy will provide.

Whether the improvement is sustained must therefore depend on political will. But also crucial is whether the economy outperforms the rather modest growth the budget projects — for if it does, that will make the road far easier, including by cushioning the effect welfare cuts have on low income earners.

Tackling the structural obstacles to expanding output and creating jobs should therefore be an even higher priority than before. If the government shirks that task, the pain it has had to inflict will have been wasted.

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