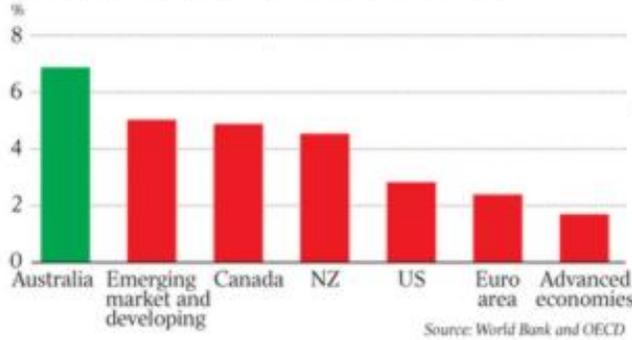


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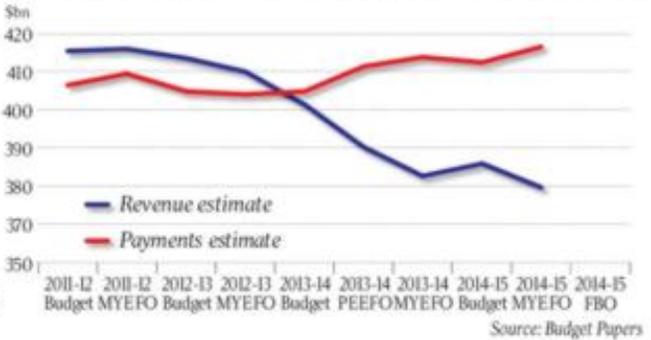
Australia's economic outlook still gloomy as time to fix finances runs out

HENRY ERGAS THE AUSTRALIAN DECEMBER 20, 2014 12:00AM

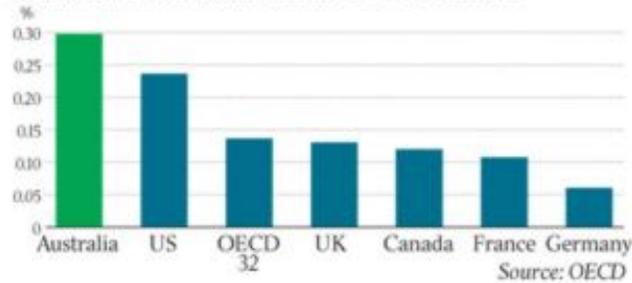
TERMS OF TRADE VOLITILITY, 1983-2013



THE ROAD TO THE 2014-15 FINAL BUDGET OUTCOME



PERCENTAGE CHANGE IN REAL PUBLIC SOCIAL SPENDING BETWEEN 2007-08 AND 2012-13



AVERAGE REAL SPENDING GROWTH, RUDD-GILLARD-RUDD V ABBOTT

Average real spending growth	Average annual % change (real)		Spending ratio (real)
	RGR	Abbott	
Payments (cash)	4.3%	1.4%	3.1
Expenses (accrual)	4.1%	1.4%	2.9

Source: Rudd-Gillard-Rudd (Final Budget Outcome, 2007-08 to 2013-14); Abbott (2014-15 MYEFO)

WITH this week's mid-year economic and fiscal outlook projecting deficits through to 2019-20, Australia's prosperity is as threatened as our peaceful way of life. But while the horrors of terrorism have brought Australians together, the economic risks this country faces are tearing our political system apart. Whether the government can regain the initiative, focusing the nation's attention on the dangers of simply letting our fiscal situation drift as export prices plunge, is the crucial question for the year ahead.

At an aggregate level, it's easy to explain the mess we're in. According to the final budget outcome, which reports the amounts the commonwealth received and outlaid in each year, commonwealth spending increased by nearly 50 per cent from 2007 to last year; receipts, on the other hand, rose by less than half that. With Labor spending \$2 for each dollar in additional revenue, its last year in office left a gap between spending and getting of 3.1 per cent of gross domestic product.

That gap won't be closed anytime soon. MYEFO projects that, adjusting for inflation, expenditure will rise at an average annual rate of 0.8 per cent during the next four years, which is less than one-third the rate at which it would have grown had the Abbott government kept Labor's spending plans in place. Even so, to return to surplus by 2017-18, revenues would need to increase at an average annual rate of 4.7 per cent a year in real terms, rather than the 4 per cent annual growth that is expected.

As deficits accumulate, net public debt will rise to 17.2 per cent of GDP in 2016-17, when it will amount

to \$11,551 per man, woman and child. For sure, as a share of GDP, it will still be well below that in the US or Britain, not to mention Japan; but it would be a mistake to take any comfort from those comparisons.

After all, Australia is far more exposed to international shocks than most other advanced economies. Our terms of trade, which measure the ratio of the prices we receive for our exports to the prices we pay for our imports, are three times more volatile than those of the advanced economies as a whole.

The risk those gyrations create of boom-bust cycles means our balance sheet must be strong enough to withstand sharp falls in revenues without having to slash public expenditure precisely when cuts would be at their most painful.

Experience in the global financial crisis, which highlighted just how suddenly countries' fiscal positions could deteriorate, reinforces that imperative. In Britain, the GFC caused the fourth biggest cumulative rise in public debt relative to GDP since 1700, behind only the Napoleonic Wars and world wars I and II. In the US, too, the GFC's fiscal toll, which saw public debt rise nearly fivefold, is rivalled solely by that of World War II.

The future generations that inherit swollen debt burdens will be far poorer than they would have been had their governments' finances been on a sustainable footing when the crisis struck. Little wonder the Murray report concluded that "as a capital-importing country exposed to fluctuating terms of trade and characterised by a concentrated banking system", Australia's public finances needed to be "better positioned than most".

Unfortunately, even the wafer-thin surplus that is projected for 2019-20 rests on heroic assumptions. After remaining below trend this year, economic growth is forecast to accelerate in 2015-16, while unemployment declines. At the same time, receipts are expected to start climbing from 23.6 per cent to 24.8 per cent of GDP, while spending, which has increased as a share of GDP in this government's first year, falls back towards 25.2 per cent of GDP, which is still well above the 23.1 per cent achieved in the Howard government's final year.

However, with recent budgets consistently overestimating revenues and so underestimating the budget deficit, those forecasts seem likely to prove unduly rosy.

Wayne Swan's 2011-12 budget, for example, projected that this year's revenues would reach \$416 billion; after many downgrades, MYEFO expects them to be \$36bn less than that, a shortfall of nearly 9 per cent. Payments, in contrast, will be 2.5 per cent higher than Swan had projected, yielding a total hit to the budget bottom line of nearly 19 per cent.

Underpinning those variances are even greater errors in forecasting the terms of trade which, since the resource boom began, have been among the largest factors affecting budget outcomes. For example, after the 2010-11 budget, which asserted that the terms of trade would suffer only a "modest fall", the 2011-12 budget estimated they would decline by 7.5 per cent in 2012-13 and by just 0.75 per cent in 2013-14; in fact, the terms of trade fell by nearly 14 per cent across those two years and have continued falling since then.

That the errors have been so great is not necessarily an indictment of Treasury, although its forecasting has displayed more than a hint of "optimism bias".

Rather, the errors reflect the impossibility of predicting complex economic processes well enough for

“finetuning” to work. They show, in other words, how misguided it is to believe that governments can play God, using spending and taxing to control the economy with the precision of an engineer tweaking a dial.

Instead, as governments stumble in the fiscal dark, the danger is that their twists and turns will aggravate shocks, leaving taxpayers to foot the bill. All that should make governments choose prudent fiscal settings, providing consumers, workers and investors with a predictable framework in which to plan their future. But with serious risks on both the revenue and on the spending side, there must be questions about whether MYEFO goes far enough to meet that goal.

Clearly, the increasingly unsettled international environment hardly helps. But the problems are compounded by the government's approach to bringing the budget under control. Although there are important areas, such as higher education, where it is pursuing far-reaching change, in many others structural reform plays little role in improving fiscal outcomes. Instead, the government is hoping inflation will do the heavy lifting.

The aspect of that approach that has attracted most attention is MYEFO's reliance on bracket creep, whereby rising nominal incomes drag taxpayers into higher tax rates. But damaging though it is, bracket creep accounts for only 10 per cent of the projected increase in revenues in the period to 2017-18, rising to around 20 per cent by 2020-21, at which point effective tax rates will be nearly as high as they were before the tax cuts of John Howard's last term.

Rather, where inflation plays by far the greatest role is on the spending side. Including the recently announced freezes on reimbursements for medical services, changes to the indexation of payments generate 40 per cent of the projected improvement to 2017-18 in the budget bottom line. Moreover, as the full effects make themselves felt of the proposed shift in 2017 from increasing pensions in line with wages to indexing them by CPI, that share rises, probably to more than 50 per cent.

However, the political sustainability of “restraint without reform” is questionable. And inevitably, the probability of backsliding introduces a material degree of risk into the government's fiscal strategy.

For example, had the policy of indexing pensions only to CPI been in place from 2003, the age pension, which is already below the amount the Association of Superannuation Funds of Australia judges necessary for a strictly “modest” lifestyle, would be more than a third lower than it is today. With such large gaps opening up between pensions and community standards, holding the line against calls for more rapid pension increases is unlikely to be easy, particularly as older votes are crucial to the government's survival. And similar pressures could arise in health and schooling where, as of 2017-18, the government will cap increases in its payments to the states by population growth and CPI.

To point to those difficulties is not to suggest expenditure restraint is undesirable. On the contrary, social spending in Australia has increased by 30 per cent since 2007, compared with an average for the advanced economies of barely 14 per cent; and with real net disposable income per capita, the best measure of living standards, falling by 3.4 per cent since the March quarter of 2012, our ability to afford lavish spending programs is rapidly vanishing.

But experience has shown time and again that durably controlling social spending requires reforms that “re-engineer” the way it achieves its goals, not simply fiscal controls that all too readily come unstuck. The return to surplus may have to be a long and winding road but, for that path to be credible, spending caps must complement, not replace, serious reforms to spending programs.

Yes, inflation taxes have long been a government's best friend; but especially with the threat of global deflation looming, entitlements must ultimately be tackled head-on, rather than whittled away by stealth.

The political constraints structural reform faces are nonetheless painfully obvious. Ignoring the immense damage a fiscal crisis would impose on the most vulnerable, Labor seems entirely focused on preventing the government from achieving the surplus it was never able to deliver, regardless of whether that costs Australia its triple-A credit rating. The Greens' obstructionism is even more adamant, as their opposition to indexation of the fuel excise, which they had long advocated, shows. As for the crossbench, it is at sixes and sevens, and with Clive Palmer struggling to keep his party intact it seems likely to remain so.

But the need to manage that quagmire merely increases the importance of taking the time to properly explain policies to a wary, restless public. With no scope for doling out generous compensation, reform will invariably be hard fought; and until voters are convinced that change is indispensable, Labor can only gain by opposing it.

Under those circumstances, success is partly a matter of being more selective than the government has been in picking its fights. Few delusions are more damaging than the belief that if a policy is unpopular, it should be thrust down the electorate's throats. And as the government sorts out the flotsam from the jetsam, it should make good on its commitment to radically redefine its paid parental leave scheme, whose steep costs cut across its message of fiscal restraint.

Yet it must also learn to galvanise public imagination. "Banana republic" moments, which reshape the public mood, are made, not born; knowing how to exploit them is the mark of a leader. With the mining boom having boosted national income by 13 per cent, the collapse in export prices, and the fall in the dollar with them, should provide the government with a golden opportunity to do so.

The ancient Greeks, who knew a thing or two about politics and human conflict, distinguished *chronos*, the mere passage of calendar time, from *kairos*, those times of special significance that must be seized, as they will never recur. For the Abbott government, the start of next year marks that decisive phase. Either it grasps it, or "the bright day is done / and we are for the dark".

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