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Alas, poor Europe's infinite debt

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Illustration: Eric Lobbecke Source: Supplied

IT'S not difficult to end up like Europe. What is hard, once the rot sets in, is to prevent the slide into debt from becoming a tumble.

Whether Tony Abbott can get his budget strategy back on track without committing political suicide is therefore the central question for 2015.

Despite all appearances, no European government set out to make its economy a basket case.

On the contrary, what is striking is just how frequent the attempts were to restore fiscal sustainability: data compiled by the International Monetary Fund shows that, from 1991 to 2007, the 25 European Union countries implemented 229 fiscal adjustment plans, of which 100 were aimed at a cumulative improvement in the headline budget balance of at least 1 per cent of GDP within three years.

Nor were the plans spectacular failures: on average, the more ambitious plans forecast a turnaround in the budget bottom line of 2.5 per cent of GDP and delivered 80 per cent of what was promised. Yet they rarely had an enduring impact on ever-mounting debt.

That reflects the sheer force of the process that drives rising indebtedness. Even when public debt is only 30 per cent to 40 per cent of GDP, all it takes is a hike in interest rates (which increases governments' interest expense) combined with a persistent slowing in growth (which reduces government revenues while putting upward pressure on spending) to knock budget repair badly off course.

With each adverse shock pushing the debt-to-GDP ratio a few notches higher, governments find they must run ever harder merely to stand still. By that point, even a sustained fiscal effort may not prevent debt from exploding.

For example, despite a spendthrift reputation, Italian governments consistently ran primary surpluses (that is, net of interest payments) from 1990 to 2007.

But the burden of servicing outstanding loans meant that not even 17 straight years in which revenues exceeded non-interest expenses were enough to return the debt-to-GDP ratio to manageable levels.

To make matters worse, as debt increases, the political costs of fiscal retrenchment rise too. After all, the pain involved in budget repair is immediate and tangible while the gains are longer-term and diffuse; the larger the adjustment needed, the greater the pain.

It is therefore one thing to claim that good policy is good politics, and another to survive putting good policy into effect. Rather, experience shows that the chariots of fiscal history crush the virtuous every bit as often as they run over the undeserving.

The tax increases George HW Bush agreed to as part of his 1990 deficit-reduction compromise plan with congress helped to set the basis for Bill Clinton's surpluses, but they also helped make Bush a one-term president. Equally, Kenneth Clarke's 1993 budget achieved the most substantial fiscal turnaround in recent British history, but its deep unpopularity contributed to Tony Blair's victory in 1997.

And although Germany's prosperity rests on Social Democratic chancellor Gerhard Schroeder's 2003 fiscal consolidation plan, it also tore his party apart and propelled Angela Merkel to the position she still enjoys.

Ultimately, the political costs of retrenchment can become so steep that no government is willing to bear them. In France, for example, the centre-right government of Raymond Barre launched successive attempts to stem budget deficits in 1976 and 1977, when public debt was still low by global standards. Although derailed by the second oil shock in 1979, the vitriolic response to Barre's plans helped sweep the Left to power in 1981, inaugurating a big-spending period that nearly doubled the ratio of debt to GDP.

With Barre's fate vivid in French politicians' minds, it took until 1995 before another serious effort at debt reduction was made, by the centre-right government of Alain Juppe.

Destroyed by a backlash against its alleged unfairness, the collapse of the "Plan Juppe" removed fundamental reform from the political agenda, leaving France exposed to the crisis that has now pushed its debt-to-GDP ratio to 100 per cent, forced a quarter of its young people into unemployment and fanned the rise of the extreme Right.

That isn't to ignore instances in which budget repair has gone hand in hand with electoral success, including Nigel Lawson's British budget in 1984, Bill Clinton's Omnibus Budget Reconciliation Act in 1993 and Paul Martin's 1995 Plan in Canada, as well as our own Hawke-Keating (1987-89) and Howard-Costello (1996-98) consolidations.

Most of those cases, however, involved exceptional circumstances, including a widely shared consensus about the need for budget repair, a compliant or seriously weakened opposition and, perhaps most importantly, the tailwind of stronger-than-expected economic growth. And, in every case, they involved governments with substantial political capital or outstanding political skills.

That makes them remote from the state we're in, with the government's mismanagement of the budget compounding the difficulties.

Sure, after last month's reshuffle Abbott has promised a fresh start; but if the problem lies with Hamlet and Polonius, convincing Rosencrantz or Guildenstern to swap parts is hardly likely to save the play.

None of which means Abbott should throw his hands up in despair; instead, he needs to better pick his fights, make greater use of consultation and properly explain policies to a wary, volatile electorate. And Joe Hockey, too, must find a way of being as effective in the public arena as he can be in parliament — or seriously consider whether he's in the right job.

Even so, the struggle for fiscal sanity offers no guarantees of success: perhaps our political system "can't handle the truth", as Jack Nicholson would say.

If it fails, Europe, here we come. And the tickets are all one-way.