THE AUSTRALIAN

MYEFO: spending reform won't come easy

HENRY ERGAS THE AUSTRALIAN DECEMBER 14, 2015 12:00AM

Illustration: Eric Lobbecke.

With the Mid-Year Economic and Fiscal Outlook only a sleep away, the Treasurer is facing his baptism of fire. But whatever the political risks involved in acknowledging the seriousness of our fiscal challenge, simply closing one's eyes and wishing really hard for the deficit to disappear is hardly an option. Rather, while avoiding both alarmism and complacency, Scott Morrison must show the government has a credible strategy for budget repair.

That our economy is more or less bearing up should facilitate his task. While the fading of the resource boom sent Canada into recession, the growth rate of GDP — the broadest measure of the volume of goods and services produced — still has a 2 in front of it.

Given that the terms of trade are now some 40 per cent below the peak they reached in 2011, while investment in the resource sector has nearly halved, that is a considerable achievement.

RBA governor Glenn Stevens was therefore right to suggest that although "the transition in growth is not perfectly smooth", the Australian economy has "coped remarkably well through a lengthy period of very large shocks in a difficult world".

There are, however, some worrying signs. Foremost among them is a possible decline in the economy's potential growth rate (that is, the rate of growth it should be able to sustain over time). Yes, our current performance is respectable; but coming at a time when interest rates are very low, bank funding reasonably available and consumer and business confidence only slightly below average, one might have hoped growth rates would be closer to Australia's long-run norm of over 3 per cent.

No magic potion can restore the economy's pep; what is clear, however, is that unless growth performance improves, the gap between community aspirations for public spending and what the economy can afford will only widen.

Attempting to close that gap by increasing the tax burden would be counter-productive: rather than unlocking the economy's potential, tax increases would stymie the return to higher rates of growth. And the longer-term damage would be every bit as significant as the immediate hit to economic activity.

For example, by raising prices relative to incomes, lifting the GST to 15 per cent would increase the tax wedge — that is, the effective tax rate on an additional dollar earned — by an amount ranging from 3.7 percentage points for the lowest tax bracket to 2.3 percentage points at the top. Even were that increase fully accompanied by the income tax cuts the Grattan Institute has proposed, the marginal tax wedge would still rise by about 1 percentage point for relatively low-income earners and by over 2 percentage points for those earning $80,000 a year and above.

As higher effective marginal tax rates reduce the incentives to work and invest (and do so more than proportionately as tax rates rise), national income, instead of growing, would shrink.

That makes it unfortunate that tax reform has become a codeword for increasing taxes. And with what passes for debate in this area generating an even higher than customary ratio of dust to motion, any focus on ensuring public spending is as efficient as it should be has gotten lost in the swirling clouds.

Yet it is impossible to sensibly assess revenue needs without considering how large outlays ought to be; and attention to the spending side is all the more urgent as the dividends that could be obtained from expenditure reform greatly outweigh those that could come from rejigging the tax system.

That is because even sweeping changes in the tax mix are unlikely to increase efficiency by much more than 20 cents for each dollar of government revenues affected. In contrast, when a dollar of excess costs is eliminated from public spending, that entire dollar is a gain to the community, and on top of that, there is an additional gain from avoiding the efficiency loss which the taxes required to pay for that waste would have caused.

As a result, cutting unnecessary public spending by a dollar increases incomes by about $1.20 — and there is no shortage of opportunities to do so. But spending reform is uneven, and in too many areas, has lacked clarity of purpose.

Education is an obvious case. Adjusting for inflation, operating expenses have increased by more than a third over the past decade; but on almost every indicator, outcomes are deteriorating. Instead of structural reform, however, state governments are trying to make public-school systems that lack any incentive to be efficient work by exhortation and appeasement.

Much the same could be said about healthcare. Yes, there have been fiscal savings; but they have come largely from short-term gimmicks such as freezes on indexation. Meanwhile, rather than bring fundamental change to the health system's financing and operation, the Abbott government walked away from the case-mix budgeting that was the best part of Labor's hospital-funding agreement with the states.

Nor are those the only areas crying out for reform. For instance, the Abbott government's shipbuilding plan — announced without proper consideration of the risks — approached the platonic ideal of poor policy development; and with billions of dollars at stake, eminent defence analysts, such as Mark Thomson and Hugh White, have voiced concerns that the submarine decision will prove a repeat performance.

No doubt, spending reform will never come easy. And whenever reducing public spending is mooted, Australians prove as touchy as a clutch of Capulets confronted by the Montague push.

Laser-beamed tax increases, such as the ill-judged budget deficit levy, are naturally easier and less contentious. But God gave the Treasurer two eyes: one for revenues and one for outlays. Tomorrow is his chance to show he has both wide open.