Government will hurt in the long run

Distracted by Europe's slow-motion train wreck, Australian politicians are yet to acknowledge that this country is hurtling along the same track.

by: Adam Creighton, The Australian - September 28, 2012

For decades, European governments have absorbed more and more of their countries' incomes. The global financial crisis merely accelerated a trend that has long been apparent.

In the two decades to 1997, public debt to national income in the 12 original eurozone countries grew from about 30 per cent to more than 75 per cent. Public spending now exceeds 50 per cent of gross domestic product in Britain, France and Italy.

The US, increasingly the land of the less free, is not far behind either, now confiscating about 45 per cent of its citizens' income.

Such egregiously high fractions hobble economic growth and clearly undermine governments' creditworthiness.

Politicians here trumpet Australia's relatively low levels of public debt and relatively lithe public sector. But public spending as a fraction of national income, already a chunky 36 per cent, has grown from about 25 per cent in the 1970s. Treasury's 2010 Intergenerational Report declares it is poised to surge past 40 per cent over the next decade as the ageing population pushes up health and pension costs.

But that analysis naturally ignores politicians' spending spree since. A new report by Robert Carling, a senior fellow at the Centre for Independent Studies and a former Treasury official, shows Australian politicians' proclivity to introduce new spending programs is inflating government even more rapidly.

He finds three-quarters of the growth of Australian government spending in the decade to 2010 - 4 per cent a year - arose not from the growing cost of existing government programs but from the addition of new ones.

Without any of the new spending programs or active policy changes, real spending per person would have fallen.

Think of policies such as the first-home owner grant, which transfers tax from renters to people rich enough to buy houses. Or Family Tax Benefit B, an initiative of the former Coalition government that, for instance, ensures poor single workers subsidise the lifestyles of "working families" with one child on $175,000 a year. Or the $3.6 billion annual increase in the Age Pension.

All up, in the first decade of the 21st century, politicians had foist an extra $85bn a year in costs on taxpayers, equivalent to almost a quarter of total spending.

The second decade is shaping up to be far costlier. Consider the torrent of well-meaning proposals embraced since 2010: the national disability insurance scheme, an extension to Medicare to include dental care, a proposal to increase school funding, an increase in the superannuation guarantee from 9 per cent to 12 per cent, pay increases for community and childcare workers, a new paid parental leave scheme, a sizeable boost to aged-care funding, and the new "school kids bonus".

Only two years into the decade, then, Carling calculates that the new proposals will add $28bn a year to annual spending by 2020, in today's dollars.

Without substantial increases in taxation, the public debt will balloon. Any diminution of the resource boom will only steepen the debt trajectory, and neither major political party is touting major tax increases.

Senior policymakers such as former Treasury secretary Ken Henry argue for an increase in taxation; suggestions to broaden the base and increase the rate of the GST (Goods and Services Tax) are routinely mooted.

But rather than sap growth and distort the economy by lifting taxes yet further, the debate should consider instead how to keep politicians from increasing public expenditure to the country's great long-term detriment.

Carling says the federal government should be forced to observe a hard fiscal rule that require new spending to be offset by cuts to existing programs, and that all existing schemes be subject to audit.

But rules are only as good as they are observed. Politicians of all stripes ultimately need to put partisanship aside and agree on some sensible limits. The turmoil in Europe and the US make a strong case for this.

Lifting the eligibility age for the Age Pension to 67 by 2023 was perhaps the Rudd government's most sensible decision, and one which the opposition has wisely refrained from challenging. This gives room for hope that some agreement is possible.

Australia's long-term fiscal future

by Robert Carling, : 27 Sep 2012

One of Australia's strengths going into the global financial crisis was the condition of its public finances. We are now in danger of frittering away that strength.

Everyone knows that we had budget surpluses and little or no public debt before the crisis. This made the economy more resilient against global shocks. Less well understood is the advantage of having a smaller government sector than most other developed countries. At around 36 per cent of gross domestic product (GDP), the general government sector (including all levels of government) can hardly be described as "small" in any absolute sense, but we have managed to avoid expanding it to the magnitudes of 45 per cent or 50 per cent associated with euro-sclerosis and now the euro-crisis.

Those who want more government spending see Australia's ranking in international comparisons not as a strength but as an opportunity to load up the public sector with costly new programs. If our governments follow this route, there will be much higher levels of public debt and/or much higher taxation somewhere in our future. The recent flurry of new spending initiatives by the federal government should be seen in this light.

The Intergenerational Reports (long-term fiscal outlook statements), which were first commissioned by the Howard government, have repeatedly revealed that Australia has a long-term fiscal problem stemming from population ageing and other societal trends. The last Commonwealth IGR (in 2010) projected an increase in the share of Commonwealth spending in GDP by 4.7 percentage points over 40 years and quantified the excess of spending over revenue in 2050 at 2.8 per cent of GDP, excluding interest expense.

The Commonwealth projections alone would be enough to lift Australia's government sector to 40 per cent of GDP. In addition, the NSW government has made similar projections for the state budget and quantified its long-term fiscal gap at 1.8 per cent of gross state product.

The task presented to governments by these IGRs was to chip away at the long-term fiscal gaps through structural reforms to lower the future growth path of government spending. The phased increase in the eligibility age for the age pension to 67 is one example of what needs to be done. There is still time for governments to take more measures of that kind because the effects of ageing don't start to bite until some way into the next decade. There is a window of opportunity to chip away at the problem.

Instead, government decisions are adding to the long-term fiscal gap. The IGR was prepared on the basis of then-existing policies. Policy changes since the IGR baseline was set in early 2010 (such as the national disability scheme and education funding), together with other pressures that the government may yet cave in to (such as a big increase in the Newstart allowance) could easily add almost $30 billion a year to the government expenditure baseline by 2020. There have been some offsetting measures, but most of them have been in the form of revenue increases or expenditure deferrals, not permanent cuts to spending programs. And notwithstanding the revenue increases, there are also long-term risks to revenue. The IGR assumes that Commonwealth tax revenue will be 23.5 per cent of GDP, but it is currently around 22 per cent.

The solutions may be politically difficult, but they are not rocket science. If large discretionary tax increases are to be avoided, governments will need to refrain from making so many new spending commitments that then are locked in to the spending base. The community also needs to refrain from demanding them. Alternatively, governments have to become much better at finding offsetting savings in the existing spending base. And at the same time, they have to keep chipping away at the long-term fiscal gap.