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Budget rhetoric must catch up with hard reality

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*The long boom years fooled politicians into believing the good times were the new normal. They now need to face the facts, writes **John Daley***

The gap between political rhetoric and the reality of Australian government finances is increasingly stark. Public opinion is running ahead of politicians in understanding our new reality.

The Prime Minister has indicated that this year's budget is not going to be in surplus, and the next few budgets may not be either. The opposition has also backed away from promises to deliver a surplus in its first budget.

Dealing with this situation will require a big change in political rhetoric. It is not enough that spending will produce benefits. To ensure a balanced budget in the medium term, we need to accept that there are some good ideas we cannot afford. Politics is always about trade-offs.

Nor can political rhetoric rely on showing that savings match any new expenditure. This has been the consistent pattern over the last four years, but it is not enough. To repair a structural deficit, savings must be more than new spending.

The rhetoric is that there is no need for such significant change because the federal budget will return to surplus when revenue eventually increases again. The reality is that "automatic stabilisers" – governments spending less in good times and more in tough times – only bring a budget back to "normal", and on current settings, this is a deficit.

The rhetoric is that revenues were hit unexpectedly because the dollar stayed high but minerals prices fell. The reality is that after the global financial crisis, revenues, or at least revenue forecasts, were never going to return to boom levels, and we could only count on a return to "normal". Previous forecasts overestimated recurrent revenues by up to $20 billion a year and needed to be brought back to reality, as a **Grattan Institute report** published last week reveals. For the last few years company tax has been around $6 billion less than forecast, even after allowing for economic growth and the exchange rate. The carbon price and the Minerals Resource Rent Tax at current prices will collect less than forecasts.

Moreover, when minerals prices fall, then government expenditure is likely to increase as a share of GDP. Real expenditure on health, education and welfare has been growing rapidly over the last decade, and we did not notice only because the prices of minerals, taxed by government, were increasing even faster.

Our political culture is finding it hard to adjust because it is based on a decade of tailwinds. The global economy boomed in the 2000s, driven by cheap credit. House prices (and therefore capital gains tax and stamp duties) rose quickly as Australian interest rates fell. The sharemarket boom delivered further capital gains. And minerals prices (and therefore company tax and royalties) increased relative to the price of everything else, a shift without parallel in the last 50 years.

Tailwinds don't get much better than this, yet Australia's political rhetoric treated these tailwinds as normal. On reforms such as the GST, carbon pricing and school funding, governments ensured that "no one was worse off" – at least if they earned less than $100,000 per year.

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For the next decade, however, Australia will almost certainly be kicking into the wind. Everyone is expecting minerals prices to fall; the only question is how far. Federal and state governments face increasing pressure on their health budgets, costing them an extra 2 per cent of GDP over the decade on current trends.

This is why Australian governments cannot return their budgets to surplus unless they start making some hard calls. The rhetoric isn't promising. Many insist cuts should not be made if they will affect growth and jobs. However, improving the budget bottom line can always drag on growth and jobs in the short term. An adjustment now is better than the alternative of long-term deficits leading to increasing debt, interest payments, and the loss of government flexibility in a crisis.

Europe offers cold comfort. The president of the European Commission, Jose Manuel Barroso, is suggesting that current levels of austerity in Greece and other places arc politically unacceptable. The International Monetary Fund is conceding it may have underestimated the impact of austerity on jobs and growth.

It would be easy to draw the wrong lesson and conclude that balancing the budget doesn't matter, but no one has worked out how Greece will repay its debt without enormous social pain. Governments that seem unlikely to pay will face rising costs. Our political rhetoric has not clearly learnt the real lesson from Europe: Australian governments should do everything they can to avoid the diabolical choices many European governments now face.

We show little signs of facing these realities - yet. The federal government still officially aims to run a surplus in the medium term. Many claim that it is acceptable to have a deficit in today's conditions. The reality is that Australia has solid economic growth at 3.1 per cent of GDP, low unemployment at 5.6 per cent, good economic growth amongst our trading partners, and mining prices that remain much higher than long-term averages. If we are not running a surplus at this point in the cycle, when are we planning to run one?

Reality is unlikely to change, so rhetoric must - and sooner rather than later. Budget repair will be painful, and given the size of the problem, will probably involve both tax increases and revenue cuts. These burdens will have to be shared across the community. Reality is not always easy but it's always better than the alternative.

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