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Tasmanian State Budget 2006-07

Labor's election commitments met in full –at the cost of four years of (modest) Budget deficits

16 June 2006

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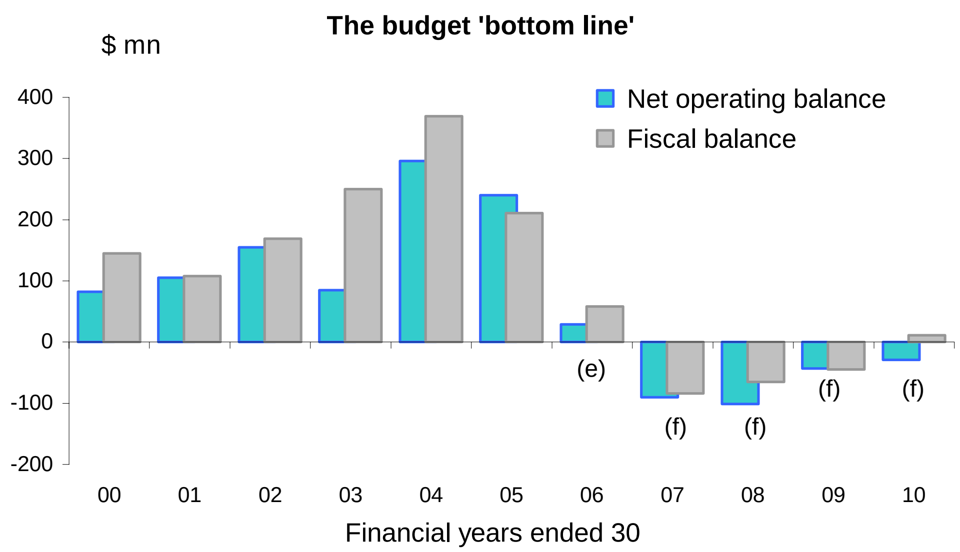
Michael Aird's first Budget fully delivers on the Lennon Government's election promises. Over the next four years, 'operating expenses' (wages and salaries of public sector employees, grants and subsidies, etc.) will be at least $500mn higher, and capital expenditures at least $230mn higher, than envisaged before the March 18 State election.

As a result, the Tasmanian 'general government' sector will incur **operating deficits** (operating expenses in excess of revenues) in each of the next four years (2006-07 through 2009-10) and **fiscal deficits** (that is, after accounting for capital expenditures) in each of the next three years – in breach of the new five-year fiscal strategy announced in the Budget.

However these deficits on the accrual accounting measures of the Budget's bottom line are fully covered by depreciation provisions. The **cash balance** will thus remain in surplus, allowing the Government to continue to accumulate net financial assets: these will rise from $202mn as at 30 June this year to $535mn by 30 June 2010. For the most part, these assets will be applied to offsetting the Government's unfunded superannuation liability – albeit at a slower rate than previously envisaged.



Funding election commitments

The Budget provides for more than $500mn of additional 'operating expenses' (employment and other operating costs, grants and subsidies, etc.) and over $230mn of additional capital investments over the next four years to fulfill the Lennon Government's election undertakings.

By far the largest spending increases are in **health**, where operating expenses will be boosted by $346mn over the next four years (including $100mn in 2006-07 alone) compared with the level envisaged prior to the election. This will fund, among other things, an additional 450 staff at the Royal Hobart Hospital, a new emergency department at the Launceston General Hospital, two new ambulance crews, and a $20mn package of improvements in dental care. Health also gets an extra $114mn of capital funding over the next four years to provide, among other things, purchases of new medical equipment for the RHH, LGH and NWRH and 100 new ambulances.

The Budget also provides $50mn in additional recurrent and $45mn of additional capital funding for **education** (including 60 new primary school teachers and 29 year 7 teachers over the next five years and $30mn for the new Kingston High School); $40mn in additional recurrent and $43mn capital funding for **public safety** (including 12 extra police officers); and $23mn for programs to assist the agricultural sector.

In total, operating expenses will rise by 7% in 2006-07 – the third consecutive year in which operating expenses have risen by at least this amount – but are then projected to slow to an average of just 1.7% per annum over the following three years.

Beyond the commitments made (as part of the agreement between all States and the Commonwealth Government) to abolish mortgage duty and stamp duty on conveyance of business assets (other than real property), which will cost $80mn over the next four years, there were no **revenue** measures in the Budget. Total revenues will rise by 3.5% in 2006-07, and by an average of 2.3% per annum over the following three years.

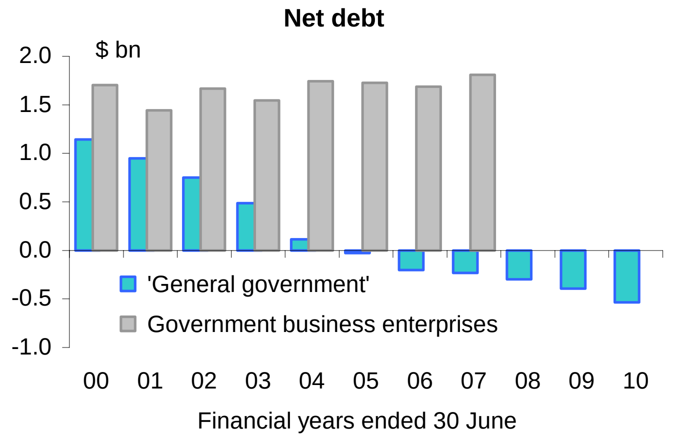
A new fiscal strategy – honoured in the breach

The medium-term fiscal strategy introduced by former Treasurer Dr David Crean focused on eliminating the net debt of the 'general government' sector (ie, excluding government business enterprises such as Hydro Tasmania) and, over a longer period of time, the government's unfunded superannuation liability.

With net debt having been eliminated two years ahead of the scheduled envisaged by Dr Crean, the 2006-07 Budget sets out a new fiscal strategy which (as foreshadowed by the Premier during the election campaign) pushes out the target for extinguishing the superannuation liability from 2018 to 2033, and allowing greater scope for increased infrastructure spending.

The key elements of the new fiscal strategy are:

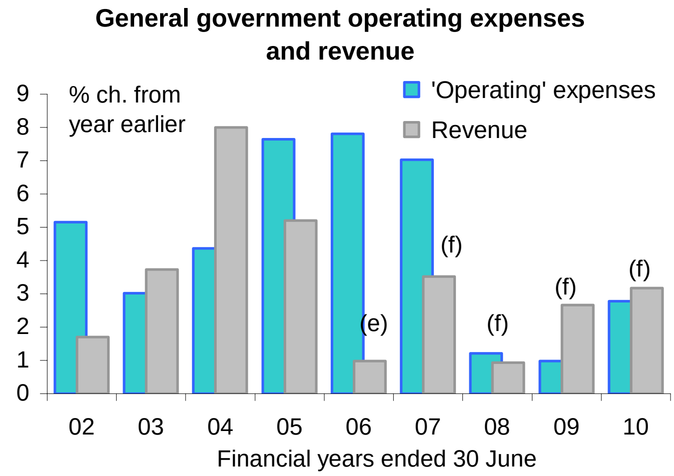
- to maintain a **net operating surplus** (that is, revenues to exceed operating expenses) on a four-year rolling average basis;
- to maintain a **fiscal surplus** (that is, to cover capital expenditures out of the operating surplus and depreciation provisions) on a four-year rolling average basis;
- to maintain the 'general government' **net debt free** and to keep the ratio of **total State net debt to revenue** on a declining trend on a four-year rolling average basis;
- to keep Tasmania's **State taxation** burden below the all-State average (as measured by the Grants Commission), with **no new taxes** and **no increase in existing taxes**; and
- to **maintain the level of infrastructure spending** (net of depreciation) constant in real terms.



At face value, the forward estimates suggest that the first two legs of this new fiscal strategy will not be met beyond the 2007-08 fiscal year (the large surpluses for 2004-05 and 2005-06 will keep the four-year rolling averages 'in the black' until then despite the deficits forecast for 2006-07 and 2007-08).

Apart from the ACT, Tasmania is the only State currently planning to run operating deficits in each of the next four years (NSW is expecting an operating deficit in 2006-07 but on the projections in its most recent Budget will return to operating surpluses in 2007-08; South Australia is yet to bring down its 2006-07 Budget). On the other hand, most States and Territories envisage running fiscal deficits (that is, after providing for capital expenditures) over the next four years. And Tasmania's *average* fiscal deficit over the next four years is equivalent to about ¼% of gross State product, smaller than those of any other State or Territory except Western Australia.

Of course this all presumes that the forward estimates of revenue and expenses will prove to be accurate. Revenue growth could be (as it has been in recent years) stronger than envisaged in the forward estimates. On the other hand, keeping the growth of operating expenses within the forward estimates for 2007-08 and beyond (to just 1¾% per annum), is likely to be a formidable task given that wages and salaries (which account for about half of total operating expenses) are likely to rise by at least 4% pa on average.

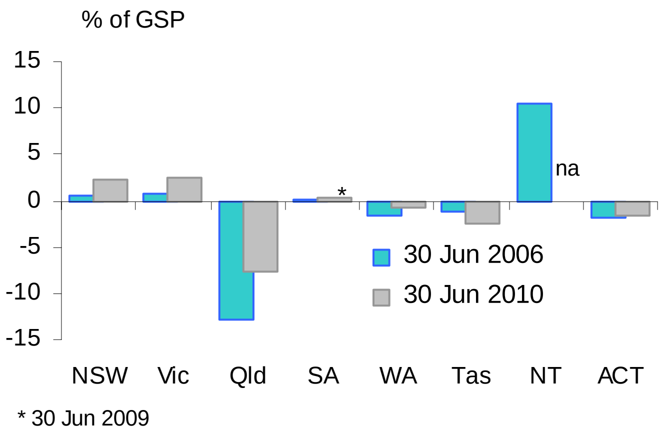


The other legs of the Fiscal Strategy are all satisfied. In particular, because the cash balance remains in surplus (with the accrual accounting measure of the fiscal deficit effectively covered by depreciation provisions), the general government sector will not be borrowing from the capital markets. It will continue to accumulate net financial assets – albeit at a slower rate than envisaged before the election: the Government is now expected to have net financial assets of $394mn as at 30 June 2009, as against the $578mn envisaged at the time of February's Mid-Year Review of the 2005-06 budget.

Most other States and Territories (with the exception of WA) will be running cash deficits over the next four years and will thus experience an increase in net debt.

Tasmania will thus continue to have the strongest general government net debt position (as a proportion of gross State product, or GSP) of any State except Queensland.

General government net debt



However Tasmania does not compare so favourably on some other balance sheet indicators:

- Tasmania's unfunded general government **superannuation liability** remain relatively higher than that of any other jurisdiction, at over 19% of GSP throughout the forward estimates period;
- Tasmania's **total State sector net debt** remains higher than that of any jurisdiction except the Northern Territory, at 8.5% of GSP by 30 June 2007. This reflects the fact that Tasmania's **government business enterprises** have relatively higher debt levels (projected at 9.8% of GSP by 30 June next year) of any State or Territory.

The Budget did not provide for any equity injection into Hydro Tasmania or any of the government's other business enterprises. However, dividend and tax equivalent payments from both Hydro Tasmania and Forestry Tasmania will decline (by a total of $28mn) in 2006-07, though this will be largely offset by increased income from the Motor Accidents Insurance Board.

Nonetheless, there is no suggestion that Tasmania's AA+ credit rating is in any way imperiled by the (comparatively modest) fiscal deficits foreshadowed in this year's Budget.

A buoyant outlook for Tasmania's economy

The Budget is predicated on another year of strong growth in the Tasmanian economy (unlike most other States, Tasmania still does not publish economic projections for the full four-year forward estimates period).

Treasury's measure of **State economic activity** (a rough proxy for the Statistics Bureau's measure of real gross State product, which Treasury regards as 'not reliable for a small economy such as Tasmania') is forecast to grow by 3½% in 2006-07, in line with the Commonwealth Treasury's forecast for growth in the national economy and the same as projected for 2005-06 (though this latter forecast has been lowered from 4% at the time of the February Mid-Year Review).

This forecast assumes (not unreasonably) that **consumer spending** in Tasmania will be less affected than in other parts of Australia by rising interest rates (since Tasmanians have smaller mortgages) and that economic activity will not be 'significantly affected if petrol prices continue to rise'. **Housing investment** is forecast to rebound in 2006-07; while **business investment** is expected to be boosted by a number of tourism projects, new retail ventures, the on-going roll-out of natural gas connections, and a number of forestry projects (not including the Gunns' pulp mill, construction of which, if it proceeds, will not commence until 2007-08).

This forecast may be a little optimistic. It implies that Tasmania's economy will grow at a faster rate in per capita terms than the national average (since Australia's population is likely to grow at nearly double the 0.6% forecast for Tasmania). True, Tasmania's per capita economic growth rate did exceed the national average (by a margin of more than 1 pc point) in 2004-05, and will probably do so again in 2005-06.

However the pick-up in national economic growth in 2006-07 (to 3¼%, from 2½% in 2005-06, according to Commonwealth Treasury forecasts) is driven largely by the 'resources boom', from which Tasmania derives little benefit (and which, via its impact on the A$, adversely affects the competitiveness of Tasmania's non-mining export industries).

Treasury expects **employment** to grow by an average of 6,100 or 2¾% in 2006-07, well above the national average forecast by Commonwealth Treasury of 1%, but down from 3¼% in 2005-06, in part due to 'shortages of skilled labour' – which is in turn expected to encourage higher immigration of skilled workers to Tasmania and constrain interstate emigration. Because the strong employment growth of recent years is encouraging Tasmania's relatively large number of 'hidden unemployed' to enter the labour market, the **unemployment rate** is expected to decline only slowly, to an average of 6¼% in 2006-07, from 6½% in 2005-06.

Interestingly, Treasury expects slightly higher **inflation** in Hobart than in mainland capitals (on average), as a result of the 'tight labour market' and increases in housing, health and transport costs.

Election promises honoured but longer-term challenges remain to be addressed

As noted earlier, the Budget honours in full the Lennon Government's election promises, and does so without seriously imperiling the strong fiscal position which has been achieved over the past eight years – notwithstanding the operating and fiscal deficits forecast over the next four years. In particular, the Budget has responded to recurring problems in Tasmania's health system which have been a source of widespread public concern in recent years.

However, the Budget does surprisingly little to address the longer-term economic challenges now facing Tasmania.

Although the Budget Papers acknowledge, in a number of places, the fact that Tasmanian **productivity** levels are relatively low (85% of the national average), that this is a major reason for Tasmanian wage levels being more than 10% below the national average, and that 'improvements in productivity lead to sustainable increases in real overall income and hence living standards', it is difficult to discern any coherent strategy for correcting this long-standing weakness in Tasmania's economic standing. As I've emphasized in other recent commentaries on the Tasmanian economy, this State's relatively low labour costs do not represent a significant source of competitive advantage when its commensurately low level of output per hour worked is taken into account.

That's not to say that there are *no* measures in the Budget which are directed towards improving productivity. It provides (for example) nearly $10mn to TAFE over the next four years for training up to 340 new apprentices, and $1.5mn to establish an Innovation and Research Centre at the University. And the overview section of the Budget Papers includes a strong endorsement of the role that competition policy initiatives (in the implementation of which Tasmania has performed better than most other States) can play in improving productivity.

Over the longer term, the main answers to Tasmania's 'productivity problem' lie in weaning the economy off its dependence on essentially unprocessed commodities where Tasmania is a 'price taker', and in increasing both the quantity and quality of the education received by Tasmanian children and adults.

From that perspective, it is a little disappointing that the increase in spending on education was not only dramatically smaller than that on health ($95mn as against $460mn) - but also barely larger than the increase in spending on 'safety' ($83mn).

'Operating' expenditure on health is estimated to rise by around 7¾% in 2006-07, and on 'public order and safety' by 6½%, whereas spending on education is forecast to rise by only 2¾% - less than the forecast rate of inflation. Education's share of total operating expenses will fall from 28.3% in 2005-06 to 26% in 2006-07.

Unquestionably, health has been a major social and political issue which the Government had to address.

And having about 14 months ago specifically called for an increase in funding for the public dental services which my father used to run, I'm certainly not criticizing the additional funding provided for them in this Budget.

However, without decrying people's entitlement to feel 'safe', it's not as if Tasmania is experiencing a major crime wave or an imminent terrorist threat.

On the other hand, there's plenty of 'hard' evidence showing that Tasmanians have lower educational outcomes and fewer skills than their counterparts on the mainland, and that Tasmanian school children perform less well on objective test scores than their mainland counterparts the longer they remain in the education system.

Given the conservative projections for expenditure growth beyond the 2006-07 financial year, it is not yet clear how these challenges will be addressed over the remainder of the current Parliamentary term.

Although the business community has been disappointed by the absence of any new tax relief in the Budget, in my view this is now a lesser priority than other measures to lift skills and productivity.

Still room for improvement in the Budget Papers

This time last year I observed that – without implying that Treasury was trying to hide anything - in a number of respects Tasmania's Budget Papers fall short of 'best practice' in other jurisdictions.

This year's Budget Papers provide more detail on what the Government has done or proposes to do with its cash surpluses. However in other respects Tasmania still does not provide useful information which is available in other States' (and the Commonwealth's) Budget documents.

In particular it would be useful to have totals of the discretionary spending and revenue measures in the Budget, and a reconciliation of the most recent with previous Budget estimates separating out the impact of policy decisions and 'parameter variations' (changes in economic and other assumptions).

Most other States also now provide four-year projections for the key economic parameters (such as economic and employment growth) and for the financial statements of the government business enterprise sector, whereas Tasmania provides these details only for the year to which the Budget relates.

Finally, it would also be helpful if Treasury provided more information on its measure of 'State economic activity'. I don't contest Treasury's assertion that there are problems with ABS' measure of gross State product for Tasmania; but it would assist in making assessments of Treasury's forecasts if it provided some historical data on its measure (which are always 'unavailable') and some detail on how it is constructed. Queensland Treasury does this exceptionally well; in this area, Tasmania could do a lot better.

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