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Tasmanian Mid-Year Budget Review 2006-07

Economic growth estimates revised down but very little change to the Budget projections

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A more realistic outlook for the economy

The Mid-Year Financial Report released by the Department of Treasury and Finance last Thursday (15th February) revises down the projection for growth in '**State economic activity**' in 2006-07 from 3½% to 2¾%, a change which Treasury attributes to 'weaker national economic conditions' (as reflected in the downward revision to the forecast for national economic growth in the Federal Government's Mid-Year Economic and Fiscal Outlook released in December) and to 'increases in interest rates and the effects of drought and late frosts in Tasmania'.

The forecast for year-average growth in **employment** has also been revised down from the Budget's 2¾% to just ¾%. However with the decline in employment growth mirrored by a reduction in labour force participation, the forecast for the **unemployment rate** for 2006-07 as a whole has been left at 6¼%. The forecast of population growth in the current financial year has been left at 0.6%.

These revisions reflect a more realistic view of the short-term prospects for the Tasmanian economy than those set out in the Budget (as I noted at the time and again in mid-November following the release of the September quarter estimates of State final demand).

However the forecasts may still be overly optimistic even after these revisions, as can be seen by considering what is required for them to be achieved. (This calls for some understanding of how the ABS puts together its estimates of gross State product or GSP and assumptions about how various components of it may change; some readers may wish to skip over the next four paragraphs).

Assuming (for the sake of illustration) that the 'balancing item' in the ABS measure of Tasmania's gross State product (which notionally represents the balance on trade with the mainland, net international trade in services, and movements in inventories) subtracts around 2 pc points from 2006-07 GSP growth (compared with an average of 3.3 pc points pa over the past five years), and that the balance on net international trade in goods adds around ¾ pc pt to 2006-07 GSP growth (compared with an average of zero over the past five years), then spending by Tasmanian households and business and by governments would need to grow by about 3¼% on average, to produce 2¾% GSP growth in 2006-07.

But such was the slowing in State final demand growth (the only bit of GSP for which quarterly estimates are available) during 2006 that, even making a generous allowance for the distortion to the September quarter figures caused by the sale of Spirit III, State final demand would need to grow by an average of around 3% per quarter in the December quarter (now ended) and in the March and June quarters – to be nearly 9% higher in the June quarter 2007 than a year earlier.

The data on which these calculations have been based could be revised. And alternative assumptions about overseas and international trade, which would lower the growth in State final demand 'required' in order to attain 2¾% growth in real GSP, could be made.

Moreover, as Treasury always observes in a footnote to the table summarizing these forecasts, its estimates of 'underlying State economic activity' are 'not designed to … forecast the … GSP series produced by ABS'.

Nonetheless, these calculations do indicate why Treasury's outlook still looks to be on the high side of plausible outcomes (although much less so than at the time of the Budget).

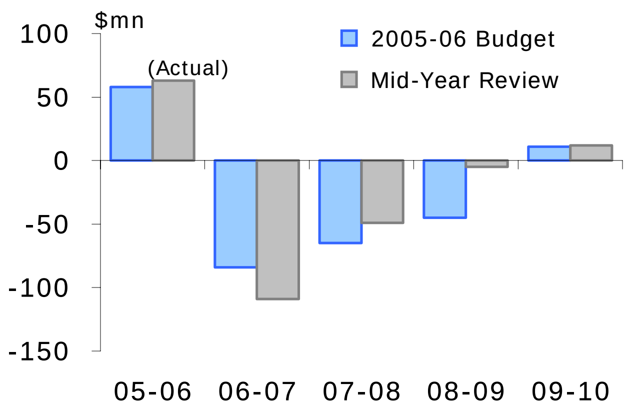
The employment forecast has been revised down by a much larger margin than the forecast for GSP, and seems less open to query. Attaining it will require net new jobs growth averaging about 700 per month over the remainder of the year, compared with net job losses averaging 166 per month over the past seven months.

Budget aggregates little changed

Despite the downward revisions to projections for economic and employment growth, there has been little variation in the forward estimates of the key Budget aggregates. Most of the main sources of State revenue are not particularly sensitive (at least in the short term) to fluctuations in economic activity; and that payroll tax (which would seem to be sensitive to movements in employment) is only paid by about 5% of all business in the State.

The **fiscal balance**, the principal accrual accounting measure of the Budget bottom line, is now projected to be in deficit by $109mn in 2006-07, compared with the Budget time forecast of $84mn. This largely reflects a $94mn (or 2.6%) upward revision to operating **expenses** and a $73mn upward revision to **receipts**, resulting in a $21mn increase in the forecast **net operating deficit** to $111mn.

General government fiscal balance

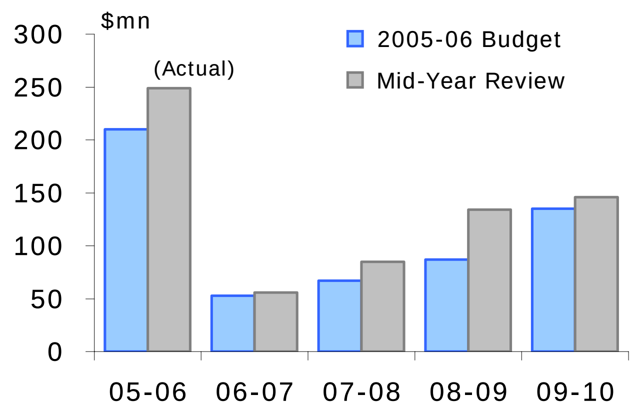


Some of the revisions to revenues and expenses are however largely due to differences in the timing of certain transactions (for example in relation to the Community Forest Agreement). Others are in 'non-cash' items (such as the depreciation and the imputed interest on the Government's superannuation liability).

The Government's **cash balance**, actually now looks slightly stronger than at Budget time, with a surplus of $56mn projected for 2006-07, an upward revision of $3mn.

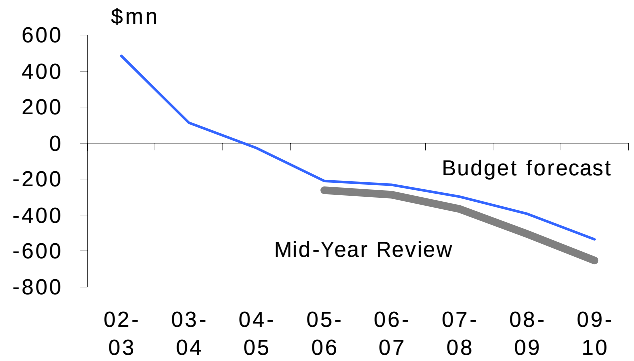
In addition, projections of both the accrual and cash accounting measures of the Budget bottom line for the three 'out years' of the forward estimates period (2007-08 through 2009-10) have improved slightly, the fiscal balance by an average of $21mn per annum – though it remains in deficit until 2009-10, – and the cash balance by an average of $25mn per annum.

General government cash balance



With the cash surpluses for 2006-07 and beyond having been revised upwards, and the 2005-06 outcome having been nearly $40mn better than predicted in the June Budget, the general government net debt position is now expected to be a little stronger than envisaged in the Budget. The general government is now expected to be a net creditor to the tune of $286mn by 30 June this year ($54mn more than expected at Budget time).

General government net debt



By 30 June 2010, the Government now expects to have net financial assets of $652mn, compared with $535mn projected in the Budget. (These net assets are for the most part set against the Government's unfunded superannuation liability).

Estimates assume very tight expense control

The forward estimates assume very tight control over expenses from 2007-08 onwards. Operating expenses are now projected to grow by an average of just 1.2% per annum between 2007-08 and 2009-10, down from 1.7% per annum in the Budget.

This compares with 5.3% growth in operating expenses forecast for the current financial year, and with growth of 5.9% per annum, on average, over the past five years.

With 'employee expenses' forecast to grow by over 4% pa between 2007-08 and 2009-10, other operating expenses, grants and subsidies will have to decline outright in order to this forecast. It is not yet clear what this might entail in practice.

In fact, the Government will need to exercise even greater expenditure restraint than implied by these forward estimates – or, alternatively, find additional revenues (which are fairly conservatively forecast to grow by 2.1% pa over the three 'out-years') – if it is to achieve all of the elements of the new **fiscal strategy** set out by Treasurer Michael Aird in the 2005-06 Budget.

On the current set of forward estimates, two of those elements – achieving surpluses on the net operating and fiscal balances on a rolling four-year average basis – will not be achieved. The others, requiring the general government sector to remain net debt-free and for capital expenditures to be covered by depreciation provisions on a four-year rolling average basis, look set to be achieved.

The forward estimates do not, of course, yet include any provision for the financing of a new **Royal Hobart Hospital** (quite properly, since the Government is yet to make any decisions about that).

Financing the construction of a new hospital should not require amendments to the Government's fiscal strategy. Although there is (in my opinion) no reason why some of the construction costs should not be financed by debt, given the Mid-Year Review's projections for the net debt position a prudent amount of borrowing for this purpose can still be undertaken without breaching the requirement to remain net debt free.

Comparisons with other States

Tasmania is the last State to publish its Mid-Year Review (Queensland's was released in January, while those of all the other States and Territories and of the Commonwealth were released before Christmas).

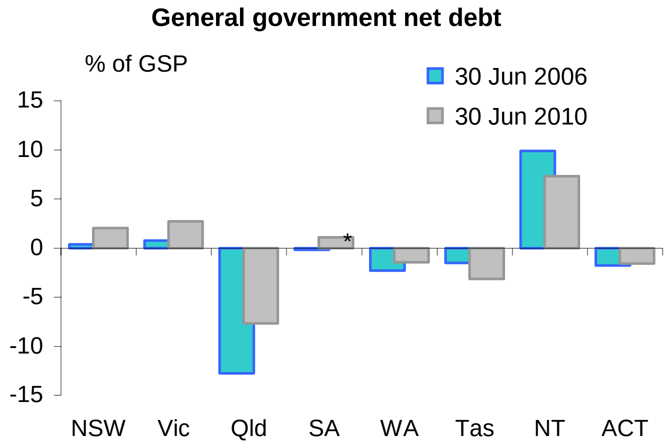
Although it is unclear why the Tasmanian Government is tardier in this regard than its peers, it does at least allow an up-to-date comparison of Tasmania's financial standing with that of other States and Territories.

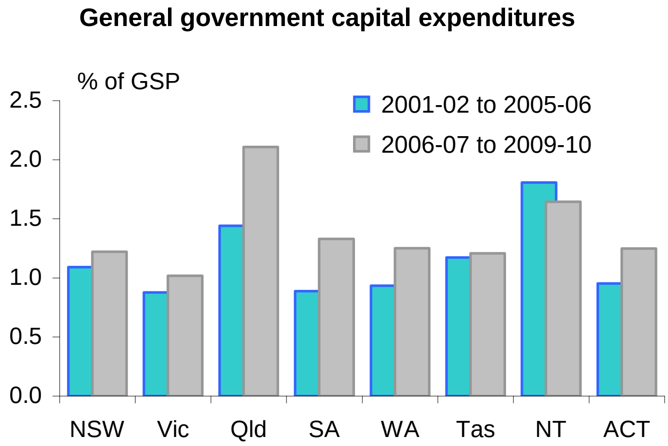
Tasmania is the only State expecting to incur net operating deficits in its general government sector over the four years to 2009-10, although NSW will do so in 2006-07 and the ACT is also expected to incur operating deficits in this and each of the following three fiscal years.

On the other hand, most of the mainland States are ramping up their capital expenditures this year and over the next three, whereas Tasmania's capital expenditures are currently forecast to decline over the forward estimates period. Most other State Governments will be funding part of their capital expenditures through borrowings. Tasmania and Western Australia are the only States to be projecting cash surpluses over the four years to 2009-10. In Western Australia's case, this is of course because the revenues thrown off by that State's mining boom are more than sufficient to cover its substantial infrastructure programs and to accumulate net financial assets.

Tasmania, Queensland, Western Australia and the ACT are (along with the Commonwealth) the only jurisdictions expecting to remain debt free over the next four years.

On the other hand, Tasmania has (by a fairly wide margin) a relatively higher unfunded superannuation liability than any other State (at over 19% of GSP). And despite a now much-improved expected result in 2006-07 compared with that projected at Budget time, Tasmania's non-budget sector has a relatively higher net debt (projected at 9.8% of GSP by 30 June this year) than any other State or Territory.





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