Tasmanian State Budget 2009-10

Not your typical pre-election Budget

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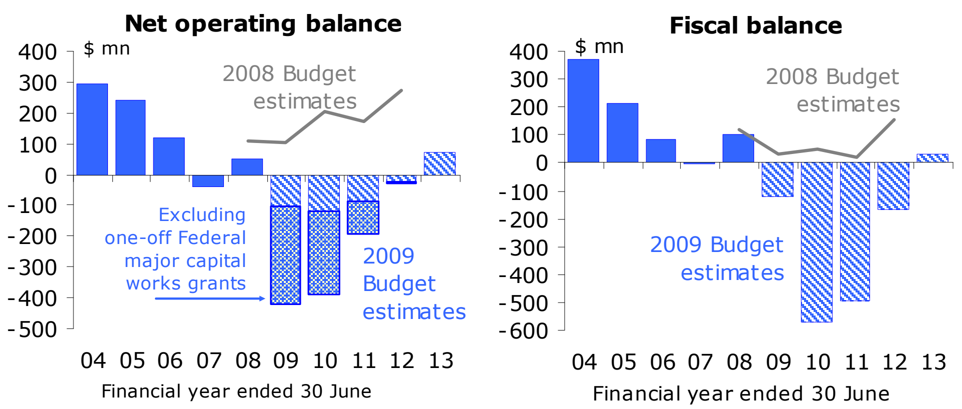
This time last year, on the back of a buoyant outlook for the Tasmanian economy, revenue projections had been revised up substantially from the preceding Budget, allowing the Government to commit to more than $1bn of new spending over four years, while still projecting surpluses on every measure throughout the forward estimates period and claiming the strongest 'general government' net debt position of any State or Territory by 2012. That appeared to put the Government in a strong position, at least from a budgetary perspective, in the lead up to the State election due in March 2011.

The contrast with this year's Budget could hardly have been greater. The global financial crisis, the ensuing sharp downturn in global economic activity, and its flow-on effects on the Australian economy, have resulted in a substantial deterioration in the outlook for the Tasmanian economy and a dramatic turn-around in the Tasmanian Government's financial position:

- Treasury expects Tasmania to experience a prolonged **recession**, with **employment** declining for two consecutive years, pushing the State's **unemployment rate** up by 3½ percentage points over the next two years;
- The State's major **revenue sources** have been revised downwards by an average of nearly $400mn per annum;
- the Budget includes **expenditure saving measures** averaging $190mn per annum over the next four years, as against only $52mn per annum (on average) in new recurrent spending;
- and despite these, the budget will be in **deficit** on every measure until 2012-13, with the fiscal deficits in 2009-10 and 2010-11 in particular being quite large by historical standards and (relative to the size of the State's economy) by comparison with most other States.

There are nonetheless three pieces of 'good news' in the Budget. First, there are **no tax increases**. Second, the Government will spend more on **infrastructure** in the next two years than it has in the past six years, largely thanks to the Federal Government's economic stimulus and 'nation-building' programs. And third, the Government's conservative fiscal management over the past decade has meant that it has accumulated sufficient cash balances to fund the projected deficits without borrowing, and without risking the State's **credit rating**.

The Budget's 'bottom lines'



Note: the 'net operating balance' is revenue (including, in this year's Budget, from one-off grants from the Federal government for capital works programs) less operating expenses (including depreciation). The 'fiscal balance' is the operating balance plus net asset purchases (capital works spending, minus depreciation and asset sales proceeds).

Revenue projections crumble …

The shape of this year's Budget has been largely dictated by the deterioration in the Government's revenues:

- Tasmania's share of **GST revenues** has been revised down by more than $1bn over the four years from 2008-09 through 2011-12, including by more than $300mn in each of 2009-10 and 2010-11. These downward revisions are almost entirely due to weaker growth in national consumer spending; but because Tasmania receives an above-average per capita share of these revenues (under the Grants Commission's formula for distributing them among the States and Territories), and because they account for a larger share of Tasmania's total revenues than other States, the impact of this reduction in total GST revenues is greater on Tasmania than on any other State;
- Revenue from **State taxes** has been revised down by $550mn over the four years 2008-09 through 2011-12. This largely reflects a $464mn reduction in revenue from **stamp duties**, due in turn to the substantial decline in property market and other dutiable transactions. Revenue from **payroll taxes** has also been revised down by $106mn over the four years to 2011-12, in line with weaker projected employment levels;
- **Interest income** has been revised down by a total of $129mn over the four years to 2011-12, as a result of lower interest rates and the run-down in the Government's holdings of interest-bearing assets required to finance its projected deficits (although the Government will also collect almost $40mn more in fees for guaranteeing the borrowings of its State-owned enterprises);
- **Dividends and income tax equivalents** from State-owned enterprises have been revised downwards by $112mn over the four years to 2011-12, of which $69mn is attributable to lower payments from the Motor Accidents Insurance Board whose investments have been significantly impacted by the global financial crisis.

In an accounting sense, these revenue losses are almost completely offset by an additional $1.4bn (over the four years to 2011-12) in **grants from the Commonwealth Government** as part of the latter's economic stimulus, 'nation building', 'Education Revolution' and COAG reform programs. Of this amount, almost $700mn is in the form of grants for specific capital expenditures, which formally counts towards the Government's revenues and hence makes the net operating deficit appear smaller than would otherwise be the case.

However these grants carry a concomitant requirement for spending, and hence neither reduce the overall fiscal deficit, nor (since they are 'one-off' in nature whereas the loss of revenues is permanent) lessens the need for offsetting actions elsewhere in the Budget.

… forcing a search for expenditure savings

The Government's response to the substantial deterioration on the revenue side of the Budget has been to pursue a number of **'Budget Management Strategies'** expected to result in savings totalling $555mn over the four years to 2011-12 (or $761mn including the final year of the forward estimates period, 2012-13):

- of this amount, $341mn (over five years) is expected to come from **'efficiency dividends'** – that is, from a requirement that agencies achieve program and other objectives using fewer resources.
- in addition, the Government will seek savings totaling $136mn (over the four years to 2012-13) through **'Agency Cost Reduction Requirements'** including leaving vacancies unfilled, early retirements, reduced working hours and voluntary redundancies;
- $99mn through **limiting public sector wage rises** (to no more than 1% pa in 2009-10 and 2010-11, and 2½% pa in 2011-12 and 2012-13);
- $66mn by **eliminating 'middle management' positions**;
- and $34mn through reductions in spending on advertising, mobile phones, vehicles and travel.

These are significant savings, building to the equivalent of over 5% of total operating expenses by 2012-13.

Equally significant is the Government's approach of specifying reductions in 'inputs' (employee numbers, average rates of pay, and specific categories of non-salary expenses), rather than in 'outputs' (specific services or programs).

Although it would be astonishing if there were not scope to deliver existing services and programs more efficiently, this strategy of relying on pre-determined reductions in 'inputs' does carry some risks.

For example, relying on 'voluntary redundancies' and across-the-board ceilings on wage increases in order to reduce overall salary expenses runs the risk that public sector employees who have the best prospect of finding employment elsewhere will be the ones who leave, rather than those who would most likely be made redundant on performance criteria.

Similarly there is no guarantee that the pursuit of arbitrarily-specified 'efficiency dividends' will result in increased efficiency, as opposed to a deterioration in the quality of service delivery.

By way of example, last year's Commonwealth Budget imposed an 'efficiency dividend' on the Australian Bureau of Statistics (among other agencies). The result was a significant deterioration in the quality and reliability of two of the ABS' most important statistical series (retail sales and the labour force), eventually prompting a re-instatement of the funding cut in this year's Commonwealth Budget. There are countless similar examples in private sector experience.

In any event, these administrative savings will be partly offset by new expenditure policy decisions totalling $209mn over the four years to 2012-13 (of which the most significant is an additional $48mn for ambulance and patient transfer services); and by the expenditure of additional Commonwealth grant funding, in areas such as education, health and legal aid.

Record infrastructure spending

While the Government has kept a tight rein on recurrent expenditures, the 2009-10 Budget provides for a record levels of **infrastructure spending**. Capital spending through the Budget will total $2.2bn over the four years to 2012-13 – more than over the 11 years to 2008-09.

Of this amount, $952mn is funded by Commonwealth grants, and will be spent on roads, education infrastructure and housing, particularly in 2009-10 and 2010-11. The balance is from State sources and includes expenditure on water infrastructure, hospital infrastructure and IT, roads (including the Brighton hub and the controversial Tarkine Road), child and family centres and housing. The decision to abandon the proposed waterfront construction of a new Royal Hobart Hospital in favour of redevelopment of the existing site will save $285mn (net) over the next four years.

In addition, infrastructure spending by government business enterprises is expected to total $1.9bn over the next four years.

Treasury estimates that public sector infrastructure spending will boost the State's economy by 1¾% in 2009-10 and 2% in 2010-11, and increase employment by a total of 4,100 over these two years.

Large deficits for the next two years …

Even with the savings from the Government's 'Budget Management Strategies', the budget will incur significant **deficits** over the next two years. The magnitude of the 'operating deficits' in 2009-10 and 2010-11 is (as the Budget Papers acknowledge) masked by the accounting treatment of grants from the Commonwealth Government under its economic stimulus and 'nation-building' programs as 'revenue'; without these, the 'operating deficit' would be $435mn in 2009-10 and $357mn in 2010-11 (equivalent to about 2% and 1½%, respectively of gross State product, in these years).

The **fiscal balance** (which includes capital works spending net of asset sales proceeds) will blow out to $569mn in 2009-10 (a turnaround of more than $600mn from the $51mn surplus envisaged for 2009-10 in last year's Budget) and remain at a still large $492mn in 2010-11. These are equivalent to about 2½% and 2% of GSP, respectively – larger than currently projected by any other State or Territory (although the Queensland and NSW Budgets for 2009-10 will not be brought down until later this week).

The Government will also run **cash deficits** from 2009-10 through 2011-12, for the first time since 1996-97. Although directly comparable figures are not available, the cash deficits projected for 2009-10 and 2010-11, of $429mn and $342mn, respectively, are almost certainly the largest run by any Tasmanian Government since the early 1990s.

Consistent with normal practice, the Forward Estimates do not include any allowance for the forthcoming sale of TOTE Tasmania, estimates of the possible proceeds from which have ranged from $90mn up to as much as $500mn.

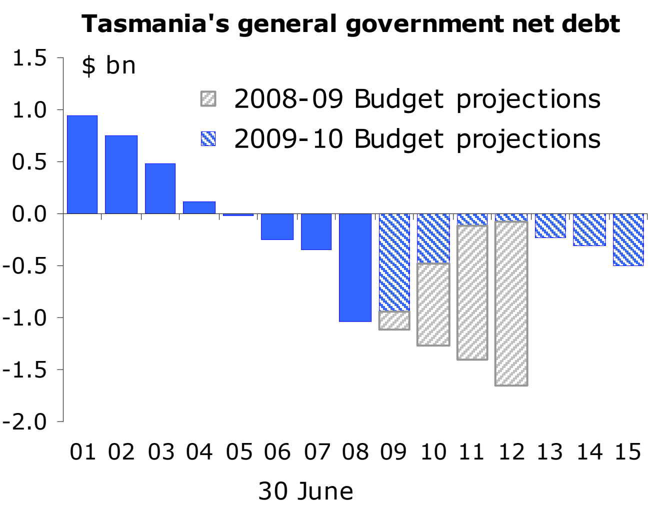
However, the Government is committed to 'reinvesting these proceeds … in infrastructure and State assets' rather than using them for debt repayment (and if the Government ends up resuming responsibility for the State's decrepit railway system there may be a considerable requirement for expenditure in that area).

The Government's new **Interim Fiscal Strategy** targets, among other things, returning the net operating balance to surplus on a four-year rolling average basis (both including and excluding capital grants from the Commonwealth) by 2014-15, and the attainment of an overall fiscal surplus by 2014-15.

… but the Budget will remain 'net debt free'

The Government's relatively conservative fiscal management over the past decade allowed it to accumulate net financial assets ('negative net debt') of just over $1bn by the end of the 2007-08 financial year. These assets will now be run down to just $72mn by the end of the 2011-12 financial year in order to finance the deficits projected in the forward estimates.

This means that the Government will not need to undertake any (net) borrowing, and (just) allows the Government to maintain its Interim Fiscal Strategy target of keeping the 'general government' sector **net debt free**. Along with the ACT and (on the most recent projections ahead of its Budget due later this week) Queensland, Tasmania is the only State or Territory now making this assertion.



Total financial liabilities remain high

Despite maintaining the net debt free status of the 'general government' sector, Tasmania's other two financial Achilles heels remain.

The State's **unfunded superannuation liability** as at 30 June 2009 has been revised upwards by $460mn to $4.4bn, and by $500-550mn over each of the next three years, reflecting the decline in investment markets over the past 12 months. (The upward revision would have been greater had the Government discounted its future liabilities at the current long term Commonwealth bond rate, now just over 5½%, as formally required by the accounting standards, rather than 6.0% which Treasury believes 'more appropriately reflects the average bond rate over the life of the liability'. The rating agencies appear to regard this as reasonable, however).

In addition, the value of assets held in the Superannuation Provision Account, the vehicle in which the Government accumulates employer superannuation contributions and (in previous years) cash from budget surpluses to defray the liability, have been revised down (since last year's Budget) by amounts rising from $129mn at 30 June 2010 to $303mn by 30 June 2012 (reflecting the fact that the Government will not be able to transfer cash surpluses to the SPA).

As a result, the Government's net superannuation liability is now expected to rise gradually over the next few years, from $3.0bn at the end of this month to $3.2bn by 2012 ($853mn more than forecast this time last year), in contrast to the gradual declines projected in previous Budgets. Hence the Government has been obliged to push the target date for eliminating the net liability out by another two years, to 2035.

Tasmania's **public non-financial corporations** (government business enterprise or GBE) **net debt** is also projected to rise by from an expected $2.2bn at the end of this month to $2.65bn by 30 June 2012 (some $290mn more than envisaged in last year's Budget) before levelling out in 2012-13.

These two liabilities are relatively larger for Tasmania than for other States, and are the main reason why Tasmania's ratio of **net financial liabilities to revenue** (one of the key indicators used by rating agencies to assess States' credit ratings) remains relatively high. Together with Tasmania's relative small and narrowly-based economy, this is the main reason why Tasmania's S&P credit rating has remained one notch below the other States (until the downgrading of Queensland's rating earlier this year).

Indeed this ratio is expected to rise from 116% in 2008-09 to 129% in 2009-10 and to remain above the Interim Fiscal Strategy target of 110% until after 2014-15. However S&P has endorsed the Government's projections that this ratio will decline over the medium term. Interestingly, it also assumes that the Government's capital works spend will fall short of the Budget projections. For these reasons, S&P regards Tasmania's AA+ credit rating as 'stable'.

A surprisingly gloomy economic outlook

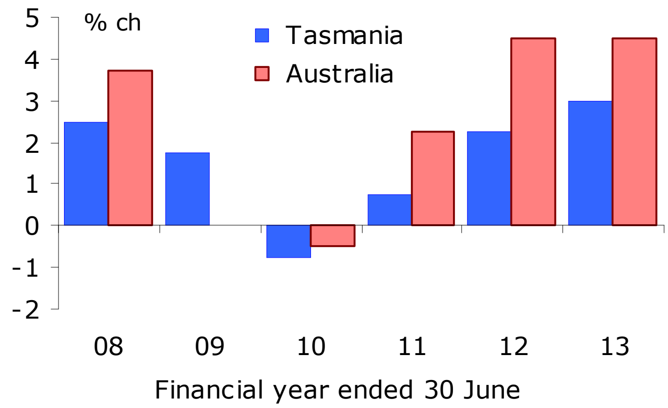
The Budget has been framed in the context of a rather **pessimistic outlook for the State's economy** over the next two years:

- Treasury expects **real gross State product** to decline by ¾% in 2009-10 and to grow by ¾% in 2010-11, before picking up to 2¼% in 2011-12 and 3% in 2012-13;
- **employment** is forecast to decline by 2% in 2009-10 and by a further ¾% in 2010-11, before returning to positive growth in 2011-12;
- which will in turn push the State's **unemployment rate** from an average of 4¾% in the current financial year to 7% in 2009-10, rising to an average of 8¼% in 2010-11 where it is expected to remain in 2011-12 before falling to 7½% in 2012-13.

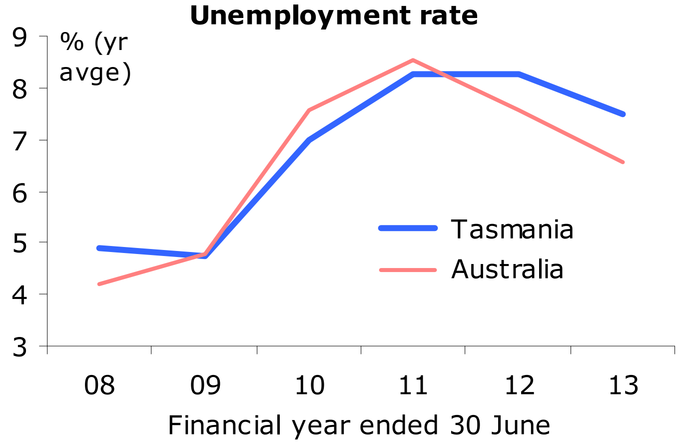
These forecasts imply that Tasmania's economy will under-perform the national economy by a wide margin, especially beyond the 2009-10 financial year. The Commonwealth Treasury expects the national economy to contract by ½% in 2009-10 (a forecast which some analysts now regard as being a little on the conservative side) before growing by 2¼% in 2010-11 and then (more controversially) by 4½% per annum in the two following years. Commonwealth Treasury expects Australia-wide employment to fall by 1½% in 2009-10 but then to grow by ½% in 2010-11.

Treasury's gloomy economic outlook

Real gross product growth



Unemployment rate



Treasury's relatively pessimistic view of Tasmania's medium-term economic prospects is based on the observation that 'following the most recent major recession in 1990-91, Tasmania's recovery was much slower than the national recovery and it took several years for employment, in particular, to recover to pre-recession levels'.

While this is an accurate historical account, it gives surprisingly little weight to the extent of structural change which has occurred since then (even though the section of the Budget Papers setting out Treasury's economic outlook concludes with a seven-page appendix listing and describing Tasmania's economic reforms over the past decade).

The deeper recession and slower recovery (relative to the rest of Australia) which Tasmania experienced in the early 1990s was in part due to the need for more severe fiscal restraint in Tasmania (and Victoria, Tasmania's major mainland market) than in most other States at that time (as a result of the fiscal mis-management which both States suffered in the 1980s), overlaid in Tasmania's case by the effects of the winding down of the (then) HEC's construction workforce following the end of the dam-building era. Although Tasmania is now again seeking savings in public sector employment, they are not on the same scale as in the early 1990s.

Additionally, Treasury argues that the same factors which have allowed Tasmania's economy to hold up more strongly than the national average over the past year – a below-average proportion of activity generated by highly-cyclical sectors such as mining, manufacturing and construction (in contrast to the early 1990s), a below-average household exposure to the financial crisis (because of relatively lower levels of debt and financial assets), and an above-average benefit from the Federal Government's economic stimulus packages – will constrain the recovery in Tasmania relative to other States.

Thus Treasury argues that the national recovery will be 'driven, in part, by the resource sector [which] is likely to favour the resource rich states, which does not include Tasmania'; and that 'middle- and higher-income households … [of which] Tasmania has a smaller proportion than nationally' will account for much of the expected return to stronger household consumption nationally from 2010-11 onwards.

Yet the Western Australian Treasury, in its Budget Papers released last month, forecasts that WA's economy – the most 'resource-rich' in the nation – will contract by 1¼% in 2009-10 and a further ½% in 2010-11, suggesting that it does not share the view that the national recovery will be concentrated in the resource-rich States. And to the extent that the global financial crisis has resulted in a permanent change in Australian households' propensity to fund consumption spending by borrowing in anticipation of future capital gains, so that consumer spending recovers more slowly than in previous upturns, it is not necessarily the case that Tasmanian households will be at a disadvantage.

The third reason for Treasury's pessimism regarding Tasmania's medium-term economic prospects is that a relatively higher proportion of Tasmania's workforce is comprised of unskilled workers, who 'tend to be more vulnerable to redundancies during periods of job-shedding' and are more likely to 'remain unemployed or leave the workforce' when the labour market improves.

This is unarguable, and underscores the importance of improving Tasmania's below average education participation rates and attainment outcomes over the longer term.

Nonetheless, it seems to this analyst that the short- and medium-term outlook for the Tasmanian economy may not be as gloomy as painted by Treasury in this year's Budget Papers. We think Tasmania's economy will show zero growth in 2009-10, followed by 1½-2% growth in 2010-11, and that the State's unemployment rate will peak at around 7¾% in 2010-11.

That does not necessarily mean that the Budget's bottom-line outcomes will be better than projected, since the linkages between year-by-year variations in State economic growth and State Government revenues or expenditures are rather tenuous.

Further improvements in the Budget Papers

Over the past few years there has been a substantial improvement in the quality of Tasmania's Budget Papers, and that has continued in this year's Budget. Noticeable and welcome advances include:

- **more comprehensive economic forecasts**, including forecasts for the major expenditure components of gross State product (household consumption, business and residential investment, etc.) and for gross State product itself (finally setting aside Treasury's long-standing reticence about forecasting this measure of overall economic performance, although its reservations about the reliability of ABS' measurement of the concept for Tasmania remain);
- explicit consideration of **alternative scenarios** for elements of the economic forecasts and for some of the key financial strategy targets (although space has precluded attention to these in this report, they are a useful addition to assessing the risks around the Budget);
- more comprehensive **detail about infrastructure spending** than has been presented in previous Budgets; and
- the inclusion for the first time of financial statements for the **public financial corporations sector** (which is dominated by the MAIB and the Retirement Benefits Board). This sector runs small annual surpluses (in the range $25-63mn over the next four years) but, importantly, have net financial assets expected to rise from $242mn at the end of this month to a projected $730mn by June 2012.

These are in addition to the most comprehensive analysis of movements in projections of revenues and expenditures from one budget statement to the next (the 'Policy and Parameter Statement' at the end of Chapter 4 in Budget Paper No. 1) of any jurisdiction in Australia, and greater transparency around some of the previously somewhat obscure corners of the Budget, such as the Superannuation Provision Account and the Tasmanian Risk Management Fund.

Tasmania can now share with Western Australia a claim to presenting the most comprehensive and transparent set of Budget Papers of any government in Australia.

One additional plea from this analyst would be more historical information on some of the key Budget aggregates, such as appears (in different forms) in the South Australian, New South Wales and Victorian Budgets, to facilitate historical comparisons without needing to refer to a succession of budget documents from previous years. In particular, it would be helpful to include final outcomes for the year preceding the financial year that ends shortly after the Budget is presented (as is the practice in most though not all other States).

A concluding assessment

The 2009-10 State Budget has been framed in more challenging circumstances than any since that of 1990-91, given the prospect of the most serious downturn in the State's economy since then and the magnitude of the decline in the Government's revenues.

The Federal Government's economic stimulus and 'nation-building' programs have allowed the Government to incorporate a substantial capital works program into the Budget, but have not alleviated the need for difficult decisions with regard to recurrent expenditures.

The Government is seeking to achieve significant savings in its operating costs. The Government hopes these can be achieved by procuring operational and administrative efficiencies, and by across-the-board reductions in specific types of expenses, rather than from a comprehensive review of the need for and cost of existing programs.

To the extent that it has made judgements about particular areas of expenditure, it has focussed on what some regard as 'soft targets' (such as national parks and the arts), rather than asking more difficult questions about whether 'core' services such as education, health and law enforcement are currently being organized and delivered in the most effective and efficient fashion. These areas are, after all, by far the largest areas of State government spending.

The Government's 'input-oriented' approach has been often pursued in large private sector corporations, and is much beloved by management consultants. There is no doubt that it will result in reduced expenditures. What is less clear is whether it will result in genuine 'efficiency gains' as opposed to unplanned deteriorations in service quality.

Although the Government will, over the next two years, incur budget deficits which are quite large both by Tasmanian standards of the past two decades and (as a proportion of the State's economy) larger than those of most other States, the Government's relatively conservative fiscal management over the past decade will allow them to be financed without recourse to net new borrowing, or to tax increases, and without putting the State's credit rating at risk.

This illustrates why governments should run surpluses during 'good times' – so that when times turn bad, as they inevitably do, governments have the capacity to support economic activity and employment through infrastructure investments and are not compelled to implement actions (such as tax increases) which intensify economic pressures on businesses or households.

It is possible that 'the times' for Tasmania will not be as bleak as portrayed by Treasury's forecasts. That, too, would highlight the benefits of economic reforms pursued in more propitious circumstances, and should strengthen the resolve of the current and future Governments to pursue new and unfinished reforms over the years to come.

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