

**TASMANIA'S ECONOMY: LOTS OF PROGRESS BUT
LOTS STILL TO DO**

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by

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Thank you for the invitation to participate in the Tasmanian Economic Forum for the third time. I do appreciate the opportunity to share my thoughts on the Tasmanian economy and on ways of improving its performance.

As at the previous two Forums, I want to begin by reviewing the performance of the Tasmanian economy over the past financial year, drawing heavily on the recently published *State Accounts* which is a mine of useful information for making inter-state comparisons, and on other partial indicators including the September quarter State final demand figures published on Wednesday.

Then I want to look at some of the drivers of economic performance which I've emphasized in my previous contributions to this Forum, to see what has changed since we were last here and to share some views about what should change if recent improvements in Tasmania's economic performance are to be sustained. For those of you who attending this Forum for the third time let me apologize in advance for the fact that you will have heard some of this before.

And thirdly I want to touch on three other topical matters which hopefully will be of at least some interest.

Tasmania's economy performed strongly in the 2005-06 financial year

Tasmania's economy grew by 3.1% in 2005-06 after registering 4.1% growth in 2004-05. This is the first time since 1990-92, and only the second time in 27 years, that Tasmania's economic growth rate has exceeded that of the mainland in consecutive years (slide 2).

Over the past five years, Tasmania's *real gross State product* (GSP) has grown at an average annual rate of 3.7%. This is the best performance over any five year period since that ended 1987-88.

Once again I acknowledge that the Tasmanian Treasury has many reservations about ABS' GSP estimates for Tasmania, but since they don't publish details of, nor any history of, their 'underlying economic activity' measure, GSP is all that outside analysts have to go on. Once again I repeat my plea for Treasury to provide more detail of this measure, including a historical time series and some indication of how it is compiled. There is no reason why this should be a 'state secret'.

As was the case in 2004-05, Tasmania's economic growth rate in 2005-06 was faster than of any of the other 'non-resource rich States' (slide 3). Tasmania's average growth rate over the past five years has exceeded that of every State (and Territory) except WA and Queensland, as well as the mainland average

In *per capita* terms Tasmania's economy grew by 2.3% in 2005-06, again the fastest of the 'non-resource rich' States and Territories, and nearly a full percentage point above the national average.

Over the past five years Tasmania's per capita real GSP has grown at an average annual rate of 3.0% per annum. This is the strongest performance over any five-year period since at least the early 1980s, exceeded only by Western Australia, and matching that of Queensland. It exceeds the national average by 1 pc point - this being the only five-year interval since that ended 1988-89 over which Tasmania's per capita economic growth rate has exceeded the national average (and then it was by only 0.3 pc pts pa).

According to the measures published in ABS' *State Accounts*, Tasmania's relative per capita gross product remained unchanged at 74.7% of the national average in 2005-06 (slide 4).

That's because the measure of relative per capita GSP published by the ABS is derived from *nominal* gross product, and the implicit price deflator for Tasmania's GSP rose by 3.9% in 2005-06, compared with 4.8% for Australia as a whole (dragged up by increases of 7.9% for Queensland and 10.5% for Western Australia, in turn reflecting the huge increases in the prices of those States' resources exports). This below-average increase in Tasmania's GSP price deflator offset the above-average increase in Tasmania's real per capita GSP.

Using *real* instead of nominal data, Tasmania's per capita GSP rose from 74.7% of the national average in 2004-05 to 75.4% in 2005-06. This is still the lowest in Australia by a wide margin (SA is next at 87.2%) but it is nonetheless the highest since 1998-99

Per capita *household disposable income* rose by 6.4% in Tasmania in 2005-06, faster than anywhere else except the NT and Queensland, and nearly 1½ pc pts above the national average. This was largely due to faster growth in employee compensation (in turn due to above-average growth in employment) but also to much smaller growth in mortgage interest payments (which of course detract from disposable income)

As a result, Tasmania's per capita household disposable income relative to the national average rose another 1.2 pc pts to 85.5% - the highest since the current series began in 1989-90.

This relativity has now risen by almost 10 pc points since 2000-01 – though it is still 6 pc points below the next-lowest ranked State (SA).

However more recently Tasmania's economy appears to have slowed sharply

Tasmania's economy does appear to have slowed quite significantly over the first three quarters of 2006 (slide 5).

- the 3.6% contraction in *State final demand* (SFD) in the September quarter, reported earlier this week, was distorted by the sale of Spirit III – since this was sold to foreigners rather than locally, the offset to the sale is in exports (not included in SFD) rather than private business investment;
- even so, SFD excluding public fixed capital expenditure (the component distorted by the Spirit III sale) has fallen for three consecutive quarters, by a total of 2.2% from its peak in Dec qtr 2005.

To some extent, the slowdown in the Tasmanian economy reflects factors common to other States, particularly those not benefiting from the 'resources boom':

- consumer spending has been everywhere adversely affected by rising interest rates and (until recently) rising petrol prices;
- housing activity has likewise been impacted by rising interest rates and high land prices; and

- sectors such as manufacturing and agriculture impacted by the strong A\$ induced by high resource commodity prices, and agriculture also by drought.

However there are also some Tasmania-specific factors driving the slowing in the State's economy during 2006.

The propensity of Tasmanians to borrow and spend has been affected no less than that of other Australians by rising interest rates and (until recently) by rising petrol prices (as indicated by the consumer confidence series) (slide 6).

However consumer spending – and components of it such as retail and motor vehicle sales – are also affected by the number of consumers

Although net immigration from the mainland remains positive, it has slowed to an average of less than 10 per week since the beginning of 2005, down from a peak of over 50 per week in 2003-04, at the height of the local housing boom which owed much to the belated 'discovery' of Tasmania's (then) relatively cheap accommodation while prices in mainland capital cities seemed destined for the stratosphere.

Tasmania's population growth rate has thus slowed to about ¾% per annum, from a peak of 1.2% pa in 2003. Inevitably this has had a dampening impact on *household consumption* spending.

Given the deceleration in population growth the level of *housing activity* has held up pretty well (slide 7)

- in trend terms the level of residential investment activity in Tasmania is down just 0.7% from its peak in the September quarter 2005, cf. a decline of nearly 5½% from an 18-mth earlier peak on the mainland;
- other leading indicators of housing activity suggest a 'levelling out' for Tasmania, in contrast to the steeper decline seen in NSW and to a lesser extent Victoria (offset for the mainland as a whole by strong levels of activity in WA);
- house prices have held up pretty well in Tasmania too; the 9.4% increase in Hobart house prices over the year to the September quarter was exceeded only by the 'boom cities' of Perth and Darwin and (somewhat more surprisingly) marginally by Canberra;
- Indeed if anything the pace of house price appreciation has picked up slightly in Hobart over the past year; and the number of established house transactions has picked up a bit too.

However *business investment* has slowed markedly in Tasmania over the past year or so (slide 8).

- from a peak in the December quarter of last year, private business fixed investment has dropped by a quarter, in trend terms, over the first three quarters of 2006;
- the level of spending on plant and equipment has dropped by nearly 30% in trend terms over this period while private non-residential construction spending has fallen by more than 16%;

- this appears largely to reflect the completion of a number of major energy investment projects during 2005 and thus was perhaps to some extent inevitable.
- of course if the Gunns Pulp Mill is approved then these numbers will once again rise sharply – although it remains unclear whether and when that project will get the go-ahead; and, if it does, whether construction work on it will commence in 2007-08 as foreshadowed in this year's State budget papers.

However it is a little disappointing that there has not been any discernible increase in investment in other areas of the Tasmanian economy, notwithstanding the foreshadowing of a number of projects in (for example) tourism.

The slowdown in the Tasmanian economy during 2006 is also apparent in the key indicators of labour market performance – where the closing of the many large gaps between Tasmania and the mainland over the three or four preceding years appears to have stalled this year (slide 9).

- *Employment* has fallen by 1,900 or 0.9% (in trend terms) over the past 12 months. This reflects the loss of some 5,300 part-time jobs (7.2%) whereas full-time employment has risen by 3,400 or 2.3%. But Tasmania is the only State to have lost jobs over the past year: on the mainland, employment has increased by 2.7%;
- the *unemployment rate* has declined over the past twelve months to 6.3% (in trend terms) although this is above the most recent low of 5.7% in December 2004 and January 2005, whereas in every other State except NSW and on the mainland as a whole, unemployment is at or close to 30-year lows. The gap between Tasmania's and the mainland's trend unemployment rates has blown out from 0.6 pc points in late 2004 – early 2005 to 1.7 pc points in October and November this year, the highest since May 2003;
- Tasmania's unemployment rate would have risen further but for a decline in the *participation rate* to 60.1% in November from a most recent peak of 61.4% in December 2004, at a time when labour force participation has risen by nearly ½ a percentage point and reversing what had been a very promising trend;
- as a result, the *proportion of working-age Tasmanians in employment* has slipped back to 56.3%, the lowest since June 2005, and more than 5½ pc points lower than on the mainland, from a most recent peak of 57.3% in May and June this year.

I noted in my commentary on this year's State Budget that the Budget's forecast of 3½% growth in 'State economic activity' may have been 'a little optimistic'.

I thought it was unlikely that Tasmania's economy could grow at a faster *per capita* rate than the national average in circumstances where growth in the national economy was expected to become increasingly driven by resources exports and where relatively high commodity prices were expected to keep the A\$ at an elevated level, thereby eroding the competitiveness of the manufacturing and agricultural sectors which constitute a larger share of Tasmania's economy than of the Australian economy.

Recent data – including this week's state final demand estimates for the September quarter – have re-inforced these doubts.

To be sure, State final demand is not necessarily a reliable guide to movements in total State economic activity (GSP) (slide 10). In all but one of the past six years, the 'balancing item' in the annual State accounts (in theory the sum of the change in inventories, net interstate exports and net international services exports) has subtracted between 3 and 4 pc points from GSP growth (ie, SFD has grown at a much faster rate than GSP).

Assuming that this will also be the case in 2006-07, SFD + net international exports of goods (NIXG) would need to grow by an average of around 6½-7% if GSP growth is to average around 3½%.

This now seems implausible given the decline in SFD +NIXG over the year to the September quarter; growth in this aggregate would need to average 6-6½% per quarter – or nearly 20% *through* the year to the June quarter 2007 – for the Budget forecast to be attained. (Or something unusual would need to happen to the 'balancing item'.)

Federal Treasurer Peter Costello this week suggested that growth in the national economy in 2006-07 was now likely to be around ½ of one percentage point lower than forecast in the Budget Papers, and I suspect Tasmanian Treasurer Michael Aird will need to revise his forecast for growth in the Tasmanian economy down by at least as much.

Given that the national economy, and the distribution of economic activity around the nation, is being significantly influenced by the 'resources boom' associated with rapid growth and industrialization in China and other emerging economies, it is inevitable that economic growth is going to be faster in Western Australia, the Northern Territory and Queensland where the resources sector accounts for a much larger share of economic activity than it does in the south-eastern States (slide 11).

And the divergence in economic performance between the south east and the north & west of Australia will be further heightened by the impact that high prices for mineral and energy commodities are having on the exchange rate. We calculate that had the rise in commodity prices over the last five years or so not occurred, the A\$ would today be trading at around US59¢.

The fact that it is instead trading at nearly US80¢ is clearly to the disadvantage of other trade-exposed sectors such as manufacturing, agriculture and tourism (for whom there is no offsetting benefit in the form of higher product prices).

Manufacturing accounts for 14½% of Tasmania's economy, a higher proportion than for any other State except South Australia; while agriculture accounts for over 6½% of Tasmania's economy, the highest of any State by a wide margin.

There is of course nothing that can or should be 'done' about this (and of course this works to Tasmania's relative advantage when the exchange rate is low) – except perhaps to encourage the manufacturing and rural sectors to focus on products which can be competitive at high exchange rates, and the further development of services sectors.

Some encouraging developments on the productivity front

As I've sought to emphasize to the past two Tasmanian Economic Forums (and elsewhere), an essential ingredient in any long-term strategy to improve Tasmania's economic performance – and the living standards of Tasmanians – is to lift Tasmania's historically very poor productivity performance.

And in that respect the trend in the past two years has been very encouraging (slide 12).

During a period in which Australia's overall productivity performance has been very poor, Tasmania has recorded two consecutive years of increased (labour) productivity. Output per hour worked grew by 2.7% in Tasmania last financial year, following a 2.0% increase in 2004-05.

The *level* of labour productivity in Tasmania remains the lowest in Australia – at 85.5% of the national average (slide 13). But at least the *rate* of productivity *growth* has stepped up. Indeed over the past five years, the growth rate of labour productivity in Tasmania has averaged 2.2% per annum, faster than anywhere else in the nation except Western Australia, and more than half a percentage point above the national average

However this improvement has yet to lift the level of Tasmanian productivity out of the range (relative to the national average) into which it fell in the early years of this decade (slide 14). And it will clearly take an extended period of above-average productivity growth even to lift Tasmania back to (say) 90-92% of the national average, where Queensland and South Australia sit.

Given the very close association between relative productivity levels and relative per capita household disposable income this would probably lift Tasmanian living standards from around 86% of the national average to around 90-92%, or by around \$1800-2200 per head.

Thus it is essential that government and business sustain a focus on strategies to maintain an above-average rate of growth in productivity over the medium term.

In this context I want to re-iterate and update a point I made last year.

It's well known that labour costs are lower in Tasmania than in any other State for example in the September quarter this year average weekly earnings in Tasmania were 11% below the national average, and lower than in any other State or Territory. And a measure of labour costs derived from the State accounts, employee compensation per hour worked, was 14% lower in Tasmania than the national average in 2005-06. Having the lowest labour costs (thus defined) of any State or Territory is widely perceived as a source of comparative advantage for Tasmania – see eg the *Competition Index* published annually by the Tasmanian Treasury

But is this really a source of comparative advantage, when the reason for it is that Tasmania's work force is the least skilled of any State or Territory?

The State Accounts can be used to construct an index of 'unit labour costs' (although note, unlike the measure constructed by Federal Treasury for the Australian economy as a whole, it doesn't include on-costs such as payroll tax & workers' compensation) (slide 15).

- on this measure, shows that employee compensation per unit of output in 2005-06 was actually the third highest in Australia (after only the ACT and NSW) and about 1% above the national average.
- moreover this measure of unit labour costs has increased at an average annual rate of 4.8% over the past five years, a good deal faster than in any other State and well above the national average of 2.9% pa

That is, when account is taken of the below-average productivity of the Tasmanian workforce Tasmania's labour costs are *not* the lowest in the country, but rather are close to being the *highest*.

Investment, competition, innovation and productivity growth

One of the principal drivers of productivity growth is *fixed capital investment*.

Economic theory suggests, and empirical studies confirm, that increasing the level of capital per worker results in increased output per hour worked. The increase in business investment as a share of Tasmanian economic activity since the late 1990s – to almost the same share as the national average (slide 16) – has thus almost certainly been an important contributor to the improvement in Tasmania's productivity performance over the past five years.

Of course this also means that the sharp decline in business investment over the past three quarters (not captured by this chart which shows financial year averages) raises the risk that Tasmania's good productivity performance in recent years might go into reverse.

Levels of business investment are influenced by a myriad of factors, many of them beyond the control of a State government.

The level of State taxes is a factor, albeit I think more at the margin. It's not essential to have the lowest State taxes in the country especially if that isn't a sustainable position (as I think Queensland is now beginning to discover), although it's certainly not helpful to have the highest either.

It's probably more important to have adequate, reliable and competitively-priced infrastructure; a well-educated and trained and well-motivated work force; and a facilitative, supportive, 'can do' approach on the part of relevant State authorities.

There's now a large body of theoretical and empirical research demonstrating that - as an OECD survey of this research published in 2002 put it – '*competition* has pervasive and long-lasting effects on economic performance by affecting economic actors' incentive structure, by encouraging their innovative activities, and by selecting more efficient ones from less efficient ones over time'; and that 'the link between product market competition and productivity growth is positive and robust'.

Tasmania has a good record in implementing pro-competitive reforms; although slide 17 is a bit out of date (since with the end of 'National Competition Policy' the NCC no longer makes these assessments).

Nonetheless it's disturbing to see from time to time evidence that parts of the Tasmanian business community "don't get" the importance of competition as a driver of productivity and growth, and continue to think that one of the roles of government is to protect them from competition.

We saw this during the debate over extensions to shop trading hours (when, astonishingly, the Liberal Party opposed this reform, as did their counterparts in Western Australia more recently). And we've seen it again in the opposition by businesses to proposed 'big box' retail developments at Launceston and Hobart Airports.

It's kind of ironic that a Labor Treasurer finds it necessary to remind business figures that the role of government is to promote competition, not to stifle it; though I applaud Michael Aird for doing so!

Another area in which Tasmanian business is lagging is in regard to *innovation*, according to figures released by ABS this week (slide 18). ABS defines 'innovation' pretty broadly to include 'any new or significantly improved goods or services, or operational or managerial processes:

- only 17% of Tasmanian businesses introduced any new or significantly improved goods or services in 2004 or 2005, fewer than in any other State (though higher than in either of the Territories), compared with a national average of 19.4%;
- only 19.5% of Tasmanian businesses introduced any new or significantly improved operational or managerial processes in 2004 or 2005, a smaller proportion than anywhere else in Australia, and well below the national average of 24.9%;
- the proportion of Tasmanian businesses innovating in either of these two ways was 30.1%, lower than anywhere else except the ACT, and compared with a national average of 33.5%.

And lest it be thought that the low level of innovation by Tasmanian business is in some way due to the comparative dearth of large businesses in this State, the ABS figures show that Tasmanian businesses of all sizes rank below their corresponding national averages in regard to innovation.

Tasmania's rating is dragged down by a woeful performance in the wholesale trade sector, where only 28.8% of businesses engaged in innovation of any kind, compared with 43.4% of businesses in this sector nationally. Together with sub-par levels of innovation in Tasmania's culture and recreation, retail, manufacturing and property & business services sectors, this more than offset above-average levels of innovation in the transport & storage sector (42%) and the (largely State-owned) utilities sector (66.6%).

Education and productivity growth

The other important driver of productivity growth is investment in '*human capital*' – broadly speaking, the skills and aptitudes of the work force. Education contributes to increased productivity and economic growth in several ways: (1) by increasing the skills and abilities of individual workers (2) by raising the flexibility of workplace teams (3) by allowing for more rapid utilization and transmission of new skills and production technologies; and (4) by fostering the creation of knowledge, ideas and technological innovation.

As I've emphasized in this forum previously, Tasmania has traditionally performed poorly by comparison with the rest of Australia (slide 19).

- in 2004, only 44.8% of Tasmanians aged 15-64 had post-school qualifications, the lowest of any State or Territory and compared with a national average of 51.5%:
 - of those Tasmanians aged 25-64, only 51.1% had post-school qualifications, cf. 58.1% of all Australians;
 - only 18.3% of Tasmanians aged 25-64 had a bachelor's degree or higher, cf. 22.7% of all Australians
- conversely, 42% of Tasmanians aged 15-64 had not completed Year 12, the highest of any State or Territory and compared with a national average of 31.2%.

Although I'm not aware of any statistics which prove this, common sense suggests that Tasmania's figures are more affected by interstate migration than those for other States.

But the gap in educational attainment between Tasmania and the rest of Australia appears to have widened slightly in recent years, instead of narrowing as one would have hoped (and as it needs to if improved productivity growth rates are to be sustained)

The relatively lower levels of educational attainment of the Tasmanian work force are reflected in the pattern of employment (slide 20):

- the proportion of the Tasmanian work force employed in the highest-skilled occupations (as defined by ASCO) in 2004-05 was, at 25.7%, lower than in any other State except Queensland and below the national average of 27.1%; and
- the proportion of the Tasmanian work force employed in the lowest-skilled occupations was at 20.1% higher than in any other part of Australia except South Australia (where the proportion was the same) and more than 1 pc point above the national average.

Although at least here the gaps between Tasmania and the national average appear to be narrowing.

Of course the level of educational attainment and skills possessed by the Tasmanian workforce reflects the cumulative impact of the choices made by them, their parents and Tasmanian governments over many decades.

Until this decade, a much smaller proportion of Tasmanian children went on to upper secondary education than in most other parts of Australia, and an even smaller proportion went on to acquire tertiary qualifications (and an above-average proportion of those who did probably migrated to the mainland) (slide 21).

There was a significant improvement in the retention rate from Year 10 to Year 12 in Tasmania since the mid-1990s and the early years of this decade.

However since 2003 and especially in 2005 the retention rate to Year 12 in Tasmania has slipped back sharply. In 2005 Tasmania once again had the lowest Year 12 retention rate of any State or Territory (for the first time since 1997).

To some extent this may be a side-effect of the improvement in job prospects in Tasmania over the past couple of years. But even if this is true it is an unsatisfactory explanation. First, Tasmania is not the only place where employment prospects have improved: for example the unemployment rate in WA is now down to about 3½% yet WA's Year 12 retention rate has increased to 72.2%.

Second, Tasmanian teenagers are short-changing themselves if they leave school at Year 10 just because for the moment they find the prospect of finding a job have improved.

Encouragingly, since becoming Minister for Education after this year's State election, David Bartlett has demonstrated a clear understanding of the importance of education as a driver of productivity growth and of what needs to be done to improve Tasmania's 'human capital' over the longer term (slide 22).

In particular, Mr Bartlett doesn't seek to engage in statistical quibbles over the evidence which I presented here last year showing that Tasmanian students perform less well relative to national literacy, numeracy and problem-solving benchmarks than students anywhere else in Australia except the Northern Territory; and that Tasmanian students fall further behind their mainland counterparts against these benchmarks the longer they remain in the system.

Mr Bartlett is also hitting exactly the right mark when he emphasizes the need to see year 10 'as an entry point to further learning, not an end point', as encapsulated in his announcement this month that Year 10 students will finish the school year at the same time as students in other years.

Mr Bartlett's attitude on this point is a welcome contrast to that of the Prime Minister and former Education Minister Brendan Nelson.

And his focus on the basics of literacy and numeracy, rather than 'acting democratically' and some of the other nonsense that surfaced under the guise of 'Essential Learnings', is also exactly what Tasmania needs.

However I hope that Mr Bartlett can achieve greater success in persuading his Cabinet colleagues to devote more resources to funding his ambitions. Education spending is set to rise by only 2¾% this financial year, according to this year's Budget – less than the inflation rate, and significantly less than the increases in health or 'public order and safety'.

As I said in commenting on this year's State Budget, I don't quibble with the importance the Government is now attaching to 'fixing' the health system (and it clearly has an electoral mandate to put a lot of money into this area); but it's not as if Tasmania has been experiencing a crime wave that warrants such a huge increase in spending on law and order.

A better deal for the Arts, please

Since the organizer of today's event (Greg Phillip) did invite me to nominate "10 or 15 things that I would change if I could", I can't resist the opportunity to make a plea for additional funding for the arts (and in particular for the program of grants to individual artists and small arts organizations which is administered through the Tasmanian Arts Advisory Board which I have had the privilege of chairing since the beginning of this year).

The Tasmanian Government spends less per head of population on the arts than any other State or Territory except Queensland (slide 23). That's in large part because Tasmania doesn't have a large performing arts centre incurring a large deficit which has to be made up by the State Treasury; but that's no justification for Tasmania to be spending less than three-quarters of the national per capita average on the arts.

The present Government has been generous in its funding of arts infrastructure (highlighted by the provision for the TMAG extension) and of the Ten Days on the Island Festival (and TSO). Without detracting from that, there's not much point in generously funding venues or occasions if the support for what is hung, displayed or performed there is inadequate. After all it's works and performances that people go to see, not venues.

And apart from a two-year period in which former Arts Minister Lara Giddings was able to dip into the Economic & Social Infrastructure Fund, government support for individual arts and arts organizations has been essentially unchanged since the mid-1990s, and thus has declined by more than 20% in real terms over the past decade.

As Richard Florida's work suggests, a vibrant arts community is one of the things which acts as a 'magnet' for what he calls the 'creative classes'; while by contrast government support for professional sports conspicuously doesn't. The arts can also be an important source of innovation in their own right.

Public finances

At the past two Tasmanian Economic Forums I've highlighted the significant improvement in Tasmania's public finances over the past decade or so, (slide 24) making the point that Tasmania is now well placed to fund initiatives designed to improve the business climate, the stock of 'human capital' and to underwrite pro-competitive structural reforms (eg by – where necessary – compensating the 'losers' from particular reforms).

Since the election the financial position of the State Government has deteriorated somewhat, largely as a result of the cost of meeting the Government's election promises (which totalled some \$730mn of additional operating and capital expenses over the current four-year Forward Estimates period).

As a consequence the budget will be in 'operating deficit' for the current and the following three years; and in 'fiscal deficit' for this and the next two years. These deficits are fully covered by depreciation provisions, so that the budget remains in cash surplus over the full forward estimates period – albeit less so than envisaged before the election.

All of this is premised on very tight control of expenses from 2007-08 onwards: the forward estimates allow for operating expense growth of just 1¾% pa from 2007-08 through 2009-10 even though wages and salaries growth is likely to average around 4% pa.

On the face of it this doesn't leave much room for initiatives in other areas.

One of the fiscal challenges which the Government now faces is that of financing a new Royal Hobart Hospital. Preliminary indications are that the capital cost of this project will be at least \$450mn.

There's no reason why at least some of this cost should not be financed by major asset sales.

Although the Labor Government came to office on a platform which included very prominently a pledge not to sell the Hydro-Electric Commission (as it then was), and subsequently inserted a provision into the legislation enabling the disaggregation of the HEC which ostensibly requires a referendum to be held prior to the sale of any part of the former HEC, there is no economic reason why the Government should retain ownership of competitive businesses such as Aurora Energy or Transend Networks.

Rather, the Government should be weighing up the likely proceeds from the sale of either or both of these businesses (and/or some of the others listed in slide 25); and comparing the dividend or income tax equivalent revenue foregone if they were sold with the interest that would be incurred if the RHH were entirely financed by debt. (Note that the Government should be approaching the Commonwealth for the return to Tasmania of the additional income tax which Canberra will collect from any future private owners of these businesses).

Under plausible assumptions it seems quite realistic for asset sales to make a major contribution to financing the cost of constructing a new RHH.

On the other hand, it would not be inappropriate for part of the capital cost of a new RHH to be funded by debt. After all, this is an asset which will benefit future generations of Tasmanians as well as the present generation – and so it is not unreasonable to expect those future generations to contribute to its cost through servicing debt incurred to finance its construction.

More generally it's important to avoid the belief that the State Government should never borrow (slide 26). Certainly State governments should not intentionally run operating deficits – that is, they shouldn't spend more on public service salaries and other operating costs than can be funded from State tax revenues, Commonwealth grants etc.

But there is nothing wrong, in principle, with State Governments borrowing to fund capital expenditures. There is no principle of economics or public finance of which I'm aware that says the optimal level of debt for a government is zero (any more than there is for a private business or an individual).

Indeed it was an excessive focus on eliminating State debt (and hence on running larger-than-necessary operating surpluses and an unwillingness to borrow for infrastructure) under the Carr Government which has contributed to the poor state of the New South Wales economy in recent years.

In terms of the narrow definition of State debt, Tasmania's 'general government' balance sheet is in better shape than that of any other jurisdiction except Queensland (and Queensland is now undertaking significant borrowings in order to address its increasingly critical infrastructure deficiencies) (slide 27).

Of course this is an incomplete picture of the State's balance sheet – especially taking account of:

- Tasmania's relatively large unfunded superannuation liability (around 19% of GSP compared with about 6½% for all States and Territories on average), and partly as a consequence of the increased health and other spending promised in the election campaign this will decline at a much slower rate than previously envisaged; and

- the relatively greater debt of Tasmania's state-owned enterprises (nearly 10% of GSP, more than double the average for all States and Territories)

But some additional borrowings to fund part of the cost of constructing a new Royal Hobart Hospital would not imperil Tasmania's much improved balance sheet position or its credit rating.

Although it was in some ways disappointing that in this year's 'State of the State' speech, the Premier didn't quote me half a dozen times as he did in 2005 (just kidding!), he did make a series of very important commitments regarding reforms to State public sector financial management.

In particular, he promised a new Charter of Budget Responsibility which will require the Government to publish a pre-election financial statement (as does the Commonwealth and a number of mainland States) and political parties to have their election promises independently costed by the Treasury (of course there will need to be safeguards to ensure that the Government does not get premature access to other parties' ideas).

He also promised a presumption that government contracts will not be subject to 'commercial in confidence' restrictions unless certified by a standing committee of three of the State's most senior public servants.

These (and the other changes announced by the Premier) are important reforms which, if implemented, will take public sector financial management and accountability to a new level, and arguably to Australian best practice.

Meanwhile there are a number of other reforms which can be made to the presentation of the State Budget without requiring legislation, and which in my opinion should be made in next year's Budget, including:

- totals of discretionary spending and revenue measures;
- reconciliation to previously published forward estimates showing separate impact of 'policy decisions' and 'parameter variations';
- four-year projections of key economic parameters;
- sensitivity of budget aggregates to changes in economic parameters; and
- four-year forward estimates for non-budget sector and public sector as a whole

These changes would bring the presentation of Tasmania's budget and public finances up to best Australian practice (currently represented by Western Australia).

Summary

In summary, Tasmania's economy has made some significant progress over the past few years. But economic growth appears to have slowed sharply during the past three quarters – partly as a result of factors common to all of Australia's non-resource-rich States, but also due to the end of the 'housing boom' and the associated influx of immigrants from the mainland, and to the completion of work on a number of major energy projects. It's now difficult to see how the Budget forecast of 3½% growth in the State's economy in 2006-07 can be attained.

There is now a risk that the productivity gains which Tasmania has recorded over the past few years could turn out to have been transient. Thus there needs to be an enhanced focus on sustaining the key drivers of productivity growth – including a competitive business environment; innovation; and investment in human capital.