Tasmania's fiscal sustainability

State Treasury released its latest *Fiscal Sustainability Report* as required at five-yearly intervals by the *Fiscal Sustainability Act 2007,* this past Thursday. The first of these was published in April 2016; a 'supplementary' report was issued in October 2019, in response to questions from the Parliamentary Standing Committee on Public Accounts and following the identification of "inconsistencies" in the treatment of public sector superannuation costs.

This latest FSR has been prepared with a clear recognition of many of the things I (and many others) have been saying for a very long time about the challenges facing the Tasmanian economy: specifically, "Tasmania has the oldest and most rapidly ageing population of any state or territory … Tasmanians also have lower disposable incomes; are less likely to be in the labour force; have lower levels of productivity; and are more likely to die from preventable causes … Tasmania has a higher rate of youth unemployment; a higher rate of long-term unemployment; a higher proportion of people with a disability; and a higher proportion of households receiving welfare benefits" (page 13). These are of course well-known: however, it's unusual for them to be acknowledged so forthrightly or succinctly by a government agency.

The report is largely based on the projections contained in the *2020-21 Budget*, presented in November last year, at a time when both the economic and fiscal outlooks were bleaker than they are now. Since then we've had the *Revised Estimates Report* presented in February, and the *Pre-Election Financial Outlook Report* published in April, which presented a much improved outlook both for the Tasmanian economy and for key fiscal indicators from those depicted in last October's Budget (the October Budget projected 'underlying' net operating deficits totalling $2.95bn over the four years to 2023-24 and net debt of $4.4bn by June 2024, whereas these numbers were revised down by $617mn (to $2.3bn) and $717mn (to $3.7bn) respectively in the April PEFO).

Treasury says it can't use these more recent documents (and the projections contained in them) as the basis for this *Fiscal Sustainability Report* because they're not presented in the same detail as in the Budget (although they 'have a go' at doing so in an Appendix to the Report, on which more later). Since April we've also had upward revisions to forecasts of revenue from the GST in the most recent *Federal Budget* – although most of the likely increase in Tasmania's share of that would appear to be absorbed by the spending promises which the Government (successfully) took to the most recent state election (totalling $1.3bn according to a tally compiled by *The Mercury*'s David Killick - although some of that extends beyond the four-year 'Forward Estimates' period).

But the 'starting point' for long-term projections of the major components of Tasmania's fiscal position is almost certainly in reality 'better' than that used in this *Fiscal Sustainability Report* (although, as the Report points out, the longer-term trends driving the fiscal position are not materially affected by different 'starting points').

The report shows the trajectory of three major indicators of the State Government's fiscal position – the 'net operating balance' or NOB, which is the difference between 'operating' revenue (state taxation, grants from the Commonwealth, dividends from SOEs, fees and fines, etc.) and 'operating' expenses (wages and salaries of state employees, other 'running' expenses, grants and subsidies, depreciation, interest, superannuation etc.); the 'fiscal balance', which is the NOB plus net capital expenditure; and net debt (which is gross debt minus government holdings of cash, bank deposits and other interest-bearing assets) – under four alternative scenarios –

(1) a 'historic trends' scenario in which (for the most part) expenditure and revenue grow from the end of the current forward estimates period (2023-24) through 2034-35 at their average annual rates over the past 10 years (with specific adjustments for the impact of one-off events like Covid-19);

(2) a 'forward estimates' scenario in which expenditure and revenue continue growing after 2023-24 at the same rates as projected in the 2020-21 Budget, again after adjusting for the impact of Covid;

(3) a 'high expenditure' scenario in which spending on health (in particular) and education are assumed to grow at faster than historical average rates, and capital expenditure remains 'at elevated levels', over the projection period; and

(4) a 'low revenue' scenario in which revenues from stamp duties, GST and specific purpose payments from the Commonwealth grow at slower-than-historical-average rates.

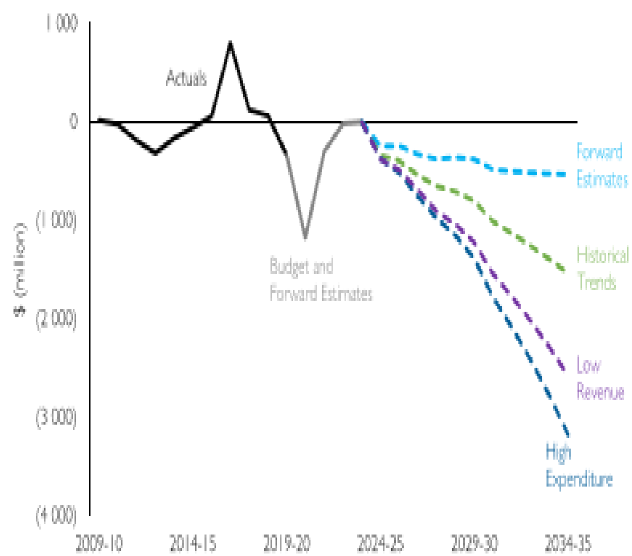
The results of these projections are summarized in the following table:

	Average annual growth (% pa) in -		*Projected value in 2034-35 ($bn)*		*Revenue from GST as % of total revenue*
	Expenses	*Revenue*	*NOB*	*Net debt*	
2019-20 values			-0.4	-0.5	37.4
'Historical trends'	4.8	3.5	-1.5	20.4	40.8
'Forward estimates'	3.7	3.2	-0.5	16.0	43.3
'High expenditure growth'	6.1	3.7	-3.2	29.8	40.4
'Low revenue growth'	4.8	2.7	-2.6	25.6	41.1

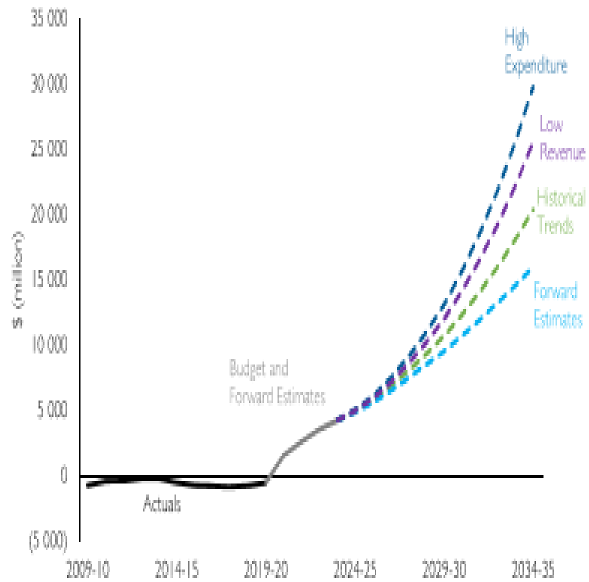
Note: 'NOB' is 'net operating balance' (negative number denotes a deficit).

The following charts (lifted directly from the Report) show the projected trajectories of the net operating balance and net debt

Net operating balance



Net debt



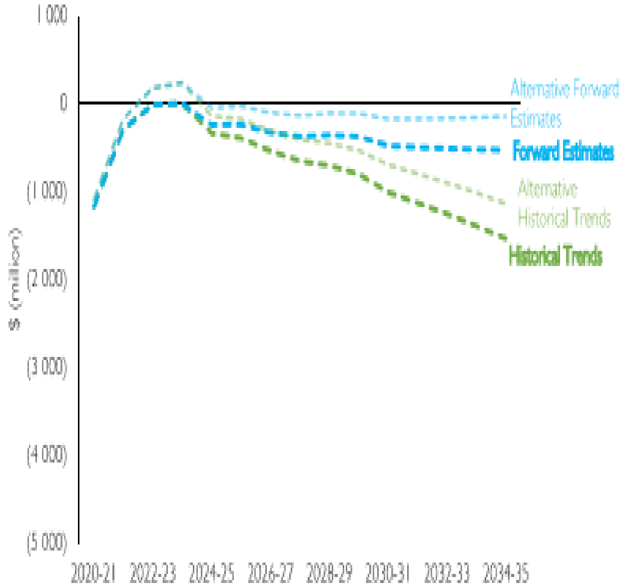
Treasury characterizes all of these projected outcomes as "manageable in the short to medium term" (page 7). It doesn't define precisely what it means by "medium term" – although it goes on to say that "the size of the corrective action required to maintain fiscal sustainability increases over the projection period" which I interpret (and I emphasize it is *my* interpretation) as meaning that Treasury regards these projected outcomes as "unsustainable" over the "longer term" – hence the need for what Treasury calls "corrective action".

Treasury makes three other (what I think are very important) points about the need for, and nature of any, such "corrective action":

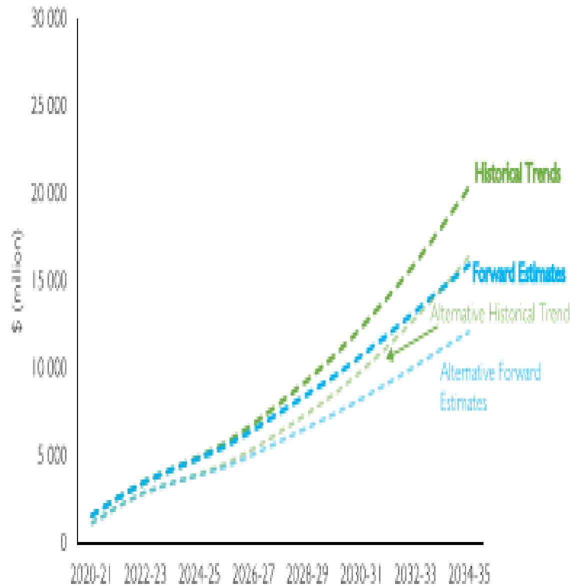
- First, it says, quite unequivocally, that "it is *not* possible to rely on economic growth to maintain fiscal sustainability" (page 7, my emphasis added) because "many of the state's revenue streams are not directly linked to economic outcomes" (page 40).
- Second, it says (again quite unequivocally) that "no *single* solution, such as constraining health expenditure, is likely to be appropriate" (page 41), and that "effective action to maintain fiscal sustainability will require the successful implementation of a *range* of measures" (page 7, my emphasis). I interpret this as implying that Treasury thinks that policy decisions will be needed on *both* the spending *and* revenue sides of the Budget in order to maintain "fiscal sustainability".
- Third, Treasury says (once again, unequivocally) that "early action to correct fiscal deterioration will mitigate the severity of the measures required to effectively maintain fiscal sustainability" (page 7) – which I interpret as Treasury saying to the Government, "the sooner you implement the range of revenue and spending measures required to restore fiscal sustainability, the less painful it will be for the Tasmanian community".

As noted earlier, the projections in this Report take as their 'starting point' the numbers in last October's 2020-21 Budget: and things have improved a bit since then. In Appendix 1 to this Report, Treasury has a 'go' at taking into account those improvements. It doesn't present any numbers (in narrative or tabular form) in this appendix, but rather depicts alternative trajectories in charts, some of which are reproduced below:

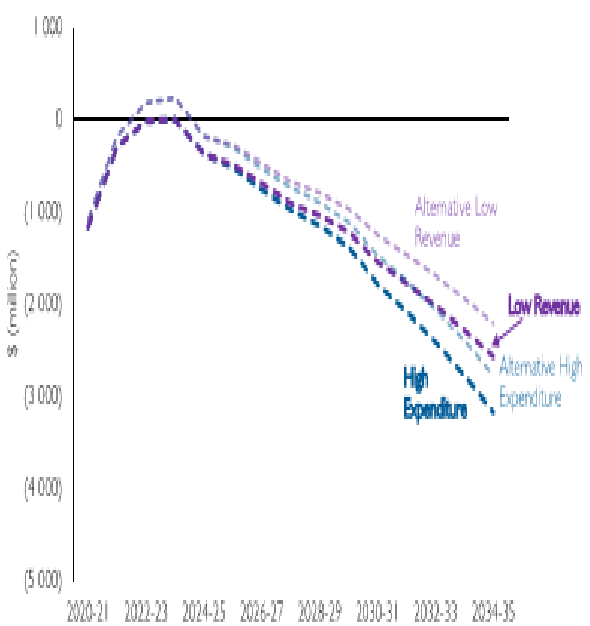
Net operating balance with alternative 'starting point'



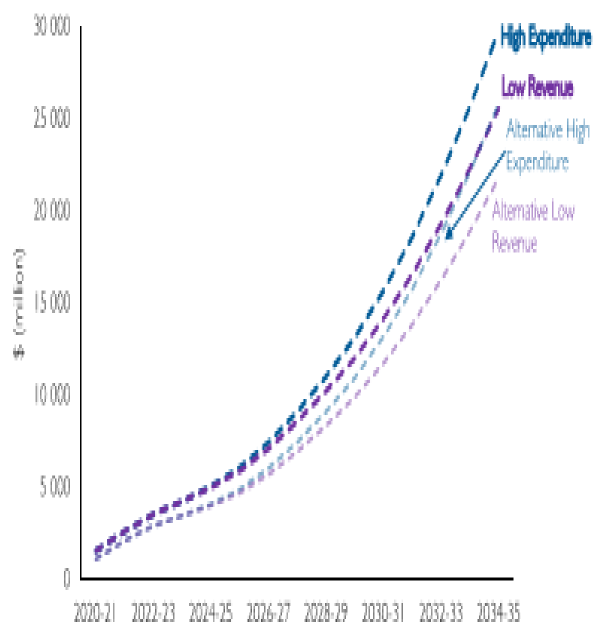
Net debt with alternative 'starting point'



Net operating balance with alternative 'starting point'



Net debt with alternative 'starting point'



The 'alternative' scenarios depicted in the above charts show less 'dire' outcomes than those in the body of the Report. In particular, the 'Alternative Forward Estimates' scenario appears to show the net operating deficit remaining fairly stable at around $100-200mn per annum (reading as best one can from the chart), compared with around $500mn per annum using last October's Budget projections as the starting point; and net debt reaching around $10bn by 2034-35, compared with $16bn using last October's Budget as the starting point.

It's 'debateable' whether that can be considered 'sustainable'. It certainly wouldn't have been, pre-Covid: prior to the 2020-21 Budget, the Government set considerable store by the achievement of 'net operating surpluses', something which Treasury is now saying is not in prospect over the medium-to-longer term even after taking into account improvements in Tasmania's fiscal position since last October.

And while these 'alternative' projections don't take account of the upward revisions to forecasts of GST revenues (from which Tasmania will benefit disproportionately) in the most recent Federal Budget, nor does it take into account the spending commitments which the Government made during the recent election campaign, which would appear to absorb most of the prospective upward revisions to Tasmania's share of GST revenue.

Moreover, these 'alternative' projections also assume (as do the corresponding 'Forward Estimates' scenario projections in the main body of the report) that the Government can contain growth in spending to more than 1 percentage point per annum below the 10-year historical trend for the next 15 years – notwithstanding the pressures for additional spending on health (in particular) which Treasury identifies in the Report.

Constraining spending in this way is likely to be extremely difficult in practice (to say nothing of being politically challenging), especially given that – according to recurring assessments by the Commonwealth Grants Commission as part of the process by which it arrives at its recommendations for distributing revenue from the GST which consistently give Tasmania a larger share than it would get under the 'equal per capita' model favoured by NSW, Victoria and in recent years Western Australia) – Tasmania has for more than five years spent about $155mn per annum (or 9½%) less on health than it "needed to" in order to provide health services of the same "quality" as the average of all states and territories.

One other serious risk which this Report highlights is Tasmania's *growing* dependence on its share of revenue from the GST. This is highlighted in the table above which shows that under *all* the scenarios modelled by Treasury, the share of Tasmania's total revenue derived from its share of the GST rises from 37.4% in 2019-20 to, at a minimum, 40.3% by 2034-35 and possibly to as much as 43.3% under the 'Forward Estimates' scenario (which is presumably the one with which the Government feels most comfortable).

This is particularly worrying for at least two reasons.

First, while projections of revenue from the GST have been revised upwards over the past six months, historically that is a relatively rare occurrence, and one that is likely the result of temporary factors, in particular the diversion of spending which would otherwise have occurred overseas (where it wouldn't be subject to Australian GST) onto domestic items (which are subject to GST) as a result of the ban on overseas travel by (most) Australians during Covid-19. A report by the Commonwealth Parliamentary Budget Office published in September last year finds that GST revenue is likely to continue to decline as a share of GDP over the long term, something which would affect Tasmania more adversely than any other state or territory except the Northern Territory.

Second, Tasmania (in company with the other eastern states and territories) is currently being sheltered from the changes to GST revenue-sharing arrangements imposed by the Morrison Government two years ago at the behest of Western Australia, by the 'transitional guarantee' that no state or territory would be worse off under the 'new rules' as they are phased in over the next five years than they would have been under the 'old rules' – a guarantee which, according to the most recent Federal Budget, will see the Federal Government adding some $7½bn to its deficits over the four years to 2024-25 in order to boost the surpluses being run over the same period by Western Australia, the only government in Australia (and probably one of very few in the world) which is currently and prospectively running budget surpluses.

But that 'guarantee' expires at the end of 2026-27 – after which, any additional transfers to Western Australia required to ensure that its share of the GST doesn't fall below 75% of what it would otherwise get under an equal-per-capita distribution will be at the expense of other states and territories. Treasury says that it has 'modelled' a 'step change' in Tasmania's GST revenue to account for the end of this guarantee, but no further details of this 'modelling' are provided, so it's impossible to gauge how fully Treasury has allowed for this.

What all this underscores, in my view, is the need for a serious debate about reform of Tasmania's state taxation system – something I tried to start in the paper which I prepared for the Tasmanian Branch of the Australia Institute last September (and which is here).

That report showed that not only does Tasmania's state taxation system generate a smaller proportion of the revenue required to fund the services which state governments provide than that of any other jurisdiction except the Northern Territory, but also that it relied on taxes which are uniformly regarded as 'bad' (stamp duties and taxes on insurance) to a greater extent than any other state except Victoria, and on 'good' taxes (payroll tax and land tax) to a lesser extent than any other state or territory except Queensland.

That report was greeted with disdain, bordering on contempt, by the State Government. I'm (sort-of) used to that: but it meant that there was *no* debate about State taxation in the lead-up to the most recent election – and the Government therefore doesn't have any kind of 'mandate' to undertake any kind of taxation reform during the life of this Parliament.

Indeed the Premier has made it quite clear that, unlike his Liberal counterpart in New South Wales (who in his 2020-21 Budget Speech said "for state governments, the reform with the greatest potential to unlock prosperity is tax"), he has no interest in reform of Tasmania's taxation system, telling a Legislative Council Estimates Committee hearing that he was "surprised that the NSW Government would actually embark on a taxation discussion at this moment" and that he didn't believe "that right now is the time for a discussion about tax reform" (nor, evidently, did he believe that it was time to talk about tax reform when Tasmania's economy was "leading the nation" before the onset of Covid-19).

The Government's response to the *Fiscal Sustainability Report* is equally dismissive, claiming that it "confirms our finances are strong"; cherry-picking parts that suit it ("the results show projected fiscal outcomes that are manageable in the short to medium-term"); and ignoring the bits that are more challenging, such as the Treasury's clearly-stated views on the need, at some point, for "corrective action", preferably sooner than later.

The Government's response implies that Tasmania will receive "significant growth in GST receipts" as a result of "Tasmania's nation-leading economic recovery" – even though the Grants Commission's long-established methodology for determining GST shares means that, to the extent that Tasmania's economic recovery really is "nation-leading", all else being equal Tasmania's share of GST revenues will decline over time.

(As an aside, the Government's response claims as evidence for Tasmania's "nation-leading" economic recovery two recent indicators - growth in State final demand and in the number of payroll jobs – in which Tasmania ranked *third* among the states and territories: good, to be sure, but not exactly 'nation-leading' – you don't get gold medals at the Olympics for coming third, and in most other competitions you don't get into the Grand Final by finishing in third place).

The Government's response also fails to acknowledge that a good deal of the additional GST revenues which Tasmania will receive as a result of the upward revisions to total GST collections in the most recent Federal Budget will be absorbed by the spending commitments the Government made during the recent election campaign (spending commitments which, as the *Fiscal Sustainability Report* explicitly acknowledges on pages 1 and 41, were also not taken into account in the Report's projections).

In short, in my view, the latest *Fiscal Sustainability Report* shows that the Tasmanian Government – like every other government in Australia (with the possible exception of Western Australia), and like almost every other government in the world – *does* have a long-term fiscal sustainability problem.

That's nothing to be ashamed of – and there's no valid reason to pretend that we don't. It's *not* an insuperable problem: and others (in particular Victoria and the Northern Territory) have bigger problems than we do. It *doesn't* need to be solved 'tomorrow', or 'this year': in that sense, it *is*, as Treasury says, 'manageable' in the short term – especially while interest rates remain as low as they are (which the Reserve Bank keeps telling us is until "2024 at the earliest").

But, as Treasury also (and rightly, in my view) says, it is a problem that *will* get harder to solve if we pretend that it doesn't exist, or try to sweep it under the carpet.

As Treasury says, we *can't* rely on stronger economic growth alone to 'solve' the problem (even if we were actually doing all that we could to improve the prospects of sustaining stronger economic growth over the longer term – which IMHO we're not). As Treasury also says, solving the problem *can't* be achieved solely through spending restraint, but instead *will* require a *range* of measures (that is, on both the revenue *and* spending sides of the Budget).

We should be talking about these things now, and over the life of the Parliament which sits for the first time on Tuesday week (22nd June). But I'm not holding my breath.