Structural Change in the Tasmanian Economy

Information Paper

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Tasmania
Explore the possibilities

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Contents

Overview

Key points

- Over the past 20 years the size and structure of the Tasmanian economy has grown and diversified significantly due to ongoing structural change.

- However, more recently, Tasmania's key economic indicators such as employment, investment and economic growth have deteriorated, relative to the national economy.

- Some of the forces driving recent economic performance are cyclical in nature, such as the very high value of the Australian dollar and the exceptionally strong levels of mining-related investment in some mainland states. In addition, the divergence between the national economic performance and the State's economic performance has encouraged workers to migrate to mainland states, which has further dampened private demand.

- The State's sectors most affected by these cyclical forces are tourism, building and construction and retail. Business and consumer confidence in Tasmania are currently at low levels, which has further contributed to weak private demand, such as for dwelling investment. This confidence tends to recover when the overall economic conditions show some signs of improvement.

- These forces will ease once the mining investment phase has passed its peak, expected to be in 2013–14, and the global supply of the key resources increases. Commodity prices are expected to decline, which will put downward pressure on the Australian dollar. In addition, many of the job opportunities in mainland Australia that are attracting workers from Tasmania will cease once the national mining investment begins to wind down.

- While these cyclical forces have been in play, the Tasmanian economy has also been subject to longer term structural changes, as it always has been. Rising real incomes, changing patterns of consumer spending and growth in output have resulted in some industries expanding, particularly services and the construction sector. Much of the growth in the services sector has been to support Tasmania's primary sector and other productive sectors. Other sectors have been contracting for decades, such as the manufacturing and the forestry and forest products sectors. These two sectors, in particular, have faced a particularly sharp decline in recent years, due in part to the strength of the Australian dollar.

- More gradual structural changes are arising from the rise of Asia, from Tasmania's ageing population and from changes in the spending patterns of households.

- The public sector is not immune from longer term structural forces, with governments facing major fiscal challenges as a result of the growing demand for government services set against weak growth in revenues.

- Over the long term, Tasmania's economy has developed and expanded in response to structural change, as resources are transferred away from industries in decline to those that are growing. However, this process can be disruptive and the transition costs can be significant, especially for workers that lose their jobs in declining industries and may not immediately find employment in the expanding industries. There is some evidence that the overall pace of structural change has increased in recent years, which has led to increased costs and disruption for many in the community.

- Tasmanian governments have no control over the global and national economic forces that have reduced the competitiveness and worsened the market conditions for many Tasmanian businesses. Further, Tasmanian governments have limited policy levers to counteract the shorter term cyclical influences identified in this report.

- The Australian Government has much more capacity to manage the impact of these forces through its fiscal and monetary policy and through adjustment assistance to affected regions.

- However, State-level policies can make a significant difference to the future longer-term growth prospects of the economy through their impacts on both the investment climate and the productive capacity of the Tasmanian economy. Examples include sustainable management of the State's finances, investment in education and skills, public infrastructure investment and planning reform.

- Economic growth can also be supported by the reform of markets over which the State has significant influence or control that are key business enablers, including electricity, water and transport.

- This paper highlights the trends in the Tasmanian economy which are structural in nature, and are likely to continue, by separating these trends from the shorter term cyclical trends. The paper will be an input into further detailed work on the policy choices available to maximise the long term growth opportunities of these economic forces for the Tasmanian economy, as well as address the adverse consequences.

Introduction

The Tasmanian economy is currently facing some major challenges due to a range of adverse external factors and relatively weak local demand for goods and services. As a result, Tasmania's performance, according to most economic indicators such as employment, investment and economic growth, has been rather weaker than the national economy. Some of these forces are cyclical in nature, while others are the result of structural changes that will have much longer term economic impacts.

While much attention is paid to cyclical economic trends, there is often insufficient focus on the underlying structural changes, which determine how economies evolve over time. Economic policy, and economic development policy in particular, can be better formulated if there is a solid understanding of the different forces that impact on the Tasmanian economy and the structural changes that occur in response to some of these forces.

This paper discusses key changes in the structure of the Tasmanian economy over the past few decades, with a particular focus on recent developments in response to changes in the external economic environment. The paper also seeks to identify the major causes of these structural changes and whether the trends identified are likely to continue in the decades ahead.

Some structural changes have been relatively rapid, such as the changes in Tasmania's forestry sector and the recent accelerated decline in manufacturing, while other changes are more gradual in nature, such as Tasmania's changing demographic profile and changes in household income, spending levels and consumer preferences. Both types of changes are important to consider as they will have an ongoing impact on the Tasmanian economy.

It is envisaged that further work will be undertaken to identify policy options for the Government to allow Tasmania to respond to the challenges and opportunities that arise as the Tasmanian economy continues to evolve in response to the range of external and internal influences.

Section 1 Tasmania's recent economic performance

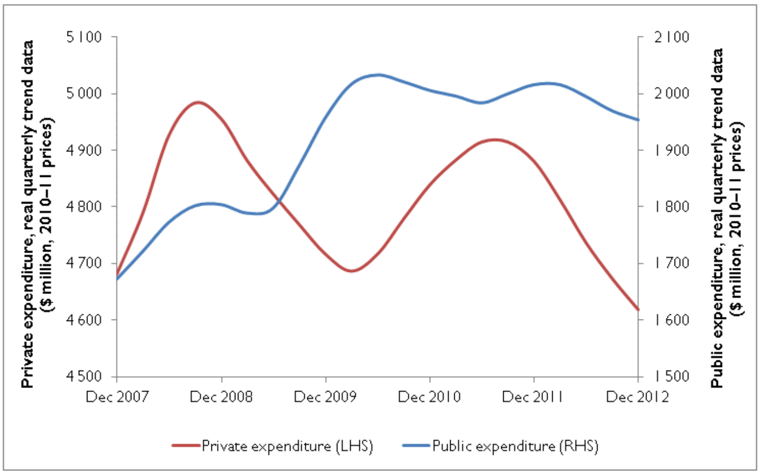
The national resources boom has led to rapid growth in mining-related investment in mainland states. Mining and mineral and metal processing have an important role in the Tasmanian economy but Tasmania's industries have not benefited substantially – directly or indirectly – from the national resources boom.

The result of the national resources boom has been a very strong Australian dollar that has placed severe pressure on Tasmania's export and import-competing industries, such as manufacturing and tourism. At the same time, consumer and business confidence in Tasmania has been low. Consumer spending has been contracting and retail spending, in particular, has been particularly weak. The reasons for this are complex but are likely to reflect the impact of global uncertainty on financial and other markets, as well as local uncertainty due to deteriorating economic circumstances in the face of the prolonged high value of the Australian dollar and other factors. Private investment, which had been recovering strongly following the global economic downturn, has recently started to ease.

In addition, the forestry and forest products sector is facing particularly adverse conditions, as discussed in more detail below, which has resulted in a sharp decline in output and employment.

The result has been only a small increase in real gross State product, of 0.5 per cent, over 2011–12. State final demand was unchanged over the period due to a reduction in real household consumption of just over one per cent being offset by an increase of almost eight per cent in business investment. Public expenditure declined slightly over 2011–12.

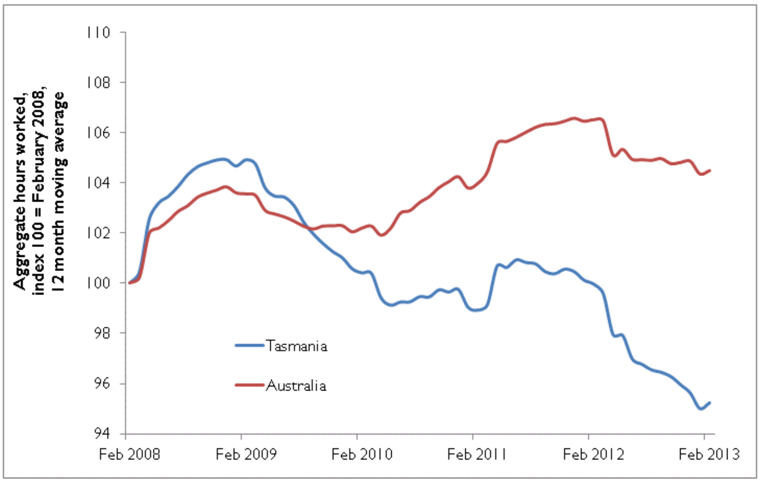
Chart 1.1: Private and public expenditure in Tasmania



Source: *Australian National Accounts: National Income, Expenditure and Product*, ABS Cat No 5206.0

From late 2008 until late 2011, private expenditure and public expenditure tended to exert opposing forces on the Tasmanian economy as Chart 1.1 above shows. More recently, private expenditure has been declining sharply at the same time as public expenditure has been relatively stable. The cyclical trends in both public and private sector activity are readily apparent from the chart.

Chart 1.2: Aggregate Hours Worked, Tasmania and Australia



Source: *The Labour Force, Australia*, ABS Cat No 6291.0

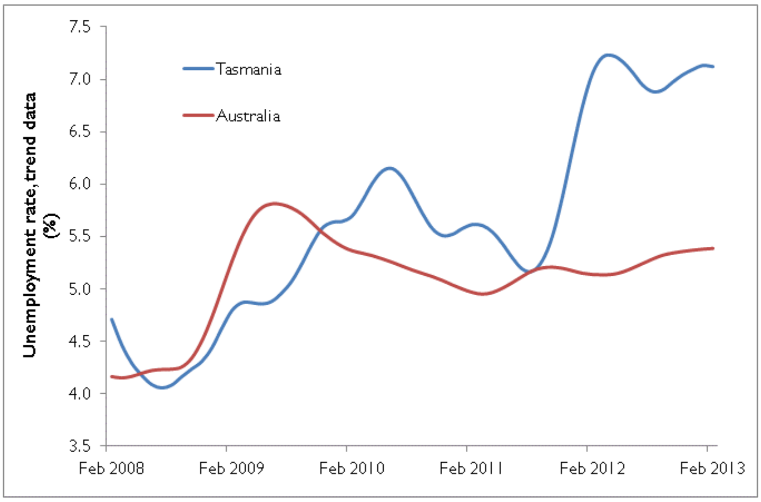
The result has been a fall in employment in Tasmania and an even larger impact on aggregate hours worked, which fell by just under five per cent in the year to February 2013. This represents a substantial decline in household earnings and explains, in part, the low level of consumer confidence and the recent decline in household spending.

At the same time, national economic activity has held up relatively well. Until recently, aggregate hours worked had been increasing for Australia as a whole, as shown in Chart 1.2 above. Compared to early 2008, there has been a four per cent increase in aggregate hours worked nationally compared with a decrease of almost five per cent in Tasmania.

This divergence in economic performance is also reflected in the trends in unemployment rates. Nationally, the unemployment rate is around 5.4 per cent in trend terms, which compares with a current rate of 7.1 per cent in Tasmania. As Chart 1.3 shows, the gap between the unemployment rate in Tasmania and nationally has been larger over the past year than at any time over the past five years.

In summary, the labour market has been far weaker in Tasmania than nationally, with declining employment in Tasmania, a greater unemployment rate and a larger decrease in aggregate hours worked and average hours worked. Unemployment remains the major concern for Tasmanian households, according to the February 2013 Survey of Enterprise Marketing and Research Services.

Chart 1.3: Unemployment rates, Tasmania and Australia



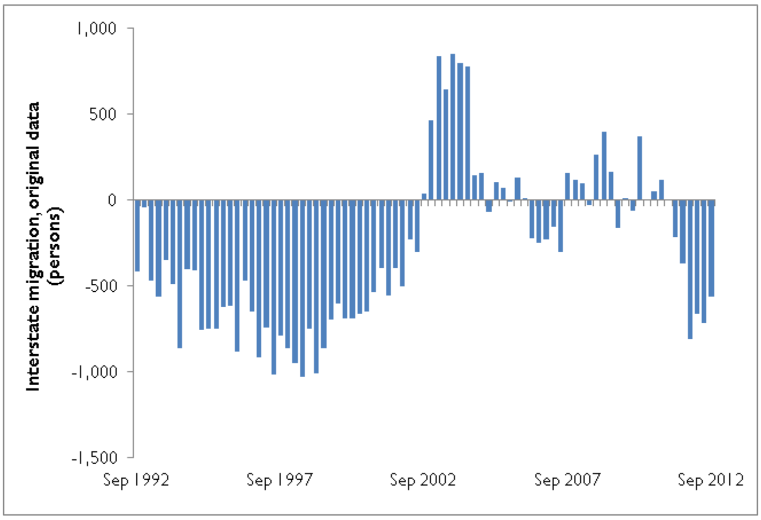
Source: *The Labour Force, Australia*, ABS Cat No 6202.0

The response to the recent divergence in economic conditions has been an increase in migration from Tasmania to mainland states, especially the resource-rich states. This is consistent with earlier research undertaken by the Department of Treasury and Finance, which found that in the short to medium term, Tasmania's population growth is largely determined by trends in net interstate migration and in turn, net interstate migration is determined largely by the relative employment opportunities in Tasmania and mainland Australia (Tasmania's Population 2003: An information paper on recent trends and State Government policies). In periods when job opportunities were greater in mainland Australia, there tended to be increased out-migration from Tasmania, and when Tasmania's labour market was relatively strong, there was much less out-migration.

In the year to September 2012, net interstate out-migration was estimated at 2 748 persons by the ABS. This compares with net out-migration of 464 persons in the year to September 2011. This difference in net migration accounted for a decline in Tasmania's population of around 0.4 per cent, halving Tasmania's total population growth to 0.2 per cent over this period.

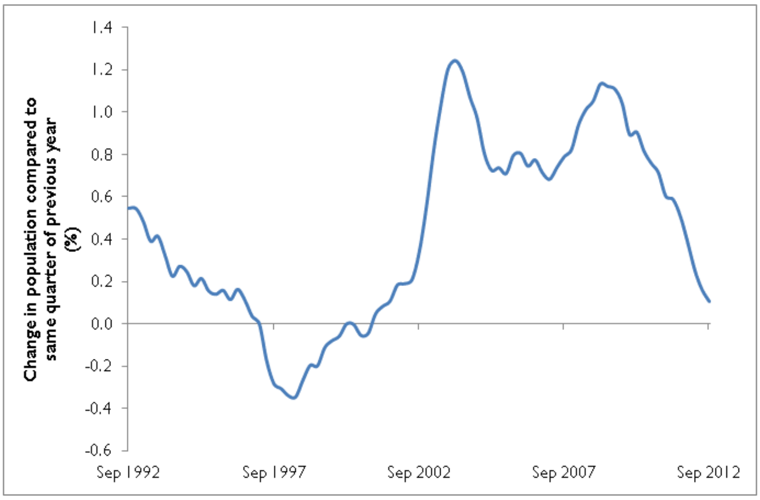
Charts 1.4 and 1.5 below show that, until recently, the underlying trend of net interstate in-migration contributed to population growth over this period. The more recent trend of net out-migration, at levels not experienced since 2001, has led to a sharp decline in Tasmania's population growth. This lower population growth has contributed to the recent decline in household spending and also helps explain the weak housing market in Tasmania, including the low demand for rental accommodation, where vacancy rates are at historically very high rates of around five per cent in the Hobart area.

Chart 1.4: Net interstate migration to and from Tasmania 1992–2012



Source: ABS, *Australian Demographic Statistics*, Cat No 3101.0

Chart 1.5: Population growth in Tasmania 1992–2012



Source: ABS, *Australian Demographic Statistics*, Cat No 3101.0

The cyclical forces that account for much of Tasmania's recent weak economic performance are not expected to persist, at least at their current level. The exceptionally strong mining-related investment in some mainland states, which is highly labour intensive, is expected to peak in 2013–14 and for some projects then decline quite sharply to ensure that production can commence while commodity prices remain high.

The new mines are highly capital intensive but not labour intensive when production commences. Once the mining investment phase winds down and production commences, the demand for labour will decline sharply in the resource-rich states. There will no longer be the very large difference in job opportunities between Tasmania and these states, which is likely to stem the out-migration from Tasmania.

At the same time, the global supply of key commodities such as iron ore and coal is expected to increase, which will put downward pressure on prices and also on the value of the Australian dollar. This will provide some support for Tasmania's export and import-competing sectors.

In recent months, the Australian dollar has remained at very high levels despite the easing in some key commodity prices and lower interest rates. This outcome has been unexpected given the close link between the prices of Australia's key export commodities and the value of the Australian dollar.

The continued strength of the Australian dollar is primarily due to what is described as the 'safe haven' effect. For global investors, several advanced economies have recently been judged to be more risky on account of high levels of government debt, weak economic growth and fragile banking systems. By contrast, Australia has relatively low sovereign debt and a more robust economy and banking system, such that the Australian Government's debt is still rated AAA with a stable outlook by all three major credit rating agencies. These factors have increased the risk-adjusted returns on Australian assets in relative terms, boosting the demand globally, from both public and private investors, for Australian dollar assets and therefore sustaining the strong demand for the Australian dollar.

It is unclear how long this safe haven effect will persist. In the medium term, some economies currently facing subdued economic conditions and major fiscal challenges, such as the United States and some major European countries, are likely to recover to the point where global investor confidence is largely restored. This will ease the demand for Australian dollar assets and put downward pressure on the Australian dollar.

Further support for the Tasmanian economy can be expected from the monetary policy of the Reserve Bank of Australia. Since 1 November 2011, there has been a cumulative cut to the RBA official cash rate of 175 basis points; the cash rate was most recently lowered to 3.00 per cent at the RBA's December 2012 meeting.

These reductions are designed to stimulate the non-mining sectors across Australia by increasing household disposable income and reducing loan financing costs for businesses. If around two thirds of these reductions were passed on in the form of lower mortgage rates, this equates to around a $105 monthly reduction in average home loan repayments in Tasmania, a substantial increase in real spending power for these households.

Tasmanian businesses can be expected to benefit not just from increased spending within Tasmania but also from increased spending by mainland households on Tasmanian goods and services.

Finally, the supply of new housing in Tasmania has not kept pace with population growth and the rate of household formation in recent years. Underlying demand for housing in Tasmania has therefore been increasing, which suggests that once economic conditions improve and household confidence is restored, there will be further stimulus from increased dwelling investment. This, in turn, tends to lead to increased consumer spending, such as on legal and property services but also on white goods and other housing-related items.

This section has focused on the cyclical forces that can have major impacts on Tasmania's economy but are short term in nature, as all the charts above have shown. The following sections examine the longer term structural changes on Tasmania's economy and the forces that create these changes. These tend to exhibit much less variation from year to year and may have smaller impacts on any one year's economic activity. However, they have a more profound influence on the future composition of the economy and the long term level of economic prosperity of the State.

Section 2 Areas of Structural Change in the Tasmanian Economy

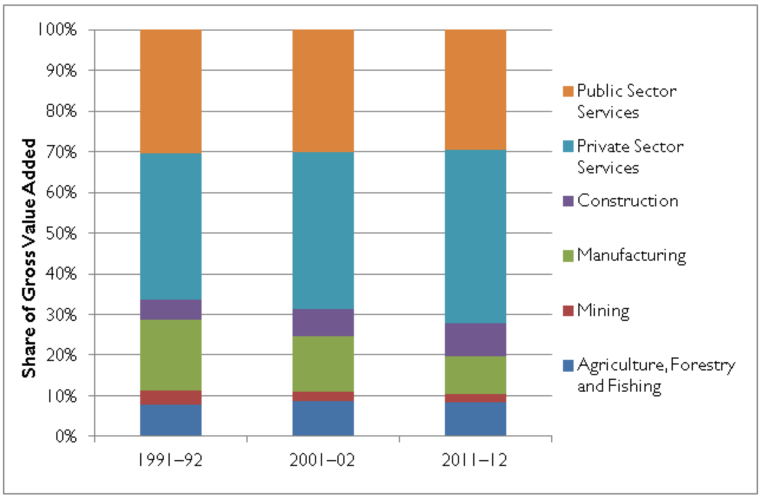
2.1 Summary of key trends in Tasmania's industries

Over the past two decades, the Tasmanian economy has expanded by just over 50 per cent in real terms. Part of this increase is due to strong growth in some industries in Tasmania that have grown strongly across Australia, such as the construction industry and some parts of the private service sector. This growth is also due to the increase in Tasmania's population, especially the working age population, over this period and productivity growth due to technology and the improvement in labour skills.

Over this period, the industry mix in Tasmania has changed significantly. Tasmania's economy is increasingly dominated by service industries, with strong growth in private sector services, as Chart 2.1 shows. Manufacturing was once a major segment of the economy but has become less so over the past two decades. According to the Australian Bureau of Statistics, manufacturing accounted for 8.7 per cent of Tasmania's gross value added (output) in 2011–12, down from 16.7 per cent in 1991–92. Since that time there has been a further contraction, much of which has been in the forest products industry.

The primary industries sector, including mining, agriculture, forestry and fishing, is a relatively small sector of the economy that has maintained its overall share at around 10 per cent of the State's output. The construction industry is subject to cyclical fluctuations but has become a growing segment of the economy in the past two decades.

Chart 2.1: Share of Gross Value Added by industry, Tasmania, 1991–92 to 2011–12, original annual data (excluding ownership of dwellings)



Source: *Australian National Accounts: State Accounts*, ABS Cat No 5220.0

The Tasmanian mining industry has declined in relative terms, from 3.4 per cent of State output in 1991–92, to 1.8 per cent in 2011–12. Despite this, the returns to Tasmania's mining industry have improved in recent years, though not to the same extent as nationally.

Over this period, the construction industry enjoyed the strongest growth as a share of the State's output, increasing from 4.8 per cent to 7.5 per cent. Many private sector service industries have also shown significant growth compared to other industries, with the financial and insurance services increasing its share of the State's output from 6.2 per cent to 8.2 per cent. Other private sector services to increase their share include information, media and telecommunications services, and also professional, scientific and technical services. This latter category has benefited from the expansion of scientific research in the State, including Antarctic-related research, the Menzies Research Institute and other University of Tasmania research activities.

Administrative and support services, which includes office administration and hiring and placing personnel, have also grown, doubling to 1.8 per cent of output in Tasmania over the past two decades. Recent trends have moved towards the outsourcing by businesses of non-core activities to specialist firms, which provide their services to a range of industries.

The retail industry grew from 5.3 per cent of the State's total output in 1991–92 to 6.2 per cent in 2011–12. A number of other service industries, particularly electricity, gas, water and waste services, and also transport, postal and warehousing all grew but experienced a decline as a share of total output throughout this period.

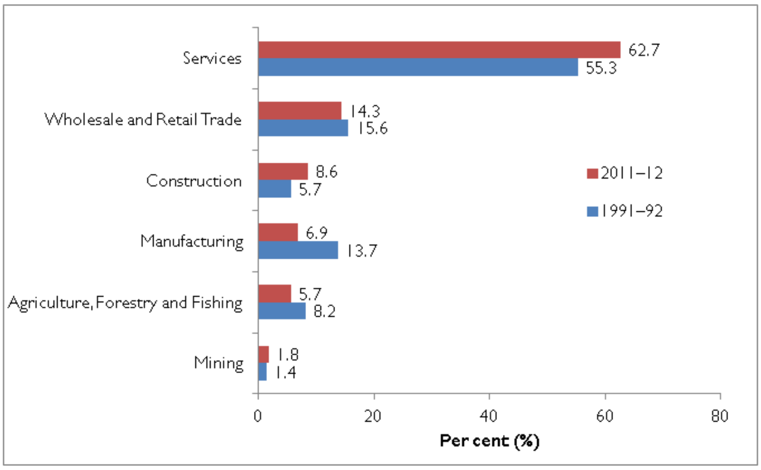
Overall, the share of total output accounted for by public sector services has declined slightly over the past two decades. By contrast, there was a 15 per cent growth in the share of private sector service industries over this period, with the share increasing from 34.6 per cent to 39.8 per cent.

Tasmania's private services sector accounts for a much smaller share of output than nationally, where private sector service industries accounted for around 45 per cent of national output over the past decade. Nationally, public sector services account for a smaller share of output than in Tasmania, accounting for just under 20 per cent over the past decade.

Within Tasmania's public sector, health care and social assistance services have become more important over the past two decades. By contrast, public administration and safety, and education and training have contracted marginally as a share of the State's output, though they remain large in absolute terms, accounting for 13.6 per cent of the State's gross value added in 2011–12.

These structural changes in the Tasmanian economy are broadly reflected in industry employment trends, as Chart 2.2 shows. Employment in service industries, such as health care and social assistance, and education and training has grown while generally jobs in the primary and secondary sectors have declined. The largest decrease has been in manufacturing, which is discussed in more detail below. In the case of mining, part of the reported increase in employment is accounted for by Fly In Fly Out workers who are resident in Tasmania but are employed in mining projects in mainland states. It is not possible to estimate labour productivity in Tasmania's mining industry from ABS data as a substantial number of those reported as working in this industry are not employed in Tasmania.

Chart 2.2 Share of employment by industry, Tasmania, 1991–92 & 2011–12

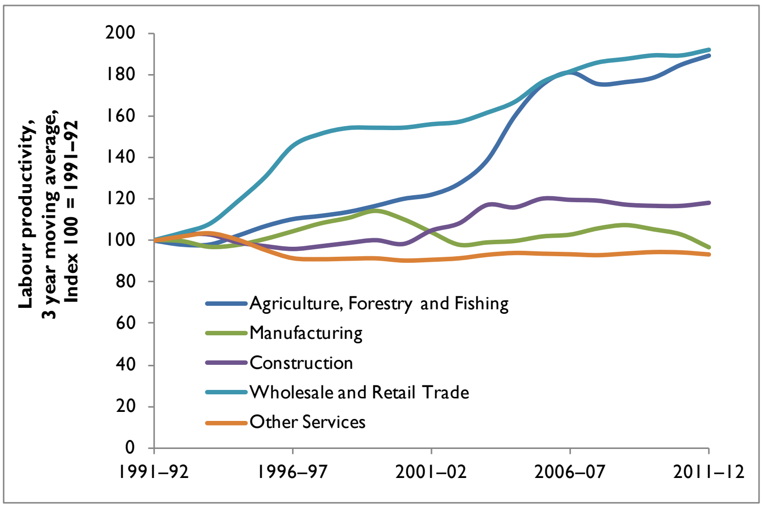


Source: *The Labour Force, Australia*, ABS Cat No 6291.0

The different private sector industries have very different labour productivity trends over the past two decades. The strongest productivity growth has been in wholesale and retail trade, and agriculture, forestry and fishing, as shown in Chart 2.3. The above average productivity growth in the agriculture, forestry and fishing industry explains why the share of employment in this industry has declined while its output share has remained constant. Construction recorded modest productivity growth over the period.

By contrast, manufacturing and other services did not record a significant change in productivity growth over the period. One important finding from these productivity trends is that the manufacturing industry, as a whole, has not been able to transfer output to higher value goods or sustain strong productivity growth over the period of decline.

Chart 2.3: Trends in labour productivity in Tasmania's private sector 1991–92 to 2011–12



Source: *Australian National Accounts: State Accounts*, ABS Cat No 5220.0 & *The Labour Force, Australia*, ABS Cat No 6291.0

2.2 Tasmania's manufacturing industry

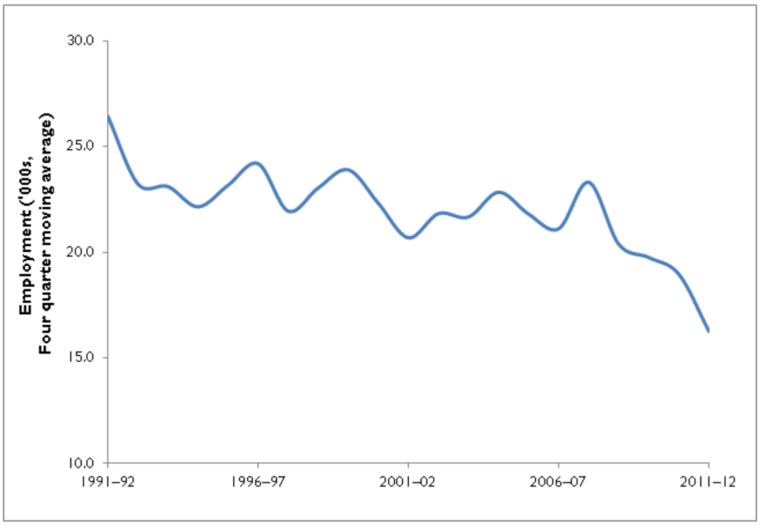
The most significant structural change affecting the Tasmanian economy in recent decades has been the decline in the manufacturing industry, both as an employer and in terms of its share of the State's economy.

In the early 1990s, the industry employed around 28 700 persons and there were over 25 major manufacturing companies in the State. The food and beverages sub-sector accounted for the largest share at around 26 per cent, with Cadbury Schweppes, J Boag and Son, Blue Ribbon, Simplot and UMT each employing over 300 persons. The wood and paper products sub-sector was almost as large, which included the Australian Paper (Burnie and Wesley Vale) paper mills, ANM (Boyer) and North Forest Products. Many of the manufacturing plants in this sector were highly labour intensive: the Burnie paper mill, in particular, employed over 4 000 persons at its peak. The other major sub-sector was metal products, which comprised Comalco, TEMCO and Pasminco-EZ.

At that time, the machinery and equipment sub-sector accounted for only six per cent of total manufacturing output, principally by Incat Tasmania, ACL Bearings, and Caterpillar Elphinstone. Textiles, clothing and footwear accounted for only five per cent of output; major firms were Coats Patons, Blundstone, Sheridan and Australian Weaving Mills. The other significant manufacturers outside these categories were Tioxide (which produced titanium dioxide pigment) and ACI Glass.

There have been substantial changes in the size and composition of the manufacturing industry in just over two decades, including a fall in employment to the current level of around 16 000. This decline has been uneven over this period, as Chart 2.4 shows.

Chart 2.4: Employment in manufacturing in Tasmania 1991–92 to 2011–12



Source: *The Labour Force, Australia*, ABS Cat No 6291.0

Much of the decline in employment has been in the food and beverages sub-sector due to the exit of some firms, such as Blue Ribbon, and the closure of some plant in others, including by Simplot and McCain and, very recently, JB Swift on King Island. The dairy-related businesses, by contrast, remain in the State and continue to be major employers.

Large scale closures have also occurred in the wood and paper products sub-sector, particularly the closure of the Australian Paper (Burnie and Wesley Vale) paper mills and some sawmilling operations. As one example, the Starwood medium density fibreboard plant at Bell Bay was built in 1997 for a reported $170 million but after being subsequently acquired by Carter Holt Harvey for $50 million, closed in 2006, with the loss of around 100 jobs.

The major new producer in this sub-sector is Ta Ann Tasmania, which currently employs over 100 people at its two mills in the Huon Valley and Smithton. Ta Ann is reported to be facing major challenges to remain viable and has reduced its output significantly due to challenges in selling its rotary peeled veneer into international markets.

The textile, clothing and footwear sub-sector has declined markedly and many firms have ceased production. Tascot Templeton Carpets closed in 2012 and Australian Weaving Mills and Waverly Woollen Mills have received State Government financial assistance over the past decade in the face of very intense competition from imports from low wage Asian economies. From producing a range of footwear in Tasmania, Blundstone now has its head office and produces gum boots only at its Moonah plant. There have been no new major enterprises in this subsector in Tasmania in recent decades.

By contrast, in the metal products sector, the three large smelters remain in operation. Their output volumes have been sustained or increased, though they have all substantially reduced their employee numbers to secure productivity gains. However, these major industrial businesses remain very important employers in the State and the flow-on employment effects on other businesses continue to be very significant.

Some large employers in the machinery and equipment sub-sector also remain in the State. At one stage the shipbuilding industry was a major employer but Incat Tasmania has reduced its workforce substantially from over 1 000 people at its peak and Austal, which employed over 110 at its peak, closed its Margate shipyard in 2010. ACL Bearings has appointed administrators and receivers.

The one large manufacturer not in these categories, Tioxide, ceased production in 1996.

Tasmania's primary industry has also expanded significantly and diversified over the past two decades. By gross value of production, the share of stone fruit in 2010–11 is almost seven times the share in 1990–91, while the shares of grapes and berry fruits tripled over the same period. There has also been an expansion in orchards of walnuts and olives. The value of apple and pear production, on the other hand, has decreased in importance, with its share of gross value decreasing from almost 12 per cent in 1990–91 to just under three per cent in 2010–11.

One of the largest growth areas over the past couple of decades has been aquaculture, particularly salmon farming and processing by Tassal, Huon Aquaculture and Petuna. These businesses employ over 1 000 workers and are set for further growth with the recent approval of additional marine leases in Macquarie Harbour in the State's west. Oyster production has also increased by around one third over this period.

Reasons for the decline in manufacturing

As economies develop, their manufacturing sector usually expands in the early and middle phases, before becoming relatively less important as the services sector becomes more established as the largest sector. In China and Vietnam, for example, the growth in recent decades has been accompanied by a very large increase in manufacturing industries. As average wage levels increase with economic development, these countries tend to become less competitive in some manufacturing industries and much activity is transferred to lower wage economies.

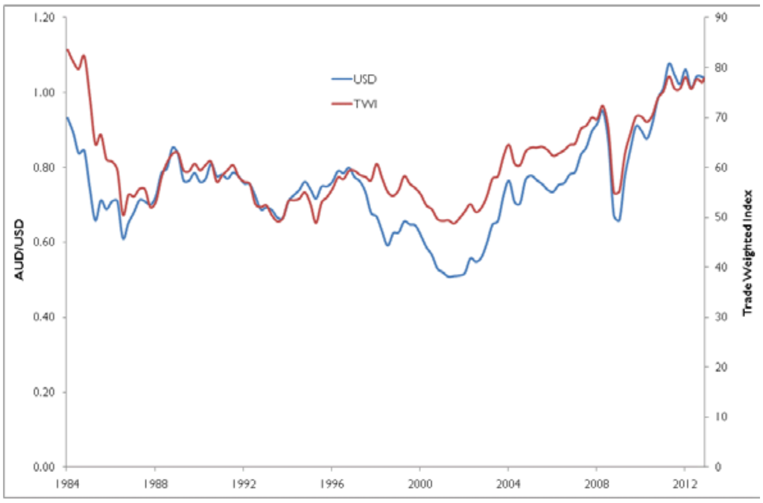
It is therefore to be expected that over the past two decades manufacturing has been in decline in Australia; in part, this has been due to the increased international competition from the rapid growth in manufacturing in the emerging Asian economies. Since 1990–91, employment in manufacturing in Australia has declined by around 13 per cent. In Tasmania, the decline over this period was much more severe, at around 44 per cent. That is, the proportional decline in manufacturing jobs has been over three times greater in Tasmania than in Australia as a whole.

The manufacturing businesses that have closed or substantially reduced their production and employment usually produced undifferentiated goods that faced strong competition from other lower cost countries, generally in Asia but also New Zealand. These businesses, often defined as 'traditional' manufacturing businesses, generally had no strong advantage in being located in Tasmania. This trend has been assisted by the phased reduction of tariffs on some goods entering Australia and some progress in bilateral trade agreements that have removed impediments to international trade.

The manufacturing businesses that have been more successful tend to produce more specialised products, often relying on highly trained and skilled employees. These businesses face much less competition from lower cost countries and have some capacity to increase the market price in response to cost pressures or a strong Australian dollar. Industries in this category include Liferaft Systems Australia, Caterpillar Elphinstone, and Incat.

The strong exchange rate is frequently cited as the reason for the decline in the manufacturing sector. This certainly accounts for part of the trend. However, in the period from 1990 to 2004 there was no underlying strengthening of the Australian dollar against the US dollar or the trade-weighted index yet over this period over 7 500 jobs were lost in manufacturing in Tasmania. During the period from 1999 to 2001 when the Australian dollar depreciated sharply against the US dollar and the currencies of Tasmania's major trading partners, there was no respite in the rate of job losses; the data suggest the rate of decline was even a little higher over this period.

Chart 2.5: Changes in the value of the Australian dollar since 1984



Source: Reserve Bank of Australia

More recently the rate of job losses in manufacturing has been increasing while the Australian dollar has remained at very high levels. In the 18 years to 2007–08, the average annual decline in employment was around 330 persons. For the past four years, however, this average decline increased to around 1 770 persons, a fivefold increase.

This suggests that there is an underlying trend of a declining manufacturing sector but that this has recently accelerated sharply in response to the additional pressure on the competitiveness of many industries caused by the sustained strong Australian dollar. In some of these cases, it appears that rather than causing the decline of otherwise viable businesses, it is more likely that the strong exchange rate has brought forward their demise.

The reduction in total employment in the manufacturing industry is not due solely to the closure of large manufacturing plants. To remain viable, manufacturing businesses have been identifying opportunities to improve their productivity, which almost always leads to lower employment per unit of output. This has been particularly evident with the metal processors, which have reduced their employment very substantially while maintaining, or in some cases increasing, their output.

Despite facing weaker commodity prices and a strong exchange rate in recent years, the three metal processors have remained in the State while many businesses in other areas of manufacturing have closed. Part of the reason is that these businesses have been able to achieve significant productivity improvements. Just as important, however, is the mutual dependency between these metal processors and Hydro Tasmania: a relationship that does not apply to any other major manufacturing business with the possible exception of Norske Skog.

For these businesses, electricity costs account for a large share of their variable costs, in some cases up to 40 per cent. Electricity costs are therefore a critical factor for their viability. The three metal processors account for around 50 per cent of Hydro Tasmania's average output.

In cases where any business faces adverse external conditions, one strategy is to seek to renegotiate input costs. Securing lower wage rates from employees is highly problematic. Equally, firms supplying inputs often do not agree to reduce their prices as they are able to sell their products elsewhere, or they would be selling below their production costs, particularly the variable cost of production.

Hydro Tasmania, however, is a highly capital intensive business with relatively high fixed costs and exceptionally low variable costs. The key issue for Hydro Tasmania, in its dealings with the metal processors, is the alternative market for its output if it no longer sells to one of these processors. Opportunities for additional electricity demand within Tasmania are very limited and flows across Basslink are already designed to capture the peak prices in the Victorian spot market. While there may be opportunities for expanded sales in mainland markets, in the short and medium term, it is highly unlikely that the volume of the extra demand would be sufficient to replace the load of any of the three metal processors.

In addition, Hydro Tasmania relies on all three metal processors for the State's System Protection Scheme, which allows Basslink to operate at full capacity. If one processor were to close, this would most likely constrain the operation of Basslink, and therefore reduce the earnings from Basslink for Hydro Tasmania.

This mutual dependency means that there are strong commercial incentives for both parties to be far more flexible in any negotiations than would ordinarily be the case in an energy supplier-customer relationship. In recent years, some of these metal processors have faced severe financial pressures as the Australian dollar price of their output has declined sharply. This mutual dependency has assisted these businesses in remaining in the State.

In summary, on the basis of the trends to date, manufacturing businesses that have the greatest prospects for long term viability are those that fit into one or more of the following categories:

- Businesses that have a significant supply or cost advantage from being located in the State, such as some aquaculture where water temperature is a critical factor, dairy-related businesses, as Tasmania has a comparative advantage in fresh milk production within Australia, and potentially some metals processing that is close to mines, such as Grange Resources' iron ore pellet plant at Port Latta. These manufacturing businesses are almost always associated with a primary industry in the State.

- Businesses that produce differentiated products in strong demand. These are generally high technology industries, whose products may contain a significant amount of information technology, that are potentially footloose but happened to become established in the State and have been able to remain due to their market strength.

- Businesses with a mutual dependence with Hydro Tasmania, as discussed above.

- Businesses, often small, that provide specialist engineering and other products to other local businesses.

A major transition has occurred in the skills required in the State's manufacturing industry. Many of the large firms that no longer operate employed a large number of unskilled and semi-skilled workers in their plant. By contrast, the existing firms that are becoming more capital intensive, and the small emerging firms in particular, rely far more on highly skilled labour.

Much of the growth in the private sector services sector has been to support Tasmania's manufacturing industry. This occurs both upstream, that is in assisting these businesses in the supply of inputs and the production technology, including information technology, at the manufacturing plants through operations and maintenance, and downstream though distribution, sales and to support any further product transformation. This trend is also evident in the primary industry sectors, including mining.

Even though direct employment in manufacturing has fallen sharply, this may present a misleading picture of the importance of the manufacturing sector to overall employment in the State due to the important role of these support service industries.

2.3 Structural change in Tasmania's forestry sector

The Tasmanian forestry industry is going through a process of structural change brought about by some major changes in market supply and demand conditions. The key external factors, in addition to the Australian dollar appreciation, include a significant contraction of traditional Japanese woodchip market, where there has also been a strong shift in demand towards woodchips from plantation resources. Australia's share of the Japanese market has declined by 50 per cent since 2008 and 25 per cent in the last financial year.

The Chinese woodchip market has expanded, but prices are substantially lower than from Japan. Competition has increased from hardwood woodchips from lower cost countries including Chile, Uruguay, Thailand and Vietnam, which are developing very substantial eucalypt plantations.

The construction industry has been facing weak economic conditions and there has been a shift in the demand away from hardwood timber for structural applications towards softwood and engineered wood products. This has had an additional negative impact on Tasmania's hardwood forestry industry.

Within Tasmania, the State's major processor of both native forest sawlog and pulpwood products, Gunns Ltd, chose to exit native forestry and to focus on its proposed plantation-based pulp mill at Bell Bay. This has involved the sale of some sawmills and the closure of some others. The plantation industry and Gunns Ltd were affected by the collapse of a number of Managed Investment Schemes, which had resulted in a sizeable expansion of plantation forestry on Crown land and privately owned land.

In mid-2011, Gunns sold its Triabunna woodchip mill to entrepreneurs Jan Cameron and Graeme Wood, who have been critical of the State Government's forestry strategies. No woodchips are currently being processed at the mill and the future prospects are highly uncertain. Compounding the problems facing the industry was Gunns' decision to enter into voluntary administration in late September 2012 and appoint receivers. The prospects for a pulp mill at Long Reach in northern Tasmania continue to be highly uncertain.

Further changes affecting the forestry industry will occur if the Parliament approves the necessary legislative measures following the agreement between several forestry industry groups and environmental groups arising from the *Tasmanian Forests Statement of Principles* process. The changes in the forestry industry to date have been profound and predominantly structural in nature. Few, if any, of these changes appear cyclical; that is, they are not likely to be reversed if economic conditions improve. They are therefore expected to have long term effects on Tasmania's forestry and forest products sector.

The major impacts to date have been a sharp decline in forestry activity. According to Dr Jacki Schirmer at the Australian National University, from 2006 to 2011 the number of jobs in the forestry and forest products industry declined from around 6 400 to around 3 450. This includes an estimated loss of 1 700 jobs in the forestry sector itself, around half of which have been in forestry contracting, such as harvesting and transport. Further jobs losses have occurred since 2011, including the loss of an estimated 100 jobs arising from the collapse of Gunns, of which 50 were at the Gunns timber processing plant at Launceston in late September 2012. Forestry Tasmania has laid off over 150 staff and is hiring fewer forest contractors in response to sharply reduced log sales.

While there will always be demand for locally produced sawn timber, there is little evidence to date that suggests that the forestry and forest products industry could grow significantly and become a major employer as in past decades. For some forest products, it is no longer evident that Tasmania has a global competitive advantage.

2.4 Structural change arising from Australia's resources boom

The national resources boom arose from the very large increase in demand for some key commodities due to the rise of Asia, principally China but also Vietnam, India and other emerging economies, as their economies become industrialised and reduce their dependence on agriculture and other primary industries.

For Australia, this resources boom is expected to operate in three phases. The first phase, which ceased in 2010–11, was the very strong boost to the prices of some of Australia's major exports, notably iron ore, coking coal (used in steel making), thermal coal and liquefied natural gas. This led to a very large improvement in the terms of trade – the price of exports in terms of the price of imports – and the value of the Australian dollar.

The output of existing mines, however, was relatively unchanged as most were already operating at close to full production: the impact of the stronger demand was almost entirely through the price effect. During this phase, the mining businesses planned future expansions in response to the high commodity prices and the expectation that this strong demand will persist over many years.

The strong exchange rate has had a major impact on many sectors of the national and Tasmanian economy. The manufacturing industry nationally has been facing much stronger competition in export markets while the price of competing imports has been declining sharply due to both the Australian dollar appreciation and the emergence of low cost manufacturers in developing countries, particularly China. Many of the trends described above for Tasmania also occurred at the national level.

Tourism demand has softened as Australia becomes an expensive tourist destination and Australian households are attracted to overseas holidays that have become substantially cheaper. International student enrolments have declined nationally and enrolments at the University of Tasmania may start to soften as the number of students attending preparatory English language courses has begun to decline.

Importantly, average household real income in Australia increased sharply, estimated at around 32 per cent over the past decade. Most Tasmanian households therefore benefited from this phase of the resources boom, except those that lost employment in manufacturing and other industries affected by the high exchange rate. Commodity prices and the terms of trade have been easing over the past year, as growth in demand for commodities has eased and global supply has started to increase, though they remain very high by historic standards. The exchange rate, however, has eased only marginally from the peak levels in 2010, as Chart 2.5 above shows.

The second phase of the resources boom is the boost in mining-related investment, which is now expected to peak in 2013–14 when the level of mining investment is forecast to exceed the level of all private non-mining investment. This massive increase in construction, and increased demand for related activities to support the projects such as manufacturing, and technical and financial services, has led to a transfer of labour and investment funds to the resource rich states. Much of the construction is relatively labour intensive.

None of these major investment projects are in Tasmania. Furthermore, Tasmania has few firms that are major suppliers for these projects. The result has been a transfer of labour from Tasmania to the resource-rich states. This accounts for part of the increase in net interstate out-migration from Tasmania in recent quarters, which has led to lower population growth in the State. In addition, this has led to a large number of Fly In Fly Out and Drive In Drive Out workers, estimated recently by the Reserve Bank of Australia at around 50 000 across Australia. This will include a share of Fly In Fly Out workers from Tasmania, though no state level estimates are available.

It is now expected that the mining investment peak will occur earlier, and at a lower level, than initially forecast, as some major mining projects, such as the BHP Olympic Dam copper and uranium mine, are not now expected to proceed as originally planned. Investment in some iron ore and coal projects may wind down quite sharply, as the mining companies seek to commence production while prices remain relatively favourable. For the LNG processing projects, continued strong investment is expected over a longer period. Some commentators anticipate a major reduction in employment in the construction and related industries after the investment peak unless some new sources of demand emerge. In particular, this is expected to lead to an exodus of construction-related workers from the mining projects, and most likely from the resource-rich states, as these projects are completed.

The third phase is the increased production from these new and expanded mines, which has recently commenced. Commodity prices are expected to trend downwards as global output responds to the strong prices and as the rate of industrialisation eases, particularly in China. Australia's terms of trade are forecast to ease further and the Australian dollar is expected to depreciate against major currencies as a result, though it will remain relatively high due to the higher export volumes from the expanded mining sector. Importantly, these new mining operations are highly capital intensive and the demand for labour to operate the mines will be relatively low, given the capital expenditure involved.

The first two phases may be regarded as cyclical in nature. It was always expected that they would be temporary and that the mining companies have major incentives to respond to the high prices as quickly as possible. The third phase is a longer term phase and may be described as more structural in nature.

The key features of this third phase are set out below:

- The exchange rate is expected to decline from current levels but remain high by historical standards due to continuing strong demand for Australia's resources. Commentators generally expect, for example, that the exchange rate against the US dollar will remain well above US 70 cents, which may be regarded as the long term average. On the other hand, some commentators have predicted that, based on fundamentals and likely future trends, the current value of the Australian dollar exchange rate may be between 15 per cent and 20 per cent above its future long term level. All traded sectors in Australia, including manufacturing, tourism, international education and the trade in international services, will have to adjust over time to a sustained high Australian dollar value, compared to its historical average.

- The governments of the resource rich states will benefit from higher royalties from these expanded mining operations and from some increased employment due to the additional mining activity, which will flow through to higher payroll tax revenues.

- The higher than average Australian dollar value will put sustained pressure on Tasmania's export and importing competing sectors to improve productivity to remain competitive. This usually involves replacing labour with capital and business restructuring to minimise costs, including, in many cases, increased outsourcing of functions that were traditionally undertaken within each business, such as some labour hire.
- The non-resource rich states, including Tasmania, will continue to fare less well than the resource rich states and the demand for labour will be relatively weak, especially for unskilled labour.

2.5 Structural change arising from the rise of Asia

Rapid economic development in Asia has created new or expanded markets in a range of areas outside the resources sector, including tourism, international education, business services and food and beverage products.

Recent estimates are that Asia currently accounts for slightly less than one quarter of the world's middle class, at around 500 million. The middle class in both China and India is growing at an extraordinary rate. According to Professor Peter Drysdale of the Australian National University, the Asian middle class is expected to increase to around three billion people in the next 20 years.

Not only is the size of the Asian middle class increasing, but real wages within this class are also increasing. Furthermore, in the case of China, the share of factor income to labour, and therefore to households, is forecast to increase as the rate of industrialisation eases and investment declines as a share of gross domestic product.

There already is very strong global competition for the increased demand from Asian households and the expanding businesses and governments in these Asian countries. Much of the competition is from within Asia itself and this trend is expected to continue. Expanding Asian universities, for example, are likely to compete with universities in developed countries. The growing demand for different, and higher quality, food and beverage products is likely to attract producers within Asia as environmental standards improve and these producers seek to meet the quality standards required.

To date, the sales of goods and services to the Asian middle class comprise a relatively small share of total Tasmanian exports. Goods exports that are consumed by these households (which include meat, dairy products, beverages including wine, cakes, honey and seafood) comprise around 9.2 per cent of total international exports from Tasmania.

In the case of rock lobster and abalone, however, which account for around 3.6 per cent of total Tasmanian exports, opportunities for further growth are limited as both these fisheries are subject to an annual total allowable catch, which are set to provide for the long term sustainable management of these species. There is some opportunity for raising production through increased output of farmed abalone, with six land-based facilities on the Tasmanian mainland. However, there is increasing competition from low cost producers of farmed abalone in South Africa, Taiwan, Chile, Japan, China and Korea, most of which produce little or no wild abalone. This has put downward pressure on the beach price of wild abalone, where Tasmania accounts for around one quarter of global wild abalone supply.

Export products destined for Asian households, which currently comprise only 5.7 per cent of Tasmania's total exports, or around 8.7 per cent of all exports to Asia, have the potential for further volume growth. The challenges that Tasmanian businesses face in building up their markets in these countries include a strong exchange rate, high labour and other costs and relatively high transport costs mean that continuing to secure a reputation for premium quality produce is an essential strategy for Tasmanian exporters, in light of the cost issues they face.

The rise of Asia has also boosted visitor numbers from the region. In 2000–01, according to the Australian Government's International Visitor Survey, there were around 20 000 visitors to Tasmania from Asia, including almost 1 500 visitors from China. This increased to 49 000 in 2011–12, with around 10 500 visitors from China. This growth of almost 30 000 visitors over the past 11 years represents around 3.5 per cent of the total number of visitors to the State in 2011–12, estimated at 855 000, according to the State Government's Tasmania Visitor Survey. While there has been growth in visitors from Asia to the State, this has not been sufficient to substantially increase total visitor numbers and therefore provide a major boost to Tasmania's tourism industry.

Part of this growth in visitor numbers has been in international education, where Tasmania has been successful in attracting international students, principally from Asia. However, Tasmania does face some challenges in attracting students and visitors from Asia such as its geographical separation from the rest of Australia and possibly its relatively cold climate. The share of all overseas students studying in Australia that come to Tasmania is below Tasmania's share of the national population. For example, of all international students enrolled at Australian universities in the calendar year to August 2012, 1.4 per cent of these studied in Tasmania (Table 2.1). Around 1.6 per cent of Asian international university students in Australia studied in Tasmania during this period. This compares to Tasmania's share of the national population of 2.3 per cent.

International students comprise around 13 per cent of all students at the University of Tasmania, compared to a national average share of around 20 per cent for all Australian universities. To date, therefore, Tasmania has not been as successful as some other states in attracting international students.

Table 2.1 – International students, higher education sector, state or territory of enrolment, calendar year to date at August 2012

State	Asia (no.)	Share (%)	All other regions (no.)	Share (%)	Total (no.)	Share (%)
NSW	53 168	34.3	24 671	35.5	77 839	34.7
VIC	47 952	30.9	19 174	27.6	67 126	29.9
QLD	21 298	13.7	12 806	18.4	34 104	15.2
SA	11 609	7.5	3 254	4.7	14 863	6.6
WA	12 428	8.0	6 293	9.1	18 721	8.3
TAS	**2 489**	**1.6**	**719**	**1.0**	**3 208**	**1.4**
NT	194	0.1	562	0.8	756	0.3
ACT	5 878	3.8	1 945	2.8	7 823	3.5
Australia	**155 016**	**100.0**	**69 424**	**100.0**	**224 440**	**100.0**

Source: Austrade

Note: For this table, Asia includes Cambodia, China, Hong Kong, Indonesia, Japan, South Korea, Laos, Malaysia, Singapore, Taiwan, Thailand and Vietnam.

There is therefore opportunity to build on the achievements so far. However, as the rise of Asia continues, a key issue for Tasmania's education sector will be the extent to which countries such as China and India continue to send their students for further study to advanced economies such as Australia, rather than build up their own universities and other institutions and rely less on overseas education, as has occurred in Japan and Singapore.

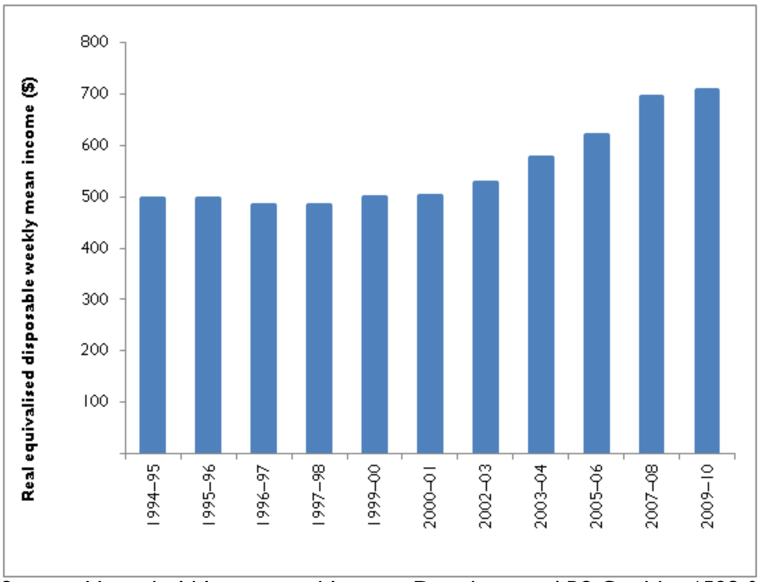
2.6 Structural change in household spending

Household spending is the most important component of aggregate demand in Tasmania. Changes in the composition of household spending, even if relatively small in year-on-year terms, can have a significant impact over time on Tasmania's industries. This section identifies some drivers of change in the spending of Tasmanian households.

Real income levels are an important driver of long-term trends in household behaviour. Income influences the level of household expenditure, the type and quality of goods and services that households consume, and the way that households manage their assets.

Similar to the rest of the nation, real average household incomes have been increasing in Tasmania over the past few decades, broadly in line with the State's economic growth. For example, household income surveys report that disposable income has increased since the late 1990s, even after accounting for inflation and changes in household composition (Chart 2.6). Notably, household income growth did appear to slow in 2009–10, probably influenced by the 2008 global economic downturn.

Chart 2.6: Real equivalised disposable income, Tasmanian households, original data



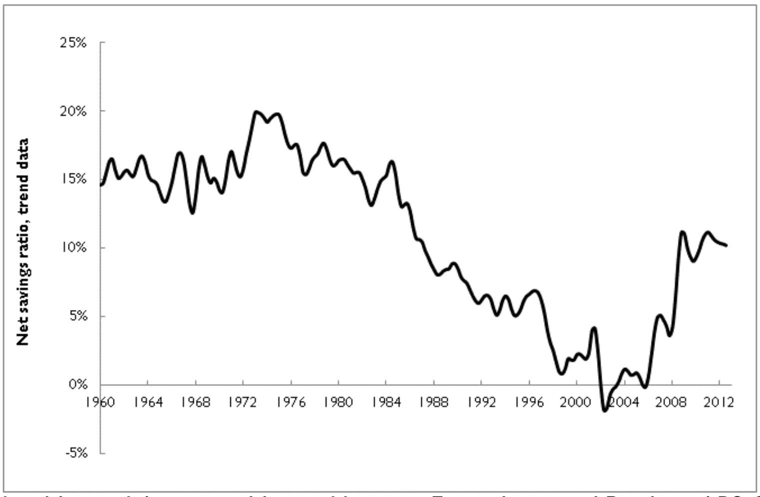
Source: Household Income and Income Distribution, ABS Cat No. 6523.0

Household savings rates

Financial deregulation, easier access to credit and changes in household behaviour arising from real wealth gains contributed to a long-term decline in savings rates from the mid-1970s through to the early-2000s (Chart 2.7). After briefly becoming negative in 2002, saving rates by Australian households have increased sharply and are now around 10 per cent of disposable incomes. Net savings data are not available at the state level, but analysis of household data suggests similar trends in savings rates have occurred in Tasmania.

There is a growing view that saving rates may remain around their current levels over the medium term, as they are closer to historic trends. The Reserve Bank of Australia, for example, no longer regards these savings rates as evidence of 'cautious' consumers. The very low savings levels of a decade ago are now increasingly regarded as an exception from the long term trend due to the specific factors noted above, particularly the wealth effect from the rapid growth in house prices and equities.

Chart 2.7: Net savings ratio, Australia[1]



Source: Australian National Accounts: National Income, Expenditure and Product, ABS Cat No. 5206.0

The implication is that that the rates of consumption growth in the period from late 1990s to early 2000s, when saving rates declined sharply and the demand for credit by households was very strong, are unlikely to be repeated. Equally, however, the slower growth in consumption in recent years, including in retail trade, is not expected to continue at the national level. For Tasmania, this suggests consumption and retail spending are likely to move more closely with changes in household income and population growth compared to recent years.

Composition of household expenditure

ABS Household Expenditure Survey (HES) data indicate that over the past three decades, broad expenditure patterns of Tasmanian households have not dramatically shifted (Table 2.2). The share of total household expenditure on housing, power and transport has increased from just over 31 per cent of total expenditure in 1984 to almost 36 per cent by 2009–10. There has been an underlying, gradual increase in the share of spending on services and a minor decline in the share spent on retail goods.

Within each of these broad expenditure categories, more disaggregated HES data also demonstrate mostly gradual changes in household expenditure over time, with some exceptions. In particular, between 2003–04 and 2009–10, nominal expenditure on housing was estimated to have increased by around 66 per cent, reflecting changes in the price of housing.

[1] The Household Savings Ratio is defined as household net savings divided by household net disposable income. Household net disposable income is calculated as household gross disposable income minus household consumption of fixed capital.

Table 2.2: Tasmanian average weekly household expenditure, nominal data

	1984	1988–89	1993–94	1998–99	2003–04	2009–10
Level ($)						
Current housing costs (selected dwelling)	39	54	60	71	99	165
Domestic fuel and power	11	14	22	22	28	38
Food and non-alcoholic beverages	63	88	102	108	135	189
Alcoholic beverages	9	13	15	16	27	27
Tobacco products	6	7	10	10	15	15
Clothing and footwear	23	24	30	32	30	39
Household furnishings and equipment	24	31	35	39	48	52
Household services and operation	13	21	30	32	44	57
Medical care and health expenses	11	18	24	29	36	50
Transport	48	66	77	95	128	178
Recreation	41	49	78	81	95	147
Personal care	6	9	10	11	13	20
Miscellaneous goods and services	18	30	37	48	62	87
Total goods and services expenditure	**312**	**425**	**530**	**593**	**759**	**1 064**
Share of total expenditure (%)						
Current housing costs (selected dwelling)	13	13	11	12	13	15
Domestic fuel and power	3	3	4	4	4	4
Food and non-alcoholic beverages	20	21	19	18	18	18
Alcoholic beverages	3	3	3	3	4	3
Tobacco products	2	2	2	2	2	1
Clothing and footwear	7	6	6	5	4	4
Household furnishings and equipment	8	7	7	7	6	5
Household services and operation	4	5	6	5	6	5
Medical care and health expenses	4	4	5	5	5	5
Transport	15	16	14	16	17	17
Recreation	13	12	15	14	12	14
Personal care	2	2	2	2	2	2
Miscellaneous goods and services	6	7	7	8	8	8
Total goods and services expenditure	**100**	**100**	**100**	**100**	**100**	**100**

Source: *Household Expenditure Survey*, ABS Cat No. 6530.0

These data are generally consistent with a gradual longer-term shift in household consumption in Australia away from retail goods and towards services. This trend is clear at the national level, where retail sales, as a share of total household spending, have fallen from around 36 per cent to 32 per cent over the past two decades. At the state level, the trend is not so clear, with retail sales at 34 per cent of total household spending in 2011–12, down from around 36 per cent two decades earlier, but having been as high as almost 38 per cent within this period.

Part of this trend is due to relative price changes over this period. Price increases for many tradable goods, which include most retail goods, have increased by less than the price of services over this period. This is likely, for example, to account for part of the decline in the share of spending on clothing and footwear over this period.

Retail spending in Tasmania has eased in recent years; in nominal terms, spending was higher in 2009–10 than in 2011–12. Some retailers have attributed the weaker spending in retail outlets to the emergence of internet shopping. Accurate online sales data are scarce; however, according to one measure by the National Australia Bank, national online spending increased by 27 per cent in the year to January 2013 and is equivalent to 5.8 per cent of traditional bricks and mortar retail spending (excluding cafés, restaurants and takeaway food). While there is some evidence from a recent Commonwealth Bank of Australia study that this growth rate may be easing, online sales will become increasingly significant in Australia, and therefore Tasmania, with potentially major implications for employment in some areas of the retail sector as they adjust to this increased competition.

2.7 Tasmania's changing demographic profile

Tasmania's population is ageing, with older people making up a larger proportion of the population and younger people making up a smaller proportion of the population than previously.

Tasmania's population is ageing more rapidly than in any other Australian state or territory. The rate of ageing in Tasmania is also increasing, in terms of the proportion of the population aged 65 and over. This increase in the rate of ageing is projected to continue until around 2025.

This ageing is caused by a number of factors, such as increased longevity (brought about by improvements in health care and medical technology), a declining fertility rate (resulting from factors such as changing attitudes and improvements in contraception) and high rates of interstate out-migration by young adults. The ageing of the Tasmanian population is expressed in the charts below which demonstrate the changes in the composition of the population in the State over the past 20 years.

Chart 2.8 (a): Tasmanian population by age and sex, June 1992

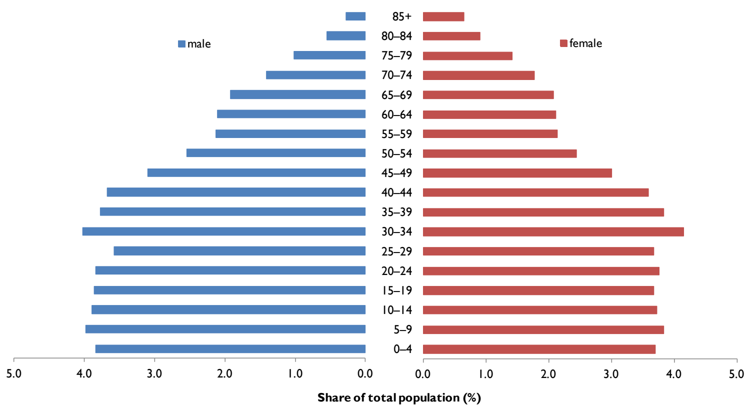
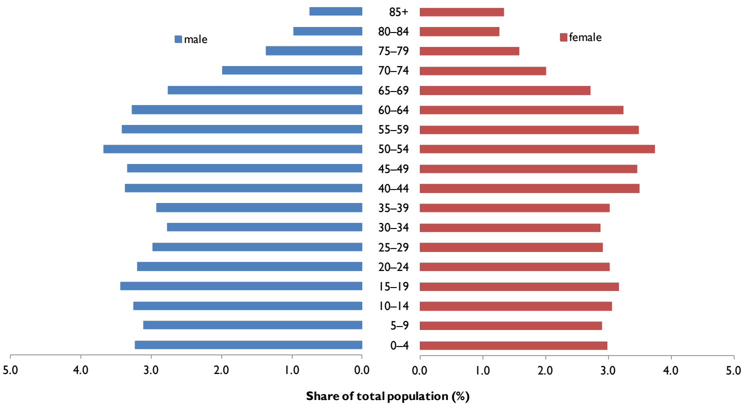


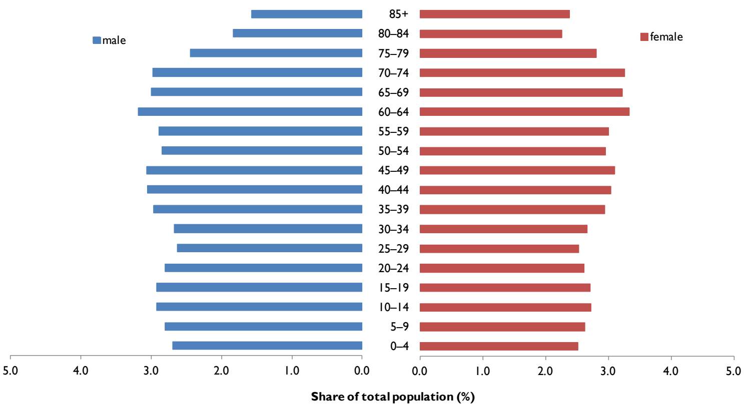
Chart 2.8 (b): Tasmanian population by age and sex, June 2012



Source: ABS, *Australian Demographic Statistics*, Cat No 3101.0

It is possible to predict the trends in sizes of the older age classes over the next few decades as these people are alive now, as shown in (Chart 2.8 (c) below), with a high degree of accuracy, given constant age-specific net migration assumptions.

Chart 2.8 (c): Projected Tasmanian population by age and sex, June 2032



Source: DCAC 2008 Population Projections

In June 1992, the proportion of the population aged 65 years and over was 12.0 per cent. This share increased to 16.7 per cent in June 2012 and is projected to increase to 25.8 per cent in June 2032.

Compared to all Australian households, households comprising those aged 65 years and over tend to spend almost twice as much, as a share of total spending, on medical and health services (9.5 per cent of all expenditure), a larger share on food and recreation (by around 2 per cent in both cases), and a smaller share on housing costs (by around 6 per cent) and transport (by 3 per cent). The demand for some financial services is also likely to be related to the number of households in the retirement phase and the value of superannuation assets they have. As the share of households in this category increases, therefore, the demand for these goods and services is expected to change.

In the case of medical and health services, a further driver for increased expenditure is that the inflation rate for health care services has tended to exceed the overall inflation rate over several years. The demand for aged care accommodation and other dwellings suitable for more elderly Australians is also likely to increase in the decades ahead.

Equally, a smaller share of spending is likely on children-related goods and services. The number of children under five in Tasmania is projected to be around 2 700 fewer in 2032 than today, a decline of over eight per cent. This will impact on the demand for a large range of goods and services purchased by households including the types of dwellings and motor vehicles, private schools, recreational services and childcare.

Nationally the average spending by households comprising persons aged 65 years and over was just under 59 per cent of the average expenditure of all households in 2009–10. Households therefore experience a major decline in spending as they move into the retirement phase. This represents a potentially major structural change in household spending in the decades ahead as the number of these households increases sharply.

This change in post-retirement household spending may be less in future decades as households have been building up their superannuation assets due to the compulsory employer contribution scheme introduced in 1992. Over time, therefore, these households are likely to have greater spending power. In addition, real incomes tend to increase over time so that spending by future generations, in both the older and younger age classes, is likely to be greater in real terms than now. Finally, average standards of health of persons in the older age classes has been increasing, which has allowed an increasing number of older persons to remain in the workforce, and also may encourage greater spending in some areas, such as recreation and travel.

However, studies estimate that a very large number of households due to enter this phase in the next 20 years have very low levels of superannuation assets (less than $100 000). This will lead to an increasing number of households being reliant on the Australian Government's aged pension as their primary income source, which will be very low once they cease working, especially if they use their lump sum superannuation benefits to pay off their mortgages. Furthermore, households may have to set quite low spending levels to account for the trend of increased longevity.

This suggests that there will be some downward pressure on total household expenditure as a result of the ageing of Tasmania's population, as well as large changes in the composition of household spending. The retail sector, in particular, may account for a smaller share of household spending as there is increasing reliance on services to these older households.

The ABS recently estimated that, nationally, people aged 25–34 are the most likely to move house, with 75 per cent reporting one or more moves in the five years to 2007–08. Conversely, people aged 65 years and over are the least likely to move, with only 17 per cent reporting any move in this five year period. This suggests that as the population ages, there will be less demand for some property services, and also for whitegoods, carpets and other items that tend to be bought following a house move. For the state governments, this will also put downward pressure on revenue from conveyance duty.

A significant shift in national household spending towards items such as medical care and health expenses would lead to lower GST receipts, under the current arrangements, which would also put pressure on the budgets of states and territories, especially Tasmania given its higher reliance on GST as a revenue source.

2.8 Structural change in Tasmania's public sector

Tasmania's public sector is an important and substantial part of the economy, both in terms of output and employment, and is subject to forces that alter its size and structure in the same way as other industries. The public sector is particularly important in Tasmania as it accounts for a relatively high percentage of the State's GSP. In 2010–11, spending by the Tasmanian government on services and infrastructure accounted for 16.8 per cent of Tasmania's GSP, which compares with the average state share of 11.6 per cent. This percentage has been gradually increasingly over recent years in Tasmania; in 2001–02 spending by the Tasmanian government on services and infrastructure accounted for only 14.7 per cent of Tasmania's GSP.

Most state and territory governments across Australia have recently been under increased fiscal pressure arising from the increasing demand and rising costs of public services and lower than anticipated revenues. The cost to the State Government of health services, in particular, has been increasing at a much greater rate than most other costs due, in part, to the demands for higher standards of care and technological innovation. In 2011–12, health spending accounted for 27.3 per cent of general government expenditure in Tasmania, up from 21.0 per cent in 2001–02. The average annual increase in health spending over this period was 8.9 per cent, appreciably higher than the average increase in all other areas of spending of 5.2 per cent.

Further demands on public spending in the health care and community services sector are inevitable, reasons for which include Tasmania's ageing population and some proposed major policy measures such as the National Disability Insurance Scheme and potentially the National Injury Insurance Scheme. In a range of other areas, there are also demands for more and improved government services.

Tasmania relies on the GST more than other states due to a lower capacity to raise revenue, greater unavoidable demand for government services and higher cost of delivering those services. Since its introduction, the GST initially provided larger revenues than expected. This enabled governments to increase their expenditure in real terms and plan further increases, as well as, for some states such as Tasmania, reduce or eliminate their net debt.

The situation altered from around 2005–06 when households increased their savings rates, as discussed above, and also allocated a greater share of their spending on non-GST goods and services, including overseas travel. This unexpected drop in the profile of GST revenues has had a particularly severe effect on Tasmania's fiscal position, compounded by weaker own source taxation revenue growth following the global economic downturn.

The effect has been a structural imbalance between the flow of the State's revenues from GST receipts, which accounts for almost 40 per cent of General Government revenue, and the State's planned expenditure on government services. Until recently, Tasmania's GST revenue had been growing at around 7 per cent per year, similar to the average growth in expenditure on government services. Since 2008–09, the average growth in national GST receipts has been less than two per cent. In the absence of a commensurate adjustment to outlays, this resulted in the rapid development of a cash deficit of $500 million in 2010–11.

Furthermore, as recently demonstrated in some southern European countries, if governments do not address structural fiscal imbalances at an early stage, private sector activity, including employment, subsequently declines significantly. This is due to reduced business and consumer confidence and also the flow-on effects of the very large decline in public sector spending, including welfare payments to households.

Governments in Australia have been reluctant to raise tax rates sufficiently to address the fiscal pressures that they face. Arguably, this reflects the views of the broader community. It may also be due to concerns that increases in taxation are likely to have a more adverse impact on private sector activity, and therefore on the economy as a whole, than reductions in public spending.

As one example, the Australian Government, as well as several state and territory governments, show no appetite for increasing the rate or coverage of the GST. State governments, for their part, have not made significant changes to their payroll tax regimes; some have, in fact, lowered the tax rate in an attempt to encourage employment. Minor real increases only in payroll revenues have been achieved in some states by leaving the thresholds unchanged.

For Tasmania, these trends, namely large increases in demand for public services and a very limited capacity to secure additional revenue, are set to continue for the medium term unless there is a major increase in GST receipts. The response in Tasmania, as in all other states, has been to rely principally on reduced public expenditure to return to fiscal balance. This has been achieved, in part, by securing lower than trend wage increases but also by a significant reduction in the number of public sector employees.

The structure of the public service has been changing in response to these pressures. To minimise the impact on public services in Tasmania, the focus has been on reducing jobs that are not ‘frontline’. There has generally, therefore, been a much larger reduction in ‘back office’ jobs, such as administrative and clerical positions than frontline positions such as teachers, nurses and police officers. Over the past year, for example, in the Department of Health and Human Services, the reduction in non-frontline jobs was approximately twice as large, as a share of all non-frontline jobs, as the reduction in frontline jobs in that agency. In the case of the Department of Police and Emergency Management, the reduction was even greater for non-frontline jobs.

Across the entire public service, the likelihood that a non-frontline position was lost in the past year was almost two times greater than the likelihood of a frontline position being lost. This is one approach government agencies are adopting to secure productivity gains in the public service.

This has had significant impacts on the structure of employment in the public sector. The total number of employees has declined by over 1 000 to date since the Government implemented its fiscal strategy in early 2011 to address the decline in revenues. Further reductions are likely in the years ahead. The demand for clerical and administrative staff, in particular, has declined sharply.

Over the past decade, public sector wage increases nationally and in Tasmania have exceeded private sector wage increases, by an average of around one per cent per year. Private sector employers have commented that, despite the overall wage increases being lower than in the public sector, these increases have still been higher than the market can justify. It is likely that the lower public sector wage increases will start to have a moderating effect on private sector wage increases in the years ahead.

A further consequence of a smaller public sector has been the reduced demand for office accommodation in Tasmania. Currently, the vacancy rate for commercial accommodation is around eight per cent, a high rate compared with the past decade. The Property Council of Australia attributes part of this high rate to the reduced demand for public sector office space. The current market conditions are not conducive to further investment in commercial accommodation in Tasmania.

Finally, as in many industries in the private sector, there will be an increasing emphasis on securing productivity gains in the services provided by the Australian and State Governments and Tasmania’s councils, to balance the growing demand for government services with the revenue sources available to fund these services.

Section 3 Structural change: the role of governments

The speed and extent to which the Tasmanian economy can respond to these structural forces is determined largely by its capacity to attract private investment, particularly in the expanding industries. The primary role of governments in this area is to create an attractive environment for private investment and to ensure there are no unnecessary obstacles to the transfer of resources to the expanding industries.

At the national level, this requires a fiscal and monetary framework designed to ensure economic stability and a taxation regime that does not inhibit economically viable investment projects. The Australian Government also funds some key public infrastructure, such as roads, ports and, increasingly, information technology-related infrastructure. It also is responsible for most business regulation that affects corporations.

State governments also have a role in maintaining a regulatory and fiscal environment that supports private investment. This includes an effective and efficient planning system, together with certainty over environmental assessment and approval processes. Investment in selected public infrastructure is also important, together with public investment needed to support industry-specific private investment projects.

It is equally important that business costs that state governments can influence or control are no higher than necessary, including business taxes and the prices for essential services such as electricity and water and sewerage. Market reform has been underway in these areas, designed to promote efficiency and constrain price rises in these sectors, often through creating opportunities for competition, while ensuring a high quality and reliable supply.

Structural change also requires a skilled and flexible labour force that can respond to the emerging market conditions and encourage private investment. State governments' education and skills programs play a key role in facilitating structural change, including enabling the private and public sector to secure the necessary productivity gains that will become increasingly important in the years ahead.

State governments' fiscal policies impact on long term economic growth at several levels. It is generally accepted that to maximise future economic growth, governments should seek to ensure that their public sectors operate as efficiently as possible. This allows taxes to be lower than otherwise and prevents the accumulation of Budget deficits that lead to growing debts and escalating interest costs.

The private sector competes with the public sector for labour, particularly skilled labour. The capacity of private sector businesses to expand and develop can be constrained if they face difficulties recruiting skilled labour because governments, at all levels, are able to attract the more highly skilled labour.

Private businesses can also become increasingly uncompetitive if they need to provide wage increases to match above-market wage increases in the public sector, as has been the trend across Australia over the past decade. This serves to discourage private investment, and therefore constrain the prospects for long term economic growth.

Structural change can be disruptive and the transition costs can be significant, especially for workers that lose their jobs in declining industries and may not immediately find employment in the expanding industries. However, governments at all levels will inhibit structural change and long term economic growth if they choose to implement policy measures designed to preserve industries in long term decline through industry assistance and other measures.

Governments are required to respond to economic issues as they arise. Some may be the result of structural change, while others may be due to more cyclical forces, or apply to specific industries, such as the forestry industry in Tasmania. In developing these policies, a critical consideration for governments is the impact of these policies on long term economic growth: that is, whether the policies will enhance or impede the capacity of the economy to evolve and develop over time and enhance the long term prosperity of the Tasmanian community.

Section 4 Summary and Conclusion

Tasmania's economy is subject to several cyclical and structural forces, almost all of which are driven by forces outside the control of the State Government. The cyclical forces, such as the boom in mining investment activity in some mainland states, the current very high exchange rate, low retail spending and the subdued demand in the housing market, have resulted in below trend economic growth in Tasmania and a widening divergence between the performance of the Tasmanian and national economies.

All economies are also affected by structural changes, which ultimately determine how economies grow and develop over time, and Tasmania is facing a set of structural forces that have led to some major changes in industry structure in recent decades. However, in the long term, structural change has a positive impact on the economy as it allows resources to move to their most efficient use, which has included growth in the services sector. Ultimately this leads to stronger economic growth, though it has resulted most recently in a decline in the manufacturing sector and a recent sharp reduction in activity in the forestry and forest products sector.

More gradual structural changes are arising from the rise of Asia, from trends in Tasmania's demographic composition and in the spending patterns of households. For the public sector, governments are responding to the challenge of meeting the growing demand for public services, with constrained revenue growth, without large increases in taxes.

Tasmania's economy has developed from decade to decade as resources are transferred away from industries in decline to those that are expanding. This process on the whole has led to the Tasmanian economy being stronger and more diversified than it was 20 years ago, but can be disruptive and the transition costs can be significant. Many workers that lose their jobs in declining industries are not immediately able to find employment in the expanding industries and some may never fully adjust as the Tasmanian economy evolves.

A very important task for policy makers is to identify the policies that can assist the Tasmanian economy to develop and grow in response to the longer term structural forces.