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State Finances after the Pandemic

Robert Carling

CIS Pandemic to Prosperity

THE CENTRE FOR INDEPENDENT STUDIES

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Introduction

The strength of Australia's government finances is an important dimension of economic performance. It helps set the foundations for the delivery of public services, the flexibility governments need to respond to unexpected events, and a stable fiscal environment for private sector investment. This strength is being severely tested by the fiscal consequences of the Covid-19 pandemic.

The latest readout of actual fiscal results came in final budget outcome reports for 2018–19, while the latest official estimates for 2019–20 and the forward estimates years 2020–21 to 2022–23 were provided in mid-year budget updates released in December 2019. However, those estimates have been overtaken by the far-reaching economic and fiscal consequences of the Covid-19 pandemic crisis that developed rapidly in the first quarter of 2020. Commonwealth and state 2020–21 budgets that were to be announced in May have been postponed to October. In these circumstances, the budget estimates reflecting pre-crisis assumptions and forecasts are useful only as a baseline showing how fiscal conditions were expected to unfold before the crisis struck.

After a long period of deterioration, Commonwealth government finances had stabilised and were exhibiting some signs of strengthening — such as the return to an approximately balanced budget in 2018–19 and a small surplus in 2019–20. Debt had reached, or was approaching, a peak. Now, large deficits are in store for 2019–20 and 2020–21, and a sharp increase in debt is certain in the last quarter of 2019–20 and in 2020–21.

This report does not dwell on these well-publicised trends in Commonwealth finances. Rather, it focuses on the state and territory sector. This sector is subject to some of the same influences as the Commonwealth, but also to different ones, which can mean that at times state finances head in a different direction from the Commonwealth. Such was the case before the pandemic crisis, with state debt on a steeply rising path at the same time as Commonwealth debt was starting to be reduced. The implications of the crisis for the Commonwealth budget dwarf those for state and territory budgets, but the latter will still experience substantial adverse effects, which will reinforce the pre-existing upward trend in state debt.

This report first surveys the likely effects of the pandemic crisis on state budgets. It then looks at the outlook for state fiscal aggregates as they were before the pandemic hit, as a baseline for considering what the aggregates might look like after including the impacts of the pandemic. It then traces the pre-crisis trends and possible impacts of the crisis in the states individually, and concludes by discussing the policy options available to manage these impacts.

Fiscal impacts of the Covid-19 pandemic

The Covid-19 pandemic has far-reaching economic consequences, not least of which are dramatic impacts on public finances. While it is national governments that will be most affected, sub-national governments such as the Australian states are also being hit hard.

The effects on state budgets fall into four categories: increases in expenditure on state functions directly involved in the response to the pandemic; reductions in revenue and increases in expenditure resulting from discretionary policy measures to assist businesses and households financially harmed by the crisis; reductions in revenue as tax bases such as employment contract; and negative asset valuation effects.

a) Increases in expenditure on state functions in response to the pandemic

As state governments are responsible for running public hospitals, the first category is dominated by health expenditures. The Commonwealth is sharing this cost impact on a 50/50 basis, but NSW for example has allocated an extra $700 million for hospitals, VIC $1.3 billion, QLD $1.2 billion and WA $500 million. (It is not clear whether these amounts are net or gross of the Commonwealth contribution.) Other states are presumably doing the same; and based on the above states' announcements, the total for all states and territories could be around $4.5 billion.

b) Impact of discretionary policy measures

In the second category, all state and territory governments have announced support measures such as waivers and deferrals of payroll tax, land tax, and business and household fees and charges. They have also announced expenditures, grants and concessional loans for industry support, relief for household expenses, assistance to vulnerable groups and retraining of workers. Governments have provided incomplete cost information for these measures; but on the fragmentary information available, the total across all states and territories could be of the order of $10 billion spread over this fiscal year and next. This does not include tax deferrals, which will shift the timing of revenue between fiscal years but not the total. Nor does it include the cost of concessional loans made by state governments, which are not direct outlays. The ultimate cost of these loans will depend on the extent of bad debts.

c) Revenue losses from shrinking tax bases

The third category is potentially much larger than the discretionary support measures. State revenue bases are exposed to the risk of substantial falls. The following are the most at-risk revenue items shown in aggregate for all states and territories in 2018–19 and as a percentage of total operating revenue:

Revenue Item	Value	% of operating revenue
GST revenue grants	$65 billion	23.0%
Payroll tax	$26 billion	9.1%
Conveyance duty	$19 billion	6.6%
Gambling taxes	$7 billion	2.4%
Vehicle stamp duty	$3 billion	1.0%
Total	**$120 billion**	**42.2%**

GST revenue — all of which is distributed to the states — is at risk of a severe decline as many of the goods and services subject to GST are among those most affected by the economic shut-down, while food (sales of which have been boosted by the crisis) is not subject to GST. Payroll tax will shrink because of falling employment and weaker growth or cuts to wage and salary rates. Property stamp duty — a notoriously volatile source of state tax revenue — is certain to fall steeply, mainly in response to a fall in the volume of turnover but also as prices weaken. Many opportunities for gambling — such as casinos and the machines in clubs and pubs — have been closed down. The number of motor vehicle sales both to households and businesses will fall sharply. While there may be other small items of state revenue at risk — such as public transport fares, admission fees and traffic fines — the above table captures the major ones, indicating that some 42% of total state operating revenue is at risk of a severe decline.

It will be very difficult to estimate just how large the decline will be. It depends, among other things, on how long the cessation of normal business continues. Given the lags in revenue collection, the March quarter is unlikely to have been significantly affected. The June quarter is likely to see the maximum impact, but the September quarter could also be strongly affected if the restrictions on activity continue much past May. The maximum impact can only be a matter of assumption at this stage. By way of illustration rather than forecast, a decline of 50% in at-risk revenue would slice $15 billion from revenue in one quarter or $30 billion in two quarters, and something in between if the restrictions are phased out from say mid-May to end-August. Whatever the total loss is, some of it could be retrieved if property and vehicle sales that would have occurred during the shut-down period are merely deferred, leading to an unusually high level of sales activity later in 2020–21.

The rough estimates given above are for all states and territories combined; but for individual states and territories, the at-risk percentage of revenue varies considerably from the average of 42%, as shown here:

NSW	VIC	QLD	WA	SA	TAS	ACT	NT
45%	46%	39%	27%	45%	50%	39%	52%

WA is at the low end of the range and will be least affected. WA receives relatively little GST revenue, allows very little gambling, already had depressed levels of real estate activity before the crisis, and relies more than other states on mining royalties, which have been little affected by shut-downs. QLD and the ACT will also feel below average impacts. At the other end of the range, and therefore relatively more at risk, are the smaller jurisdictions that rely heavily on GST revenue; particularly TAS and the NT. NSW, VIC and SA also stand to experience somewhat above-average impacts for varying reasons.

Bringing together the first three categories, the total adverse impact on state and territory budgets in two quarters could be in the order of $45 billion.

d) Negative asset valuation effects

The fourth category of fiscal impacts comes from negative asset valuation effects, which directly affect states' balance sheets. States are sizeable holders of equities and property, mainly for the purpose of funding their public sector superannuation liabilities. The values of such assets have already taken a severe hit, and the states will see significant deterioration in net financial worth from that source over and above the decline in revenue and increase in expenses discussed above. In the best case scenario, asset values could bounce back quickly; but under other scenarios they may take years to recover.

State fiscal aggregates

a) Pre-crisis trends and outlook

One of the fiscal performance metrics the states emphasise is the net operating result. (See definitions and data sources in Appendix 1.) As Figure 1 illustrates, this result recovered strongly from the deficit of 2012–13 to a peak surplus of almost $10 billion in 2016–17 that exceeded the previous peak 10 years earlier. The net operating result has since weakened but remained in surplus in 2018–19 and — on the pre-crisis estimates — in 2019–20 and beyond.

This is not to suggest that a net operating surplus of any size is necessarily a mark of strength in state finances. It is calculated before taking account of capital expenditure, which should be at least partly financed by operating surpluses rather than wholly financed by borrowing. The net operating surplus of recent years should be viewed in the context of a rapid build-up in capital expenditure — more on that below.

The aggregate state net operating surplus has declined in recent years for both revenue and expenditure reasons. After several years in which operating revenue accelerated to a rate of growth above that of operating expenditure, in recent years

Figure 1: Net operating balance of states and territories

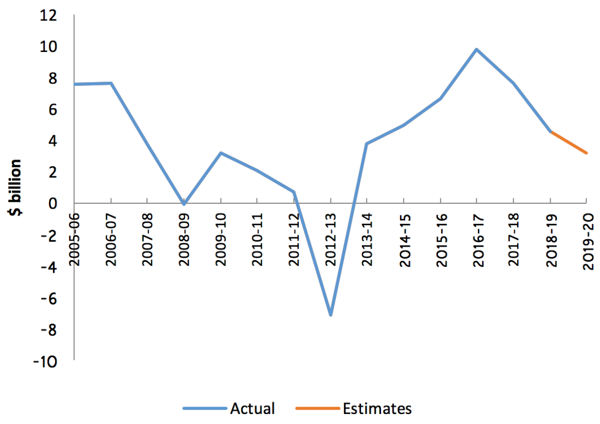


Figure 2: States' three-year moving average growth in operating revenue and expenses (% pa)

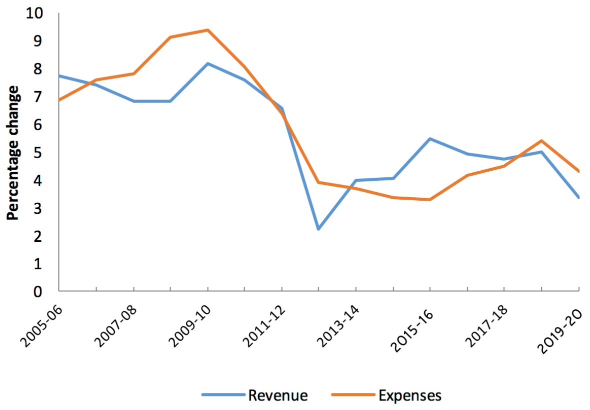


Figure 3: Gross Asset Acquisition of states and territories

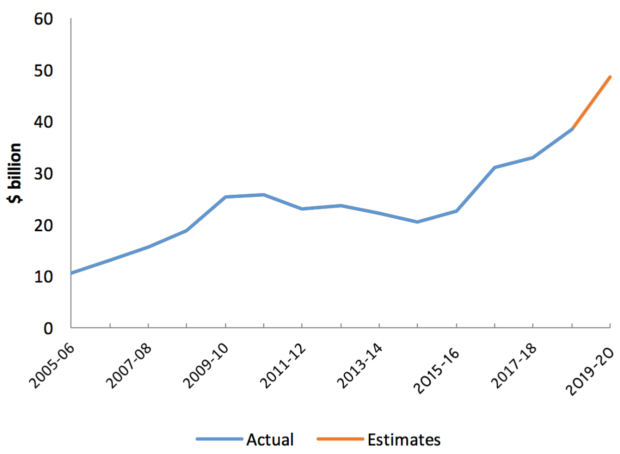
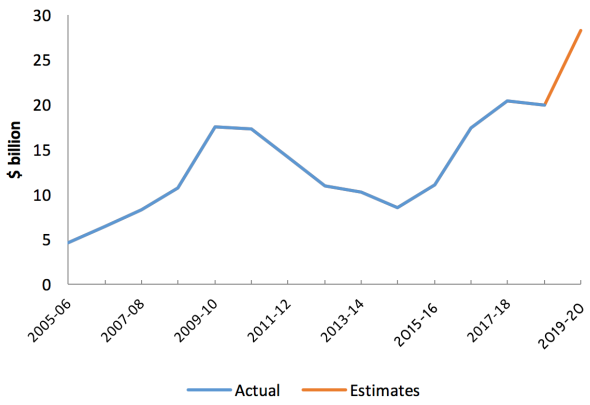


Figure 4: Net acquisition of non-financial assets of states and territories



the reverse has happened (Figure 2). On the revenue side, all states have seen GST revenue growth weaken and some states (particularly NSW and VIC) also experienced a sharp downturn in property stamp duty revenue from the exceptionally high peak of 2016–17. On the expenditure side, there was a sharp acceleration in operating expenditure in a few states, which drove up the aggregate for all states combined.

Capital expenditures have increased by much more as several states have emphasised infrastructure building. The expansion from the low point in 2014–15 can be seen in Figures 3 and 4, which show capital expenditure on a gross and net basis (that is, net of depreciation of existing assets). The gross figures are a more meaningful indicator of the short-term economic impact of state infrastructure spending. Frequent calls for more spending on infrastructure to stimulate the economy seem to have missed the point that an infrastructure boom is already happening at the state level, with gross capital expenditure increasing from around $23 billion in 2015–16 to $38 billion in 2018–19 and an estimated $49 billion in 2019–20. This is presenting problems in the form of pressure on available construction resources and major cost over-runs.

Capital outlays are deducted from the net operating result to determine the net borrowing position of the states, or what is termed the fiscal balance. This is closer to what the Commonwealth reports as its budget result (the underlying cash deficit or surplus), and on this measure the states have been consistently in deficit since 2007–08 (Figure 5). However, in contrast to the Commonwealth, the states' deficit on this measure has been expanding since 2015–16 — a reflection of the narrowing of net operating surpluses and the large increase in capital expenditure described above.

Figure 5: Net borrowing/lending of states and territories

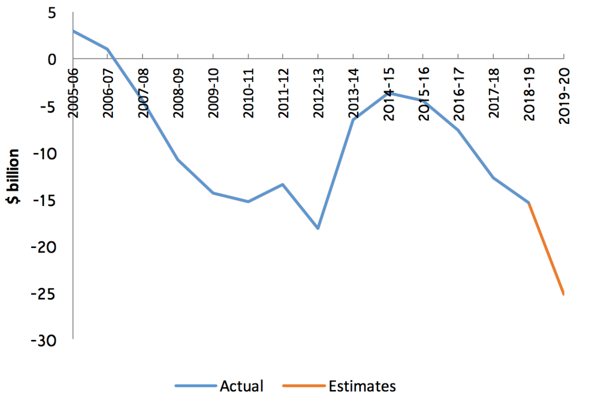


Figure 6: General government net debt of state and territories

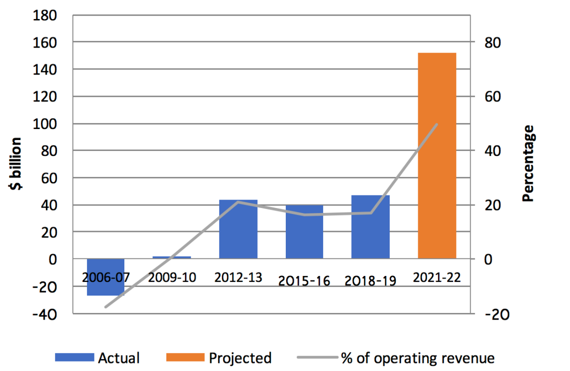


Figure 7: Non-financial public sector net debt of states and territories

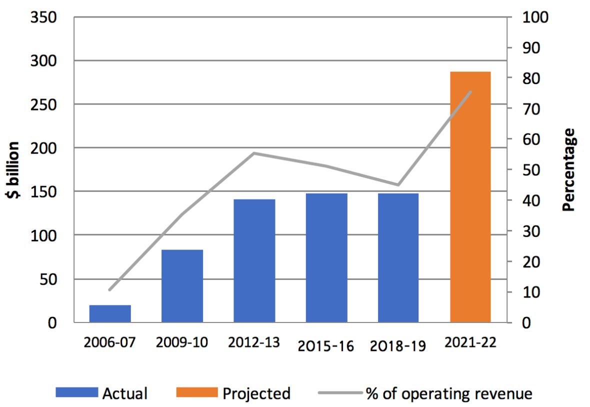
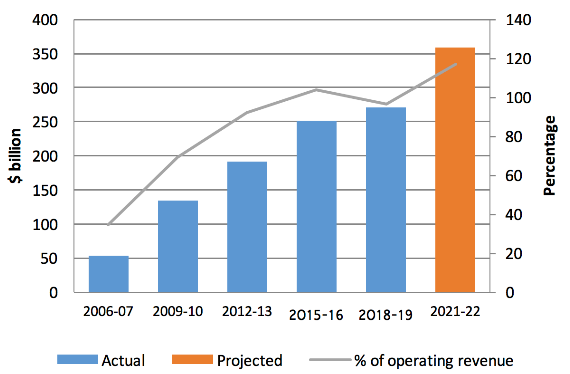


Figure 8: General government net financial liabilities of state and territories



The widening in the states' borrowing requirement is being reflected in a sharp increase in measures of debt such as net debt and net financial liabilities of the general government sector and the broader non-financial public sector (NFPS). State general government gross debt rose from $138 billion in 2016 to $191 billion in 2019, and even before the effects of the current crisis it was projected to rise to $289 billion in 2022. The corresponding figures for the NFPS are $253 billion, $313 billion and $422 billion (Appendix 2).

The translation of this build-up in gross debt to net debt was delayed by various factors, such as the receipt of large privatisation proceeds by NSW, which boosted financial assets. As these proceeds are now being spent on infrastructure, net debt is projected to increase sharply in the three years to 2022 (Figures 6 and 7). For the NFPS, for example, net debt is projected to increase from $147 billion in 2019 to $287 billion in 2022, when it will stand at around 75% of revenue — historically a very high level for the states.

Net financial liabilities are a broader measure of financial obligations, which include the unfunded public sector superannuation liabilities carried on most states' balance sheets as well as their debt liabilities. As shown in Figure 8, the addition of unfunded superannuation liabilities makes a big difference; taking general government net financial liabilities to $271 billion in 2019 and a projected $359 billion in 2022 (117% of operating revenue).

b) Outlook with pandemic impacts

As discussed in the illustrative scenario above, the short-term hit to state budgets could total $45 billion. Although spread over two financial years, this is an indication of the short-term impact on the total stock of state and territory general government debt. The medium-term effects would depend on the timing and speed of recovery and the extent of any fiscal policy tightening by state governments, but with general government net debt already rising steeply towards 50% of revenue by 2022 on pre-crisis estimates, clearly there is the potential for this increase to be steepened in the new circumstances of the pandemic. The following table provides some illustrative figuring:

Table 1: State and Territory Pre- and Post-Pandemic Gross Debt

	General government		Non-financial public sector	
Year	Pre-Covid	Post-Covid	Pre-Covid	Post-Covid
	As a percentage of operating revenue			
2019	68	n/a	96	n/a
2022	94	109	117	129
	As a percentage of Gross Domestic Product			
2019	9.8	n/a	16.1	n/a
2022	13.1	15.2	19.2	21.2

National debt aggregates

Commonwealth debt dwarfs state debt. While the focus of this report is on the latter, it is the aggregate of Commonwealth and state government debt that ultimately matters most, as it all has to be serviced from the same taxpayer pocket. This section therefore takes a short detour to consider the prospects for national public debt.

Combined Commonwealth and state general government gross debt at June 2019 was about $830 billion, or 43% of GDP. Looking ahead, general government state debt could rise from around 10% of GDP in 2019 to 15% in 2022.

In 2019, Commonwealth general government gross debt was about 33% of GDP. To date no official estimates of post-pandemic Commonwealth debt have been issued. Various private sector economists have estimated budget deficits in a wide range of $235–385 billion in the three years to 2021-22, which would add 11–18 percentage points to debt to GDP ratios, taking gross debt as a percentage of GDP to around 41 – 48%.

Combined, total general government gross debt could increase from its recent level of just above 40% of GDP to 56–63%. The IMF has forecast a figure at the top of this range at end-2021. Net debt would be 37–44% of GDP. The IMF forecast is in the middle of this range. Broader non-financial public sector net debt would be 45–52% of GDP.

Trends in individual states and territories

Individual state outcomes for 2018–19 and pre-crisis estimates to 2021–22 are summarised in Figures 9–16. The estimates to 2021–22 in these charts do not incorporate any effects of the pandemic. Data sources are listed in Appendix 1.

Figure 9: Average net operating result

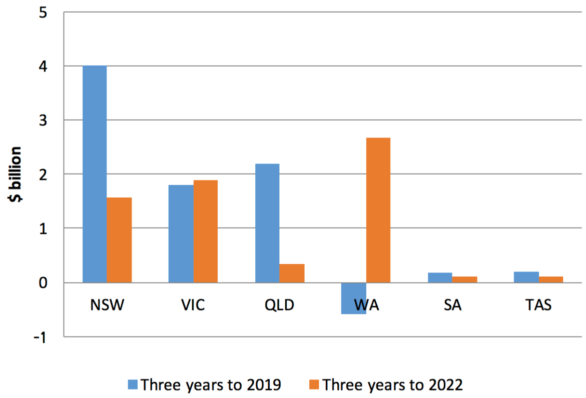
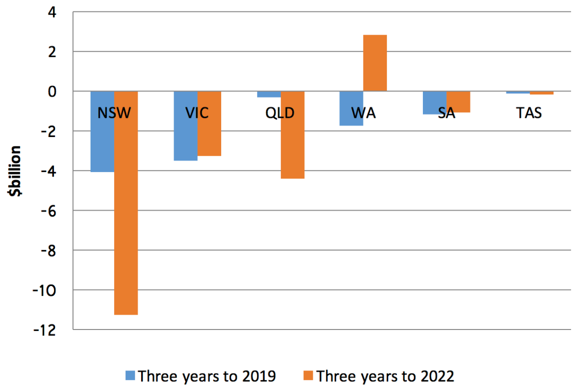


Figure 10: Average net lending/borrowing



a) New South Wales

NSW ran sizeable operating surpluses up to 2018–19 based on firm control of operating expenses and a surge in revenue from a real estate boom, although the latter turned to bust for about 18 months after 2017. State government employee numbers and payroll were tightly controlled.

The state balance sheet showed an exceptionally low level of debt up to 2019 – and even negative net debt in the general government sector – owing in part to the retention of earlier privatisation proceeds. However, broader measures such as net financial liabilities and net financial worth were much weaker owing to the presence of large unfunded employee superannuation liabilities. The state held a AAA credit rating from both major credit rating agencies.

The outlook for NSW was dramatically different from the situation up to 2019, due to both a weak revenue outlook and rapidly rising levels of spending on infrastructure. Even with continued operating expenditure restraint, operating surpluses were expected to be slender in 2019–20 and the next few years. Meanwhile, infrastructure spending began to increase rapidly in 2015–16 and is expected to reach a peak in 2019–20 at twice its level of five years ago. It is budgeted to fall back from that level in later years but remain historically high.

As a result of these trends, the NSW general government net borrowing was expected to average $11 billion a year in the three years to 2021–22, up from $4 billion in the previous three years; and net debt will increase sharply. For example, general government sector net debt was expected to rise from a negative level in 2019 to 39% of revenue by 2022, and broader non-financial public sector net debt from 13% of revenue in 2019 to 68% in 2022 — a level still below most other states but much closer than it was in 2019.

The budget impact of the pandemic could add significantly to these ratios unless corrective action is taken. This would take general government net debt to 53% of revenue and broader non-financial public sector net debt to 81% of revenue.

One credit rating agency recently qualified the NSW AAA rating with a negative outlook, in line with the same qualification to the Commonwealth's rating.

Figure 11: States' general government net debt as a percentage of operating revenue

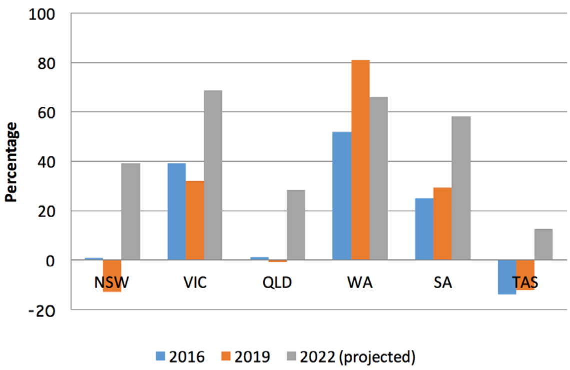
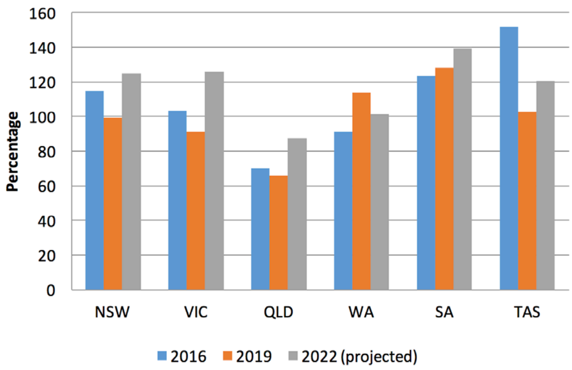


Figure 12: States' general government net financial liabilities as a percentage of operating revenue



b) Victoria

VIC also enjoyed a real estate boom up to 2017 but spent the proceeds in rapid growth of operating expenditure and therefore achieved only modest operating surpluses. In the three years to 2018–19, VIC reported the largest increase in real operating expenses per capita of all the states, and the equal largest increase in state government employment per capita.

Combined with increased capital expenditure, this resulted in sizeable borrowing requirements up to 2018–19, but debt relative to revenue fell slightly.

For the next three years, VIC — like NSW — is planning a further large increase in infrastructure spending which, combined with continued modest operating surpluses, would result in a sharp increase in debt ratios to the highest or equal highest levels among all the states in 2022. Broader measures of net financial liabilities and negative net financial worth are also very high. Nonetheless, VIC has retained its AAA credit rating.

Even the modest projected operating surpluses were predicated on a very sharp slow-down in operating expenses from the rapid growth up to 2018–19. In fact, according to the estimates out to 2021–22, real operating expenses per capita would decline in absolute terms. To achieve this, for example, the 2019–20 budget introduced a much tighter policy on public sector pay increases.

Given the recent history of rapid expenditure growth in VIC, it should not be difficult to achieve a slow-down; but that same history warrants scepticism about the assumed degree of future restraint. If it is not achieved, clearly debt will be higher even before any Covid-19 costs are added.

After adding in pandemic costs, VIC's general government net debt estimated for 2022 could rise from almost 70% of revenue to about 83%, and broader public sector net debt to just over 100% of revenue.

As with the Commonwealth and NSW, VIC's AAA credit rating was recently qualified by one rating agency with a negative outlook.

Figure 13: States' non-financial public sector net debt as a percentage of operating revenue

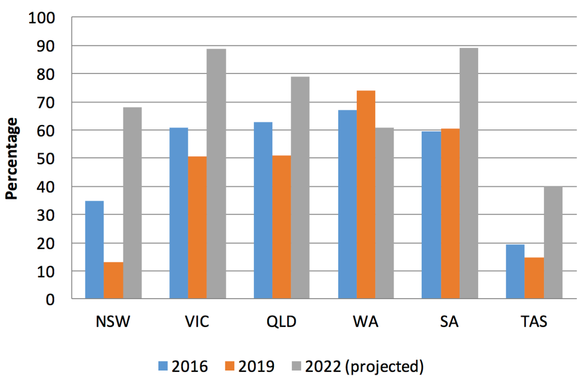
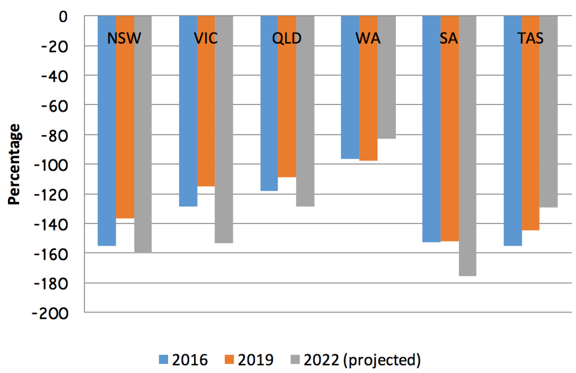


Figure 14: States' non-financial public sector net financial worth as a percentage of operating revenue



c) Queensland

Once a poster child of fiscal discipline, QLD has lost that status in the past ten years and its governments have proven unable to sustain corrective action — a failing that has left the state's finances poorly placed to absorb the shock of the Covid-19 pandemic.

The QLD government increased real operating expenses at a rapid pace in the three years to 2018–19 and increased state employment per capita at the equal highest rate. Nonetheless, the revenue experience produced solid operating surpluses and with a slow-down in capital expenditure debt fell slightly relative to revenue.

General government net debt in 2019 was close to zero, but this is a reflection of the state's public sector structure and the more meaningful figure is for the broader non-financial public sector. On this measure net debt was about 50% of revenue in 2019, equal to VIC but below WA and SA at that time.

In the 2019–20 budget, QLD was estimating tiny operating surpluses in the next three years; and with an increase in infrastructure spending, a large increase in borrowing was foreseen. This was set to send net debt back up to almost 80% of revenue in 2022, the third highest level among the states. QLD lost its AAA credit rating long ago and currently has a AA+/Aa1 rating with stable outlook. However, one of the agencies recently stated that QLD's rating would come under downward pressure from the impacts of the pandemic unless the government took corrective action.

The impacts of the crisis could lift broad non-financial public sector net debt to 90% of revenue without corrective action. There has been recent commentary that QLD's debt could reach $100 billion, which would be well over 100% of revenue. However, this refers to gross, not net, debt and to the broad non-financial public sector.

Figure 15: Percentage change in real per capita operating expenses for each state, three years to 2018-19

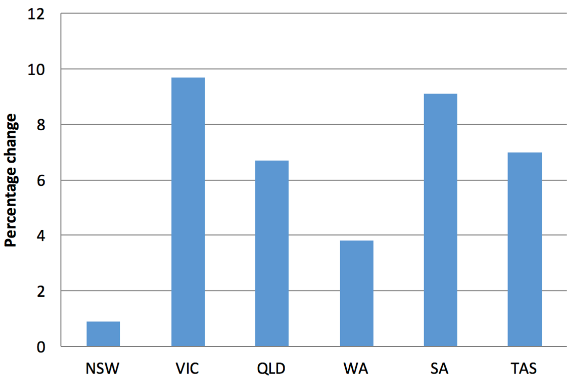
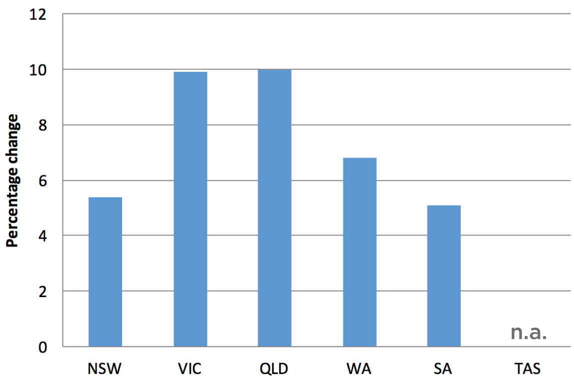


Figure 16: Percentage change in government employment per capita for each state, three years to June 2019



d) Western Australia

WA’s finances have been out of sync with other states, having seen an earlier deterioration due to rapid growth in both operating and capital expenditures combined with a revenue slump. This confluence of adverse trends peaked in 2016-17 with a large operating deficit and a smaller deficit in 2017-18. Debt increased in the three years to 2019 when it was easing in other states.

With expenditure restraint and an improved revenue outlook, WA was expecting to achieve a large operating surplus in the three years to 2022, and without the large infrastructure programs of the eastern states the net borrowing requirement was expected to turn negative — that is, the state could pay down some debt. Debt relative to revenue was expected to fall in the three years to 2022 while it was rising in all other states, and WA’s level by 2022 was set to be the second lowest.

WA has a AA+/Aa1 stable credit rating with a stable outlook.

As discussed above, WA is likely to be least affected by pandemic costs. With debt ratios still likely to fall — albeit by less — WA would clearly have the lowest debt burdens of all the states, with non-financial public sector net debt at about 66% of revenue.

e) South Australia

SA recorded very slender operating surpluses in the three years to 2018–19 and the debt burden increased. The increase in real operating expenses per capita was the second highest among the states and the increase in state employment per capita the third highest.

In the next three years, the operating budget, pre-crisis, was expected to be barely in surplus and debt ratios were expected to increase sharply to levels that would be among the highest of all the states. More broadly, net financial liabilities are expected to be the highest.

SA, on pre-crisis results and the outlook, carried a AA+/Aa1 credit rating with a stable outlook. However, as discussed above, the state’s budget will be one of the most severely affected by the pandemic, and its relative outlook would therefore suffer, with non-financial public sector net debt rising above 100% of revenue.

f) Tasmania

The current and projected TAS public debt ratios are relatively low. However, the state ranks less well when other liabilities such as unfunded superannuation are included. As a less diversified economy with a relatively large state public sector, high dependence on Commonwealth grants and mediocre long-term growth record — notwithstanding a growth spurt in recent years — TAS is considered less able to service a given level of debt than other states. Reflecting this disadvantage, it has AA+/Aa2 credit ratings.

g) The territories

The ACT once boasted very strong public finances but has dissipated this advantage over the years through indulgent operating and capital expenditures and despite high taxes and charges. Debt is rising rapidly towards levels similar to the states. For now, the ACT retains its AAA credit rating but with a negative outlook.

The NT also has seen a rapid deterioration in its finances. In 2019 it had one of the highest debt burdens, and is projected to have the highest of all states and territories in 2022. At the same time, it has the least diversified economic base, the highest dependence on Commonwealth grants and the greatest exposure to revenues at risk in the current crisis. It has the lowest credit rating of all the states and territories, with Aa3 from Moodys.

Possible policy responses

The states and territories are experiencing a major weakening of their fiscal positions. From zero 10 years ago, general government net debt is heading for a level more than 60% of revenue, and broader non-financial public sector net debt is rising from 35% to almost 90% of revenue (corresponding gross debt figures are above 100% and 130%). Some weakening was manageable, as net debt 10 years ago was low. Some of it is due to a strategic decision by governments to invest more in infrastructure, which if well chosen on cost-benefit grounds, will help drive economic growth and generate extra revenue to help service the associated debt. However, the increase in debt is also a reflection of weak expenditure management and unanticipated events, such as the current crisis. It calls for a policy response.

That response could take a number of forms:

Live with it and expect the debt burden to be lightened by economic growth

The sanguine view is that the increased debt burdens in prospect will still be manageable in the context of economic growth that will generate revenue growth and automatically reduce the burden of servicing the debt. Some jurisdictions' credit ratings may be lowered, but not all of them.

The problem with this approach is that it relies on a lot of things going right and not much going wrong. It is risky because it leaves states' finances more exposed to further shocks and ill-prepared for long-term pressures on budgets such as population ageing.

Expenditure restraint

States will need to restore net operating surpluses, and the best way to do this is to curb operating expenses. The first priority should be to eliminate all elements of pandemic-related economic support and emergency spending as soon as it is no longer justified. None of this spending should be built into the ongoing expenditure base. The next priority should be to lower projected medium-term growth rates of expenses. Even small reductions in expense growth yield large cumulative savings after several years. This approach is particularly compelling in the states such as VIC and QLD that have just recorded periods of rapid growth in operating expenses.

A constraint on this approach is that most states' forward estimates already embody quite low growth rates of expenses by past standards and they will be reluctant to go further even though savings options are available to willing governments. In the post-pandemic world states may also come under pressure to increase health expenditures.

Cancel or defer infrastructure projects

Much of the prospective increase in debt in the largest three states stems from a deliberate strategy of those states to step up infrastructure spending. Billions could be saved over the next few years by cancelling or deferring some projects, to the extent contractual commitments allow.

The problem with this option is that infrastructure spending is widely seen as an important part of an economic reform program aimed at boosting productivity growth, and as a means of delivering post-pandemic support for economic activity in the event of extended weakness. However, projects need to be more rigorously selected than has usually been the case, if the productivity gains are to be maximised.

Tax increases

States could rebuild operating surpluses by increasing their own taxes, but this is not an attractive option for a number of reasons. The taxes under states' own control (which do not include the GST) produce less than a third of total revenue and are among the most economically damaging of the nation's taxes — such as stamp duties.

An increase and/or broadening of the GST could raise substantial additional revenue for the states if the Commonwealth were to agree to allow it, but such a change is politically highly contentious and — if it is to be considered — is best viewed in the context of a larger tax reform package rather than solely for raising extra state revenue.

Privatisation

Privatisation would be a neat way to turn states' physical assets into hard cash that could be used to pay down debt. Potentially billions are available from this source. However, some states (particularly QLD, which has hitherto shunned privatisation) are better placed to take this path than others (particularly VIC) that have already exercised many of their privatisation options and have few large government business enterprises remaining as candidates for privatisation.

Economic reform

Many argue that a program of national economic reform is needed — as in the 1980s and 1990s — to reinvigorate the post-pandemic economy, particularly through productivity-enhancing reforms. If successful in lifting the long-term economic growth rate, this would reduce the burden of accumulated public debt. The states would be important actors in such a reform drive, as they were in national competition policy and tax reform in the past. The initiative and leadership will need to come from the Commonwealth, but the states should be willing participants.

Conclusion

States and territories to varying degrees have kept a lid on debt in recent years, although there has been a worryingly high rate of increase in operating expenditure in several states — notably VIC, QLD and SA — which will have to be curbed if those states are to retain robust finances.

All states and territories are facing challenges and risks in the outlook. Even before the Covid-19 pandemic struck, they were facing weaker expected revenue growth which, combined with large increases in infrastructure spending in several states, was expected to drive debt sharply higher over the next few years. WA was an exception to this pattern, having commenced a correction to an earlier upsurge in debt.

Now, the impact of the pandemic will both add to expenses and, more severely, sap various major sources of revenue at least for a time. This will reinforce the rising trend of debt in all states except WA. The range of uncertainty is wide, but general government net debt for example, which was zero 10 years ago, could reach almost 10% of GDP and more than 60% of operating revenue by 2022.

Combined with sharply rising Commonwealth debt, aggregate national public net debt seems headed for a level of around 40% of GDP in 2022, compared with 22% in 2019. The equivalent figures for national general government gross debt are around 60% and 43%.

At the state and territory level, much will have to go right over the next several years if individual states are not to see their credit ratings downgraded, their policy options become much more constrained by their debt burdens, and their exposure to future shocks and the challenges of population ageing elevated. A more prudent approach than 'do nothing and hope for the best' would be to respond with policies such as stronger expenditure restraint, rescheduling of large projects, and reform of taxes and micro-economic policies in cooperation with the Commonwealth.

Appendix 1:
Data sources and Glossary of key terms

Data sources:

State and Territory financial reports (final budget outcomes) for 2018-19

Mid-year budget updates, 2019-20

ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2017-18*, Cat. No. 5512.0 (Canberra: ABS, 2019).

ABS (Australian Bureau of Statistics), *Consumer Price Index, Australia, June 2019*, Cat. No. 6401.0 (Canberra: ABS, 2019).

ABS (Australian Bureau of Statistics), *Australian Demographic Statistics, June 2019*, Cat. No. 3101.0 (Canberra: ABS, 2019).

ABS (Australian Bureau of Statistics), *Employment and Earnings, Public Sector, Australia, 2018-19*, Cat. No. 6248.0.55.002 (Canberra: ABS, 2019)

Glossary:

General government sector: consists of government departments and agencies that provide non-market public services (such as departments of education and regulatory bodies) and are funded mainly through taxes.

Non-financial public sector: consists of the general government sector plus non-financial public corporations, which are trading enterprises that sell goods and services to consumers on a commercial basis and are owned by general government (such as water utilities).

Net debt: the sum of selected financial liabilities (mainly borrowings) less selected financial assets (mainly cash, deposits and investments). Net debt does not include superannuation-related liabilities.

Net financial liabilities: total liabilities less financial assets, but excluding the equity investments in the other sectors of the jurisdiction (e.g. net financial liabilities of the general government sector exclude the government's equity in public corporations). Includes non-debt liabilities such as accrued superannuation and long service leave entitlements, which are substantial for most governments.

Net financial worth: total stock of financial assets less total liabilities.

Operating revenue: transactions that increase net worth of the sector (primarily taxation, property income, sales of goods and services, grants from other sectors).

Operating expense: transactions that reduce net worth of the sector (primarily salaries and other compensation of government employees; consumption of goods and services such as pens, paper, travel and consultant services; depreciation of fixed assets such as roads and school buildings; interest on debt; subsidies and grants to other sectors; and transfer payments to individuals such as pensions).

Net acquisition of non-financial assets: approximately equivalent to capital expenditure on fixed assets such as roads and schools, less sales of existing assets such as public land, less depreciation of fixed assets.

Net operating balance: operating revenue less operating expense.

Fiscal balance or net lending/borrowing: net operating balance less the net acquisition of non-financial assets. A positive result reflects a net lending position and a negative result reflects a net borrowing position.

Appendix 2:
Summary of key aggregates used in this report

	2007	2010	2013	2016	2019	2022
General government gross debt						
Commonwealth ($ billion)						
at face value	53	147	257	418	542	576
at market value	67	175	301	502	645	657
States ($ billion)						
at market value	34	67	117	138	191	289
Total ($ billion)						
at market value	101	242	417	640	836	942
General government net debt						
Commonwealth ($ billion)	-42	42	154	297	374	365
as % of revenue	-17.7	17.1	49.4	88.6	87.4	75.9
States ($ billion)	-27	1	42	39	47	152
as % of revenue	-17.7	0.3	20.2	16.2	16.7	49.6
Total ($ billion)	-69	43	196	339	421	517
as % of revenue	-17.7	9.6	37.7	58.8	59.4	65.7
General government net financial liabilities						
Commonwealth ($ billion)	n.a.	169	338	590	752	n.a.
as % of revenue	n.a.	68.6	108.3	176.3	175.7	n.a.
States ($ billion)	53	134	191	252	271	359
as % of revenue	34.6	69.0	92.2	103.8	96.6	117.0
Total ($ billion)	n.a.	303	529	842	1023	n.a.
as % of revenue	n.a.	68.8	101.9	145.8	144.5	n.a.
Non-financial public sector gross debt						
Commonwealth ($ billion)	65	173	304	509	658	n.a.
as % of revenue	26.2	68.5	95.3	147.8	142.8	n.a.
States ($ billion)	92	161	232	253	313	422
as % of revenue	49.6	68.4	92.3	91.3	95.7	116.6
Total ($ billion)	157	334	536	762	971	n.a.
as % of revenue	36.2	68.5	94.0	122.7	124.2	n.a.
Non-financial public sector net debt						
Commonwealth ($ billion)	-33	42	156	300	396	n.a.
as % of revenue	-13.4	16.6	48.8	87.4	86.0	n.a.
States ($ billion)	20	83	139	148	147	272
as % of revenue	10.7	35.2	55.4	53.5	45.0	75.2
Total ($ billion)	-14	125	295	449	543	n.a.
as % of revenue	-3.1	25.6	51.7	72.3	69.5	n.a.

Sources: Commonwealth and State financial reports for 2018-19 and mid-year budget reviews for 2019-20; ABS (Australian Bureau of Statistics), Government Finance Statistics, Australia, 2017-18, Cat. No. 5512.0 (Canberra: ABS, 2019).

About the Author

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Related works

Robert Carling, *Report Card on State Finances* (CIS Research Report 23, 2017)

Robert Carling, *States of Debt* (CIS TARGET30.07, 2014)

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