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2019-20 Western Australian State Budget Briefing Note

Back in the black

May 2019

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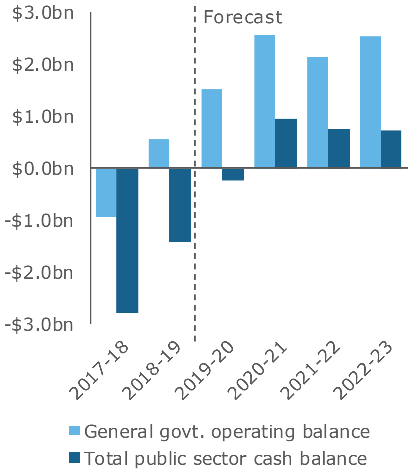
Back in the black

Budgets provide the best, statutory opportunity for a Government to take stock of the previous year, and set out how they intend to use the resources at their disposal to deliver their vision.

For his third budget, the Treasurer has chalked up the first operating surplus in five years, driven in part by on-going expenditure restraint but also benefitting from greater than expected iron ore royalties and GST revenue. While this is a positive outcome, spending commitments (including large infrastructure programs such as Metronet) mean the Government is only able to start paying down state debt when the public sector returns to a cash surplus in 2020-21 (Chart 1).

Chart 1: Back in the black

Net operating and cash balances



Source: WA State budget papers, 2019-20

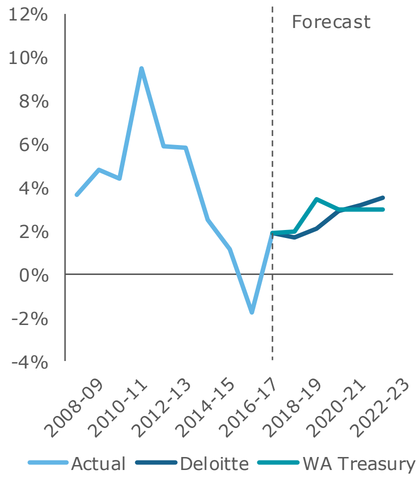
As a consequence, the Government is relatively hamstrung in what it can do until 2020-21 if it wants to deliver the forecast budget cash surplus.

These constraints exist despite WA Treasury forecasting a rebound in GSP growth to 3.5% in 2019-20. This represents a significant increase on the estimated 2.0% growth in 2018-19 (in line with our previous forecast of 2.1%, but well below the 2018-19 budget estimate of 3.25%).

Further ahead, Treasury forecasts suggest the decision to use the additional resources to pay down debt in the future, will be an easy choice. There will be little need for any increase in expenditure to stimulate the economy that is expected to be the growing at 3.0% from 2020-21 and beyond (Chart 2).

Chart 2: On the rebound

WA GSP growth and forecasts



Source: WA State budget papers, 2019-20

Unemployment is also expected to be well on track toward the conventional natural rate of 5% (the rate at which inflation is expected to pick up). Unemployment is expected to average 5.75% in 2020-21, dropping to 5.25% by the end of the forecast horizon in 2022-23.

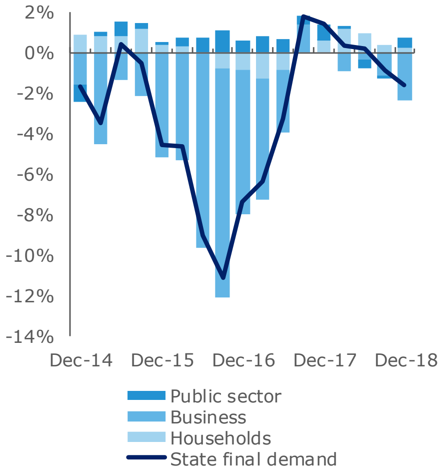
Treasury forecasts for 2019-20 are more positive than our own, and we continue to think a return to growth of 3% or higher will take longer, due to significant spare capacity in the WA economy.

The December national accounts revealed that state final demand – a measure of 'domestic' economic activity within the State – contracted by 1.6% over the 2018 calendar year, worsened by a particularly bad December quarter (Chart 3).

The main culprit was a 12.1% decline in business investment, driven by a fall in commercial construction activity, but also weak machinery and equipment purchases. Household consumption was also weak, growing by just 0.6% over the year.

Chart 3: Up and down again

Contributions to year-on-year growth in WA state final demand



Source: ABS 5206.0

Government consumption – reflecting expenditure at the local, state and federal levels – grew by 2.2% over the year, while investment by public agencies grew by 1.3%. However, growth in public demand failed to offset the decline in business investment and weak private consumption.

Dwelling investment grew by 0.9% over the year, but much of the growth occurred in the first half of 2018, with investment declining in both the September and December quarters. This was the net result of 4.5% growth in investment in alterations and additions offsetting a 1.2% decline in investment in new dwellings. This suggests some caution on the part of homeowners, with potential sellers investing in renovations to drive up prices.

The latest housing market data from the Real Estate Institute of WA (REIWA) suggests that buyers are exercising caution too. The volume of dwelling sales in the Perth area fell by 13% over 2018, accompanied by a 3.0% decline in median prices. Housing demand remains sluggish, driven by weak population growth and flat real incomes. Many residential developments planned and committed during the boom are still coming online, adding to the supply glut.

There are other reasons to believe this short-term optimism and the gains it brings might be misplaced. The expected rebound in business investment, driven by replacement iron ore projects and new developments to meet the growing global demand for spodumene and lithium hydroxide, come against a background of structural change in the global economy.

The outlook for China – WA's dominant source of export demand – remains particularly complex. While domestic credit growth has slowed, the opaque stock of debt among state owned enterprises remains at around 150% of GDP. Domestic reform to reduce reliance on investment is underway, but progress will take time - even under current ambitious targets.

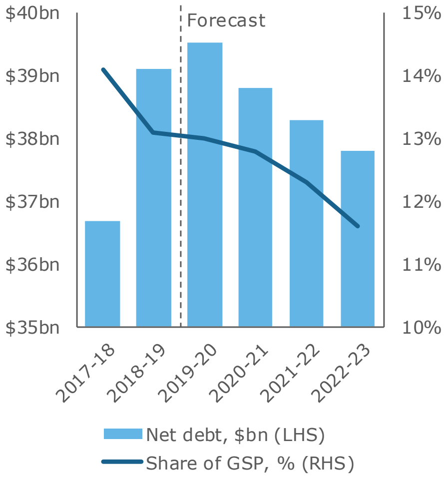
These challenges are made more difficult by the gradual deterioration in US/China trade relations. Trade negotiations underway this week are close to collapse, doing little to allay the uncertainty dragging global growth lower. A deep mutual distrust exists between both presidents, undermining the long term credibility of any deal, and consequently weighing on the outlook for WA.

Net debt

The Treasurer's decision to pay down debt brings forward the reduction in State debt set out in the last budget. Debt is expected to fall to 11.6% of GSP by the end of the forecast period, compared to 13.1% in 2018-19, reducing forecast debt interest payments by $357m over the four years to 2021-22 (Chart 4).

Chart 4: Down debt mountain

Public sector net debt



Source: WA State budget papers, 2019-20

Sticking to the debt target until the cash surplus is achieved means room for spending is limited. However the public sector balance sheet offers a strategic tool to tackle problems facing the state.

By increasing eligibility for Keystart loans for both singles and families, the Treasurer intends to support the ailing WA property market, through expanding access to finance to those locked out of the market.

Supporting the housing market is intended to have a number of beneficial knock-on impacts: reduce the number of families in negative equity in WA through providing a degree of support to demand for housing; support household spending through the wealth effect to stimulate household demand; and ensure those on low incomes retain access to the property market.

Achieving these aims will be a difficult task, albeit one that is likely to be supported by monetary policy decisions more amenable to WA.

Improving synchronicity of the housing markets in WA with the east coast has finally aligned conditions across the country.

Current interest rate futures indicate a 25 basis point cut in September, providing some relief to WA property owners and buyers.

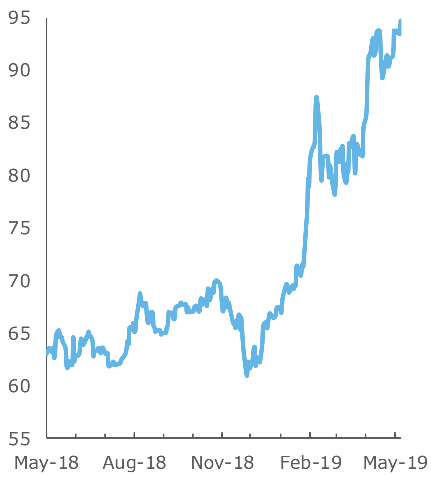
Revenue surge delivers early surplus

The Government has banked the proceeds of unbudgeted changes to two of its biggest revenue streams: iron ore royalties and GST grants.

First, the tailings dam collapse at a Vale iron ore mine in Brazil, and the impacts of Cyclone Veronica, have reduced the total global supply of iron ore by an estimated 4%. The result, since late January 2019, has been an unexpected surge in iron ore prices above US$90 per tonne (Chart 5). The bulk of iron ore royalties in WA are paid on an ad valorem basis, so the price surge has directly benefitted State Government coffers.

Chart 5: Price surge

Benchmark iron ore price, US dollars per dry metric tonne



Source: Bloomberg; NYMEX

Iron ore royalty revenue is estimated to be $5.4bn in 2018-19, compared to a forecast of $4.2bn in the last Budget 12 months ago. Treasury had conservatively budgeted for an average iron ore price of US$62 per tonne.

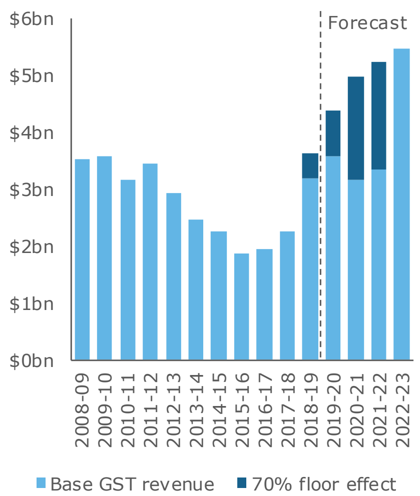
Importantly, Treasury has extended this conservatism to its forecasts of iron ore revenue over the estimates period. The average iron ore price is forecast to be US$73.5 per tonne through 2019-20, before declining to an average of US$63.7 per tonne in 2021-22 and 2022-23. We believe this is a sensible approach that helps avoid treating transitory changes as permanent revenue streams.

Second, the Commonwealth has delivered on its commitment to address the GST distribution imbalance by establishing a 70% floor on each state's GST grants relative to its population share. That measure has delivered an additional $434m in GST revenue to WA in 2018-19, and is forecast to bring an extra $4.5bn over the forward estimates.

This boost to the State coffers is compounded by the 'natural' recovery in WA's GST share, as the Commonwealth Grants Commission's lagged assessment of boom-time conditions tails off. In total, WA is set to get $20.1bn in GST revenue over the forward estimates – more than double the $8.3bn received over the last four years (Chart 6).

Chart 6: GST glee

Total WA GST revenue

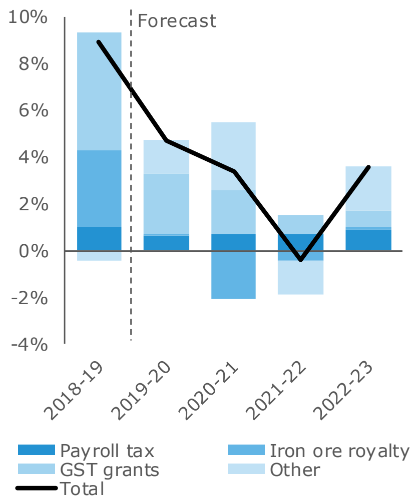


Source: State and C'th Budget Papers

Aided by the iron ore royalty and GST improvement, total general government revenue is estimated to grow by 4.7% in 2019-20 to a total of $31.3bn, followed by 3.4% growth in 2020-21. Lower iron ore royalty revenue and capital grants from the Commonwealth are forecast to drive a 0.4% fall in revenue in 2021-22, followed by 3.6% growth in 2022-23 (Chart 7).

Chart 7: Revenue ramp-up

Contributions to growth in general government revenue



Source: WA State budget papers, 2019-20

Conservatism in price forecasts, and the relative comfort of the GST floor, means that there is limited risk to the revenue side in the immediate term. However, the Budget also banks significant increases in payroll tax revenue, built on a rosy outlook for wages and employment growth. This a key risk, noting the phenomenon of sustained low nominal wage growth across Australia and sluggish jobs growth in WA since the downturn.

While better than expected revenue has not translated into additional expenditure, it has helped the government limit annual increases to household fees and charges. The Government is using the improved revenue to limit increases in household electricity costs to 1.75%, in line with inflation. Overall the total cost to households of changes set out in this budget is expected to average $128 per household.

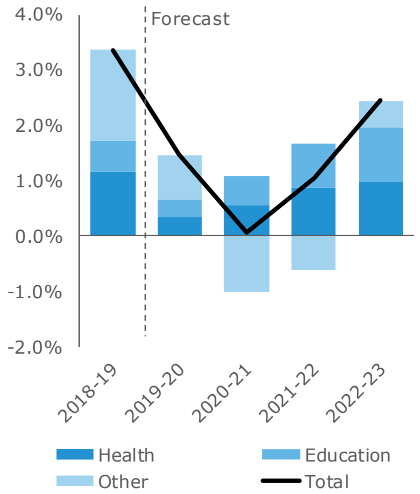
Expenditure discipline key to sustaining surpluses

While the recent revenue surge has helped return the Budget to surplus early, the Government has resisted the temptation to spend its windfall and instead continued its commitment to expenditure restraint.

Total general government outlays are estimated to grow by 1.5% in 2019-20, reaching a total of $29.8bn. Over the forward estimates period, expenditure is forecast to grow by an average of 1.3% per annum, taking total outlays in 2022-23 to $30.9bn (Chart 8).

Chart 8: Spending restraint

Contributions to growth in general government expenditure



Source: WA State budget papers, 2019-20

Achieving this target requires taming the two largest recurrent expenditure beasts: health and education. Both are demand driven and highly sensitive to population growth, and are so significant in size that even a small change can throw the surplus trajectory off track. Collectively, health and education are forecast to account for more than four-fifths of expenditure growth over the forward estimates.

Health expenditure is forecast to grow by an average of 2.1% and education by 2.9% over the forward estimates, dragging up the average across the general government sector. That doesn't sound impossible, but pales in comparison to the 8.0% average growth in health spending over the last decade, and 5.3% in education.

Part of the success story in controlling expenditure growth to date has been restraint in employment costs. Public servants can be expensive commodities, and public sector wages grew rapidly through the last mining boom as the State was forced to compete with the private sector to retain staff. The general government wage bill is estimated to fall by 4.6% in 2018-19, reflecting reductions as a result of the Government's voluntary separations scheme. Over the forward estimates, the wage bill is expected to grow by an average of 1.9% per annum, well below the 6.0% average over the last decade.

The Government has confirmed it will stand by its policy to limit general government wage increases to $1,000 per annum, a key pillar of its spending restraint agenda. However, a number of industrial agreements – including for 29,000 school staff and 16,000 health staff – expire in 2019-20, and whether these will be renewed with the $1,000 wages policy intact remains to be seen.

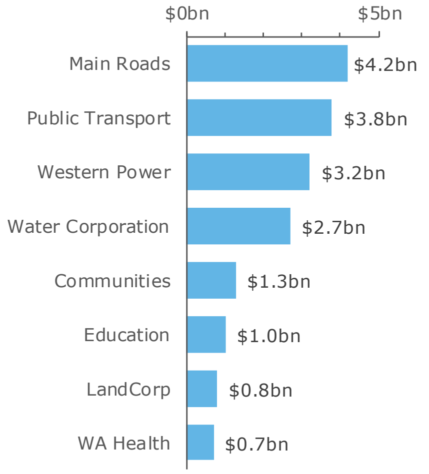
Asset investment program

While short on new projects, the budget provided greater clarity on the likely costs of projects, quite literally, in train (Chart 9).

Given the strategic priority afforded to Metronet, the Public Transport Authority remains a key recipient of funds for asset investment as activity is expected to pick up across the component projects over the forecast horizon.

Chart 9: Where the money goes

Cumulative public sector asset investment over the forward estimates



Source: WA State budget papers, 2019-20

Construction on the Yanchep Line Extension and Thornlie to Cockburn Link begins this year having received approval from Infrastructure Australia. Successive investment programmes pick up in later years during the forecast, including funding to procure 246 new rail cars to replace existing rolling stock and expand capacity to meet the requirements from the new Metronet services.

Outside of the government's flagship Metronet program, the bulk of asset investment has been allocated to public sector entities with large infrastructure portfolios, including Western Power, Main Roads WA and Water Corp to finance the ongoing maintenance and specific projects.

Risks

Overall, the government has done a commendable job in controlling the one aspect that proved to be the downfall of its predecessor - expenditure growth. It remains committed to maintaining control over salary growth, which will undoubtedly become harder when and if the projected cash surpluses begin to materialise.

In addition to the broader macroeconomic risks to the outlook, short term volatility in exchange rates and commodity prices cast a shadow over the budget regardless of actions taken to mitigate their impacts. WA's international exposure means it is overly exposed to risks from exchange rates, trade disruptions and international capital flows. Given recent geopolitical developments, the Government will require a mix of both prudence and luck to continue the progress made so far.

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