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2020-21 Western Australian State Budget Briefing Note

WA Government basks in fortune but exercises prudence

October 2020

Deloitte Access Economics

The State Government faces a difficult balancing act: using its sizeable surplus for economic support as WA emerges from the COVID-19 crisis, without doing damage to the Budget over the long term.

The State Government has delivered the delayed 2020-21 Budget against the backdrop of a world ravaged by a pandemic and the worst global recession in a century.

Governments around the world are spending big to provide direct financial support to affected households and businesses, and lift demand in the economy to accelerate the reversal of job losses.

Western Australia is certainly doing better than most jurisdictions – both in terms of getting the virus itself under control, and in mitigating the economic damage caused by the pandemic and associated lockdown measures.

Nonetheless, government support is necessary to drive the recovery as uncertainty continues to weigh on private sector investment intentions, and unemployment stands at an unhealthily high 7%. With a state election due in five months' time, the Government might also be tempted to offer some sweeteners to the electorate to cement a second term in office.

At the same time, the unfinished legacy of Budget repair lurks in the background, with the Treasurer, well before the pandemic, working hard to reduce record high public sector net debt. The Government had only just managed to return the Budget to surplus in 2018-19. The instinct to spend big is tempered by a wariness of baking in permanent spending increases over the forward estimates, which would wreak havoc on the Budget over the long term.

The State Government has opted for a middle-of-the-road approach. The general government sector will continue to turn out modest surpluses, which will then be used to fuel a cash splash on major infrastructure. The Government is banking on that infrastructure spend being sufficient to drive job creation and get the economy through the worst of the pandemic.

Budget to remain in surplus across the forward estimates

A few weeks ago, Treasury announced a $1.7 billion operating surplus for the general government sector in 2019-20 – almost entirely attributable to $7.8bn in iron ore royalty revenue, $2.2bn (or 40%) higher than forecast in the last Budget. Other than the miners, there aren't many corporates on the Terrace that would be booking annual revenue growth of that magnitude.

Surpluses are set to continue across the forward estimates period. For this Budget year, Treasury is forecasting an operating surplus of $1.2bn, followed by surpluses of $363m in 2021-22, $1.1bn in 2022-23 and $1.5bn in 2023-24.

The Budget is expected to remain in the black, but it hasn't escaped being impacted by COVID-19. Around $6.6bn has been wiped off the cumulative operating surpluses between 2019-20 and 2022-23, relative to forecasts presented in the mid-year review handed down in December 2019.

There's an important distinction to draw here, especially in a week when both Commonwealth and State Budgets are handed down. The surpluses announced by the State are in the general government *operating account* – an accrual measure of the State's recurrent revenue and expenditure. The Commonwealth presents its budget balance on an underlying *cash* basis.

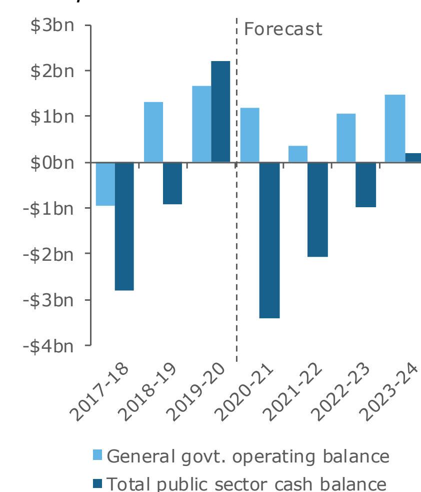
The big difference between the two is that capital expenditure on infrastructure is missing from the accrual measures, but shows up in the cash measures.

Much of that infrastructure spend also goes through public corporations (like Water Corp and Western Power) that are not part of the general government sector.

So the best like-for-like comparison is to consider WA's total public sector cash balance, which is projected to be in deficit over the next three years. Chart 1 compares the operating surpluses to the cash deficits and sums up the State's approach to using its fiscal muscle: keep the operating account in the black, and use the surpluses to (partially) fund infrastructure investment.

Chart 1: Cash crash

General government operating and total public sector cash balances



Source: State Budget Papers

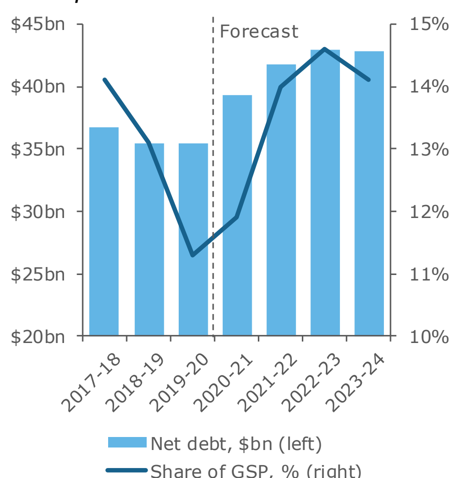
But the operating surpluses won't fully cover the infrastructure spend. Those large cash deficits shown in Chart 1 present a net additional borrowing requirement for the State, which will flow through to a ramp-up in public sector net debt.

Importantly, keeping the operating account in surplus mean that those net additional borrowings will fund investment only, rather than being used to finance recurrent deficit spending.

Net debt is expected to peak at $42.9bn in 2022-23, an increase of $7.5bn on 2019-20 (Chart 2). The State Government is quick to point out that repair measures in its first three Budgets had brought the projection for peak net debt down by around $8bn. In other words, the additional net debt that the State will incur over the forward estimates unwinds the Government's work to date in trying to reduce state indebtedness. Not a bad position to be in given the experience of other jurisdictions where debt is ballooning as governments fend off the economic effects of COVID-19.

Chart 2: Back to borrowing

Total public sector net debt



Source: State Budget Papers

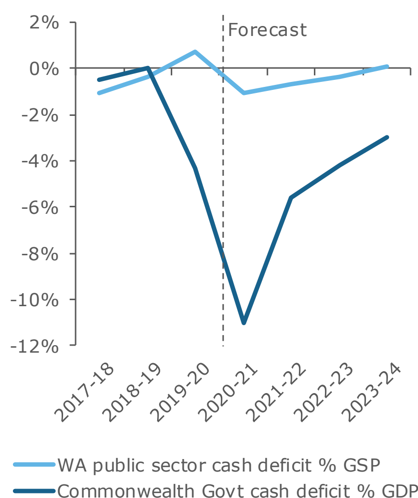
The pandemic has placed significant pressure on governments around the world to use their fiscal firepower to mitigate the economic carnage. For many countries, including Australia, that means national governments plunging their budgets deep into the red and borrowing heavily to pay for fiscal support measures.

The Commonwealth has done that in spades. It forecasts an underlying cash deficit of $214bn for 2020-21, representing about 11% of Australia's gross domestic product (GDP). Meanwhile, the State Government's total public sector cash deficit of $3.4bn will amount to just 1% of WA's gross state product (GSP) in 2020-21 (Chart 3).

The net debt profile shows a similar pattern. Commonwealth net debt is set to exceed $960bn by 2023-24, representing about 44% of the Australian economy. That compares to State public sector net debt peaking at $42.9bn, or 14.6% of the WA economy.

Chart 3: Canberra to the rescue

WA public sector cash balance and Commonwealth Govt underlying cash balance as % of GSP/GDP



Source: State and Federal Budget Papers

The Commonwealth is doing the heavy lifting for a few reasons. First, they can wield much more powerful economic levers than state and territory governments, including setting the rules around the two most important growth taxes: personal income and company profits taxes. Those growth taxes also provide a stable revenue base that will bounce back as the economy recovers and is less sensitive to volatile global factors (like the iron ore price) than state revenues.

And second, the Feds provide the bulk of direct financial support for the most vulnerable Australians, including the sick, the elderly and the unemployed. During a pandemic, shoring up these support measures is more important than ever.

So on balance, it is sensible for the State Government to keep its operating account in surplus, while also using borrowings to fund infrastructure investment – which is a key responsibility for the states.

Revenue set to tumble overall, but iron ore softens the blow

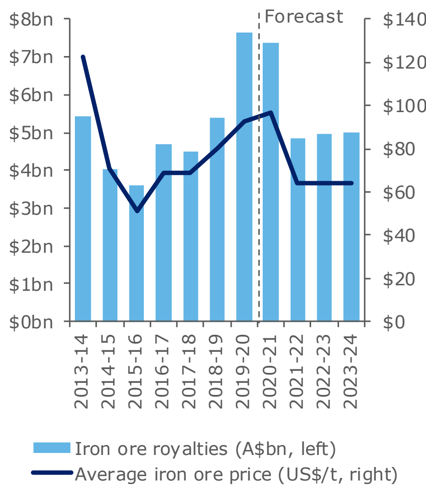
Iron ore royalties are set to remain the hero of the State Budget, at least for the coming year (Chart 4). Treasury forecasts iron ore royalty revenue of $7.4bn for 2020-21, just 3% lower than the bumper 2019-20 year.

Royalties are being driven by a price rally, not surging production volumes. And forecasting commodity prices is tricky. Treasury is banking on prices remaining above their recent average through 2020-21. The price of 62% Fe fines exported to China in CFR terms (including on-costs like freight and insurance) is expected to average US$97 per tonne in 2020-21, 4% higher than the average US$93/t observed in 2019-20.

That's a reasonable assumption given the way prices have gone over the first three months of this financial year, averaging US$115/t between July and September.

Chart 4: Rolling in it

Iron ore royalty revenue and average iron ore price (62% Fe China fines, CFR basis)



Source: State Budget Papers

But from 2021-22, Treasury is assuming prices will come down from their recent highs, averaging just US$64/t for the remainder of the forward estimates period. In turn, that will trigger a fall in iron ore royalty revenue of more than $2.5bn in 2021-22 (Chart 4).

That might seem a little heavy on the conservative side, but iron ore prices can turn on a dime. In 2014-15, amid surging supply and a collapse in Chinese demand, prices tumbled from above US$120/t down to US$70/t in a matter of months, blowing a $1.5 billion hole in that year's Budget. Conservative price assumptions reduce the likelihood of that kind of headache occurring again.

The price rally is being driven by three factors that are all short-term in nature.

First, China responded to the COVID-19 hit to its economy by deploying an extraordinary stimulus program (around 7% of its GDP). That stimulus is, in part, fuelled by investment in heavy infrastructure. Chinese steel mill output hit an all-time high in June, a record that was broken again in August. In turn, that means record demand for iron ore, putting upward pressure on prices.

Second, iron ore output from WA's major competitor was already low going into the pandemic. Brazil had not yet recovered from the hit to its capacity caused by the tailings dam catastrophe of early 2019. But Vale has announced it fully intends to restore that lost output, including through its development of the S11D megaproject – which will be the world's largest iron ore mine once completed.

And third, Brazil has taken an additional hit from its particularly bad COVID-19 experience. The country has recorded around 5 million cases and 150,000 deaths, the second-highest death toll behind the United States. That has had an extraordinary impact on its workforce and led to court enforced mine closures. Iron ore output has dropped as a result.

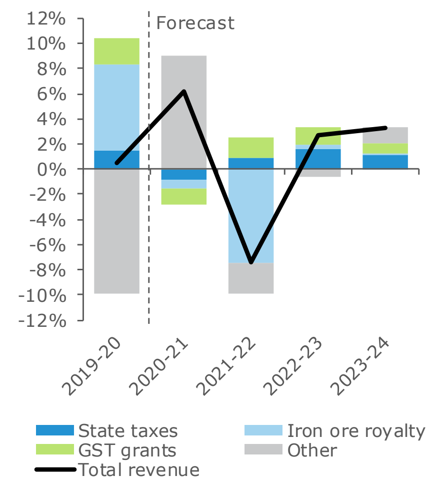
All those signs point to prices cooling off as Chinese steel output returns to more normal levels and Brazil ramps up its supply, especially once the pandemic has subsided there.

And while iron ore volumes continue to grow, they are set to do so at a more gradual pace. Treasury projects production will grow by around 1% per annum over the forward estimates period, albeit from a record high level of production achieved in the June quarter of 2020.

That means WA won't be able to rely on the current level of royalties going forward. And that's playing out in Treasury's projections for general government revenue: sustained high prices will deliver bumper iron ore royalties in 2020-21, leading to total revenue of $34.1bn (6.1% higher than 2019-20). However, it forecasts a fall in revenue to $31.6bn (a reduction of more than 7%) in 2021-22, as iron ore royalties cool off (Chart 5).

Chart 5: Shifting sands

Contributions to annual change in general govt. operating revenue



Source: State Budget Papers

Beyond iron ore royalties, the pandemic has hit almost every revenue item on the State's books. Job losses and flat or falling wages will see payroll tax revenue falling by an estimated 2.1% in 2020-21, while stamp duty and land tax receipts are forecast to fall by 5.3% and 2.8% respectively. That comes off the back of several years of weakness in the Perth housing market and stagnant median house prices.

And while cautious consumers keep a tight grip on their wallets, the State's other major source of revenue – GST grants – is set to take a hit too. On the plus side, the Commonwealth's 70% floor policy will deliver an extra $1.5bn than WA would otherwise have received in 2020-21 – but we're receiving a bigger share of a pool that is shrinking overall. The net impact is that WA is estimated to receive $3.9bn in GST grants in 2020-21, down from $4.3bn in 2019-20.

The other major source of revenue growth in 2020-21 is dividends from public sector corporations. The State Government opted to defer a significant amount of dividend income for 2019-20, meaning it will accrue this Budget year instead. The effect is that revenue from the

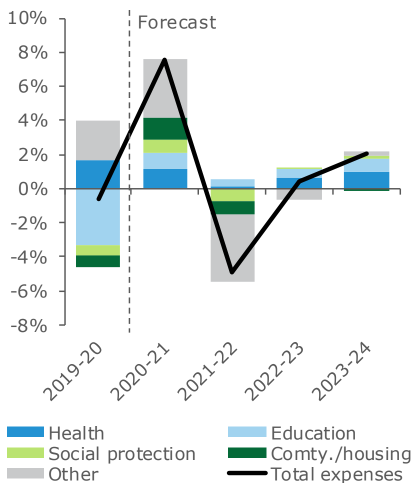
public corporations will more than triple from $1.1bn in 2019-20 to $3.7bn in 2020-21 – but that's mostly an accounting phenomenon, especially as the Government plans to use its operating surplus to fuel asset investment across the entire public sector.

Expenditure dialled up to fund COVID-19 recovery plan

General government expenditure is projected to grow by 8% in 2020-21, reaching a total of $34.1bn (Chart 6).That is mostly driven by the recurrent component of the State Government's COVID-19 recovery plan, which has a total price tag of $2.2bn in terms of additional expenditure. Of that total, around $1.1bn will be spent in 2020-21 alone.

Chart 6: Recovery ramp-up

Contributions to annual change in general govt. operating expenses



Source: State Budget Papers

Total expenditure is then set to fall in 2021-22 by around 5%, as spending on COVID-19 recovery measures tails off. Over the final two years of the forward estimates period, expenditure growth is projected to moderate to 0.5% and 2.1%, respectively.

The Budget includes funding for an additional 800 police officers, over and above increases to police numbers previously announced. But that's about the only big funding measure in the Budget that didn't feature in the State's recovery plan, released earlier in the year.

Of the $2.4bn increase in expenditure projected for 2020-21, around $1.7bn (almost 70%) is accounted for by increases in current transfers – that is, the State's own operating expenses (on things like salaries and purchases of goods and services) represent a relatively small proportion of expenditure growth. In other words, the Government is focusing its COVID-19 recovery efforts on direct payments and support.

Transport the big winner from record asset investment

Importantly, that growth in recurrent expenditure doesn't capture spending on infrastructure investment.

And the investment on the table is a whopper. The total public sector asset investment program (AIP) is set to top $27bn over the four-year forward estimates period, with most of the spend occurring in 2020-21 and 2021-22 (around $15bn per annum).

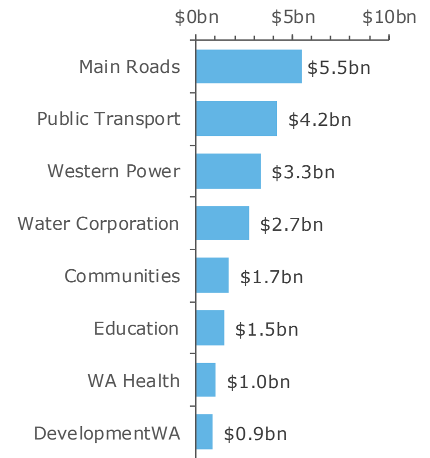
The last time asset investment was of that order of magnitude was in 2012-13, while the State was experiencing record economic growth before the mining investment boom turned sour.

This Budget has finally brought to book some of the Government's signature public transport projects under the banner of its METRONET program – including the Morley-Ellenbrook Line, level crossing removals along the inner Armadale Line, Byford Rail Extension and Midland Station relocation projects.

In total, the Government is expecting to spend $4.2bn on public transport infrastructure over the forward estimates, dwarfed only by the $5.5bn planned investment in road infrastructure (Chart 7).

Chart 7: Roads to everywhere

Asset investment program, cumulative 2020-21 to 2023-24 (major agencies)



Source: State Budget Papers

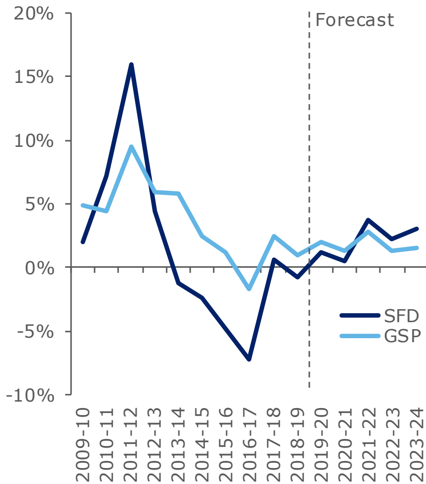
And there's more to come. The $27bn total doesn't include an additional $1.1bn in funding from the Commonwealth in its latest budget, which was announced after the State Budget cut-off.

Budget bakes in economic turnaround – but forecasting risks abound

The Budget estimates that the State's economy, as measured by GSP, grew by 2% in 2019-20, with net export growth reinforcing a 1.1% expansion in the domestic economy despite the impacts of COVID-19 in the last three months of that financial year.

Chart 8: Back in business?

Annual growth in WA state final demand (SFD) and gross state product (GSP)



Source: State Budget Papers

Treasury forecasts economic growth to slow to 1.25% in 2020-21, before bouncing back to 2.75% in 2021-22 as the economic recovery begins in earnest. This is reflected in its labour market expectations, with an average unemployment rate of 8% in 2020-21, before a decline to 7% and lower through 2021-22 and beyond.

But economic forecasts are only as good as the assumptions underpinning them – and in this environment, those assumptions are subject to a very high degree of risk and uncertainty.

The central risk to the economic outlook – and the Budget – is the timing of a health solution to COVID-19, such as the widespread availability of an effective vaccine.

Delays in achieving a health solution will delay the reopening of interstate and international borders, prolonging low consumer confidence and job losses. In turn, that will hit the Budget through both lower revenue and higher expenses, assuming the Government would respond to such a situation with further fiscal support.

So while the State Government may come in for some criticism for maintaining surpluses in these unprecedented economic times, this needs to be balanced against the record investment in infrastructure, and the need to keep some fiscal powder dry in the event of a second wave.

As Samuel Johnson said, *"Prudence keeps life safe, but does not often make it happy"*. Ain't that the truth in 2020.

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