Deloitte.
Access Economics

2018-19 Western Australian Budget Briefing Note

Sedate but sensible

May 2018

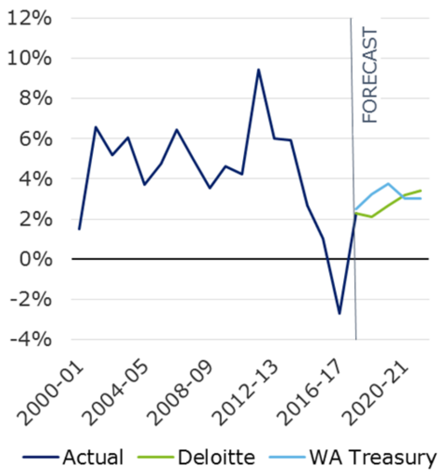
Progress, but more hard work to come

It has been 8 months since the last WA State Budget. While the outlook for the WA economy has undoubtedly improved during this period, WA Treasury has presented a notably rosier view of the outlook for the economy and public finances than the one presented in September 2017.

We agree that things have improved, but maintain a different view on the timing of the recovery. Treasury expect growth in Gross State Product (the amount of economic activity that takes place in the State) to rebound from 2.5% in 2017-18 to 3.25% in 2018-19. This is significantly higher than our own estimate of 2.1% in 2018-19 (Chart 1).

This optimism is rooted in strong growth in exports next year in part from renewed demand for iron ore and a 70% increase in WA's LNG exports over the next three years. Following this growth, Treasury estimates suggest WA will contribute 10-15% of the expected global production of LNG.

Chart 1: On the rebound
% Annual change in GSP



Source: WA State Budget Papers, Deloitte Access Economics

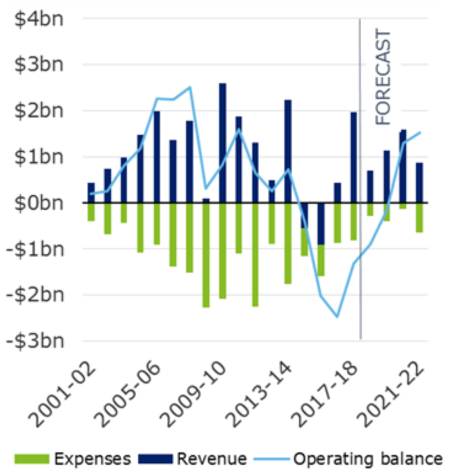
Treasury expect export growth to slow from 2019-20 onwards and in its place, household consumption is expected pick up the slack. Consumption is forecast to return to pre-boom levels of around 3.5%, supported by a moderate increase in household income and positive house price growth from 2018-19.

Recent data confirm upward momentum in the jobs market, and Treasury expect WA's relatively strong job creation over the past year to continue. Employment is projected to increase by 1.5% this year before hitting 2.25% in 2020-21 and for the rest of the forward estimates.

The improved forecasts imply good news for State finances. Better than expected revenue and controlled expenditure growth has reduced the operating deficit in 2017-18 to half the size forecast in the Mid-Year Review.

The General Government net operating deficit is expected to fall to $900m in 2018-19, down from $1.3bn in 2017-18. The State Government expects the operating deficit to reach a negligible $160m in 2019-20, before returning to a surplus of $1.3bn in 2020-21 and $1.5bn in 2021-22 (Chart 2).

Chart 2: Back in the black
General government expenditure, revenue and net operating balance



Source: WA State Budget Papers

Strong revenue growth is critical to achieving the Government's objective of an operating surplus by 2020-21. On average, General Government revenue is forecast to grow by 3.5% per annum over the forward estimates, driven by additional funding from the Federal Government (+$1.9bn).

Overall the State Government expect to improve the net operating balance as a result of a $3.4bn increase in revenue and limiting the increase in expenditure to just $1.5bn over the forward estimates.

If all goes to plan, the State's debt to GSP ratio should be falling in two years' time, declining from 14.5% to 13% by 2021-22.

A move toward a more sustainable debt trajectory, with less need to borrow to fund recurrent expenditure, bodes well for the WA Government credit rating and the cost at which it borrows from capital markets. However, even if the future doesn't pan out quite as well as WA Treasury expect, the State's finances are improving and appear to be on a more sustainable fiscal path – provided they can keep a lid on expenditure.

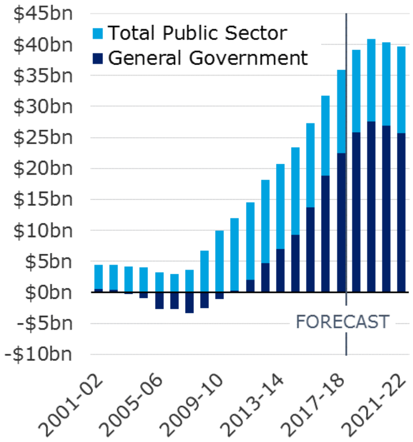
Net debt expected to level-off

Since 2007-08, the net debt of the WA public sector has only gone one way each year: up. In fact, over the four years to 2017-18, WA net debt increased by an average of almost 15% per annum. In the first two years of the forward estimates, net debt is predicted to grow by 6.6% per annum before falling in 2020-21 and 2021-22.

Chart 3 confirms that the General Government sector is the main culprit behind the rise in the State's debt profile, so it's no surprise that the Treasurer is aiming to trim these borrowings the most. Compared to last year's Budget, the State is now hoping to cut $6.3bn off General Government net debt over the first three years of the forward estimates (Chart 4).

Chart 3: Flat-lining

WA State Government net debt

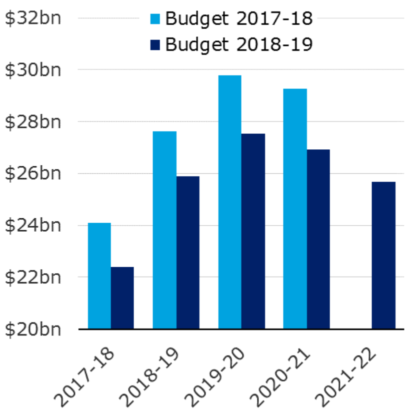


Source: Successive WA State Budgets

Asset investment by the General Government sector has been the central driver of debt growth for many years now. Asset investment accounted for nearly 90% of the rise in the net borrowing requirement of the General Government sector over the four years to 2017-18 ($10.5bn).

Chart 4: Debt decline

State Budget forecasts of WA General Government net debt



Source: Successive WA State Budgets

Over the next four years however, the State expects to cut asset investment by almost 30% compared to the prior four years. If the Treasurer can dent State borrowings through restraint in both the capital and operating budgets to the degree this Budget suggests, he will quickly become the poster boy of conservative economists. But let's be honest, it will be very hard work.

General Government expenditure: the key to Budget repair

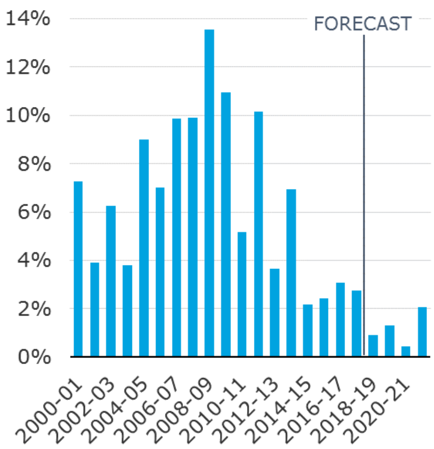
This Budget continues the tightening of the collective public sector belt, forecasting spending growth of just 0.9% in 2018-19, taking total outlays to $30.5bn. This is only a fraction higher than the forecast in the previous Budget, suggesting that the Government is holding firm on its commitment to keep spending under control.

Spending is then set to grow by 1.3% in 2019-20, a miniscule 0.5% in 2020-21 (underpinning the long-awaited surplus forecast for the same year), followed by 2.1% in 2021-22 (Chart 5).

This equates to annual average spending growth of just 1.2% over the forward estimates – a significant dive from the 6.7% average over the last decade.

Chart 5: On a shoestring

General Government expenditure, annual % growth



Source: State Budget Papers

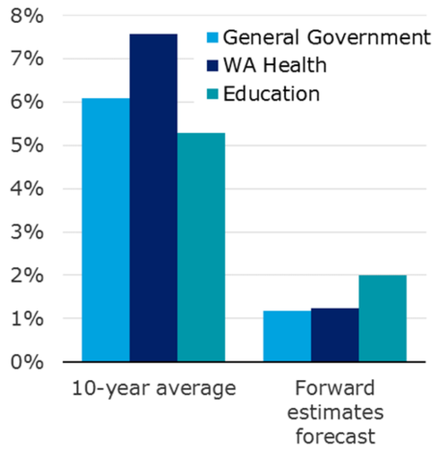
But achieving these spending targets largely relies on restraint in WA Health and the Department of Education, two mammoth agencies that account for almost half of all General Government spending.

Health gets a $200m cut to its budget for 2018-19, but whether it can achieve this target is another question – it came in $80m over budget in 2017-18. Health outlays will recover in the subsequent three years of the forward estimates, taking the agency to $9.5bn spend in 2021-22. This equates to annual average growth of 1.2%, a serious reduction compared to its average annual growth of 7.6% over the last decade (Chart 6).

Education is tasked with similar restraint, targeting 1.1% and 1.0% growth in 2018-19 and 2019-20, respectively, before bouncing back to 2.7% and 3.7% in the final two years of the forward estimates. Again, some skepticism is called for as education came in $16m over budget in 2017-18, and has averaged 5.3% annual growth over the past decade.

Chart 6: Taming the beasts

Annual % growth in spending: 10-year average vs. forward estimates forecast



Source: State Budget Papers

The Budget includes cuts to law and order spending across WA Police and the Department of Justice of 1.0% per annum over the forward estimates. These two agencies collectively spend around $3.0bn, or 10% of total General Government outlays.

Failure to achieve spending restraint across these three agency clusters could wreak serious havoc on State finances, blowing out the deficits forecast for 2018-19 and 2019-20, and undermining the long-awaited surplus planned for 2020-21.

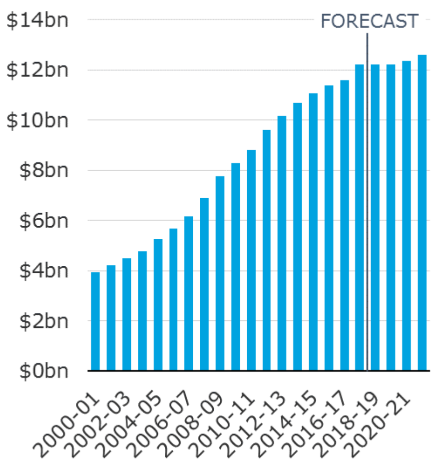
Wages and salaries

The fiscal repair measures announced in the previous Budget included a significant paring back of the public sector wage bill, including freezing salaries for politicians, introducing 20% efficiencies for senior executives and limiting public servants' wage rises to a flat $1,000.

The plan to bring wages under control also included 3,000 voluntary separations, some 2,050 of which are to be achieved by the end of 2017-18, with the remaining 950 taking place over 2018-19.

Redundancies and other payments associated with the separations scheme pushed the General Government wage bill up by 5.4% in 2017-18 to $12.2bn. But wages are set to fall by 0.2% in 2018-19, stabilising at a 0.7% average annual growth rate over the forward estimates (Chart 7).

Chart 7: Wage restraint
General Government wage bill

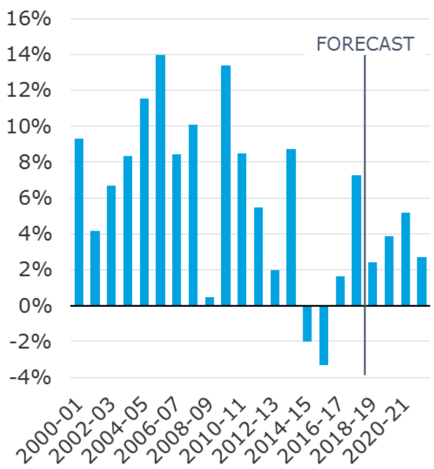


Source: State Budget Papers

Welcome back: revenue strengthens

The years of stagnant or negative revenue growth have come to an end. General Government revenue bounced back to $28.9bn in 2017-18, thanks to a sugar hit of Commonwealth funding (+$1bn). The State Government forecasts a revenue increase of 2.4% in 2018-19, rising to 3.9% in 2019-20 and 5.2% in 2020-21 (Chart 8). This growth helps return the Budget to surplus in the same year. Revenue is forecast to hit a record $33.2bn by the end of the forward estimates. That's a $3.4bn improvement over four years.

Chart 8: Money on my mind
General Government revenue, annual % growth

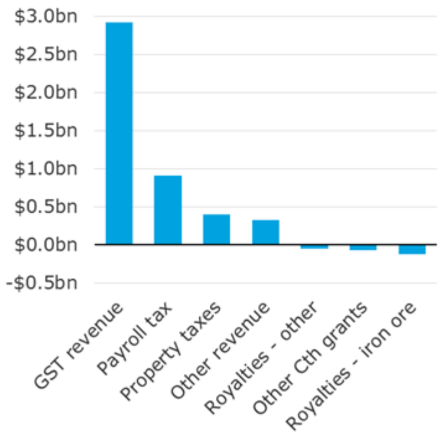


Source: State Budget Papers

Canberra comes to the party

The GST is the biggest contributor to the revenue uplift (Chart 9). WA can expect an extra $2.9bn in GST revenue over the four years to 2021-22. But don't roll out the 'Mission Accomplished' banner just yet. That still means WA only receives 64.9% of its population share of the GST pool, and purely as a result of natural recovery in the wake of the mining downturn. It remains to be seen whether the Commonwealth will pursue any meaningful change to the GST mechanism, and what this means for the State Budget.

Chart 9: Thanks Prime Minister
Contributions to General Government revenue growth over forward estimates



Source: State Budget Papers

While the recovery in Commonwealth funding is perhaps easier to forecast, the Budget also chalks up $1.3bn more over the forward estimates from a stronger payroll tax take (+$905m) and property taxes (+$395m). However, the drivers of these revenue items – a gradually recovering jobs market and a testy property market - are much more difficult to foresee.

The State's other revenue items will be a drag on the Budget. The one-off higher dividends from public corporations was realised in 2017-18 only, and a weak iron ore price outlook will see royalty revenue falling by an average of 0.8% over the estimates period. WA Treasury expect the iron ore price to average US$61.90 per tonne (CFR) in 2018-19.

Notably, the Budget took a hit when Parliament struck down the proposed increase in the gold royalty – which was to raise an additional $392m over four years – but this appears to have been compensated for by higher Commonwealth grants and a rosier outlook for the payroll and property tax takes.

While the outlook for iron ore royalties is conservative, they still pose a significant risk: for every US$1 increase (decrease) in the iron ore price, royalties rise (fall) by $76m. Likewise, WA loses between $88m and $90m from its GST share for every $100m improvement in iron ore royalties.

No free pass for households

Households were largely spared from the 'Budget repair' package announced in 2017, which had the public sector, businesses, and (almost) gold miners doing the heavy lifting.

This Budget includes a package of higher fees and charges including a 7.0% hike in electricity charges, 3.8% increase to motor vehicle charges and 10.1% increase to the emergency services levy. Overall, the 'representative' household will be slugged with an extra $292 in fees and charges over 2018-19.

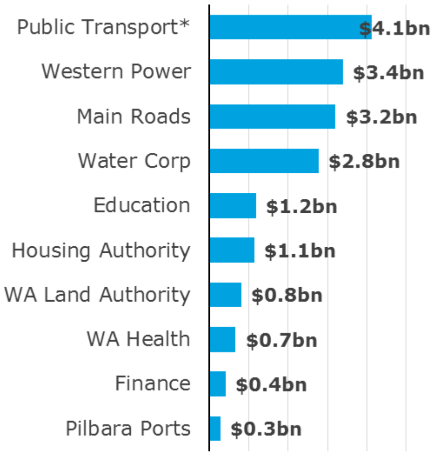
While this is no doubt painful for households, it also spreads the burden of Budget repair more broadly.

Asset Investment Program

Although asset investment is projected to fall significantly over the forward estimates, the Prime Minister's recent visit to Perth saw major dollars pledged for infrastructure across the State. So there were little surprises in the asset investment program in this Budget.

Transport is the major winner, with the Public Transport Authority expected to see $4.1bn come its way over the forward estimates (including $3.2bn for Metronet projects). Main Roads will receive $3.2bn over the forward estimates. The 10 largest beneficiaries of the capital budget account for over 80% of asset investment over the next four years (Chart 10).

Chart 10: Where is the love?
Top 10 asset investment portfolios, 2018-19 to 2021-22



*Source: WA State Budget 2018-19. *Including Metronet*

Western Power and Water Corporation (as usual) get a hefty chunk of the capital budget with a focus on investment to maintain reliability and safety of supply.

The share of asset investment delivered by the State's public corporations (as opposed to the General Government sector) is expected to increase from 55% in 2018-19 to 74% by 2021-22, reflecting a re-prioritisation of government investment towards infrastructure to support economic growth.

While Commonwealth money for infrastructure in WA is welcome, it comes with obvious strings attached - i.e. to pay for specific projects - rather than applied to budget repair. Drawing on the lessons highlighted in the recent Langoulant Review, the State Government should be careful to keep the pencil sharp on these projects.

Risks ahead, but manageable

Forecasts aside, the State Government has done well in managing expenditure growth over the past year. The trajectory of State debt meant this was well overdue. Expenditure growth increased by an average 6.7% over the preceding decade, well above the rate of economic growth as the government struggled to keep pace with the demands of a booming economy.

There remain a number of risks beyond the control of the State government that could yet undermine the plan. Key among them are potential changes to the funding received from the Federal Government.

Commonwealth funding accounts for the lion's share of the net growth in General Government revenue over the forward estimates, offsetting declines in other sources. Not only is this funding essential for the short term improvements in the net operating balance, but it is also critical to the infrastructure projects required for the State's long term economic growth.

Beyond this, overall economic activity continues to be dependent on China - a well-documented risk. Chinese growth continues to create demand for WA's resources. Recent signs of an escalation in a China - US trade war and a broadening of trade disputes across continents could weigh on growth prospects.

Domestically, potential increases to interest rates to tackle rising inflation could also undermine WA's fledgling property market recovery (although we don't see this as an imminent risk).

These challenges, in addition to ambitious plans to manage spending growth, present a difficult task over the next four years. However, with a bit of luck on the revenue front and strict spending control, we may just see a return to surplus.

Contacts

Matt Judkins
Lead WA Partner
Deloitte Access Economics
Tel: +61 8 9365 8095
mjudkins@deloitte.com.au

Noel Richards
Director
Deloitte Access Economics
Tel: +61 8 9365 7303
norichards@deloitte.com.au

Deloitte Access Economics
Level 9, Brookfield Place, Tower 2
123 St Georges Terrace
Perth WA 6000 Australia
Tel: +61 8 9365 7000
www.deloitte.com/au/deloitte-access-economics

James Campbell-Sloan
Associate Director
Deloitte Access Economics
Tel: +61 8 9365 7110
jcampbell-sloan@deloitte.com.au

Aiden Depiazzi
Analyst
Deloitte Access Economics
Tel: +61 8 9365 7853
adepiazzi@deloitte.com.au