Australian States Face Pandemic Debt Hangover

Capital Account Deficits Among World's Highest

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Key Takeaways

- Australian states' debt is surging, and we expect it to top A$600 billion by late 2024--more than double pre-pandemic levels of less than A$300 billion.
- The states' record infrastructure plans mean after capital account deficits are among the highest in the world in their peer group.
- Credit trends have diverged between Australia's commodity haves and have-nots: Western Australia is reducing debt, Queensland has arguably the largest surplus in Australia's history; meanwhile, Victoria continues to pile on debt; and New South Wales struggles to narrow its deficits.
- To tackle pandemic-related economic dislocation, state and territory governments (hereafter "states") used unprecedented fiscal packages to support community and businesses.
- Most states faced revenue write-downs and ballooning stimulus spending during the period. This moved most states' budgets into operating deficits.
- Budget repair discipline has been softer than promised as inflationary pressures hit budgets and households. This also prevented states from conducting pre-election spending cuts.

3 Downgrades, 1 Upgrade...

...and negative outlooks in between

Rating factor assessments for the parent state government

Entity	July 29, 2024	Jan. 1, 2020	Economy	Financial management	Budgetary performance	Liquidity	Debt burden
Government of the Australian Capital Territory	AA+/Stable/A-1+	AAA/Stable/A-1+	1	1	3 (-1)	1	4 (-1)
State of New South Wales New South Wales Treasury Corp.	AA+/Stable/A-1+	AAA/Stable/A-1+	1	1	4 (-1)	1	4 (-1)
State of Queensland Queensland Treasury Corp.	AA+/Stable/A-1+	AA+/Stable/A-1+	1	2	3	1	4
State of Tasmania Tasmanian Public Finance Corp.	AA+/Stable/A-1+	AA+/Stable/A-1+	2	1	4 (-1)	1	3 (-1)
State of South Australia South Australian Government Financing Authority	AA+/Stable/A-1+	AA+/Stable/A-1+	1	2	3	1	4 (-1)
State of Western Australia Western Australian Treasury Corp.	AAA/Stable/A-1+	AA+/Stable/A-1+	2	1 (+1)	1 (+1)	1	3
State of Victoria Treasury Corp. of Victoria	AA/Stable/A-1+	AAA/Stable/A-1+	1	2 (-1)	5 (-2)	2(-1)	4 (-1)

Numbers in parentheses are changes since Jan. 1, 2020. Central borrowing authorities (CBAs) are wholly owned by their respective states, manage the financial liabilities of government entities, and function essentially as extensions of government. Each CBA also benefits from an unconditional guarantee from its state. As such, we equalize the credit ratings on each CBA with those on its parent government. The scores in this table are those for the state government. We do not maintain a public rating on Northern Territory Treasury Corp.

- Budgetary performance has weakened across most states, flowing on to weaker debt assessments.
- South Australia outlook revised to negative Nov. 27, 2020
- New South Wales lowered to AA+ Dec. 7, 2020
- Victoria lowered to AA from AAA Dec. 7, 2020
- Western Australia outlook revised to positive Oct. 27, 2021
- Western Australia raised to AAA June 27, 2022
- South Australia outlook revised to stable Aug. 17, 2023
- Australian Capital Territory lowered to AA+ Sept. 8, 2023

What We Are Watching:

Infrastructure Pipeline

Largest driver of new borrowing for the states and ratings pressure

Financial Management

Post-COVID budget repair discipline waning in some states

Commodity Prices

Fiscal rift between the commodity haves and have-nots

Interest Rates

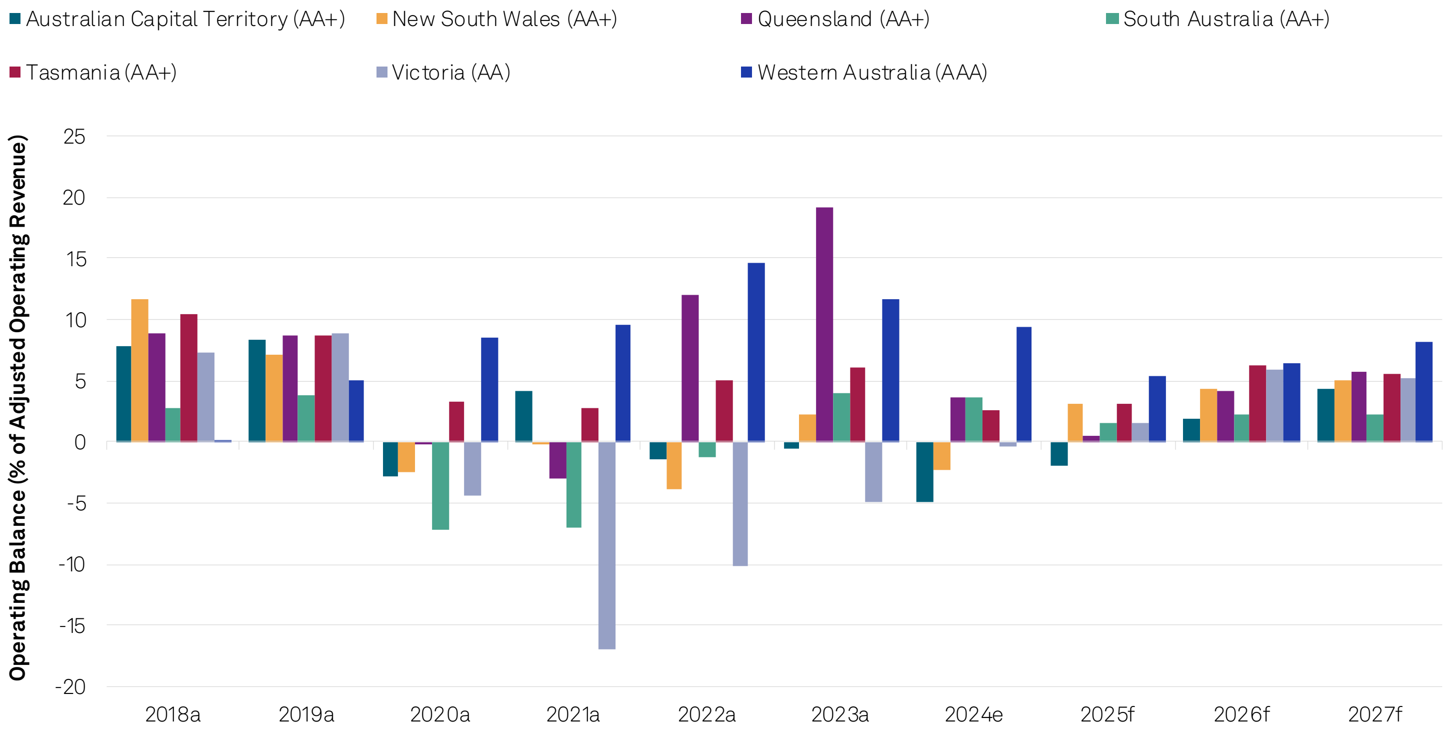
Rising interest rates hitting states' debt serviceability

Debt Burden

Looser self-imposed targets give states more leeway to borrow

COVID-era Emergency Stimulus Led To Large Operating Deficits

Operating positions are mostly improving



a--Actual. e--Estimate. f--Forecast. Forecasts are from state budgets and may differ slightly from our own base-case scenarios. Fiscal year ends June 30.
Sources: 2024-25 Budgets for most states, 2023-24 mid-year budget update for Tasmania.

- The pandemic-induced fiscal hit to most states was enormous.
- Recovery of operating margins in NSW, Victoria, and ACT materializing much slower than promised.
- We project operating margins for states to largely recover to 2018-2019 level by 2025-2026.
- Moderation in the coal price and lag in goods and services tax share could dampen Queensland's bumper surpluses.
- Queensland and Western Australia benefitted from soaring commodity prices, relative strength in the U.S. dollar. This led to record operating surpluses in 2022 and 2023.

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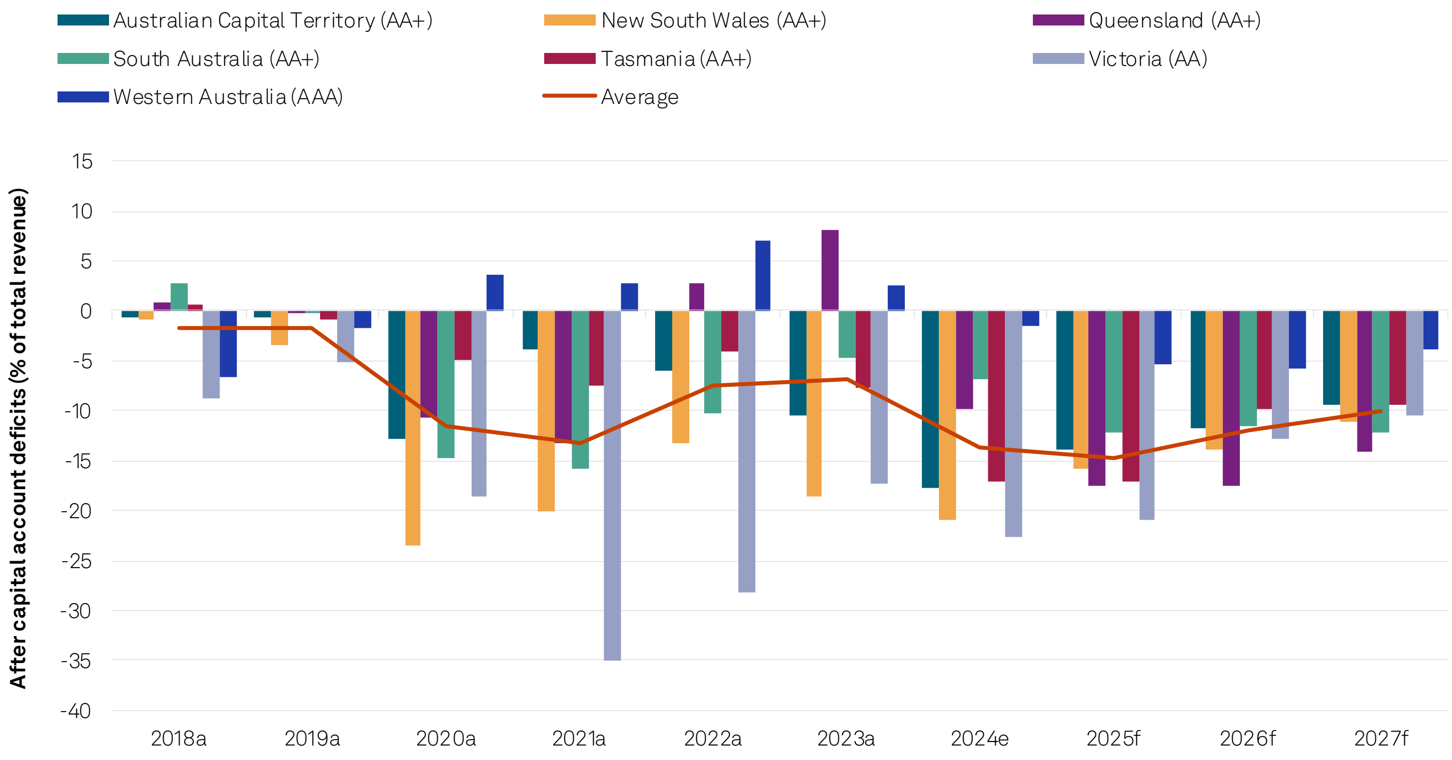
Australian States Amass Record Cash Deficits

- The end of the COVID-19 emergency gave way to a new era of elevated public investment and spending.
- Victoria's budgetary performance assessment is two notches weaker than before the pandemic.
- Australian Capital Territory, New South Wales, and Tasmania: one notch weaker.
- States are ramping up infrastructure investment, project costs have soared, and budget repair discipline has waned.
- Average after-capital account deficits were about 1.7% of revenue in 2019. This blew out to 13.2% of revenue in fiscal 2021, driven by emergency stimulus and subdued economic activity on the back of various lockdowns.

Western Australia and Queensland buck the deficit trend



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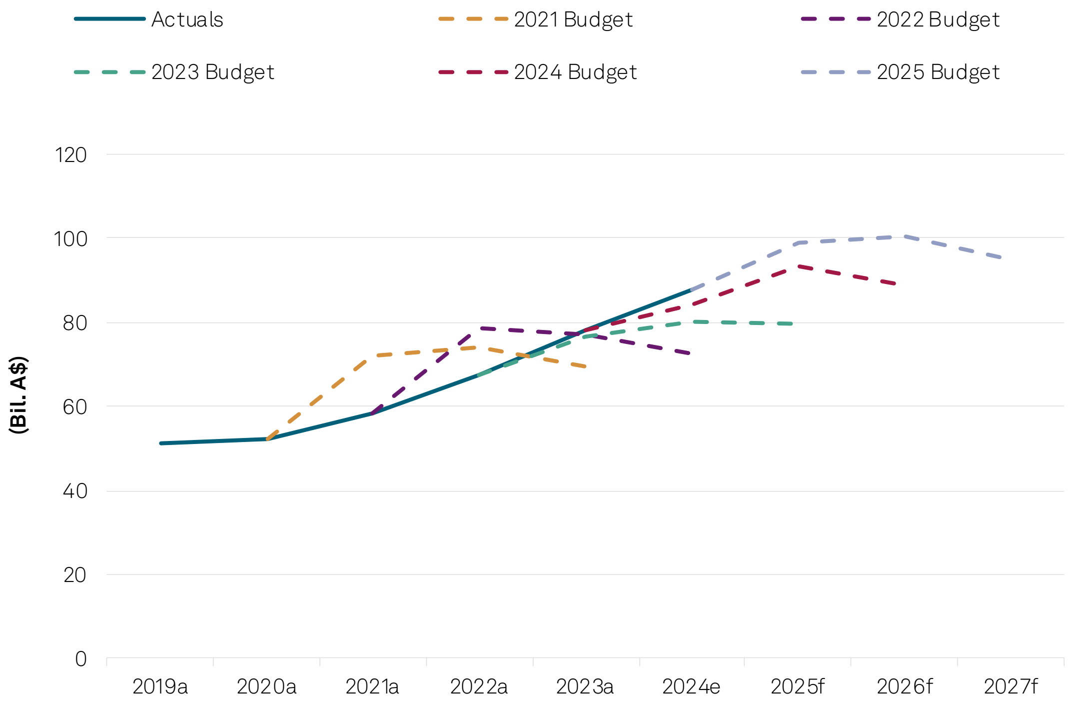
Public Infrastructure Spend Is Booming

Ambitious investment plans driving rising infrastructure projections



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- States' aggregate capital budget over fiscal 2024-2027 has swelled to more than A$350 billion (~14% of GDP).
- In fiscal 2023 and 2024, states reversed the trend of underdelivering infrastructure spending relative to budget. We estimate the total sector-wide capital spend to be almost 5% above budget in fiscal 2024, up from 2% above budget in fiscal 2023. This compares with an almost 16% underspend in fiscal 2022.
- The cost of some projects has soared because of labor, material inflation, geotechnical obstacles, and a tendency for government to commit to projects prematurely before accurate scoping and costing.

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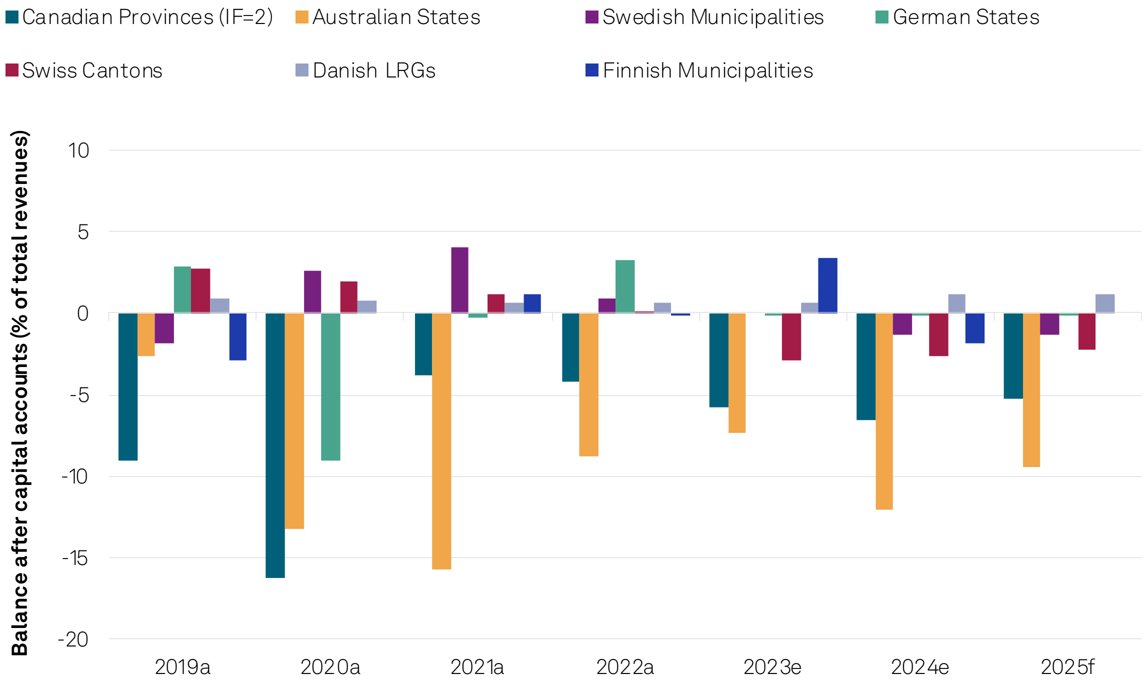
States Outspend Global Peers To Manage Population Surge

Substantial infrastructure responsibilities result in elevated cash deficits

Comparison with selected jurisdictions with institutional frameworks of 1



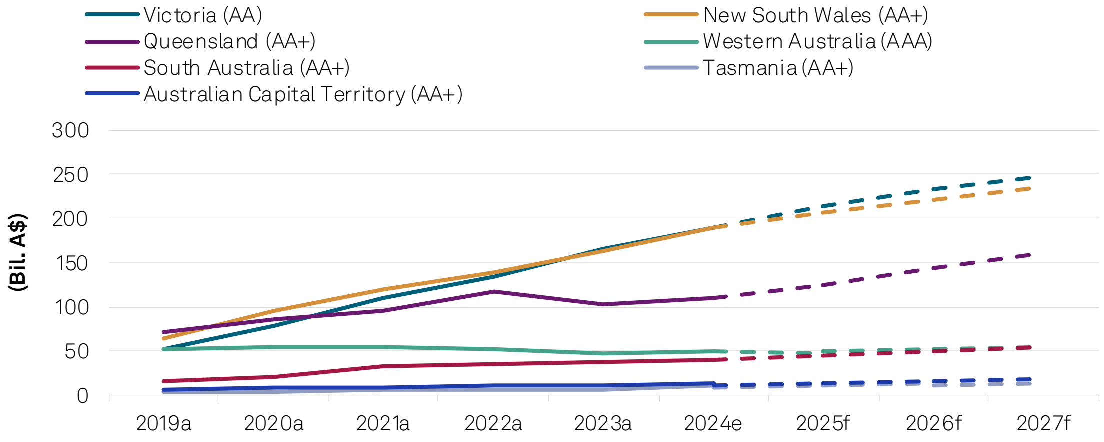
LRG--Local and regional governments. Source: S&P Global Ratings.

- Increased migration flows, roads, transport, the Olympics, energy transition, and need for social housing will spur investment. We expect states will continue to invest in infrastructure and through government-owned corporations.
- Australia's population has surged by 1.7% a year over the past 30 years. Comparatively, European population growth has hovered around 0.3-0.5% a year during this period.
- States are not constrained by external fiscal rules and carry a big share of the responsibility for transport, healthcare and education. This is supported through fiscal equalization systems. The Commonwealth collects goods and services tax revenue and redistributes it in the form of untied grants to states. The Commonwealth also provides tied grants for some state services and infrastructure, which are funded out of consolidated revenue.
- This implies a larger need and tolerance for cash deficits than subnational governments with similar institutional settings.

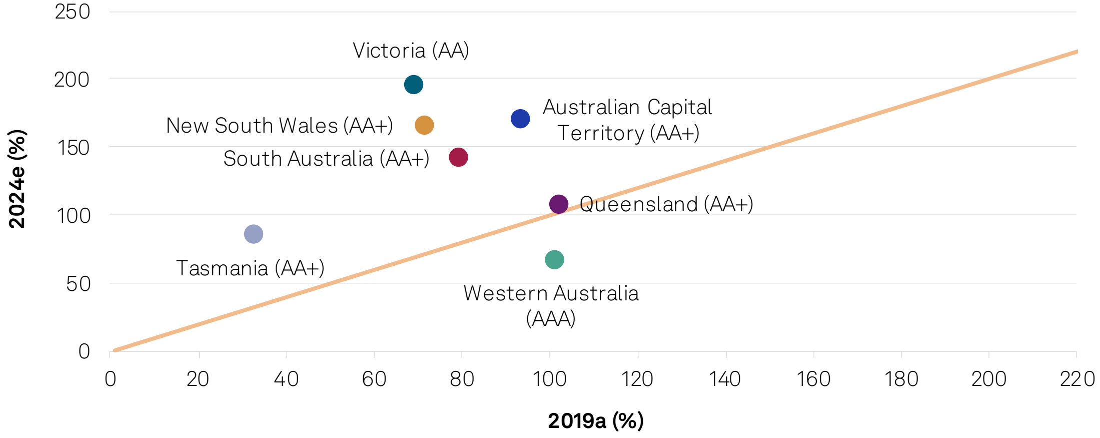
Drastic Divergence Of States' Debt Stock

- We project total tax-supported debt at the non-financial public sector level, which includes government-owned corporations (non-financial), to rise to beyond A$750 billion by 2027--nearly triple the 2019 amount.
- Victoria and NSW are drivers of this growth. They have borrowed heavily to fund operating and cash fiscal deficits in the past five years.
- Strong royalty revenues fueled bumper cash surpluses for the mineral-rich state of Western Australia, resulting in a reduction to its debt ratio in fiscal 2024.
- Tasmania, South Australia, and the Australian Capital Territory have seen debt increasing, albeit from low bases.

Semi-government debt surged over the pandemic



Subnational debt rises fastest in Victoria and NSW



a--Actual. e--Estimate. f--Forecast. NSW--New South Wales. Forecasts are from state budgets and may differ slightly from our own base-case scenarios. Fiscal year ends June 30.
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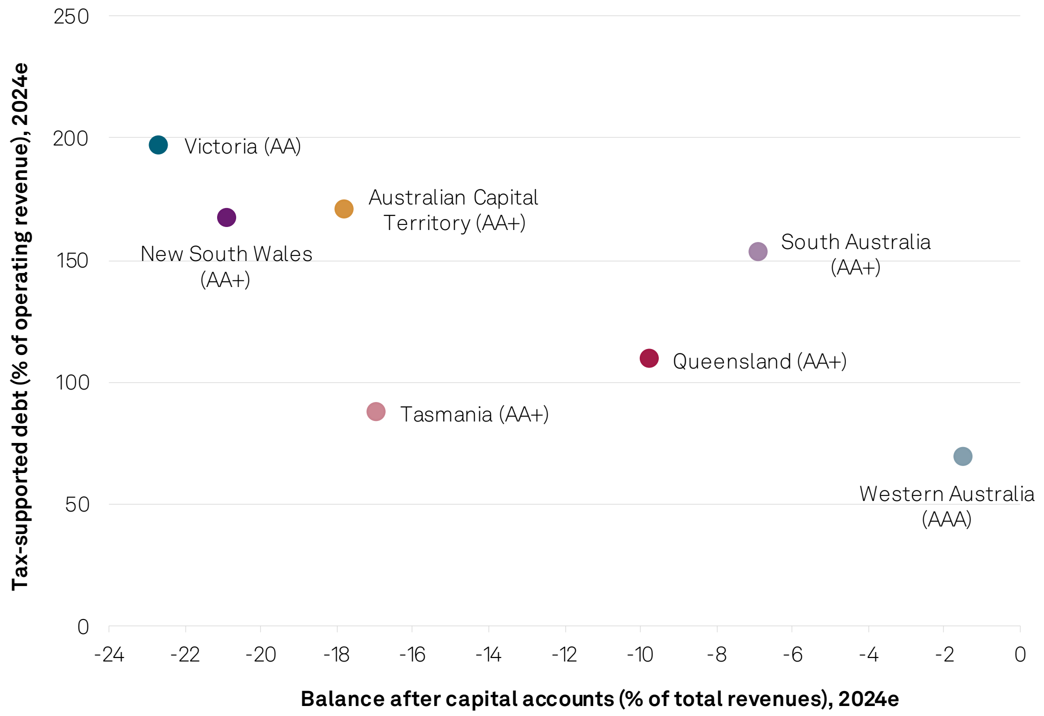
Debt Burden Variance Within Australia Is High

Budgetary performance versus debt metrics



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- We expect Queensland's debt metrics to rise faster as it transitions the economy and government-owned energy generators to net-zero emissions and prepares to host the 2032 Olympics.
- Debt has risen rapidly in Victoria and New South Wales, Australia's most populated states, where operating balances are yet to recover from the pandemic lockdowns and whose fiscal restraint is a little weaker than peers in our view.
- The other extreme is Western Australia (the largest iron ore producer in the world). The state is outperforming almost all national and international peers, due to strong royalty revenues. This is leading to a much lower debt burden than eastern states.
- A larger infrastructure pipeline will lead to increased debt growth in Tasmania. These debt metrics remain favorable compared with most domestic peers.

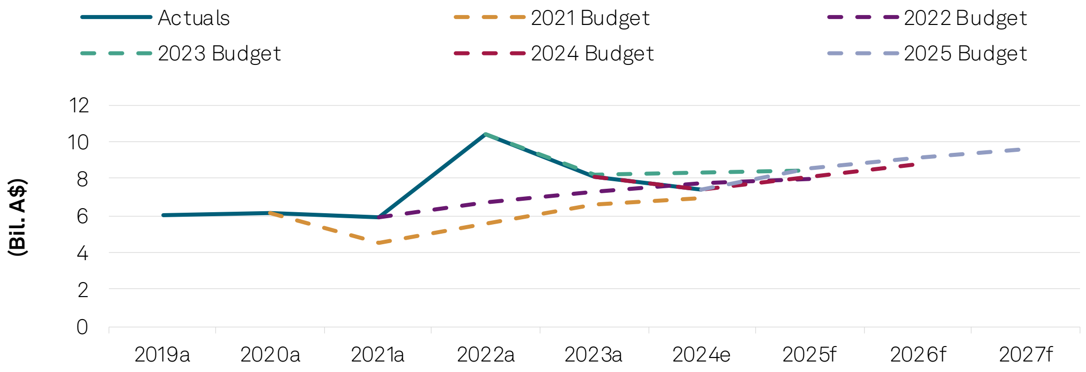
Key Revenue And Expenditure Measures

Australian States' Fiscal Levers

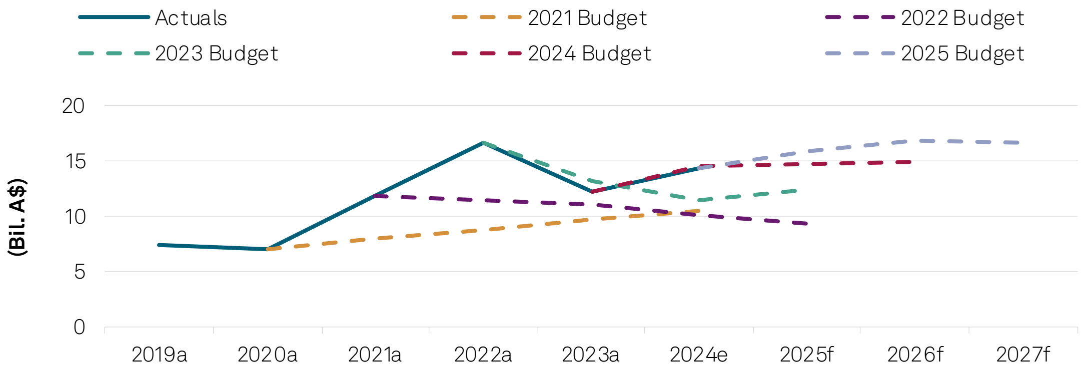
This report does not constitute a rating action

Property Post-Lockdown Boom Boosting States' Revenue

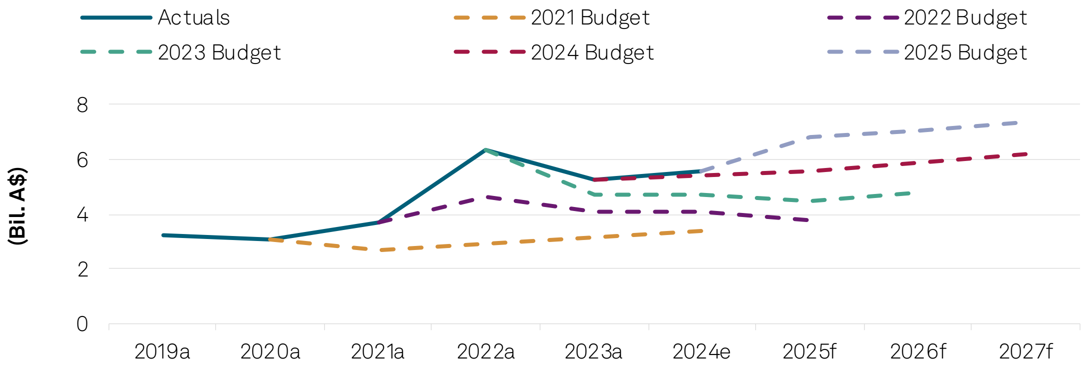
Conveyancing Duties – Victoria (AA)



Conveyancing Duties – New South Wales (AA+)



Conveyancing Duties – Queensland (AA+)



- Property transaction volumes and prices soared between fiscal 2020 and 2022, leading to record property tax revenues for the eastern seaboard states.
- House price growth has moderated over the past two years. This was spurred by the Reserve Bank of Australia's 425 basis points of interest rate hikes from May 2022 to November 2023.
- Conveyance duty growth will remain high due to stronger inbound migration and construction labor constraints.

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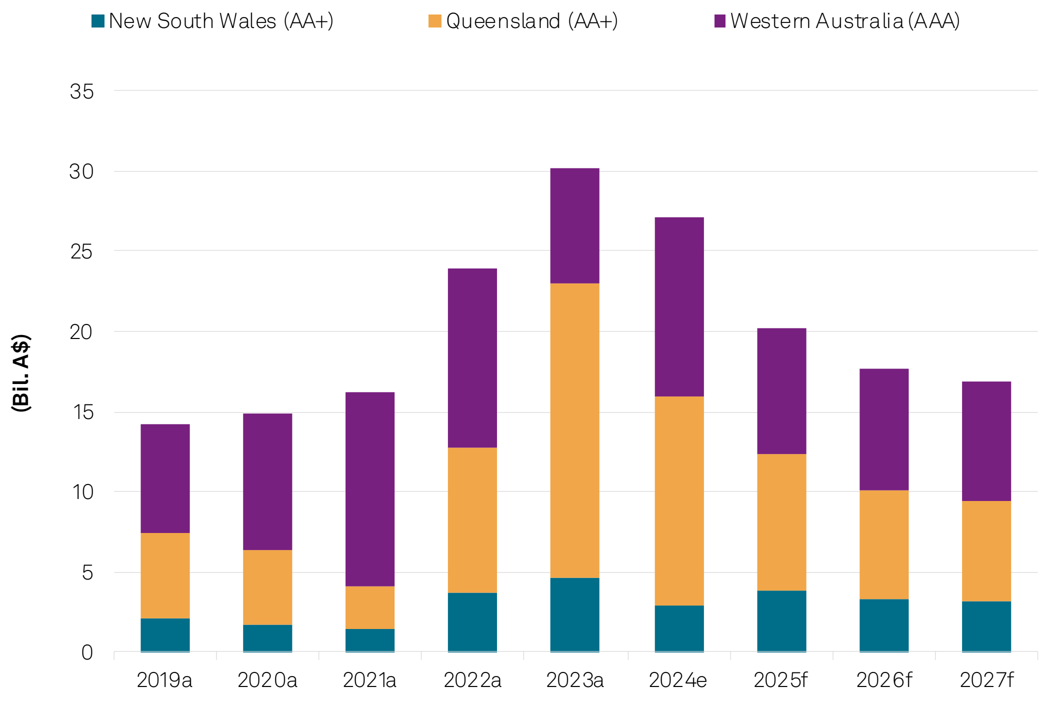
Record Commodity Royalties In Recent Years

- Elevated commodity prices fueled bumper cash surpluses for the mineral-rich states of Western Australia and Queensland.
- Queensland benefitted from a progressive coal royalty structure, implemented from July 1, 2022. Queensland's royalty revenues recorded A$40.4 billion for fiscal 2022-2024, up massively compared with projections for the same period from the 2022 budget of A$12.8 billion.
- Western Australia reaps the benefit of strong iron ore prices and strong demand from China, the world's largest steelmaker.
- New South Wales will hope to claim some benefit by hiking coal royalties from mid-2024.

Record royalties for Western Australia and Queensland



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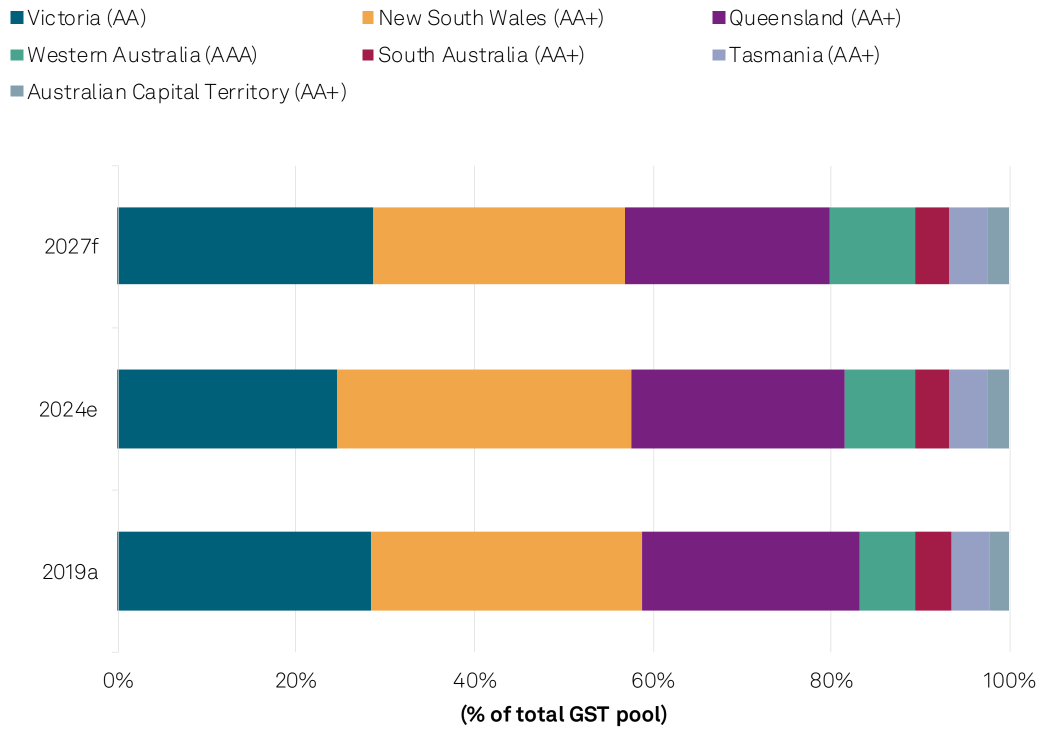
Source: 2024-25 Budgets.

GST Pool To Grow; Carve Up Between States Fluctuates

- We anticipate goods and services tax (GST) grants to continue to grow to almost A$90 billion in fiscal 2025. This comes after a period of shrinkage in 2020 and 2021 due to the nationwide lockdowns and subdued economic conditions.
- Grants will be affected by tweaks to revenue-sharing following the Commonwealth Grants Commission's March 2024 methodology review. Victoria will benefit from higher grants from 2025 as it has lower capacity to raise mining revenue, and its population is growing from inward migration.
- The three-year extension of the GST "no worse off" transitional guarantee until 2031 will support revenues.

Eastern states receive the lion's share



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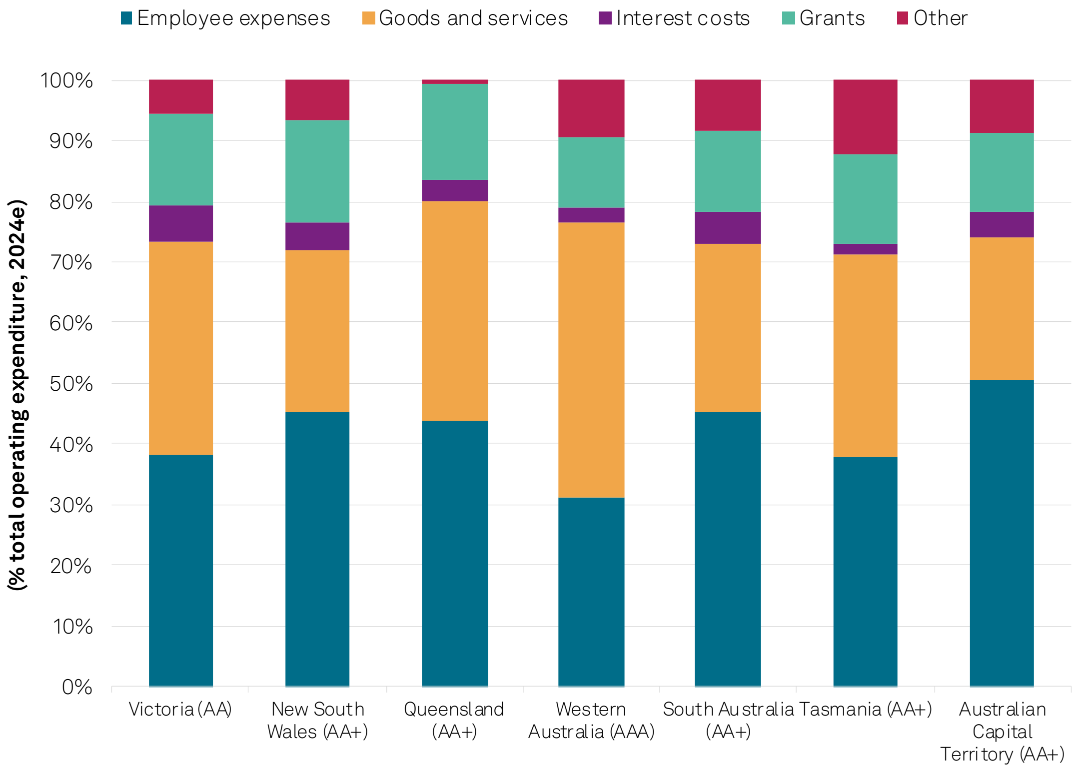
Public Service Salaries Make Up 40% of Total Sector Recurrent Spending



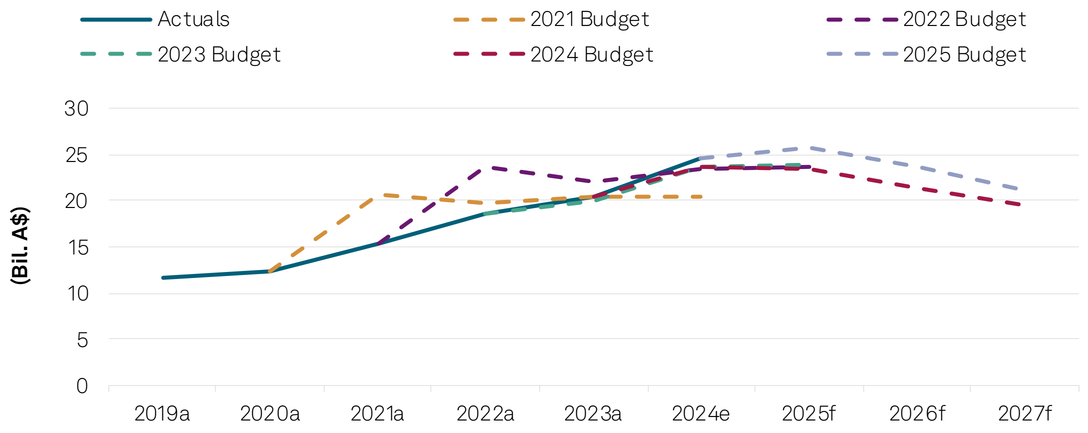
e--Estimate. Fiscal year ends June 30.

Sources: 2024-25 Budgets for most states, 2023-24 mid-year budget update for Tasmania.

- The largest component of recurrent expenditure are public sector salaries for most states, which we consider can be hard to downsize.
- Australian Capital Territory's employee expenditure rose by 50% between 2019 and 2024. This is the territory's largest expenditure item, making up 51% of all operating expenditure.
- Queensland and Victoria increased employee expenditure across the same period by 44% and 41%, respectively.

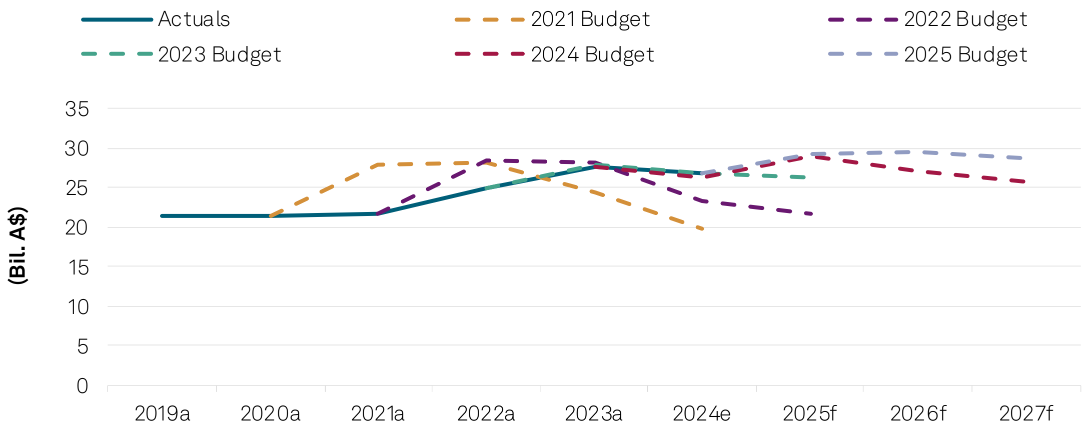
Public Infrastructure Investment At Record Levels

Victoria (AA) continues to ratchet up infrastructure investment



- Big cost increases have seen capital overruns above Victoria's budgeted amounts in fiscal 2023 and 2024. In contrast, capacity constraints saw Victoria deliver much less than its budgeted capital spending in 2021 and 2022.
- The flagship North East Link project was reassessed at A$26 billion in the 2023-24 mid-year budget review, from a budgeted A$15.8 billion in 2019.

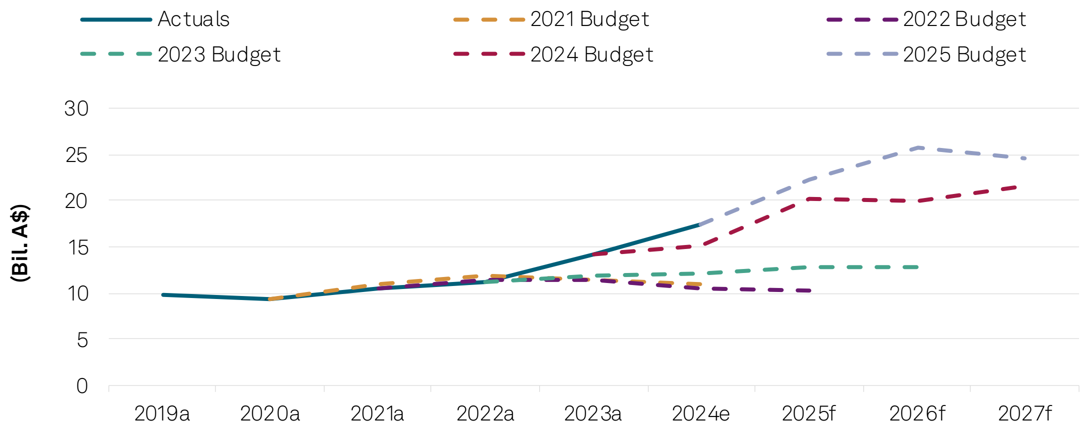
New South Wales (AA+) infrastructure investment has been steadily growing



- New South Wales has a large steady infrastructure pipeline. We forecast capex (on a cash basis) will exceed A$85 billion over the next three years.
- Like other states, New South Wales has historically under-delivered its capex budget. Cost escalation and improving project deliverability mean the state's capital spend is tracking closer to budget in recent years.

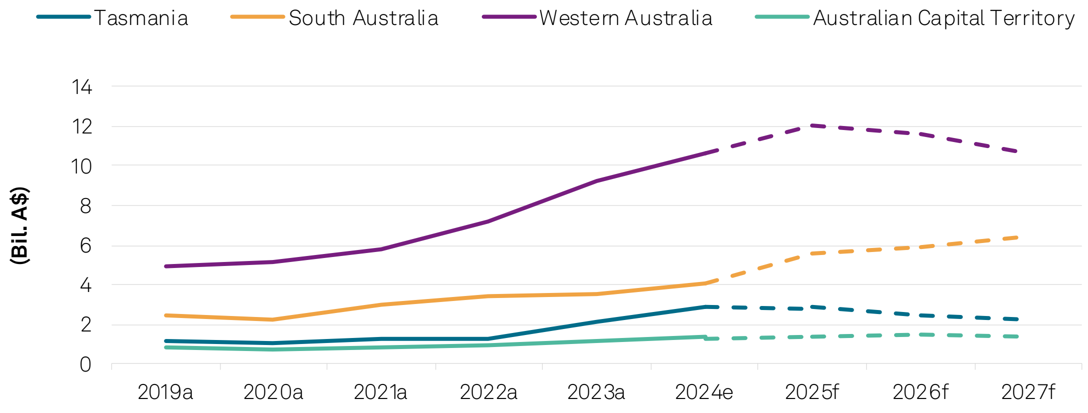
Public Infrastructure Investment At Record Levels

Queensland (AA+) infrastructure spending is about to shoot up



- In its 2025 budget, Queensland increased its substantial infrastructure pipeline by 18% over fiscal 2024-2027 compared with its previous budget.
- The state's infrastructure projects focus on renewable energy and storage projects as part of its domestic energy transition, and the 2032 Brisbane Olympics.

Capital expenditure is growing from much smaller bases in other states



- We anticipate Tasmania's 2025 budget (due in October) will show a larger infrastructure program than previous budgets. Capex jumped 66% in fiscal 2023, albeit from a low base.
- Western Australia's infrastructure spending grew 15% in fiscal 2024 as it enlarged its pipeline of projects. However, this remains much less than that of the eastern seaboard states.

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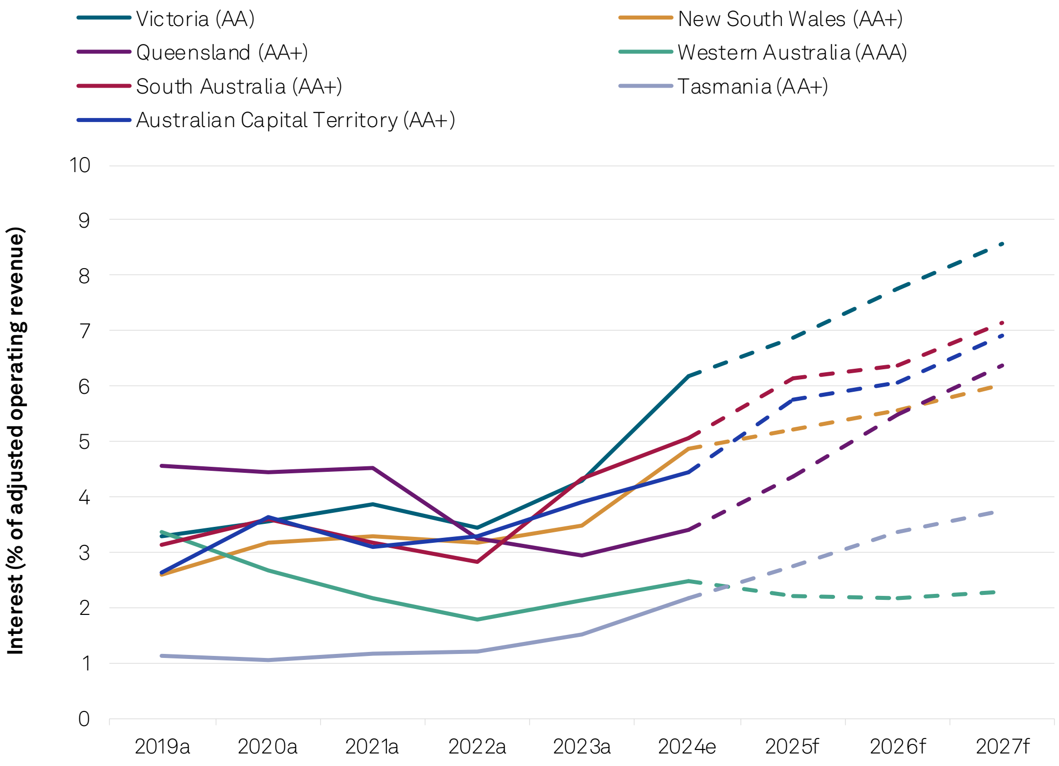
Borrowing Costs To Rise

Interest costs forecast to rise



a--Actual. e--Estimate. F--Forecast.

Sources: 2024-25 Budgets for most states, 2023-24 mid-year budget update for Tasmania.

- Rising interest expenses could impede government capacity for other public spending.
- On our measures, interest costs are greater than 5% of operating revenue for all states except Western Australia and Tasmania.
- We expect Tasmania's interest costs as a proportion of operating revenue to rise by 3.3x its very low 2019 level.
- We project sectorwide interest expenses to double to A$28 billion collectively by fiscal 2027, from fiscal 2023.
- Debt serviceability is manageable, for now, and won't erode creditworthiness. This is because most state debt is in the form of fixed-rate domestic bonds. State borrowing authorities locked in low borrowing costs at longer tenors during the cheap money era of 2020-2021.

Budget Repair Discipline Has Waned In Some States

Entity	July 29, 2024	Jan. 1 2020	Financial management
Government of the Australian Capital Territory	AA+/Stable/A-1+	AAA/Stable/A-1+	1
State of New South Wales New South Wales Treasury Corp.	AA+/Stable/A-1+	AAA/Stable/A-1+	1
State of Queensland Queensland Treasury Corp.	AA+/Stable/A-1+	AA+/Stable/A-1+	2
State of Tasmania Tasmanian Public Finance Corp.	AA+/Stable/A-1+	AA+/Stable/A-1+	1
State of South Australia South Australian Government Financing Authority	AA+/Stable/A-1+	AA+/Stable/A-1+	2
State of Western Australia Western Australian Treasury Corp.	AAA/Stable/A-1+	AA+/Stable/A-1+	1 (+1)
State of Victoria Treasury Corp. of Victoria	AA/Stable/A-1+	AAA/Stable/A-1+	2 (-1)

Note: Numbers in parentheses are changes since Jan. 1, 2020. Central borrowing authorities (CBAs) are wholly owned by their respective states, manage the financial liabilities of government entities, and function essentially as extensions of government. Each CBA also benefits from an unconditional guarantee from its state. As such, we equalise the credit ratings on each CBA with those on its parent government. The scores in this table are those for the state government. We do not maintain a public rating on Northern Territory Treasury Corp.

- Fiscal consolidation for most states is dragging out longer than promised. The economic rebound post pandemic led to improved taxation and consumption receipts; however, these have been channeled into new spending initiatives. Some of the new discretionary spending addresses pressure on public hospitals.
- Ratings may be negatively affected if expenditure control deteriorates, which would signal weakening financial management.
- Western Australia's financial management is extremely strong due to tight expenditure control.
- Our perception of Victoria's financial management has weakened over the same period, due to weakening governance practices and lapsing expenditure control.

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