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Economics & Markets Research

Victorian Budget Preview 2009-10

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Victorian fiscal position may raise issues for rating

- The Victorian government is looking to bring forward, and introduce new, expenditure measures to support the state economy in the 2009-10 budget released next week.
- However, falls in revenues and increasing debt levels could see Victoria's fiscal position weaken significantly.
- Key financial metrics are likely to deteriorate and may pose a risk to the state's credit rating should the downturn deepen further.
- The clear implication is that the call on markets will increase significantly over the forecast period whether the state uses the government guarantee or not. However, the credit rating risk looks to be an issue for a later date and so TCV bonds might perform better than other states in the near-term.

The Victorian Budget is released on the 5th of May and it is expected to show just how tough the economic environment is for the states and how negatively it will impact on state finances. The likelihood is that the economy will contract in 2009-10 and as a result the government's budget position will deteriorate markedly. Despite a sharp reduction in revenues, spending will remain solid with public investment projects brought forward, in the hope that such measures will shield the state from the worst of the economic downturn. The option provided by the Federal government to offer a guarantee on state debt does give Victoria some flexibility around taking on additional debt to achieve this. Nonetheless, the downside risks to the budget in coming years could leave Victoria's AAA credit rating in a precarious position going forward.

The government has already reportedly stated the 2009-10 Budget will see revenues fall around $2 billion (down from current revenues of around $38 billion), with further falls of $2 billion each year over the next four years. Given that the sharpest downturn in the economy is expected in 2009-10, there is significant downside risk to these already large falls in revenue. GST receipts are already reported to be down and will most likely continue to deteriorate as consumption slows further; payroll taxes will weaken as the unemployment rate, by our reckoning, climbs to a least 7¼% in the year; stamp duty (already down more than $700 million in the year to December on the 2008-09 budget estimate) will also likely remain soft as transactions stay well down on boom time levels. Additional taxation measures to increase revenues have reportedly been ruled out. The government has also said no taxation relief will be forthcoming.

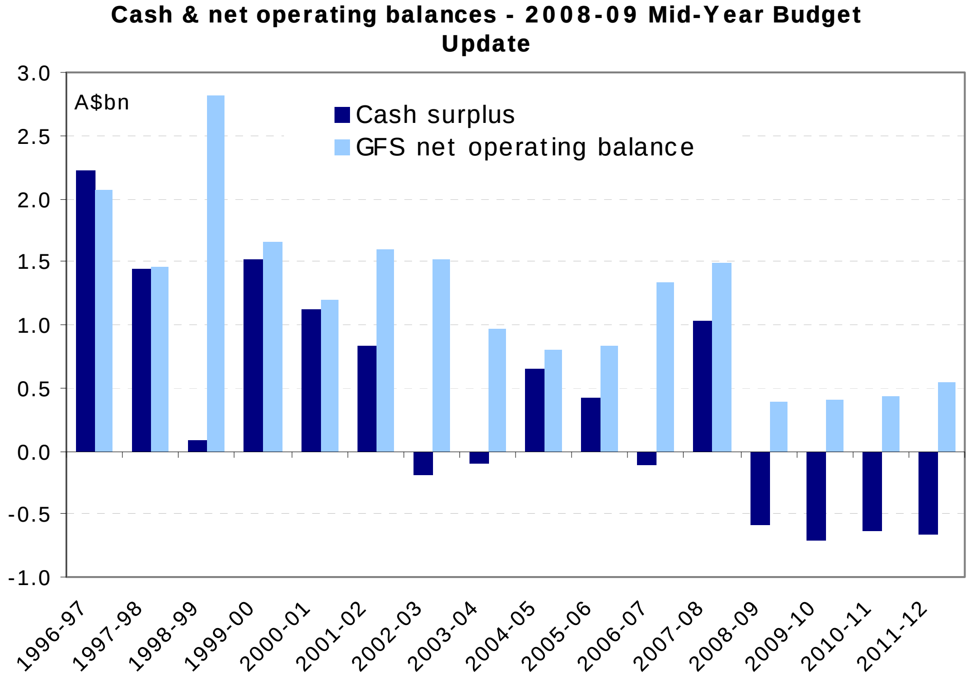
On the expenditure side some saving is expected to be made on the capping of public sector wage growth. However, we expect that any savings will be more than offset by increased expenditure measures as the government attempts to buffer the economy from a more severe downturn. The main thrust on the expenditure side of the budget will be the increases in infrastructure spending as tens of billions of dollars worth of projects look set to be brought forward to stimulate the ailing economy. The majority of this spending is debt funded and as such government net debt is expected to rise by as much as 70% over the next three years.

The implications for the budget of weaker revenues and greater expenses is to not only put the budget surplus in jeopardy but also inevitably results in a deterioration of other key budget metrics.

The cash surplus for 2008-09 has already shrunk from an estimate of $828mn in last year's budget to $382mn in December's Mid Year Update. The government's Mid-Year Financial Report suggests the net operating balance to December was $46mn, well short of the expected $382mn target for June 2009. It should be noted that taxation is not symmetrical with the bulk of land tax for example expected to be collected in the second-half of the year. However, given the downside risks to revenues it would seem unlikely that the new 2008-09 government target of a surplus equal to 1% of revenues (currently equivalent to around $370-$380mn) is now achievable. Despite this, in early April the Premier reportedly suggested that the pre-2008-09 target of a surplus of at least $100mn was still achievable.

It is now clear that the Mid-Year Update projections for 2009-10 and beyond for surpluses exceeding $400mn are too optimistic. Revenue growth will most likely remain negative through much of this period and the pressure will be on to cut expenditure significantly if a surplus is to be maintained.

Figure 1: Mid-Year Budget update surplus forecast now seem optimistic



Source: ANZ, S&P

Critically, the likely reduction in revenues in coming years in combination with rising net debt has seen a marked deterioration in key liability ratios, used in the credit rating process. Using recent reports of revenue falls and debt increases[1], Figure 2 demonstrates the upside risk to the key net financial liabilities to operating revenue ratio in the forecast period. The sharp rise in the ratio, well in excess of that calculated using figures from the Mid-Year Budget Update, approaches Standard & Poor's AAA trigger range. Indeed in a recent report S&P state that "*Absent of any deterioration in other credit metrics, the ratings on the state are likely to come under pressure if the ratio of net financial liabilities to operating revenue exceeds 130%.*" [2] The relatively conservative measure constructed here reached 129.9% in the 2011-12 fiscal year.

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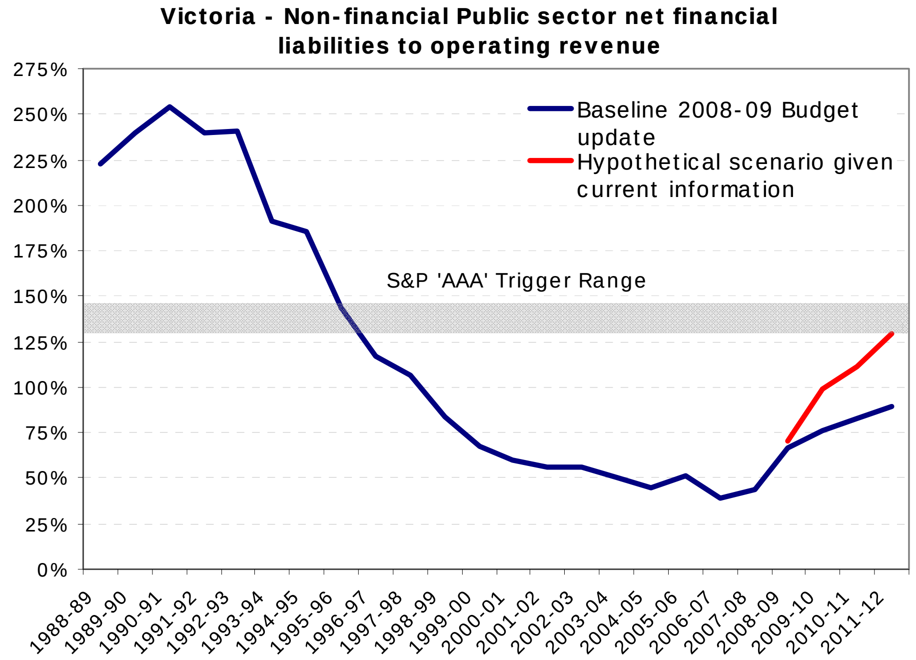
1 Calculated using projected $2bn falls in revenues in coming years and the projected 70% increase in net debt as reported recently in the media.

http://www.abc.net.au/news/stories/2009/04/24/2551687.htm
http://www.theage.com.au/national/2bn-hole-predicted-for-budget-20090407-9zog.html

2 Credit FAQ: How Stable Is The Credit Quality Of The Australian States? Published March 17 2009

This clearly highlights the precarious financial position the state may find itself in coming years and brings into focus the risk to Victoria's credit rating going forward if we see further deterioration in the fiscal position. Nevertheless, it should be noted that Victoria's budget position does look like it will remain in better shape than Queensland's. In particular, Queensland's rating downgrade was triggered largely because the states key liability ratios were forecast to break through trigger levels in 2010. In contrast, by our calculations Victoria will only approach these triggers by 2012. And will only breech trigger levels should significant downside to revenues or upside to liabilities from our base scenario occur.

Figure 2: Downturn results in deterioration of key budget metrics



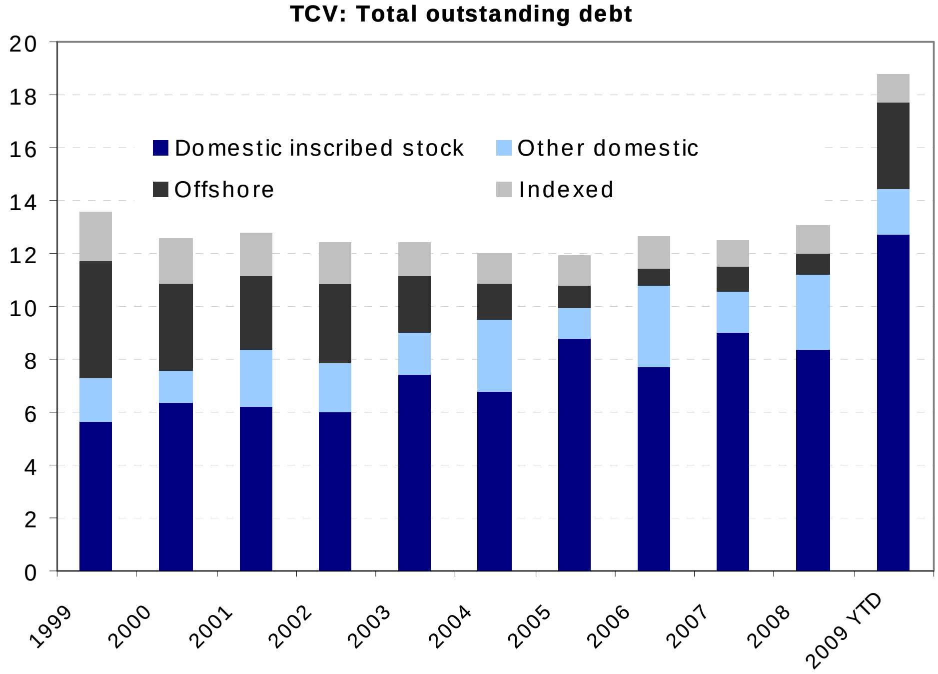
Source: ANZ, S&P

Bond market implications

The increased risk of Victoria's financial situation deteriorating further and the requirement to issue more debt to fund spending clearly has implications for TCV semi-government rates. TCV have been out performing other states since the Queensland downgrade in February on the basis that fiscal pressures are not as severe in Victoria and the government has taken a conservative approach on spending that would not threaten the rate.

There will clearly be a significant increase in bond issuance over coming year if the Budget position deteriorates as much as now looks likely. Other states are likely to increase borrowing significantly as well.

Figure 3: Debt issuance is set to soar to fund expenditure program



Source: TCV

Figure 3 shows that the average amount of TCV debt outstanding averaged around $12.6bn from 1999 to 2008. However, in 2009 debt outstanding has risen to $18.8bn. The funding program for this year was $4.4bn. This requirement is likely to increase significantly in coming years in line with the "tens of billions" of new borrowing referred to in official comments. These new funds can be assumed to have almost a direct feed through into a commensurate increase in the borrowing programme over coming years. There should be some clarity around this when the Budget is released next week.

What is not yet clear is whether the State will decide to take up the Commonwealth's offer to use a guarantee to cover existing debt or on efforts to raise new funding (or both). This will have a big impact on how TCV bonds are priced relative to other states once this issue is clarified (up to 28 days after the guarantee measures are passed in Parliament after May 12th).

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