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The two worrying trends revealed in Australia's AAA warning

Article originally published on [The Australian Financial Review] on 30th April 2025

Opinion Politics Federal Federal election

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The next federal government should be thinking about ways to get control of the financially imprudent behaviour of the state and territory governments.

Collectively, the states and territories have incurred budget deficits totalling $210 billion over the past five years. **Getty Images**

Ratings agency S&P this week warned that Australia's AAA credit rating – something shared with only 10 other countries – may be 'at risk' as a result of additional, unfunded spending promised by both sides of politics during the current election campaign, coming on top of "lax fiscal discipline" from "big-spending state governments".

Credit ratings are, inherently, somewhat subjective. But they do matter. While the interest rates that the Australian federal, state and territory governments pay on the bonds they issue to finance their deficits ultimately reflect the collective judgements of investors in bonds, those judgements are in turn influenced by credit ratings. In particular, some investors – including many central banks – are restricted to holding only AAA-rate bonds in their portfolios. And central banks are important investors in Australian government bonds.

According to the International Monetary Fund, central banks held US$236 billion (A$369 billion at current exchange rates) of A$-denominated assets as at the end of 2024. Most of that would have been in the form of Federal, state and territory government bonds. And that would represent over one quarter of the total value of federal, state and territory government bonds outstanding at the end of 2024, according to ABS.

So if central banks (and others) were to lose some of their appetite for Australian federal, state and territory bonds, the result would almost certainly be higher interest rates on newly-issued bonds, and hence an even greater proportion of government revenues being diverted to paying interest, as opposed to being spent on services that Australians value.

While S&P's statement is only a warning – and falls short of an announcement that either the federal government or any of the states is on 'negative watch', which typically precedes a formal rating downgrade – it does nonetheless highlight two worrying developments in Australia's fiscal position.

The first is the continued growth in federal government spending unfunded by equivalent revenues. Although the Albanese Government deserves credit for presiding over the first two federal budget surpluses since 2007-08 (albeit largely thanks to windfall revenue gains, rather than 'policy decisions'), the budget is now back in deficit, and forecast to remain so for at least another ten years.

Of particular concern, as noted by S&P, is the rapid growth in spending under the heading 'investments in financial assets for policy purposes' – sometimes referred to as 'off-budget' spending because it is excluded from the 'underlying cash balance' which most analysts (and journalists) regard as 'the' measure of the budget's 'bottom line'. This spending is forecast to average almost $21 billion a year over the five years to 2028-29, compared with an average of $9.4 billion a year over the past decade. This spending has to be funded by additional debt, no less than if it were including in 'underlying' payments.

Ideally, decisions about spending under this heading should be included in what my fellow independent economist Chris Richardson calls the 'table of truth', the table in Budget Paper No. 1 which sets out the extent to which changes in the budget 'bottom line' from one budget statement to the next are due to 'policy decisions' as opposed to 'parameter variations' (changes in economic and other assumptions made as part of the process of arriving at the forward estimates of the budget).

And perhaps it's time to abandon the distinction between the 'underlying' and 'headline' budget balances, originally introduced by Peter Costello in 1996 to avoid giving a misleading impression of the 'true' condition of the budget by including the proceeds of privatisations (as the Hawke and Keating Governments had done).

The second worrying development to which S&P refer is the rapid deterioration in the fiscal position of all of Australia's state and territory governments (with the exception of mineral-rich and politically-powerful Western Australia).

Collectively, the states and territories have incurred budget deficits totalling $210 billion over the past five years (only $ 5 billion less than the federal government) – and are proposing to incur deficits totalling a further $188 billion over the next four years ($56 billion more than the Federal Government is forecasting for its deficits over that interval).

Including their GBEs, the states and territories have incurred deficits totalling $237 billion over the past five years, and envisage incurring another $285 billion of deficits over the four years to 2027-28.

As a result, the combined net debt of the state and territory governments is projected to reach $704 billion by 30th June 2028, which is only $10 billion less than projected for Federal Government net debt by that date. At the end of the 2018-19 financial year, total state and territory net debt stood at $151 billion, less than 40% of the Federal Government's $396 billion.

Australia used to have a mechanism whereby the Federal Government could exercise some control over the borrowing proclivities of state and territory governments. It was called the Loan Council. It was established in the aftermath of a much earlier borrowing binge by state governments, in the 1920s, and ratified by the Australian people in 1928, at one of only eight referenda which have been approved by a majority of voters in a majority of states. Under the Financial Agreement which that referendum endorsed, the Loan Council (on which the Federal Government effectively had a majority) determined how much each state could borrow each financial year, and the Federal Government then undertook those borrowings in its own name, handing the proceeds over to the states. In 1933, those controls were extended to borrowings (undertaken in their own names) by state-owned enterprises.

The Loan Council was abolished by the Keating Government in the early 1990s, in part because its controls were being circumvented by state governments (led by Victoria) exploiting the exemptions granted to government-owned 'financial enterprises' (which were originally intended to avoid restricting the ordinary operations of state banks).

And by requiring state and territory governments to borrow in their own names (rather than having the Federal Government do it for them), it was thought that credit rating agencies and the bond markets would exercise some 'discipline' over state and territory government budgets.

That hasn't happened, for two reasons.

First, the ratings agencies explicitly assume that the Federal Government 'stands behind' the debts of the state and territory governments – noting, for example, the guarantees which the Federal Government provided for state and territory government bonds during the Covid pandemic. That means that the states and territories have higher credit ratings than they would have if the Federal Government made it clear that they would not 'bail out' any state or territory government that found itself in a dire financial position (as successive US Federal Governments have done with regard to the debts of US state and local governments).

Second, state and territory governments have a 'captive market' for their debt in the form of the Australian banks, who are required to hold prescribed proportions of their assets in 'high quality liquid assets, in order to comply with APRA's liquidity requirements. And the banks prefer to hold state and territory government bonds in order to meet those requirements than Federal government bonds, because they carry higher yields. Hence, as at the end of 2024, banks held $327 billion of state and territory government securities, as opposed to $107 billion of federal government securities.

But precisely because the ratings agencies assume that the Federal Government underwrites the debt of the states and territories, they have regard to state and territory debt when considering the Federal Government's credit rating. And the outlook for ongoing increases in the level of state and territory government debt now represents a significant risk to the Federal Government's AAA rating.

Faced with that prospect, the next Federal Government – whichever party constitutes it – should be thinking about re-introducing the Loan Council as a means of re-imposing some control over state and territory finances. Since there are no longer any state banks, it would not be necessary to provide an exemption for state-owned financial enterprises, thus closing off one of the principal avenues used by state governments to evade Loan Council borrowing limits in the 1980s. Because it will be the Federal Government that will wear some of the cost (in the form of higher interest rates on its own debt) if it isn't able to exert some control over the financially imprudent behaviour of the state and territory governments.

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