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Queensland Budget and Debt: COVID-19 Update

Report prepared for the Australian Institute for Progress

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The report is based on information and data available to the authors in mid-September 2020.

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Contents

About the authors 5
Abbreviations 6
Summary 8
1. Introduction 14
1.1 Background 14
1.2 Scope of work 15
1.3 Methodology and limitations of the study 17
1.4 Structure of the report 18
2. Review of the COVID-19 FER 19
2.1 Overview 19
2.2 Economic assumptions 19
2.3 Revenue estimates 25
2.2 Expenses 29
3. Operating statement forecasts and projections 33
3.1 Overview of the operating statement 33
3.2 Methodology adopted to produce operating statement forward estimates 33
3.2 Updated operating statement estimates 35
3.3 Public debt interest 39
4. Debt metric impacts 41
4.1 Overview of the balance sheet 41
4.2 Methodology for calculating balance sheet forward estimates 41

4.3 Balance sheet estimates ... 43

4.4 Updated net debt estimate ... 47

5. Discussion ... 49

5.1 Queensland's fiscal situation pre-COVID-19 ... 49

5.2 Future debt burden and fiscal sustainability ... 50

5.3 Credit rating ... 51

5.4 Coverage of defined benefit superannuation liability ... 53

5.5 Potential fiscal principles for Queensland ... 57

5.6 Worst case scenario ... 66

6. Conclusion ... 68

References ... 71

Appendix 1: Savings measures ... 74

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In recent years, Gene has been a course leader and expert presenter for several short courses delivered by University of Queensland's International Development unit. These courses have covered topics such as best practice policy development, industry policy and trade policy (e.g. tariff policies), cost benefit analysis, taxation, natural resource economics for officials from Indonesia's Ministries of Finance (Kemenkeu) and National Development Planning (Bappenas).

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Abbreviations

ABS	Australian Bureau of Statistics
CSG	Coal seam gas
C19-FER	COVID-19 Fiscal and Economic Review
DRF	Debt Retirement Fund
FER	Fiscal and Economic Review
FTE	Full-time equivalent
FY	Financial or fiscal year
GFC	Global financial crisis
GOC	Government-owned corporation
GSP	Gross State Product
GST	Goods and Services Tax
HFE	Horizontal Fiscal Equalisation
LTAAB	Long Term Asset Advisory Board
LNG	Liquified natural gas
Mt	Mega-tonnes
MYFER	Mid Year Fiscal and Economic Review
NFA	Non-financial assets
NFPS	Non-financial public sector
PNFC	Public non-financial corporation (i.e. the non-financial GOCs)
QAO	Queensland Audit Office
QTC	Queensland Treasury Corporation
RBA	Reserve Bank of Australia

Key points

- The Queensland Government released its COVID-19 Fiscal and Economic Review (C19-FER) on 7 September 2020. Such a review would normally provide full budget estimates, but this one only provided an update of Queensland's public finances for the year's 2019-20 and 2020-21.
- This report uses the C19-FER budget estimates and extends the analysis to incorporate budget estimates for the full forward estimates period including the years 2021-22 to 2023-24.
- Total gross debt in the Non-financial Public Sector is expected to increase by approximately 59%-66% from $71 billion (in 2018-19) to $113 billion to $118 billion (worst case) before the middle of the decade. General government debt will increase by 124%-140% in the same period to $72-77 billion and will have to be directly serviced by the operating budget, resulting in higher interest payments that will detract from frontline services or require higher taxes in the future.
- Growth in net debt in the General Government sector is estimated to almost triple from around $14 billion in 2019-20 to over $40 billion in 2022-23.
- From 2019-20 and across the full forward estimates period, the cumulative net operating balance in the General Government Sector is estimated to be a deficit of over $18 billion.
- After adding infrastructure investment less depreciation, the cumulative fiscal balance over the five years is estimated to be a deficit of $38 billion.
- Annual interest payments will rise to nearly $2 billion over the forward estimates, amounting to nearly 3% of revenue. If interest rates rise to long-term average levels in the future, the interest bill would increase substantially. While the Government is currently borrowing at 1-1.5% per annum, rates of 3-4% or higher are more typical, historically.
- The Queensland Government should consider introducing stronger fiscal rules, such as setting an expenditure growth ceiling and targeting a fiscal balance (or allowing only small fiscal deficits) in the General Government sector over the economic cycle.

Summary

The COVID-19 pandemic has led to a substantial deterioration in the Queensland Government's own-source and Commonwealth Grants revenues (e,g. GST) in 2019-20 and 2020-21 and, at the same time, has prompted an unprecedented increase in public spending to support households and businesses in an effort to try to revive the ailing economy. Despite the significant deterioration in the budget position, to date, the Government has provided far less than the usual amount of information on the current state of Queensland's public finances in its 40-page *COVID-19 Fiscal and Economic Review* (FER). So far the Government has only provided estimates for the current and previous financial years, revealing fiscal deficits of $9.3 billion in 2019-20 and $13.1 billion in 2020-21, with total state debt estimated to climb to $102 billion by mid-2021, more than $18 billion more than previously forecast.

The Government claims that the high degree of uncertainty around the economic outlook prevents it from producing full budget forward estimates over the next few years, as is standard practice. It is likely that the real reason for not producing full forward estimates is that the Government realises how bad the outlook for the budget is and it has decided it is better not to publish these estimates in the lead up to an election. It goes without saying that, in times of greater uncertainty, budget estimates should be provided more often, rather than less often, in the public interest.

Adept Economics estimates of the current outlook for Queensland's public finances are presented in Table 1. On our assessment, the Government is set to run substantial deficits for several years at least and total debt will climb to $110-115 billion by mid-2024, and possibly to around $116 billion if the state government fails to achieve its promised $3 billion in savings targets. That amount of debt would represent approximately 154% of total government revenue in the Non-financial Public Sector (NFPS) in 2023-24. These figures represent our best estimates based on the available information at the time of publication but remain highly uncertain given how rapidly circumstances can change with the virus still spreading through the Australian community.

Table 1. Queensland budget estimates, $ million

Budget item	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Net operating balance	992	-5,898	-8,136	-2,824	-1,576	274
Fiscal balance	-2,191	-9,318	-13,084	-8,115	-4,534	-2,839
General Government debt	32,202	44,226	60,903	67,618	70,753	72,192
Total (NFPS) debt	70,909	84,936	101,962	108,890	111,578	113,017

Source: Estimates from 2018-19 to 2019-20 are the official estimates in the COVID-19 FER and estimates from 2021-22 to 2023-24 are Adept Economics' projections. NB. Debt is inclusive of leases, securities, and derivatives.

The actual budget deficits and debt we see over the next few years will depend on the pace of economic recovery, and the extent to which the Government achieves its $3 billion of savings plan. So, in addition to producing the main estimates in Table 1, we have produced a worst-case scenario (Table 2), in which savings are not achieved and the pace of recovery is slower over the forward estimates. In this scenario, total NFPS debt could end up at around $118 billion by 2023-24.

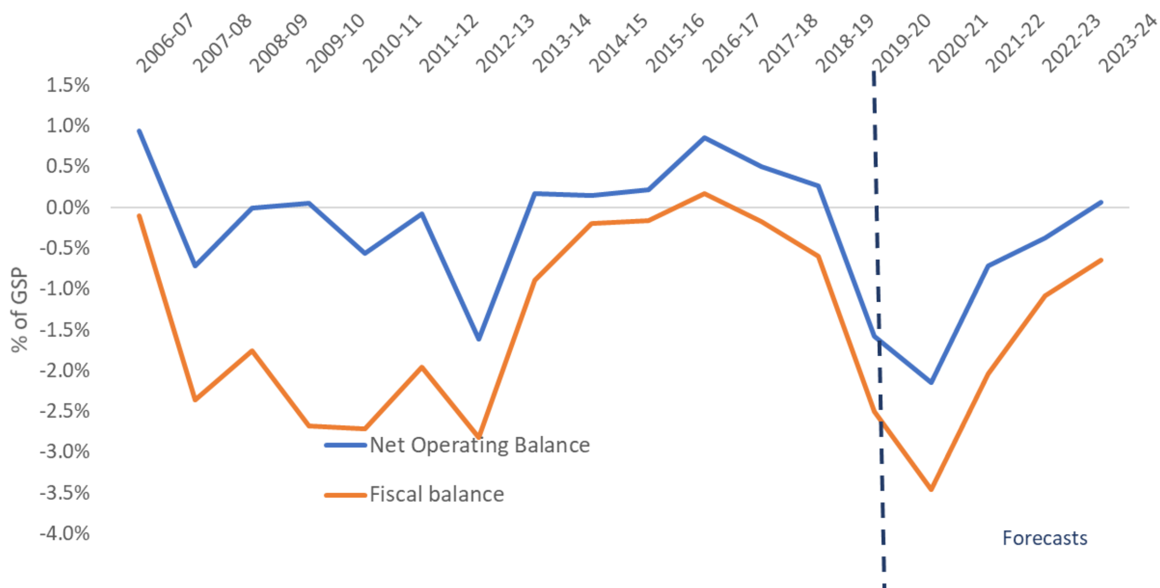
Table 2. Queensland budget estimates, worst case scenario, $ million

Budget item	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Net operating balance	992	-5,898	-8,436	-3,248	-2,277	-483
Fiscal balance	-2,191	-9,319	-13,384	-8,539	-5,235	-3,596
General Government debt	32,202	44,226	61,203	69,342	74,177	77,373
Total (NFPS) debt	70,909	84,936	102,262	110,614	115,002	118,198

Source: Estimates from 2018-19 to 2019-20 are the official estimates in the COVID-19 FER and estimates from 2021-22 to 2023-24 are Adept Economics' projections. NB. Debt is inclusive of leases, securities, and derivatives.

Taking a longer-term perspective, the expected budget deficits as a result of COVID will be substantially worse than what was experienced during the Global Financial Crisis, with the fiscal balance reaching -3½% of GSP in 2020-21 (Figure 1). At the height of the GFC, the rapid and deep deterioration in the Commonwealth and state budgets in the late 2000's seemed incredible at the time, but the impact of COVID has been more significant on public finances.

Figure 1. Estimated General Government budget balances as percentage of Queensland GSP



Source: Adept Economics, 2020.

From a public finance perspective, the critical difference between what occurred during the GFC and its aftermath and COVID is that the fiscal deterioration is largely the result of the operating side of the budget, rather than because the Government is funding a peculiarly large capital works program. To the extent that expenses announced in the lead up to the election from the Government's $3 billion unallocated "war chest" occur in 2020-21, this fiscal deficit will blow out further.

The $70-75 billion (at least) of general government debt expected by mid-2024 will have to be directly serviced by the budget and the higher interest payments will detract from frontline services or require higher taxes and charges than otherwise in the future. The deterioration of Queensland's public finances reinforces the need for the Government to develop a credible long-term fiscal strategy to materially reduce the important debt-to-revenue and debt-to-GSP ratios (Table 3).

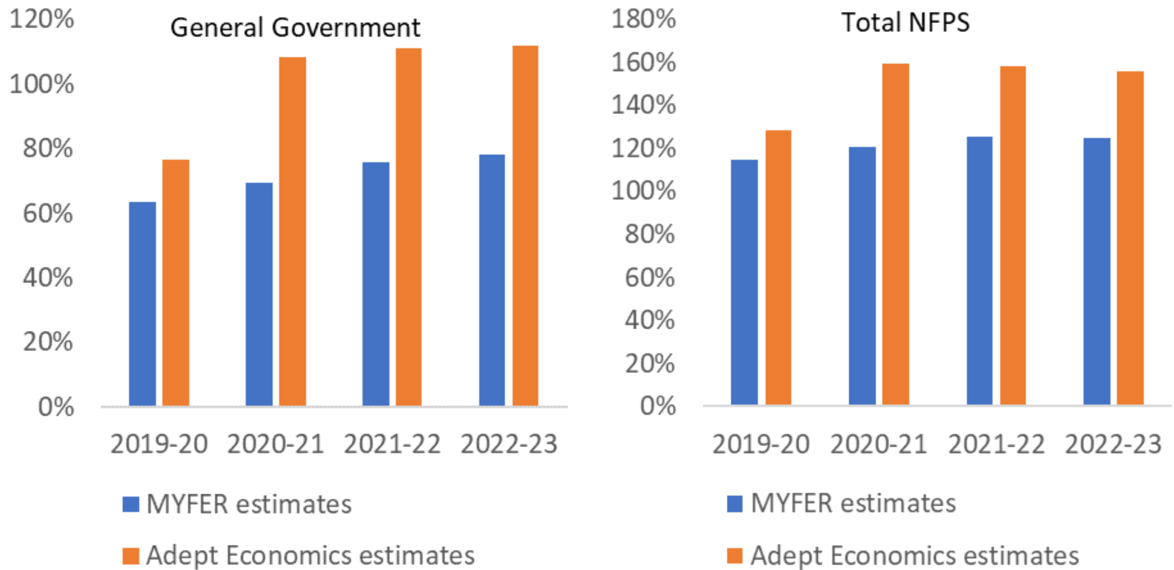
Table 3. Queensland debt metric estimates

Metric	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
General government debt-to-revenue ratio	53.8%	76.6%	108.3%	111.1%	111.9%	108.5%
Total (NFPS) government debt-to-revenue ratio	103.8%	128.3%	159.0%	158.3%	155.6%	149.8%
General government debt-to-GSP ratio	8.7%	11.9%	16.1%	17.0%	17.0%	16.5%
Total (NFPS) government debt-to-GSP ratio	19.2%	22.8%	26.9%	27.5%	26.8%	25.8%

Source: Adept Economics estimates. NB. Debt is inclusive of leases, securities, and derivatives. Actual 2018-19 estimates are from the Queensland Government COVID-19 FER.

Crucial metrics are expected to deteriorate substantially compared with what was expected at the time of the 2019-20 MYFER and will be of concern to rating agencies (Figure 2). Total Government debt is expected to reach around 150% of revenue and will climb to between 25-30% of GSP by 2023-24. There is expected to be some slight improvement in the metrics in the final year of the forward estimates which reflects the expected recovery of economic activity and consequently government revenue. Nonetheless, we expect the Government will still be running multi-billion-dollar fiscal deficits and debt metrics will not improve materially without improved budget management and a credible fiscal plan relative to recent years.

Figure 2. Comparison of debt metric estimates with MYFER 2019-20 estimates



Source: Adept Economics estimates. NB. Debt is inclusive of leases, securities, and derivatives.

Even on the Government's self-imposed fiscal rules, it was failing pre-COVID. Moreover, its Queensland Future Fund is not a genuine debt reduction strategy, as it merely shuffles funds around on its balance sheet. The failure of the Queensland Future Fund is evident in the Government having to radically revise down the amount of funds it would pull out of the Employer Fund at QIC—invested to cover the defined benefit superannuation liability—from $4 billion to merely $1 billion, because of the deterioration in global economic conditions that meant more money would be required in the fund.

The future is too uncertain now to speculate regarding what will happen to the State's credit rating. Many governments around the world are in challenging fiscal positions, and Queensland is already not on the highest rung of credit ratings (i.e. AAA). It is possible the ratings agencies could put Queensland on "negative watch." Much will depend on whether the Queensland Government can demonstrate a credible long-term fiscal strategy to stabilise and eventually reduce debt.

Given the poor state of the economy, now is not the time for austerity. But the Government could consider introducing credible fiscal rules such as an expenditure growth constraint related to long-run average nominal GSP growth which could apply once the economy is recovering. Importantly, given the size of the deficits and debt, finding a sustainable fiscal balance target in the NFPS will be required to support a credible pathway to sound financial management.

The Queensland Government might also reconsider whether it could undertake some "no regrets" asset sales or long-term leases which provides funds it could use to pay down debt and reduce the ongoing interest bill. Balance sheet management, converting risky assets into cash or new infrastructure, is an especially important risk management tool. To simply rule out one of the most useful tools of public financial management is not a sound strategy in the middle of the largest economic downturn since the Great Depression.

The Government has been lucky interest rates have been so low, but if it needs to borrow or refinance at higher interest rates in the future, the growing interest bill could become a major burden on Queensland taxpayers. It is important to recognise that the current low interest rate environment is a result of policy decisions made by central banks to stimulate economic activity. In the future, interest rates could increase to more normal levels without activist central bank intervention.

Moreover, even at the historically low rates the Queensland Government can currently borrow at (around 1-1½% per annum), the additional $20-25 billion of General Government borrowing from the Queensland Treasury Corporation (QTC) expected as a result of the COVID-crisis will cost up to $400 million in additional interest payments per annum. The additional interest payments will take Queensland's General Government interest bill to around $1.9 billion to $2 billion per annum, compared with the $1.5 billion that was expected in 2019-20 at the time of the 2019-20 MYFER. This will make operating surpluses more challenging to achieve. And then there is the risk that borrowings will need to be refinanced at a higher rate in the future.

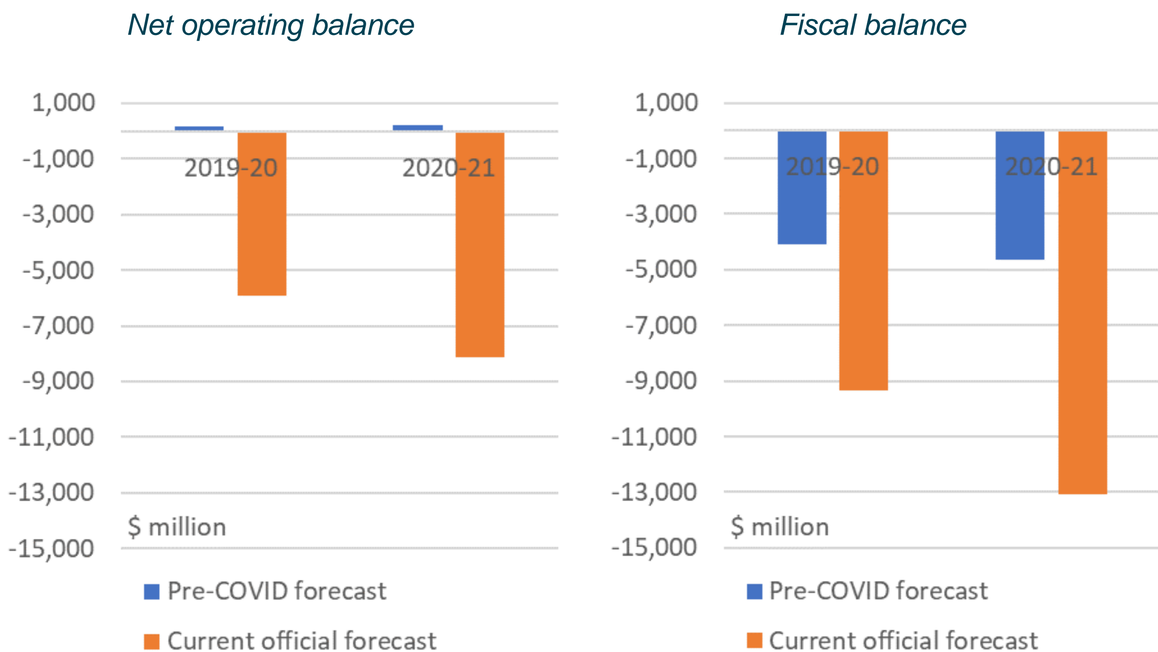
Finally, the Queensland Government should keep in mind that increasing public infrastructure spending to boost economic activity in the short-term may not necessarily lead to higher growth in the long-term, particularly without high-quality project selection and prioritisation processes. Making poor economic and social infrastructure choices can lower the returns to the capital stock and make maintaining and replenishing that capital stock much more burdensome. Accordingly, the Queensland Government must ensure that it maintains highly credible project prioritisation and selection processes even during the severe economic downturn. In this regard, it is disappointing that Building Queensland, despite all of its governance flaws, has been absorbed back into the Queensland Treasury Department. It is also disappointing that, at a time when high-quality independent economic policy advice is required more than ever before, the Queensland Productivity Commission (despite its own staffing and governance flaws) has been also absorbed back into Queensland Treasury.

1. Introduction

1.1 Background

The COVID-19 pandemic has led to a substantial deterioration in the Queensland Government's own-source revenues and Commonwealth Grants (e,g. GST) in 2019-20 and 2020-21 and, at the same time, has prompted an unprecedented increase in public spending to support households and businesses in an effort to try to revive the ailing economy. Despite the significant deterioration in the budget position, to date the Government has provided far less than the usual amount of information on the current state of Queensland's public finances. For instance, the Government has only provided estimates for the current and previous financial years, revealing fiscal deficits of $9.3 billion in 2019-20 and $13.1 billion in 2020-21, with total state debt to climb to $102 billion by mid-2021, more than $18 billion than previously forecast (Figure 3).

Figure 3. Queensland Government budget forecasts, current and pre-COVID



Source: Queensland Government budget documents. N.B. the pre-COVID forecasts are those which were presented in the Mid Year Fiscal and Economic Review published in December 2019.

The Australian Institute for Progress (AiP) has commissioned Adept Economics to assess the current state of Queensland's public finances. This is an important assignment given the

limited information presented in the Government's recent budget update, which at approximately 40 pages, is highly inadequate and insufficient to inform the public debate in the lead up to the 31 October state election.

1.2 Scope of work

This report provides the best possible estimates of Queensland's current fiscal outlook to 2023-24, the financial year for which estimates normally would have been provided by the Government. In contrast, the Queensland Government has only produced forecasts of budget aggregates for 2020-21. The Government has claimed the future is too uncertain to make forecasts and projections beyond the current financial year. Certainly, there is a high level of uncertainty, but we believe the public debate would be enhanced by an attempt to put reasonable bounds around future budget aggregates over the usual forward estimates period rather than say nothing at all, especially in an election year.

It is highly likely that the Queensland Treasury is keeping its own estimates of budget aggregates over the forward estimates and it would be desirable for the public debate for the Government to release them. In the absence of the Government doing this, we believe this report will offer great value to the Queensland community. A 2008 OECD paper emphasises the importance of Government's making decisions around and reporting on budget forward estimates:

> *The forward estimates are rolling baseline projections for all revenues and expenditures for three years beyond the next budget. After the budget is passed, the first year of the forward estimates becomes the base for next year's budget, and another out-year is added to the forward estimates. The forward estimates are an integral part of the budget process – in fact, the whole budget process is built around them – and they are generally viewed as the single most significant and successful budgeting reform in Australia.*
>
> *The fact that 80% of annual expenditure is authorised by "special" (permanent) legislation with only 20% of expenditure being approved through the annual budget reinforces the importance of the forward estimates, as they incorporate both types of expenditures. By bringing forward the consideration of their enduring costs, the*

forward estimates in fact form the primary vehicle for monitoring and overseeing the "special" (permanent) appropriations.[1]

Incidentally, in relation to Queensland Treasury's ability to produce forecasts of budget aggregates, Treasury has previously been highly confident. For instance, at a Productivity Commission hearing into horizontal fiscal equalisation (HFE) in 2018, the then Under Treasurer Jim Murphy said, "we don't have difficulty in forecasting GST revenue, luckily."[2]

Because of the additional uncertainty in this time of COVID, we have decided to develop two scenarios for the analysis, a base scenario consistent with Queensland Treasury's assumptions of a gradual return to normal economic activity, and a less optimistic but nonetheless very reasonable scenario.

This report is based on publicly available information as at mid-September 2020, including the *COVID-19 Fiscal and Economic Review* released on 7 September by Treasurer Cameron Dick. It considers spending and revenue measures announced by the Queensland Government since the *Mid Year Fiscal and Economic Review* (MYFER) released in December 2019. Normally, the Government would have released a budget by June, and its original intention was to bring the budget forward by two months to April this year.

Our analysis provides estimates of the major budget aggregates for 2019-20, the current financial year of 2020-21, and three years of forward estimates 2021-22 to 2023-24. The major budget aggregates in the General Government sector and Non-financial Public Sector (which includes GOCs) include:

- Net operating balance - revenues less operating expenses (i.e. including depreciation but not net capital investment);
- Fiscal balance - revenues less operating and capital expenses;
- Gross debt - defined as borrowings plus lease liabilities; and
- Net debt - gross debt less liquid financial assets, broadly speaking.

Prior to COVID-19, the net operating balance was only in very small surplus, and multi-billion-dollar fiscal deficits (which includes net infrastructure investment) were forecast and projected. Gross debt was already projected to reach nearly $92 billion by 2022-23, while net debt appeared to be more favourable.

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[1] Blöndal, J.R. et al. (2008) "Budgeting in Australia", *OECD Journal on Budgeting*, vol. 8, no. 2, p. 17.
[2] Productivity Commission (2018) *Inquiry into Horizontal Fiscal Equalisation: Transcript of Proceedings at Royal on the Park Hotel, Brisbane, Queensland on Monday, 5 February 2018 at 9.00 am*, p. 602.

Queenslanders are fortunate that previous governments have built up a stock of assets to set against the defined benefit superannuation liability, assets which reduce net debt. However, because the superannuation liability is not counted in the net debt metric (but the assets offsetting the liability are counted), in Queensland the Gross Debt figure is also a useful indication of the sustainability of the fiscal position.

1.3 Methodology and limitations of the study

The study is based on publicly available information. Adept Economics does not have the same level of resources as Queensland Treasury, nor do we have access to all of the information (e.g. up-to-date revenue collections data from Office of State Revenue) available to the Treasury in the preparation of its budget.

The basic methodology was to formulate plausible estimates of the trajectory of the major budget aggregates over the current budget forward estimates period (2020-21 to 2023-24) based on:

- reviewing the available information released since MYFER in relation to expense, revenue and loan measures announced by the Government;
- using available information and data to quantify potential revenue losses from the COVID-related downturn; and
- applying judgment to combine all this information to formulate plausible and internally consistent budget aggregate estimates, which build on those presented by the Queensland Treasurer on 7 September 2020 in the *COVID-19 Fiscal and Economic Review*.

Also, the estimates reflect economic conditions and policy decisions announced by mid-September 2020. Actual budget estimates published by the Treasury in November could vary substantially from the estimates in this report either due to new policy measures announced in the lead up to the 31 October election or changes in the economic outlook - given the rapidly evolving nature of the crisis. Further, if there is a change of Government, the budget update scheduled for November may or may not take place or be re-scheduled to a later date.

The expenses and budget balance estimates will be subject to change as the Government identifies specific expenditures it would make out of the reported $4 billion “war chest” for

which it has provisioned, with $1 billion for two new loans programs, leaving $3 billion to be allocated in the lead up to the state election.[3]

1.4 Structure of the report

The paper is structured as follows:

- Section 2 reviews the Queensland Government's *COVID-19 Fiscal and Economic Review* published on 7 September 2020;
- Section 3 presents our estimates of the operating statement over the forward estimates;
- Section 4 presents balance sheet estimates;
- Section 5 provides a discussion of relevant issues, including the coverage of the defined benefits superannuation liability, and the credit rating; and
- Section 6 concludes the paper.

[3] Elks, S. (2020) "Queensland Labor has $4bn war chest to splash cash", *The Australian*, 7 September 2020.

2. Review of the COVID-19 FER

2.1 Overview

The Queensland Government has committed to over $7 billion in revenue and expense measures in response to the COVID global pandemic over three stages. The immediate stimulus makes up the bulk of state expenditure and featured funding targeted at containment efforts, household costs, firm bills and employee retraining and wage assistance. Stage one and stage two exhibit economy-wide packages and industry-targeted measures with an emphasis on education, infrastructure, the arts, sport and tourism. Additional programmes are mainly smaller project-specific funding schemes, but larger measures such as the Building our Regions Program and Land Tax relief also fall within this bracket.

At the same time, the COVID-recession has massively reduced state government revenues, particularly gambling revenues in the first half of 2020 when pubs and clubs were closed, payroll tax, and stamp duty, along with GST receipts redistributed by the Commonwealth. On 7 September, Treasurer Cameron Dick released the COVID-19 FER reporting Queensland Treasury's estimates of 2019-20 and 2020-21 budget aggregates taking into account the new expense and revenue measures and the deteriorated economic outlook.

In this section, we review the economic assumptions and revenue and expense estimates in the COVID-19 FER, assessing their reasonableness and what they mean for the evolution of the budget over the forward estimates to 2023-24, which in our view the statement should have presented.

2.2 Economic assumptions

2.2.1 Macroeconomic assumptions

Prior to the COVID-19 emergency, the Queensland Government forecast the Queensland economy to record a relatively modest 2½% real growth rate in 2019-20, revised down from the 3% growth rate forecast at the time of the 2019-20 State Budget. These growth rates are

well below Queensland's average annual GSP growth of 3¾% per year over the 30-year period from 1989-90 to 2019-20.[4]

Despite this lower than trend growth rate, the Queensland economy was still expected to grow at a higher rate than the national economy (as it usually does because of higher population growth), according to RBA forecasts at the same time, and the state was also tracking for a net operating surplus in the General Government sector of $151 million in 2019-20.

In the COVID-19 Fiscal and Economic Review, the Queensland Government has substantially downgraded its economic forecasts, but its forecasts could be considered relatively optimistic, given they are based on two critical assumptions, namely that:

- "the spread of the virus remains contained in Queensland and restrictions continue to be gradually unwound, with the majority of general economic and social activity gradually returning to 'normal' over the forecast period" [i.e. by 30 June 2021]; and
- "a vaccine may be developed by mid-2021 and this would subsequently allow for the opening of international borders."[5]

In relation to the first assumption, while it is certainly true that the virus has been contained in Queensland up until this point, it is arguable that the incremental economic and social costs of maintaining a close to complete elimination strategy in Queensland rises with each day the social distancing restrictions (including a relatively hard state border closure) remain in place. Eventually, these costs will show up in reduced economic activity, employment growth and government revenues.

Concerning the second assumption, while it appears that the world is on track to develop a vaccine by mid-2021, it is by no means clear that the majority of Queenslanders would have access to the vaccine (let alone be willing first participants) by that date. It may take several months to roll out the vaccine across Queensland and build sufficient community trust in the new vaccine such that take-up rates are high.

Queensland Treasury's economic parameter assumptions, compared with those which were assumed at the time of MYFER in December 2019, are presented in Table 4. They reflect a large contraction in GSP and employment growth in the final quarter of 2019-20 and a slight recovery in activity (in annual average terms) over 2020-21. Population growth is expected

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[4] ABS 5220.0 Australian National Accounts: State Accounts, 2018-19, Table 4. Accessed: https://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5220.02018-19?OpenDocument
[5] Queensland Government (2020) *COVID-19 Fiscal and Economic Review*, p. 6 and p. 14.

to more than halve due to a lack of international and far lower interstate migration due to border restrictions. On the other hand, there is some anecdotal evidence of Victorians wishing to move to Queensland due to the nature of that state's social distancing restrictions (including a curfew). However, it is very early days in terms of discerning a clear migration trend.

Table 4. Queensland Treasury's economic assumptions

	MYFER 2019-20	C19-FER 2019-20	MYFER 2020-21	C19-FER 2020-21
Gross State Product growth	2.5%	-0.25%	2.75%	0.25%
Employment growth	1.5%	0.5%	1.5%	-3%
Unemployment rate	6.25%	6.4%	6%	8.5%
Inflation (i.e. CPI % change)	2%	1.2%	2%	1.25%
Wage Price Index growth	2.25%	1.9%	2.5%	1.25%
Population growth	1.75%	1.5%	1.75%	0.75%

Source: Queensland Government budget documents.

Lower population growth will be a concern to many businesses because, historically, strong population growth has contributed substantially to Queensland's overall economic growth rate. In addition to lower migration impacting population growth, there may be an impact on the natural increase of the population, too. Some demographers have argued that the coronavirus will lead to a reduction in the birth rate because of the associated economic and social uncertainty.[6]

Queensland Treasury's economic assumptions are slightly stronger than those adopted by the Australian Government in its Economic and Fiscal Update in July, estimates which would be worse if the Stage 4 lockdown in Victoria, which occurred after the Australian Government's update, were incorporated). The Queensland Treasury notes:

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[6] https://www.anu.edu.au/news/all-news/coronavirus-crisis-%E2%80%98likely-to-reduce-birth-rate%E2%80%99

The stronger growth profile forecast for Queensland compared with nationally reflects Queensland's relative success in containing the spread of COVID-19, which has so far allowed for a faster unwinding of emergency health restrictions, combined with the State's economy being less reliant on the services sector (many elements of which were most severely impacted directly by the crisis) compared with major southern states.[7]

The Treasury is correct that Queensland has a "stronger growth profile" than the rest of Australia. Certainly, the state has lost proportionately fewer jobs than the national average (Figure 4). Whether this is due to the state's industry mix—i.e. having a larger relative contribution of primary and mining industries—or due to COVID-19-related policies is not easy to answer. Without a detailed econometric study of the question, no firm conclusions can be drawn.

Figure 4. Payroll jobs, Queensland and Australia, 14 March to 22 August 2020, ABS estimates

Source: ABS, 2020.

[7] Queensland Government (2020) *COVID-19 Fiscal and Economic Review*, p. 6.

2.2.2 Commodity price assumptions

Other critical budget assumptions revealed in the COVID-19 FER relate to the exchange rate, coal export volumes and commodity prices, which determine government royalty revenue (Table 5). The exchange rate is relevant given that commodity prices are denominated in US dollar terms, so, when the Australian dollar appreciates, prices in Australian dollars fall and so too do royalty revenues. The C19-FER AUD/USD exchange rate forecast of 0.70 US dollars for 2020-21 appears reasonable given that, up to 11 September 2020, the exchange rate had average 0.7141 since 1 July 2020. Queensland Treasury's coal export volume forecasts also appear reasonable and reflect some cutback in production due to lower global demand during the COVID-recession.

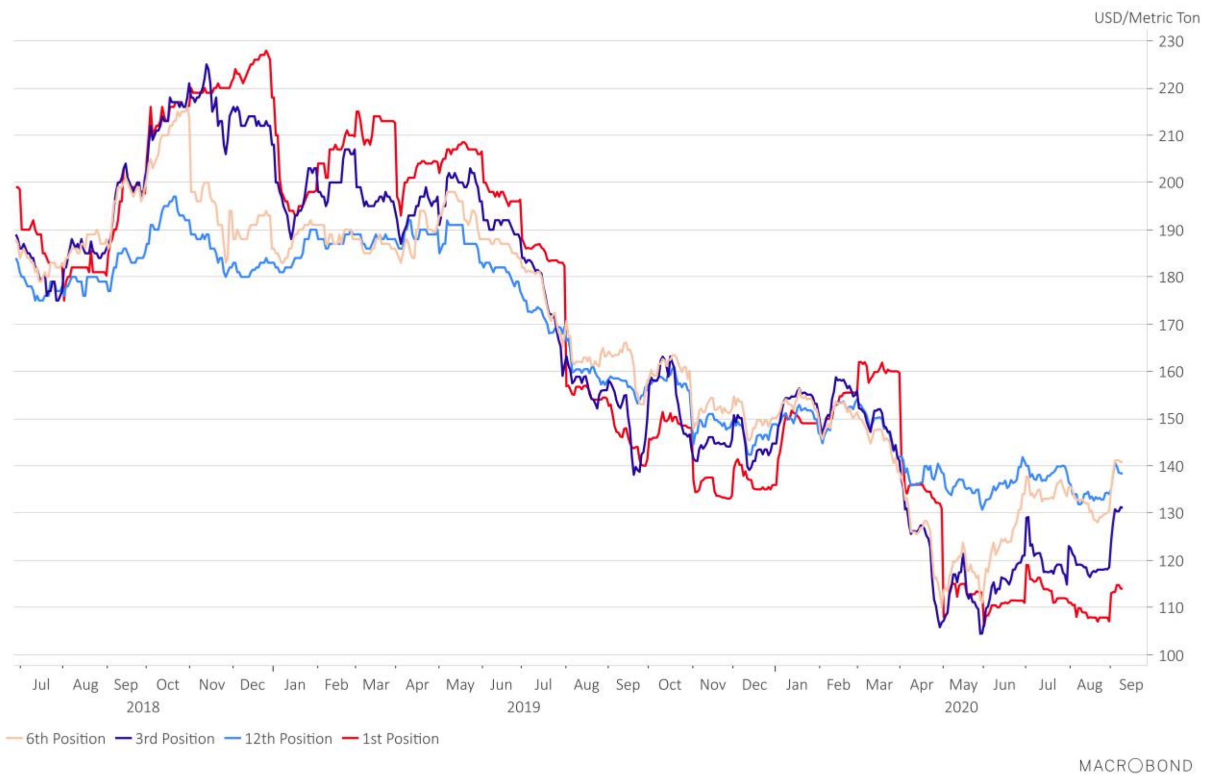
Table 5. Royalty revenue assumptions

Parameter	MYFER 2019-20	C19-FER 2019-20	C19-FER 2020-21
Coal exports (Mt)	216	204	201
Exchange rate (AUD/USD)	0.67	0.67	0.70
Hard coking coal price (USD/tonne)	156	152	131
Semi-soft coal price (USD/tonne)	110	111	93
Thermal coal price (USD/tonne)	90	88	70
Brent oil price (USD/barrel)	65	65	40

Source: Queensland Government (2020) COVID-19 Fiscal and Economic Review, p. 36.

The commodity price assumptions appear reasonable based on available market data. For instance, coking coal futures prices suggest a price range of 130-140 USD/tonne over the rest of 2020-21, and it is this price which is most critical for determining royalty revenues (Figure 5). Note in the figure that the first '1st position' relates to a one-month-ahead futures contract, 3rd position relates to a three-months-ahead futures contract, and so on.

Figure 5. Coal, Futures, SGX TSI Australia Premium Coking Coal, Close, USD per tonne



Source: Macrobond, 2020.

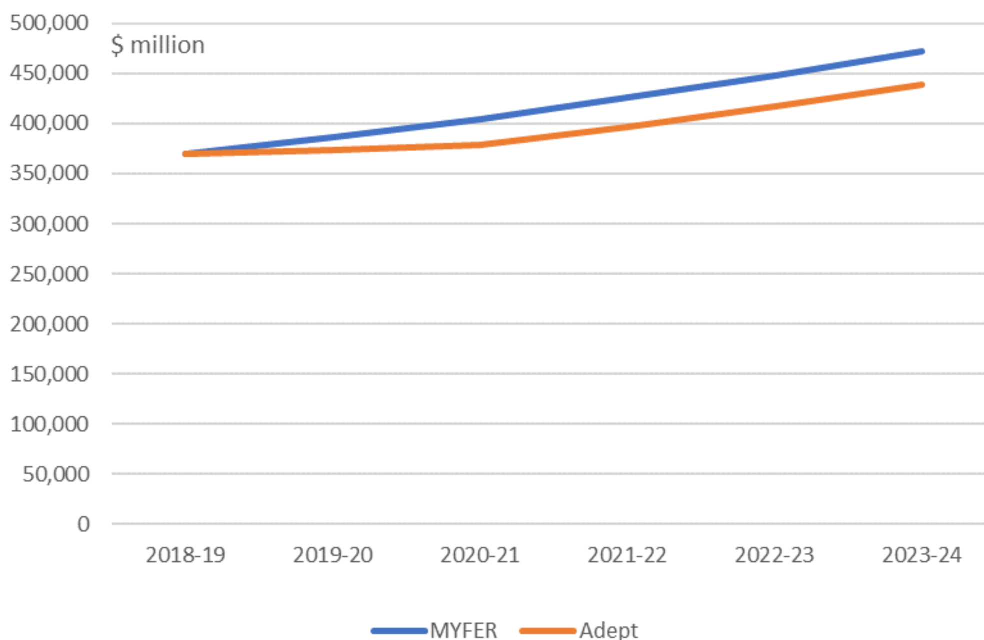
2.2.3 Economic assumptions for budget estimates in this report

For the purposes of this report, we have made assumptions regarding the key economic parameters, as budget aggregates are sensitive—to different degrees—to the business cycle. We use the C19-FER assumptions as the base case and use what we regard as realistic assumptions for the pace of economic recovery from the COVID-19 recession. In our view, the biggest risk to the economic outlook and the forecasts of the Australian Treasury and RBA, are the so-called default cliffs and insolvency tsunamis as borrowers start having to repay loans and companies can no longer rely on safe harbour protection to avoid insolvency. These could start to have a deleterious impact on national and state economic activity over the coming months and these impacts could lead to a relatively slow recovery from the recession.

In our analysis, we adopt the Queensland Treasury nominal GSP forecasts for 2019-20 and 2020-21 (approx. 1% and 1.5% growth, respectively), and then assume a ramping up of growth to the usual assumed nominal GSP growth in the final years of the forward estimates

of Queensland state budgets, which is 5.25%. Reflecting our view of a slower ramp-up in economic activity, we assume nominal GSP growth of 4.75% in 2021-22, 5% in 2022-23, and 5.25% in 2023-24. Based on these forecasts, we expect a persistent output gap, between actual GSP and what would have been expected at the time of MYFER in December 2020, which will persist for several years (Figure 6). This output gap will mean persistently lower revenues than previously expected for those budget items closely linked to the economic cycle, including own source tax revenues and GST transfers, and our modelling incorporates this sensitivity.

Figure 6. Nominal GSP projection compared with projection implied by MYFER 2019-20



Source: Adept Economics estimates based on ABS and Queensland Government data.

2.3 Revenue estimates

Due to both the COVID-recession and economic stimulus measures, total state General Government revenue is expected by Queensland Treasury to be $7.67 billion lower than was previously expected across the current and previous financial years (Table 6). The bulk of this reduction is due to the major revenue streams: taxation, royalties, and GST receipts. Across the two financial years, around one-third of the reduction in revenue was due to falls in tax receipts, and around one-quarter each of the reduction was attributable to falls in

grants revenue and other revenue, which includes royalties. In relative terms, the categories which experienced the largest falls in revenue across the two financial years were:

- other revenue (i.e. royalties), which declined by 17.0%;
- dividend and tax-equivalent income (i.e. GOC earnings), which declined by 12.6%; and
- taxation revenue, which declined by 8.0%.

Overall, total revenue is expected to decline by 6.3% in the two financial years, with an estimated reduction of 3.7% in 2019-20 and a forecast reduction of 8.9% in 2020-21.

Table 6. COVID-19 FER revenue estimates and variations from MYFER estimates

Revenue item	2018-19 Actual $M	2019-20 Estimate $M	2020-21 Estimate $M	2019-20 Variance $M	2020-21 Variance $M	Total Variance $M
Taxation revenue	14,165	14,566	13,835	-579	-1,900	-2,479
Grants revenue	28,307	27,569	28,988	-692	-1,253	-1,945
Sales of goods & services	5,789	5,809	6,015	-298	-275	-573
Interest income	2,191	2,020	1,864	-27	-122	-149
Dividend & tax equiv. income	2,786	1,895	1,280	-292	-166	-458
Other revenue (incl. royalties)	6,596	5,859	4,257	-308	-1,761	-2,069
Total	**59,834**	**57,719**	**56,239**	**-2,195**	**-5,476**	**-7,671**

Source: Adept Economics based on Queensland Government estimates. Columns 5 and 6 report the differences between the estimates presented in the C-19 FER (columns 3 and 4 of this table) and the corresponding estimates made in the 2019-20 MYFER.

The largest contributions to declining tax revenues come from payroll tax and transfer/stamp duty, which account for nearly two-thirds of the total reduction in tax revenue (Table 7). Payroll tax and stamp duty are both expected to decline by more than 10% to previous expectations in 2019-20 and 2020-21, with the bulk of the reduction in 2020-21. Payroll tax is expected to be 17.8% lower than previously forecast in 2020-21 and stamp duty is expected to be 20.9% lower.

In relation to royalties and land rents, coal and petroleum (LNG) royalties account for the vast bulk of the reduction in revenues, with around three-quarters of the reduction accounted for by coal royalties alone (Table 7). Coal royalties are estimated to decline by $1.3 billion across the two financial years, with total royalties and land rents declining by $1.7 billion.

Table 7. COVID-19 FER tax and royalty revenue estimates and variations from MYFER estimates

Revenue item	2018-19 Actual $M	2019-20 Estimate $M	2020-21 Estimate $M	2019-20 Variance $M	2020-21 Variance $M	Total Variance $M
Taxation revenue						
Payroll tax	4,160	4,200	3,679	-121	-796	-917
Transfer duty	3,195	3,041	2,536	-12	-669	-681
Other duties	1,549	1,583	1,585	-34	-111	-145
Gambling taxes	1,333	1,258	1,371	-156	-96	-252
Land tax	1,334	1,407	1,493	-112	-105	-217
Motor vehicle reg.	1,850	1,896	1,948	-14	-25	-39
Other taxes	745	1,181	1,223	-131	-98	-229
Total	14,165	14,566	13,835	-579	-1,900	-2,479
Royalties						
Coal royalties	4,372	3,517	2,196	-179	-1,108	-1,287
Petroleum royalties	454	466	303	-83	-288	-371
Other royalties	393	513	465	-18	-18	-36
Land rents	159	151	152	-17	-17	-34
Total	5,378	4,647	3,115	-297	-1,433	-1,730

Source: Adept Economics based on Queensland Government estimates. Columns 5 and 6 report the differences between the estimates presented in the C-19 FER (columns 3 and 4 of this table) and the corresponding estimates made in the 2019-20 MYFER.

2.2 Expenses

The state government has significantly increased its expenditure during the pandemic, up by $6.7 billion or 5.6% relative to the previously expected total across 2019-20 and 2020-21 (Table 8).

Table 8. COVID-19 FER Queensland General Government expense estimates and variations from MYFER estimates

Expense item	2018-19 Actual $M	2019-20 Estimate $M	2020-21 Estimate $M	2019-20 Variance $M	2020-21 Variance $M	Total Variance $M
Employee expenses	24,019	25,657	26,296	146	508	654
Super interest cost	642	346	238	0	-35	-35
Other super expenses	3,012	3,104	3,171	7	4	11
Other operating expenses	16,490	17,264	16,966	2,088	1,150	3,238
Depreciation & amortisation	3,451	4,033	4,248	82	160	242
Other interest expenses	1,581	1,508	1,679	-36	42	6
Grants expenses	9,647	11,704	11,778	1,565	1,066	2,631
Total expenses	**58,842**	**63,617**	**64,375**	**3,854**	**2,893**	**6,747**

Source: Adept Economics based on Queensland Government estimates. Columns 5 and 6 report the differences between the estimates presented in the C-19 FER (columns 3 and 4 of this table) and the corresponding estimates made in the 2019-20 MYFER.

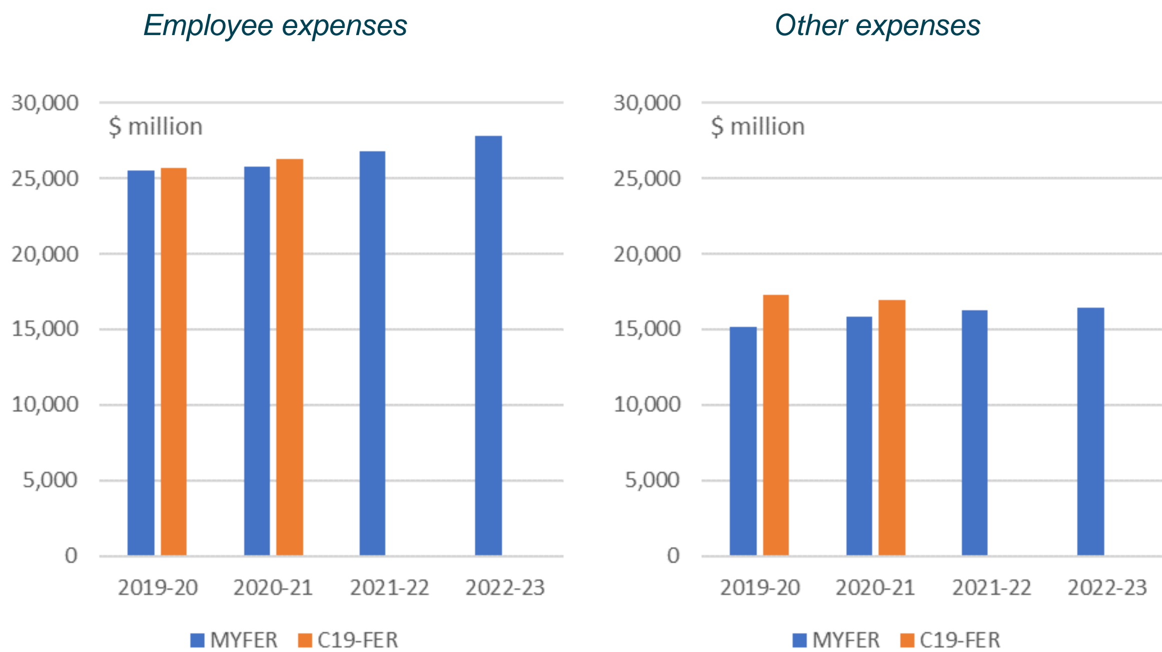
Other operating expenses, which could be on a wide range of items including contractors and supplies, account for nearly half of the increase, while grant expenses (e.g. payments to local governments, schools, Community Service Obligation payments to GOCs, First Home

Owners' Grants, etc.) account for around two-fifths of the increase. among other payments. Employee expenses only account for approximately 10% of the increase.

That said, employee expenses growth is expected to exceed the benchmark of average population growth set by the Queensland Government. In the COVID-19 FER, it is reported that two-year average FTE growth in 2020-21 would be 2.2% compared with the expected two-year average population growth on 1¼%.[8] While the Queensland Government could be forgiven for missing this benchmark in the current circumstances (of unforeseen expenses growth and population growth), there nonetheless remains a concern that the growth of the Queensland Public Service over the past 5 or so years is not sustainable in the long-run.

The growth in other expenses is far more pronounced than growth in employee expenses (Figure 7). But future employee expenses growth will begin at a higher base than otherwise and we account for this in our modelling.

Figure 7. Employee and other expenses, Queensland General Government



Source: Queensland Treasury estimates.

The State Government has also committed to $3 billion worth of savings measures over four years. An extensive list of measures has been released, including efforts to cut down on new

[8] Queensland Government (2020) *COVID-19 Fiscal and Economic Review*, p. 24.

hires and executives in the public service, defer new ICT projects, and eliminate program replications across agencies (see Appendix 1). Treasurer Dick has commenced implementing what he has defined as major savings measures, such as rescinding the contracts of nearly 40 staff involved in an IT project which should save approximately $600,000 per month.[9] We would note that $3 billion of identified savings would be completely offset by additional spending out of the Government's "war chest" it has provisioned for with additional borrowing.

We note that in the rush to find immediate savings, it is often easiest to defer technology upgrades and reduce spending on new hires, particularly at the executive level. However, often these kinds of programs can drive productivity improvements that make the public service more efficient and ultimately save the Queensland taxpayer money. And while reducing replication is an important part of keeping costs down, if it means sacrificing alternative sources of independent advice, the approach may ultimately backfire.

The achievability of this savings target remains unclear. As the QAO report and the analysis in *Beautiful One Day, Broke the Next* show, the Government has failed to limit spending growth to its estimates in the past. If anything, the savings measures will probably just prevent future expenses burgeoning further than they already have as a result of the COVID-response.

Note not all measures have a direct one-to-one impact on the budget balance. For instance, concessional loans, which are loans provided by the government on more favourable terms than those offered by the market, are "treated as an expense on initial recognition and unwound over the loan term".[10] The concessional elements are equivalent to the loan discount portion of the concessional loan that would otherwise have to be covered by loan recipients if they received market-based rates.

The accounting treatment of concessional loans is particularly relevant to this round of budget forecasts due to the $1 billion *Concessional Jobs Support Loan Facility (CJSLF)* administered by the Queensland Rural and Industry Development Authority. The CJSLF will provide 10-year term loans of up to $250,000, waiving repayments and interest payments for the first year and only charging two years of interest at a fixed 2.5% per annum rate.[11]

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[9] Horn, A. (2020) "Queensland treasurer finds $3 billion saving in public service belt tightening", ABC News, 9 July 2020.
[10] Australian Government (2019) *Uniform Presentation Framework: For the Presentation of Uniform Financial Information by Commonwealth, State and Territory Governments*, p. 36
[11] https://www.qrida.qld.gov.au/current-programs/covid-19-business-support/queensland-covid19-jobs-support-scheme

Although providing up to $1 billion in loans, only the concessional elements (i.e. interest payments covered by Government) will be accounted for as an expense.

The Queensland Government has also established a $150 million loan facility for Queensland universities in Cairns and the Gold Coast. The Government intends to recoup the loans through a repayment program that is expected to span over the next five years.[12] Given the significant impact of the reduction in overseas student enrolments on university budgets, in our view, it is likely that universities will seek to defer or roll over these loan facilities.

[12] Queensland Government (2020) $150 million to back Qld universities during COVID-19, 2 August 2020, media release.

3. Operating statement forecasts and projections

3.1 Overview of the operating statement

The operating statement presents core financial aggregates and provides insight into the economic and fiscal health of an organisation or institution. The 2019-20 MYFER reported a very slim operating balance in the General Government sector of $151 million, which will not withstand the economic damage caused by the Commonwealth and Queensland Government's response to COVID-19, as Treasurer Dick has already acknowledged. The inability of the Queensland Government to constrain its spending in the past has, in large part, placed Queensland in a less favourable position to tackle the coronavirus than otherwise. One of the central justifications for surplus budgets is to pay down debt and have sufficient fiscal firepower (i.e. borrowing capacity) for unexpected economic shocks, such as COVID.

3.2 Methodology adopted to produce operating statement forward estimates

We have taken the Queensland Treasury's COVID-19 FER estimates as the new baseline and have consequently incorporated their estimates for 2018-19 and 2019-20 which appear reasonable based on information to date. That said, we know that the estimated deficit for 2019-20 could increase due to spending from the unallocated $3 billion "war chest". This would not affect the debt estimates considered in the next section as that borrowing is already incorporated in the forward estimates of borrowings.

Broadly speaking, for 2021-22 and 2022-23, we estimate line items in the General Government sector operating statement by making plausible assumptions regarding the percentage by which they will fall short of the estimates made in the December 2019 MYFER. This is based on either our estimates of the output gap (discussed above) or a conservative assumption regarding what lost revenue (relative to the baseline) has been recovered. As MYFER 2019-20 did not produce estimates for 2023-24, as that financial year was not then in the window of the forward estimates, we estimated 2023-24 line items by growing our 2022-23 estimates by our assumed rate of nominal GSP growth in 2023-24 (i.e. 5.25%).

The following revenue line items are assumed to be dependent on the output gap (i.e. the variation of GSP from its previously projected growth path at the time of the December 2019 MYFER):

- payroll tax;
- transfer duty and other duties; and
- gambling taxes and levies.

Other revenue items are much less sensitive to economic conditions and hence we adopt different assumptions in producing forward estimates. Specifically, we assume:

- half of grants revenue, which is approximately the GST receipts component, is sensitive to the output gap;
- other taxes (i.e. land tax, motor vehicle registration, and other taxes) return to levels forecast in MYFER 2019-20 in 2021-22 and 2022-23;
- all other revenue items (including royalties and other revenue, sales of goods and services, interest income, dividend and tax-equivalent income) are assumed to have only recovered 75% of lost revenue (relative to the MYFER baseline) in 2021-22, but recover to the MYFER baseline estimates by 2022-23.

Assumptions made for expenses in the forward estimates are as follows:

- employee expenses are assumed to grow from the higher base established in 2020-21, at the same rate as employee expenses growth previously incorporated in the forward estimates (i.e. 3.8% to 4.0% per annum);
- other operating expenses are assumed to revert back to MYFER 2019-20 estimates with some additional spending from emergency measures beyond the current financial year added in (see below);
- depreciation and amortisation are assumed to grow over the forward estimates from the higher base established in 2020-21, at the growth rates in the MYFER-2019-20 estimates;
- superannuation interest cost and other interest costs remain at the level of 2020-21 to reflect the likelihood of persistently low interest rates over the forward estimates;
- grants expenses and other super expenses are assumed to revert back to MYFER 2019-20 estimates; and
- the Government's planned savings program will be offset over the forward estimates by additional spending from the unallocated $3 billion “war chest”.

We have also allowed for $200 million of additional operating expenses and $100 million of capital spending in 2021-22 as a result of some spending from the emergency measures spilling over into next financial year.

Finally, note the estimates include additional interest expenses based on applying an assumed average interest rate on new borrowings from QTC of 1.25% per annum, which is broadly consistent with Australian state government bond yields. For instance, on 11 September 2020, the yield on ten-year NSW Treasury Corporation bonds reported by the RBA was 1.27%.[13] QTC is likely borrowing close to this rate as the penalty for not having a AAA rating has declined substantially in recent years.

3.2 Updated operating statement estimates

Adept Economics estimates of the main aggregates in the General Government sector operating statement are presented in Table 9. These estimates are based on Queensland Treasury's estimates reported in the COVID-19 FER for 2018-19 to 2020-21 but extended with Adept Economics' projections for 2022-23 and 2023-24, so a full set of budget forward estimates is presented. In our view, the budget position will worsen in 2019-20 and 2020-21 before recovering from 2021-22 onward, but with a persistent output gap limiting the pace of recovery. We expect the fiscal balance in the General Government sector to improve from -$13.1 billion in 2020-21 to -$2.8 billion in 2023-24. In our view, it will be a long road towards a sustainable budget position, which Queensland may not achieve until the end of this decade.

[13] Available via the Statistical Tables page on the RBA's website www.rba.gov.au.

Table 9. Queensland General Government Sector Operating Statement, main aggregates, $ million

Budget item	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
A. Revenue from transactions	59,834	57,719	56,239	60,880	63,225	66,545
B. Expenses from transactions	58,842	63,617	64,375	63,704	64,802	66,271
C. Net operating balance (A-B)	992	-5,898	-8,136	-2824	-1576	274
D. Net acquisition of non-financial assets	3,182	3,421	4,948	5,291	2,958	3,113
E. Fiscal balance (C-D)	-2,191	-9,318	-13,084	-8,115	-4,534	-2,839

Source: Estimates from 2018-19 to 2019-20 are the official estimates in the COVID-19 FER and estimates from 2021-22 to 2023-24 are Adept Economics' projections. N.B. Calculations may not work out exactly due to rounding.

In 2019-20 and 2020-21, expenses are expected to exceed revenue by a large margin before returning to be roughly in balance in the subsequent three years. Across the period 2019-20 to 2023-24, the aggregate net operating balance in the General Government Sector is estimated to be a deficit of over $18 billion. After adding in the net acquisition of non-financial assets (i.e. infrastructure investment less depreciation and other asset movements), the aggregate fiscal balance over the five years is a fiscal deficit of $37.9 billion. This figure represents the amount of borrowing needed by the State Government to meet its service delivery and infrastructure investment obligations over the period.

These estimates represent a substantial deterioration in the Queensland Budget position from that reported in the 2019-20 MYFER (Table 10). The estimates in this table show the difference between the estimates in Table 9 above and the estimates which were presented in the 2019-20 MYFER in December 2019. For example, the $13,084 million fiscal deficit (i.e. negative fiscal balance) now expected in 2020-21 is $8,451 million larger than the $4,633 million deficit in 2020-21 that was expected at the time of MYFER in December 2019. The deterioration in the fiscal balance in the General Government sector over the five-year period amounts to $20 billion or a doubling of the accumulated fiscal deficits over the period.

Table 10. Queensland General Government Sector Operating Statement, main aggregates, deviation of forward estimates from 2019-20 MYFER estimates

Budget item	2019-20 $ million	2020-21 $ million	2021-22 $ million	2022-23 $ million
A. Revenue from transactions	-2,195	-5,476	-2,486	-1,969
B. Expenses from transactions	3,854	2,893	933	751
C. Net operating balance (A-B)	-6,049	-8,370	-3,419	-2,718
D. Net acquisition of non-financial assets	-798	81	99	0
E. Fiscal balance (C-D)	**-5,250**	**-8,451**	**-3,518**	**-2,719**

Source: Adept Economics estimates, based partly on reported Queensland Treasury estimates.

The contributions of different budget items to the deterioration in budget balances over the forward estimates are shown in Table 11. The variations in budget items represent the differences between the values now expected (a combination of Queensland Treasury's estimates and Adept Economics' projections) and what was presented in the 2019-20 MYFER in December 2019. Across the forward estimates, the deterioration in the operating and fiscal balances are a result of both increases in expenses and investments and significant deteriorations in a range of revenue sources. For example, revenue deteriorations account for 59% of the deterioration in the net operating balance, while expense variations account for the remaining 41%.

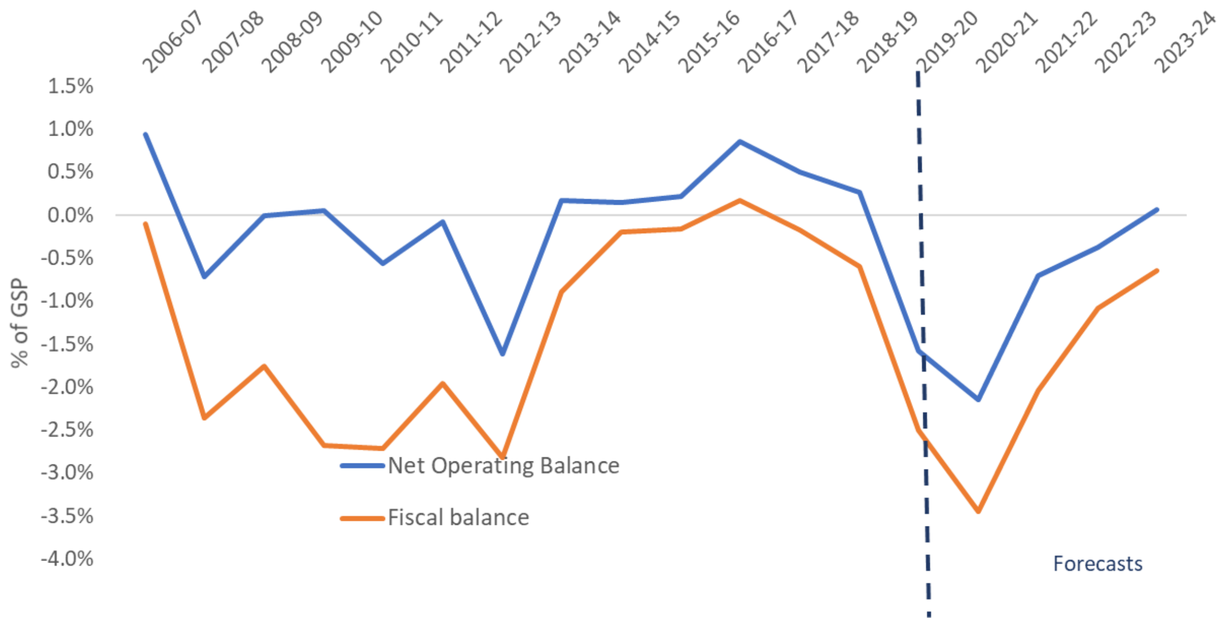
Table 11. Sources of deterioration of budget balances from MYFER 2019-20 estimates

Budget item	2019-20 $ million	2020-21 $ million	2021-22 $ million	2022-23 $ million
Net operating balance – MYFER	151	234	595	1142
Additional expenses	3,854	2,893	933	751
Variations in revenue items	-2,195	-5,476	-2,486	-1,969
Transfer/stamp duty	-12	-669	-231	-253
Payroll tax	-121	-796	-326	-364
Royalties	-297	-1,433	-394	1
Grants	-692	-1,253	-1,053	-1,109
GOC earnings	-292	-166	-51	0
Other	-781	-1,159	-431	-244
Net operating balance – revised	-5,898	-8,135	-2,824	-1,577
Net acquisitions of non-financial assets – MYFER	4,219	4,867	5,192	2,958
Additional net acquisitions of non-financial assets	-798	81	99	0
Fiscal balance – revised	-9,319	-13,083	-8,115	-4,535

Source: Adept Economics estimates, based partly on reported Queensland Treasury estimates. N.B. Figures may not add precisely or match totals in previous tables due to rounding.

The expected budget deficits will be substantially worse than what was experienced during the Global Financial Crisis (GFC) (Figure 8). The fiscal deficit is estimated to be over 4% of GSP, compared with a peak of around 3% of GSP in the years following the GFC and then at the end of the mining boom in 2012-13.

Figure 8. Estimated budget balances as percentage of Queensland GSP



Source: Adept Economics, 2020.

3.3 Public debt interest

The growing stock of debt will lead to annual interest payments of around $1.8-1.9 billion by 2023-24. This will amount to nearly 3% of revenue in the General Government sector. If interest rates rise from their historically low levels in the future, the interest bill could increase substantially. It would be very difficult to model this scenario as it would require modelling of the maturity structure of the debt and its refinancing.

To provide some context, the yield on 10-year Commonwealth Government bonds has been significantly higher than the current yield (in 2020) of just under 1%.[14] For example, for the whole 10-year Commonwealth bond series since 1969, the average monthly yield is 7.75% although this period included the high inflation period of the 1970s and 1980s. The average yield on 10-year bonds since formal RBA independence in 1996 (which helped significantly to tame inflation) is 4.71% and the average yield since 2010 is 3.14%. Without undertaking a full study of the likely trajectory of bond yields in the future, in our view it would seem more likely than not that borrowing rates will rise from the current low levels of around 1% to

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[14] Queensland Government/QTC bonds will trade at higher yields than Commonwealth Government bonds. The spread can range from under 10 basis points (0.1 percentage points) to 50 basis points (0.5 percentage points) depending on market conditions.

between 3-5% once central banks unwind extremely accommodative monetary policy. This will, in turn, increase borrowing costs for the Queensland Government's borrowing authority, the Queensland Treasury Corporation.

In the long-run, if the interest rate that QTC is able to borrow were to rise to say 5% per annum, then the annual interest bill of the Queensland Government would be $3 billion based on expected borrowings from QTC of $68 billion by mid-2024. It should be noted this is a hypothetical calculation and a fuller analysis would require modelling of the evolution of Queensland Government debt, its maturity structure, and how it is refinanced over time.

4. Debt metric impacts

4.1 Overview of the balance sheet

The balance sheet reports the projected assets, liabilities and net worth of the General Government Sector or Non-financial Public Sector as at 30 June each financial year. It represents the *stock* of government assets and liabilities as opposed to the *flow* of income and expenditure reported in the operating statement. It is, accordingly, a snapshot of the Government's financial health, and its various metrics such as gross debt, net debt, and net worth, are relevant in assessing the Government's overall financial position.

In the analysis in this section, we focus on financial assets and liabilities, as these are typically the focus of attention by rating agencies, given non-financial assets are a lot less liquid.

4.2 Methodology for calculating balance sheet forward estimates

4.2.1 Assets

As a base for the forward estimates, we use the estimates produced by Queensland Treasury in the COVID-19 FER. The value of assets held by the Queensland Government has deteriorated as a result of the COVID-19 crisis. As QIC's CEO Damien Frawley told the Economics and Governance Committee of the Queensland Parliament on 22 June 2020:

> *While equity markets have clawed back a significant proportion of losses, the volatility and sharp fall driven by COVID-19 should not be underestimated. Other asset classes are still feeling the impact of precautionary measures taken to manage the pandemic. Unlisted assets such as infrastructure and real estate have been significantly impacted by the shutdown, with assets such as shopping centres, airports and sea ports notably impacted.*[15]

Hence, as expected, the COVID-19 FER has revealed a decline in the value of Queensland's financial assets as a result of the COVID-crisis. Total financial assets were written down from an expected $60.4 billion at 30 June 2020 to $58.5 billion. This resulted

[15] Queensland Parliament Economics and Governance Committee, *Public Briefing—Inquiry into the Queensland government's economic response to COVID-19: Transcript of Proceedings, Monday 22 June 2020, Brisbane*, p. 3.

from reductions in investments, loans and placements—largely managed by QTC—from $31.5 billion to $29.4 billion, and reductions in the value of equity in GOCs from $23.7 billion to $22.1 billion. The value of investment, loans and placements (and also cash and deposits and advances paid) is relevant to the calculation of net debt below. For simplicity, in 2021-22 and 2022-23, these assets are assumed to revert to their MYFER 2019-20 estimated values. In 2023-24, they are all assumed to grow at the same rate as nominal GSP (i.e. an assumed 5.25%).

4.2.1 Borrowings

Borrowings (and hence debt) is assumed to increase in accordance with the increase in the fiscal deficit in each year over the forward estimates. Two adjustments are made to this simple formula, however, to reflect:

- the pre-financing of $3 billion of additional spending (from the so-called "war chest"), with the debt already incorporated in the forward estimates; and
- additional cash coming back to the government with the repayment of various loans it has made as emergency measures, which will reduce the borrowing requirement.

It is very difficult to forecast how these factors will affect the Government's borrowing requirement in any one year, so we have made simple assumptions to take them into account. Specifically, it is assumed:

- pre-financing of spending reduces the borrowing requirement by $1 billion in each of the years 2021-22 to 2023-24, and
- loan repayments from approximately $2 billion of loan programs will bring back $400 million in cash back to the Government in each of the years 2021-22 to 2023-24.[16]

These assumptions are relatively favourable to the Government, in our view, and we are also assuming that it can find the $3 billion of savings as planned, which will provide the cash that can offset the $3 billion of additional borrowings to fund the "war chest".

For simplicity, and because changes to borrowings are the major component to changes in liabilities, we assume other liabilities (largely leases) are unchanged from MYFER 2019-20 estimates for 2021-22 and 2022-23 and remain at the same value in 2023-24 as in 2022-23.

[16] It should be noted here that there is no information available to estimate loan terms or the likely proportion of bad debts.

4.3 Balance sheet estimates

Total gross debt in the Non-financial Public Sector is expected to increase to $110-115 billion before the middle of the decade (Table 12). The $70-75 billion of general government debt expected by mid-2024 will have to be directly serviced by the operating budget, resulting in higher interest payments that will detract from frontline services or require higher taxes and charges than otherwise in the future. As noted above, we believe the assumptions we have made are relatively favourable to the Government, as we have assumed they can achieve their savings targets. If this were not the case, gross debt would reach $116 billion by mid-2024.

Table 12. Queensland gross debt estimates, $ million

Budget item	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
General Government	32,202	44,226	60,903	67,618	70,753	72,192
Total (NFPS)	70,909	84,936	101,962	108,890	111,578	113,017

Source: Adept Economics estimates. Actual figures for 2018-19 are from the Queensland Government MYFER 2018-19. NB. Debt is inclusive of leases, securities, and derivatives.

The deterioration of Queensland's public finances reinforces the need for the Government to come up with a credible long-term fiscal strategy to stabilise and ideally eventually reduce the important debt-to-revenue and debt-to-GSP ratios (Table 13).

The deterioration in the metrics in Table 13 (below) demonstrate the urgent need to reconsider the Queensland Governments so-called fiscal rules that are set out annually in the State Budget. These rules are often adjusted and sometimes weakened by incoming governments to suit political needs. That said, it is clear from this analysis of the Queensland Government's overall fiscal position that more work needs to be done on developing a set of sustainable fiscal rules that aligns with the Queensland Government's (and ultimately the Queensland taxpayers) financial management responsibility. As part of this, the whole State Sector should be the frame of evaluation and measures such as the fiscal balance, which includes the borrowing requirements for infrastructure spending, should be favoured over the operating balance.

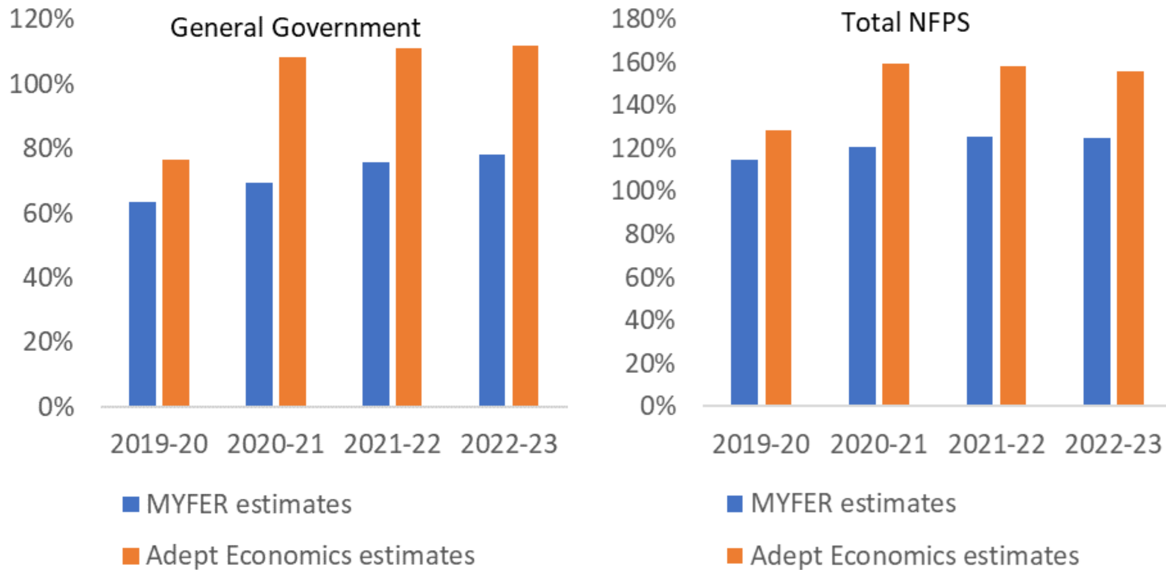
Table 13. Queensland debt ratio estimates

Metric	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
General government debt-to-revenue ratio	53.8%	76.6%	108.3%	111.1%	111.9%	108.5%
Total (NFPS) government debt-to-revenue ratio	103.8%	128.3%	159.0%	158.3%	155.6%	149.8%
General government debt-to-GSP ratio	8.7%	11.9%	16.1%	17.0%	17.0%	16.5%
Total (NFPS) government debt-to-GSP ratio	19.2%	22.8%	26.9%	27.5%	26.8%	25.8%

Source: Adept Economics estimates. Actual 2018-19 estimates are from the Queensland Government MYFER 2018-19. NB. Debt is inclusive of leases, securities, and derivatives.

These crucial public finance metrics are expected to deteriorate substantially compared with what was expected at the time of the 2019-20 MYFER and will be of concern to rating agencies. Figure 9 (below) illustrates the difference between the 2019-20 MYFER gross debt estimates and the Adept Economics (mid-September 2020) estimates, which are largely based on the 1-page press release from the Queensland Treasurer released on 28 July 2020 and the subsequent 40-page COVID19-FER release on 7 September 2020. In both the General Government Sector and the Non-financial Public Sector, gross debt has increased significantly as a result of the Commonwealth and Queensland Government's response to the global COVID pandemic.

Figure 9. Comparison of debt metric estimates with MYFER 2019-20 estimates



Source: Adept Economics estimates. NB. Debt is inclusive of leases, securities, and derivatives. NFPS stands for the Non-financial Public Sector.

The Queensland Government was not meeting its own fiscal targets before its (and the Commonwealth Government's) response to the coronavirus plunged the state into a deep recession. Moreover, various attempts at budget repair prior to COVID have been ill-advised, to say the least, and, in some cases, ham-fisted. For instance, the Queensland Future Fund has not been a genuine debt reduction strategy vehicle, as it has merely shuffled funds around on the State's balance sheet.

Furthermore, the comparison of the Queensland Future Fund with the NSW Generations Fund, the NSW debt retirement fund, is invalid because that fund was largely seeded with money raised by privatising WestConnex, a Sydney motorway, which converted an illiquid asset into a liquid asset, which arguably might be viewed favourably by the rating agencies (Box 1).

Box 1. NSW Generations Fund

The NSW Generations Fund (NGF) is NSW's sovereign wealth fund. The NGF is primarily designed to maintain debt levels in line with a triple-A credit rating while growing the Government's budget balance to allow for investment into infrastructure projects. By law, funds within the NGF can only be used for the purpose of "paying down debt, or funding community services and facilities projects".

Funding allocations from the fund are overseen by the NSW Generations Fund Advisory Board, chaired by Glenn Stevens AC. The NSW Government, NSW Treasury and NGF Advisory Board have partnered with the NSW Treasury Corporation to manage the standalone entity, very long-term investment fund.

My Community Project (MCP) was the first community initiative to receive funding from the NGF. The MCP is a vote-based scheme that supports community-based projects voted on by NSW residents. As of 15 August 2019, 61,437 votes from the community saw 248 successful projects receive a total of $24.7 million in funding.

The NGF was seeded with $10 billion at its inception in late 2018 and was valued at $10.9 billion as at 30 June 2019. The initial investment was made up of $7 billion acquired from the sale of a 51% stake in WestConnex and $3 billion from balance sheet reserves. The fund has been supplemented with $300 million in additional funds since the 2019-20 Budget was handed down and is forecast to grow to more than $30 billion by 2030.

Sources: NSW Government (2019) NSW Generations Fund Annual Report 2018-19 and NSW Budget website.

The failure of the Queensland Future Fund is evident in the Government having to radically revise down the amount of funds it would pull out of the Employer Fund at QIC—invested to cover the defined benefit superannuation liability—from $4 billion to just $1 billion, because of the deterioration in global economic conditions which meant it needed to leave more money in the Employer Fund.

On the Future Fund, our final point is that even if rating agencies agreed in principle to give special recognition to the Future Fund—despite the fact it has no material impact on budget aggregates—that agreement would be likely only for a Future Fund full of liquid assets, not one full of illiquid assets such as the Titles Registry and Cross River Rail.

The future is too uncertain now to speculate regarding what will happen to Queensland's credit rating. Many governments around the world are in challenging fiscal positions, and

Queensland is already not on the highest rung of credit ratings, having lost its AAA rating in 2009. It is possible the ratings agencies could put Queensland on “negative watch.” Much will depend on whether the Queensland Government can demonstrate a credible long-term fiscal strategy to stabilise and eventually reduce debt.

Given the poor state of the economy and hence the available excess capacity, now is not the time for austerity. That said, now is also not the time for ill-considered spending measures simply to boost economic activity in the short-term. Spending must be targeted to those public services most needed and investment towards those projects most likely to boost economic activity in the long-term.

In this regard, the Queensland Government should consider introducing credible fiscal rules such as an expenditure growth constraint related to long-run revenue growth which it could apply immediately. Of course, the long-run revenue growth rate will be higher than current actual revenue growth, allowing the Queensland Government to run operating deficits over the next two to three years.

The Government could also reconsider whether it could undertake some “no regrets” asset sales or leases which would provide much needed budget flexibility and provide funds it could use to pay down debt in the future and reduce the ongoing interest bill.

Related to this, the Government has been lucky interest rates have been so low, but if it needs to borrow or refinance at higher interest rates in the future, the growing interest bill could become a major burden on Queensland taxpayers. With loose monetary policy in play all over the world, the probability that real interest rates will eventually rise is significant in our view.

4.4 Updated net debt estimate

Net debt in the General Government sector is estimated to grow from $14.2 billion in 2019-20 to over $40 billion by 30 June 2023, compared with the $21.3 billion which was expected by 30 June 2023 at the time of MYFER 2019-20 (Table 14). This increase represents a substantial deterioration in the net debt position of the General Government sector, which is the metric which tends to be favoured by commentators attempting to downplay concerns over growing debt. Even using the narrower net debt figure for the General Government sector, there is no escaping the uncomfortable reality that Queensland’s fiscal position is expected to deteriorate rapidly from an already precarious starting point.

Table 14. Queensland General Government net debt, $ million

Balance sheet item	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Borrowings, leases, and securities & derivatives	32,201	44,226	60,903	67,618	70,753	72,192
Deposits held and advances received*	2,692	1,844	1,527	1,485	1,584	1,667
Debt for net debt calculation	34,893	46,070	62,430	69,103	72,337	73,859
*Less Financial assets for net debt calculation***	*35,092*	*31,878*	*36,841*	*31,462*	*31,300*	*32,943*
Net debt	**-198**	**14,192**	**25,589**	**37,641**	**41,037**	**40,916**

*Source: Adept Economics estimates, based partly on reported Queensland Treasury estimates. Actual 2018-19 estimates are from the Queensland Government MYFER 2018-19. *For simplicity, these are assumed to be unchanged from the estimates at the time of MYFER 2019-20. **Financial assets for the net debt calculation include cash and deposits, advances paid, and investments, loans, and placements. The estimate of financial assets appears artificially high in 2020-21 because the Government is pre-financing its $3 billion "war chest". N.B. Calculations may not work out exactly due to rounding.*

5. Discussion

5.1 Queensland's fiscal situation pre-COVID-19

The Queensland Audit Office (QAO) published the 2018-19 audit of Queensland Government state finances on 11 February 2020. The QAO's report indicates that Queensland's fiscal position was in a precarious position prior to the pandemic outbreak and that "financial performance of the Queensland Government has reduced over the last two financial years".[17] In particular, the QAO flagged concerns around:

- expenses increasing at a faster rate than its revenue streams over the last two financial years;
- a declining share of GST grants following a review of the Commonwealth Grants Commission's methodology for assessing state fiscal capacity; and
- the government's intention to borrow to invest in capital works over the forward estimates.

Despite maintaining the view that Queensland held sufficient investments to meet its future superannuation obligations and that increasing borrowings remained sustainable over the short-term, the QAO said both need to be managed carefully. Furthermore, the QAO recommended that expenses should be reeled in to match revenue growth to improve financial sustainability, and that fiscal headroom should be secured to handle emerging and unforeseen liabilities.[18]

The QAO report identifies an important relationship between expenditure and revenue growth. In a highly cyclical economy like Queensland's, which is dominated by the resources and tourism sectors, it is both more prudent and more manageable to link year-to-year expenditure growth to the long-run growth in revenue (say over 10 years) given the cyclical nature of the Queensland economy.

The QAO also rightly identifies that sufficient 'fiscal headroom' should always be available to have the capacity to respond to unforeseen events and liabilities. While this point is true, it is also critical that the Queensland Government continues to enhance its project prioritisation and selection processes to ensure that the Queensland taxpayer is well-served by the multi-

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[17] Queensland Audit Office (2020) *Queensland Government state finances: 2018–19 results of financial audits*, Report 11: 2019–20, p. 1.
[18] Queensland Audit Office (2020) *Queensland Government state finances: 2018–19 results of financial audits*, Report 11: 2019–20.

billion dollar economic and social infrastructure built. If particular economic or social infrastructure projects are considered to enhance the welfare of Queenslanders, then there is no reason not to pursue them.

5.2 Future debt burden and fiscal sustainability

Based on the analysis presented in the previous sections, Queensland's fiscal position is estimated to deteriorate substantially from an already precarious starting position. This deterioration will impose an ongoing burden on the budget through higher interest payments and reduced fiscal flexibility (or headroom). Even at the historically low rates at which the Queensland Government can currently borrow, around 1-1½% per annum, the additional $30 billion of General Government debt expected as a result of the COVID-crisis will cost up to $450 million in interest payments per annum. And then there is the risk that borrowings will need to be refinanced at a higher rate in the future. The additional interest payments will take Queensland's General Government interest bill to around, and possibly over, $2 billion per annum, compared with the $1.5 billion that was expected in 2019-20 at the time of the 2019-20 MYFER.

Failure to take corrective budgetary action in recent years has now placed Queensland in an unfavourable fiscal position to handle the pandemic. Prior to the COVID-19 pandemic, the state budget debt metrics, such as net debt-GSP and borrowings-revenue ratios, which were already projected to blow out over the forward estimates, were poor.

In July 2019, credit rating agency Moody's, monitoring the debt levels of Australian states, cautioned in a research note that:

> *… The funding requirements of Australian states project a significant increase in debt over the four years to fiscal 2023, averaging around AUD45 billion per year, which in conjunction with narrowing operating margins will weaken states' credit profiles.*[19]

In the 2019-20 MYFER, it was forecast that NFPS total debt would increase to around $92 billion and the debt-to-revenue ratio would increase to nearly 125 percent by 2022-23.[20] Since the pandemic, Queensland's fiscal position has deteriorated further. According to

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[19] https://www.moodys.com/research/Moodys-Australian-states-face-rising-debt-burdens-from-growing-revenue--PBC_1186549

[20] Queensland Government (2019) *Mid Year Fiscal and Economic Review 2019-20*, p. 35.

Moody's (2020), the Queensland Government will have to service more debt, nominally, than any other state in Australia.[21]

The Government has made much of its Queensland Future Fund, even though it does not generate any new funds in net terms for the Government and is not a long-term strategy to stabilise or pay down debt. Furthermore, the deterioration of the economic outlook since December 2019 when it was announced has meant that its composition is largely different from what was proposed initially.

5.3 Credit rating

Access to credit is of vital importance to economies in times of fiscal distress and burgeoning debt levels. Australia and Queensland have so far maintained their strong credit ratings throughout the pandemic. S&P and Fitch have revised Australia's outlook to negative, but according to Moody's the nation's fiscal position remains stable (Table 15).

Table 15. Australian and Queensland Government credit ratings

Rating agency	Queensland	Australia
S&P	AA+ Stable	AAA Negative
Moody's	Aa1 Stable	Aaa Stable
Fitch	AA Stable	AAA Negative

Source: rating agencies, 2020.

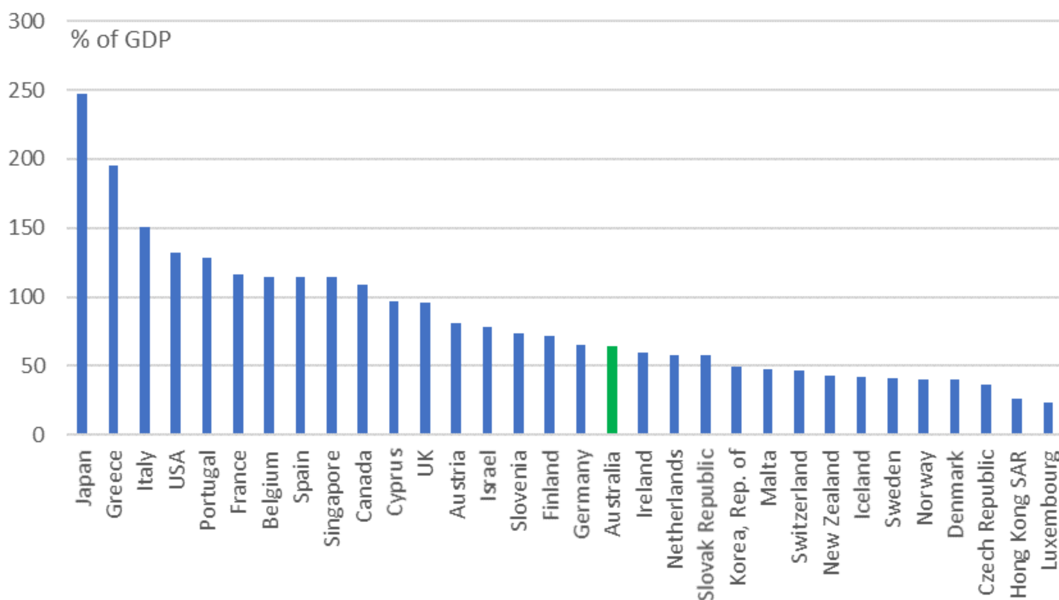
Fitch and S&P both acknowledged that a credit downgrade for Australia is possible if corrective strategies are not employed to stabilise fiscal and economic conditions. A suppressed global economy and sharp increases in expenditure and government debt are expected to produce a large fiscal deficit at the federal level. Australia's strong performance on the health front was recognised as coming at a significant cost to business and economy more broadly. As Fitch put it:

[21] Manning, J. (2020) *Debt burdens surge amid pandemic; but strong fiscal starting positions, institutional capacity preserve credit profiles,* Regional & Local Governments – Australia Research, 2.

> *While these measures have effectively curbed the spread of the virus, they also constrained household consumption and reduced business sentiment and investment.*[22]

Despite taking on an historic level of debt, Australia's nationwide fiscal metrics remain strong relative to other major economies. According to the IMF's April 2020 *Fiscal Monitor*, Australia remains well below the average debt accumulated by advanced economies in terms of gross debt position as a percentage of GDP (see Figure 10). This figure does not account for additional expenditure measures such as the JobKeeper extension.

Figure 10: Gross public debt position (% of GDP) of advanced economies, IMF estimates for 2021



Source: IMF Data Mapper, 2020.

Rating agencies appear relatively sanguine of the debt blowouts affecting state budgets, and one has even expressed support for RBA Governor Philip Lowe's call for the states to engage in greater economic stimulus spending. On 22 August 2020, *The Australian* reported:

[22] https://www.fitchratings.com/research/sovereigns/fitch-revises-australia-outlook-to-negative-affirms-rating-at-aaa-21-05-2020

Ratings agencies backed the call from the central bank. Standard & Poor's Global Ratings analyst Anthony Walker said: "State government balance sheets have plenty of room to accommodate additional infrastructure investment."[23]

These views miss the point about the relationship between the quality of infrastructure spending and future economic growth and income levels. As many prominent economists have noted, if new public economic or social infrastructure doesn't provide an adequate return to society then GDP per capita falls, not rises, over the long-term (relative to where it would otherwise be).

Moody's is the only credit rating agency to have officially revisited Queensland's credit rating since the outbreak. In a research paper published July 2020, Moody's announced that Queensland would preserve its credit profile rating of Aa1. Moody's qualifies this viewpoint by acknowledging that a material deterioration in budgetary outcomes can be expected for all states in 2020 and 2021, and significant budgetary repair measures will need to be implemented once the outbreak has been resolved.[24] Rising debt burden, narrowing fiscal buffers, and economic activity propped up by debt-funded public spending, along with revenue shocks and increased expenditures were cited as applying "heightened downward pressure on state credit profiles".[25] Queensland's easy access to low-interest global funding markets was acknowledged as a point of strength for handling the fiscal pressures of the pandemic. This highlights the importance of Queensland's current credit rating, and the significance of a possible downgrade.

5.4 Coverage of defined benefit superannuation liability

Queensland is the only state to fully fund a defined benefit superannuation scheme. The defined benefit superannuation liability is covered by investments managed by QIC. According to the State Actuary, there were $26,937 million (i.e. $26.9 billion) worth of assets allocated to the scheme as at 30 June 2019.[26] At an Inquiry into the Queensland government's economic response to COVID-19, responding to a question regarding the

[23] Benson, S. and Commins, P. (2020) "Coronavirus: RBA governor Philip Lowe calls on states to spend extra $40bn", *The Australian*, 22 August 2020.
[24] Manning, J. (2020), p. 2.
[25] Ibid.
[26] State Actuary's Office, Queensland Treasury (2020) *Actuarial Investigation of QSuper as at 30 June 2019*, p. 22.

coverage of the defined benefit superannuation liability, State Actuary Wayne Cannon reported that, up until the week prior to 22 June 2020:

> *…assets are 10 per cent higher than the level of vested benefits that would be payable to members. So it is still in a surplus position would be my answer to that question.*[27]

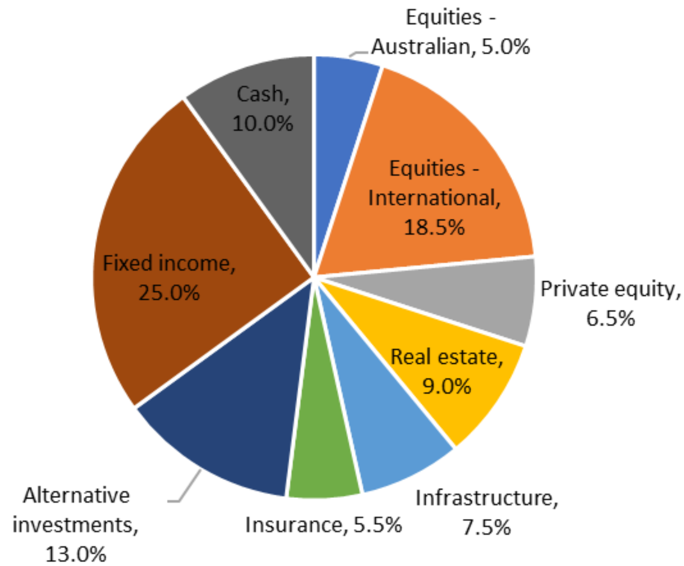
This suggests that the Government's investment options still adequately cover the defined benefit superannuation scheme despite impacts of the coronavirus on financial markets around the globe.

There is a State Government guarantee to pay its defined benefit superannuation liability, which they are legally obliged to do, and there appears little risk it will never be able to pay these given a government's legal power to raise taxation levels. However, if it has set aside insufficient funds to pay defined benefit superannuation, then it will need to find the money from the budget, possibly meaning less money spent on frontline services or higher taxes and charges than otherwise.

The coverage of the super liability varies with economic and financial market conditions. State-owned QIC invests the funds on the Government's behalf in a range of assets (Figure 11).

[27] Queensland Parliament Economics and Governance Committee, *Public Briefing—Inquiry into the Queensland government's economic response to COVID-19: Transcript of Proceedings, Monday 22 June 2020, Brisbane,* p. 12.

Figure 11. Target asset allocation for Employer Fund



Source: State Actuary's Office, Queensland Treasury (2019) Actuarial Investigation of QSuper as at 30 June 2019, p. 23.

This could change though if global equity markets deteriorate or property values are substantially written down. It is considered by many that US equities in particular are over-valued. Partly this has been driven by Quantitative Easing, which raises the nominal prices of assets in an economy (i.e. it could be inflationary).

Figure 12. S&P 500

Source: MacroBond, 2020.

With the information we have been provided we have been able to produce a back of the envelope estimate at how the Defined Benefit fund has fared during the pandemic. In the 2019-20 MYFER, Queensland Treasury explained that:

> *The Queensland Future Fund will be seeded with an initial $5 billion investment, $2 billion redirected from the Government's existing debt retirement plan and a further $3 billion invested from the surplus in the Defined Benefit fund. The Defined Benefit fund will continue to remain in surplus.*[28]

Then, in an update on Queensland's fiscal position on 23 July 2020, Cameron Dick reported that the Queensland Future Fund would instead be made up of:

- At least $4 billion from the Titles Registry;
- At least $160 million from Cross River Rail precincts; and
- Only $1 billion from the Defined Benefit Scheme.[29]

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[28] Queensland Government (2019) *Mid Year Fiscal and Economic Review 2019-20*, p. 3.
[29] Queensland Government (2020) Media Release: Update on Queensland's fiscal position, 23 July 2020.

In the *COVID-19 Fiscal and Economic Review* of 7 September 2020, it was revealed that, regarding the Debt Retirement Fund (DRF), a sub-fund of the Queensland Future Fund:

> *The Government has commenced due diligence on a range of assets to be transferred into the DRF, based on their growth potential. The Titles Registry, government equities and $1 billion from the Defined Benefit Fund surplus have been factored into this C19-FER as they are planned to be transferred to the DRF by 30 June 2021, meeting the initial target of $5 billion.*
>
> *Other assets that will be subject to due diligence include government land and property.*[30]

Assuming that Treasurer Dick intends to maintain at least a small surplus in the Defined Benefit fund, which is a very safe assumption, it appears that the fund may have declined in value by up to $2 billion as the Queensland Treasurer is only now willing to transfer $1 billion instead of the initial $3 billion proposed by his predecessor.

5.5 Potential fiscal principles for Queensland

5.5.1 Introduction to fiscal principles

For many years, Queensland governments of both persuasions have published fiscal principles (or rules) as part of their annual budget reporting. These principles, in theory, hold the government of the day to account against their own financial management guidelines. For example, in the 2000-01 State Budget, the then Queensland Government identified five relatively strong (albeit quite general) fiscal principles, as follows:

i. Competitive tax environment
ii. Affordable service provision
iii. Capital funding whereby: “Borrowings or other financial arrangements will only be undertaken for capital investments and only where these can be serviced within the operating surplus, consistent with maintaining a AAA credit rating”.
iv. Managing financial risk whereby: “The Government will ensure that the State’s financial assets cover all accruing and expected future liabilities of the General Government Sector”.

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[30] Queensland Government (2020) *COVID-19 Fiscal and Economic Review*, p. 20.

v. Building the State’s net worth.[31]

These fiscal principles, which have effectively acted to encourage governments to stay close to balanced budgeting, have been adjusted slightly from budget to budget and, arguably, have been weakened in recent years. Indeed, the 2012 Commission of Audit found that: “In the past, Government failed to meet, on a consistent basis, the fiscal principles articulated in its own Charter of Fiscal Responsibility. And it failed to apply sufficient rigour and discipline to the evaluation and project management of major infrastructure investments in recent years.”[32]

The Commission observed:

> *There is an urgent need to restore the highest standards of financial management to public administration – with an enhanced long term financial planning framework, improved budget, cash and asset management, and greater transparency and accountability.*[33]

In our view, this observation remains as true today as it did in 2012. The current Queensland Government has arguably focussed more on financial gymnastics and accounting tricks than on a genuine commitment to adhering to its own fiscal guidelines. And with COVID being the ‘rainy day’ that the fiscal principles are meant to ensure adequate provision for, the failure to adhere to these guidelines has manifested in an astonishingly poor set of forward estimates that have been hidden from the Queensland people in the recent budget update.

Incidentally, a recent QAO report on the Queensland Government response to COVID-19 has drawn attention to deficiencies in program oversight, consistent with the Queensland Government still not meeting the highest standards of financial management. The Auditor-General observed in the QAO report published 22 September:

> *While collating this report, we were unable to obtain information on some aspects of the response measures. Both Queensland Treasury and the Department of the Premier and Cabinet told us that, although they are involved in coordinating the response, they do not have complete information about what the uptake rates of the individual measures are.*

[31] 2000-01 Queensland State Budget, Box 1.2 The Fiscal Principles of the Queensland Government. Accessed: https://s3.treasury.qld.gov.au/files/budget-paper-2_2000-01.pdf
[32] Queensland Commission of Audit Final Report 2013. Volume 1 Executive Summary and Recommendations (p.1-17).
[33] Ibid.

> *We recognise that government agencies have had to work under extraordinary circumstances during the pandemic, rapidly designing response measures to unprecedented events. However, it is critical that the effectiveness of the government's response is monitored and assessed to determine whether program outcomes have been achieved. This requires fit-for-purpose governance and reporting arrangements at a whole-of-government level.*[34]

It goes without saying that there is likely to be a high degree of inefficiency and ineffectiveness in government programs in such circumstances, with much wasted public money.

5.5.2 Fiscal rules adopted by Queensland Governments

Table 16 below illustrates a number of the Queensland Government's fiscal rules at three different points in time in the past decade.

The first fiscal metric relates to debt and, at the 2012-13 Budget, the Queensland Government targeted total debt across the Non-Financial Public Sector, which includes the Government Owned Corporations (GOCs). As at the 2015-16 Budget, the debt target had been narrowed to the General Government sector. The metric remains unchanged in 2019-20.

The second metric relates to the annual operating balance. In 2012-13 the Queensland Government targeted the fiscal balance, which includes provisions for infrastructure investment (see discussion below). As at the 2015-16 Budget, this metric was weakened to allow for fiscal deficits to fund up to 50% of new infrastructure investment in the General Government sector. The metric remains unchanged in 2019-20.

The third metric relates to maintaining a competitive tax environment for Queensland businesses. In 2015-16, the Queensland Government put a precise ceiling on the target of "at or below 8.5% of nominal GSP". While there are advantages to applying a taxation ceiling in relation to GSP, the problem is that the Queensland economy is highly cyclical and as a result so are revenues relative to GSP with leading and lagging taxes affecting the metric (see discussion below). Further, the efficiency of taxation matters as much as the level of taxation, and it would be more sensible in our view for governments to aim to raise revenue

[34] Queensland Audit Office (2020) *Queensland Government response to COVID-19*, Report 3:2020-21.

in the least economically distorting way as opposed to setting a ceiling with seemingly no theoretical or empirical justification apart from the 8.5% figure being the long-run average.

The fourth metric relates to fully funding the Queensland Government's ongoing and long-term liabilities such as WorkCover and public sector superannuation. This principle has been least subject to adjustment over the years with reliable bipartisan support. However, in recent years the current Queensland Government has used excess funds (i.e. funds beyond what is deemed actuarially required) to prop up its operating balance via one-off reductions in the General Government Sector debt (resulting in a lower interest bill) and to maintain the accounting gimmickry of the Queensland Future Fund. But the Government has got itself into trouble by announcing a large and risky withdrawal only to later backtrack as stock market returns fell due to COVID and hence more capital was required to be preserved in the fund (discussed above).

Finally, a new fifth metric relating to the growth in the public service has been introduced. While a laudable goal, pegging the growth in the public service to a ceiling of medium-term population growth is, in our view, only a second-best option and would not work in a number of situations including during COVID where the demand for additional public servants is high (e.g. nurses and police) while the rate of population growth in Queensland is very low (or perhaps even declining).

What really matters is: (i) whether the size of the public service is sustainable, (ii) is fit-for-purpose, and (iii) the efficiency of service delivery. These criteria should be evaluated both from the ground-up and the top-down (see related infrastructure discussion above). To the extent that a public service growth ceiling can drive public service sustainability, efficiency and value-for-money, a better top-down metric would be to target population growth as a moving average (over say 5 years) less an efficiency/productivity factor to account for continual improvement in service delivery efficiency (supported for example by investing in new technology).[35] However, this type of target could only be contemplated until a review of the public service has been completed to ensure that the current baseline (in terms of size and services delivered) is at about right.

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[35] Since 1981, Queensland's average annual rate of population growth has been 2% per year. If the 5-year moving average population growth was 2% per year and the efficiency factor 5%, then the target ceiling for the growth in the public service would be: 2% - {2%*5%} = 1.9%. For example, if the size of the Queensland Public Service was 250,000 employees in Year-1, then the difference between applying the two growth rates to Year-2 would be (5,000 – 4,750) = 250 employees.

In terms of a ground-up approach, a better metric would be to benchmark the size and performance of the QPS against other jurisdictions with a similar geographical and population structure to Queensland both at a macro level and also by government service (e.g. teachers, nurses, police). In this way, an assessment can be made whether the initial number of public servants is right for Queensland. Further, the assessment can provide a target ceiling in terms of the number of *public servants per capita* as opposed to a medium-term population growth target.

Table 16. Changes in Queensland Government's fiscal rules from 2012-13 budget to 2019-20 budget

2012-13 Budget	2015-16 Budget	2019-20 Budget
Stabilise then significantly reduce debt in the NFPS	Target ongoing reductions in Queensland's relative debt burden, as measured by the General Government debt to revenue ratio	No change
Achieve and maintain a General Government sector fiscal balance	Target net operating surpluses that ensure any new capital investment in the General Government Sector is funded primarily through recurrent revenues rather than borrowing	No change
Maintain a competitive tax environment	Maintain competitive taxation – own-source revenue to remain at or below 8.5% of nominal GSP	No change
Target full funding of long-term liabilities such as superannuation in accordance with actuarial advice	Target full funding of long-term liabilities such as superannuation and WorkCover in accordance with actuarial advice	No change
Not used	Not used	Maintain a sustainable public service by ensuring that overall growth in full-time equivalents (FTE) employees, on average over the forward estimates, does not exceed population growth.

Source: Queensland Government Budget Papers 2012-13, 2015-16 and 2019,20

5.5.3 Guidance on fiscal principles

While the purpose of this report is not to recommend a new set of fiscal principles, some useful points can be made.

First, because Queensland is a highly cyclical economy Government own-source revenues are often difficult to predict let alone target as a proportion of GSP. This in turn makes it difficult to manage expenditure such that consistent and credible (as opposed to contrived) small surpluses in the General Government Sector Operating Statement can be reliably achieved.

Other highly resource dependent economies, such as Norway (oil) and Chile (copper) for example, try to average out these revenue fluctuations by investing excess revenue in a sovereign wealth fund to be accessed by future generations. However, given Queensland's reliance on its royalty revenue to fund concurrent expenditure, a better approach would be to set a sustainable target for the long-run growth in its expenditure. This target, in nominal terms, should be no more than the long-term nominal growth rate in GSP, and potentially somewhat less in order to encourage and maintain the efficiency of government service delivery.[36]

Over the 29 years from 1989-90 to 2018-19, Queensland's GSP grew by 6½% per year in nominal terms and by 3¾% per year in real terms (indicating a long-run inflation rate of 2¾%). The four components of the nominal GSP growth rate are the so-called 3-P's (productivity, participation, population) and inflation. Queensland's long-run population growth rate is 2% (discussed below). The participation rate has risen over time, mainly driven by the increased rate of female labour force participation, offset to some extent by declining male labour force participation. However, this trend growth has largely levelled off (notwithstanding current COVID labour market effects). Productivity growth has contributed, on average, between 1-1½% per year to Queensland's economic growth.

Accordingly, in our view, the Queensland Government should explore the feasibility of targeting the long-run nominal GSP growth rate as the absolute maximum ceiling for nominal expenditure growth on average over the forward estimates. An efficiency or productivity factor of, say, between 0.1 and 0.5 percentage points, could be applied to this ceiling to drive continual improvement in public sector service delivery and value for money such that the effective nominal expenditure growth target is between 6% and 6.4% per year. An

[36] If the nominal expenditure growth rate was larger than the nominal GSP growth rate, then the size of the public service as a share of GSP would grow larger.

advantage of linking the expenditure growth target to GSP growth is that, by and large, Commonwealth Government grants and GST repatriation is correlated to the size of the Queensland economy.[37]

Second, fiscal headroom matters to provide governments with the fiscal firepower to manage an economic crisis such as COVID. In other words, there are significant risks to running debt levels at close to the debt ceiling. This is not to say, however, that Queensland is at or near its debt ceiling. Nevertheless, the Queensland Government should make it a fiscal principle to, at the very least, not suffer another downgrade.

While Queensland is well below its maximum potential debt ceiling, the size of the state's debt is now so large relative to revenues that, even with continual small operating surpluses, it would take decades to eliminate debt in the General Government Sector. These operating surpluses are required to fund annual infrastructure investment such as for roads and hospitals meaning that without a major re-assessment of policy, it is virtually impossible to see Queensland substantially paying down its General Government debt.

Third, strong governance processes around infrastructure project selection and prioritisation are important to make sure the Queensland taxpayer is getting the best value for money for its investments. This is particularly important for multi-billion-dollar megaprojects such as Cross River Rail. In this regard, it is disappointing that Treasurer Dick announced that Building Queensland, notwithstanding its own serious governance flaws that affected its perceived and actual independence, not to mention sluggishness, would be absorbed back into Queensland Treasury. Ironically, Building Queensland was a 2015 State Election commitment of the current Government's designed to demonstrate a commitment to transparency, independence, objectivity, and rigour. And yet five years later, BQ along with its worthy remit are no more. A future Queensland Government would benefit from establishing an independent advisor on major infrastructure project selection, prioritisation and governance.

There have been numerous proposals for sustainable fiscal principles. One general principle of debt dynamics is that if the interest rate on borrowings is greater than the growth rate of the economy, interest payments will rise as a share of the economy over time. There would be a point where this is unsustainable and a serious effort to reduce debt would be required. At a time of historically low interest rates, some macroeconomists (such as the current RBA

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[37] Note that this approach assumes that the current size and performance of the public service is already at the 'ideal level'. We recommend that this assumption be tested before new fiscal principles are applied. Further, any efficiency factor applied would be subject to periodic review.

Governor) have argued that now is the time to expand borrowing to support increased public infrastructure investment. While it is true that the opportunity cost of new investment is low when the economy is operating at below capacity, not having a debt ceiling to force real project prioritisation is dangerous. Rather than set a macro goal for public infrastructure investment, each proposal should be considered on its merits, with ideally a full business case and cost benefit analysis being provided to the public for scrutiny. One important lesson from the past is that it is often wiser to adopt continual marginal improvements to existing public infrastructure (i.e. 'squeezing the lemon') before choosing the more expensive and riskier 'big bang' option.

Concerning the current COVID recession and dramatically rising debt levels, in our view, a zero fiscal balance (i.e. neither a deficit nor surplus) *on average* over the economic cycle would be a reasonable fiscal target once Queensland Treasury is confident that Queensland's economic growth rate has returned to trend (possibly adjusted down for an expected lower population growth rate). However, if Queensland returns to its previous relatively strong population growth rate then it would be possible to successfully target declining debt-to-revenue and debt-to-GSP metrics at the same time as running small fiscal deficits.

Assuming Queensland's population growth rate returns to trend, then targeting small fiscal deficits in the General Government Sector on average over the economic cycle whereby more than 50% of new infrastructure investment is funded out of operating surpluses would be sustainable.[38] Importantly, the fiscal balance recommendation is less about maintaining fiscal headroom for the bad times (as the risk of default remains low) and more about encouraging Cabinets to make the tough policy choices between competing expenditure and investment options at all times.

In terms of the GOCs, these firms are generally regulated and, in theory, borrow to invest in commercially viable infrastructure to achieve a commercial return. Governments should allow GOCs to operate on a commercial basis and not direct them to invest in uneconomic infrastructure or price services at below marginal cost without providing compensation via community service obligation payments. Governments should allow GOCs to retain sufficient profits (i.e. financial assets) to reinvest in their businesses to maintain reliable and efficient

[38] While it is true that the amplitude of economic cycles has greatly decreased, particularly since the beginning of independent monetary policy, the Queensland economy remains relatively highly cyclical due to its dependence on a number of key globally exposed industries (such as resources and tourism). That said, often the resources and tourism cycles counter-balance each other because of the impact of exchange rate movements.

network infrastructure while at the same time providing a commercial return to the Queensland taxpayer. This is often a difficult balancing act. If GOCs are operating on commercial terms in the best interests of their shareholders (i.e. the Queensland taxpayer) then, *by assumption*, their borrowings are efficient and should not be subject to an overall borrowing ceiling. That said, given that the Queensland taxpayer is ultimately ‘on the hook’ to cover GOC debt via potentially higher utilities prices or increased future taxation if things go bad, it is worth thinking about setting an overall annual limit to the fiscal balance in the NFPS.

Finally, we should note that this discussion has not offered precise fiscal targets because it is outside the scope of this report to do so. In our view, regardless of the outcome of the Queensland State Election, the new government would be well served to seek independent advice on the adequacy of its fiscal principles in light of the COVID recession and ongoing challenges with reducing Queensland’s high debt burden.

5.6 Worst case scenario

Finally, we have considered what might be considered a worst case scenario, in which GSP growth is weaker in the current financial year, assuming 0% nominal growth (resulting in an additional $300 million write down in revenue in 2020-21), the economy only grows at 4% per annum over 2021-22 to 2023-24, and the Government fails to achieve its savings targets and instead uses any savings to fund additional spending (in addition to that pre-financed by the “war chest”). In this scenario, our model estimates that, by mid-2024, General Government debt could end up at $77 billion and total NFPS debt could end up at $118 billion.

Table 17. Queensland budget estimates, worst case scenario, $ million

Budget item	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Net operating balance	992	-5,898	-8,436	-3,248	-2,277	-483
Fiscal balance	-2,191	-9,319	-13,384	-8,539	-5,235	-3,596
General Government debt	32,202	44,226	61,203	69,342	74,177	77,373
Total (NFPS) debt	70,909	84,936	102,262	110,614	115,002	118,198

Source: Adept Economics estimates. NB. Debt is inclusive of leases, securities, and derivatives.

Actual 2018-19 estimates are from the Queensland Government COVID-19 FER.

6. Conclusion

This paper has built on the COVID19-FER released by Treasurer Cameron Dick on 7 September 2020 by providing budget estimates for 2021-22 to 2023-24. These additional years would normally be reported in the Queensland Budget's forward estimates.

Queensland's fiscal outlook is now even worse than what was suggested by the discouraging figures presented by Treasurer Cameron Dick in his partial budget update on 23 July 2020. Own-source revenues have declined substantially and expenditure has risen as would be expected in the middle of an economic crisis. Both net debt and gross debt have increased significantly, putting Queensland's credit rating in jeopardy once again in our view.

Given the poor state of the Queensland economy, now is not the time for austerity, but the Government could consider introducing stronger fiscal rules such as a nominal expenditure growth constraint tied to the long-run growth in nominal GSP (as a maximum ceiling) and targeting the fiscal balance in the General Government Sector. These stronger principles could be potentially applied from 2021-22 after a comprehensive review of the state of the government's finances was undertaken and, of course, only if the threat of the pandemic subsides in the next 9 months.

Linking the growth in nominal government expenditure to long-run nominal GSP growth (rather than directly to revenue growth) is more likely to be a smoother and more sustainable fiscal principle. In our view, the Queensland Government should set the long-run nominal GSP growth rate as the absolute maximum ceiling for nominal expenditure growth. An efficiency or productivity factor of, say, 0.5 percentage points, should be applied to this ceiling to drive continual improvement in public sector service delivery and value for money such that the effective nominal expenditure growth target is 6% per year.

Of course, there are many intricacies to consider, especially given that half of Queensland's revenue is sourced from the Commonwealth via direct grants and the return of GST revenues. That said, by and large, Commonwealth Government grants and GST repatriation is closely linked to the size of the Queensland economy.

The formula for calculating Queensland's GST share is complicated and the dollar amount is often hard to predict over the medium term. For instance, as a result of COVID, the total amount of GST revenue will shrink in line with Australia's overall economic contraction. In other words, the total GST pie will be smaller. Moreover, given that Victoria's economy has

been affected significantly more than any other state, it is probable that in the medium-term a greater share of Queensland's and NSW's GST revenues will flow to Victoria.

The Queensland Government should be open to considering whether it could undertake any "no regrets" asset sales or leases, which would release funds that it could use to pay down debt in the future and, therefore, reduce the ongoing interest bill. The Government has been lucky interest rates have been so low, but, if it needs to borrow or refinance debt at higher interest rates in the future, the growing interest bill, increasing to around $2 billion per annum over the forward estimates, could become a major burden on Queensland taxpayers. We note here that low global interest rates are more of a central bank policy choice than a result of excess global savings relative to investment opportunities.

On our assessment, the Government is set to run substantial deficits for the next several years at least and total debt will climb to $110-115 billion by mid-2024, and possibly to around $116 billion if the state government fails to achieve its announced $3 billion in savings targets. A 'worst case' scenario would see total debt climb to $118 billion and possibly higher. Based on our central scenario, the amount of debt would represent approximately 154% of total government revenue in 2023-24 in the NFPS. These figures represent our best estimates based on the available information at the time of publication but remain highly uncertain given how rapidly circumstances can change with the virus still spreading through the Australian community and the Queensland Government aiming for zero community transmission.

The expected budget deficits will be substantially worse than what was experienced during the Global Financial Crisis, with the fiscal balance reaching -3½% of GSP in 2020-21. The difference between what occurred during the GFC and its aftermath and now is that the fiscal deterioration is largely the result of the operating side of the budget, rather than because the Government is funding a peculiarly large capital works program (as was the case in 2008-09 and 2009-10).

Given the unprecedented economic and budgetary impacts of COVID, the Queensland Government should revisit its fiscal principles in order to protect the integrity of its public finances. In our view, in addition to the expenditure constraint described above, the fiscal balance in the general government sector should be another fiscal target, from 2021-22 if the health and economic threat of the pandemic has passed. This rule would require all new infrastructure investment in the General Government Sector (such as for roads and hospitals) to be funded out of recurrent revenue on average over the economic cycle. It would, therefore, at times require a reprioritisation between expenditure and investment

needs. This recommendation is as much about maintaining fiscal headroom for the bad times as it is about encouraging Cabinets to make the tough policy choices between competing expenditure and investment options at all times.

So long as the Queensland Government remains well below its potential debt ceiling, as demonstrated by not suffering another credit downgrade, then small fiscal deficits can be tolerated in the general government sector for economic and social infrastructure that is expected to expand the economy and/or increase general government revenues in the future without the need to sacrifice current expenditure commitments.

To sum up the situation as at September 2020, there is no escaping the uncomfortable reality that Queensland's fiscal position is expected to deteriorate rapidly from an already precarious starting point. The Queensland economy is suffering and it will take several years for the economy to once again achieve the high growth, agility and dynamism that have been its hallmarks of past decades. A commitment to sound financial management will greatly assist Queensland returning to its glory days.

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Appendix 1: Savings measures

- Maintain public service positions at 1 July 2020 levels (excluding frontline services) for 12 months in line with the priorities outlined above [creating jobs, building essential infrastructure and delivering frontline services]
- Internal recruitment only to fill non-frontline roles for 12 months
- Limit secondment of frontline staff to non-frontline roles
- Better utilise outer urban government office space to allow more public servants to work closer to home
- Stop the reallocation of non-frontline public service positions into the Brisbane CBD including 1 William Street
- Natural reduction of Senior Executive Service roles
- Consolidation of underutilised government social media accounts
- Six-month hold on non-essential new ICT projects
- Reduce the use of external consultancies and contractors by the government with a view to ending arrangements where possible
- Limit printing of glossy publications to those focused on creating jobs, attracting industries or building economic recovery
- Simplify production of government annual reports to reduce production costs
- Eliminate program replication across agencies
- Cease production of marketing materials except for critical government activities:
    - Essential information on Queensland's Unite and Recover economic plan including tourism, business promotion and investment attraction
    - Public and road safety.[39]

[39] Queensland Government (2020) Media Release: New savings measures for Queensland, Media Release, 9 July 2020.