



Victorian Budget 15 | 16

For Families



Presented by Tim Pallas MP,
Treasurer of the State of Victoria

Strategy and Outlook
Budget Paper No. 2

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2015-16



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for the information of Honourable Members

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CHAPTER 1 – ECONOMIC AND FISCAL OVERVIEW

The Government's first budget delivers on its election commitments and makes responsible investments in the services and infrastructure required to support a growing population and drive growth in the Victorian economy.

Victoria's continued high population growth reflects the attraction of the State as a place to live. However, this growth combined with a changing economy is creating social and economic pressures. To respond to these challenges, the *2015-16 Budget* delivers services more broadly and effectively, and invests in infrastructure to improve the long-term liveability and productivity of Melbourne and regional Victoria.

The budget will boost employment and productivity through a significant infrastructure program. In addition, employment growth will be augmented through targeted investment in funding for the Government's Back to Work Plan, the Premier's Jobs and Investment Panel, the Future Industries Fund and the Regional Jobs Fund. These measures will help create 100 000 jobs.

From 2011-12 to 2014-15, government expenditure on core services failed to keep pace with population growth. To ensure that all Victorians continue to enjoy high quality economic and social infrastructure, this budget restores funding to critical core services, including health and education. A key focus is supporting the most vulnerable, including funding to improve the responsiveness of the child protection system and address family violence issues.

Undertaking the biggest ever investment in the State's education system will lift the quality and condition of learning environments for all Victorians, and ensure that training provision is matched to the needs of the changing Victorian economy.

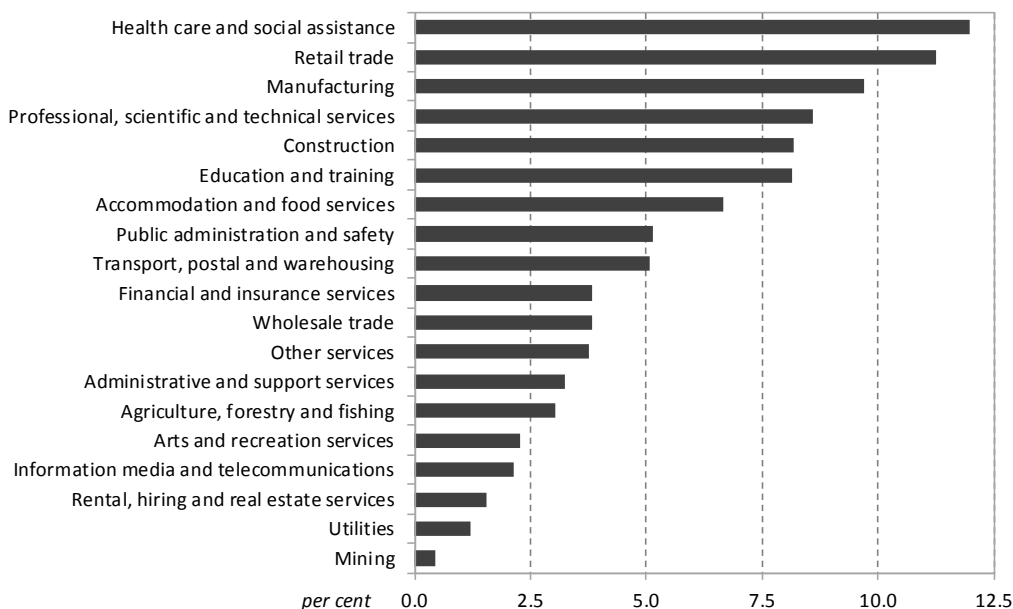
The Government's major projects agenda will sensibly invest in productive, appropriate and economically justifiable transport infrastructure that improves the linkages between Victorians and jobs across the State. The *2015-16 Budget* commits up to \$22 billion total estimated investment (TEI) in new asset initiatives, including \$9–\$11 billion for the Melbourne Metro Rail Project and \$5–\$6 billion to honour the Government's election commitment to remove 50 level crossings.

Underpinning the budget is disciplined financial management which supports the State's triple-A credit rating. The Government is forecasting a strong and responsible operating surplus of \$1.2 billion in 2015-16, with accumulated surpluses over the budget and forward estimates of \$5.8 billion. By June 2019 net debt as a proportion of gross state product (GSP) is expected to be 4.4 per cent, lower than the June 2018 estimate of 4.5 per cent published in the *2014 Pre-Election Budget Update*.

PEOPLE AS THE DRIVERS OF GROWTH

A distinctive feature of the Victorian economy is its reliance on human capital. Compared with the national average, the Victorian economy is driven by industries with a high labour (or human capital) input. This includes a relatively high services share of GSP and a large weighting of knowledge-intensive industries like finance and professional services.

Chart 1.1: Victorian employment share by industry – February 2015



Source: Department of Treasury and Finance; Australian Bureau of Statistics

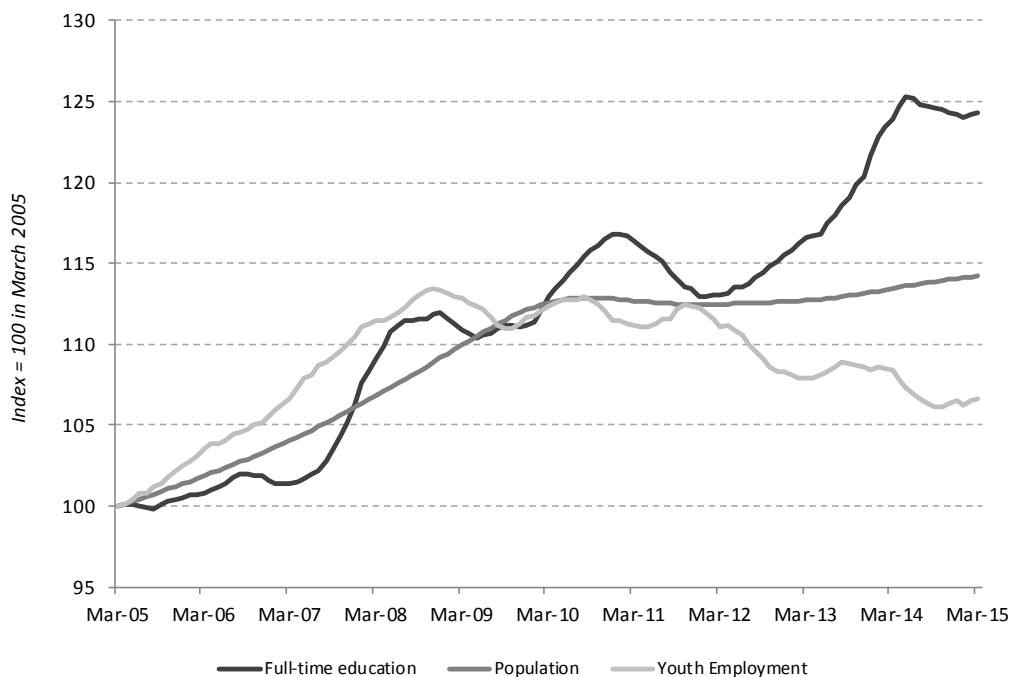
Victoria’s future economic prosperity relies on policies which invest in people by strengthening skills, supporting population growth fostering innovation and efficiently connecting workers with jobs. This requires:

- investing in education: all Victorians need access to high quality education and training, in an advanced learning environment, at all stages of their lives. Significant education investment ensures that Victorians maximise their participation in the workforce;
- investing in health: modern, well-funded health care will ensure that all Victorians can access high quality patient care. This investment delivers better health outcomes and a more productive workforce; and
- addressing Victoria’s growing population: improved public transport and roads will drive productivity and ensure Victorians have efficient and reliable access to jobs markets.

Looking ahead, industries are evolving and require a workforce with greater skills and capabilities. New investments in education and training are required. The Government’s initiatives will provide the critical bridge between industry and job seekers. In addition, the Government can be a job creator, through its investment in services and a sustainable pipeline of infrastructure works.

Young people are at the cutting edge of these developments. They have been disproportionately affected by the recent labour market downturn, and have also moved in increased numbers into full-time study (Chart 1.2). Victoria’s youth unemployment rate rose from 12.3 per cent in early 2014 to 15.0 per cent in early 2015, well above the national average of 13.5 per cent. The rise in the number of unemployed youth over the past year has been driven by the sub-cohort who are in full-time education, reflecting the likelihood that some of the increase in full-time study has been driven by a lack of employment opportunities.

Chart 1.2: Victorian youth engagement in full time education and employment



Source: Department of Treasury and Finance; Australian Bureau of Statistics

Note: 12 month moving average

The budget is focused on people. Victoria’s diversity of industry is its strength, and the Government is committed to ensuring that these remain the pillars on which our State grows.

PUTTING PEOPLE AND FAMILIES FIRST

Growing jobs and the economy

In meeting future challenges, Victoria starts from a position of competitive strength: a skilled workforce, diverse industry base, liveable cities and regions, and strong transport links. The *2015-16 Budget* builds on these strengths by making responsible investments that prepare this generation to compete in the global economy.

Through the Back to Work Plan, \$100 million will be made available to provide financial assistance to businesses hiring people at risk of being excluded from the labour market, including unemployed youth, the long-term unemployed and retrenched workers. The Premier's Jobs and Investment Panel will see the Government work with economic and industry leaders to invest \$508 million over five years to drive growth and jobs in Victoria. This includes funding to establish the 'start-up' initiative, a \$60 million body to bring our most promising and innovative ideas to life through business case development, investment attraction and intellectual property advice.

The \$200 million Regional Jobs Fund will focus on creating jobs and industries that are vital to the continued economic prosperity of rural Victoria. The focus will be on partnering with local government and business to make the most of regional Victoria's strengths and attractions.

The budget actively supports Victoria's competitive advantages through initiatives that leverage our world-class education and research institutions, and develop our strategic growth sectors. By investing in these sectors, workers will be given avenues to transition to jobs that allow them to leverage their existing capabilities and develop new skills. Six sectors have been identified as having strong growth and jobs prospects. These are:

- medical technology and pharmaceuticals;
- new energy technology;
- food and fibre;
- transport, defence and construction technology;
- international education; and
- professional services.

The growth of these sectors is being actively encouraged to position Victoria as a high-skill, high-wage economy, commencing with the establishment of the \$200 million Future Industries Fund.

Supporting small businesses

Victoria's small businesses are a vital part of our economy. Over 500 000 small businesses provide employment for Victorians, often in high-skilled, high-wage jobs. The Government is delivering a package of measures that will reduce the costs of running a small business, make it easier for small businesses to compete and provide greater access to the public sector market.

The costs of complying with regulatory requirements will also be reduced. The Government will undertake a comprehensive review of legislation and regulation that impacts on small business. Regulation will be removed or redesigned if it has an unjustified or excessive impact on small businesses. Regulators will be subject to performance improvement targets to reduce the burden they impose on small businesses in the administration and enforcement of regulation.

To ease the burden on small businesses, regulators will also be required to work together to develop simpler, more user-friendly compliance plans to reduce the time small businesses spend in complying with regulation.

Small businesses in border towns in particular will benefit from Automatic Mutual Recognition, which will eliminate the need to be licensed in multiple states to do the same work in different locations.

The Government will exempt all vehicles classified as mobile plant (under 4.5 tonnes) and plant-based special purpose vehicles (over 4.5 tonnes) from motor vehicle stamp duty from 1 July 2015. These vehicles include body types such as backhoes, excavators, bulldozers, headers, scrapers, tractors and off-road water sprayers.

The Government will work with the Commonwealth and other states and territories to address anti-competitive behaviour and competitive neutrality issues identified in the Harper Review of Competition Policy, and their impact on small business.

Public sector procurement will operate to create more opportunities for small businesses to provide goods and services to government departments and agencies. Smaller contracts that can be delivered by small firms will be offered where appropriate, along with a commitment to pay within 30 days for contracts below \$3 million.

Chapter 2 *Economic context* provides further information on economic conditions and the outlook for the Victorian, Australian and international economy.

Chapter 3 *The jobs challenge* provides more information on Victorian labour market trends, and their economic and social implications.

Creating the Education State

Victoria's economy is changing, with more employment on offer in industries that require greater skills and qualification levels. The biggest investment in the education sector in the State's history targets resources to create a world-leading education and training system. This will support Victorians embracing the opportunities that the future economy offers.

Investing in early childhood development

High quality and accessible children's services ensure that Victorian parents can be confident that their children are getting the best possible start in life. Recognising the importance of early childhood education, the *2015-16 Budget* provides \$50 million over four years for local councils to construct new, and upgrade existing, early learning facilities and expand other early childhood services across Victorian regional and metropolitan areas.

The Government is also providing \$9 million over four years for early childhood intervention services and flexible support packages to assist children with a disability or developmental delay, and their families.

Investing in our schools

The *2015-16 Budget* implements the Government's Back to School commitments.

School funding for 2016 and 2017 fully reflects Victoria's obligations under the Gonski agreement. The Government's education strategy will be driven by the key principles of the Gonski Review that:

- all students should have access to a high standard of education regardless of their background; and
- a key priority is to reduce educational disadvantage by targeting resources to the most disadvantaged students, and to schools with a high concentration of disadvantaged students.

The Government will implement its election commitments to ensure transparency of school funding allocations and deliver improved school performance outcomes through additional investment.

Funding of \$2.9 billion over four years is provided for school education across Victoria to improve every child's learning outcome and student experience. In addition, \$567.5 million is being spent on school capital programs to improve classrooms, with further works to modernise and regenerate school facilities across Victoria.

The Government will set out the key changes for improving school outcomes and reducing educational disadvantage ahead of the 2016 school year, following consultation with stakeholders. The Government will also commission a review of school funding and allocations which will provide a basis for schools funding beyond 2017.

Investing in vocational education and training

The Government is committed to a strong and responsive training system to develop the skills required to grasp new economic opportunities.

Ten new technical schools will be established across the State. Catering to students in Years 7 to 12, they will focus on local industries and be backed by local providers.

The Government will strengthen the TAFE sector as a central element of the training system by investing \$300 million into the TAFE Rescue Fund to reopen closed campuses, upgrade buildings, workshops, laboratories and classrooms, and support those institutes under financial stress. Funding of \$40 million over four years is provided to establish the Victorian Skills Commissioner and to continue funding for local learning and employment networks.

In addition, the Government is providing \$50 million for the TAFE Back to Work Fund for TAFEs to develop and expand courses that align with the needs of local employers, including those eligible for the Back to Work Scheme. The fund will allow TAFEs to better meet the training needs of businesses that hire unemployed youth, the long-term unemployed and retrenched workers.

To guide future investment decisions, the Government has established a VET Funding Review to consider how to improve the quality, stability and sustainability of the Victorian training market.

A modern health care system

High quality and accessible health services are critical to Victorians enjoying a better quality of life and increased productivity. The *2015-16 Budget* provides an additional \$1.3 billion over four years for health services to respond to growing patient demand across Victoria and ensure more hospital patients can receive the highest standard of care. This funding also includes investment in rural and regional healthcare to address the inequality of health outcomes in these areas.

The *2015-16 Budget* provides funding to modernise Victorian hospitals, increase the capacity of public hospital infrastructure and improve health outcomes. This includes \$200 million for the new Western Women's and Children's Hospital and \$106.3 million to expand Casey Hospital to help meet demand from growing populations in Melbourne's west and south-east. A further \$85 million is allocated to expand acute health services at the Werribee Mercy Hospital through constructing six additional operating theatres and 64 new inpatient beds. The budget also provides \$20 million for an intensive care unit and short stay unit at the Angliss Hospital in the outer east and \$10 million for a new cardiac catheterisation laboratory at Ballarat Health Services which will provide urgent heart assessment, treatment and care.

Funding of over \$150 million over four years is allocated for Victorians with a disability, their families and carers. The *2015-16 Budget* also invests \$111.8 million for mental health, including \$88.2 million to meet service demand for intensive, specialist clinical support.

Improving emergency service management

Reflecting the importance of the State's emergency services, funding is being provided to ensure responsiveness and better outcomes for all Victorians. The Government is investing \$99 million to strengthen ambulance services and upgrade ambulance stations and equipment. Funding will enable upgrades to nine existing stations and construction of a new station at Wendouree.

The Government is enhancing emergency fire services to protect local communities. This includes \$43 million to enhance the capacity of the Country Fire Authority by upgrading stations and purchasing new trucks. This new investment is in addition to the revenue collected through the Fire Services Property Levy. Levy rates will not be affected as a result of election commitments being funded in the budget.

Making our communities safer

Victoria's social diversity is one of the State's great strengths. Some groups within our community experience disadvantage and there are social problems requiring urgent attention.

To support new responses to key social challenges and to make our communities safer, significant investment is provided for combating family violence, the impacts of ice addiction and the care of our most vulnerable children. These initiatives include:

- \$81.3 million over five years, with \$57.9 million in 2015-16, to support the Royal Commission into Family Violence and to provide funding in the interim across a range of portfolios to strengthen services' response capacity and capabilities, as well as improve support to survivors of family violence;
- \$65.4 million over four years to employ additional child protection workers to respond to reports of child abuse and neglect, expand the capacity of child protection services and support after hours responses;
- \$48.1 million over four years to strengthen Child FIRST and the Family Services system to assist more vulnerable families each year. This funding will enable the Child FIRST intake and referral system to undertake additional assessments and Family Services to provide more family counselling and parenting skills training;
- \$45.5 million over four years for the Ice Action Taskforce to develop strategies to reduce the demand, supply and harm of the drug ice. This funding will enable individuals and families affected by the ice epidemic to access improved treatment and rehabilitation services, whilst making our communities safer;
- \$39.4 million over four years to support growth in demand for out-of-home care for children who are unable to live safely with their families;
- \$31.4 million over four years to consolidate allowances to provide greater support to carers, helping to meet their costs;
- \$21.3 million over four years to extend the Springboard program, supporting young people to transition from out-of-home care to independent living;

- \$20.8 million over four years to expand placement prevention and reunification services statewide and provide assistance to vulnerable families whose children are at risk of being placed in out-of-home care, and assisting children in out-of-home care reunite with their families; and
- \$11.7 million over four years to support children who cannot return to their parents to transition into permanent care, and provide permanent carers with access to flexible funding to achieve better outcomes.

Maintaining Victoria as the major events capital of Australia

Melbourne is the nation's sporting, arts and cultural capital, home to a number of internationally recognised events and major attractions. Victoria has also developed a strong business events industry which brings thousands of delegates from interstate and overseas to the State annually.

The Government will grow Victoria's visitor economy and make sure the State never loses its edge on major events and tourism. This will enable the Government to pursue an enhanced strategy in this area, whilst expanding the State's footprint into major conventions. The *2015-16 Budget* invests \$80 million to sponsor more major events across Victoria. Funding is also provided to undertake the Stage 2 development of the Melbourne Exhibition and Convention Centre.

The *2015-16 Budget* provides over \$200 million to support Victorian arts, culture, film, television, music and design and give our creative industries a new life. This includes funding to:

- invest in the independent arts sector so more people can get involved;
- support regional galleries and help bring the arts to new regional audiences;
- continue the National Gallery's Summer Program for modern art and design;
- start Music Works to boost Victorian contemporary music and support local jobs; and
- support the Victorian screen industry, including Film Victoria.

The budget also provides \$13.4 million to restore and refurbish the Palais Theatre.

The Government is committed to upgrading stadiums across Victoria, so they can host more events and make room for more spectators. The *2015-16 Budget* invests \$70 million to build a new grandstand at Geelong's Simonds Stadium, improving facilities for spectators and increasing the ground's capacity to 36 000. A further \$25 million is provided to redevelop the historic Junction Oval in St Kilda to create the new home of Victorian cricket, for families and professional players alike.

Infrastructure that addresses Victoria's needs

Victoria needs to have an accessible, efficient and reliable transport and infrastructure system. Significant infrastructure investment will contribute to reducing road congestion, overcrowding on public transport and ensure government services can meet growing demand.

The Government's major projects agenda will deliver a well-planned and integrated transport network, and act as a sustainable pipeline of works that will create jobs and increase productivity. With some projects commencing construction immediately and others being appropriately staged over the medium-term, these projects will generate ongoing activity in the local construction industry and provide a reliable source of economic activity and create around 16 000 jobs.

In order to deliver its major projects agenda in a sensible and sustainable manner, the Government will establish Infrastructure Victoria and Projects Victoria. These bodies will ensure that transport and infrastructure investments are strategically planned and efficiently delivered. The newly created role of Victorian Chief Engineer will further support the focus on ensuring projects are delivered in a timely and efficient manner, as well as overseeing the registration of Victorian engineers. The Victorian Government Architect will complement these activities by providing advice on how to improve design outcomes for capital works and urban design more generally. The Government will also pilot Building Information Modelling (BIM) on select projects to enhance project efficiency and outcomes in delivering buildings and infrastructure, with a potential staged implementation of BIM across infrastructure projects in the future.

The *2014-15 Budget Update* provided funding to advance key asset election commitments including the Level Crossing Removal Program and the Melbourne Metro Rail Project. Building on this investment, the *2015-16 Budget* commits:

- \$9–\$11 billion to deliver the Melbourne Metro Rail Project, including \$1.5 billion over the forward estimates period to complete the planning and design of the project, and to commence construction in 2018;
- \$5–\$6 billion, including \$2–\$2.4 billion over the forward estimates period, to implement the Government's commitments to remove 50 level crossings over eight years to reduce congestion and improve safety for cars and trains;
- \$1.3 billion to purchase 37 high-capacity metro trains for deployment on the Cranbourne-Pakenham rail corridor, and for a new maintenance depot and associated infrastructure upgrade. This will upgrade and transform Melbourne's busiest train line, and free up existing trains to meet demand on other lines;
- over \$600 million to build 20 new E-Class trams, build 21 new VLocity train carriages, and refurbish the Comeng train fleet and B-Class trams; and
- \$150 million for the next stage of the M80 Upgrade, including the upgrade of the Sunshine Avenue interchange, which will provide decongestion benefits at the Sunshine Avenue end of the section, and the upgrade of the EJ Whitten Bridge, which will address safety issues.

Easing road congestion is a significant priority for the Government. The CityLink-Tulla widening project will widen the CityLink and Tullamarine Freeway and introduce a Freeway Management System. It will build capacity, boost performance and improve safety on one of Melbourne's busiest roads. The CityLink-Tulla widening is proceeding under the Market-led Proposals Interim Guideline and will be fully self-funded by Transurban. When combined with the widening of the Tullamarine Freeway to Melbourne Airport, the total cost of the project is around \$1.3 billion, of which the State and Commonwealth Government's contribution is \$273 million. Construction on the project will commence in 2015 and be completed in 2018.

The *2015-16 Budget* also funds planning and early works for major projects. This includes \$40 million for constructing the first stage of the West Gate Distributor project, which will significantly increase productivity for the freight industry and be of significant benefit to Geelong, Ballarat and western suburban road commuters travelling over the West Gate Bridge. The first stage includes widening Whitehall Street to provide an upgraded connection to Footscray Road, and strengthening and widening Shepherd Bridge over the Maribyrnong River.

The Government has received a market-led proposal from Transurban to provide for expanded capacity on the West Gate Freeway and a new connection from the West Gate Freeway to CityLink via a new Maribyrnong River crossing. The proposal has been through stage one and stage two assessments and is currently being considered in stage three under the Market-led Proposals Interim Guideline. The stage two assessment concludes that the proposal has the potential to deliver material benefits to the State, including aligning with the Government's policy objectives and infrastructure priorities. Should the stage three assessment recommend proceeding further with the proposal, the Government would then commence either direct negotiations with Transurban or a competitive approach to project procurement.

The proposal has the potential to create a more efficient and robust transport network by improving connectivity between the west and the CBD, taking pressure off the West Gate Bridge, removing thousands of trucks from suburban roads, and improving the efficiency of freight movements at the Port of Melbourne.

Further details of the Government's major projects agenda are outlined in Budget Paper No. 3, *2015-16 Service Delivery*.

Asset recycling

An important source of funding for the State's infrastructure program is the recycling of state-owned assets. The proceeds from the medium-term lease of the Port of Melbourne will be used to fund investment in new transport-related capital projects through the establishment of the Victorian Transport Building Fund.

Where it is in the community's interest, capital currently tied up in mature businesses can be recycled to build new assets for the benefit of the community, which would not otherwise have been affordable. The Government will consider the potential for future asset recycling opportunities. This approach is enhanced by the Commonwealth Government's asset recycling initiative which provides financial incentives to state and territory governments to divest assets and reinvest the proceeds in new productive infrastructure.

Working with local government

The Government will consider options to support local business communities who work together to invest in services, activities and assets for their collective benefit. This will include a review of legislative and practical barriers to establishing Business Improvement Districts, which have been a successful model in several overseas jurisdictions. The Government will work closely with local government in undertaking this work.

The Government is also providing \$50 million in 2015-16 as an initial contribution towards a new Interface Infrastructure Fund to support councils in outer suburban areas to deliver improved local infrastructure. This will assist in supporting local areas that have experienced unique infrastructure challenges in recent years, including significant population growth.

RESPONSIBLE FINANCIAL MANAGEMENT

The *2015-16 Budget* invests in public services and infrastructure for all Victorians while maintaining a responsible fiscal position.

The general government sector operating surplus (net result from transactions) is estimated to be \$1.2 billion in 2015-16, growing to \$1.8 billion in 2018-19, reflecting the Government's commitment to deliver high-quality services and infrastructure in a fiscally responsible manner. Forecast surpluses are a result of expenses growing at a slower rate than revenues. Over the budget and forward estimates expenses are expected to grow by 3.0 per cent a year on average compared with revenue growth of 3.4 per cent.

The *2015-16 Budget* delivers \$9.2 billion of new output initiatives and retains Government infrastructure investment (GII) at historically high levels. Estimated GII over the budget and forward estimates averages \$5.3 billion a year compared with the historical average of \$4.9 billion over the decade to 2014-15. The *2015-16 Budget* includes up to \$22 billion total estimated investment in new asset initiatives that will improve the longer-term productivity and liveability of Melbourne and regional cities.

Investment in services and infrastructure has not resulted in increasing net debt as there are significant savings from not proceeding with the East West Link. Net debt as a percentage of GSP is projected to peak at 5.8 per cent in June 2015 before declining to 4.4 per cent of GSP by June 2019, lower than the June 2018 estimate published in the *2014 Pre-Election Budget Update*. This level and trajectory of net debt is consistent with the Government's commitment to maintaining the State's triple-A credit rating.

Table 1.1: General government fiscal aggregates

	<i>Unit of measure</i>	<i>2013-14 actual</i>	<i>2014-15 revised</i>	<i>2015-16 budget</i>	<i>2016-17 estimate</i>	<i>2017-18 estimate</i>	<i>2018-19 estimate</i>
Net result from transactions	\$ billion	2.0	0.9	1.2	1.4	1.4	1.8
Government infrastructure investment ^{(a)(b)}	\$ billion	5.5	4.2	5.2	6.5	4.5	5.1
Net debt	\$ billion	21.2	21.2	16.9	19.3	19.5	19.8
Net debt to GSP	per cent	6.0	5.8	4.4	4.8	4.6	4.4

Source: Department of Treasury and Finance

Notes:

(a) Includes general government net infrastructure investment and estimated cashflows for Partnerships Victoria projects.

(b) Excludes the impact in 2015-16 of the medium-term lease over the operations of the Port of Melbourne.

To maintain a stable revenue base, the *2015-16 Budget* outlook includes modest revenue measures. A 3.0 per cent stamp duty surcharge will be applied to foreign buyers of residential real estate, and a 0.5 per cent land tax surcharge will be applied to absentee owners of property in Victoria, in addition to any other land tax payable. These measures will help ensure that all property owners contribute to funding the improved infrastructure and services which contribute to rising property values. These measures do not increase the tax burden on Victorian residents and are consistent with the Government's commitment not to fund its election commitments through increased taxes on the Victorian community.

In addition, the Government will undertake a broader review of current policies affecting housing affordability, including taxation, regulatory settings and the suite of grants and concessions available to different categories of property purchasers. The review will be completed by the end of 2015 and will guide future reforms to improve housing affordability for all Victorians.

The Government has reviewed the fiscal strategy to more closely align with its priorities to provide services and infrastructure for all Victorians in a fiscally responsible manner. The *2015-16 Budget* reflects the Government's long-term financial management objectives (Table 1.2).

Table 1.2: Long-term financial management objectives

<i>Priority</i>	<i>Objective</i>
Sound financial management	Victoria’s finances will be managed in a responsible manner to provide capacity to fund services and infrastructure at levels consistent with maintaining a triple-A credit rating.
Improving services	Public services will improve over time.
Building infrastructure	Public infrastructure will grow steadily over time to meet the needs of a growing population.
Efficient use of public resources	Public sector resources will be invested in services and infrastructure to maximise the economic, social and environmental benefits.

Progress towards these long-term financial management objectives is supported by the following financial measures and targets (Table 1.3).

Table 1.3: Financial measures and targets for 2015-16 Budget

<i>Financial measures</i>	<i>Target</i>
Net debt	General government net debt as a percentage of GSP to be maintained at a sustainable level over the medium-term.
Superannuation liabilities	Fully fund the unfunded superannuation liability by 2035.
Operating surplus	A net operating surplus consistent with maintaining general government net debt at a sustainable level over the medium term.

Chapter 4 *Budget Position and Outlook* provides an overview of the budget position for 2015-16 and the forward estimate years (2016-17 to 2018-19).

FUNDING OF THE FEDERATION

The Government will strongly advocate for Victoria’s interests and progressive national reform. Making the federation work more effectively and fairly is a high priority, but involves a number of significant challenges.

The Commonwealth Government’s 2014 decision to abandon existing funding agreements and reduce indexation on health and school grants from 2017-18 will strip billions from core services over the next 10 years. This is unsustainable. The Commonwealth needs to partner with states to address the fiscal pressures associated with population and economic change, not simply shift them to states.

States also need increased certainty in the handling of expiring National Partnership (NP) agreements. The Commonwealth's refusal to provide funding certainty for significant NP agreements, including the NP on Universal Access to Early Childhood Education, compromises the effective planning and delivery of services by state governments and their non-government partners.

The scale of Victoria's infrastructure program means that a fair share of Commonwealth funding is critical. In the five years from 2013-14, Victoria's expected share of infrastructure funding is just 20 per cent, below Victoria's population share of around 25 per cent. If the Commonwealth withdraws infrastructure funding previously allocated to the State for the East West Link, Victoria's share will drop to 13 per cent in that period.

GST is Victoria's single largest revenue source. The Commonwealth Grants Commission 2015 Methodology Review recommended a number of important adjustments to the formula for distributing GST revenue between states and territories. Victoria particularly welcomes the Commission's recognition of the additional costs of providing critical infrastructure in urban centres such as Melbourne, and its more consistent treatment of Commonwealth funding for road and rail projects. These changes represent a substantial improvement to the model for allocating GST revenue. However, Victorians continue to subsidise other states and territories. Following the approach recommended by the 2015 Methodology Review, approximately \$1.5 billion will be redistributed away from Victoria in 2015-16, or \$247 for every Victorian. In the longer term, Victoria supports re-examining the system to ensure that it is more transparent, simple and fair for all jurisdictions.

Victoria will work constructively with all governments to address economic and fiscal challenges through processes including the Commonwealth Government's white papers on reform of the federation and tax reform. The Victorian Government will be focusing on tax reform as a priority in 2015-16. The July 2015 special meeting of the Council of Australian Governments (COAG) will provide an important opportunity to progress these issues, including discussing sustainable funding arrangements in major service areas.

The Government has a strong public transport and infrastructure agenda that will benefit Victoria and the nation, and welcomes the Commonwealth's commitment to partner with Victoria to build new infrastructure through the National Partnership on Asset Recycling. Victoria will continue to work with the Commonwealth to finalise arrangements under this agreement, and looks forward to a similar, constructive approach on other Commonwealth-State issues.

CHAPTER 2 – ECONOMIC CONTEXT

- Positive signs for Victoria’s economy have recently emerged as the national economy transitions to more balanced growth, assisted by low interest rates and a depreciated Australian dollar. Victoria’s traditional growth drivers of household consumption and dwelling construction are strengthening, although labour income growth remains weak.
- Other structural shifts are presenting challenges for some industries as well as growth opportunities in new and emerging sectors. Victoria’s industry structure is diverse and able to adapt to these changes. Structural adjustment is a long-standing characteristic of the Victorian economy.
- Real gross state product (GSP) growth is forecast to rise to 2.50 per cent in 2015-16 from 2.25 per cent in 2014-15. This is expected to be driven by strengthening household consumption and export growth, the latter in response to the lower Australian dollar and increasing demand from Asia.
- Business investment is expected to grow moderately as consumer spending improves and exports strengthen, supported by low borrowing costs and a more favourable exchange rate.
- The improvement in the labour market since late 2014 is expected to consolidate in 2015-16. Employment is forecast to grow around its long-run average, supported by the Government’s Back to Work Plan. The unemployment rate is expected to stabilise around its current level in 2015-16 and 2016-17. Thereafter, it is projected to ease as employment grows at trend and the participation rate moves lower.
- Population growth is projected to remain high across the budget and forward estimates as Victoria continues to attract migrants from overseas and interstate.

VICTORIAN ECONOMIC CONDITIONS AND OUTLOOK

Victoria's economic environment is improving, reflecting its continued resilience in light of recent challenging conditions. Positive signs have emerged in the State's traditional growth drivers of household consumption and dwelling investment as the national economy shifts from growth led by mining investment to broader-based drivers. These are responding to low interest rates and strong asset price growth, while the lower Australian dollar is assisting business competitiveness. Other structural shifts are presenting challenges for some industries as well as growth opportunities in new and developing sectors. The State's diverse industry structure, its highly skilled workforce and strong population growth will help Victoria adapt to external pressures and take advantage of emerging opportunities.

Low interest rates, combined with high population growth, have increased demand in Victoria's residential property market. Strong price growth among established dwellings is encouraging further residential construction. Likewise, financial asset prices have grown solidly as investors seek higher returns in a low interest rate environment.

Reduced interest payments and rising asset prices have strengthened household financial positions and supported consumer spending. In addition, lower petrol prices have bolstered household expenditure by allowing disposable income to be redirected towards other goods and services. However, the pick-up in consumption has come amid stalled growth in employee income, a result of subdued growth in wages and flat aggregate hours worked in the Victorian economy. Softness in the labour market has also been reflected in heightened job security concerns and weak consumer sentiment.

Household consumption and dwelling investment form a relatively large share of Victoria's output compared with the other states. Together, these account for around two-thirds of Victoria's GSP, and the share has increased over the past two decades.

The lower Australian dollar should also assist the transition to more balanced economic growth. The depreciation has continued since the *2014-15 Budget Update* and in trade-weighted terms is now around 20 per cent below its peak in 2013. A lower exchange rate is a significant driver of competitiveness of Victorian businesses in global markets. This includes sectors which are key strengths of the State's economy such as professional services, education, agriculture and advanced manufacturing. Further, there should be a shift in domestic spending towards local products as international alternatives become relatively more expensive.

The outlook for Victoria's economy over the medium term is positive, but varies across industries as structural changes continue to shape the economy's composition. Household services industries have increased as a share of output over the past two decades, underpinned by shifting consumer preferences and an ageing population. Business services have also expanded above the statewide average over this period. Victoria's population is highly educated and has the skill base to support additional growth in these knowledge-intensive industries. Strong migration inflows are further contributing to the State's skilled workforce.

Victoria is poised to take advantage of opportunities in other areas of comparative strength. For example, the State's export sectors are likely to benefit from the burgeoning Asian middle class and recently signed free trade agreements with China, Japan and Korea.

As outlined in Chapter 1 *Economic and fiscal overview*, the Government is encouraging growth in six key sectors with the potential to drive longer-term economic growth: medical technology and pharmaceuticals, new energy technology, food and fibre, transport, defence and construction technology, international education and professional services.

Table 2.1 sets out the economic forecasts for the *2015-16 Budget*. The forecasts are projected to revert towards trend rates over the final two years of the forward estimates period.

Table 2.1: Victorian economic forecasts^(a)

	(per cent)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	actual	forecast	forecast	forecast	projection	projection
Real gross state product	1.7	2.25	2.50	2.75	2.75	2.75
Employment	0.6	2.00	1.50	1.50	1.50	1.50
Unemployment rate ^(b)	6.2	6.50	6.25	6.25	6.00	5.75
Consumer price index ^(c)	2.8	1.50	2.75	2.75	2.50	2.50
Wage price index ^(d)	2.7	2.75	3.25	3.50	3.50	3.50
Population ^(e)	1.9	1.8	1.8	1.8	1.8	1.8

Sources: Department of Treasury and Finance; Australian Bureau of Statistics

Notes:

(a) Per cent change in year-average compared with previous year, except for the unemployment rate (see note (b)) and population (see note (e)). Forecasts are rounded to the nearest 0.25 percentage points, except for population (see note (e)).

Projections for 2017-18 and 2018-19 represent trend rates, except for the unemployment rate which shows a path towards trend.

The key assumptions underlying the economic forecasts include: interest rates that follow movements in market expectations in the short term, and stabilise thereafter; a trade-weighted index of 64.5; and oil prices that follow the path suggested by oil futures.

(b) Year-average rate.

(c) Melbourne consumer price index.

(d) Total hourly rate excluding bonuses.

(e) Per cent change over the year to 30 June. Forecasts are rounded to the nearest 0.1 percentage point.

Gross state product

Victoria's real GDP growth is forecast to rise to 2.50 per cent in 2015-16 from 2.25 per cent in 2014-15. This reflects strengthening household consumption as well as higher export growth in response to the lower exchange rate and increasing overseas demand.

Household consumption growth is predicted to continue to benefit from low interest rates and rising asset prices. Labour income growth is expected to recover as growth picks up in wages and aggregate hours worked. The forecasts assume a further near-term moderation of the household saving ratio to sustain spending growth, consistent with increasing household wealth.

Dwelling investment is forecast to grow solidly in the short term, in line with recent strength in the established property market and supported by a surge in construction of multi-unit dwellings.

Business investment is expected to grow moderately over the forecast period following a period of stagnation since the global financial crisis. Despite improved business conditions, firms have been reluctant to invest. However, given low borrowing costs and a more favourable exchange rate, firms are predicted to increase their capital expenditure as consumer spending improves and exports strengthen.

Victoria's trade deficit is predicted to widen more slowly than over the previous decade. Exporters will benefit from the Australian dollar depreciating as well as accelerating demand for Victorian products from Asia. Imported goods and services, such as outbound tourism, will become relatively more expensive due to the lower exchange rate but growth is expected to rise broadly in line with state final demand.

The wind-down in mining investment in Western Australia and Queensland may soften demand for professional services provided by Victorian firms to resource companies. However, a lower exchange rate will likely encourage a relative shift in prospective tourists travelling domestically rather than overseas, leading to more interstate visitors to Victoria.

Other economic indicators

Labour market

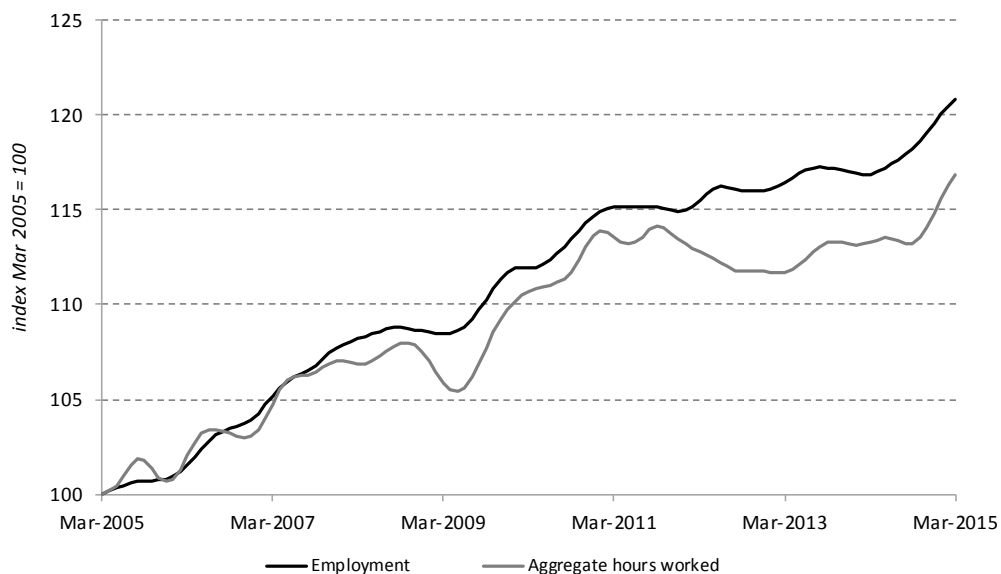
Victorian labour market conditions have been weak over the past four years. The unemployment rate has risen and broader measures of spare capacity are at 20-year highs. The bulk of employment growth over this period has been in part-time rather than full-time positions, contributing to softness in the aggregate number of hours worked (see Chart 2.1 and Chapter 3 *The jobs challenge*).

Since late 2014, the labour market has shown tentative signs of improvement. Employment growth has lifted markedly and the unemployment rate has edged lower, although it remains elevated.

Labour market conditions are expected to stabilise in 2015-16 and 2016-17. Employment is forecast to grow around its long-run average as consumer spending strengthens and businesses seek additional labour, supported by the Government's Back to Work Plan and other jobs initiatives contained in the budget. In the near term, there may be a relative shift towards full-time employment and more hours worked by existing employees.

The unemployment rate is expected to stabilise around its current level across 2015-16 and 2016-17 and is projected to ease thereafter as employment grows at trend and the participation rate moves lower.

Chart 2.1: Victorian employment and aggregate hours worked



Sources: Department of Treasury and Finance; Australian Bureau of Statistics (trend data)

Prices and wages

Melbourne inflation is expected to lift in 2015-16, but be within the Reserve Bank’s national target band of 2–3 per cent. Declining global oil prices and the repeal of the carbon price have contributed to low inflation in 2014-15, but these effects should largely unwind in 2015-16. The depreciation of the Australian dollar since early 2013 will continue to place upward pressure on the prices of trade-exposed items over the next few years, although the pass-through may be limited by heightened competition faced by businesses.

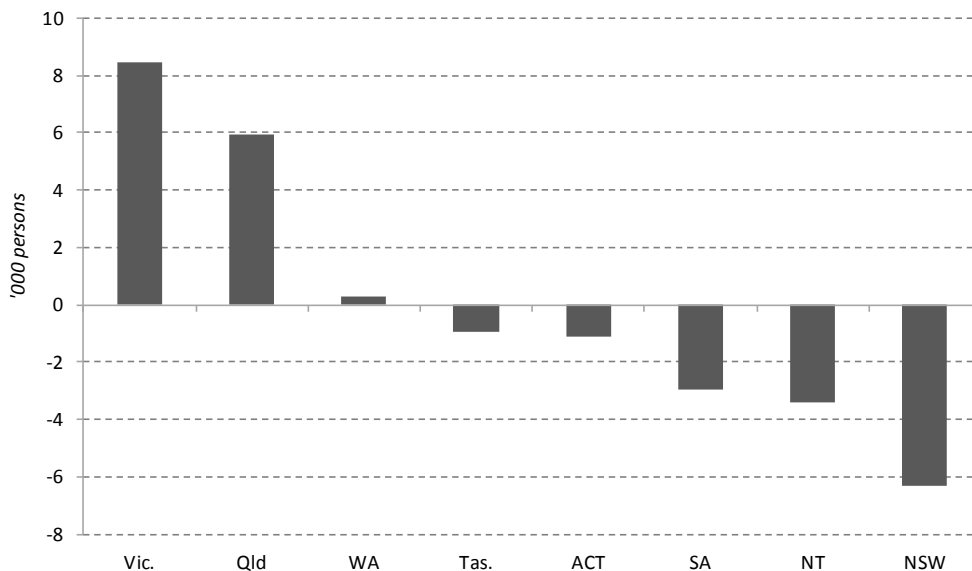
Improving labour market conditions and consumer demand are expected to gradually stimulate inflation among the non-tradable components of the consumer price index, although this is likely to take some time. Two further tobacco excise rises by the Commonwealth will add to inflation in 2015-16 and 2016-17.

Annual wages growth has been historically low given elevated unemployment and constrained bargaining power of employees in seeking additional wage increases. Growth is forecast to improve in 2015-16 and 2016-17 as economic conditions strengthen and spare capacity in the labour market eases.

Population

Population growth is expected to remain high over the forecast period as Victoria continues to be a favoured destination for international and interstate migrants. The State accounted for 28 per cent of national net overseas migration over the year to September 2014. It also recorded the highest net interstate migration of all jurisdictions (see Chart 2.2), with a net inflow to Victoria from each state and territory except the Northern Territory. This highlights the attractiveness of Victoria as a place to live and work, and confidence in the State's economic outlook.

Chart 2.2: Net interstate migration, year to September 2014



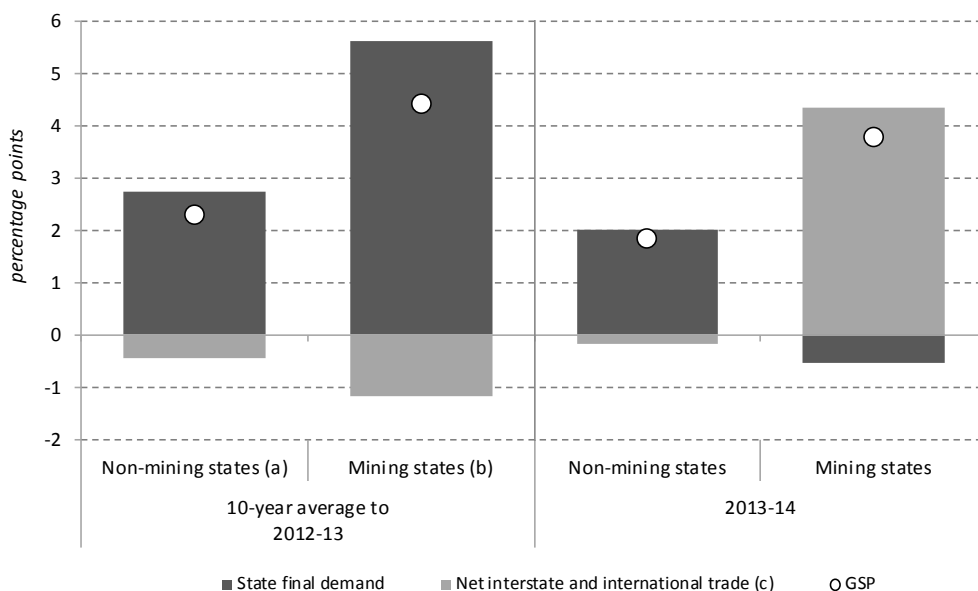
Sources: Department of Treasury and Finance; Australian Bureau of Statistics

AUSTRALIAN ECONOMIC CONDITIONS AND OUTLOOK

Australia's economic growth is likely to be below trend in the near term as the transition towards more balanced growth continues. Consensus forecasts suggest growth in gross domestic product will ease slightly to 2.6 per cent in 2015 before improving to 3.1 per cent in 2016.

The composition of growth across the states in 2013-14 reflected the dynamics of this transition. State final demand, which includes mining-related business investment, detracted from GSP growth in Western Australia and made a small contribution in Queensland. Conversely, the trade sector contributed strongly to growth as the mining boom entered its production phase (see Chart 2.3). This inverted the pattern of the previous decade when mining investment accelerated in response to surging commodity prices. Growth for these states combined was lower than the decade average, yet remained higher than in the non-mining states.

Chart 2.3: Contributions to GDP growth



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

Notes:

- (a) Victoria, New South Wales, South Australia and Tasmania.
- (b) Queensland and Western Australia.
- (c) Includes changes in inventories, an adjustment for net household expenditure interstate, the balancing item discrepancy and statistical discrepancies.

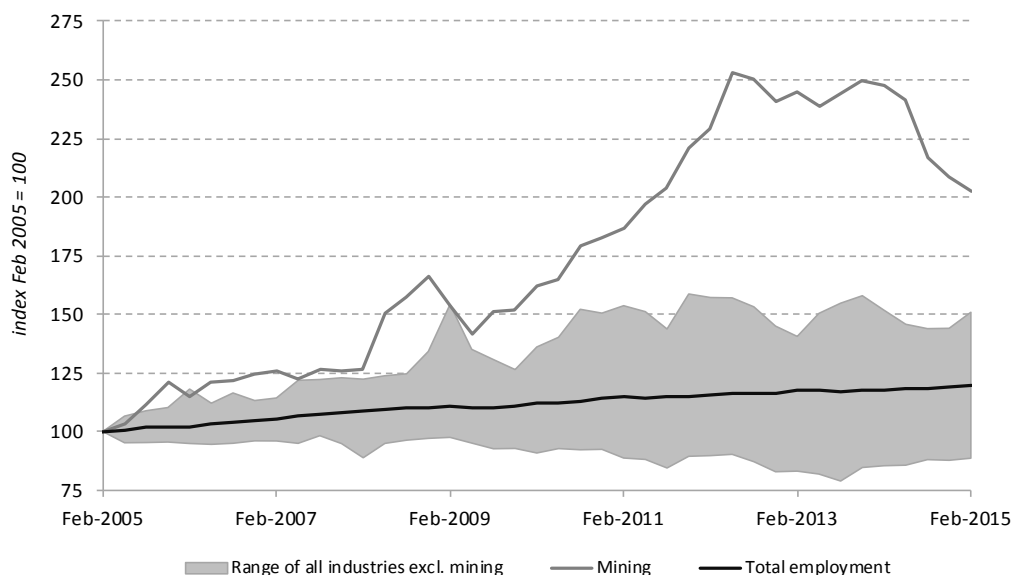
The production phase of the mining boom has strongly increased the supply of mineral resources, particularly iron ore. Combined with softening demand from China and expanded supply from other countries, there has been a significant fall in commodity prices and Australia’s terms of trade. The decline in imported oil prices has only partially offset this trend. The falling terms of trade has softened national income growth and may constrain consumer spending.

Low interest rates have stimulated the national property market, particularly in Sydney where investor activity has intensified, and in Melbourne to a lesser extent. Robust price growth is encouraging stronger dwelling investment. Consumer demand growth has also picked up across the non-mining states, but eased in Western Australia and Queensland.

Non-mining business investment has been less responsive than expected to low borrowing costs, and more recently, the depreciated exchange rate. Surveyed expectations of capital expenditure suggest that a recovery in non-mining investment may be delayed.

The national labour market is expected to remain subdued in the near term as the growth transition progresses. The mining industry accounted for almost 20 per cent of the increase in national employment from 2009 to 2012, despite representing only 2 per cent of those employed. However, the production phase of the mining boom is less labour intensive than the investment phase, leading to lower employment in the industry and placing pressure on the labour markets in Western Australia and Queensland (see Chart 2.4). Spare capacity in the non-mining states is likely to ease over time as broader economic conditions improve. This is consistent with a relative shift in interstate migration flows towards non-mining states.

Chart 2.4: Industry employment, Australia



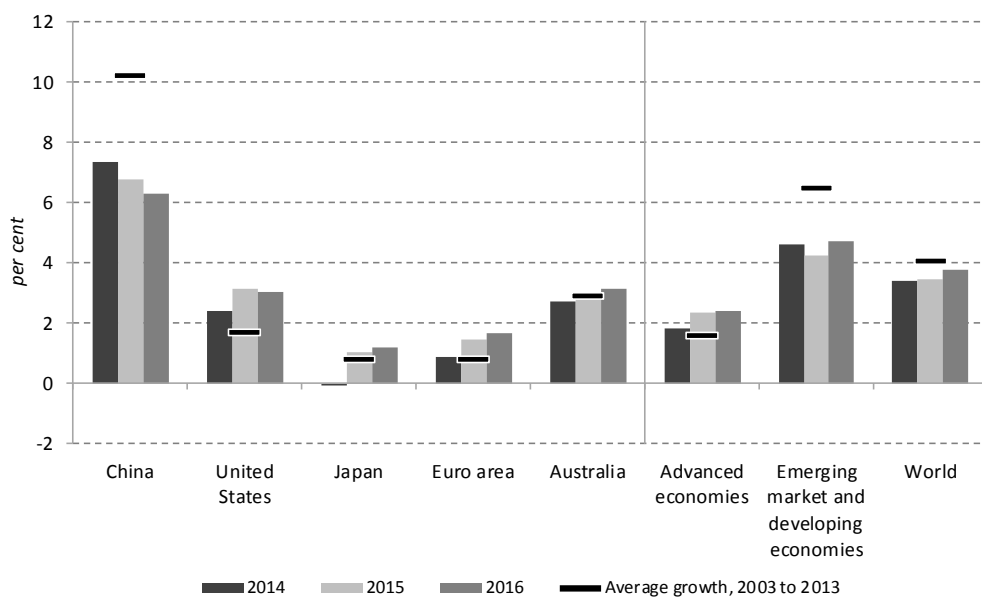
Sources: Department of Treasury and Finance; Australian Bureau of Statistics

National inflation is likely to remain contained over the forecast period. The depreciation of the exchange rate will place upward pressure on import prices, but will be counterbalanced by spare capacity in the labour market and muted inflation expectations.

INTERNATIONAL ECONOMIC CONDITIONS AND OUTLOOK

The global economic outlook has moderated since the *2014-15 Budget Update*, due to weaker growth prospects for emerging economies including China, Russia and Brazil. The sharp fall in oil prices, a result of subdued global demand and increased supply, is negatively affecting oil exporters but benefiting net oil importers, including most advanced economies. The International Monetary Fund predicts global growth will rise marginally in 2015 and further in 2016 (see Chart 2.5).

Chart 2.5: IMF economic growth forecasts for some major trading partners



Source: International Monetary Fund, *World Economic Outlook*, April 2015

The United States recovery continues to progress as labour market conditions and household spending improve, assisted by accommodative monetary policy and lower oil prices. The unemployment rate has almost halved since its peak in 2009, although this reflects, in part, declining labour force participation. The recent appreciation of the US dollar will inhibit international competitiveness, but overall economic conditions are expected to strengthen, providing scope for interest rates to be lifted later in 2015.

The moderation in China’s growth is expected to continue as it transitions away from residential construction and infrastructure investment towards a more consumer-led economy. However, growth will remain high compared with other countries. Demand for Australia’s minerals will be negatively affected by this transition while consumer-focused export sectors should benefit.

Japan entered a recession in 2014 following the increase in its consumption tax rate, but returned to positive growth towards the end of the year. Monetary stimulus, the depreciation of the yen, and the reduction in oil prices should support a gradual recovery in activity, as will the postponement of the second consumption tax rise to 2017.

Modest growth in the euro area is gaining momentum, with support from lower oil prices, monetary stimulus and the recent euro depreciation. However, the recovery is fragile and susceptible to further financial market instability. The euro area unemployment rate, while moderating, remains high.

New Zealand’s economy expanded solidly in 2014 with growth driven by private demand, particularly private investment. Growth is expected to moderate over the near term.

RISKS TO THE OUTLOOK

The risks to Victoria's economic outlook are broadly balanced.

The lower Australian dollar has the potential to underpin Victoria's competitiveness and economic growth but the benefits are yet to be fully realised. Business investment and export growth may respond more strongly than expected to the improved conditions resulting from the depreciation, as well as low interest rates.

On the other hand, any protracted weakness in the labour market could further constrain labour income and household consumption growth. Consumers may also become more risk averse and save a greater share of income if there is persistent unease surrounding the economic outlook. Similarly, businesses may remain reluctant to invest or hire additional workers without consistent signs of rising demand.

An extended period of low interest rates and possible further cuts may overstimulate asset prices, particularly in the property market. A sharp price correction would adversely affect household balance sheets and likely constrain consumption growth. However, if asset prices record sustained and higher than expected growth, there may be a more rapid decline in the household saving ratio and greater spending.

Globally, a prolonged downturn in the Chinese property market would limit construction growth and reduce demand for Australia's mineral resources, leading to further declines in commodity prices and the terms of trade. However, a more rapid transition to consumer-led growth in China would likely boost Victorian exports.

The risk of Greece exiting the euro zone resurfaced in early 2015, with management of the nation's debt subject to ongoing deliberations. An exit could unsettle equity markets and confidence. Geopolitical tensions in the Ukraine and instability in the Middle East may also escalate.

A faster than expected recovery and lifting of interest rates in the US could lead to a further depreciation of the Australian dollar. This would deliver additional support to Victoria's trade-exposed businesses and likely see a more pronounced shift in household spending towards domestically produced goods and services.

Prolonged weakness in global oil prices would keep local petrol prices low, placing downward pressure on inflation and supporting Victorian household consumption.

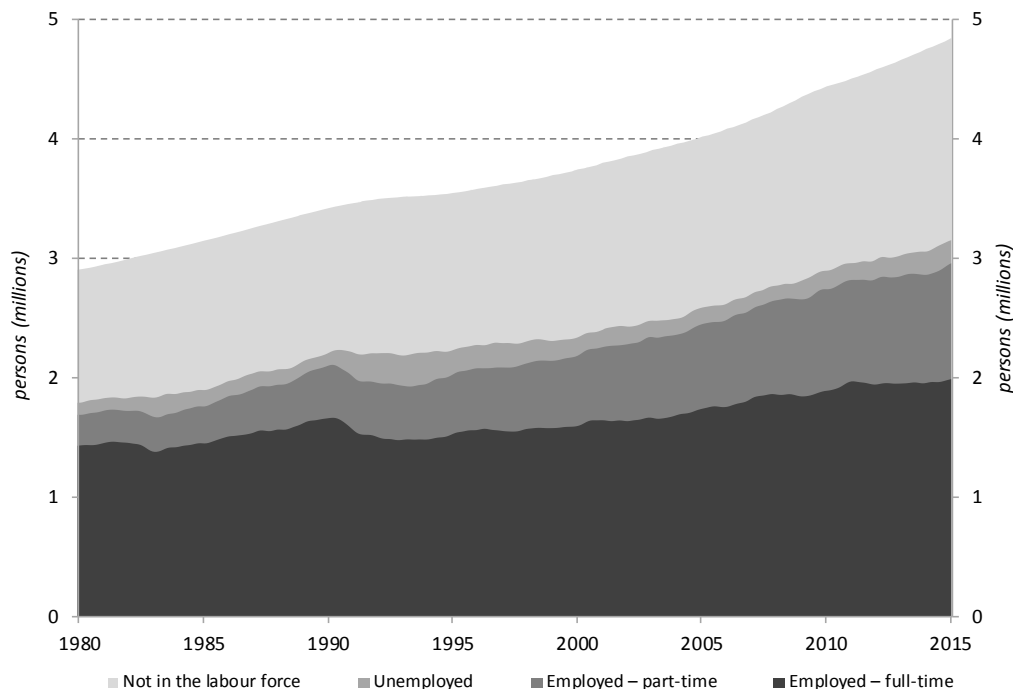
CHAPTER 3 – THE JOBS CHALLENGE

- Victoria's labour market is constantly undergoing structural change as well as cyclical fluctuations. Key structural trends in recent decades include rising female labour force participation, an associated increase in the part-time share of total employment, and jobs growth driven by industries predominantly employing workers with post-school qualifications.
- A near 20-year run of fairly consistent full-time jobs growth ended in early 2011. Since then, employment growth has slowed and aggregate hours worked in the economy have remained relatively flat, despite the addition of 140 000 mostly part-time jobs.
- Victoria has recently experienced a cyclical labour market event with some similarities to past recessions, albeit on a smaller scale. But relative to previous downturns, recent weakness has been absorbed in part by falling average hours worked rather than increasing unemployment.
- This appears to have disproportionately affected young people, with youth hours worked and employment falling sharply in recent years. Importantly, participation of young people in full-time education continued to rise over the same period.
- Policy needs to be geared towards lifting overall economic activity to support job creation by boosting confidence, encouraging new business formation, undertaking regulatory reform and improving linkages between people and jobs.
- Increasing demand for skills highlights the importance of quality outcomes from the education and training system. This is also relevant to workers in occupations vulnerable to the adjustment pressures associated with structural change, as well as young people who are either disengaged or at risk of becoming disengaged from the education system and the labour market.
- The Government is implementing measures to help create 100 000 jobs over two years, including the Back to Work Scheme which will support those at risk of extended periods of unemployment, including young people and retrenched workers. The Government has committed to infrastructure projects that will improve linkages between people and work and create construction jobs. The Government is also investing significantly in education and skills, including a focus on reskilling workers.

OVERVIEW OF THE VICTORIAN LABOUR MARKET

Victoria’s labour market is constantly undergoing structural change as well as cyclical fluctuations. Both aspects are captured in the changing composition of the population aged 15 years and over (see Chart 3.1).

Chart 3.1: Composition of Victoria’s civilian population aged 15 years and over



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

A key feature of the Victorian labour market is the long-term shift in the composition of employment in favour of part-time jobs. This is associated with the rising participation of women in the labour market, which has resulted in the female share of total employment increasing to 45.8 per cent, up from 38.7 per cent 30 years ago. Coupled with rising male part-time employment, the part-time share of total jobs has almost doubled over the past three decades, and now comprises one-third of all employment.

This long-term compositional shift has recently accelerated. This reflects the level of full-time employment remaining broadly flat over the past four years, following nearly 20 years of fairly consistent growth.

It should also be noted that the proportion of the population aged 15 years and over who are not working is much larger than those classified as unemployed. The size of the cohort outside the labour force represents one of the inherent limitations of relying on the unemployment rate as a sole indicator of the strength or weakness of the labour market.

This cohort primarily includes retirees, stay-at-home parents and a growing number of full-time students as youth participation in education increases and young people remain in education for longer. However, it also includes people who want to work but are no longer actively seeking employment (i.e. ‘discouraged workers’).

The proportion of the population outside the labour force has increased significantly in recent years. Victoria’s population aged 15 years and over has grown by around 340 000 people since early 2011, while employment has only increased by around 140 000 people over the same period. Of the remainder, around 50 000 people are currently unemployed, while 150 000 people are classified as outside the labour force.

THE RECENT VICTORIAN LABOUR MARKET DOWNTURN

Victoria’s unemployment rate rose to 6.9 per cent in July 2014, the highest recorded since October 2001 in the wake of the collapse of Ansett. It also exceeded the immediate post-global financial crisis high, and was the culmination of a three-year period in which the unemployment rate consistently trended upwards (see Chart 3.2).

Chart 3.2: Victorian trend unemployment rate



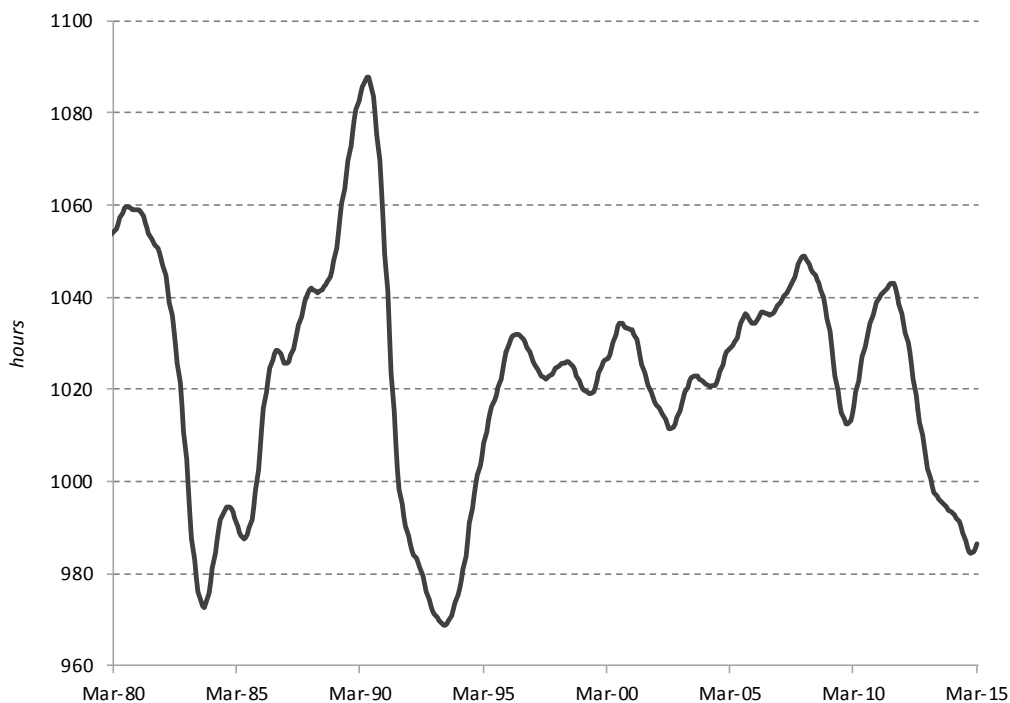
Source: Australian Bureau of Statistics

However, the unemployment rate is, in isolation, only a partial indicator of the strength or softness of the labour market. Other metrics indicate that the Victorian labour market has experienced a significant cyclical event in recent years, albeit on a smaller scale relative to the recessions of the 1980s and 1990s. These include:

- aggregate and average hours worked (indicators of the overall utilisation of labour); and
- the underemployment rate (a measure of people who have a job and would like to work additional hours) and labour force underutilisation rate (the sum of the unemployment and underemployment rates).

Average hours worked per Victorian aged 15 years and over have fallen sharply over the past four years, and are approaching levels not seen since the recessions of the early 1980s and 1990s (see Chart 3.3). This is a strong indicator of the labour market softness experienced in Victoria in recent years.

Chart 3.3: Annual hours worked per Victorian aged 15 years and over



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

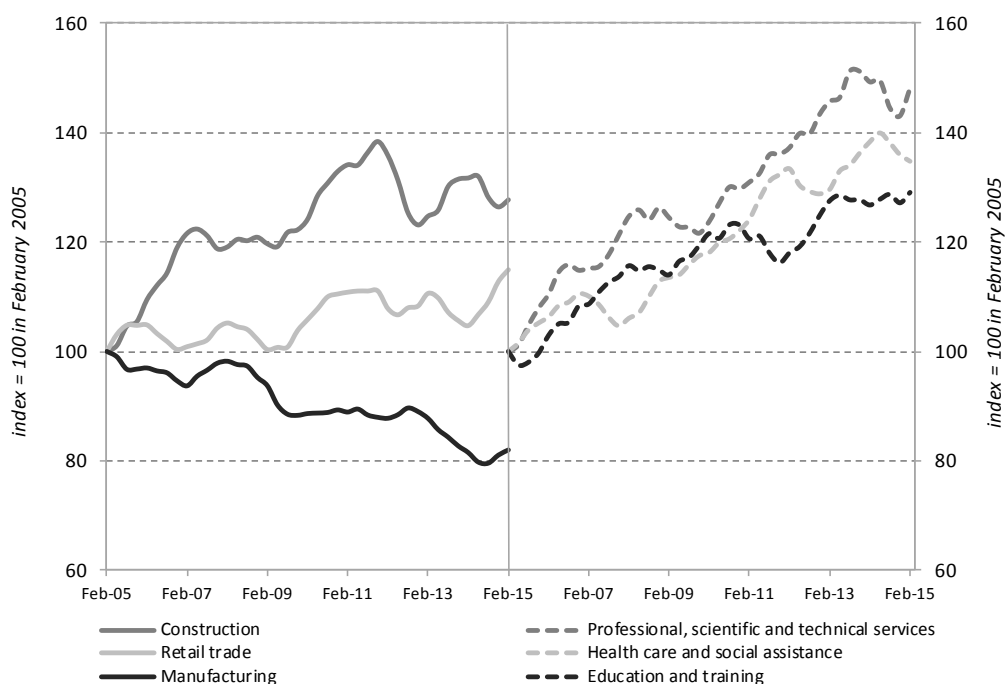
Significantly, the fall in average hours worked has not been evenly spread across all age groups, but has been concentrated in the youth (15-24 years) cohorts.

The 5.1 per cent reduction in average hours worked per Victorian aged 15 years and over since early 2011 comprises a:

- 14.3 per cent decline among those aged 15-19 years;
- 9.4 per cent decline among those aged 20-24 years;
- 2.6 per cent decline among those aged 25-64 years; but a
- 4.9 per cent increase among those aged 65 years and over.

Reflecting this, aggregate hours worked in the Victorian economy have been relatively flat over the past four years, despite the addition of around 140 000 mostly part-time jobs.

Chart 3.4: Victorian industry aggregate hours worked, year average (original data)



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

Recent softness in aggregate hours worked can be attributed to a combination of structural and cyclical factors operating across individual industries (see Chart 3.4), including:

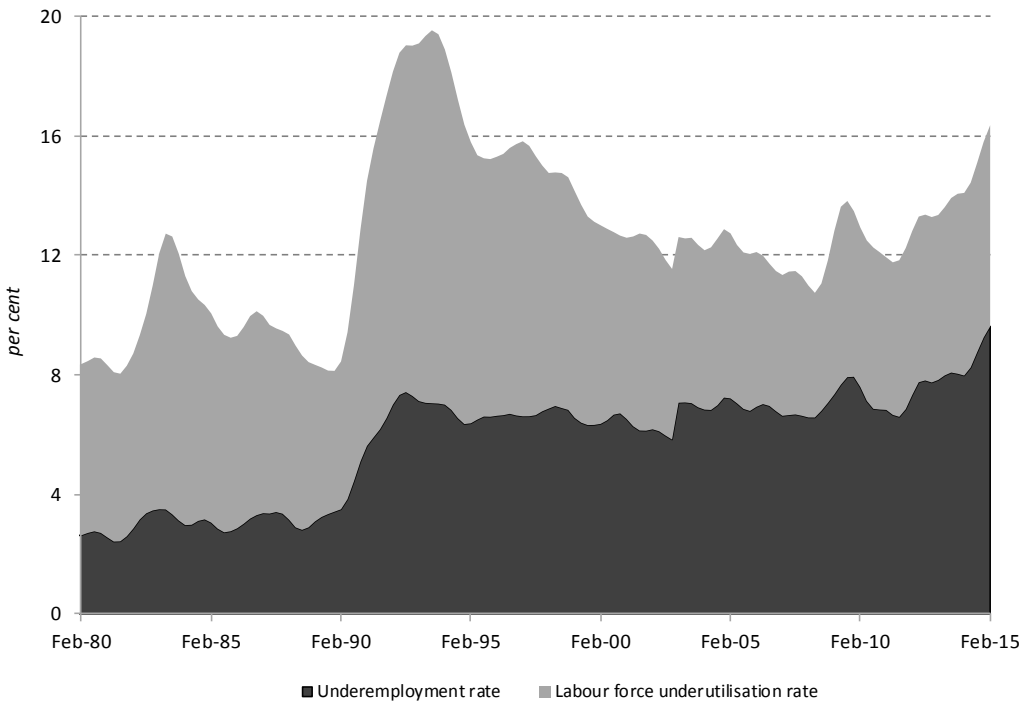
- manufacturing, where a decline in hours worked accelerated between late 2012 and 2014, affected by the high Australian dollar;
- construction, where activity and hours worked moderated from the immediate post-global financial crisis highs, but remain well above the levels of a decade ago;
- retail trade, where Victorian hours worked stabilised between 2010 and 2014, but have nevertheless out-performed the national average (nationally, retail hours worked have yet to recover to their pre-global financial crisis peak);

- professional, scientific and technical services, where hours worked grew significantly over the past decade, but have fallen from their 2013 peak, partly affected by the end of the mining construction boom (e.g. affecting engineering and other specialist consulting services); and
- health care and social assistance and education and training, where hours worked have grown less rapidly over the past four years than they did over the preceding six.

The moderation of growth in hours worked in industries broadly linked to population growth, coupled with the decline in manufacturing and construction hours worked in recent years, largely explains recent softness in aggregate hours worked in the Victorian economy.

The associated decline in average hours worked coincided with a rise in the level of the underemployment and labour force underutilisation rates. From 6.6 per cent in mid-2011, Victoria’s underemployment rate (a measure of people who have a job and would like to work additional hours) rose to 9.6 per cent in February 2015, the highest in the history of the series (see Chart 3.5).

Chart 3.5: Victorian underemployment and labour force underutilisation rates



Source: Australian Bureau of Statistics

The labour force underutilisation rate (the sum of the unemployment and underemployment rates) increased to 16.4 per cent in February 2015, its highest level in over 20 years. This implies that spare capacity in the Victorian labour market is now at its highest level since the early stages of the recovery from the 1990s recession.

However, it is important to note that as the unemployment rate is well below levels associated with previous cyclical downturns, recent weakness has been more weighted towards underemployment (i.e. a reduction in average hours worked) than unemployment (i.e. mass retrenchments).

Indeed, of the half a million Victorians currently classified as underutilised, around 60 per cent are employed and would like to work additional hours. While this may reflect, in part, greater labour market flexibility, it also implies that employment growth can improve without a commensurate improvement in broader measures of labour market spare capacity.

TRENDS IN YOUTH LABOUR FORCE PARTICIPATION AND EDUCATION

While the level of Victorian employment has increased by around 10 per cent since the onset of the global financial crisis, the level of youth employment is down nearly 5 per cent over the same period, with the bulk of this decline occurring over the past four years (see Chart 3.6). This corresponds to over 20 000 fewer young Victorians in jobs.

Chart 3.6: Victorian youth employment, 12 month average (original data)



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

Average hours worked by young Victorians have fallen by more than 10 per cent over the past four years, driven by a 16.5 per cent decline in average full-time hours worked, partially offset by a 7.1 per cent rise in average part-time hours worked.

Consistent with trends in industry hours worked, the decline in youth employment has been led by falls in manufacturing. Youth jobs have also declined in the retail trade industry, which accounts for nearly a quarter of all youth employment in the State.

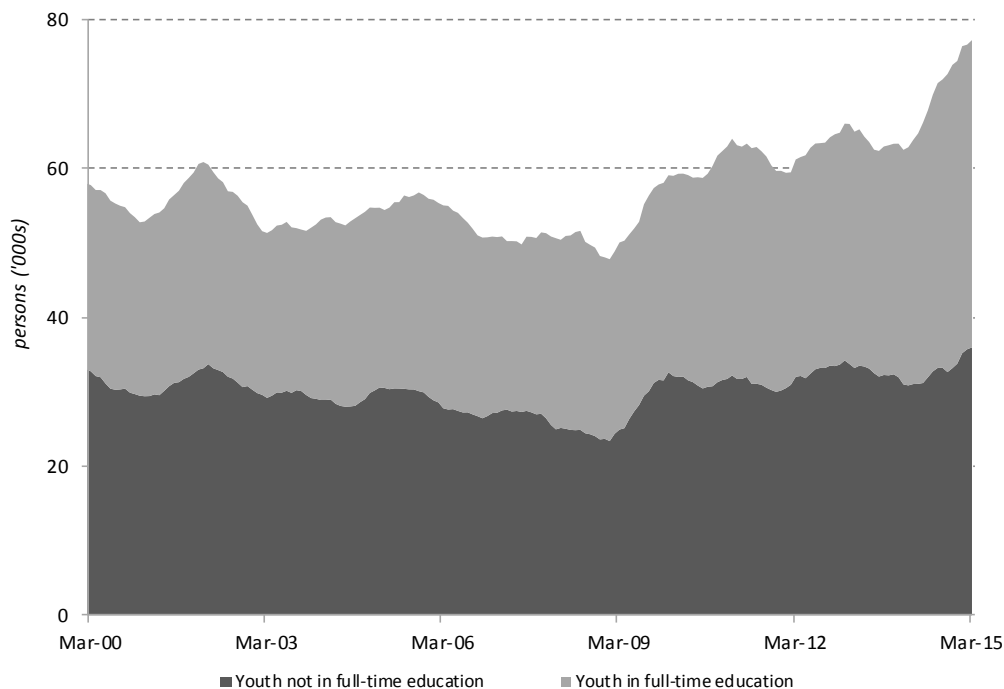
However, the proportion of young Victorians in full-time education rose to 58.3 per cent in 2013-14. This was the highest of all states, above the national average (51.8 per cent), and up from 53.5 per cent in 2011-12. Given that the number of young Victorians in full-time education increased by over 40 000 people over the two years to 2013-14, this supports the notion that a substitution between full-time work and full-time education is occurring among Victoria's youth.

This may reflect, in part, a response to the recent softness in the Victorian labour market, as well as the recovery in international student numbers from early 2014 following the moderation in the level of the domestic currency. However, young Victorians may also be responding to signals that job opportunities are increasingly in sectors requiring higher levels of skills and training.

The share of youth in full-time education rose strongly in 2012-13, a year in which average youth hours worked fell by over 6 per cent. The increase coincided with the Commonwealth Government uncapping the number of university places for domestic students, which may also be reflected in the outcome for the following year.

Importantly, the rise in the number of unemployed youth over the past year has been driven by the sub-cohort who are in full-time education (see Chart 3.7). This signals that despite falling youth employment, many young Victorians are remaining engaged with both the education system and the labour market.

Chart 3.7: Composition of Victorian unemployed youth – year average (original data)



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

A proxy for youth underutilisation, the proportion of Victorian young people both not in full-time education and either unemployed or outside the labour force is currently 10.4 per cent, the lowest of all states. Although this metric remains below the national average (11.6 per cent), it has nevertheless increased from 9.4 per cent over the past year.

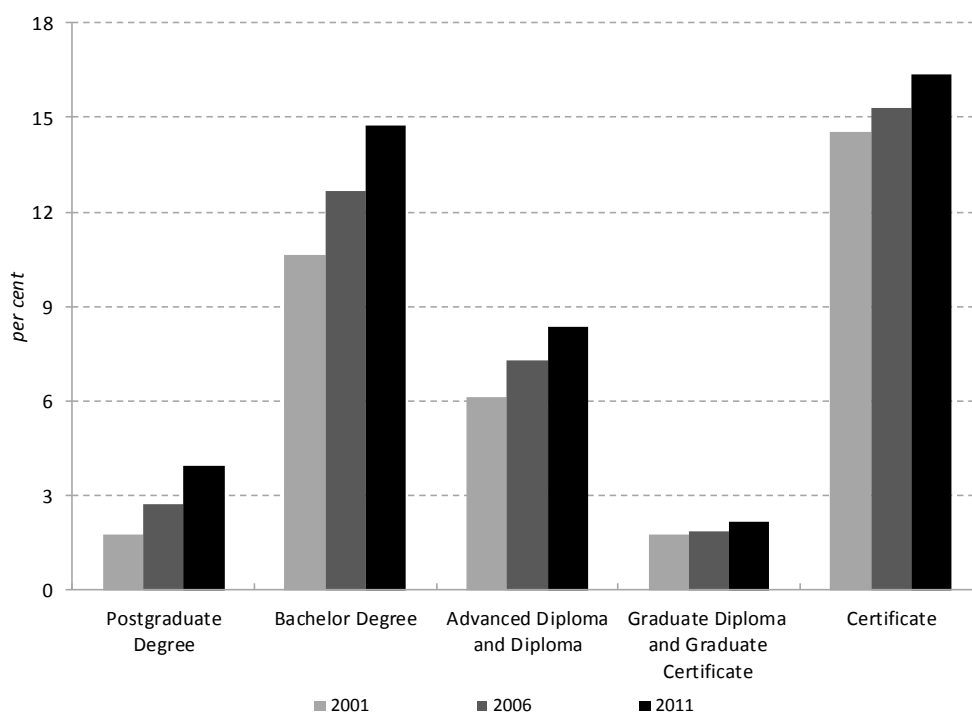
Recent trends in the youth labour market therefore appear to reflect the structural shift in employment patterns towards skilled occupations and a greater uptake of higher qualifications, exacerbated by recent cyclical weakness.

The Government’s Back to Work Plan and significant investment in education and skills will support those young people who are either disengaged or at risk of being disengaged from both the labour market and the education system.

INDUSTRY EMPLOYMENT TRENDS AND SKILLS

The share of the Victorian population aged 15 years and over with a post-school qualification rose significantly over the decade to 2011, with large increases in the proportion of the population holding a bachelor degree or higher (see Chart 3.8).

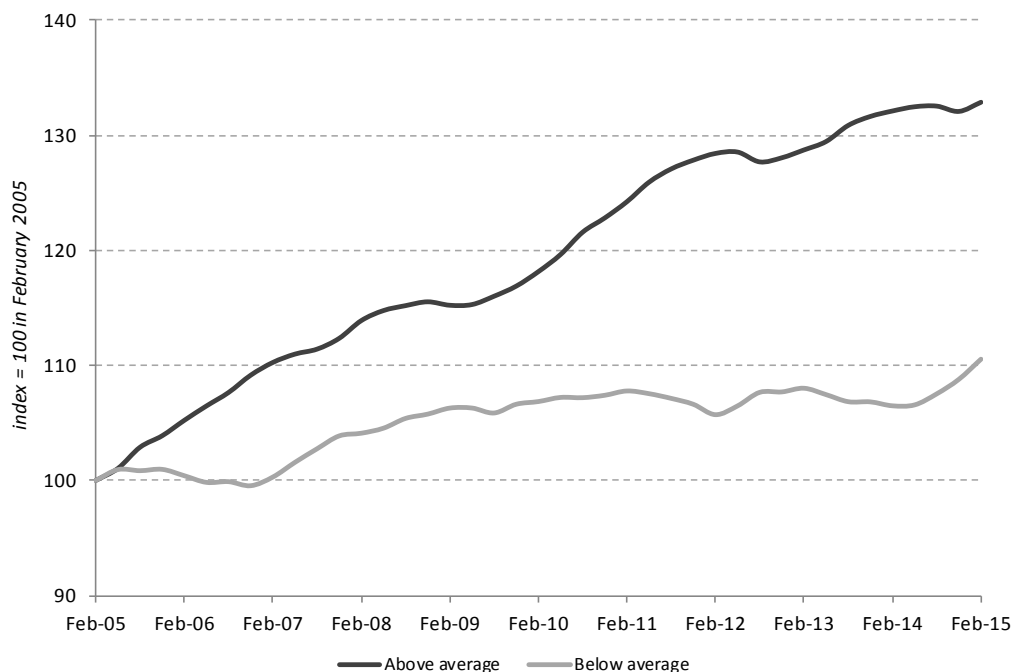
Chart 3.8: Proportion of Victorians aged 15 years and over with a post-school qualification



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

The industry drivers of employment growth are increasingly those with highly skilled workforces (see Chart 3.9). In addition to parts of manufacturing (e.g. specialised machinery and equipment manufacturing, and pharmaceutical and medicinal product manufacturing), health care and social assistance, professional, scientific and technical services, education and training, construction, and public administration and safety industries accounted for nearly two-thirds of net jobs growth over the past decade, and predominantly employ workers with post-school qualifications.

Chart 3.9: Victorian jobs growth by share of industry workforce with a post-school qualification^{(a)(b)(c)}



Sources: Department of Treasury and Finance; Australian Bureau of Statistics

Notes:

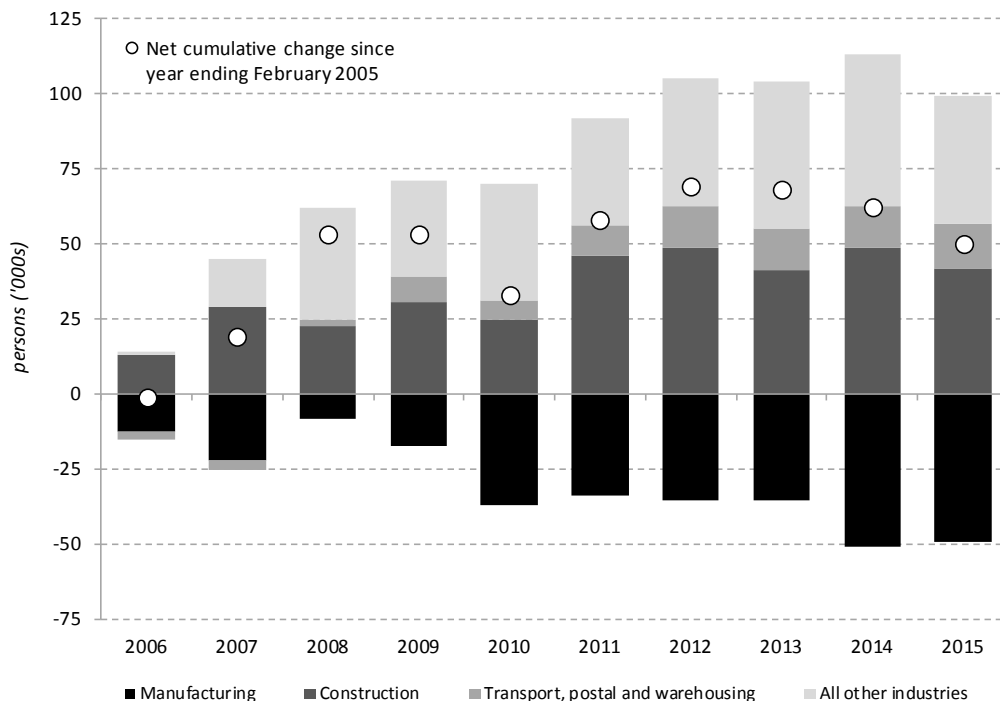
- (a) 63.9 per cent of Victorian workers aged 15 years and over had a post-school qualification at the 2011 Census.
- (b) Above-average industries include: health care and social assistance, professional, scientific and technical services, construction, education and training, public administration and safety, financial and insurance services, other services, information media and telecommunications, rental, hiring and real estate services, electricity, gas, water and waste services, and mining.
- (c) Below average industries include: retail trade, manufacturing, accommodation and food services, transport, postal and warehousing, wholesale trade, administrative and support services, agriculture forestry and fishing, and arts and recreation services.

Reflecting this trend, the aggregated employment share of these five industries is 42.0 per cent, up from 37.3 per cent a decade ago. As the industries driving jobs growth increasingly require post-school qualifications, this further indicates that a substitution between work and full-time education may explain part of the recent decline in hours worked by young Victorians.

The shift in industry employment patterns has implications for some occupations. For example, employment of technicians, trade workers, machinery operators, drivers, and labourers increased by an annual average of 0.6 per cent over the past decade, well below the rate of growth for all occupations (2.0 per cent). This trend reinforces the need for a strong, responsive and high quality training system.

Since 2012, employment in these occupations has been in decline (see Chart 3.10). This can be largely attributed to the recent fall in manufacturing industry employment, reinforced by a cyclical moderation in the construction industry.

Chart 3.10: Cumulative change in Victorian employment in selected occupations^(a)



Sources: Australian Bureau of Statistics; Department of Treasury and Finance

Note:

(a) Selected occupations refers to technicians, trade workers, machinery operators, drivers and labourers.

Given the industries driving jobs growth are increasingly demanding higher skills, the Government is supporting Victoria’s youth through improvements to the education and training system. The Government is also addressing cyclical weakness in the labour market as an immediate priority, given the challenges posed by upcoming closures and associated retrenchments within the automotive manufacturing sector.

Box 3.1: The impact of automotive manufacturing sector closures

There were over 40 000 workers employed in the Victorian automotive manufacturing sector in 2006, representing more than half of the national automotive manufacturing workforce. By early 2015, Victorian jobs in automotive manufacturing had decreased by nearly 40 per cent to approximately 25 000 persons, representing around 0.8 per cent of total employment in the State.

The job losses resulting from the closures of the manufacturing plants of Ford, Holden and Toyota between now and 2017 will be significant, and have an impact concentrated in the local labour markets in which the manufacturers and their suppliers operate.

However, the skills and capabilities of many workers affected by the closures may be transferable to other sectors (e.g. fabrication engineering trades workers, construction, distribution and production managers, and engineering professionals).

The 2014 Commonwealth Review of the Victorian and South Australian economies reported that 25 per cent of workers who left the automotive manufacturing industry between 2006 and 2011 moved to jobs in the transport, postal and warehousing, retail trade or wholesale trade industries. Approximately 8 per cent of male workers who exited the automotive manufacturing sector moved into the construction industry.

These sectors will be critical in providing alternative jobs for those affected workers, along with the six growth industries identified by the Government. The Government's upcoming plan for automotive industry transition, Back to Work Plan and up to \$22 billion total estimated investment (TEI) in new asset initiatives, will support jobs growth in the industries best placed to accommodate the workers expected to be displaced between now and 2017.

THE GOVERNMENT'S PLAN TO DRIVE JOBS GROWTH BY INVESTING IN QUALITY EDUCATION, SKILLS AND INFRASTRUCTURE

Given the state of the labour market, the Government is taking a series of actions that are geared towards lifting overall economic activity to support job creation by boosting confidence, encouraging new business formation, undertaking regulatory reform and improving linkages between people and jobs.

There is also an increasing need to focus on young people who are either disengaged or at risk of becoming disengaged from both the education system and the labour market.

Finally, the growing demand for skills highlights the importance of quality outcomes from the education and training system. This is also relevant with respect to those workers vulnerable to the adjustment pressures associated with structural change. These challenges require a comprehensive policy response.

Accordingly, the *2015-16 Budget* is focused on creating jobs, and investing in education and skills to provide employment opportunities for all Victorians. This includes vulnerable groups such as young people at risk of not successfully transitioning from the education system to the workforce as quality skills become increasingly important.

Coupled with the Government's investment in education and skills is a significant major projects agenda to create local jobs. These measures will help create 100 000 jobs and stimulate economic growth across the State.

A comprehensive jobs package

The Government has committed \$100 million over two years to deliver the Back to Work Scheme, which will provide financial assistance to businesses hiring those at risk of extended periods of unemployment, including young people and retrenched workers. This will provide support to those most affected by the recent cyclical labour market downturn.

The Government has also identified six growth industries (medical technology and pharmaceuticals, new energy technology, food and fibre, transport, defence and construction technology, international education and professional services) based on the shift in employment patterns across industries towards higher skilled occupations.

As part of the Back To Work Plan, the Future Industries Fund will provide \$200 million over four years in targeted support to develop these key industries. Additionally, the Premier's Jobs and Investment Panel – an independent body of senior business and industry leaders – will provide direct advice to the Premier on the allocation of \$508 million over five years for jobs and investment, and the \$200 million Regional Jobs Fund will support job-creating projects in Regional Victoria.

Access to finance to drive innovation in new industries

The Government will establish a body to support the development and delivery of innovative ideas in Victoria. The 'start-up' initiative will help innovative businesses develop business cases, deal with Government, get IP advice, manage finances and attract investment.

Education and training

The Government is preparing Victoria's workforce for an increasingly knowledge-based economy. Recognising that the industry drivers of employment growth are increasingly those with highly skilled workforces, the Government is:

- investing significantly in education and skills, including a focus on reskilling workers;
- providing \$300 million to complete the \$320 million TAFE Rescue Fund, helping campuses across the state reopen closed buildings, upgrade workshops and classrooms and become more financially sustainable;
- providing young people and displaced workers with opportunities to develop the skills they need to get a job in the industries that will drive Victoria's future prosperity; and
- delivering community service obligations and enhancing the regulation of training providers.

Regulatory reform

Victoria relies on a strong and competitive business sector to sustain a high level of employment and economic growth.

The Government will strengthen the business environment by keeping taxes and other charges as low as possible and by minimising the burden of regulation.

Infrastructure investment

Investment in infrastructure is an important stimulant for the economy, supporting direct jobs created through construction and indirect jobs in the construction supply chain (including manufacturing, transport and logistics and professional services).

Infrastructure investment also enhances productivity, thereby increasing the long-term growth potential of the Victorian economy and labour market. The provision of appropriate and economically justifiable transport infrastructure is also critical to improving the linkages between people and jobs across the State.

The Government has committed to fund major projects in a way that is responsible and sustainable. To support this, the Government will establish:

- Infrastructure Victoria, an independent body to advise on long-term priorities; and
- Projects Victoria, to further ensure that infrastructure projects are well planned and efficiently delivered.

The Government is acting now to support investments in projects that will build economic capacity, and create the jobs needed to keep Victoria growing, including:

- the removal of 50 of the most dangerous and congested level crossings in metropolitan Melbourne over the next eight years;
- priority road initiatives such as the West Gate Distributor project and Chandler Highway Bridge duplication. Over the next eight years, the Government has guaranteed a total of \$1 billion for the repair and upgrade of roads in outer suburban areas, and \$1 billion for the repair and upgrade of roads and level crossings in regional areas; and
- the Melbourne Metro Rail Project, which will increase the capacity, reliability and efficiency of Melbourne's busiest train lines, allowing more people to get to jobs, education and other services more easily.

CHAPTER 4 – BUDGET POSITION AND OUTLOOK

- The *2015-16 Budget* delivers on the Government's election commitments which include \$9.2 billion in new output initiatives and up to \$22 billion total estimated investment (TEI) in new asset initiatives.
- The general government sector operating surplus is estimated to be \$1.2 billion in 2015-16, growing to \$1.8 billion in 2018-19. These surpluses reflect the Government's commitment to provide high-quality services for all Victorians in a fiscally responsible manner.
- Net debt to gross state product (GSP) is projected to decrease from its June 2015 level of 5.8 per cent to 4.4 per cent by June 2019. The June 2019 estimate is lower than the June 2018 estimate of 4.5 per cent published in the *2014 Pre-Election Budget Update*, consistent with the Government's commitment to maintain the State's triple-A credit rating.
- The Government is on track to fully fund the State's unfunded superannuation liability by 2035. The general government superannuation funding ratio – the proportion of liabilities of the former State Superannuation Fund which is backed by superannuation plan assets – is projected to increase from 46.0 per cent at June 2015 to 48.9 per cent by June 2019.
- As a result of the decrease in net debt and improvement in the superannuation funding ratio, net financial liabilities as a proportion of GSP are expected to decrease from a peak of 16.4 per cent at June 2015, to 12.1 per cent by June 2019.

This chapter outlines the budget position of the general government sector. The broader public sector is covered in Chapter 5 *Position and outlook of the broader public sector*. This budget paper takes into account the financial impacts as at 28 April 2015 of all policy decisions taken by the Victorian Government, as well as Commonwealth Government funding revisions and other information that affects the financial statements, unless otherwise stated.

GENERAL GOVERNMENT SECTOR

Overview

The 2015-16 *Budget* projects strong surpluses and declining net debt as a percentage of GSP over the forward estimates (Table 4.1).

Table 4.1: General government fiscal aggregates

	<i>Unit of measure</i>	<i>2013-14 actual</i>	<i>2014-15 revised</i>	<i>2015-16 budget</i>	<i>2016-17 estimate</i>	<i>2017-18 estimate</i>	<i>2018-19 estimate</i>
Net result from transactions	\$ billion	2.0	0.9	1.2	1.4	1.4	1.8
Government infrastructure investment ^{(a)(b)}	\$ billion	5.5	4.2	5.2	6.5	4.5	5.1
Net debt	\$ billion	21.2	21.2	16.9	19.3	19.5	19.8
Net debt to GSP	per cent	6.0	5.8	4.4	4.8	4.6	4.4

Source: Department of Treasury and Finance

Notes:

(a) Includes general government net infrastructure investment and estimated cashflows for Partnerships Victoria projects.

(b) Excludes the impact in 2015-16 of the medium-term lease over the operations of the Port of Melbourne.

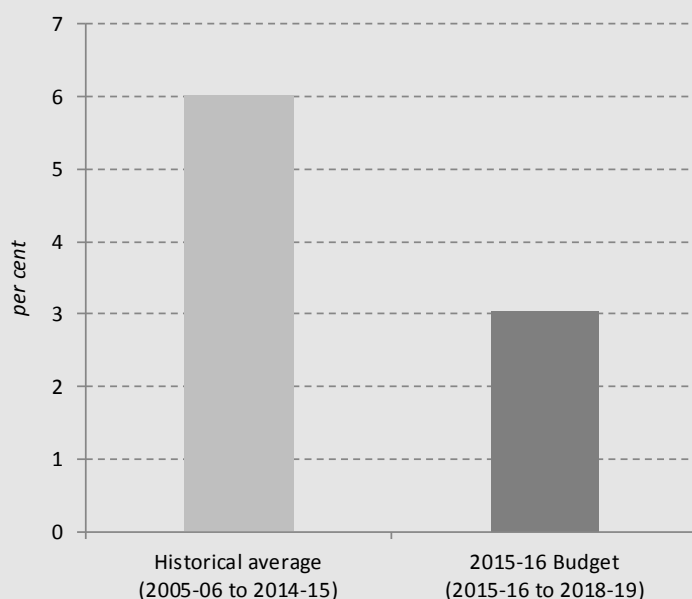
These fiscal projections reflect the Government's budget strategy which focuses on investing in high-quality services and productivity enhancing, value-for-money infrastructure (Box 4.1).

Box 4.1: Budget strategy

The Government's budget strategy has been adopted to address the shortfall in funding for services inherited from the former government. At the *2014 Pre-Election Budget Update*, expenses were forecast to grow by an average of just 2.5 per cent a year over the four years to 2017-18 at a time when population growth is expected to average 1.8 per cent and inflation of 2.6 per cent.

The previous government's strategy to constrain expenses growth would have resulted in an unsustainable shortfall in the levels of expenditure required to meet the growing demand on core services for families, including on health, education and frontline social services. The *2015-16 Budget* begins to correct this shortfall with responsible growth in operating expenses of 3.0 per cent a year, as compared with revenue growth of 3.4 per cent on average a year over the budget and forward estimates (Chart 4.1).

Chart 4.1: Average growth in expenses^{(a)(b)}



Source: Department of Treasury and Finance

Notes:

- (a) Growth in expenses in the period to 2014-15 excludes the impact of the revised AASB 119 Employee Benefits.
- (b) The figure for 2014-15 used in the calculation of the historical average is an estimate.

The Government is committed to delivering high quality services and infrastructure for all Victorians in a fiscally responsible manner. Forecast expenditure growth remains low by historical standards and below the corresponding rate of growth in revenue. As a result, the general government sector operating surplus (net result from transactions) is estimated to be \$1.2 billion in 2015-16, and grow to \$1.8 billion in 2018-19.

Importantly, the cost of providing additional core services does not add to the State's debt burden. By June 2019, net debt is projected to be 4.4 per cent of GSP, lower than inherited by the Government in the *2014 Pre-Election Budget Update*.

The Government's prudent approach to funding its priorities for Victorian families continues the tradition upheld by successive Labor governments of strong financial management, consistent with its commitment to maintaining the State's triple-A credit rating.

The *2015-16 Budget* delivers \$9.2 billion of new output initiatives focusing on:

- a progressive social agenda that invests in key service delivery across health, disability and community services, responding to social challenges including \$250 million for child protection and family services, \$81 million for family violence initiatives and \$30 million for ice addiction action, so that all Victorians can enjoy an improved standard of living;
- the Education State commitments which prepare Victoria's workforce for a knowledge-based economy. The Government is providing \$2.9 billion of funding over the budget and forward estimates for schools including committing to funding levels in the Gonks School Funding Agreement for the 2016 and 2017 school years; and
- tackling job creation that includes the Back to Work Plan with support for businesses to employ people likely to be excluded from the labour market by providing \$508 million for the creation of the Premier's Jobs and Investment Fund, \$500 million for the Regional Jobs and Infrastructure Fund and \$200 million for the Future Industries Fund. These initiatives complement the jobs that will be created through several major project initiatives including the Melbourne Metro Rail Project, the Level Crossing Removal Program and the School Capital Program.

The \$9.2 billion of new output expenditure includes \$3.2 billion for the Government's election commitments. Funding provisions have been made to deliver the remaining election commitments in future budgets.

The *2015-16 Budget* outlook includes modest revenue measures. A 3.0 per cent stamp duty surcharge is to be applied to foreign buyers of residential real estate, and a 0.5 per cent land tax surcharge will be applied to absentee owners of property in Victoria. These measures do not increase the tax burden on Victorian residents and are consistent with the Government's commitment not to fund its election commitments through increased taxes on the Victorian community.

Box 4.2: East West Link

On 15 April 2015, the Government announced that it had negotiated an agreement with the East West Link consortium. Under the agreement, the State will purchase the companies in the consortium (EWL Project Co) for one dollar. All assets owned by EWL Project Co will transfer to the State.

Net costs of \$339 million had already been drawn down and paid to the consortium for the bid process, design and pre-construction. These costs have already been incurred and cannot be retrieved. They will be retained by the consortium subject to a certification process between it and the State.

A further \$81 million of fees were incurred to establish the EWL Project Co credit facility of \$3 billion. The State intends to negotiate with the banks to take over that facility to contribute to funding for the Melbourne Metro Rail Project and will receive value for those fees. All rates, fees, swaps and obligations related to the credit facility will now be worked through between the financiers and the State.

The *2014-15 Budget* disclosed the \$6-\$8 billion total estimated investment for East West Link – Eastern Section, and \$8-\$10 billion for the Western Section.

Of this, the project incurred costs under the former Government over 2013-14 and 2014-15. The majority of these costs relate to land and property acquisitions, which the Government has already announced will now be sold, with the proceeds to offset these costs.

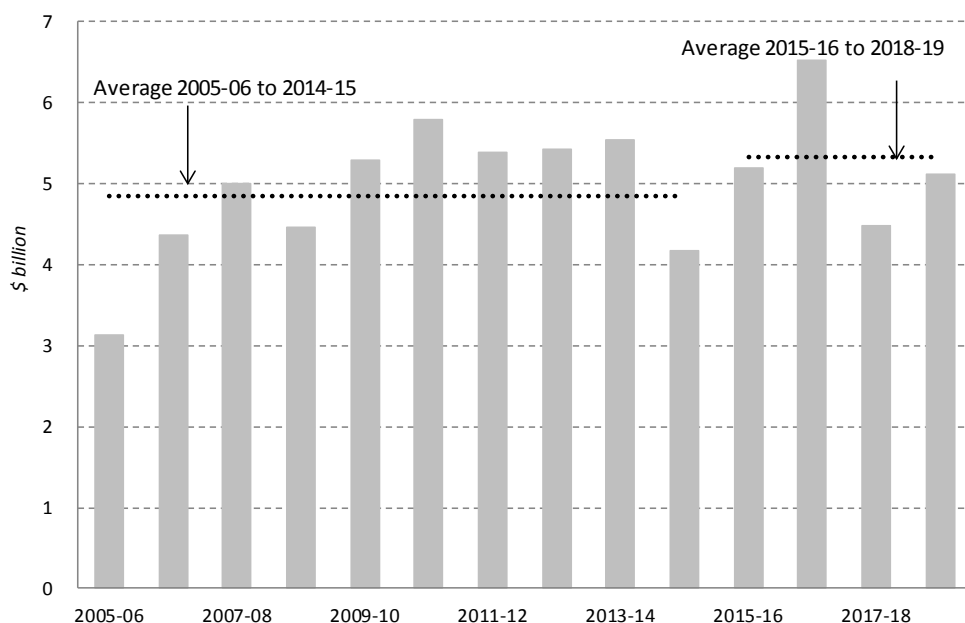
The remaining costs relate to planning, procurement and the former Government reimbursing costs incurred by the unsuccessful bidders.

With the Government successfully negotiating this agreement with the consortium, the remaining allocated funding, amounting to around \$7 billion across the budget and forward estimates, is now available to fund other more critical priorities.

Government infrastructure investment (GII) remains at historically high levels. Estimated GII over the budget and forward estimates averages \$5.3 billion a year compared with the historical average of \$4.9 billion over the decade to 2014-15 (Chart 4.2).

The *2015-16 Budget* includes up to \$22 billion TEI of new infrastructure investment that will improve the longer-term productivity and liveability of Melbourne and regional Victoria.

Chart 4.2: Government infrastructure investment^{(a)(b)(c)}



Source: Department of Treasury and Finance

Notes:

- (a) Includes general government net infrastructure investment and estimated cashflows for Partnerships Victoria projects.
- (b) Excludes the impact in 2015-16 of the medium-term lease over the operations of the Port of Melbourne.
- (c) The figure for 2014-15 is an estimate.

The Government is on track to fully fund the State’s unfunded superannuation liability by 2035. The general government superannuation funding ratio – the proportion of liabilities of the former State Superannuation Fund which is backed by superannuation plan assets – is projected to increase from 46.0 per cent at June 2015 to 48.9 per cent by June 2019.

BUDGET AND FORWARD ESTIMATES OUTLOOK

Table 4.2 summarises the operating statement over the budget and forward estimates for the general government sector. A comprehensive operating statement is presented in Table 1.1 in Budget Paper No. 5, Chapter 1 *Estimated financial statements and notes*.

Table 4.2: Summary operating statement for the general government sector^(a)

	(\$ million)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	actual	revised	budget	estimate	estimate	estimate
Revenue						
Taxation	16 901	18 274	19 024	19 804	20 403	21 340
Dividends, TER and interest ^(b)	1 277	1 850	1 975	1 841	1 874	1 919
Sales of goods and services	6 725	6 525	6 779	6 909	7 016	7 026
Grants	25 145	24 584	25 579	26 090	27 508	28 605
Other current revenue	2 317	2 309	2 171	2 249	2 235	2 289
Total revenue	52 365	53 542	55 529	56 894	59 037	61 179
% change ^(c)	7.7	2.2	3.7	2.5	3.8	3.6
Expenses						
Employee expenses	18 012	18 478	19 903	20 568	21 492	22 346
Superannuation ^(d)	2 929	2 902	2 988	2 967	2 953	2 946
Depreciation	2 364	2 497	2 577	2 722	2 880	3 146
Interest expense	2 138	2 103	2 096	2 099	2 163	2 118
Other operating expenses	17 360	18 459	18 058	17 993	18 636	18 945
Grants and other transfers	7 586	8 220	8 687	9 149	9 547	9 849
Total expenses	50 388	52 659	54 310	55 497	57 671	59 351
% change	3.0	4.5	3.1	2.2	3.9	2.9
Net result from transactions	1 976	883	1 219	1 397	1 366	1 828
Total other economic flows included in net result	(1 203)	(351)	5 147	(256)	(256)	(275)
Net result	773	532	6 366	1 141	1 110	1 553

Source: Department of Treasury and Finance

Notes:

(a) Figures in this table are subject to rounding to the nearest million and may not add up to totals.

(b) Comprises dividends, income tax and rate equivalent revenue and interest.

(c) The estimate for revenue growth in 2013-14 includes the Commonwealth Government's decision to prepay \$1 billion of its contribution to the East West Link project late in 2013-14.

(d) Comprises superannuation interest expense and other superannuation expenses.

The operating surplus for 2015-16 is expected to be \$1.2 billion, growing to \$1.8 billion in 2018-19. These operating surpluses allow significant investment in social services and infrastructure while keeping debt at manageable levels.

These surpluses are a result of expenses growing at a slower rate than revenues. Over the budget and forward estimates expenses are expected to grow by 3.0 per cent a year on average compared with revenue growth of 3.4 per cent over the same period.

Revenue outlook

Victoria is expected to collect \$56 billion in total revenue in 2015-16, with revenue growth averaging 3.4 per cent over the budget and forward estimates. This is below average revenue growth of 6.3 per cent over the past decade, a period when accelerated growth in income was driven by favourable economic conditions prior to the global financial crisis.

As outlined in Chapter 2 *Economic context*, despite a moderation in global economic conditions that has been weighing on the domestic environment and Victoria's income and consumption-based taxes, Victoria's economic outlook is positive.

The low interest rate environment has been an important driver of revenue growth from Victoria's property market. This is likely to continue into 2016.

Over the forward estimates, historically low interest rates and the significant depreciation in the Australian dollar will provide a boost to domestic spending. This will accelerate the transition towards stronger and more balanced growth across Australia, which will particularly benefit Victoria's diversified economy. As demand picks up, this will absorb spare capacity in the labour market, supporting stronger wages, income, consumption and revenue.

Taxation

The level of total taxation revenue is expected to grow by 4.1 per cent to \$19 billion in 2015-16, then by an average of 3.9 per cent a year over the forward estimates to \$21 billion in 2018-19. Strong land transfer duty revenue is offsetting weakness in income and consumption-based taxes such as payroll and gambling. Looking forward, an expected pick-up in demand will boost employment and income, which should offset the projected easing in land transfer duty growth as the property cycle matures.

Specifically:

- land transfer duty revenue is expected to grow by 2.9 per cent to around \$5.0 billion in 2015-16. These forecasts include the new stamp duty surcharge to be applied to foreign buyers of residential real estate from 2015-2016 onwards. Since the middle of 2013, the property market has grown strongly, driven largely by investor activity. While interest rates are likely to remain low for some time, the current cycle of strong growth has already lasted two years. Historically, a period of more subdued growth has followed periods of strong growth in land transfer duty as reflected in the below-trend growth forecast from 2015-16 onwards;

- land tax revenue is forecast to fall by 1.4 per cent to \$1.8 billion in 2015-16 reflecting the second year of the bi-annual revaluation cycle. From 2016-17 onwards, land value growth is expected to follow projected rates of nominal economic growth. This includes the impact of the land tax surcharge that will be applied to absentee owners of property in Victoria announced in this budget that will be introduced from the 2016 land tax year;
- payroll tax revenue is expected to grow by 6.2 per cent to \$5.4 billion in 2015-16. As demand recovers this should boost full-time employment and drive a recovery in payroll tax. While Victorian employment growth has strengthened since mid-2014, much of this has been concentrated in part-time jobs. Aggregate hours worked, which is closely aligned with payroll tax revenue, has not experienced the same growth, as discussed in Chapter 3 *The jobs challenge*;
- gambling tax revenue is forecast to grow by 3.9 per cent to \$1.9 billion in 2015-16 and by an average of 2.9 per cent a year over the forward estimates. The growth in gambling tax revenue reflects general weakness in nominal consumption expenditure. Despite an expected recovery in household income, gambling expenditure will continue to decline as a share of household consumption, weighing on revenue growth;
- insurance tax revenue is anticipated to grow by 5.4 per cent to \$1.2 billion in 2015-16 before settling to around its trend growth rate of 6.8 per cent a year over the forward estimates. Stronger than expected competition from low cost and overseas insurers is driving down premium rates in the Australian insurance market; and
- motor vehicle taxes are expected to grow by 4.5 per cent to \$2.2 billion in 2015-16, and by an average of 4.2 per cent over the forward estimates, broadly in line with its trend growth rate. Despite a period of modest income growth, motor vehicle purchases have remained resilient, supporting solid growth in motor vehicle duties.

Details of specific revenue measures since the *2014-15 Budget Update* are contained in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

Dividends, income tax equivalent and interest

Dividends, income tax equivalent and interest revenue is projected to be \$2.0 billion in 2015-16, an increase of 6.8 per cent from 2014-15, and remain stable around this level over the forward estimates.

The outlook for investment revenue in 2015-16 is consistent with the strong performance of the Public Financial Corporation (PFC) sector.

Consistent with previous commitments the Government is not taking a dividend from WorkSafe Victoria across the budget and forward estimates. Instead, surplus accumulated will be used to fund improvements to benefits and access to benefits for injured workers, lower WorkCover premiums for Victorian businesses and programs to improve workplace safety and the health of the Victorian workforce.

Sales of goods and services

Revenue from the sales of goods and services is expected to grow by 3.9 per cent to \$6.8 billion in 2015-16. This growth reflects an increase in the capital asset charge from VicTrack associated with an increase in the capital asset base for which there is an offset in grant expenses. Thereafter growth moderates to an average of 1.2 per cent a year over the forward estimates.

Grants

Total grants revenue is expected to grow by 4.0 per cent to \$26 billion in 2015-16 and increase by 3.8 per cent a year on average to \$29 billion in 2018-19. The movement in total grants revenue is largely driven by growth in the GST.

Victoria's GST revenue is expected to increase by 6.3 per cent in 2015-16, up from 4.4 per cent growth in 2014-15 as Australia recovers from subdued income growth and Victoria's share of the GST increases. As Australia transitions to more balanced growth over the forward estimates, income and consumption will improve further. Price growth will be stronger, particularly as the impact of the carbon tax removal and the recent fall in petrol prices subsides.

Growth in national dwelling investment, which grew by 8.1 per cent in the year to December 2014, is also expected to continue providing some support to the national pool in the near term.

Over the forward estimates, despite a fall in commodity prices, growth in export volumes in the mining states will support their fiscal positions. This will in turn, contribute to growth in Victoria's share of GST, consistent with the established principles of GST distribution.

These factors will contribute to stronger GST growth of 7.5 per cent a year on average over the forward estimates.

Commonwealth grants for specific policy purposes are projected to be \$12.7 billion a year on average across the budget and forward estimates. The Commonwealth provides these grants as contributions towards healthcare, education, disability and other services, and major infrastructure investment. While the outlook is relatively stable across the forward estimates there is significant movement in the underlying components of the grants.

Recurrent grants are lower in 2016-17 primarily due to the agreed transfer of responsibilities under the Home and Community Care National Partnership from Victoria to the Commonwealth. Growth in recurrent grants is expected to decrease from 2017-18 onwards due to the Commonwealth's decision to reduce funding growth for the Health Reform and schools agreements. Total specific policy purposes grants for 2017-18 and 2018-19 are relatively stable due to the offsetting impact of capital grants.

Other current revenue

Other current revenue includes fines, royalties, donations and gifts, assets received free of charge and other miscellaneous revenues. Other current revenue is projected to decrease by 6.0 per cent to \$2.2 billion in 2015-16 due to lower fees and fines revenue, and grow by an average of 1.8 per cent a year across the forward estimates.

Expenses outlook

The Government will spend \$54 billion in 2015-16 providing services to the community. Total expenses are expected to grow by 3.0 per cent a year on average over the budget and forward estimates compared with a 3.4 per cent growth in revenue over the same period.

The level and expected growth in expenses is higher than estimates forecast in *2014 Pre-Election Budget Update* reflecting the Government's decision to invest more in services. However, expenses growth remains lower than revenue growth over the forward estimates and is reflected in large and growing operating surpluses.

Specifically:

- employee expenses (including superannuation), which accounts for 42 per cent of operating expenditure in 2015-16, is projected to grow by 7.1 per cent to \$23 billion in 2015-16 and by 3.4 per cent a year on average over the forward estimates. The growth in 2015-16 is driven by annual growth in wages, growth in staffing numbers associated with growing patient demand and increased investment in the education sector;
- grants and other transfer expenses includes funding provided to non-government schools, VicTrack and V/Line for operational costs incurred in the provision of transport services, and local governments. Expenditure is forecast to grow by 5.7 per cent to \$8.7 billion in 2015-16 and by 4.3 per cent a year on average over the forward estimates. This increase primarily reflects growth in capital asset payments to VicTrack;
- other operating expenses includes the purchase of supplies and services in the human services, health and transport sectors, and maintenance accounts. Other operating expenses are projected to decrease by 2.2 per cent in 2015-16 and grow by an average of 1.6 per cent a year to \$19 billion in 2018-19;
- depreciation expenses are projected to grow by 3.2 per cent to \$2.6 billion in 2015-16, increasing by 6.9 per cent a year on average over the forward estimates to \$3.1 billion in 2018-19. Growth in the depreciable asset base over the forward estimates reflects the Government's commitment to invest in state infrastructure, particularly within the transport network through the Melbourne Metro Rail Project and the procurement of additional E-Class trams; and
- interest expenses are forecast to be \$2.1 billion in 2015-16, a 0.3 per cent decline from 2014-15 in line with the reduction in net debt profile in 2015-16. Interest payments over the forward estimates are expected to grow by 0.4 per cent a year on average.

Medium-term demographic changes including a growing population and an increasing proportion of Victorians aged 65 and over pose challenges to sustainably funding the delivery of high-quality services.

Other economic flows

The difference between the net result from transactions and the net result is other economic flows included in the net result. This typically includes gains and losses from the disposal of non-financial assets, adjustments for bad and doubtful debts and revaluations of financial assets and liabilities.

The revised gain in other economic flows of \$5.1 billion in 2015-16 largely reflects forecast gains of entering into a medium-term lease over the operations of the Port of Melbourne partly offset by the impact of bad and doubtful debts.

Reconciliation of estimates to the *2014-15 Budget Update*

The net result from transactions has been revised down by \$1.0 billion in 2015-16 and to an average of \$1.4 billion across 2016-17 and 2017-18, since the *2014-15 Budget Update*.

Table 4.3: Reconciliation of estimates to the 2014-15 Budget Update^{(a)(b)}

(\$ million)

	2015-16 budget	2016-17 estimate	2017-18 estimate
Net result from transactions: 2014-15 Budget Update	2 198	2 414	2 444
Policy decision variations			
Revenue policy decision variations	49	76	91
Output policy decision variations ^(c)	(1 049)	(897)	(793)
	(1 000)	(821)	(703)
Economic/demographic variations			
Taxation	283	66	(175)
Investment income ^(d)	257	115	(118)
	540	181	(293)
Commonwealth grant variations			
General purpose grants	228	70	(279)
Specific purpose grants ^(e)	(529)	(8)	918
	(301)	63	639
Administrative variations			
Contingency offset for new policy ^(f)	89	127	273
Other administrative variations	(308)	(566)	(994)
	(219)	(439)	(721)
Total variation since 2014-15 Budget Update	(979)	(1 017)	(1 078)
Net result from transactions 2015-16 Budget	1 219	1 397	1 366

Source: Department of Treasury and Finance

Notes:

- (a) This table has been refined since the 2014-15 Budget Update to remove the double count of categories appearing under both revenue and expenses. Signage denotes impact on operating result.
- (b) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (c) This is represented in Table 4.4 as the 2015-16 Budget output policy decisions.
- (d) Investment income includes dividends and income tax and rate equivalent revenue.
- (e) Reflects the change in grant revenue as per Budget Paper No. 5, Chapter 1 Note 5 Grant Revenue less associated expense movements.
- (f) Represents release of Funding Not Allocated to Specific Purposes contingencies associated with demand for government services.

Policy decision variations

New revenue and output policy decisions reflect the impact of the 2014-15 Budget output initiatives net of new savings.

Details of specific policy initiatives since the 2014-15 Budget Update are contained in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

Economic and demographic variations

Since the *2014-15 Budget Update*, land transfer duty, land tax and investment income have been the key drivers of variances in expected economic and demographic variations:

- land transfer duty revenue is expected to be around \$332 million higher in 2015-16, \$146 million higher in 2016-17 and \$86 million lower in 2017-18, compared to the forecasts in the *2014-15 Budget Update*. Over the past two years, the property market has been on a strong upward trajectory driven by historically low interest rates and increased investor activity. However, given the cyclical nature of the property market, the risks of a downturn increase as the current strong property cycle matures. The flatter growth rates in the forward estimates years compared to those forecast in the *2014-15 Budget Update* cause forecast revenue to be lower in 2017-18;
- land tax revenue in 2015-16 is forecast to be \$53 million higher compared with the *2014-15 Budget Update*. This is mainly due to greater investor activity in the property market, as a higher proportion of Victoria's stock of land is held by businesses and investors, who do not receive the primary place of residence exemption;
- partly offsetting land transfer duty and land tax revenue, payroll tax is expected to be \$38 million lower in 2015-16 compared with *2014-15 Budget Update*. A divergence between aggregate hours worked and total employment means payroll tax revenue has not kept pace with recent gains in employment. Over the forward estimates, aggregate hours worked are expected to improve in line with the forecast period of sustained employment growth. Payroll tax forecasts align with previous forecasts from 2016-17 onwards; and
- total investment income has increased by an average of \$186 million in 2015-16 and 2016-17 compared to the *2014-15 Budget Update*, and reduced by \$118 million in 2017-18. The increase in 2015-16 and 2016-17 primarily reflects additional dividends from the Transport Accident Corporation (TAC) that will be used to fund additional road infrastructure investment. Partly offsetting this, dividends previously scheduled for WorkSafe Victoria will not be taken in this budget, in line with the Government's commitment before the election. Instead, accumulated surpluses will be reinvested in improved benefits for injured workers, lower premiums for businesses, and programs to improve workplace safety and the health of the Victorian workforce. The Government has convened a WorkHealth advisory group to advise how best to meet these commitments before returning monies to the State in future years. In addition, lower expected investment income in 2017-18 largely reflects lower income tax equivalent payments by TAC due to reduced investment income and the impact of bond rate movements on claim costs.

Commonwealth grants variations

General purpose grants (GST revenue) for 2015-16 are expected to be \$228 million stronger than forecast in the *2014-15 Budget Update*. The upgrade reflects growth in the GST pool and an improvement to Victoria's GST relativity as recommended by the Commonwealth Grants Commission (CGC) in their methodology review. The decrease in GST in 2017-18 largely reflects the impact of lower expected relativities, although overall growth in GST revenue is still expected to be strong.

Commonwealth specific purpose and national partnership grants revenue is expected to decrease by \$529 million in 2015-16 and increase by \$918 million in 2017-18. This primarily reflects the rescheduling to 2017-18 of expected revenues under the asset recycling initiative, consistent with the Government's priorities for infrastructure investment.

Administrative variations

The release of contingency as part of the *2015-16 Budget* to offset new policy decisions averages \$163 million a year.

Other administrative variations have reduced the operating surplus by \$623 million a year on average from 2015-16 to 2017-18. These movements largely reflect:

- prudent provisioning for future budgets to meet the Government's service delivery priorities;
- higher than expected payments for the tail of the First Home Owners Grant scheme; and
- additional depreciation averaging \$41 million due to a change in accounting policy for measuring the fair value of school buildings.

New output initiatives by department

The *2015-16 Budget* provides \$9.2 billion in new output initiatives over the five years to 2018-19.

The Government is advancing a progressive social agenda by delivering on its election commitments across all portfolios.

Table 4.4 shows the impact of new output measures in this budget summarised by department, with further detail in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

Table 4.4: Net impact of the 2015-16 Budget new output initiatives^{(a)(b)}

(\$ million)

	2015-16 budget	2016-17 estimate	2017-18 estimate	2018-19 estimate
Economic Development, Jobs, Transport and Resources	608	445	459	383
Education and Training	467	795	945	965
Environment, Land, Water and Planning	153	42	1	2
Health and Human Services	730	687	751	807
Justice and Regulation	130	145	144	144
Premier and Cabinet	49	36	37	36
Treasury and Finance	13	3	3	3
Courts	8	4	5	5
Parliament	1	1	1	1
Whole of government	72	17	12	14
Subtotal	2 231	2 176	2 358	2 359
Less:				
Funding from reprioritisation of existing resources ^(c)	490	371	332	257
Adjustments ^(d)	620	824	1 143	1 377
Savings	72	84	91	88
2015-16 Budget output policy decisions	1 049	897	793	637
Less: contingency offset for new policy ^(e)	89	127	273	312
Net impact	960	770	520	325

Source: Department of Treasury and Finance

Notes:

- (a) Department totals reflect gross expenditure outlined in Budget Paper No. 3, Chapter 1 Output, asset investment, savings and revenue initiatives.
- (b) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (c) This includes the reprioritisation of resources previously allocated to departments and retained revenues.
- (d) Primarily incorporates the net impact of the creation and release of Decisions Made but Not Yet Allocated contingencies.
- (e) Represents release of Funding Not Allocated to Specific Purposes Contingencies associated with demand for government services.

CASH FLOWS

This budget reallocates provisions for projects announced by the former government that will no longer proceed, to provide funding to boost output priorities and deliver the Government's key asset election commitments.

Net debt is expected to fall over the budget and forward estimates as a percentage of GSP to a level lower than forecast in the *2014 Pre-Election Budget Update*.

Total net investment in fixed assets is projected to be a net negative of \$2.3 billion in 2015-16 and average \$4.9 billion a year over the forward estimates. This largely reflects the net impact of additional investment in new assets including prudent provisioning for future budgets and remaining capital election commitments, and the forecast proceeds from entering into a medium-term lease over the operations of the Port of Melbourne.

In addition to net investment in fixed assets, infrastructure investment is also funded and delivered through public private partnerships. These projects are included in the general government infrastructure investment measure, which is projected to be \$5.2 billion for 2015-16, and average \$5.4 billion a year over the forward estimates.

Table 4.5: Application of cash resources for the general government sector^(a)

	(\$ million)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	actual	revised	budget	estimate	estimate	estimate
Net result from transactions	1 976	883	1 219	1 397	1 366	1 828
Add back: non-cash revenue and expenses (net) ^(b)	1 966	3 469	2 536	2 460	3 205	2 805
Net cash flows from operating activities	3 943	4 352	3 755	3 856	4 570	4 634
Less:						
Net investment in fixed assets						
Purchases of non-financial assets	3 997	4 018	4 552	5 667	4 663	3 744
Net cash flows from investments in financial assets for policy purposes	1 478	720	(6 511)	150	(1 111)	69
Funding not allocated to specific purposes ^(c)	..	..	..	500	1 000	1 450
Proceeds from asset sales	(271)	(360)	(322)	(554)	(490)	(294)
Total net investment in fixed assets^(d)	5 205	4 378	(2 281)	5 763	4 062	4 970
Surplus/(deficit) of cash from operations after funding net investment in fixed assets	(1 262)	(26)	6 036	(1 907)	508	(336)
Finance leases ^(e)	110	36	1 050	417	654	..
Other movements	(19)	3	643	38	45	49
Decrease/(increase) in net debt	(1 353)	(65)	4 342	(2 361)	(191)	(385)

Source: Department of Treasury and Finance

Notes:

- (a) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (b) Includes depreciation, movements in the unfunded superannuation liability and liability for employee benefits.
- (c) The amount available to be allocated to specific departments and projects in future budgets including capital contributions to other sectors.
- (d) Includes total purchases of plant, property and equipment, and net capital contributions to other sectors of government net of proceeds from asset sales.
- (e) The 2014-15 estimate relates to the metropolitan Melbourne buses contract. The 2015-16 figure relates to the Victorian Comprehensive Cancer Centre (VCCC). The 2016-17 figure relates to the Bendigo Hospital redevelopment (Stage 1) and the New Schools PPP (Tranche 1). The 2017-18 figure relates to the Bendigo Hospital redevelopment (Stage 2), Ravenhall Prison and the New Schools PPP Tranche 2.

New asset initiatives by department

The *2015-16 Budget* provides up to \$22 billion TEI in new asset initiatives.

The *2014-15 Budget Update* provided funding to advance key asset election commitments including the Melbourne Metro Rail Project and the Level Crossing Removal Program. This budget builds upon that funding to further those infrastructure priorities and develop an integrated transport network.

The budget commits \$9-\$11 billion to deliver the Melbourne Metro Rail Project, including \$1.5 billion over the budget and forward estimates to complete the planning and design of the project and to commence construction by 2018.

In addition, a further \$5-\$6 billion, including between \$2.0 billion to \$2.4 billion over the budget and forward estimates is committed to implement the Government's commitment to remove 50 level crossings over eight years to reduce congestion and improve safety for cars and trains.

The budget also provides capital funding to meet the demands of a growing population by expanding school and hospital capacity and investing in public transport rolling stock.

Table 4.6 shows the impact of new asset measures in this budget summarised by department. Details of individual asset initiatives can be found in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

Table 4.6: New asset funding in the 2015-16 Budget^(a)

	(\$ million)	
	2015-16 budget	TEI ^(b)
Economic Development, Jobs, Transport and Resources	580	17 320– 20 320
Education and Training	294	668
Environment, Land, Water and Planning	18	31
Health and Human Services	172	715
Justice and Regulation	138	253
Premier and Cabinet	3	8
Treasury and Finance	..	..
Courts	8	10
Parliament	4	9
Whole of government	5	6
Total 2015-16 Budget asset funding	1 221	19 020– 22 020

Source: Department of Treasury and Finance

Notes:

- (a) Includes projects which are to be delivered through the public non-financial corporations sector on behalf of the Government.
- (b) Budget Paper No. 4 State Capital Program provides project-level cashflow information about the Government's new asset investments announced in the 2015-16 Budget, while Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives* includes a detailed list and description of all asset initiatives announced in the 2015-16 Budget.

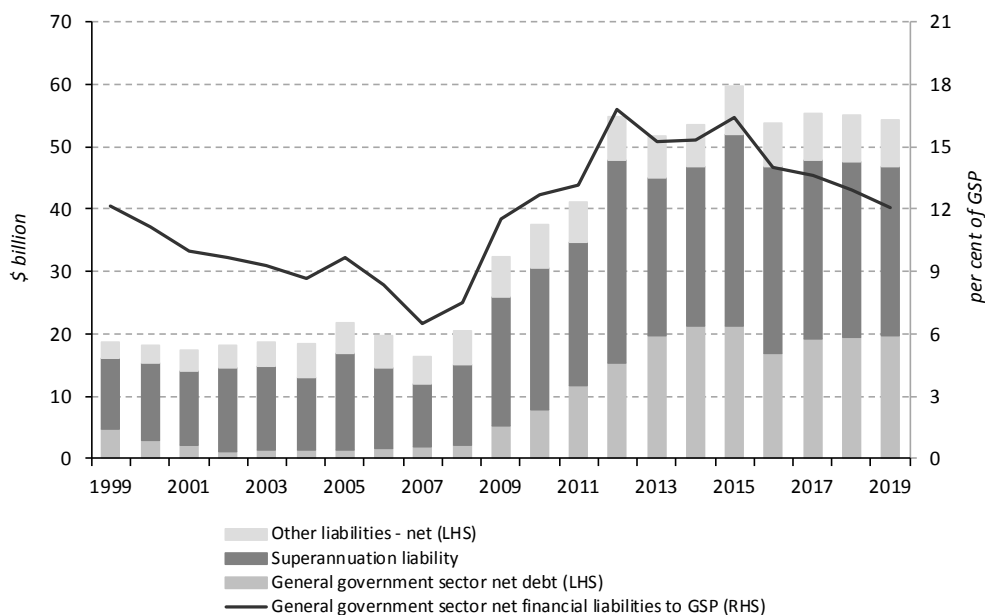
NET DEBT AND NET FINANCIAL LIABILITIES

Net debt as a proportion of GDP is expected to be 5.8 per cent at June 2015 before declining sharply in 2015-16 largely reflecting the receipt of proceeds from entering into a medium-term lease over the operations of the Port of Melbourne. By June 2019 net debt as a proportion of GDP is expected to be 4.4 per cent, lower than the June 2018 estimate of 4.5 per cent published in the *2014 Pre-Election Budget Update*.

Chart 4.3 presents the trend in net financial liabilities, a key measure of overall indebtedness used by international credit rating agencies to assess the State's financial position. General government net financial liabilities sums the superannuation liability, net debt (sum of deposits held, advances received and borrowings, less the sum of cash, deposits, advances paid and investments, loans and placements) and other net liabilities. Overall, estimated net financial liabilities as a proportion of GDP are on a downward trajectory over the forward estimates.

The increase in the superannuation liability since 30 June 2014 is primarily due to a significant reduction in the discount rate required to value this liability under Australian Accounting Standard AASB 119 *Employee Benefits*. This does not impact on the amount of cash required to fund the superannuation liability over time.

Chart 4.3: General government net financial liabilities^(a)



Source: Department of Treasury and Finance

Note:

(a) Superannuation liabilities between 1999 and 2004 are calculated under the previous Australian accounting standard, whereas from 2005 onward AASB 119 Employee Benefits has been applied.

Table 4.7: General government sector net debt and net financial liabilities

	(\$ billion)					
	2014	2015	2016	2017	2018	2019
	<i>actual</i>	<i>revised</i>	<i>budget</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Financial assets						
Cash and deposits	4.5	4.9	5.1	5.4	5.8	6.2
Advances paid	4.6	4.6	4.5	4.5	4.4	4.4
Investments, loans and placements	3.1	3.0	3.1	3.3	3.4	3.5
Total	12.2	12.5	12.8	13.2	13.6	14.1
Financial liabilities						
Deposits held and advances received	0.4	0.4	0.4	0.4	0.4	0.4
Borrowings	33.0	33.3	29.2	32.0	32.7	33.5
Total	33.4	33.8	29.7	32.4	33.1	34.0
Net debt ^(a)	21.2	21.2	16.9	19.3	19.5	19.8
Superannuation liability	25.7	30.8	29.8	28.7	28.1	27.0
Net debt plus superannuation liability	46.9	52.0	46.7	47.9	47.5	46.9
Other liabilities (net) ^(b)	6.7	7.6	7.1	7.3	7.5	7.4
Net financial liabilities ^(c)	53.5	59.6	53.8	55.3	55.0	54.3
	<i>(per cent)</i>					
Net debt to GSP ^(d)	6.0	5.8	4.4	4.8	4.6	4.4
Net debt plus superannuation liability to GSP ^(d)	13.4	14.3	12.2	11.8	11.1	10.4
Net financial liabilities to GSP ^(d)	15.3	16.4	14.0	13.6	12.9	12.1

Source: Department of Treasury and Finance

Notes:

- (a) Net debt is the sum of deposits held, advances received and borrowings, less the sum of cash, deposits, advances paid and investments, loans and placements.
- (b) Includes other employee entitlements and provisions and liabilities, less other non-equity financial assets.
- (c) Net financial liabilities are the sum of superannuation, borrowings and other liabilities less other non-equity financial assets.
- (d) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.

FISCAL RISKS

This section contains a number of known risks, which if realised, are likely to impact on the State's financial position and budget outcomes.

Details of specific contingent assets and liabilities, defined as possible assets or liabilities that arise from past events, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, are contained within Budget Paper No. 5, Chapter 6 *Contingent assets and contingent liabilities*.

General fiscal risks

State taxes

State tax forecasts are primarily based on an estimated relationship between taxation revenue and projected economic variables. As a result, the main source of risk to the taxation estimates is the economic environment.

For example, higher than expected economic activity or inflation will tend to lead to higher taxation revenue. Specific economic risks are presented in Chapter 2 *Economic context* and the fiscal implications of variations in economic parameters from forecasts are considered in Appendix A *Sensitivity analysis*.

There is also the risk of changes in the relationship between the economic variables and taxation revenue (such as consumer spending and motor vehicle taxes, or employment and payroll tax). Some state taxes, such as stamp duty on land transfers, are sourced from relatively volatile tax bases, and revenue from these sources may be subject to substantial annual variations.

The most likely source of risks to state tax revenue over the forward estimates is in land transfer duty. A fall in investor sentiment could cause a decline in Australia's property market activity and therefore tax revenue on property transactions.

Commonwealth grants

The distribution of GST grants between the states and territories is determined by the size of the national GST pool and each jurisdiction's population share weighted by its GST relativity. Changes to national economic conditions, particularly regarding consumer spending, affect the size of the national pool.

Revenue sharing relativities are determined by the Commonwealth Treasurer, informed by the recommendations of the Commonwealth Grants Commission (CGC). The recommended 2015-16 GST relativities, as advised by the CGC, are discussed in Budget Paper No. 5, Chapter 4 *State revenue*.

States also require increased certainty over the handling of tied funding agreements. The *2014-15 Commonwealth Budget* unilaterally reversed existing funding agreements for the health and education sectors, resulting in significant cuts to Commonwealth funding for core services from 2017-18 onwards.

The refusal to maintain funding previously agreed, as well as the Commonwealth's refusal to provide funding certainty for a number of National Partnership agreements scheduled to expire, presents a financial and service delivery risk over coming years.

Employee expenses

Employee expenses are the State's largest expense. Wages policy sets the framework for enterprise agreement negotiations and in part contributes to the projection of employee expenses.

Demand growth

Another key risk is growth in demand for government services exceeding current projections. This can occur, for example, as a result of higher than forecast population growth or expenditure in response to unforeseen events such as natural disasters, including bushfires and floods.

The estimates incorporate contingency provisions to mitigate the impact of expenditure risks, which may be realised during the budget and forward estimates. The contingency provisions are designed to address the likely growth in Victoria's population and consequent derived demand for government services.

Realised expenditure risks will affect total expenditure and the annual budget position to the extent they exceed the contingency provision factored into the estimates. More detailed disclosures of general government output and asset contingencies not allocated to departments are shown in note 12(c) and note 19(c) of Budget Paper No. 5, Chapter 1 *Estimated financial statements for the general government sector*.

In the longer term, the demand for services is expected to come under increasing pressure due to demographic pressures such as an ageing population. The Government will need to become increasingly efficient and innovative in the delivery of services to ensure that key priorities can continue to be met.

Specific fiscal risks

National Disability Insurance Scheme

Victoria is hosting a launch site for the National Disability Insurance Scheme (NDIS), which will provide useful information to guide the rollout of the full scheme across the State by July 2019. Once fully implemented, Victoria's investment in disability care and support will increase to an estimated \$2.5 billion a year, with the Commonwealth providing around \$2.6 billion a year. Victoria will work with the Commonwealth Government to monitor and manage any risks associated with implementing the full scheme.

National Injury Insurance Scheme

The Productivity Commission recommended the establishment of a National Injury Insurance Scheme (NIIS) to support people who suffer catastrophic injuries. The Commonwealth Government expects the State to fund the total cost in Victoria of a NIIS, as well as contribute to the cost of the NDIS. Victoria already provides support for people injured in motor vehicle and workplace accidents, and is discussing other streams of a NIIS with other jurisdictions but has not agreed to implement them.

Commonwealth schools funding

While final State allocations for the 2018 and 2019 school years are still subject to negotiation, the *2014-15 Commonwealth Budget* indicated that Commonwealth funding for Victorian schools would be reduced to the rate of growth of the consumer price index, plus an adjustment for enrolment growth. This is expected to significantly reduce Commonwealth growth funding to Victoria from 2017-18 onwards.

Universal Access to Early Childhood Education

Commonwealth funding under the National Partnership Agreement on Universal Access to Early Childhood Education which provides for one-third of the 15 hours per week of pre-school support per student is currently due to cease from 1 January 2016 with ongoing Commonwealth funding uncertain.

National Health Reform

The National Health Reform Agreement (NHRA) significantly changed the way the Commonwealth funds Victorian hospitals. Commonwealth growth funding is derived from a complex model based on the number of procedures delivered (activity) and an efficient price determined by an independent administrator. The *2014-15 Commonwealth Budget* announced that from 1 July 2017, the Commonwealth will cease the NHRA and provide significantly lower growth funding based on the consumer price index and population growth. This is expected to significantly reduce the Commonwealth contribution for Victorian hospitals from 2017-18 onwards.

CHAPTER 5 – POSITION AND OUTLOOK OF THE BROADER PUBLIC SECTOR

- The non-financial public sector (NFPS) is estimated to generate positive operating results over the budget and forward estimates period. This reflects the strong outlook in the general government sector focused on delivering high-quality services for all Victorians in a fiscally responsible manner.
- NFPS gross debt is projected to reach 80.7 per cent of revenue in 2014-15, before declining to 73.6 per cent by 2018-19 as cash flow surpluses reduce the reliance on debt funding. The strong outlook for the State's financial position supports the State's triple-A credit rating.
- The net result of the public financial corporations (PFC) sector is estimated to be stable with surpluses averaging \$672 million a year over the budget and forward estimates.
- The net result from transactions of the public non-financial corporations (PNFC) sector is estimated to be an average deficit of \$439 million a year over the budget and forward estimates.

This chapter provides an overview of the activities of the broader public sector, comprising:

- the NFPS, which consolidates the general government sector and the public non-financial corporations sector. The general government sector is discussed in Chapter 4 *Budget position and outlook*. The PNFC sector comprises a wide range of entities that provide services primarily funded from user charges and fees. The largest PNFCs provide water, housing, transport and port services; and
- the State of Victoria, which is a consolidation of the NFPS and the PFC sectors. PFCs can be categorised into two broad types: those that provide services to the general public and businesses (such as WorkSafe Victoria and the Transport Accident Commission), and those that provide financial services, predominantly to other government entities (such as the Victorian Funds Management Corporation, Treasury Corporation of Victoria and the Victorian Managed Insurance Authority).

SUMMARY OPERATING RESULTS – NON-FINANCIAL PUBLIC SECTOR

Table 5.1: Summary operating statement for the non-financial public sector^(a)

	(\$ million)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	actual	revised	budget	estimate	estimate	estimate
Revenue						
Taxation revenue	16 505	17 861	18 595	19 567	20 148	21 065
Dividends, income tax equivalents and interest ^(b)	669	1 060	1 201	1 131	1 161	1 161
Sales of goods and services	11 005	10 533	10 654	10 595	10 912	11 269
Grants	25 125	24 586	25 581	26 093	27 510	28 608
Other revenue	2 730	2 786	2 592	2 686	2 686	2 758
Total revenue	56 034	56 827	58 623	60 073	62 418	64 862
% change	10.6	1.4	3.2	2.5	3.9	3.9
Expenses						
Employee expenses	19 019	19 505	20 940	21 612	22 560	23 432
Superannuation ^(c)	3 030	2 990	3 078	3 058	3 048	3 042
Depreciation	4 251	4 475	4 707	4 956	5 138	5 511
Interest expense	2 824	2 757	2 753	2 745	2 808	2 788
Other operating expenses	20 099	21 291	20 863	20 816	21 568	22 055
Grants and other transfers	5 041	5 576	5 822	6 169	6 503	6 806
Total expenses	54 263	56 594	58 162	59 357	61 626	63 633
% change	3.6	4.3	2.8	2.1	3.8	3.3
Net result from transactions	1 771	232	460	716	793	1 229
Total other economic flows included in net result	(1 165)	(343)	3 831	(273)	(242)	(292)
Net result	606	(111)	4 292	443	551	938

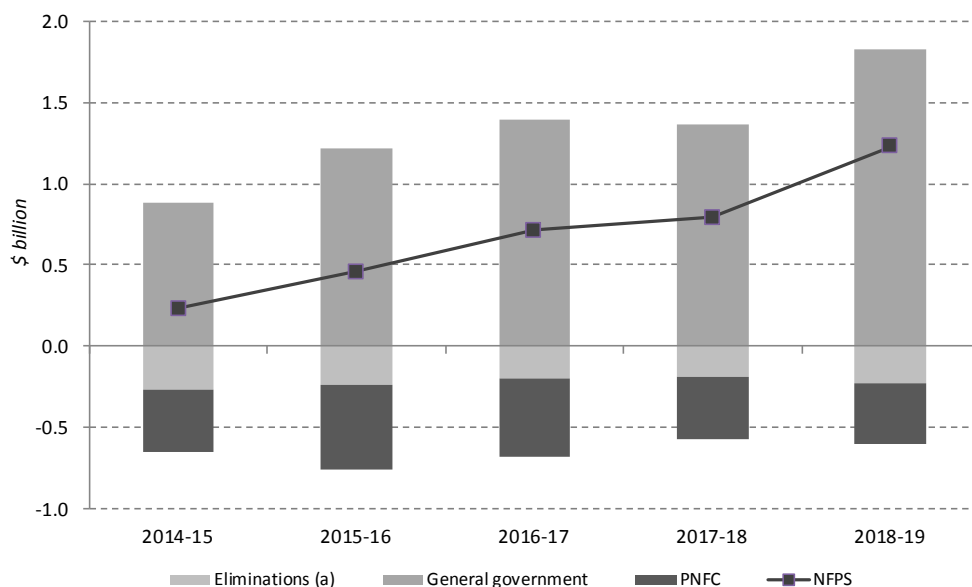
Source: Department of Treasury and Finance

Notes:

- (a) This is a summary operating statement. The comprehensive operating statement is presented in Budget Paper No. 5 Statement of Finances.
- (b) Comprises dividends, income tax and rate equivalent revenue and interest.
- (c) Comprises superannuation interest expense and other superannuation expenses.

Table 5.1 shows that the operating performance of the NFPS is forecast to improve over the budget and forward estimates period, with the net result from transactions rising to a \$1.2 billion surplus by 2018-19. The improvement is mainly driven by the performance of the general government sector, which is projected to record a net result from transactions of \$1.8 billion in 2018-19. The components of the NFPS net operating result from transactions are shown in Chart 5.1.

Chart 5.1: Components of the NFPS net operating result from transactions



Source: Department of Treasury and Finance

Note:

(a) Eliminations include transactions between the sectors, including dividends paid from PNFCs to the general government sector.

The PNFC sector is projected to record an average deficit of \$439 million over the budget and forward estimates.

A major contributor to the projected deficits of the PNFC sector is the operating position of VicTrack. Cash operating surpluses of VicTrack do not fully cover depreciation on a regular basis, resulting in reported operating losses over the budget and forward estimates. The net result from transactions of VicTrack is estimated to be a deficit of \$460 million on average over the budget and forward estimates. But the operating cash flow surplus of VicTrack is, on average, \$127 million over the budget and forward estimates. The Government considers that VicTrack is financially sustainable from a cash perspective.

Most PNFC entities are projected to record operating profits across the budget and forward estimates period. The metropolitan water sector averages a net result from transactions of \$240 million per year over the budget and forward estimates.

A strong performance from the metropolitan water sector has improved the projected performance of the PNFC sector compared with the previous estimates contained in the 2014-15 Budget Update.

APPLICATION OF CASH RESOURCES

Table 5.2 shows that the NFPS is projected to generate operating cash flow surpluses averaging \$5.5 billion a year over the budget and forward estimates period. These surpluses will be used to fund the State's infrastructure program.

Table 5.2: Application of cash resources for the non-financial public sector

	(\$ million)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	<i>actual</i>	<i>revised</i>	<i>budget</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Net result from transactions	1 771	232	460	716	793	1 229
Add back: non-cash income and expenses (net) ^(a)	3 865	5 257	4 415	4 341	5 169	4 991
Net cash flows from operating activities	5 636	5 490	4 875	5 057	5 962	6 221
Less:						
Net investment in fixed assets						
Net cash flows from investments in non-financial assets	6 791	6 115	(506)	6 964	5 828	5 410
Net cash flows from investments in financial assets for policy purposes	(13)	(386)	53	(46)	(1 179)	52
Capital provision approved but not yet allocated ^(b)	..	..	..	500	1 000	1 450
Total net investment in fixed assets^(c)	6 779	5 729	(453)	7 418	5 649	6 912
Surplus/(deficit) of cash from operations after funding net investment in fixed assets	(1 143)	(239)	5 328	(2 361)	313	(691)
Finance leases ^(d)	110	36	1 050	417	654	..
Other investment activities (net)	89	(56)	587	(4)	(40)	2
Decrease/(increase) in net debt	(1 341)	(220)	3 691	(2 774)	(301)	(693)

Source: Department of Treasury and Finance

Notes:

- (a) Includes depreciation and movements in the unfunded superannuation liability and liability for employee benefits.
- (b) The amount available to be allocated to specific departments and projects in future budgets including capital contributions to other sectors.
- (c) Includes total purchases of plant, property and equipment, and capital contributions to other sectors of government net of proceeds from asset sales.
- (d) The 2013-14 actual relates to the metropolitan Melbourne buses contract. The 2015-16 figure relates to the Victorian Comprehensive Cancer Centre (VCCC). The 2016-17 figure relates to the Bendigo Hospital redevelopment (Stage 1) and the New Schools PPP (Tranche 1). The 2017-18 estimate relates to the Ravenhall Prison project, the Bendigo Hospital project (stage 2) and the New Schools PPP project (tranche 2).

Infrastructure

Table 5.2 also provides estimates of net investment in fixed assets which consists of infrastructure expenditure net of proceeds from asset sales. Substantial proceeds from asset sales result in a net inflow of investment in fixed assets in 2015-16 before increasing to \$7.4 billion in 2016-17.

Forecasts indicate the PNFC sector will deliver a significant proportion of the Government's projected infrastructure program. The key PNFC sector infrastructure projects under development include:

- investment in transport infrastructure to meet patronage growth and improve network performance. This includes extensive investment to transform Melbourne's busiest train line, the Cranbourne-Pakenham rail corridor, with 37 new high-capacity trains, a new maintenance depot and associated infrastructure upgrades. Further rolling stock investments across the network include new X'Trapolis metropolitan trains, regional trains, and life extension works to components of the existing metropolitan train and tram fleet;
- various water-related infrastructure, including Goulburn-Murray Water's Connections Program, connecting irrigators to a modernised main system of irrigation channels; and
- the Port Capacity Expansion project, which includes developing a third international container terminal and a Pre-Delivery Inspection Facility at Webb Dock. This will enhance stevedore competition and ensure that Victoria can continue to respond to trade demand.

NON-FINANCIAL PUBLIC SECTOR NET DEBT AND NET FINANCIAL LIABILITIES

Table 5.3 provides details of NFPS net debt and superannuation liabilities. It shows that the ratio of net debt to gross state product (GSP) will fall from 9.9 per cent in 2014-15 to 8.1 per cent by 2018-19.

Superannuation liabilities are projected to fall slightly over the forward estimates, resulting in a fall in net financial liabilities to GSP from 20.4 per cent in 2014-15 to 15.6 per cent in 2018-19.

Table 5.3: Non-financial public sector net debt and net financial liabilities

(\$ billion)

	2013-14 actual	2014-15 revised	2015-16 budget	2016-17 estimate	2017-18 estimate	2018-19 estimate
Financial assets						
Cash and deposits	5.5	5.5	5.6	5.8	6.2	6.5
Advances paid	0.1	0.1	0.1	0.1	0.1	0.1
Investments, loans and placements	4.1	4.1	4.3	4.3	4.6	4.9
Total	9.7	9.7	10.0	10.2	10.8	11.5
Financial liabilities						
Deposits held and advances received	0.5	0.5	0.5	0.5	0.5	0.5
Borrowings	45.1	45.4	41.9	45.0	45.9	47.2
Total	45.6	45.8	42.4	45.5	46.4	47.7
Net debt ^(a)	35.9	36.1	32.5	35.2	35.5	36.2
Superannuation liability	25.7	30.8	29.8	28.7	28.1	27.1
Net debt plus superannuation liability	61.7	66.9	62.3	63.9	63.6	63.3
Other liabilities (net) ^(b)	6.4	7.2	6.7	6.7	6.8	6.7
Net financial liabilities ^(c)	68.0	74.2	69.0	70.7	70.4	70.0
	(per cent)					
Net debt to GSP ^(d)	10.3	9.9	8.5	8.7	8.3	8.1
Net debt plus superannuation liability to GSP ^(d)	17.6	18.4	16.2	15.8	14.9	14.1
Net financial liabilities to GSP ^(d)	19.4	20.4	18.0	17.5	16.5	15.6
Net debt plus superannuation liability to revenue ^(e)	110.0	117.8	106.3	106.4	101.9	97.6

Source: Department of Treasury and Finance

Notes:

- (a) The sum of borrowings, deposits held and advances received less the sum of cash and deposits, advances paid, and investments, loans and placements.
- (b) Includes other employee entitlements and provisions and other non-equity liabilities, less other non-equity financial assets.
- (c) Total liabilities less financial assets (excluding investments in other sector entities).
- (d) The ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
- (e) The sum of non-financial public sector net debt plus the superannuation liability as a proportion of non-financial public sector total operating revenue.

Table 5.4 projects several indicators of financial sustainability for the NFPS which are expected to improve by 2018-19. The improvement is driven by the strengthening operating cash flow surpluses and receipts from asset sales.

The ratio of operating cash flow surplus to revenue indicates the extent to which cash generated from operations can be used to fund infrastructure.

The ratio of gross debt to revenue is a measure of indebtedness. The decline in the State's indebtedness compared to 2013-14 and 2014-15 levels are reflected in the improved ratio of interest expense to revenue. This ratio measures the extent to which revenues can be used to fund essential services and infrastructure, rather than meet debt obligations.

Table 5.4: Indicators of financial sustainability for the non-financial public sector

	<i>(per cent)</i>					
	<i>2013-14</i>	<i>2014-15</i>	<i>2015-16</i>	<i>2016-17</i>	<i>2017-18</i>	<i>2018-19</i>
	<i>actual</i>	<i>revised</i>	<i>budget</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Operating cash flow surplus to revenue	10.1	9.7	8.3	8.4	9.6	9.6
Gross debt to revenue ^(a)	81.4	80.7	72.4	75.7	74.3	73.6
Interest expense to revenue	5.0	4.9	4.7	4.6	4.5	4.3

Source: Department of Treasury and Finance

Note:

(a) Gross debt includes borrowings and deposits held and advances received.

SUMMARY OPERATING RESULTS – STATE OF VICTORIA

Table 5.5: Summary operating statement for the State of Victoria^(a)

	(\$ million)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	actual	revised	budget	estimate	estimate	estimate
Revenue						
Taxation revenue	16 490	17 847	18 581	19 552	20 133	21 049
Dividends, income tax equivalents and interest ^(b)	1 853	1 519	1 913	2 119	2 141	2 032
Sales of goods and services	14 233	13 856	14 137	14 252	14 748	15 291
Grants	25 019	24 470	25 435	25 941	27 366	28 465
Other revenue	2 750	2 811	2 615	2 710	2 711	2 784
Total revenue	60 346	60 503	62 680	64 574	67 100	69 621
% change	11.3	0.3	3.6	3.0	3.9	3.8
Expenses						
Employee expenses	19 038	19 476	20 900	21 577	22 528	23 410
Superannuation ^(c)	3 054	3 013	3 102	3 082	3 072	3 066
Depreciation	4 294	4 527	4 761	5 014	5 193	5 567
Interest expense	2 954	2 866	2 841	2 828	2 887	2 851
Other operating expenses	25 114	26 405	26 225	26 379	27 416	28 142
Grants and other transfers	5 037	5 574	5 822	6 169	6 503	6 806
Total expenses	59 490	61 861	63 652	65 049	67 599	69 841
% change	3.8	4.0	2.9	2.2	3.9	3.3
Net result from transactions	857	(1 358)	(972)	(475)	(500)	(220)
Total other economic flows included in net result	803	(254.1)	5 314	1 165	1 364	1 514
Net result	1 659	(1 613)	4 342	690	864	1 295

Source: Department of Treasury and Finance

Notes:

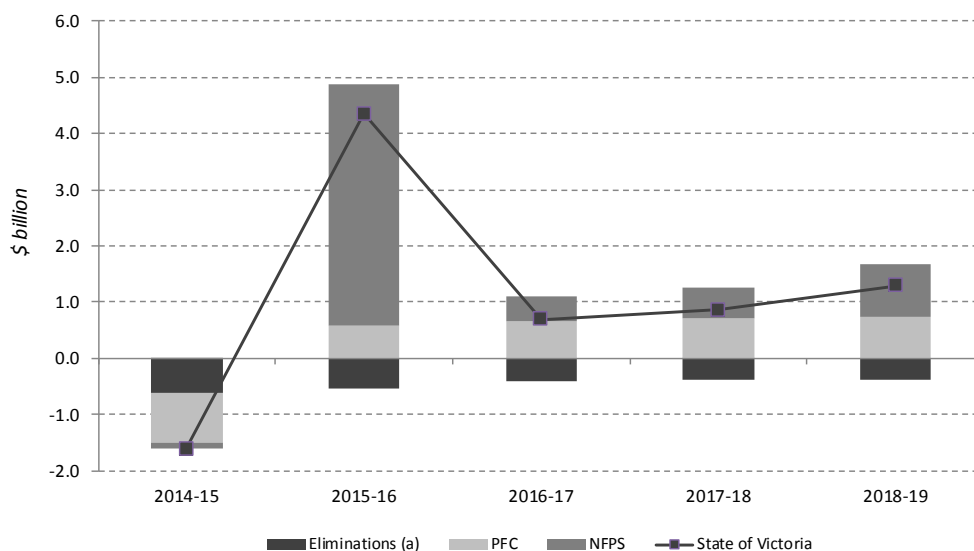
- (a) This is a summary operating statement. The comprehensive operating statement is presented in Budget Paper No. 5 Statement of Finances.
- (b) Comprises dividends, income tax and rate equivalent revenue and interest.
- (c) Comprises superannuation interest expense and other superannuation expenses.

Table 5.5 shows the operating results for the State. The net result for the State is projected to be in surplus over the budget and forward estimates. The net result includes other economic flows, which are projected to contribute an average of \$2.3 billion a year toward the net surplus over the budget and forward estimates period. The other economic flows include projected investment returns of the State's insurance agencies which are used to service their liabilities.

As a result, the net result is considered a more meaningful measure of the expected operating position of this sector and the State. Other economic flows also include valuation gains on revaluation of financial liabilities, which primarily result from movements in bond rates used to value these liabilities. For budgeting purposes, these items are assumed to be zero in the forward estimates but historical movements in these revaluations can be significant. Other economic flows are expected to increase significantly in 2015-16 to \$5.3 billion.

The PFC sector is forecast to record an average net surplus of \$672 million between 2015-16 and 2018-19, primarily due to strong investment returns and valuation gains associated with improved financial market conditions. The sector is projected to remain in a strong financial position.

Chart 5.2: Components of whole of state net result (after other economic flows)



Source: Department of Treasury and Finance

Note:

(a) Eliminations include transactions between the sectors, including dividends paid from PFCs to the general government sector.

STATE OF VICTORIA – FINANCIAL POSITION

Table 5.6 shows that the State’s financial position is projected to improve over the budget and forward estimates period. Borrowings are projected to fall significantly in 2015-16, while financial assets are projected to increase in line with long-term trends in investment returns and non-financial asset growth. As a result, the State’s net assets are forecast to increase from \$142.7 billion in 2015-16 to \$159.1 billion by 2018-19.

Table 5.6: Financial position of the State of Victoria

	(\$ billion)					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
	<i>actual</i>	<i>revised</i>	<i>budget</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Assets						
Total financial assets ^(a)	48	48	51	52	53	56
Total non-financial assets ^(b)	201	212	215	219	231	233
Total assets	248	261	266	271	284	289
Liabilities						
Superannuation	26	31	30	29	28	27
Borrowings	51	52	49	51	52	53
Deposits held and advances received	2	2	2	2	2	2
Other liabilities	38	41	42	44	45	47
Total liabilities	117	126	123	126	127	129
Net assets	131	135	143	145	156	159

Source: Department of Treasury and Finance

Notes:

- (a) Financial assets include cash and deposits, advances paid, investments, loans and placements, receivables, and investments accounted for using the equity method.
- (b) Non-financial assets include inventories, non-financial assets held for sale, land, buildings, infrastructure, plant and equipment, and other non-financial assets.

APPENDIX A – SENSITIVITY ANALYSIS

The *2015-16 Budget* is predicated on macroeconomic forecasts and assumptions which are subject to variation. This section explores the impact of variations in these parameters on key fiscal aggregates of the general government sector.

Two types of sensitivity analysis are presented. First, the fiscal impact of independent variations in economic variables is considered. This type of analysis could be useful, for example, in considering the impact of a forecast error in an individual economic parameter on the fiscal aggregates. Second, the simultaneous impact of variations in a number of economic variables is considered with reference to recent historical examples. The analysis attempts to capture some, though not all, of the interrelationships between economic variables. This provides a better understanding of the fiscal impact where the general economic environment is materially different from forecast.

While sensitivity analysis provides a useful indication of the fiscal impact of variations in economic conditions, care should be exercised in interpreting these results. The relationships between economic and fiscal aggregates are complex, and typically depend on the specific characteristics of the economic shock. For example, an asset price shock in the property market is likely to have a different fiscal impact to a sector-specific shock in say manufacturing, even if the overall impact on gross state product (GSP) and employment is similar.

SENSITIVITY TO INDEPENDENT VARIATIONS IN MAJOR ECONOMIC PARAMETERS

Table A.1 presents the sensitivity of financial aggregates, if the levels of key economic parameters are 1 per cent above the forecast for each year of the budget and forward estimates period, holding all else constant. The impacts shown are broadly symmetrical. That is, the estimated fiscal impact would apply equally in the opposite direction if a 1 per cent decrease in each variable was considered.

Table A.1: Sensitivity of key fiscal aggregates to selected economic indicators being 1 per cent higher than expected from 2014-15^{(a)(b)(c)(d)(e)}

(\$ million)

	2015-16 estimate	2016-17 estimate	2017-18 estimate	2018-19 estimate
GSP				
Income from transactions	160	169	180	196
Expenses from transactions	7	(1)	(9)	(18)
Net result from transactions	153	170	189	214
Net debt	(153)	(323)	(513)	(727)
Interest rates^(f)				
Income from transactions	227	189	299	162
Expenses from transactions	2	82	99	106
Net result from transactions	225	107	200	56
Net debt	(225)	(428)	(730)	(881)
Consumer prices^(g)				
Income from transactions	219	297	310	337
Expenses from transactions	71	72	64	50
Net result from transactions	148	226	247	286
Net result	148	226	247	287
Net debt	(148)	(381)	(635)	(929)
Employment				
Income from transactions	62	72	75	79
Expenses from transactions	(2)	(5)	(9)	(13)
Net result from transactions	64	78	84	92
Net debt	(64)	(142)	(226)	(318)
Average weekly earnings				
Income from transactions	(34)	30	(1)	(11)
Expenses from transactions	10	10	10	10
Net result from transactions	(44)	21	(11)	(21)
Net debt	44	23	34	55
Enterprise bargaining agreements^(h)				
Income from transactions	30	30	32	31
Expenses from transactions	213	258	278	299
Net result from transactions	(183)	(228)	(247)	(268)
Net debt	183	397	628	881
Domestic share prices				
Income from transactions	..	3	1	5
Expenses from transactions	..	(2)	(2)	(2)
Net result from transactions	..	5	3	7
Net debt	..	(3)	(5)	(11)
Overseas share prices				
Income from transactions	..	10	9	20
Expenses from transactions	..	(2)	(2)	(3)
Net result from transactions	..	12	11	23
Net debt	..	(10)	(19)	(40)

Table A.1: Sensitivity of key fiscal aggregates to selected economic indicators being 1 per cent higher than expected from 2014-15 (continued)

(\$ million)

	2015-16 estimate	2016-17 estimate	2017-18 estimate	2018-19 estimate
Property prices				
Income from transactions	60	93	93	98
Expenses from transactions	(2)	(6)	(11)	(16)
Net result from transactions	62	99	104	113
Other economic flows	2	5	4	3
Net result	64	103	108	116
Net debt	(64)	(167)	(274)	(390)
Property volumes				
Income from transactions	52	53	53	54
Expenses from transactions	(1)	(4)	(7)	(10)
Net result from transactions	53	57	60	64
Net debt	(53)	(110)	(170)	(234)

Source: Department of Treasury and Finance

Notes:

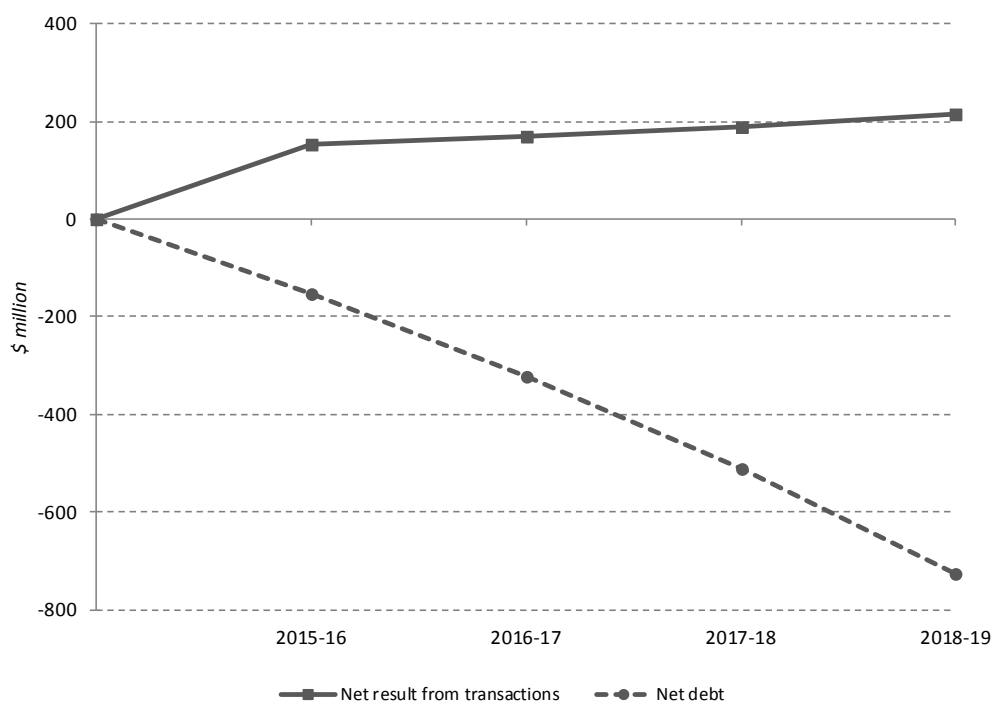
- (a) For 2015-16 Budget, the Department of Treasury and Finance has reviewed the methodology for generating the sensitivity analysis. This has resulted in identification of superannuation expense movements which flow through to net debt in more detail, consequently affecting the calculation of the net debt sensitivities to interest rates, consumer prices, enterprise bargaining agreements, domestic and overseas share prices, and property prices.
- (b) Variations are applied to the economic variables in the budget year. For the out years it is assumed that variables' growth rates match those under a no-variation scenario. This implies that economic variables are 1 per cent higher across the budget and forward years compared with a no-variation scenario.
- (c) A positive number for income from transactions denotes an increase in revenue. A positive number for expenses from transactions denotes an increase in expenses (and hence a reduction in the net result from transactions and net result). A positive number for other economic flows represents a gain. A positive number for the net result from transactions and net result denotes a higher surplus or lower deficit. A positive number for net debt denotes a higher level of net debt in the relevant year compared with a no-variation scenario. Numbers may not balance due to rounding.
- (d) The impact of a 1 per cent lower than expected outcome for an economic variable would, in most instances, simply be the opposite of the impact shown in the table.
- (e) Only reasonably quantifiable impacts have been included in the analysis.
- (f) Assumes interest rates are 1 percentage point higher across the entire term structure, i.e. short and long-term rates, over the budget and forward estimates period.
- (g) Incorporates the impact of the departmental funding model arrangements. It is assumed that an increase in consumer prices within the budget year does not affect employee entitlements.
- (h) Represents a 1 per cent increase in all government enterprise agreements.

Sensitivity to gross state product

Higher than expected GSP is associated with higher household consumption, leading to higher revenue from state taxes and goods and services tax (GST). This increases the net result from transactions and reduces net debt. As net debt is a stock variable, the impacts in each year accumulate over the forward estimates.

Based on Table A.1, if GSP was 1 per cent higher than forecast in 2015-16, the net result from transactions would increase by \$153 million. An increase in the net result would lower net debt by the same amount. Over the budget and forward estimates period, the increased surpluses would reduce the stock of net debt by \$727 million.

Chart A.1: Sensitivity of key fiscal aggregates to GSP being 1 per cent higher than expected from 2015-16^(a)



Source: Department of Treasury and Finance

Note:

(a) See footnotes for Table A.1 for detailed description of estimates.

Sensitivity to interest rates

An increase in interest rates results in a gain on the valuation of insurance liabilities of the state-owned insurance agencies, partially offset by a loss on the valuation of investment assets.

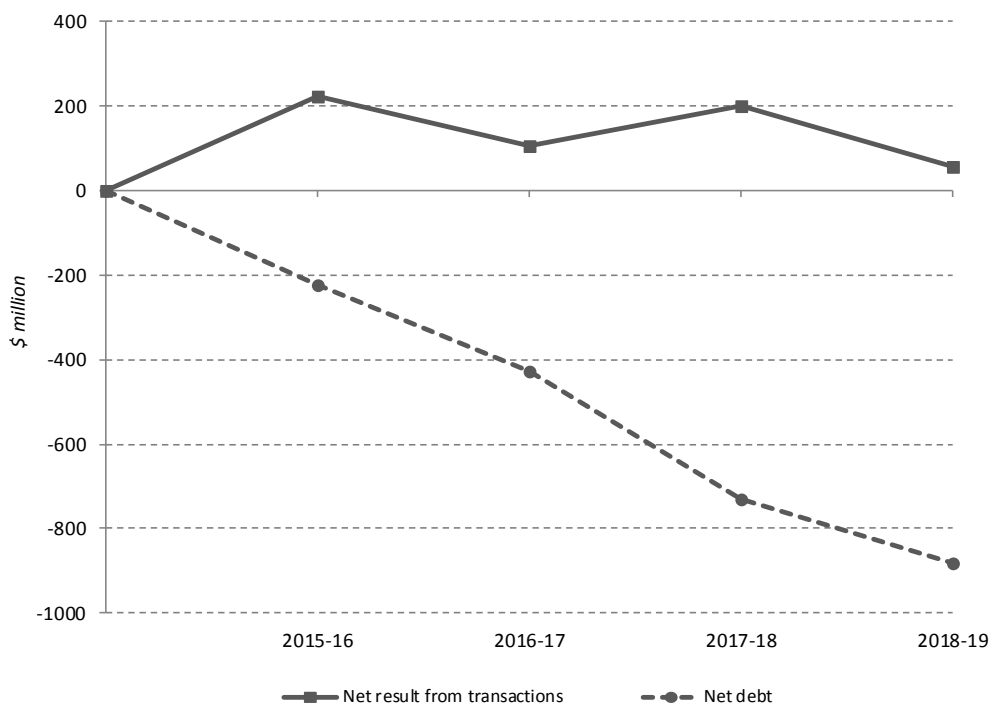
As dividends of the State’s insurance agencies are based on performance from insurance operations, which excludes the initial impact of discount rate movements, the increase in interest rates will have little direct impact on dividends in the budget year. As income tax equivalents (ITEs) of the insurance agencies are assessed on profit before tax which includes the impact of interest rates on liability and asset values, an increase in interest rates will increase ITEs.

Higher borrowing costs lead to reduced net results of public non-financial corporations, lowering dividends and ITEs payable to the State.

An increase in interest rates also increases the superannuation expense and borrowing cost of the general government sector over the out years.

The combined effect of these influences produces the profile shown in Chart A.2.

Chart A.2: Sensitivity of key fiscal aggregates to interest rates being 1 per cent higher than expected from 2015-16^(a)



Source: Department of Treasury and Finance

Note:

(a) See footnotes for Table A.1 for detailed description of estimates.

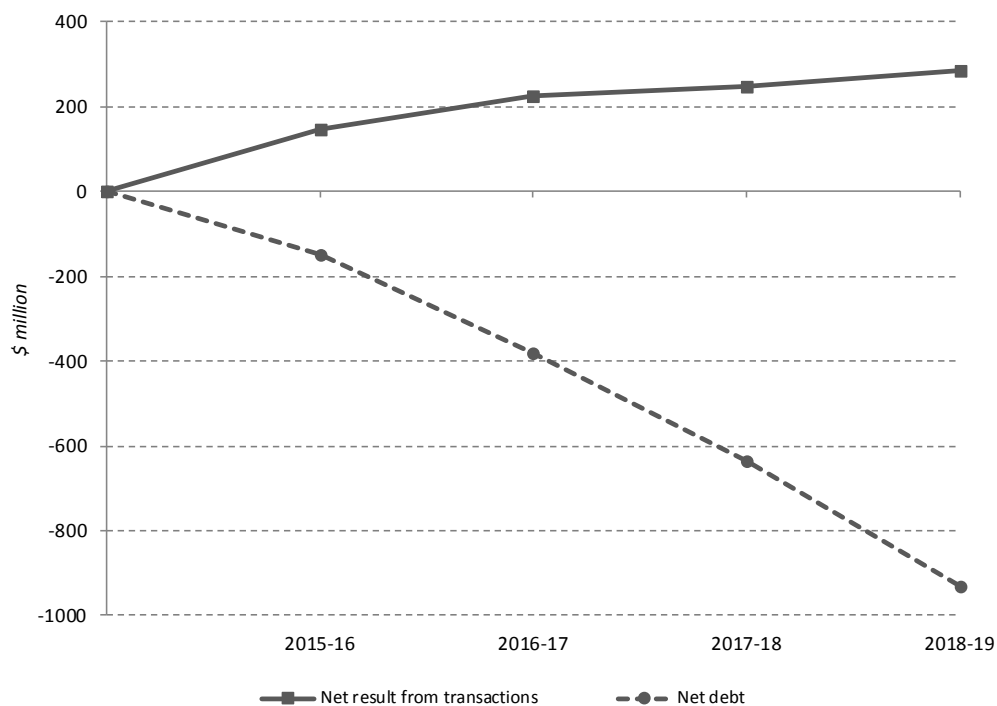
Sensitivity to consumer prices

Higher consumer prices lead to higher taxation revenue, as the nominal values of tax bases rise. Commonwealth-sourced revenue also rises due to indexation. Dividends and ITEs from the State’s insurance agencies are reduced, mainly due to higher claims expenses.

Government expenses are affected through the higher cost of supplies and services and some increases in outlays on grants and transfers. Reflecting the operation of departmental funding arrangements, the impact of higher prices is limited as only a portion of department funding is automatically indexed to inflation. An increase in consumer prices also increases the superannuation expense in the out years.

Overall, there is a positive impact on the net result from transactions and a cumulative reduction in net debt over the budget and forward estimates.

Chart A.3: Sensitivity of key fiscal aggregates to consumer prices being 1 per cent higher than expected from 2015-16^(a)



Source: Department of Treasury and Finance

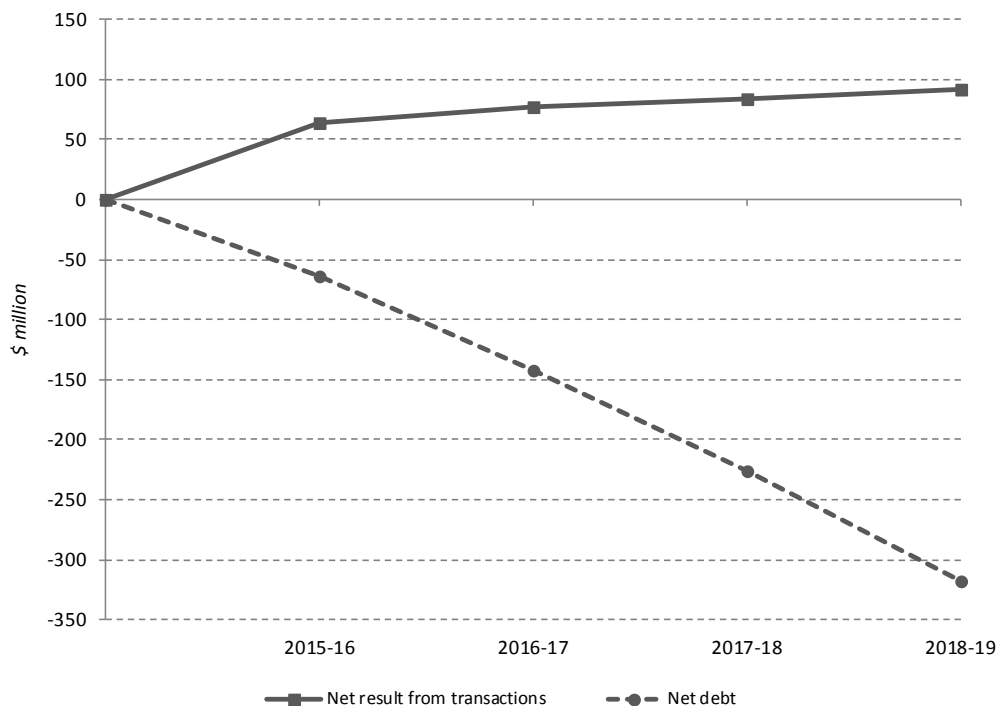
Note:

(a) See footnotes for Table A.1 for detailed description of estimates.

Sensitivity to employment

Higher than expected employment results in additional payroll tax revenue. An increase in the remuneration base also results in additional revenue from higher premiums for WorkSafe Victoria. This leads to higher ITEs for the State. These impacts increase the net result from transactions and cumulatively reduce net debt.

Chart A.4: Sensitivity of key fiscal aggregates to employment being 1 per cent higher than expected from 2015-16^(a)



Source: Department of Treasury and Finance

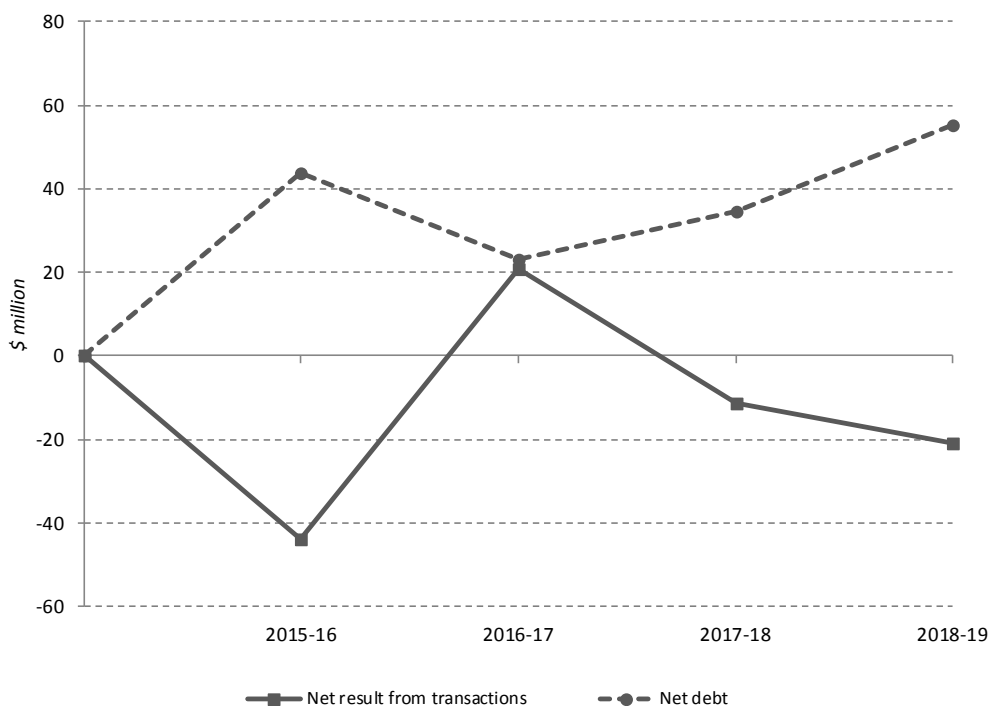
Note:

(a) See footnotes for Table A.1 for detailed description of estimates.

Sensitivity to average weekly earnings

A rise in the level of wages in the economy (but not in the public sector) results in higher payroll tax revenue in each year. ITEs fall as claims expenses for WorkSafe Victoria increase, partially offset by increased premium revenue. Overall, these effects lead to a lower net result from transactions over most of the budget and forward estimates period.

Chart A.5: Sensitivity of key fiscal aggregates to average weekly earnings being 1 per cent higher than expected from 2015-16^(a)



Source: Department of Treasury and Finance

Note:

(a) See footnotes for Table A.1 for detailed description of estimates.

Sensitivity to enterprise agreements

All government enterprise agreements are assumed to be unchanged over the projection period. An across-the-board increase in wages arising from an enterprise agreement, which exceeds the wages policy guideline rate, increases the general government sector's employee entitlement expenses.

Increased employee entitlements also increase the value of the superannuation liability and flow through to a greater superannuation expense in the out years. These impacts result in a decline in the net result from transactions and cumulatively higher net debt over the budget and forward estimates.

Sensitivity to domestic and overseas share prices

A rise in share prices increases the net results of the State's insurance agencies. This leads to an increase in the ITEs payable to the State; however the availability of carry-forward tax losses means there is only a small impact on ITEs in the budget year. There is no significant impact on underlying dividends payable to the State as these are based on the agencies' performance from insurance operations, which excludes the impact of investment returns being higher than the agencies' budgeted long-term rates of return.

An increase in domestic and international share prices also reduces the value of the superannuation liability due to the associated increase in superannuation fund assets. This then reduces the superannuation interest expense beyond the budget year, thereby improving the net result from transactions in these years.

Sensitivity to property prices and volumes

Higher property prices have an immediate impact on the net result from transactions through increased collections of land transfer duty. At the same time, the value of the superannuation liability decreases due to the increased value of property holdings in superannuation funds' investment portfolios. In later years, higher property prices continue to raise land transfer duty and land tax revenues, while the previous reduction in the superannuation liability reduces ongoing superannuation expenses. Each of these factors increase the net result from transactions and lower net debt.

Higher property transaction volumes increase land transfer duty receipts, leading to a rise in the net result from transactions and a reduction in net debt.

SENSITIVITY TO VARIATIONS IN THE ECONOMIC OUTLOOK

The previous section considered the fiscal implications of independent variations in selected economic parameters. Typically, however, variations in economic parameters do not occur in isolation. For example, general economic conditions may differ from expectations, particularly in the event of an unanticipated economic or financial shock, causing most or all economic parameters to vary from forecasts.

This section considers two examples where general economic conditions varied significantly from expectations, resulting in the broad sweep of economic parameters being different from forecast. In the first example, in 2006-07 growth was significantly stronger than anticipated while in the second example, in 2008-09 the onset of the global financial crisis resulted in most economic and financial variables being lower than initially forecast.

The analysis confirms that the fiscal impact of variations in economic parameters can be significantly greater than indicated by the sum of each variable's individual impact. This highlights the point that the relationships between economic parameters and fiscal aggregates are complex and heavily influenced by the specific nature and characteristics of a given economic shock. Such shocks affect Victoria's fiscal position to varying degrees, but given the composition of Victoria's revenue base, property-related shocks are likely to have the largest impact on the fiscal situation.

The State’s fiscal position in any year is the product of economic trends and policy changes in that and previous years. Similarly, an economic shock in a given year will affect fiscal outcomes in that and later years.

The outcomes for a particular year will diverge from forecast values because of forecast errors and policy changes. This analysis highlights the critical impact that government policy decisions have on the final result, which by nature cannot be captured by standard sensitivity analysis.

2006-07 – economic growth exceeding expectations

Table A.2 presents a situation where economic growth was underestimated. It shows the largest forecast error in the macroeconomic variables was for employment. Real GSP was also underestimated, and there were relatively minor errors in the forecasting of prices and wages.

Table A.2: Actual deviations of growth rates of key economic variables from 2006-07 Budget forecasts

(per cent)

	2006-07 budget ^(a)	2006-07 actual	Forecast error ^(b)
Real GSP	3.3	3.7	0.5
Employment	1.3	3.2	1.9
Consumer price index	2.5	2.6	0.1
Wage price index ^(c)	3.5	3.6	0.1

Sources: Australian Bureau of Statistics; Department of Treasury and Finance

Notes:

- (a) Forecast in May 2006 for 2006-07 Budget.
- (b) Percentage point variation.
- (c) Total hourly rate excluding bonuses.

The main areas of revenue forecast error in 2006-07 relate to the underestimation of land transfer duty and of other revenue, while payroll tax was close to forecast (Table A.3). Strong land transfer duty revenues largely reflect the property cycle. As land transfer duty is a transaction-based tax, with the bulk of revenue collected from the residential property sector, collections are subject to the volatile nature of consumer sentiment. In 2006-07, both house prices and volumes were in growth phases, and in the second half of the financial year consumer sentiment was well above historical averages.

A significant portion of other revenue is composed of tied grants from the Commonwealth Government for health and education purposes. Forecasts are finalised around four months before the start of the relevant budget year and alternative arrangements may be made with the Commonwealth Government at any time during the ensuing 16 months to affect revenue from this source.

As payroll tax is levied on the stock of employees, forecast errors in growth are unlikely to have a large effect on revenue from this line. This proved to be the case in 2006-07. Despite growth in employment being two percentage points higher than anticipated, the 2006-07 outcome for payroll tax was largely consistent with budgeted estimates. This suggests a disconnect at that time between Victoria's labour market performance and payroll tax collections, and may have occurred because payroll tax is levied on a small share of Victorian businesses, which may not necessarily have been the drivers of growth.

Table A.3: Actual deviations of key revenue lines from 2006-07 Budget forecasts

(\$ million)

	2006-07 budget	2006-07 actual	Forecast error	Forecast error (%)
Payroll taxes	3 418	3 479	61	2
Land transfer duty	2 424	2 961	537	22
Other own-sourced revenue	5 129	5 262	133	3
Taxation revenue	10 971	11 702	731	7
Other revenue	13 002	14 600	1 598	12
GST	8 469	8 584	114	1
Total revenue	32 442	34 886	2 444	8
Total expenses	32 125	33 551	1 426	4
Net result from transactions	317	1 335	1 018	321

Source: Department of Treasury and Finance

2008-09 – global financial crisis

A situation where economic growth was overestimated is shown in Table A.4. The largest forecast errors occurred in real GSP and consumption. Relatively small errors occurred in employment as employers chose to reduce hours and accept productivity falls rather than lay off staff. Consumer prices and wages were less affected by the global financial crisis and consequently the level of forecast error was much lower for these variables.

Table A.4: Actual deviations of growth rates of key economic variables from 2008-09 Budget forecasts

(per cent)

	2008-09 budget ^(a)	2008-09 actual	Forecast error ^(b)
Real GSP	3.0	1.3	(1.7)
Consumption (unpublished)	2.8	0.2	(2.6)
Employment	1.5	0.9	(0.6)
Consumer price index	3.0	2.8	(0.2)
Wage price index ^(c)	3.8	4.0	0.3

Sources: Australian Bureau of Statistics; Department of Treasury and Finance

Notes:

(a) Forecast in May 2008 for 2008-09 Budget.

(b) Percentage point variation.

(c) Total hourly rate excluding bonuses.

The impact of the global financial crisis on revenue is evident in Table A.5, which shows forecast revenue and expenditure compared with the actual outcome. Both revenue and expenditure were underestimated; however expenditure was underestimated to a greater extent leading to a forecast error of \$576 million in the net result from transactions.

This increase in expenditure largely reflects the Commonwealth Government’s fiscal stimulus packages, such as *Building the Education Revolution*, which were mostly distributed by the states.

Much of the overestimation of revenue can be attributed to the weak performance of the property market, with the land transfer duty forecast being over \$900 million higher than the actual outcome. By contrast, the error in the forecast of payroll tax revenue was small and partly reflects the response of employers to hoard labour.

The pervading weak consumer sentiment during the global financial crisis led to much weaker consumption growth, and consequently to a sizeable forecast error for GST revenue. The global financial crisis seems to have created a structural shift in the economy, with the impacts felt over a number of years. Households adjusted their behaviour and entered a phase of reducing debt. This hastened the return of the household savings ratio to long-term averages, following a sustained period of near zero savings.

The overestimation of land transfer duty and GST was dwarfed by the underestimation of other revenues. A large share of this was the increased Commonwealth Government disbursements to the states as part of the stimulus package. However, these revenues were partially offset by increased expenditure as the Commonwealth Government’s stimulus payments were spent. Of the \$3.2 billion forecast error for other revenues, approximately \$2.4 billion is attributable to grants revenue other than GST.

This analysis reports the contemporaneous effect of macroeconomic shocks, whereas in many situations there will be enduring influences. While the national GST pool recovered from the lows of 2009-10 following the global financial crisis, since then its growth has remained below trend. This is consistent with the changes in household consumption. Similarly, following a temporary recovery in land transfer volumes in 2009-10, property market turnover was subdued in subsequent years as potential buyers were cautious about entering the market.

Table A.5: Actual deviations of key revenue lines from 2008-09 Budget forecasts

(\$ million)

	2008-09 budget	2008-09 actual	Forecast error	Forecast error (%)
Payroll taxes	3 963	3 980	17	..
Land transfer duty	3 737	2 801	(936)	(25)
Other own-sourced revenue	5 683	5 846	163	3
Taxation revenue	13 383	12 627	(756)	(6)
Other revenue	14 146	17 339	3 193	23
GST	10 281	9 319	(962)	(9)
Total revenue	37 810	39 285	1 475	4
Total expenses	36 982	39 034	2 051	6
Net result from transactions	828	251	(576)	(70)

Source: Department of Treasury and Finance

STYLE CONVENTIONS

Figures in the tables and in the text have been rounded. Discrepancies in tables between totals and sums of components reflect rounding. Percentage changes in all tables are based on the underlying unrounded amounts.

The notation used in the tables and charts is as follows:

..	zero, or rounded to zero
(xxx.x)	negative numbers
1 basis point	0.01 per cent
1 billion	1 000 million
Cat. No.	catalogue number
na	not available or not applicable
nm	new measure
ongoing	continuing output, program, project etc.
tbd	to be determined
LHS	left-hand-side
RHS	right-hand-side

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