



Building for Growth

2013-14 VICTORIAN BUDGET

Strategy and Outlook
Budget Paper No. 2

Presented by the Hon. Michael O'Brien MP
Treasurer of the State of Victoria



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Strategy and Outlook

2013-14



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The Hon. Michael O'Brien MP

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for the information of Honourable Members

Budget Paper No. 2

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CHAPTER 1 – ECONOMIC AND FISCAL OVERVIEW

The *2013-14 Budget* delivers high-quality services and major new investments in infrastructure that will promote economic growth and provide the platform for Victoria's future. The Government's ongoing commitment to responsible economic and financial management means that it can fund these initiatives sustainably.

Victoria's economy is performing well and continues to compare favourably to Australia's non-mining states and international peers. This reflects the State's many competitive advantages and strong financial management. The State's medium-term prospects are positive, despite immediate challenges of the high Australian dollar and soft global conditions.

Victoria's underlying strengths include a diverse and flexible economy, highly skilled workforce, strong export performance and liveability. This flexibility promotes economic stability and reduces reliance on particular sectors to drive growth. The Government is working closely with business and the broader community to drive new opportunities for employment and growth that build on these competitive strengths.

Since the Government came to office, reductions in Victoria's share of goods and services tax (GST) and subdued growth in the GST pool and state taxes have resulted in significant downgrades to revenue forecasts. The Government has responded by prudently managing expenditure over the budget and forward estimates, restructuring the public sector to focus on fostering investment and jobs and delivering frontline services more effectively. The Government's efforts mean that general government net financial liabilities are expected to fall over the forward estimates as a percentage of gross state product (GSP).

The *2013-14 Budget* promotes productivity, employment and economic growth. It delivers investment in transformational economic infrastructure projects and new road, rail and social infrastructure required to keep pace with population growth and maintain liveability.

The centrepiece of the *2013-14 Budget* infrastructure program is the East West Link – Stage 1. This project has an estimated capital cost of between \$6 billion and \$8 billion. It will ease congestion and better link people, products and markets across the State. The Government is also funding major capital investment in health, including the new Monash Children's Hospital, the Royal Victorian Eye and Ear Hospital redevelopment and the Waurn Ponds Community Hospital, in addition to continuing the Box Hill Hospital redevelopment, new Bendigo Hospital and the construction of the Victorian Comprehensive Cancer Centre.

These investments are made possible by the Government having worked hard to restore sound management to Victoria's finances as well as innovations in the public private partnership (PPP) framework to better leverage private sector participation in capital projects.

As well as boosting funding in health, disability services, education and transport, the Government is pursuing reforms to drive more responsive and productive services. In the *2013-14 Budget*, the Government is:

- supporting innovation and better services in TAFE and strengthening competition between public and private providers in vocational education and training (VET);
- delivering improved school performance through greater autonomy, better teachers, more innovative teaching methods and targeted help for disadvantaged schools;
- providing an additional ongoing elective surgery funding pool to encourage more efficient use and the treatment of more patients; and
- investing additional funds in *Services Connect* to explore innovative ways to deliver family and community support services so that vulnerable people find it easier to access services through one assessment process and a single worker.

SOLID ECONOMIC OUTLOOK

Victoria's economy is expected to grow by 2.25 per cent in 2013-14 notwithstanding the ongoing headwinds of moderate international conditions and a continued high Australian dollar. These factors are continuing to encourage changes in the State's industry composition as resources move to their highest value use. Growth is expected to increase to 2.75 per cent in 2014-15 as the impact of low interest rates and improving conditions for the State's trading partners flow through the economy. Chapter 2 *Economic Context* presents the State's short and medium-term economic outlook around which this budget is framed.

To address these challenges and build for the future, the Government has a strong economic strategy aimed at driving employment and growth.

The Government is positioning Victoria to sustainably contribute funding to major infrastructure projects which can boost productivity and facilitate additional private sector investment. This is made possible by responsibly managing the State's finances and driving value for money in infrastructure delivery. The high-value, high-risk process places greater scrutiny on business cases and project delivery to protect the State from cost overruns on major projects. This process complements the Government's Implementation Guidelines to the Victorian Code of Practice for the Building and Construction Industry and a renewed focus on PPPs to better leverage private sector involvement.

With this framework in place, the Government's infrastructure investment is projected to be \$6.1 billion in 2013-14.

Recognising that the public sector itself comprises a significant proportion of Victoria's economy, the Government is also driving improvements in the responsiveness and productivity of its own services. Reforms to education, health and community services and reconfiguring departments will help deliver services more efficiently and in new and innovative ways that prioritise community needs.

To ensure Victoria remains a leading place to do business and invest, the Government is continuing to reduce red tape and expedite project approvals. It is also undertaking significant planning zone reforms, retargeting the First Home Owner Grant to boost new construction, streamlining identification of surplus government land and bringing it to market, and reforming fire services funding.

Chapter 3 *Long-Term Economic and Fiscal Outlook* provides more information on the Government's economic reform strategy.

STRONG GOVERNMENT FINANCES AND BETTER SERVICES

The *2013-14 Budget* delivers strong operating surpluses required to fund major new investment in infrastructure, while delivering core services effectively and ensuring the State's finances are managed responsibly.

Table 1.1: General government fiscal aggregates and measures

	<i>Unit of Measure</i>	<i>2011-12 Actual</i>	<i>2012-13 Revised</i>	<i>2013-14 Budget</i>	<i>2014-15 Estimate</i>	<i>2015-16 Estimate</i>	<i>2016-17 Estimate</i>
Net result from transactions	\$ million	571.2	177.0	224.5	398.7	1 927.7	2 547.4
Government fiscal result ^(a)	\$ million	571.2	177.0	817.6	1 005.5	2 545.0	3 173.8
Net debt ^(b)	\$ billion	15.2	19.8	23.0	25.1	24.4	22.7
Net debt to GSP ^(c)	per cent	4.6	5.8	6.4	6.6	6.1	5.4
Government infrastructure investment ^(d)	\$ billion	5.4	5.4	6.1	6.6	4.0	3.5

Source: Department of Treasury and Finance

Notes:

- (a) Equals to the net result from transactions less the impact of the revised AASB 119 Employee Benefits, which applies from 2013-14.
- (b) The sum of borrowings, deposits held and advances received less the sum of cash and deposits, advances paid, and investments, loans and placements.
- (c) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
- (d) Includes general government net infrastructure investment and estimated cashflows for Partnerships Victoria projects, and excludes one off fiscal stimulus payments for Nation Building – Economic Stimulus Plan Social Housing component and Building the Education Revolution.

The Government has achieved a strong fiscal position despite the State facing significant revenue pressures. More modest economic growth in recent years has correspondingly reduced growth in government revenues, particularly GST revenue. Growth in the national GST pool is easing as household spending has tended to favour GST-exempt goods and services. This effect has been exacerbated by the State's share of the national GST pool decreasing in 2013-14. In 2013-14, Victoria's GST grant is estimated to be around \$1.2 billion less than a population based GST distribution would deliver. Consumer caution across the country and heightened economic uncertainty at the national level have also weighed on Victoria's property market, flowing through to soft growth in forecast land transfer duty revenue.

Victoria's fiscal pressures are compounded by the Commonwealth raising service delivery expectations in areas of state responsibility without providing appropriate funding support. There is also the ongoing risk that grants will be reduced or costs shifted to states to alleviate Commonwealth Government budget pressures.

Faced with these revenue challenges, the Government has acted decisively to restrain spending and provide a stronger medium-term budget position. Since the *2011-12 Budget*, the Government has implemented savings and targeted revenue-raising initiatives averaging around \$3 billion a year over the budget and forward estimates to improve the State's finances (Table 1.2).

Expenditure growth over the forward estimates is expected to average 2.5 per cent a year, significantly lower than the 7.3 per cent average annual growth rate over the decade to 2010-11. This compares to forecast average annual revenue growth of 4.0 per cent over the forward estimates.

The Government's savings measures return expenditure growth to more sustainable levels consistent with the more modest revenue outlook. At the same time, focusing on more efficient government operations has allowed the State to deliver improved frontline services to Victorians while responsibly funding a record commitment to new infrastructure projects.

Table 1.2: Variations to revenue compared with estimated aggregate savings and targeted revenue measures

(\$ million)

	2013-14	2014-15	2015-16	2016-17
Land transfer duty	- 831	- 719	- 629	- 394
GST revenue	-1 786	-1 888	-1 860	-1 712
Major sources of variations to revenue ^(a)	-2 617	-2 607	-2 490	-2 106
Previous savings and targeted revenue measures	2 203	2 624	2 956	3 039
2013-14 Budget savings and targeted revenue measures	258	377	454	547
Total: savings and targeted revenue ^{(b)(c)(d)}	2 461	3 001	3 410	3 585

Source: Department of Treasury and Finance

Notes:

- (a) Variations to revenue over 2013-14 to 2016-17 are based on revised forecasts from the 2013-14 Budget against the 2010-11 Budget Update forward estimates extrapolated using an average growth rate over the period 2010-11 to 2013-14 and adjusted for the effect of targeted revenue measures.
- (b) Previous savings and targeted revenue-raising measure estimates are based on budget and forward estimates announced in the 2011-12 to 2013-14 budget documents adjusted where forecasts have changed and include estimates for the continuing impact of those measures for the 2013-14 Budget and forward estimates.
- (c) Savings and targeted revenue measures are combined and presented as positive numbers in this table to demonstrate the favourable impact on the State's budget capacity. The savings measures are represented as negative numbers in Chapter 1 of Budget Paper No. 3 to demonstrate reduced spending.
- (d) Some totals may not add due to rounding.

The Government's public sector restructure, announced in April 2013, will further sharpen the focus on promoting investment and jobs, and providing better services to Victorians. Key changes include:

- integrating urban and transport planning with local infrastructure and services;
- bringing land and water management together with primary industries to help boost productivity in Victoria's food and fibre sector; and
- bringing the energy and resources portfolio into the Department of State Development, Business and Innovation to enable a stronger focus on major development opportunities, such as better using Victoria's coal resources.

These changes complement the Sustainable Government Initiative, which reduced back-office and administrative positions of the public service workforce. Frontline service delivery staff have been protected from these reductions.

The 2013-14 Budget implements several measures to reform and better target public services. Key initiatives include:

- redirecting the First Home Owner Grant to new homes only and increasing it to \$10 000. Together with bringing forward first home buyer stamp duty concessions, the retargeted program will encourage construction and improve affordability, while ensuring first home buyers of established dwellings receive a 40 per cent reduction in stamp duty from 1 July 2013;

- introducing a maximum to gas and electricity concessions automatically provided. This is designed to curb excessive utility household costs and address fraud and misuse, while ensuring the benefit is protected for those most in need; and
- creating an additional ongoing elective surgery funding pool, using greater competition to deliver better and more efficient services. This program will improve outcomes and allow a greater number of patients to be treated more quickly.

Spending in the *2013-14 Budget* prioritises frontline service delivery, improving efficiency across government, driving economy wide productivity and innovation and protecting the more vulnerable members of the community. This is reflected in targeted initiatives including:

- enhancing the capacity of health services, focusing on emergency inpatient services, outpatient services, renal dialysis, chemotherapy and radiotherapy services;
- supporting proposals from TAFE institutes for innovation, collaboration, structural reform and business transformation;
- protecting Victoria's vulnerable children by maintaining the 24-hour child protection emergency response service and providing specialist support to vulnerable students facing barriers to learning;
- delivering new spending on disability services, with targeted funding to government schools to support students with moderate to severe disabilities and up to 720 additional individual support packages to provide essential care and support services for people with a disability, their families and carers; and
- committing to the launch of the National Disability Insurance Scheme (NDIS) in the Barwon area.

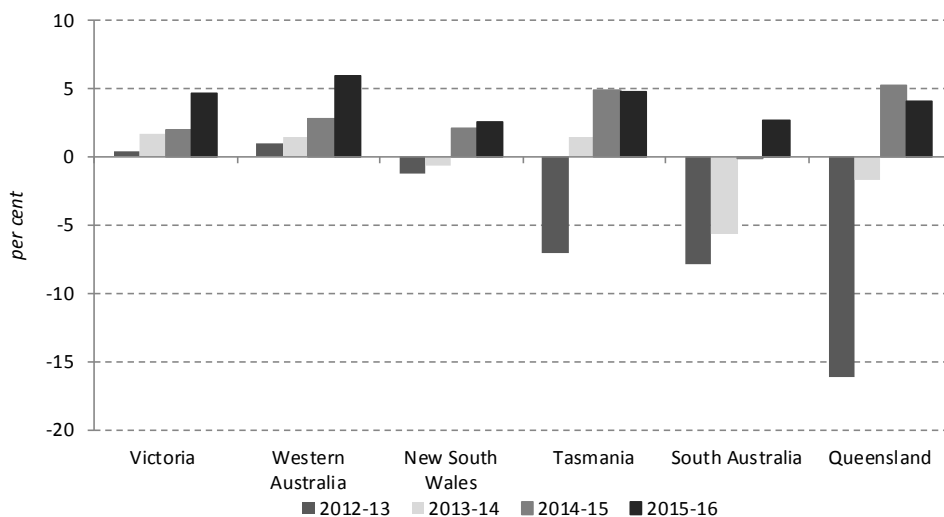
2013-14 BUDGET STRATEGY

The *2013-14 Budget* continues to strengthen Victoria's budget position. Without a strong budget position, targeted new spending would not be affordable and would exacerbate current fiscal challenges.

Victoria's fiscal strategy uses growing surpluses to fund the infrastructure required by an expanding population and to sustain economic growth and the State's liveability, while prudently managing debt. The Government's efforts are expected to result in net general government financial liabilities falling over the forward estimates as a percentage of GSP.

The budget is projected to be in surplus every year over the forward estimates, with the net result from transactions growing from \$225 million in 2013-14 to \$2.5 billion in 2016-17. Victoria is now one of only two states, the other being resource-rich Western Australia, forecasting budget surpluses in each year over the four years to 2015-16 (Chart 1.1).

Chart 1.1: Net operating balance as a share of total revenue by state^(a)



Sources: Victorian budget papers and other states' budgets and budget updates.

Note:

(a) To ensure comparability, Victoria's estimates are adjusted to exclude the impact of changes to accounting standard AASB 119.

As announced in *2012-13 Budget*, the Government has adopted overarching financial management principles as long-term financial management objectives (Table 1.3).

Table 1.3: Long-term financial management objectives

Managing responsibly	Victoria's state finances will be managed responsibly to enhance the well-being of Victorians.
Looking after the future	The endowment of public sector wealth bequeathed by the current generation of Victorians to the next will be no less than the current generation inherited from the previous generation.
Managing the unexpected	The State's financial position will be robust enough to absorb and recover from unanticipated events, and to absorb the volatility inherent in revenues and expenses.
Improving services	Victoria's public services will improve over time through enhanced efficiency and through a growing capacity of the Victorian economy to fund those services.
Maximising community benefit	Public sector resources will be allocated to those activities which generate maximum community benefit.

The Government’s medium-term fiscal strategy (Table 1.4) provide a framework to ensure the State’s finances can withstand unexpected adverse fiscal or economic events and that the State can continue providing high quality infrastructure and services.

Table 1.4: Medium-term fiscal strategy

<i>Financial measures</i>	<i>Parameters</i>
Infrastructure investment	Infrastructure investment of 1.3 per cent of GSP (calculated as a rolling five-year average).
Net debt	General government net debt reduced as a percentage of GSP over the decade to 2022.
Superannuation liabilities	Fully fund the unfunded superannuation liability by 2035.
Operating surplus	A net operating surplus of at least \$100 million and consistent with the infrastructure and debt parameters.

The Government’s strategy means it can advance transformational infrastructure projects and improve the capacity and quality of transport and other key economic and social infrastructure. Government infrastructure investment is projected to be \$6.1 billion in 2013-14.

By 2015-16, infrastructure investment is forecast to be fully funded from cash generated by operating surpluses, with general government net debt decreasing in nominal terms from 2015.

Government infrastructure investment of \$6.1 billion in 2013-14 aligns with the Government’s medium-term fiscal parameter of infrastructure investment of 1.3 per cent of GSP (calculated as a five-year rolling average).

The *2013-14 Budget* provides significant funding for capital projects to improve the efficiency and scale of transport, freight and logistics to better link people, products and markets. Major projects include:

- road and rail upgrades across Melbourne and regional Victoria, including a commitment to deliver the East West Link project, with the first stage being the Eastern section from the Eastern Freeway at Hoddle Street to City Link in Parkville. The Government has provided the funding capacity to deliver this first stage, commencing in 2013-14. The East West Link – Stage 1 has an estimated capital cost of between \$6 billion and \$8 billion;
- funding to further develop the Port of Hastings. The Port of Hastings development is critical to accommodate future growth in freight trade and ensure appropriate goods transportation options are available for Victorian businesses. Completing the Port of Hastings project will significantly expand Victoria’s container capacity and complements the current \$1.6 billion expansion of container and automotive capacity at the Port of Melbourne; and
- further planning and development of the Melbourne Metro Rail Tunnel. This project will build capacity in Melbourne’s rail network to service increasing demand for train services, particularly in Melbourne’s growth areas in the north, west and south-east.

At the same time, the Government is investing in new infrastructure to meet the needs of a growing population, secure future economic growth and enhance liveability.

The upgrade of Ringwood railway station will deliver a modern integrated hub for commuters and complement more private sector investment in the adjacent retail precinct. This project demonstrates how targeted investments, integrated transport and urban planning can boost employment and deliver better community outcomes. This, together with other investments in public transport across metropolitan Melbourne and regional Victoria, demonstrates the Government's commitment to deliver an effective and safe public transport system.

To relieve congestion, reduce individual road users' trip times and improve safety, the budget funds a package of early works as a further step towards the removal of railway level crossings on key main roads, including Main Road (St Albans), North Road (Ormond), Blackburn Road (Blackburn), Mountain Highway and Scoresby Road (Bayswater). Funding is also provided to undertake planning for the removal of the Murrumbeena Road (Murrumbeena) and Burke Road (Glen Iris) level crossings. The Government is also providing new funding to support maintenance of the State's arterial road network and the West Gate bridge and a range of road improvements and upgrades.

The *2013-14 Budget* provides for significant investment in rural Victoria, such as in the future of the Macalister Irrigation District in central Gippsland. This investment will modernise on-farm infrastructure, increase agricultural productivity and production capacity and improve the health of the area's waterways and estuaries.

All projects with a total estimated investment of \$100 million or more, or those identified as high risk, must comply with the Government's high-value, high-risk process. This will improve business case development and project implementation, protecting the State from cost overruns on major projects.

Chapter 4 *Budget Position and Outlook* outlines the revised budget position for 2013-14 and the forward estimates period (2014-15 to 2016-17).

CHAPTER 2 – ECONOMIC CONTEXT

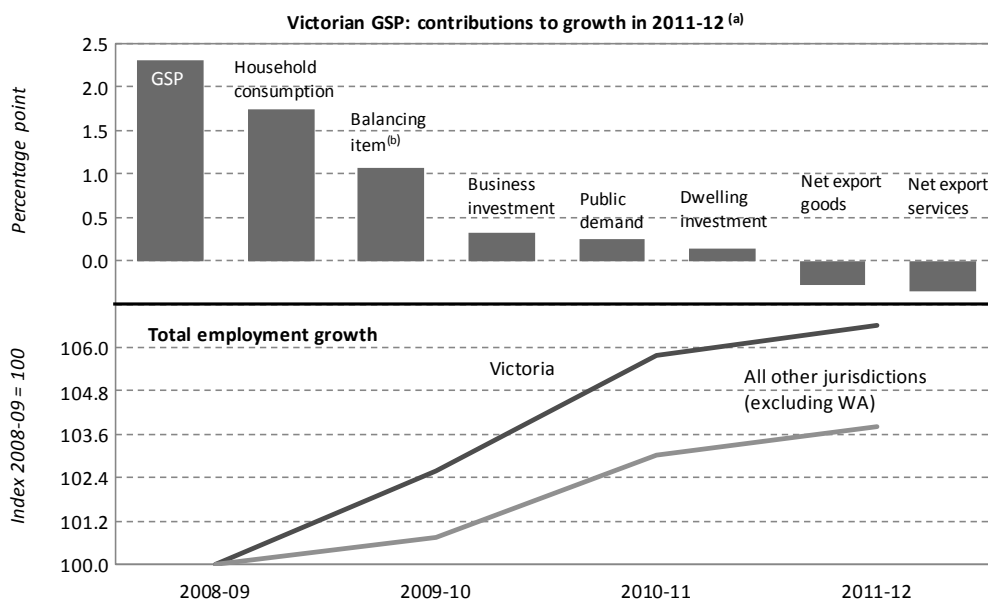
- The fundamentals supporting the Victorian economy remain strong. Consumer confidence is returning in a low interest rate environment. There is renewed strength in dwelling investment as the property market shows signs of improvement. Net migration is supporting population growth. Unemployment and inflation are low, and Victoria has the highest labour participation rate of all the non-mining states.
- The Victorian economy is performing solidly and is expected to significantly strengthen in 2013-14, growing by 2.25 per cent. This compares favourably to Australia's other non-mining states and international peers.
- Concerns about Europe continue to dominate the risk outlook. This has been partially offset by positive news from the US and China. An improving Chinese economy or an acceleration in the US economic recovery could improve Victoria's trade position.
- There is a divergence of economic activity between non-mining and mining states. While Victoria is also affected by this distinction, with growth rates below long term trends, Victoria compares favourably to Australia's other non-mining states and international peers. The outlook is also positive compared to many other advanced economies, especially in the euro zone.

VICTORIAN ECONOMIC CONDITIONS AND OUTLOOK

The economic environment in Victoria remains favourable. Unemployment is expected to fall and inflation is expected to remain low. After relatively robust growth in GSP of 2.3 per cent in 2011-12, partial indicators point towards economic growth moderating to 1.5 per cent in 2012-13, before accelerating to 2.25 per cent in 2013-14. This is consistent with Australia's growth outlook. The factors weighing on economic growth are expected to persist only in the short term, with the economy moving back to trend growth in 2014-15 as the impact of low interest rates and improving conditions in Asia and the US flow through.

Employment growth in Victoria since the global financial crisis has been high compared to other jurisdictions excluding Western Australia. More generally, broader indicators of economic conditions show Victoria's economy continues to perform positively. In recent years, interstate trade (reflected in the balancing item in Chart 2.1) has been a key component of Victoria's economy and has significantly contributed to GSP growth.

Chart 2.1: General economic indicators of the Victorian economy



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

Notes:

- (a) The contributions to growth of the components of GSP do not always add exactly to the growth in GSP. This can happen as a result of rounding and the lack of additivity of the chain volume estimates prior to the latest complete financial year.
- (b) The balancing item reflects changes in inventories, total net interstate trade as well as other miscellaneous items such as the balancing item discrepancy and adjustments for balance of payments trade.

Table 2.1 sets out the economic projections for the 2013-14 Budget.

Table 2.1: Victorian economic projections^(a)

	(per cent)					
	2011-12 Actual	2012-13 Forecast	2013-14 Forecast	2014-15 Forecast	2015-16 Forecast	2016-17 Forecast
Real gross state product	2.3	1.50	2.25	2.75	2.75	2.75
Employment	0.8	0.50	1.50	1.75	1.75	1.50
Unemployment rate	5.4	5.75	5.50	5.25	5.00	5.00
Consumer price index ^(b)	2.3	2.25	2.50	2.50	2.50	2.50
Wage price index ^(c)	3.5	3.50	3.50	3.50	3.50	3.50
Population	1.6	1.70	1.70	1.70	1.70	1.70

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

Notes:

- (a) Year-average per cent change on previous year, except for the unemployment rate which is a year-average per cent, and population which is year-ended per cent change to 30 June. All economic projections are rounded to the nearest 0.25 percentage point, except population projections, which are rounded to the nearest 0.1 percentage point. The key assumptions underlying the economic projections include: interest rate movements that follow market expectations from the Bloomberg survey up to the June quarter 2014 and held at zero thereafter, constant exchange rates, and oil prices that follow the path suggested by oil futures.
- (b) All references to the consumer price index refer to the Melbourne consumer price index.
- (c) Total hourly rate excluding bonuses.

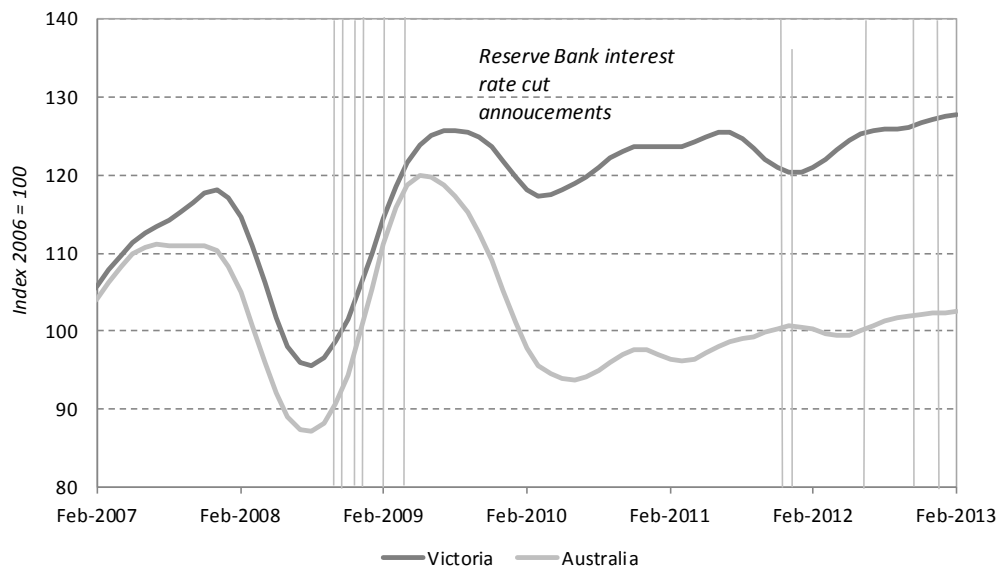
Gross state product

Growth in the Victorian economy is expected to rise to 2.25 per cent in 2013-14, after growing at a more moderate rate in 2012-13.

Household consumption is expected to post solid growth in 2013-14, underpinned by improving consumer sentiment, wage growth remaining around trend, improved global economic conditions and equity prices, and a continued low interest rate environment. While consumption growth for 2012-13 is likely to be lower than previously forecast, recent asset price growth and solid improvements in retail sales suggest that activity is improving. Importantly, consumer sentiment has grown strongly over the past year, even as household debt relative to income has been stable with the savings rate hovering around 10 per cent.

In line with the brighter consumer outlook, Victoria's property market is showing signs of improvement after slowing in 2011-12. Dwelling approvals remain high compared to other states and dwelling investment has consistently grown in the first half of 2013, as a low interest rate environment filters through to encourage housing finance commitments (Chart 2.2) and household incomes increase steadily. This suggests a positive outlook for 2013-14; partial indicators support a revival in the property market, with modestly improving house prices and rising auction activity in the established housing market. Continued population growth is likely to support the return of dwelling investment to trend growth in the medium term.

Chart 2.2: Value of Victorian and Australian housing finance commitments (including refinancing)



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

Business investment is expected to grow modestly in 2013-14, reflecting general uncertainty about the near-term outlook for demand. Businesses will likely wait for evidence of a sustained pick-up in demand before committing to significant new investment. Nonetheless, confidence has improved and financing conditions remain favourable with low interest rates and recent improvements in equity prices and profit expectations. Beyond 2013-14, investment activity will continue to increase, with non-residential construction underway to support the return to trend growth in the forward estimates.

Public demand growth has moderated in 2012-13, however it is still supported by record capital spending by the Victorian Government. Over the coming years, public demand growth is expected to be sustainable, below the national boom years of the 2000s and the years immediately following the 2008 global financial crisis when short-term fiscal stimulus funding was provided by the Commonwealth.

The high Australian dollar has impacted negatively on Victorian exports, including education, tourism and manufactured goods. However, while education exports have declined over the past few years, the Department of Immigration and Citizenship expects foreign student numbers to increase over the medium term. Relaxation of Commonwealth student visa restrictions would encourage further growth in student numbers to Victoria. Monetary stimulus measures in Victoria's main export destinations (such as the US and Japan) should see their growth pick up, flowing through to an increase in merchandise export growth in 2013-14.

Continued growth in other states will benefit Victoria through increased net interstate trade. The flows in interstate trade are likely to come from knowledge, innovation and technology-based industries that are based in the state such as biotechnology.

Victoria's agricultural production and exports performed strongly in recent years, following the ending of the drought. Wheat prices and export volumes have also been high. However, due to less favourable weather conditions, wheat production is expected to return to more usual levels, and wheat prices have also been softening since the middle of 2012. Exports of dairy products also improved, although Victoria faces strong competition into Asian markets from New Zealand. This might influence the contribution to GSP from exports.

Other economic indicators

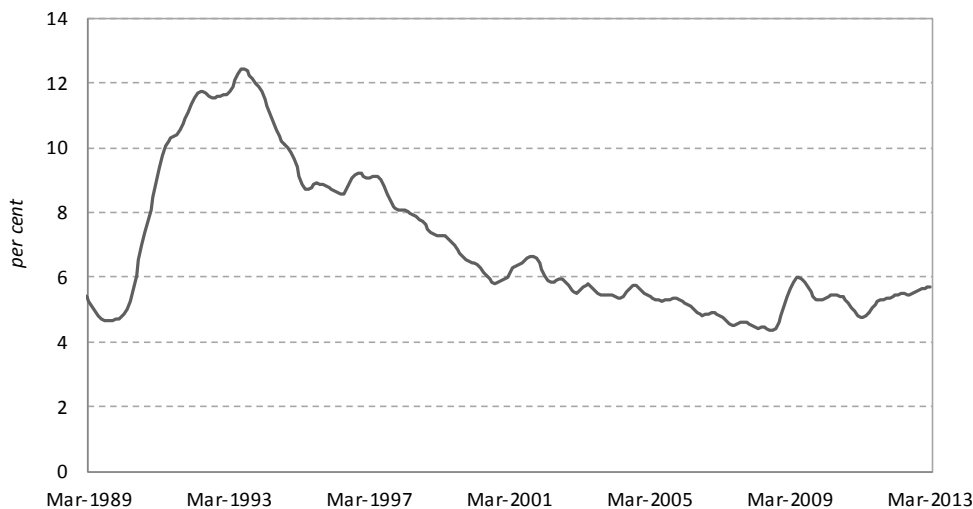
Labour market

Victorian employment growth moderated in 2012-13 but should strengthen further in 2013-14 to 1.5 per cent.

While some Victorian industries face challenging conditions, many industries experienced growth in employment in the past year, reflecting the benefits of Victoria's diverse economy. These included professional, scientific and technical services, wholesale trade, retail trade, and accommodation and food services. However, employment in the construction industry has been subdued, along with the administrative and support services.

The unemployment rate remains low (Chart 2.3), consistent with the national rate. While Victoria's participation rate has moderated over the past year, it is the highest of the non-mining states. As employment growth further strengthens from 2013-14, the unemployment rate is expected to ease back to around 5 per cent in the medium term.

Chart 2.3: Victoria's unemployment rate



Source: Australian Bureau of Statistics

Over the past ten years, employment growth has been above the long-term trend, averaging over 2 per cent a year. Trend growth is likely to moderate later in the decade, in line with broader economic trends and demographic changes, including population ageing.

Prices and wages

Total Victorian wages growth has been relatively steady with the wage price index growing around trend at 3.5 per cent over 2012. Annual growth in public sector wages (Commonwealth, State and local governments) during 2012 has been below the private sector. This in part reflects the influence of the Victorian Government's public sector wages policy which provides for annualised wage increases of 2.5 per cent. Increases above 2.5 per cent per year must be offset by genuine productivity gains linked to workforce reform.

Furthermore, Victoria's relatively stable unemployment rate throughout 2012 has assisted the recent steadiness in wages growth. Since real wages growth is being matched by similar growth in productivity, unit labour costs have been kept in check and consumer prices constrained, placing neither upward or downward pressure on prices.

Wages growth is expected to remain at trend in 2013-14 and across the forward estimates.

Underlying inflation has been low and within the Reserve Bank’s target band of 2 to 3 per cent. Inflation in Melbourne has been on par with the national headline rate over 2012. With improving economic conditions, wage growth around trend and a waning of the Australian dollar’s deflationary effect on trade-exposed prices, the underlying rate of inflation is expected to remain around the middle of the Reserve Bank’s target band at 2.5 per cent.

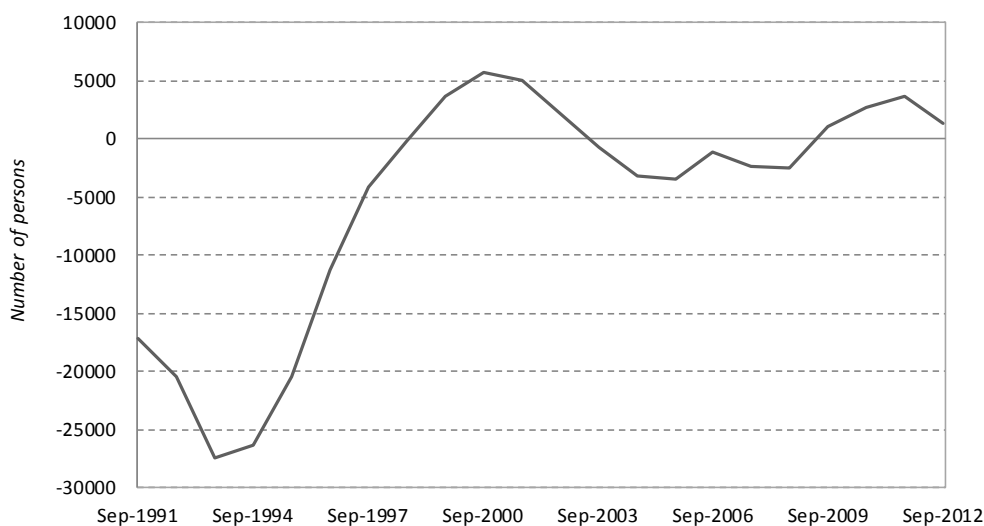
Population

Over 2011-12 population growth in Victoria has edged upwards. Net overseas migration continues to significantly influence annual population growth in Victoria, accounting for over half of the population increase in 2011-12. Victoria’s share of national net overseas migration remains around historic trends, with only New South Wales of the other non-mining states having a slightly higher share in 2011-12.

Victoria continues to attract interstate migration and receives a positive net inflow of interstate migrants (Chart 2.4).

Recent trends in migration are likely to continue, leading to forecast population growth that is slightly higher than experienced in recent years. Population growth is expected to grow at trend of 1.7 per cent in 2013-14 and across the forward estimates period.

Chart 2.4: Victoria’s net annual interstate migration is positive

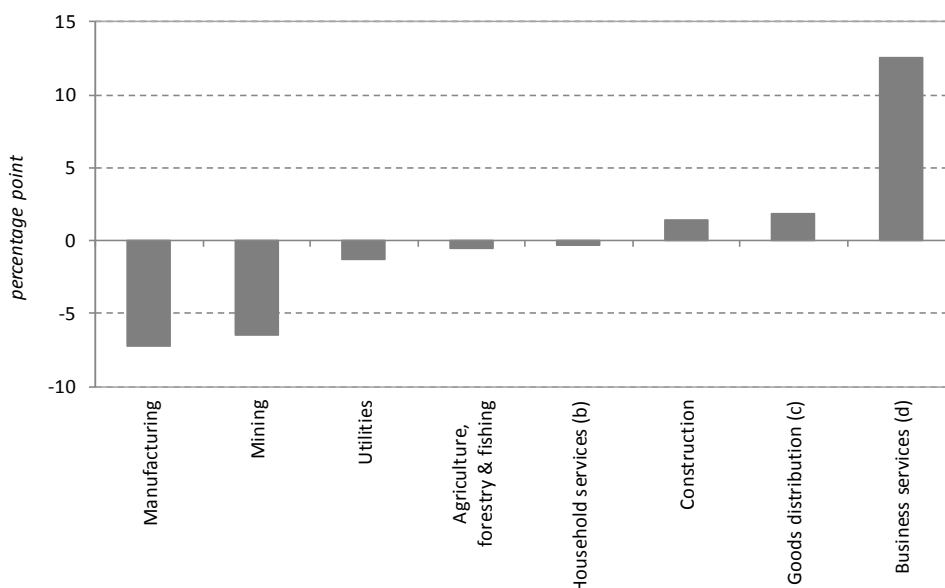


Source: Australian Bureau of Statistics

Structural change in the Victorian economy

While manufacturing output has grown by 5 per cent since 1989-90, the rest of the Victorian economy has grown even more strongly and so manufacturing's share of output has fallen from 17.4 per cent in 1989-90 to 9.9 per cent in 2011-12. As the number of people working in the sector has fallen, productivity has increased in manufacturing, reflecting a change away from low-value products that sought to compete on price to higher value products that compete on quality. Over the same period, there has been strong growth in business services, which include financial and insurance services and professional, scientific and technical services, that has become an increasingly important driver of Victorian economic performance (Chart 2.5). This industry has had strong links to the resources boom, attracting labour and capital away from other industries.

Chart 2.5: Change in Victorian industry gross value added shares, 1990-91 to 2011-12^(a)



Source: Australian Bureau of Statistics

Notes:

- (a) Excluding ownership of dwellings.
- (b) Includes accommodation and food services, arts and recreation services, education and training, health care and social assistance, public administration and safety and other services.
- (c) Includes retail trade, wholesale trade and transport, postal and warehousing.
- (d) Includes financial and insurance services, administrative and support services, information, media and telecommunication services, rental, hiring and real estate services and professional, scientific and technical services.

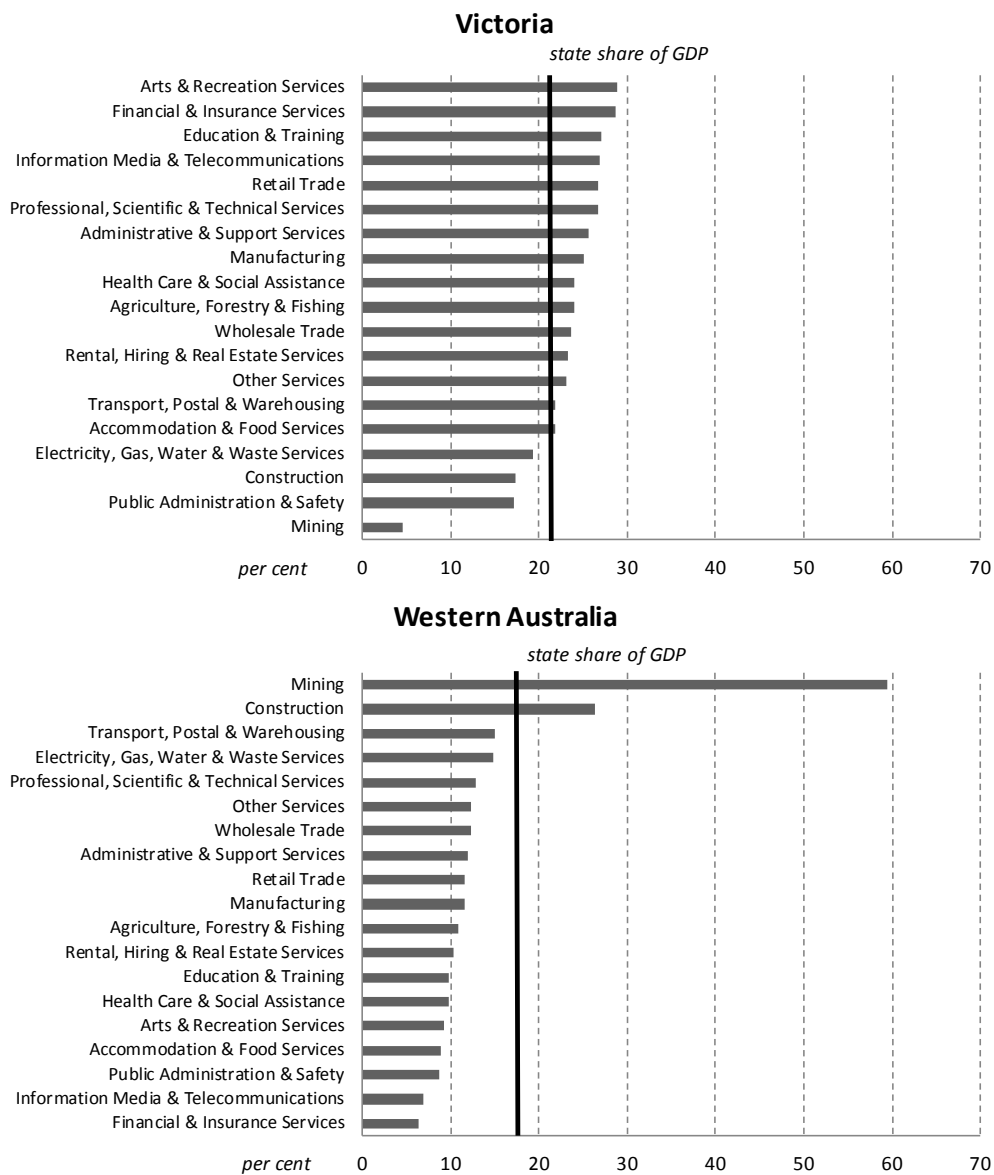
The Victorian economy generated positive net employment growth in 2011-12. Reported job losses at individual workplaces are relatively small, but can significantly affect community perceptions and have concentrated impacts on particular sectors or regions which rely heavily on individual businesses.

Victoria does not rely on a single sector to drive economic growth. It is a more stable economy, both resilient and adaptable to changing economic circumstances. As Victoria's economic structure is closer to the Australian average, its growth rate is likely to be similar to the national average and is likely to be also influenced by similar factors. This is unlike those states whose growth rates are likely to diverge from the Australian average because they rely on a narrower economic base (Chart 2.6).

Structural change has benefitted the Victorian economy. For instance, if industry shares of the economy remained as they were 20 years ago, manufacturing would today comprise about one fifth of Victorian output. Had Victoria not seen the expansion of rapidly growing, high value sectors (such as business services and health care) contributing to structural change, then the consequences of the recent high Australian dollar would have been far more dramatic than it has been for Victoria.

Structural change enables productivity improvements to occur. Businesses across the economy, including in the manufacturing sector, recognise the need to adapt and are adjusting to challenges to their competitiveness (for example from a high Australian dollar).

Chart 2.6: State industry share as a percentage of Australian total industry^(a), 2011-12



Source: Australian Bureau of Statistics

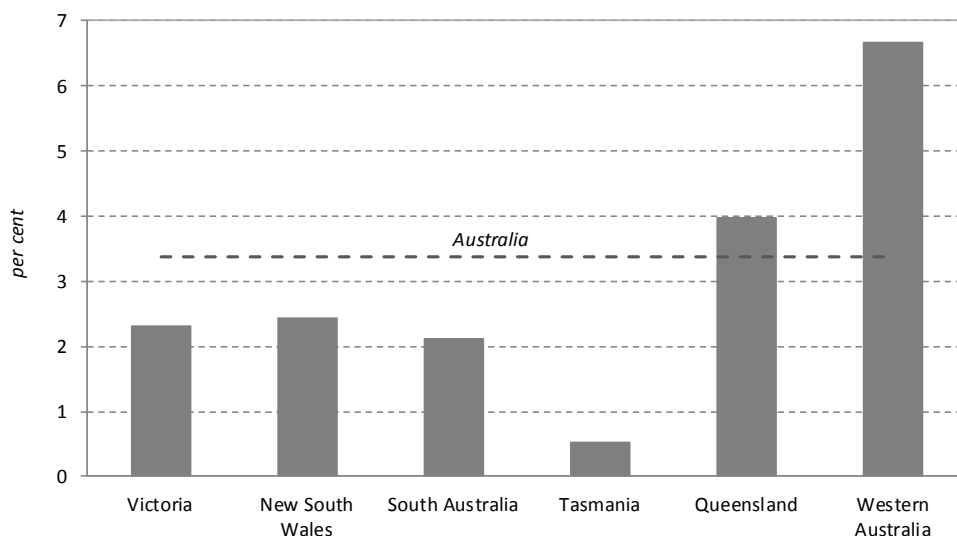
Note:

(a) Chain volume measure, excludes ownership of dwellings.

AUSTRALIAN ECONOMIC CONDITIONS AND OUTLOOK

The resource-rich states of Western Australia and Queensland recorded the strongest real GSP growth among the states in 2011-12, while Victoria's GSP growth compares favourably with other non-mining states (Chart 2.7).

Chart 2.7: State GSP growth in 2011-12



Source: Australian Bureau of Statistics

Falls in global commodity prices in the middle of 2012 have led to some scaling back of investment plans in the coal and iron ore sectors. As a result, the peak in mining investment is close to being reached or has passed. While there may be a period before full mining production is reached, the medium-term outlook for commodity prices is positive which will benefit the resource-rich states and indirectly benefit Victoria.

Overall, the fundamentals of the Australian economy remain strong and the outlook remains positive compared to many other advanced economies, especially in the euro zone. The Reserve Bank¹ expects Australian economic growth to be below trend at around 2.5 per cent over 2013 before picking up to just under 3 per cent over 2014.

National employment growth was below trend in 2011-12 at 1.1 per cent. There was some strength in the resource-rich states which were the only states to record growth stronger than the national average. Despite below trend employment growth, the national unemployment rate has only increased marginally over the past year. At the same time the

¹ February 2013 Statement of Monetary Policy

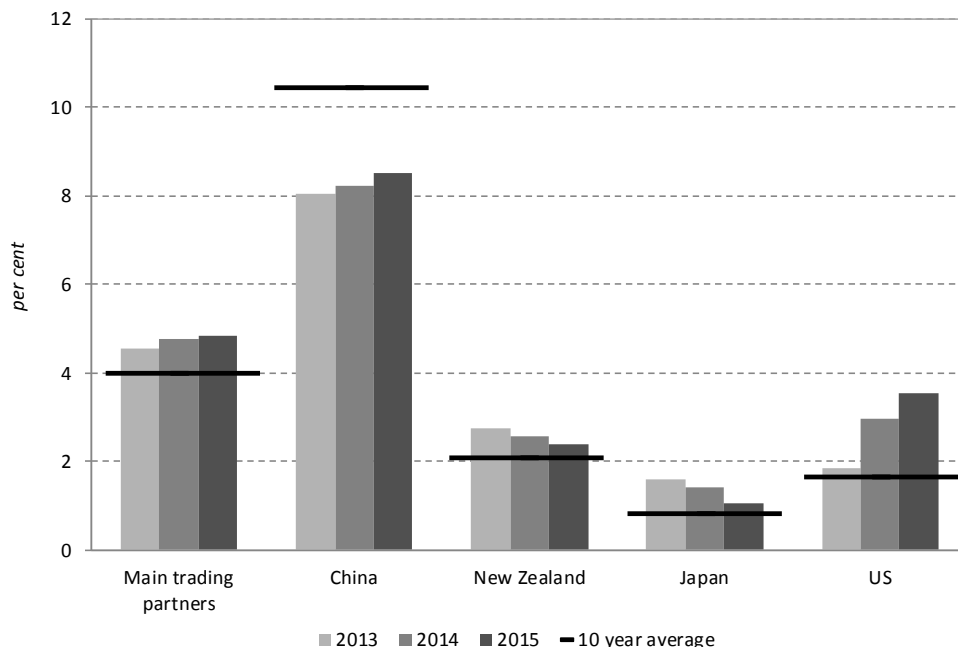
participation rate has eased slightly. Leading indicators point towards modest employment growth in the near term, with pressures on parts of the domestic economy and the global outlook likely to weigh on hiring decisions.

INTERNATIONAL ECONOMIC CONDITIONS AND OUTLOOK

The risks to the global growth outlook have lessened and appear to be more balanced. The International Monetary Fund² expects an ongoing gradual mending of the global economy for 2013 with growth forecast to accelerate in 2014.

Economic growth is expected to remain solid in many emerging economies, which include some key trading partners of both Australia and Victoria (Chart 2.8). Growth has stabilised in China at what appears to be a sustainable pace while picking up in the rest of east Asia (excluding Japan).

Chart 2.8: Economic growth forecasts for Victoria’s main merchandise export destinations^(a)



Sources: International Monetary Fund; Australian Bureau of Statistics

Note:

(a) The main trading partners growth rates are weighted averages of the growth rates for China, New Zealand, Japan and the US, with the weights being the value of Victorian merchandise exports to these destinations.

² April 2013 World Economic Outlook

Economic weakness persists in Japan (a significant trading partner for Victoria). As a result, the Japanese government has recently adopted more expansionary macroeconomic policies. These measures are expected to assist the Japanese economy after years of stagnation.

The US economy continues to grow moderately, with further improvement in the housing market, and the labour market showing signs of recovery. However, the downside risk in the medium-term for the US is the absence of a strong fiscal consolidation plan.

While indicators of economic activity in the advanced economies have improved slightly, vulnerabilities remain, particularly in Europe. Economic activity in the euro zone contracted further in 2012, with the growth outlook for 2013 being subdued. The European Union's deal to fund the bailout of Cyprus using bank deposits has the potential to aggravate future flights of capital in response to bad news. In addition, record high unemployment in several of the larger euro zone economies is affecting economic growth.

Nonetheless, the impact of a renewed European crisis on Victoria is expected to be softened by more positive developments in its major trading partners.

Risks to the outlook

Economic growth could be stronger in 2013-14 and beyond. Global risks are receding compared to previous expectations and there have been a number of partial indicators showing strength. An improving Chinese economy due to domestic factors or an acceleration in the US economic recovery could improve Victoria's trade position both directly and as the benefits flow to our major trading partners. Improvements in productivity as businesses adapt to competitiveness challenges and a more positive international environment would contribute to a stronger outlook. The fundamentals for both households and businesses remain strong, and along with a low interest rate environment may result in a stronger rebound than currently anticipated.

On the downside, should the international outlook deteriorate, with Europe remaining as a key risk, then local confidence could fall and domestic growth weaken. A European crisis is likely to impact Victoria through direct and indirect channels. Panic in international financial markets could undermine liquidity to Victorian businesses and consumers, raising borrowing costs. A worsening in the economic outlook for the euro zone or international security concerns could affect growth in Australia's major trading partners. This could be reflected not only in Victoria's international exports, but also interstate exports as demand for our goods and services declines in other states.

A significant fall in the value of the Australian dollar, should it occur, would put upward pressure on the inflation rate. But it would also ease pressure on exporters and import competitors.

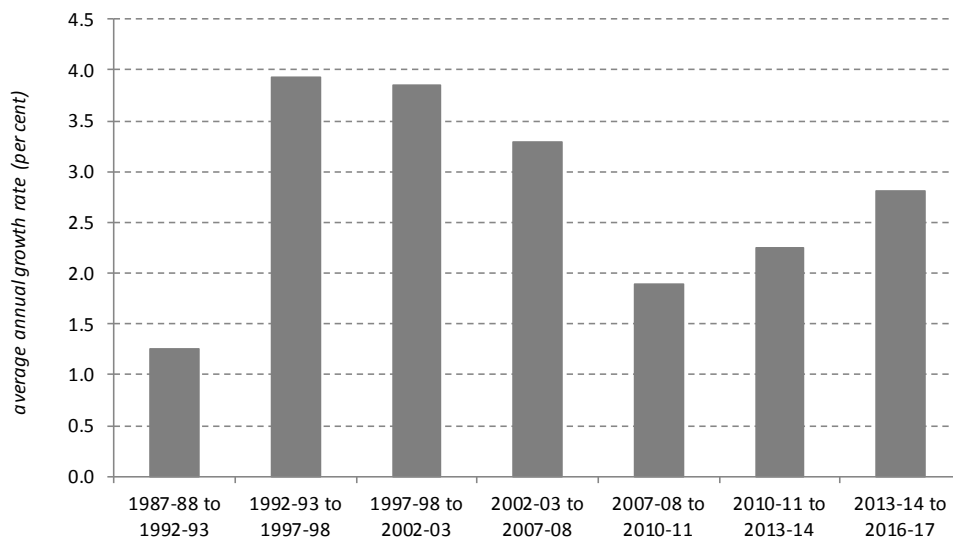
CHAPTER 3 – LONG-TERM ECONOMIC AND FISCAL OUTLOOK

- Victoria's long-term economic outlook is strong, but (as is the case nationally) is not expected to return to levels seen in the two decades prior to the global financial crisis. Long-term economic growth is likely to average 2.75 per cent per year rather than the 3.5 per cent per year recorded in the late 1990s and early 2000s.
- This demands a strong policy response focussed on key building blocks that drive long term growth: greater productivity, strong finances, efficient services, low taxes and a climate conducive to investment.
- The revenue outlook for the State is positive and likely to recover to an annual average growth rate of 4.0 per cent over the forward estimates. However, growth is unlikely to return to the rates of the last decade due to a lower level of forecast economic growth, and the changing composition of economic growth which is less skewed towards key revenue lines. For Victoria, these trends are exacerbated by a consistently low share of the GST pool.
- The Commonwealth Government is also experiencing fiscal pressures. There is a substantial risk that the Commonwealth will seek to alleviate its budget pressures by reducing grants or increasing cost shifting to the states. In a number of areas, the Commonwealth has raised service delivery expectations in areas of state responsibility without providing appropriate funding support.
- Increasing public debt is not the answer to revenue or economic growth pressures. State governments cannot accumulate significant debt without compromising service delivery capacity and tax competitiveness in future years.
- The Government has a strong economic and fiscal strategy based on strengthening the State's finances, improving productivity growth, targeting spending to improve service delivery and investing in high quality infrastructure.

FUTURE GROWTH MUST COME FROM STRONG FUNDAMENTALS

Victoria's economic outlook is strong, but (as is the case throughout Australia) economic growth is unlikely to return to levels seen prior to the global financial crisis. Growth over the last two decades was driven by factors that are unlikely to be repeated. The medium-term estimate of trend economic growth is 2.75 per cent, compared with 3.5 per cent a decade ago. This is close to the national growth trend outlook of 3 per cent.

Chart 3.1: Victorian historical real GDP^(a)



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

Note:

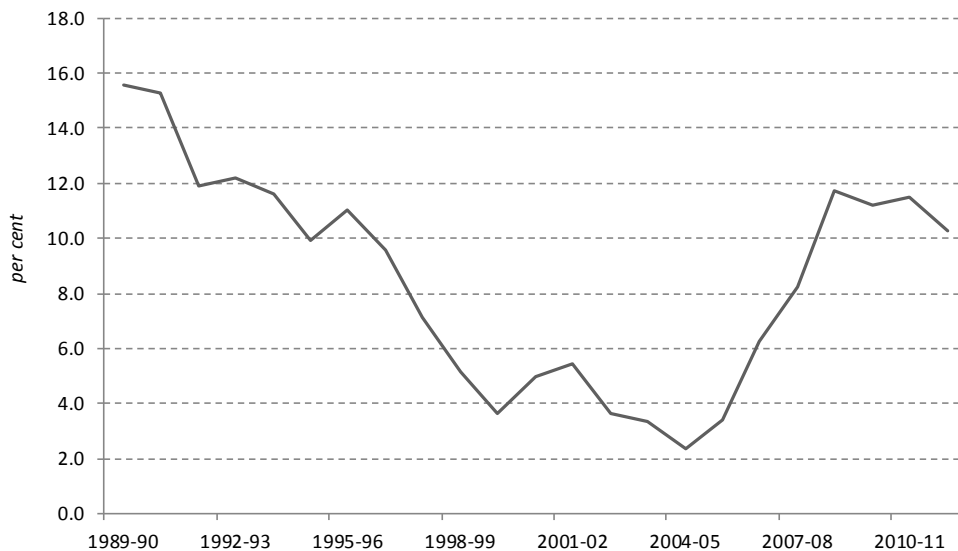
(a) Data prior to 1989-90 are calculated using growth rates from a constant price GSP series.

The very strong growth (of up to 4 per cent average annual growth) over the last two decades was driven by exceptional factors. During the early 1990s Victoria was recovering from a severe recession and experienced high growth rates as the economy utilised excess capacity. During the late 1990s and early 2000s, Victoria benefited from strong productivity growth flowing from microeconomic reform. In the mid 2000s, growth was supported by the emergence of strong trading partners and high levels of household consumption.

Strong household consumption over the last decade was fuelled by an unsustainable increase in debt and reduced household savings, driven by a structural decline in interest rates. In response to a more unstable global environment since the global financial crisis, household consumption and savings are now returning to more sustainable levels and towards the long-term trend, with higher levels of debt repayment and lower consumption.

Chart 3.2 shows Victoria’s gross household savings reached 2.4 per cent in 2004-05. This is abnormally low compared with the previous average savings rate of 12.1 per cent between 1990-97 and the more recent average of 11.2 per cent between 2009-12.

Chart 3.2: Victoria’s gross household savings ratio



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

At the same time, Victoria’s population, like that of other Australian jurisdictions and industrialised nations, is ageing. The ageing of the population will reduce the number of people of working age supporting each person of retirement age. This could have a negative effect on the rate of economic growth over the medium and longer-term.

CHANGES IN THE REVENUE BASE

The lower economic growth outlook is likely to reduce revenue growth, particularly goods and services tax (GST) revenue and state taxation. In addition, changes in the composition of economic growth mean growth in revenue, particularly from GST and land transfer duty, is likely to be lower for a given level of growth than in the past.

Reduced medium-term state taxation revenue growth outlook

Growth in the State’s taxation revenue has slowed in part as a result of moderated gross state product (GSP) growth. Between 2002-03 and 2007-08 average revenue growth was 6.6 per cent per year, compared with 4.1 per cent between 2008-09 to 2011-12. As shown in Chart 3.3, state taxation revenue has moved broadly in line with trends in GSP. Since trend GSP growth is forecast to be lower (but still positive), it is likely that taxation revenue growth will also be lower.

Chart 3.3: State taxation revenue and nominal GSP growth



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

Notwithstanding positive GSP growth, expectations of lower economic growth will impact all taxation revenue lines. Property-based taxes are likely to be the most affected. While the property market is prone to cycles, it is unlikely that growth in property tax revenue will consistently return to the rates observed during the boom years.

Similar economic trends are evident at the national level, suggesting growth in Commonwealth grants revenue, particularly from the GST, will also be lower going forward. For example, the Commonwealth's *2012-13 Mid-Year Economic and Fiscal Outlook* incorporated a medium-term projection for nominal GDP growth of 5.25 per cent, compared with average growth of 8 per cent a year in the five years to 2007-08. While GST growth is forecast to pick up over the forward estimates, it is likely to settle at a lower rate of growth than in the past. For Victoria, these impacts are exacerbated by a consistently low share of the overall GST pool.

Less GST and state revenue as a proportion of the economy

In addition to lower economic growth, the composition of economic growth is expected to be less skewed towards the state's key revenue lines, including GST and land transfer duty. This suggests the revenue growth will be lower for a given level of economic growth than in the past.

Prior to the global financial crisis, growth in land transfer duty surged, growing by an average of 16.3 per cent a year from 2001-02 to 2007-08, as falling interest rates fuelled a housing boom. This reduced to an average rate of -2.8 per cent a year from 2008-09 to 2011-12.

While the property market is forecast to recover, it is unlikely that growth in land transfer duty revenue will consistently maintain the rates observed during the boom years going forward.

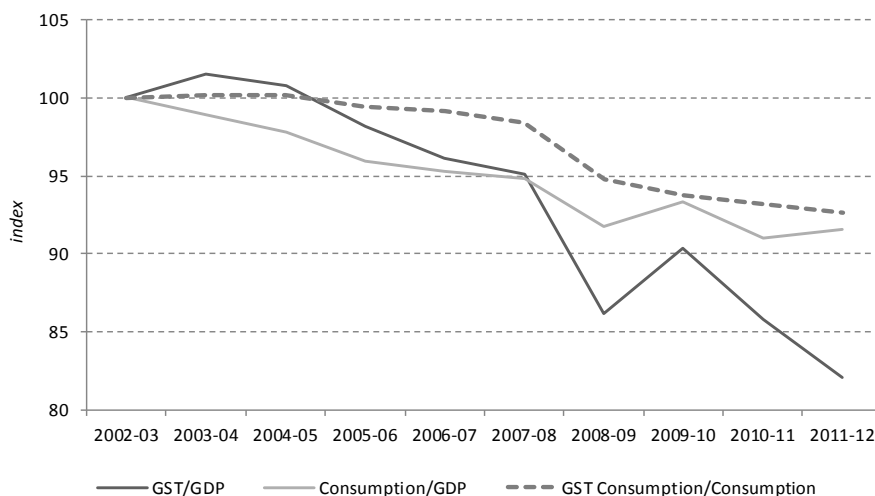
As with land transfer duty, Victorian GST revenue was strong prior to the global financial crisis, averaging growth of 8.9 per cent year from 2001-02 to 2007-08. Since then, growth has slowed to just 2.9 per cent a year over the past four years.

In addition to slower nominal GDP growth, GST revenue is being affected by the recent decline in the share of consumption in the economy, and a change in the composition of consumer spending away from goods subject to GST (see Chart 3.4).

The decline in the consumption share of the economy has been steady since 2002-03, largely reflecting the strength of investment, as distinct from sustained weakness in household consumption. Indeed, growth in nominal household consumption has averaged 6 per cent a year over this period. This process is likely to stabilise, as the investment boom runs its course.

More dramatic in recent years has been the decline in the share of consumption that is subject to GST. In other words, growth in household consumption in recent years has largely been driven by growth in goods not subject to GST, including education, health, utilities and rents. By comparison, growth in goods subject to GST has been more modest since the global financial crisis.

Chart 3.4: The movement away from consumption subject to GST



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

Underpinning this trend is changing consumption patterns. Growth in the volume of consumption goods subject to GST has declined since the global financial crisis while growth in GST-exempt consumption goods has largely maintained its pre-crisis rate. At the same time, there has been slower price inflation for goods subject to GST since the global financial crisis. The appreciation of the Australian dollar over this period is likely to

have been a major contributor to weak inflation in consumption goods subject to GST, which tend to be more trade exposed. In contrast, GST-exempt consumption goods, which are typically non-traded, maintained a similar pace of inflation before and after the global financial crisis.

Combining these various impacts, the national GST pool has fallen from a peak of 3.9 per cent of GDP in 2003-04 to 3.1 per cent in 2011-12, and is expected to remain flat over the forward estimates period. While the decline appears modest in percentage terms, in dollar terms the national GST pool would have been \$10.9 billion higher in 2011-12 had the ratio of GST to GDP been maintained, and Victoria would have received an additional \$2.5 billion in GST grants.

Victoria is also expecting to receive a lower share of the GST in 2013-14 than in 2012-13. This is based on the *Commonwealth Grants Commission Report on GST Revenue Sharing Relativities – 2013 Update*, which recommends a decrease in Victoria's GST share from 22.9 per cent in 2012-13 to 22.6 per cent in 2013-14. This equates to 90 cents for every dollar of GST Victoria would receive if the money were distributed on a per capita basis, instead of 92 cents. Combining both the weaker outlook for the national GST pool and Victoria's lower relative share, GST revenue is expected to be \$1.5 billion lower than previously expected from 2012-13 through the forward estimates.

A fairer share from Canberra

The Commonwealth is also facing fiscal pressures. This creates a risk that the Commonwealth will seek to alleviate its budget pressures by cutting funding or shifting costs to the states.

The Commonwealth has disregarded the service delivery realities faced by state governments when negotiating with the states. For example, it chose to ignore the advice of its own statistical agency and misinterpret Census data in order to reduce hospital funding to Victoria in 2012-13. Demonstrating a lack understanding of how hospitals are funded, the Commonwealth withdrew funding after the finalisation of budgets, leaving hospitals with no choice but to cut services.

At the same time that revenue growth is easing, the responsibilities of the Victorian government in responding to the diverse and changing requirements of the population are significant and growing. This underscores the importance of reforms to ensure services are provided to the community in the most efficient and effective way. New approaches to service delivery will be required, along with a focus on the outcomes being sought rather than funding inputs.

The Government is ensuring it can deliver services to the public more cost effectively. Implementation of the Sustainable Government Initiative has helped minimise government costs and the public sector restructure announced in April 2013 will refocus departments to ensure better service delivery.

THE GOVERNMENT'S ECONOMIC AND FISCAL STRATEGY

The Government has responded decisively and responsibly to the economic and financial challenges facing Victoria. The Government's economic and fiscal strategy addresses the challenges directly, and within the appropriate scope and capability of a state government, to drive future economic growth and prosperity.

The Government is focused on:

- rebuilding budget capacity;
- improving productivity, including through the provision of major infrastructure, more responsive and productive service delivery and continuing to build the skills and capabilities of the Victorian workforce; and
- ensuring Victoria is a competitive and low-cost place to do business.

Rebuilding budget capacity

A strong budget position is critical to secure Victoria's growth.

Strong fiscal management supports Victoria's growth prospects, enhances business confidence and attracts investment in the State, while also safeguarding Victoria against adverse financial shocks.

The Government will use growing operating surpluses to provide infrastructure to meet the needs of an expanding population and to maintain economic growth and liveability, without accumulating unsustainable public debt.

The Government's medium-term infrastructure investment parameter of 1.3 per cent of GSP (calculated as a rolling average to take into account the variation in the size of asset investment) provides a target for the level of government expenditure needed to ensure Victorians can access high quality services that improve over time.

Funding additional expenditure through deficits and the accumulation of further debt is unsustainable, and would compromise future services and tax competitiveness, increasing the burden on future generations.

The use of borrowing by state governments to fund the acquisition of long-term assets is often justified by a claim that the benefits generated will be enjoyed over a number of years. This argument has validity in corporate settings where the assets are income-producing and are often acquired in discrete bundles. Similarly, households can accumulate a larger amount of debt in the short-term, knowing they have the rest of their working lives to save and repay. However, for governments, capital expenditure to support service delivery and public good provision is required every year and does not normally generate income.

Some commentators argue that increasing state debt is sometimes justified to ‘kick-start’ the economy. Moving the State’s finances into deficit is not an effective way to counteract business cycle fluctuations or the forces of structural change because:

- government activity is around 15 per cent of Victoria’s GSP, so the ability of State spending to influence aggregate demand is limited;
- unlike the Commonwealth, state governments have a limited ability to make significant immediate payments to individuals, as the Commonwealth did in the global financial crisis in an attempt to stimulate the economy;
- states have a small tax base which limits the capacity to make short-run tax changes, or changes to how and when grant funding is spent; and
- decisions to undertake significant new service delivery programs or infrastructure projects require long lead times. Project complexities and lead times associated with sourcing and training new staff make timely and short-term fiscal stimulus difficult, with such initiatives potentially ending up pro-cyclical.

Global experience also suggests that debt is sticky. Once a government starts to live beyond its means, it is very difficult to return to stability.

State governments drive activity and employment through creating a strong business environment with competitive taxes, good services, efficient regulation and high quality infrastructure.

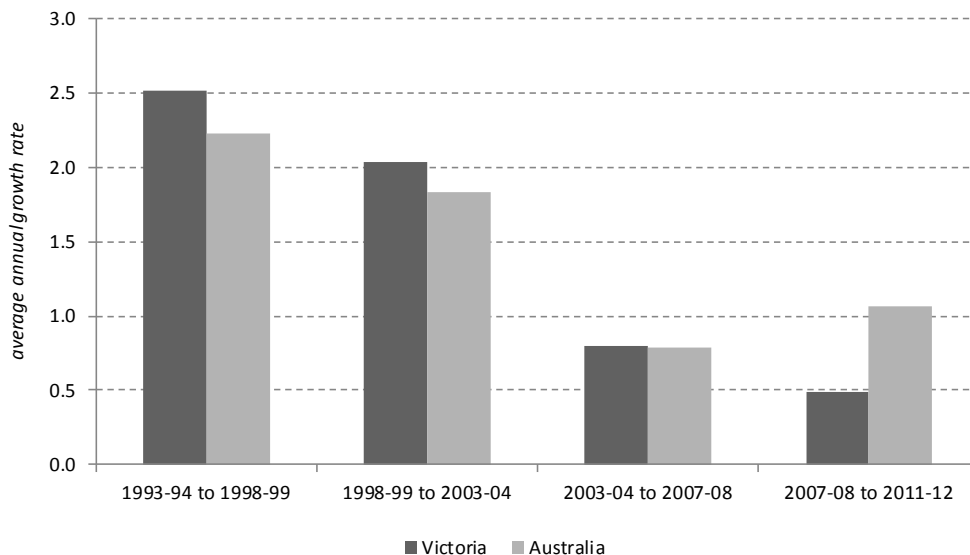
The Government’s economic and fiscal strategy is based on strengthening the State’s finances, improving productivity growth, targeting spending to improve service delivery, and investing in high quality infrastructure.

Improving productivity

Productivity, not debt, is the key to sustainable prosperity.

As Chart 3.5 shows, labour productivity growth in Victoria has deteriorated over the past decade, dipping below the national average in the most recent incomplete productivity growth cycle. Despite this longer-term trend, Victorian labour productivity growth modestly resumed in 2011-12, suggesting scope for improvement in longer-term outcomes.

Chart 3.5: Victorian and Australian labour productivity growth (average annual growth), 1993-94 to 2011-12^(a)



Source: Australian Bureau of Statistics.

Note:

(a) 2007-08 to 2011-12 represents an incomplete productivity cycle. The ABS use peak-to-peak productivity data to determine productivity growth cycles. The ABS is yet to determine if 2007-08 to 2011-12 is a complete productivity growth cycle.

The productivity and competitiveness of enterprises reflects decisions about how to organise production and deliver services, capacity to adopt new technology and customer relationships. This means that the Victorian Government’s influence on productivity is largely through the impact of its institutional frameworks and policies on business decisions.

Fostering competitive markets and exposing organisations to external disciplines to perform well is critical to enhancing productivity growth. In the public sector, where many services are delivered in non-market environments characterised by restrictive and anti-competitive practices, structures that promote competition and innovation can help drive efficiency and improve the diversity and quality of services available.

The Government is focusing on policies to ensure the delivery of productivity-enhancing infrastructure that attracts private sector investment, planning regulation that is responsive to productive investment, a regulatory framework that is efficient and minimises the impact on business, and developing the skills and capabilities of the Victorian workforce to improve quality and efficiency

Building major infrastructure

High-quality economic infrastructure reduces business costs, attracts new private investment, and improves workforce participation and productivity.

The Government is facilitating major transformational infrastructure projects and investing in the capacity and quality of road, rail and other key economic and social infrastructure. The *2013-14 Budget* delivers Government infrastructure investment in 2013-14 of \$6.1 billion, which aligns with the Government's medium-term fiscal parameter for infrastructure investment of 1.3 per cent of GSP (calculated as a five-year rolling average).

At the same time, new infrastructure projects over \$100 million or classified as high risk must comply with the high-value high-risk process to improve business case development and project implementation, protecting the budget from cost overruns on major projects.

Improved infrastructure procurement processes are being implemented with reforms to the public private partnership (PPP) model as part of the *2013-14 Budget*. The changes will ensure Victoria has the right model to engage the private sector to drive innovation and efficiency in infrastructure delivery. Changes include adopting modified financing structures, including a greater range of services and streamlining PPP tender processes. Value for money will continue to be tested through a robust Public Sector Comparator benchmark. The assumed alternative procurement option will be removed and where appropriate the comparator will be an affordability benchmark with a scope ladder.

The *2013-14 Budget* provides funding for the further development of new long-term major infrastructure projects to improve the efficiency and scale of freight and logistics to better link people, products and markets. This includes:

- commitment to deliver the East West Link project, with the first stage being the Eastern section to connect the Eastern Freeway at Hoddle Street to City Link in Parkville. The East West Link – Stage 1 has an estimated capital cost of between \$6 billion and \$8 billion. Construction is expected to commence in late 2014 and is anticipated to be completed in 5 years; and
- funding to further develop the Port of Hastings. When the Port of Hastings project is complete, Victoria's container capacity will be significantly enhanced.

The Government is also investing to develop and modernise infrastructure to meet the needs of a growing population and to maintain economic growth and liveability. The *2013-14 Budget* funds:

- Major investment in health and hospitals including the new Monash Children's Hospital, which will deliver 230 beds and enable families to access specialist paediatric services closer to where they live, the Royal Victorian Eye and Ear Hospital redevelopment and construction of the new Waurin Ponds Community Hospital in Southern Geelong, delivering 32 beds. The Government is also committing to an expansion of the Northern Hospital to increase in-patient capacity by 32 additional beds, as well as redevelopment and expansion of the Werribee Mercy Hospital mental health facilities. This is in addition to the continuing investment in the new Bendigo

Hospital, the construction of the Victorian Comprehensive Cancer Centre and the redevelopment of Box Hill Hospital.

- Public transport investment, including eight new X'Trapolis metropolitan commuter trains to commence running on the network by 2015, which adds to the seven funded in the *2011-12 Budget* (of which four of the seven are now in service). The Government has also ordered 40 new regional carriages to fully realise the benefits of the Regional Rail Link project when it is operational. These investments are in addition to 50 new low-floor trams currently being built for Melbourne's tram network.
- Important public transport initiatives, including \$100 million for Bayside rail improvements, which will improve services and station amenity for passengers on the Frankston line and support the deployment of X'Trapolis trains on the Frankston, Werribee and Williamstown lines. New rail stations including a new Grovedale Station for residents of Greater Geelong, a new Epsom Station in northern Bendigo, and, subject to negotiations with the owners of Southland Shopping Centre, a new station at Southland Shopping Centre on the Frankston line. A package of early works toward the removal of five level crossings through the Metro level crossing blitz program, as well as further planning and investigations for another two level crossings. This builds on the removal of five level crossings already underway.
- \$202 million for arterial road restoration and maintenance, such as the West Gate Bridge, which augments VicRoads' base funding for road maintenance.
- \$203 million for the State's school capital program.

Public sector reform to boost growth

The Government's public sector restructure, announced in April 2013, is designed to further sharpen the focus on securing investment and jobs, and providing better services to Victorians. Key changes include:

- integrating urban and transport planning with local infrastructure and services;
- bringing land and water management together with primary industries to help boost the productivity of Victoria's food and fibre sector; and
- bringing the energy and resources portfolio into the new Department of State Development, Business and Innovation to enable a stronger focus on major development opportunities such as Victoria's coal resources.

These changes follow implementation of the Sustainable Government Initiative, a managed reduction in back office and administrative positions of the public service workforce.

The Government is also:

- strengthening its role as an active shareholder of public sector commercial entities to ensure they provide value for Victorian taxpayers and the community;
- undertaking targeted cost and efficiency reviews of entities, especially where those entities impose direct costs on the community;
- investigating using the market to provide some services that are provided internally by government. This is being undertaken, for example, as part of the *Victorian Government ICT Strategy 2013 to 2014*, released in February 2013; and
- delivering the government's data and intellectual property resources to the community. Public sector agencies are working to meet the target of releasing 1 000 datasets for reuse by industry and the public by September 2013.

The Government is also exploring a commissioning approach for the procurement of services from private, public or not-for-profit organisations to better harness the benefits of competition. A more competitive and accountable environment will drive providers to continually lower the cost and improve the quality of their services.

In August 2012, the Victorian and Commonwealth Governments agreed to a launch site of the National Disability Insurance Scheme in the Barwon area commencing on 1 July 2013. Over the course of the launch, approximately 5 000 eligible people with significant disabilities will have their needs assessed and will start to receive 'reasonable and necessary' support under a National Disability Insurance Scheme model. The launch will test the existing model and inform future directions for disability support.

The *2013-14 Budget* funds initiatives that will drive the responsiveness and productivity of government services, including:

- opening additional elective surgery funding pools to greater competition to provide a better, more efficient service to enable more patients to be treated; and
- further developing *Services Connect* as Victoria's integrated family and community support system, by extending activity at the existing trial sites in Dandenong and Barwon. *Services Connect* will improve the way government and partner agencies deliver support to those most in need in our community, ensuring service delivery is client centred and more efficient.

Reform of education and training

Improving the educational outcomes of the school sector and the skills and capabilities of the Victorian workforce will have a significant impact on productivity and workforce participation.

Real reforms in the school sector

The path to improved school performance lies with greater autonomy for schools, better teachers, more innovative teaching methods and targeted help for under-performing schools. Both the government and non-government school sectors have a role in delivering these improvements. Recent publications outline the Government's vision for the future of school leadership, teaching and school performance, with a focus on teacher effectiveness, school autonomy and accountability for improving student outcomes. Key reforms include:

- school-based reforms to increase school autonomy, balanced with clear expectations, accountability and support, as set out in the *Towards Victoria as a Learning Community* policy statement; and
- new policy and actions in the areas of teaching and school leadership emerging from the *New Directions for School Leadership and the Teaching Profession* discussion paper, which focuses on potential strategies to attract great people into teaching, create a high performing profession and provide strong direction and support.

The Government's broader schools reform agenda will also be supported through the workforce reforms delivered over the life of the Schools Enterprise Bargaining Agreement. Progression through salary levels will no longer be automatic with a more rigorous assessment of performance to be undertaken annually, and principals will be able to make appointments purely on merit.

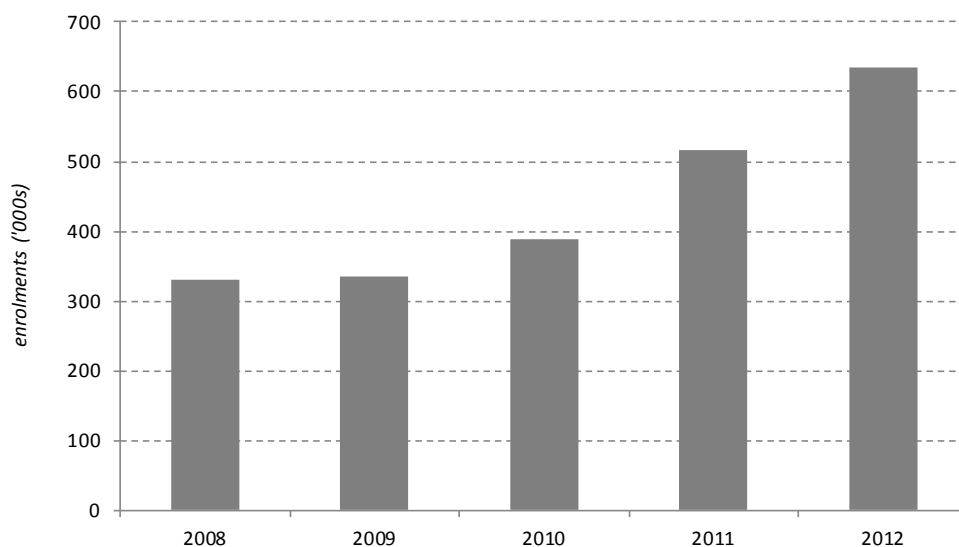
The *2013-14 Budget* supports this agenda by investing in leadership and development programs to lift teacher and school performance. This continues the reforms implemented by the Government in previous budgets, focusing on empowering school leaders and teachers by devolving more decision making to principals and school communities.

The strongest adult and tertiary education sector in Australia

Victoria's training system remains the most responsive in Australia to the changing needs of the labour market.

The *2013-14 Budget* builds on the Government's commitment to increase the skills and capability of the Victorian workforce. Based on the latest comprehensive data release, the Government has invested more money in training than any other Australian jurisdiction, both in total and on a per capita basis. Chart 3.6 shows that Government funded Vocational Education and Training (VET) enrolments continue to exhibit strong growth, demonstrating the strength of Victoria's training market.

Chart 3.6: Victorian Government funded VET enrolments^(a)



Source: Department of Education and Early Childhood Development

Note:

(a) Excludes pre-accredited training.

Key to the reform agenda announced in *Next Steps for Refocusing Vocational Training in Victoria* is targeted funding through the rebalancing of subsidy rates to better reflect the relative public value of courses and ensuring VET providers are responsive to industry needs. In response to these changes, a larger share of commencements has been in courses of high public value. In 2013, 65 per cent of commencing enrolments were in courses for Bands A and B (courses such as apprenticeships, trades and nursing), compared with 52 per cent at the same time in 2012.

Recent reforms have strengthened competition between public and private providers in the VET market and improved information provided to students on the quality of providers. Ensuring TAFE institutes and privately owned training providers receive the same training subsidy rates establishes a level playing field for all VET providers. A new VET market monitoring unit advises on competition and pricing activity in the market and providers are required to publish indicative prices up front.

Building on these reforms, the Government is committed to strengthening the competitive footing of the TAFE sector by establishing TAFE institutes as enterprises with the requisite management and board capacities by:

- providing TAFE institutes with greater autonomy over their assets and more flexibility in financial arrangements;
- reducing the regulatory burden on TAFE institutes through streamlined reporting requirements and by more clearly defining roles and responsibilities of TAFE institutes and the Department of Education and Early Childhood Development;

- allowing TAFE institutes to have more control over workplace relations; and
- modernising TAFE institutes' constitutions to provide a clearer understanding of Government's expectations.

To support this, the Government is providing \$200 million over four years to support innovation, collaboration and structural reform in Victorian TAFE institutes to ensure their competitiveness in the VET sector.

A competitive and low cost place to do business and invest

The Government is focused on providing a more affordable and competitive business environment in Victoria.

Planning and land use

For the economy to adapt to change and take advantage of new opportunities, it is vital that planning and land use policy is flexible and responds to changing investment and employment patterns. A flexible land use system unlocks and maximises the economic value inherent in Victoria's land assets.

The Government is developing a Metropolitan Planning Strategy (MPS) that will guide Melbourne's land-use planning and transport needs over the next 30 to 40 years. The MPS will help guide decisions on Melbourne's development and will support urban renewal in strategic locations across Melbourne, such as Fishermans Bend.

This is supported by:

- action to streamline identification of surplus government land and bring it to market, encouraging flexible land use and stimulating economic growth. The Government has commenced a pilot for rezoning surplus sites from the Department of Education and Early Childhood Development to enable the land to be appropriately zoned more efficiently and thereby used more effectively;
- seeking opportunities for urban development on the rail network located near rail stations and other transport hubs;
- delivering new planning zones to encourage investment, economic growth and certainty to residents and businesses; and
- accelerating and streamlining planning and environmental approval processes to increase certainty for businesses seeking to invest in Victoria, while appropriately balancing planning and environmental outcomes.

These actions will support a planning system that is responsive to productive investment.

Reducing regulatory costs

Excessive red tape imposes unnecessary costs on business and is a barrier to productivity improvements in the Victorian economy. The Government has a comprehensive program to reduce red tape affecting businesses, not-for-profit organisations, government service providers and households by 25 per cent by 1 July 2014. To date, the Red Tape Reduction Program has identified over \$500 million a year in red tape savings to Victorians.

Key reforms that reduce costs and improve opportunities for Victorian business to expand and innovate include:

- reinstating the Victorian Civil and Administrative Tribunal major cases planning list;
- introducing shorter approval timeframes for planning applications under VicSmart;
- simplifying rules for new houses constructed on lots less than 300 square metres through the Small Lot Housing Code;
- delivering significant zoning reform that will facilitate more development in commercial and industrial zones and reduce entry barriers for smaller supermarkets;
- opening up national parks to environmentally appropriate private sector tourism investment to ensure Victorians get maximum benefit from the State's natural assets;
- relaxing floor space restrictions on bulky good retail centres, which will allow stores to open smaller, lower cost premises;
- lifting the ban on Easter Sunday trading for large businesses (those with 20 or more employees);
- reforming feed-in tariffs for roof-top solar electricity to minimise cross-subsidies, which increase costs for Victorian electricity consumers; and
- simplifying environmental reporting by removing the mandatory requirement for large water users to prepare, submit and report against a water management action plan.

A range of further opportunities to achieve the Government's red tape target are being identified by the recently appointed Red Tape Commissioner, who provides an important bridge between the business community and government. The Commissioner will provide the Government with an initial list of reform opportunities over the next few months.

To establish clear expectations for regulators to improve their compliance and administrative practices, the Government is issuing Ministerial Statements of Expectations (SOEs) to all Victorian regulators. Stage One of the reform is underway, with five of Victoria's highest-impact regulators currently being issued red tape reduction SOEs by each regulator's responsible Minister. These regulators must outline the changes they intend to implement to meet their red tape performance measures by 1 July 2013. The second stage of the reform will involve implementing SOEs covering a broad range of performance and governance objectives for all regulators from late 2013.

The VCEC is progressing regulatory improvement work with selected large regulators to help focus how risk-based approaches can be applied to reduce the red tape burden for compliant businesses.

Taxation reform

An efficient taxation system is critical to supporting a competitive business environment.

On 1 July 2013, the Government will replace the insurance-based fire services levy with the Fire Services Property Levy, as recommended by the Victorian Bushfires Royal Commission. This significant tax reform will replace an inefficient and inequitable tax on insurance with an efficient and fair property levy that ensures all property owners contribute to funding Victoria's fire services. The reduction in GST and stamp duty on insurance as a result of the removal of the insurance-based levy, combined with the introduction of a concession for pensioners and some veterans, will deliver savings of approximately \$100 million to Victorian households and businesses in the 2013-14 financial year.

To increase the pool of GST revenue available to states, Victoria will work with other states and the Commonwealth to explore the feasibility of lowering the GST low-value threshold.

Industrial relations

Changes to industrial relations in the public and private sectors that support flexibility and new employment opportunities will drive productivity and investment in Victoria.

The Government is continuing to advocate to the Commonwealth for sensible and necessary industrial relations reforms, such as monitoring the Commonwealth's response to the recommendations made by the Fair Work Act Review Panel. The Government is also strengthening the capacity of the public sector in workplace relations.

To address the industrial relations causes of high construction costs, the Government is monitoring and enforcing compliance with the *Implementation Guidelines to the Victorian Code of Practice for the Building and Construction Industry*. During 2012-13, attention has focused on compliance during project tendering, ensuring that the Guidelines apply to the 45 newest projects over \$10 million. In 2013-14, there will be an increased focus on project compliance, to ensure that the on-site conduct of contractors complies with the Guidelines.

Negotiations for new Enterprise Bargaining Agreements (EBA) covering the significant majority of public sector employees have been concluded. These EBAs will deliver important workforce reforms. Some examples include:

- Victoria Police EBA – restored greater managerial prerogative of Victoria Police to increase flexibility around placing and moving sworn officers to meet demand and improved operational capacity consistent with the recommendations of the Rush Inquiry;
- Nurses EBA – enhanced local flexibility for a ward or unit in the application of nurse-to-patient ratios across the 28-day rostering period; and
- Schools EBA – increased flexibility for principals to manage their schools and workforce, including a more rigorous performance assessment process.

Private sector investment and employment

Access to new markets, both interstate and overseas, enables firms to grow.

The State's international engagement strategy will enable businesses to tap into new sources of trade and investment opportunities. A focus of the Government's efforts is on the opportunities presented by the Asian century and the emerging new markets in the region. The *2013-14 Budget* funds an international education strategy to help the sector take advantage of expanding opportunities in the global market and builds on Victoria's global reputation as a quality provider of international education. In addition, the Government is establishing new Victorian Government Business Offices in Western China and Indonesia.

To ensure Victoria remains a leading state in attracting private investment, the Government is being more proactive in attracting investment and identifying, promoting and supporting private investment into the State. The *2013-14 Budget* funds establishment of the Office of State Development to attract new and productive investment to Victoria. The new Department of State Development, Business and Innovation will focus on facilitating significant projects, which require a whole-of-government approach. The Department will expedite project approvals across government in order to bring major projects to market.

CHAPTER 4 – BUDGET POSITION AND OUTLOOK

- The Government’s fiscal strategy uses growing operating surpluses to provide infrastructure to meet the needs of an expanding population and maintain economic growth and liveability, while stabilising and then reducing net debt after June 2015.
- The operating result is projected to be \$225 million in 2013-14 and remain in surplus in every year of the forward estimates, growing to \$2.5 billion by 2016-17.
- The Government has acted decisively to address revenue challenges by restraining expenditure growth and creating a stronger medium-term budget position. Forecast expenditure growth over the forward estimates will average 2.5 per cent each year compared to forecast revenue growth of, on average, 4.0 per cent each year.
- Government infrastructure investment for the general government sector is projected to be \$6.1 billion in 2013-14, and average \$4.7 billion over the forward estimates. By 2015-16, infrastructure investment is forecast to be fully funded from operating surpluses.

OVERVIEW

The Government has set out a medium-term fiscal strategy (Chapter 1 *Economic and fiscal overview*) that builds a stronger budget position for Victoria. The focus of this strategy is to generate the financial capacity to fund infrastructure sustainably without excessive borrowing, and rebuild the budget capacity to deal with future fiscal shocks.

This chapter deals with 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 26 April 2013 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.

Table 4.1: General government fiscal aggregates and measures

		(\$ million)					
	Unit of Measure	2011-12 Actual	2012-13 Revised	2013-14 Budget	2014-15 Estimate	2015-16 Estimate	2016-17 Estimate
Net result from transactions	\$ million	571.2	177.0	224.5	398.7	1 927.7	2 547.4
Government fiscal result ^(a)	\$ million	571.2	177.0	817.6	1 005.5	2 545.0	3 173.8
Net debt ^(b)	\$ billion	15.2	19.8	23.0	25.1	24.4	22.7
Net debt to GSP ^(c)	per cent	4.6	5.8	6.4	6.6	6.1	5.4
Government infrastructure investment ^(d)	\$ billion	5.4	5.4	6.1	6.6	4.0	3.5

Source: Department of Treasury and Finance

Notes:

- (a) Equals to the net result from transactions after excluding the impact of the revised AASB 119 Employee Benefits, which applies from 2013-14.
- (b) The sum of borrowings, deposits held and advances received less the sum of cash and deposits, advances paid, and investments, loans and placements.
- (c) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
- (d) Includes general government net infrastructure investment and estimated cashflows for Partnerships Victoria projects, and excludes one-off fiscal stimulus payments for Nation Building – Economic Stimulus Plan Social Housing component and Building the Education Revolution.

The operating result (net result from transactions) for the general government sector is expected to be \$225 million in 2013-14, increasing to \$2.5 billion by 2016-17. Growing operating surpluses support, and are consistent with, the Government's medium-term fiscal strategy.

The government fiscal result excludes the impact of the revised accounting standard AASB 119 *Employee Benefits*, which changes the way defined benefit superannuation costs are presented in the operating statement. This measure provides another analytical measure of Victoria's fiscal outlook that is comparable with estimates of the operating result in previous publications. A detailed explanation of the revision to AASB 119 can be found at Note 1 of Budget Paper No. 5 *Estimated Financial Statements*. The estimated government fiscal result for 2013-14 is \$818 million, increasing to \$3.2 billion by 2016-17.

These strong and growing operating surpluses will be used to invest in state-changing infrastructure, including East West Link – Stage 1. These forecasts have been revised down over the period 2013-14 and 2015-16 since the *2012-13 Budget Update*. These revisions largely reflect lower expected revenue from GST and other Commonwealth grants, partially offset by the net impact of higher investment income together with new policy initiatives announced in the *2013-14 Budget* funded through new savings, the release of contingencies for policy purposes and targeted revenue measures.

Net debt is forecast to increase in 2013-14 and 2014-15, rising to 6.6 per cent of GSP at June 2015. Once the full impact of the Government's fiscal restraint is realised, the growing operating surpluses will produce sufficient cash balances to fully fund infrastructure investment and reduce net debt. By June 2017 net debt is expected to have fallen significantly in both nominal dollars and as a proportion of GSP.

BUDGET AND FORWARD ESTIMATES OUTLOOK

Table 4.2 presents a summary operating statement for the general government sector. A comprehensive operating statement is presented in Budget Paper No. 5, Chapter 1 *Estimated Financial Statements for the general government sector*.

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

	(\$ million)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Revenue						
Taxation	15 026.9	15 621.4	16 454.4	17 514.5	18 299.4	19 262.0
Dividends, TER and interest ^(c)	1 351.7	1 905.3	1 538.5	1 502.1	1 641.3	1 598.2
Sales of goods and services	6 267.2	6 916.7	6 949.5	7 085.2	7 336.7	7 422.1
Grants	22 599.8	21 693.0	23 310.5	23 937.0	25 199.6	26 230.4
Other current revenue	2 636.7	1 969.2	2 074.5	1 935.9	1 997.3	2 030.7
Total revenue	47 882.3	48 105.6	50 327.5	51 974.7	54 474.3	56 543.4
% change	4.0%	0.5%	4.6%	3.3%	4.8%	3.8%
Expenses						
Employee expenses	17 120.1	17 546.3	17 947.1	18 667.7	19 292.7	19 860.4
Superannuation ^(d)	2 632.5	2 369.4	3 031.0	3 034.4	3 047.3	3 048.4
Depreciation	2 126.5	2 264.9	2 377.7	2 541.2	2 620.7	2 750.1
Interest expense	1 242.6	1 750.6	2 176.9	2 309.8	2 299.0	2 291.8
Other operating expenses	15 955.6	16 293.7	16 573.0	16 678.2	16 764.6	17 271.4
Grants and other transfers	8 233.8	7 703.7	7 997.4	8 344.8	8 522.4	8 773.8
Total expenses	47 311.0	47 928.6	50 103.0	51 576.0	52 546.6	53 996.0
% change ^(e)	4.0%	1.3%	3.3%	2.9%	1.9%	2.8%
Net result from transactions	571.2	177.0	224.5	398.7	1 927.7	2 547.4
Total other economic flows included in net result	(10 298.6)	3 207.6	(264.0)	(293.0)	(335.1)	(352.0)
Net result	(9 727.3)	3 384.7	(39.6)	105.8	1 592.6	2 195.4
Expected return on superannuation assets taken to other comprehensive income and not included in net result from transactions	..	..	593.2	606.8	617.3	626.4
Government fiscal result^(f)	571.2	177.0	817.6	1 005.5	2 545.0	3 173.8

Source: Department of Treasury and Finance

Notes:

- (a) This is an abbreviated operating statement. The comprehensive operating statement is presented in Budget Paper No. 5, Chapter 1 *Estimated Financial Statements for the general government sector*, and provides additional information on economic flow measurements which, when added to the net result from transactions, yields the net result.
- (b) Figures for 2011-12 and 2012-13 are prepared under accounting standards relevant at the time, which do not take into account the changes to the revised AASB 119 Employee Benefits.
- (c) Comprises dividends, income tax and rate equivalent revenue and interest.
- (d) Comprises superannuation interest expense and other superannuation expenses.
- (e) The estimated expense growth from 2013-14 is derived by excluding the impact of the revised AASB 119 Employee Benefits.
- (f) Equals to the net result from transactions after excluding the impact of the revised AASB 119 Employee Benefits, which applies from 2013-14.

Analysis of the revised 2012-13 operating result can be found in Budget Paper No. 5, Appendix B *2012-13 Budget outcome incorporating the financial report for the March quarter 2013*.

Revenue outlook

Revenue is expected to grow by 4.6 per cent in 2013-14. Over the forward estimates, revenue is expected to increase at an average rate of 4.0 per cent a year. While revenue growth is expected to recover from several years of slower growth and maintain a steady trend over the forward estimates, it is unlikely to return to rates of around 6.9 per cent experienced over the decade to June 2011.

State taxation revenue is expected to grow by 5.3 per cent in 2013-14, driven by the expected recovery in payroll tax and land transfer duty. Over the forward estimates, growth is forecast to average 5.4 per cent a year as the economy returns to trend growth. Specifically:

- payroll tax is expected to grow by 6.1 per cent in 2013-14 and by an average of 5.7 per cent a year over the forward estimates, consistent with trend growth in the labour market;
- land tax revenue is expected to fall by 1.4 per cent in 2013-14 following growth of 13.3 per cent in 2012-13. This uneven pattern reflects the biennial land tax revaluation cycle and the disaggregation of land holdings. Growth is expected to average 8.2 per cent a year over the forward estimates;
- land transfer duty is expected to grow by 9.1 per cent in 2013-14. This follows two successive years of decline and captures improvements seen in Victoria's property market since the end of 2012. Growth is expected to average 6.4 per cent a year over the forward estimates, in line with a return to trend economic growth;
- gambling taxes are expected to grow by 4.1 per cent in 2013-14 and by an average of 3.7 per cent a year over the forward estimates, reflecting moderate growth in player losses and household consumption as well as a continuation of the decline in gambling expenditure as a share of consumption;
- taxes on insurance (excluding insurance contributions to fire services) are expected to fall by 0.9 per cent in 2013-14 as the transition to a new funding regime results in a lower insurance premium base on which to levy insurance stamp duties. Growth is expected to recover to an average of 6.5 per cent a year over the forward estimates; and
- motor vehicle taxes are expected to grow by 4.0 per cent in 2013-14 and by an average of 4.3 per cent a year over the forward estimates, underpinned by ongoing solid economic and population growth.

GST revenue is projected to grow by 2.5 per cent in 2013-14, reflecting Victoria's lower share and subdued growth in the GST national pool. However, it is projected to increase to an average of 6.5 per cent per year over the forward estimates.

Other grants are expected to increase by 12.6 per cent in 2013-14, following a fall of 12.7 per cent in 2012-13. The fall in 2012-13 reflects a series of decisions by the Commonwealth Government since 2011 to rephase around \$500 million of grants from 2012-13 to other years. Growth is expected to average 1.5 per cent a year over the forward estimates. This growth largely reflects indexation arrangements for the major Commonwealth grants, and the cessation of funding for the Regional Rail Link project after 2015-16.

Total dividends, income tax equivalents and interest revenue is expected to fall by 19.3 per cent in 2013-14, largely due to the one-off increase in 2012-13 associated with dividends from the State Electricity Commission of Victoria (reflecting projected cash flow that is surplus to its operational requirements), and lower dividends from Melbourne Water due to the impact of the price freeze and refund of charges to customers in 2012-13. This overall reduction in 2013-14 also incorporates higher interest revenue associated with the first full year interest revenue for the desalination plant. Across the forward estimates, these revenues grow by an average of 1.3 per cent, in line with expected investment returns in the water sector and the State-owned insurers.

Revenue from sales of goods and services is expected to increase by 0.5 per cent in 2013-14 following the large increase in 2012-13 associated with the one-off recognition of revenues from the Melbourne Water Corporation upon commissioning of the desalination plant. Over the forward estimates growth is expected to average 2.2 per cent a year.

Other operating revenue includes fines, royalties, donations and gifts, assets received free of charge and other miscellaneous income. These revenues are projected to increase by 5.3 per cent in 2013-14, primarily reflecting revenue from the sale of land in Kew which is now anticipated to be completed in 2013-14, then remain relatively stable over the forward estimates period.

Expenses outlook

The Government will spend \$50 billion delivering services in 2013-14. Total expenses are projected to grow by 3.3 per cent in 2013-14 and by 2.5 per cent a year on average over the forward estimates period (excluding the impact of revisions to AASB 119). Total growth in expenses over the budget and forward estimates is largely due to:

- total employee expenses (including superannuation), which constitute 41 per cent of annual government expense in 2013-14 and are expected to grow by 2.4 per cent in 2013-14 and by an average of 3.0 per cent across the forward estimates (excluding the impact of revisions to AASB 119). This growth reflects the counter-veiling impacts of increased staffing for ongoing service delivery, moderated wage increases due to the Government's wages policy and savings measures aimed at improving the efficiency of back-office functions;
- other operating expenses, which are expected to grow by 1.7 per cent in 2013-14 and by an average of 1.4 per cent a year over the forward estimates. These growth rates reflect indexation less savings and efficiencies applied to back-office functions;

- grants and transfer payments, which are expected to grow by 3.8 per cent in 2013-14 and by an average of 3.1 per cent a year over the forward estimates largely reflecting funding for non-government schools and grants on-passed to local government;
- depreciation expenses, which are projected to grow by 5.0 per cent in 2013-14 and by an average 5.0 per cent a year over the forward estimates. This growth is broadly consistent with the net increase in the depreciable non-financial asset base due to Government's continued investment in infrastructure; and
- interest payments, which are expected to increase in 2013-14 by 24.3 per cent primarily due to the first full year of payments associated with the commissioning of the Desalination Plant. These interest payments are offset by matching interest revenue. Across the forward estimates, growth in interest payments averages 1.7 per cent, in line with the profile of net debt which stabilises before decreasing after June 2015.

Other economic flows

Differences between the net result from transactions and the net result overall are due to other economic flows. Other economic flows include items such as actuarial adjustments, and bad and doubtful debts.

The revised forecast for other economic flows in 2012-13 primarily reflects an actuarial gain on superannuation of around \$3.6 billion. This is made up of a \$2.5 billion gain that arose from favourable movements in the bond rate used to value the State's superannuation liability, and a further \$1.1 billion actuarial gain due to higher than expected returns on superannuation assets for the year to date. It is important to note that changes in the superannuation liability that are attributable to bond rate movements do not impact the amount of cash required to fund the liability over time.

The estimate for other economic flows over the budget and forward estimate years primarily reflects provisions for bad and doubtful debts.

Reconciliation of forward estimates to previously published estimates

Excluding the impact of the revision to AASB 119 *Employee Benefits*, the net result from transactions has been revised down over the period 2013-14 to 2015-16 since the *2012-13 Budget Update* was released in December 2012. The major driver of the lower operating surpluses is lower expected revenue from GST and other Commonwealth grants, partially offset by the net impact of higher investment income together with new policy initiatives announced in the *2013-14 Budget* funded through new savings, the release of contingencies for policy purposes and targeted revenue measures.

Table 4.3: Reconciliation of estimates to the 2012-13 Budget Update

(\$ million)

	2013-14 Budget	2014-15 Estimate	2015-16 Estimate
Net result from transactions: 2012-13 Budget Update	834.7	1 260.0	2 636.8
Less: Impact of AASB 119	593.2	606.8	617.3
Plus: Variations in income from transactions since 2012-13 Budget Update			
Policy decision variations	119.9	137.8	157.7
Economic/demographic variations			
Taxation	(11.5)	34.1	47.8
Investment income ^(a)	200.8	87.0	138.1
	189.2	121.1	185.9
Commonwealth grant variations			
General purpose grants	(202.1)	(307.6)	(391.9)
Specific purpose grants	19.6	(143.3)	(314.5)
	(182.5)	(450.9)	(706.3)
Variations in own-source revenue ^(b)	223.4	73.6	97.5
Administrative variations	84.3	79.2	127.4
Total variation in income from transactions since 2012-13 Budget Update	434.3	(39.1)	(137.9)
Less: Variations in expenses from transactions since 2012-13 Budget Update			
Policy decision variations ^(c)	620.0	560.3	400.7
Commonwealth grant variations	10.3	(2.3)	(7.1)
Variations in own-source revenue ^(b)	116.1	33.9	17.7
Administrative variations			
Superannuation variations	47.6	50.1	52.3
Contingency offset for new policy ^(d)	(488.0)	(494.6)	(508.4)
Other administrative variations	145.5	67.9	(1.3)
Total administrative variations	(295.0)	(376.6)	(457.3)
Total variation in expenses since 2012-13 Budget Update (excluding impact of change to AASB 119)	451.4	215.3	(46.1)
Revised net result from transactions	224.5	398.7	1 927.7
2013-14 Budget Government Fiscal Result	817.6	1 005.5	2 545.0

Source: Department of Treasury and Finance

Notes:

- (a) Investment income includes dividends, income tax and rate equivalent revenue and interest.
(b) Own-source revenue variations represent third party variations by departments.
(c) This is represented in Table 4.4 as the 2013-14 Budget output policy decisions.
(d) Represents release of contingencies associated with demand for government services.

Impact of changes to AASB 119

A revised version of AASB 119 *Employee Benefits*, which came into effect on 1 January 2013, changed the way defined benefit superannuation costs are presented in the operating statement.

In particular, the revised AASB 119 requires a net interest cost to be calculated using the discount rate (a long-term Commonwealth Government bond rate) without reference to the expected rate of investment return on plan assets, as was previously the case. The higher expected investment return that is in excess of the discount rate is then recognised under other comprehensive income as an economic flow such that the total superannuation liability is unchanged as a result of the revised AASB 119.

Variations to income from transactions

The revision to total revenue compared to the *2012-13 Budget Update* is mainly attributed to weaker revenue from GST and other Commonwealth grants, offset by revised estimates of own-source revenue, investment income, and new targeted revenue measures.

Policy decision variations

Revenue policy decisions in the *2013-14 Budget* are expected to increase forecast revenue by around \$140 million a year on average over the period 2013-14 to 2015-16. This includes a broadened scope of the congestion levy in inner Melbourne, addressing anomalies in land tax compliance and retargeting the Driver Reward Scheme.

Details of specific revenue policy initiatives are contained in Budget Paper No. 3 *Service Delivery*.

Economic and demographic variations

Taxation revenue is, on average, largely unchanged between 2013-14 and 2015-16. Specifically, over the three year period:

- land tax is up by an average of \$48 million a year, following revisions to the expected biennial revaluations of land value;
- land transfer duty is up by an average of \$35 million a year, reflecting the recent improvements in the property market;
- taxes on insurance are up by an average of \$6 million a year, in line with a return to trend growth in the Victorian economy; and
- motor vehicle taxes are up by an average of \$38 million a year, in line with recent strength in both registrations and transfers of vehicles.

These movements are largely offset by downward revisions to:

- payroll tax, down by an average of \$75 million a year, to incorporate changes in the composition of employment growth towards higher part-time employment, moderating growth in total hours worked; and
- gambling taxes, down by an average of \$32 million a year.

Investment income is expected to be higher in 2013-14 primarily reflecting:

- higher dividends from the public financial corporations (PFC) sector, due to the once-off impact of the introduction of interim dividends framework consistent with that which applies to the public non-financial corporations (PNFC) sector;
- a stronger than previously forecast financial performance from the Treasury Corporation of Victoria during 2012-13; and
- receipt of a dividend from the State Electricity Commission of Victoria reflecting an anticipated payment of a special dividend from Snowy Hydro Limited.

Beyond 2013-14, investment income will be higher than previously forecast, largely reflecting stronger investment returns in the PFC sector, which are forecast to grow in line with longer-term trends.

Commonwealth grant variations

General purpose grants (GST revenue) have been revised down in 2013-14, and by an average of \$350 million a year over the next two years. This reflects the impact of slower growth in the GST national pool, in part due to a further decline in the proportion of consumption on goods and services that are subject to GST. Victoria is also expected to receive a lower share of the GST national pool over the period than previously forecast.

Commonwealth specific purpose and national partnerships grants revenue estimates have been reduced beyond 2013-14 largely due to an anticipated reduction in revenue levels from the Commonwealth for health. These revisions are consistent with the arrangements of the new Health Reform Agreement where the Commonwealth will provide funds for new growth on a shared basis. Other relatively minor revisions to national partnership revenue over the period occur in the health and education sectors, which are matched by corresponding expenditure.

Own-source revenue

Own-source revenue is higher in 2013-14 and by an average of around \$85 million across the next two years. Particular drivers of this revision include:

- fees and fines revenue, which is estimated to be higher than previous forecasts by around \$50 million a year across the period to better align estimates with projected infringement volume;
- additional third-party revenue for hospital related activities, which is matched with corresponding expenditure; and
- a rephase of revenue from later years into 2013-14 associated with land sales from the Kew Residential Services site reflecting changed market conditions. In addition to the revenue impacts there are offsetting reductions in expenses.

These increases in own-source revenue are partly offset by a downwards revision to revenue from Melbourne Strategic Assessment activities by a total of \$25 million over the period, largely due to a weaker outlook for land development and lower forecast revenue from developers.

Administrative variations

Revenue estimates have been revised upwards over the period largely reflecting activities in the transport and fire services sectors. These revisions are partly offset by a reduction in forecast revenue associated with the Victorian desalination plant from Melbourne Water Corporation primarily due to a reduction in anticipated water purchases from 50 gigalitres to zero gigalitres.

Variations to expenses from transactions

Total expenses in 2013-14 have increased since the *2012-13 Budget Update*, largely reflecting the impact of new policy, partially offset by the impact of new savings and the release of contingencies for policy purposes. By 2015-16 expenses have been revised down reflecting the falling net impact on expenses of new policy spending offset by savings.

Policy decision variations

New output policy decisions reflect the impact of the *2013-14 Budget* output initiatives (Table 4.4) net of new savings.

Commonwealth grant variations

Variations to Commonwealth grants expense are largely driven by minor revisions to Commonwealth related national partnership expenditure, primarily in the health and education sectors.

Variations due to changes in own-source revenue

Expenses associated with own-source revenue have been revised upwards in each year. This primarily reflects the offsetting expenditure impact of revenue changes outlined above, including a rephase associated with the Kew Residential Services, and higher third party revenue from hospital activities.

Administrative variations

In addition to the impact of the revised AASB 119 discussed previously, superannuation-related expenses have increased since the *2012-13 Budget Update*, primarily due to movements in bond rates.

The release of contingencies as part of the *2013-14 Budget* to offset new policy decisions averages around \$500 million a year over the period.

Other administrative variations are projected to increase expenses in 2013-14, before marginally reducing expenses by 2015-16. Revisions from administrative factors that have increased expenses over the period include:

- an increase in interest expense primarily reflecting the additional servicing costs associated with the revised profile of borrowings, together with an increase in assumed borrowing rates;

- rephases of expenditure from 2012-13 into later years to better reflect anticipated funding profiles, in particular relating to the racing industry to better reflect expected timing of capital works, and grants for energy and technology programs;
- revised timing of expenditure associated with the preventive health program which has rephased the estimated expense over the budget and forward estimates relative to *2012-13 Budget Update* forecasts; and
- revised timing of expenditure associated with the digital education revolution program on-costs which has resulted in rephased expenditure into 2012-13 and 2013-14.

These increases are partly offset by:

- a reduction in non-cash depreciation expenses, largely resulting from a revaluation of Government assets in line with accounting standards;
- a reduction in forecast operating expenses associated with the Victorian desalination project; and
- a revision to contingency provisions to better reflect likely growth in expenditure associated with the revised fiscal and economic outlook.

New output initiatives by department

The *2013-14 Budget* provides over \$3.5 billion in new output initiatives over the four years to 2016-17. The Government's fiscal strategy has constrained expenditure through increased savings and the better targeting of government services, including \$1.6 billion of savings and targeted revenue measures as part of the *2013-14 Budget*.

These measures increase operating surpluses and provide funding to support key Government priorities. As well as boosting funding in health, disability services, education and transport, the Government is reforming service provision to drive more responsive and productive services.

The *2013-14 Budget* includes substantial and carefully targeted expenditure to continue the Government's commitment to key services for Victorians across metropolitan and rural Victoria, including:

- funding for hospitals and healthcare;
- greater access to services and innovative and new service models for vulnerable children, families, and people with disabilities, including early childhood intervention services, and disability support services in government schools;
- funding for TAFEs to support innovation, better services and to build business models to ensure their financial sustainability;
- improvements to public transport services; and
- additional support for victims of crime.

The impact of new output measures in this budget are summarised by department in Table 4.4, with further detail in Budget Paper No. 3 *Service Delivery*.

Table 4.4: Net impact of 2013-14 Budget new output initiatives^(a)

(\$ million)

	2013-14 <i>Budget</i>	2014-15 <i>Estimate</i>	2015-16 <i>Estimate</i>	2016-17 <i>Estimate</i>
Education and Early Childhood Development	78.6	75.8	27.1	19.9
Environment and Primary Industries	55.0	52.2	22.2	10.3
Health	426.3	444.7	453.3	467.1
Human Services	117.5	98.5	110.7	99.3
Justice	74.7	99.0	54.3	61.7
Premier and Cabinet	13.4	10.7	1.3	1.3
State Development, Business and Innovation	51.7	53.1	36.4	35.7
Transport, Planning and Local Infrastructure	126.4	123.5	103.0	99.9
Treasury and Finance	6.5	2.8	2.9	..
Parliament	0.5	0.5	..	..
Subtotal	950.6	960.7	811.1	795.2
Less funding from reprioritisation and adjustments ^(b)	192.6	160.8	114.6	98.7
Less savings	138.1	239.6	295.9	345.6
2013-14 Budget output policy decisions	620.0	560.3	400.7	350.9
Less contingency offset for new policy ^(c)	488.0	494.6	508.4	479.0
Net impact	131.9	65.7	(107.7)	(128.1)

Source: Department of Treasury and Finance

Notes:

(a) Departmental totals reflect gross expenditure outlined in Budget Paper No. 3 Service Delivery.

(b) This includes the reprioritisation of resources previously allocated to departments.

(c) Represents release of contingencies associated with demand for government services.

CASH FLOWS

The Government's strategy to constrain expenditure growth and drive improved productivity in the delivery of government services will provide increasing cash from operating activities over the forward estimates.

These increasing cash surpluses over the forward estimates will finance infrastructure investment in a sustainable manner and repay existing accumulated debt. By 2015-16, it is projected that cash from operating activities will be sufficient to fund infrastructure investment and reduce net debt.

Table 4.5: Application of cash resources for the general government sector

(\$ million)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	<i>Actual</i>	<i>Revised</i>	<i>Budget</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>
Net result from transactions	571.2	177.0	224.5	398.7	1 927.7	2 547.4
Add back: Non-cash income and expenses (net) ^(a)	2 186.3	1 548.6	2 507.1	2 688.1	2 743.3	2 731.4
Net cash flows from operating activities	2 757.5	1 725.6	2 731.6	3 086.9	4 671.0	5 278.8
Less:						
Net investment in fixed assets						
Purchases of non-financial assets	3 564.9	4 088.5	4 868.9	3 911.1	2 840.5	3 033.9
Net cash flows from investments in financial assets for policy purposes	1 831.1	1 521.7	1 377.3	1 399.4	47.2	112.8
Capital provision approved but not yet allocated ^(b)	..	..	..	225.6	504.2	818.1
Proceeds from asset sales	(167.1)	(405.7)	(420.2)	(434.3)	(500.8)	(437.0)
Total net investment in fixed assets ^(c)	5 228.9	5 204.5	5 826.0	5 101.8	2 891.0	3 527.8
Finance leases ^(d)	916.0	1 055.3	..	..	1 050.4	..
Other investment activities (net)	12.7	69.2	48.4	54.5	62.2	61.2
Decrease/(increase) in net debt	(3 400.1)	(4 603.5)	(3 142.8)	(2 069.5)	667.3	1 689.8

Source: Department of Treasury and Finance

Notes:

- (a) Includes depreciation, movements in the unfunded superannuation liability and liability for employee benefits.
- (b) Amount available to be allocated to specific departments and projects in future budgets, including contributions to other sectors.
- (c) Includes total purchases of property plant and equipment, and capital contributions to other sectors of government net of proceeds from asset sales.
- (d) The finance lease amount in 2011-12 relates to the Royal Children's Hospital, and finance leases in 2012-13 relate to the Biosciences Research Centre and Peninsula Link projects. The 2012-13 estimate is net of the financing arrangements associated with the Victorian desalination plant project which forms part of the PNFC sector net debt. The 2015-16 estimate relates to Victorian Comprehensive Cancer Centre.

Total net infrastructure investment in fixed assets is projected to be \$5.8 billion in 2013-14 and average over \$3.8 billion a year over the forward estimates (Table 4.5).

In addition to net infrastructure investment, the Government is also funding and facilitating significant *Partnerships Victoria* (PV) capital projects. Forecast total Government-funded and facilitated infrastructure (Government infrastructure investment) is \$6.1 billion in 2013-14 and averages \$4.7 billion a year over the forward estimates. This aligns with the Government's infrastructure fiscal parameter of 1.3 per cent of GSP as a rolling five-year average in every year of the forward estimates.

New asset initiatives by department

The Government is facilitating major infrastructure projects and investing in the capacity and quality of road, rail and other key economic and social infrastructure to support the delivery of government services for current and future generations.

Major investment funded in the *2013-14 Budget* includes:

- the introduction of key transformational projects for the state including the East West Link – Stage 1;
- transport passenger service improvements including more metropolitan trains;
- road network capacity and quality improvements including rail crossing grade separations; and
- upgraded and modernised schools and new schools in growth corridors.

Details of individual asset initiatives can be found in Budget Paper No. 3 *Service Delivery*.

Table 4.6: New asset funding 2013-14 Budget^{(a)(b)}

(\$ million)

	2013-14 Budget	TEI ^(a)
Education and Early Childhood Development	98.5	303.0
Environment and Primary Industries	6.8	36.0
Health	110.1	629.4
Human Services	6.7	20.0
Justice	83.1	185.0
Premier and Cabinet	11.7	13.2
State Development, Business and Innovation	9.1	16.9
Transport, Planning and Local Infrastructure ^(c)	499.0	7 292– 9 292
Treasury and Finance	..	..
Parliament	..	..
Total 2013-14 Budget asset funding^(c)	825.0	8 495– 10 495

Source: Department of Treasury and Finance

Notes:

- (a) Budget Paper No. 4 State Capital Program provides project-level cashflow information about the Government's new asset investments announced in the 2013-14 Budget, while Budget Paper No. 3 Service Delivery includes a detailed list and description of all asset initiatives announced in the 2013-14 Budget.
- (b) Includes projects which are to be delivered through the public non-financial corporations sector on behalf of the Government.
- (c) Includes East West Link – Stage 1 project TEI of approximately \$6–8 billion.

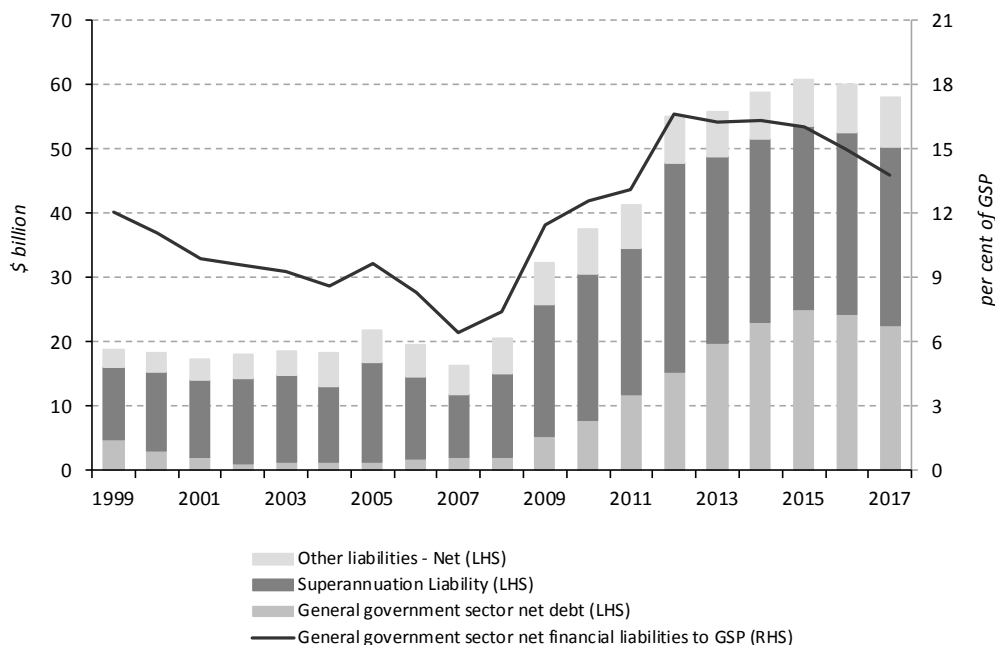
NET DEBT AND NET FINANCIAL LIABILITIES

A strong budget position is critical to securing Victoria's growth. The *2013-14 Budget* forecasts substantial reductions in June 2017 net debt as a proportion of GSP compared to the forecast peak in June 2015.

Net debt is projected to rise compared to the *2012-13 Budget Update* forecast by 2014-15, largely as a result of lower operating surpluses and necessary state-changing infrastructure investment. Net debt is expected to peak in June 2015 at 6.6 per cent of GSP. From 2015-16 onwards the Government's continued expenditure constraint will drive sharp reductions to forecast net debt (both in nominal dollars and as a proportion of GSP).

Estimated net financial liabilities as a proportion of GSP are on a downwards trajectory over the forward estimates. The Government continues to take action to fully fund the unfunded superannuation liability by 2035 and any changes in the superannuation liability that arise solely due to movements in the discount rate do not affect this.

Chart 4.1 General government net financial liabilities as at 30 June^(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 has been applied.

Over recent years, and especially since the global financial crisis, the superannuation liability has fluctuated significantly. These variations are primarily due to movements in the discount rate that is required to value the superannuation liability under Australian Accounting Standard AASB 119, *Employee Benefits*.

Table 4.7: General government sector net debt and net financial liabilities as at 30 June

	(\$ billion)					
	2012	2013	2014	2015	2016	2017
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Financial assets						
Cash and deposits	4.6	4.7	4.9	5.1	5.4	5.7
Advances paid	0.3	4.6	4.6	4.5	4.5	4.5
Investments, loans and placements	2.6	2.6	2.7	2.8	2.9	2.9
Total	7.5	12.0	12.2	12.5	12.8	13.2
Financial liabilities						
Deposits held and advances received	0.4	0.4	0.4	0.4	0.4	0.4
Borrowings	22.4	31.5	34.8	37.1	36.8	35.5
Total	22.8	31.8	35.2	37.5	37.2	35.9
Net debt ^(a)	15.2	19.8	23.0	25.1	24.4	22.7
Superannuation liability	32.6	28.9	28.7	28.4	28.1	27.7
Net debt plus superannuation liability	47.8	48.7	51.6	53.5	52.5	50.4
Other liabilities (net) ^(b)	7.2	7.1	7.2	7.4	7.5	7.7
Net financial liabilities ^(c)	55.0	55.8	58.9	60.8	60.0	58.1
	(per cent)					
Net debt to GSP ^(d)	4.6	5.8	6.4	6.6	6.1	5.4
Net debt plus superannuation liability to GSP ^(d)	14.5	14.2	14.3	14.1	13.1	11.9
Net financial liabilities to GSP ^(d)	16.7	16.2	16.3	16.0	15.0	13.8

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 other liabilities, less other non-equity assets.
- (c) Net financial liabilities is the sum of superannuation, borrowings and other liabilities less 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 considers a number of known risks which, if realised, are likely to impact on the State's financial performance and budget outcomes.

Revenue risks

State taxes

State tax forecasts are primarily based on an assumed or 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.

Changes in economic conditions from those projected will affect taxation revenue. 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 forecast are considered in Appendix A *Sensitivity Analysis Table*.

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

Commonwealth grants

The distribution of GST grants between states and territories is determined by the size of the GST national pool and each state or territory's population share weighted by its GST relativities, as informed by recommendations of the Commonwealth Grants Commission (CGC). Any changes to national economic conditions will directly affect the GST national pool, while changes to the CGC's methodology, changing fiscal circumstances of any state or territory or revisions to data used by the CGC could result in material changes in Victoria's share of the pool. Revisions to historical data may be significant in the CGC's *2014 Update* as the Australian Bureau of Statistics continues to update its social and demographic statistics as a result of the 2011 Census.

The level of National Partnership and specific purpose payments funding received by Victoria is determined by the policies of the Commonwealth Government and funding arrangements agreed by the Council of Australian Governments. Some National Partnership funding is also subject to the State achieving certain performance benchmarks. Decisions of the Commonwealth Government can substantially alter the ongoing provision or phasing of payments under individual agreements, with significant revenue implications in a given financial period.

Public transport fares

Revenue received from public transport fares is used towards funding contractual arrangements with public transport operators and other transport projects. There is a risk that public transport patronage and fare revenue may vary from projected levels with a resulting impact on the budget.

Expenditure risks

Employee expenses are the largest expense incurred by the State. Major enterprise bargaining agreements are a significant driver of this expense. If the related costs above the guideline rate are not offset by genuine productivity gains, this will increase expenditure.

Another key risk is growth in demand for government services which may exceed current projections, for example, as a result of higher population growth or expenditure in response to unforeseen events such as natural disasters, including bushfires and floods.

The *2013-14 Budget* includes a contingency provision to mitigate the impact of expenditure risks which may be realised during the budget year or over the forward estimates period. The contingency provision also includes a general allowance for 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. The aggregate level of operating contingency provision is shown in Note 12 of Budget Paper No. 5, Chapter 1 *Estimated financial statements for the general government sector*.

The forward estimates also include an unallocated capital provision to provide capacity for future asset investment requirements. Given the size and complexity of the capital program, there are likely to be variations in actual costs (compared with budgets) for individual asset investment projects. However, the budget and forward estimates assume that capital cost pressures are managed within existing financial estimates. Management of capital cost pressures may occur by:

- reallocating existing departmental resources within departments' global capital budgets (reflecting the likelihood that cost overruns on some projects will be offset by cost underruns in other areas); or
- re-scoping projects to fit within funding parameters; or
- funding projects from the unallocated capital funding set aside in the forward estimates.

Specific fiscal risks

Review of funding for schooling

The Commonwealth Government has responded to its review of school funding (the Gonski Report). It is proposing a national school funding approach based on a national per student funding level (a national resource standard) and additional funding for disadvantaged students. To facilitate this reform, the Commonwealth has proposed an injection of funding for schools of \$14.5 billion over the next six years with costs being shared between the Commonwealth and the states. Victorian schools would receive \$4 billion of this amount.

The Commonwealth Government has introduced legislation into parliament to enshrine principles for the yet-to-be negotiated school funding model, and set a deadline for completion of negotiations of 30 June 2013. Negotiations on school funding arrangements pose significant financial risks for states as the majority funders of schooling.

National Disability Insurance Scheme

The Commonwealth Government has committed to introducing a National Disability Insurance Scheme (NDIS) to support people living with a disability. It is proposing that the states provide some of the additional funding required for the full NDIS implementation, contrary to the recommendations of the Productivity Commission. Discussions between the states and Commonwealth are continuing regarding appropriate funding arrangements.

National Injury Insurance Scheme

The Commonwealth Government expects Victoria to fund the total cost of a National Injury Insurance Scheme, to provide support to people who suffer catastrophic injuries. If fully implemented, the Productivity Commission estimated that the National Injury Insurance Scheme could cost Victoria around an additional \$145 million each year (in 2010-11 dollars).

Superannuation contributions

In March 2012, the Commonwealth Government amended its Superannuation Guarantee (SG) legislation to provide for a series of increases in the rate of compulsory employer contributions. The SG rate will increase from the current rate of 9 per cent to 9.25 per cent from 1 July 2013. A series of further increases will see the SG rate reach 12 per cent from 1 July 2019. The Public Sector Workplace Relations Policies (2012) stipulated that in complying with wages policy, all agreed wage outcomes need to take into account employer superannuation guarantee contributions.

Social and community services sector pay equity case

Fair Work Australia handed down its decision in the social and community sector equal remuneration case on 1 February 2012. The Victorian Government has committed to fund its share of the wage increase, to the value of \$200 million. Supplementation for 2012-13 and 2013-14 is being provided to affected non-government organisations enabling them to pay their staff in accordance with the Fair Work Australia decision.

The Victorian Government is continuing discussions with the Commonwealth Government regarding the Commonwealth's offer.

CHAPTER 5 – POSITION AND OUTLOOK OF THE BROADER PUBLIC SECTOR

- The non-financial public sector (NFPS) is projected to generate improving operating results across the budget and forward estimates period, returning to operating surplus by 2015-16, driven by improved performances from the general government and public non-financial corporations (PNFC) sectors.
- The NFPS capital expenditure requirements are expected to be funded from operating cash flow surpluses, rather than debt by 2015-16. This will eliminate the need for new borrowings across the sector enabling debt to remain at sustainable levels.
- NFPS net debt is projected to peak at 11.1 per cent of gross state product (GSP) in 2014-15, before falling to 9.6 per cent in 2016-17.
- The public financial corporations (PFC) sector is expected to generate a substantial net surplus in 2012-13, largely due to improved conditions in financial markets. From 2013-14 onwards, the PFC sector is expected to generate strong and growing surpluses driven by profits generated by the State's insurance agencies.

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

- the NFPS, which consolidates the general government sector and the PNFC 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 while meeting commercial principles. The largest PNFCs provide water, housing, transport and port services; and
- the State of Victoria, which consolidates 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 the Victorian WorkCover Authority and Transport Accident Commission), and those that provide financial services, predominantly to other government entities (such as the Victorian Funds Management Corporation and Treasury Corporation of Victoria).

SUMMARY OPERATING RESULTS – NON-FINANCIAL PUBLIC SECTOR

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

	(\$ million)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Revenue						
Taxation revenue	14 789.5	15 298.6	16 050.3	17 066.0	17 802.8	18 730.9
Dividends, TER and interest ^(c)	985.1	942.2	787.7	805.2	839.4	869.8
Sales of goods and services	9 626.9	9 985.4	11 226.7	11 603.7	12 062.6	12 390.0
Grants	22 559.4	21 688.7	23 290.6	23 896.6	25 168.2	26 202.9
Other revenue	2 788.2	2 350.8	2 485.6	2 348.7	2 424.2	2 473.6
Total revenue	50 749.1	50 265.7	53 841.0	55 720.2	58 297.3	60 667.2
% change	2.4	-1.0	7.1	3.5	4.6	4.1
Expenses						
Employee expenses	18 058.4	18 533.1	18 948.1	19 702.5	20 363.7	20 959.3
Superannuation ^(d)	2 744.3	2 454.4	3 117.2	3 124.0	3 140.3	3 143.5
Depreciation	3 842.6	4 152.2	4 397.0	4 619.4	4 889.0	5 088.8
Interest expense	1 928.0	2 428.7	2 940.4	3 128.9	3 171.3	3 216.1
Other operating expenses	18 408.9	19 009.9	19 476.0	19 766.0	19 789.8	20 354.2
Grants and other transfers	5 721.0	5 124.2	5 268.7	5 449.3	5 659.3	5 904.2
Total expenses	50 703.3	51 702.4	54 147.3	55 790.2	57 013.4	58 666.2
% change ^(e)	3.2	2.0	3.6	3.0	2.2	2.9
Net result from transactions – net operating balance	45.8	(1 436.7)	(306.3)	(70.0)	1 283.8	2 001.0
Total other economic flows included in net result	(10 464.4)	3 179.0	(298.5)	(324.8)	(371.4)	(389.4)
Net result	(10 418.6)	1 742.3	(604.8)	(394.7)	912.4	1 611.6
Expected return on superannuation assets taken to other comprehensive income and not included in the net result from transactions	..	..	593.2	606.8	617.3	626.4
Government fiscal result^(f)	45.8	(1 436.7)	286.8	536.8	1 901.2	2 627.4

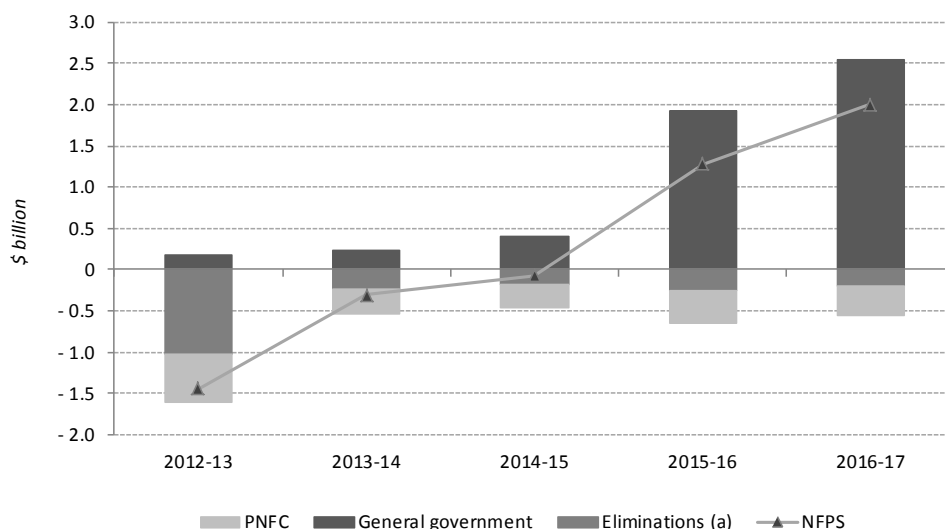
Source: Department of Treasury and Finance

Notes:

- (a) This is a summary operating statement. The comprehensive operating statement is presented in Budget Paper No. 5 Statement of Finances.
- (b) Figures for 2011-12 and 2012-13 are prepared under accounting standards relevant at the time, which do not take into account the changes to the revised AASB 119 Employee Benefits.
- (c) Comprises dividends, income tax and rate equivalent revenue and interest.
- (d) Comprises superannuation interest expense and other superannuation expenses.
- (e) The estimated expense growth from 2013-14 is derived by excluding the impact of the revised AASB 119 Employee Benefits.
- (f) Equals to the net result from transactions after excluding the impact of the revised AASB 119 Employee Benefits, which applies from 2013-14.

The NFPS is forecast to record a net deficit from transactions of \$1.4 billion in 2012-13, improving over the forward estimates period to a net surplus from transactions of \$2.0 billion by 2016-17. This results in an average surplus of \$720 million over the budget and forward estimate years. Chart 5.1 shows that this result is driven by an average surplus from transactions of \$1.3 billion within the general government sector, offset by an average deficit of \$334 million for the PNFC sector (discussed below).

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 forecast to record a net deficit from transactions of \$598 million in 2012-13, before recovering over the budget and forward estimates. The following trends within the sector are driving the forecast results:

- improvement in the metropolitan water sector across the forward estimates for Melbourne Water Corporation and the metropolitan water retailers. This represents a recovery from the 2012-13 performance, which was adversely impacted by a price freeze and refunds to customers of desalination plant costs recovered early. As the desalination plant was not operational until 2012-13, water customers were compensated through refunds applied by the metropolitan water retailers in 2012-13;

- an improved operating performance by Places Victoria over the forward estimates in line with operational efficiencies associated with current restructuring. Improvements in the housing market are also expected to bolster revenues, especially from 2014-15;
- the nature of VicTrack's underlying funding arrangements. VicTrack has forecast substantial deficits across the forward estimates period. A substantial proportion of VicTrack's revenue is grants from the general government sector. The grants are sufficient to allow VicTrack to maintain a cash operating surplus, but are insufficient to fully cover depreciation, resulting in operating losses; and
- projected deficits within the Director of Housing across the forward estimates period. This is due to the impact of its current rental operating model which has relatively fixed revenue streams and escalating costs associated with managing a large and ageing asset portfolio.

The net result from transactions for the PNFC sector in 2012-13 has not changed significantly since the *2012-13 Budget Update*, however the deficits across the forward estimate years are now forecast to be higher, as a result of:

- higher depreciation charges for VicTrack following asset revaluations and the transfer of assets to VicTrack from entities within the general government sector;
- a less rapid improvement in the operating performance of Places Victoria is forecast due to a protracted period of weak activity in the housing market in 2012-13 and 2013-14 and subsequent to that a more modest rate of recovery now forecast for that market;
- a change in the funding mix from operating to capital grants and increases in grants to the not for profit sector for the Director of Housing, and
- reclassification for certain entities of movements in deferred income tax assets and deferred income tax liabilities as revaluations (other economic flows) rather than as an adjustment to income tax expense.

In spite of the above, the PNFC sector is forecast to remain in a strong and sustainable position, as evidenced by the improving operating cash flow surpluses, which are projected to average \$1.6 billion a year across the budget and forward estimates period.

APPLICATION OF CASH RESOURCES

Table 5.2 below shows that the NFPS is forecast to generate operating cash flow surpluses averaging \$5.4 billion a year across the budget and forward estimates period. These surpluses are estimated to fund 83 per cent of the State's infrastructure spending during this period and to fully fund infrastructure from 2015-16.

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

	(\$ million)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Net result from transactions	45.8	(1 436.7)	(306.3)	(70.0)	1 283.8	2 001.0
Add back: Non-cash income and expenses (net) ^(a)	3 796.6	3 153.4	4 285.5	4 562.6	4 831.2	4 887.5
Net cash flows from operating activities	3 842.4	1 716.6	3 979.1	4 492.7	6 115.0	6 888.5
Less:						
Net investment in fixed assets						
Expenditure on approved projects	7 376.5	7 356.9	8 565.7	7 761.9	5 129.6	5 143.0
Capital provision approved but not yet allocated ^(b)	..	..	..	225.6	504.2	818.1
Proceeds from asset sales	(289.3)	(508.6)	(525.9)	(553.9)	(591.1)	(510.9)
Total net investment in fixed assets	7 087.1	6 848.2	8 039.8	7 433.6	5 042.7	5 450.2
Finance leases ^(c)	917.1	5 371.4	..	..	1 050.4	..
Other investment activities (net)	726.7	18.5	(1.1)	1.9	5.6	4.5
Decrease/(increase) in net debt	(4 888.5)	(10 521.5)	(4 059.5)	(2 942.9)	16.2	1 433.8

Source: Department of Treasury and Finance

Notes:

- (a) Includes depreciation and movements in superannuation liability and liability for employee benefits.
- (b) Amount available to be allocated to specific departments and projects through future Government decisions, including contributions to other sectors.
- (c) The finance lease amount in 2011-12 relates to the redevelopment of the Royal Children's Hospital, and the finance lease amount in 2012-13 relates to the Biosciences Research Centre, the Peninsula Link project and the Victorian desalination plant. The 2015-16 estimate relates to the Victorian Comprehensive Cancer Centre.

Infrastructure

The PNFC sector is forecast to deliver 48 per cent of State's infrastructure program over the budget and forward estimates period. The key PNFC sector infrastructure projects under development include:

- the Regional Rail Link project delivering dedicated regional tracks from West Werribee to Southern Cross Station, two new dedicated regional service platforms at Southern Cross Station, new stations at Wyndham Vale, Tarneit and West Footscray, substantial modifications to Sunshine and Footscray stations, and several new rail bridges;
- the Port Capacity Project, which includes the development of a third container terminal and a purpose built automotive facility at Webb Dock. This will ensure that Victoria's port handling capacity continues to grow;
- Goulburn-Murray Water's Connections Program, connecting irrigators to a modernised main system of irrigation channels; and
- various transport infrastructure, including significant investment in new trains and trams.

NON-FINANCIAL PUBLIC SECTOR NET DEBT AND NET FINANCIAL LIABILITIES

The State is forecasting a reduced reliance on debt to fund infrastructure. By 2015-16, it is estimated that operating cash surpluses will fully fund capital expenditure. This will constrain debt growth, and result in debt levels falling in 2016-17.

The ratios of net debt to gross state product (GSP) and net debt plus superannuation to GSP are forecast to peak by 2014-15 and 2013-14 respectively, before reducing in subsequent periods.

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

	(\$ million)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Financial assets						
Cash and deposits	5 374.2	5 157.9	5 399.4	5 690.9	5 991.3	6 469.1
Advances paid	88.6	133.4	131.0	129.0	127.4	126.2
Investments, loans and placements ^(a)	3 682.9	3 528.0	3 556.6	3 629.1	3 711.6	3 769.0
Total	9 145.7	8 819.3	9 087.0	9 449.0	9 830.2	10 364.3
Financial liabilities						
Deposits held and advances received	507.2	471.8	477.9	477.1	478.2	479.1
Borrowings	33 259.7	43 490.0	47 811.2	51 116.8	51 480.8	50 580.1
Total	33 766.9	43 961.9	48 289.1	51 593.9	51 959.0	51 059.2
Net debt ^(b)	24 621.1	35 142.6	39 202.1	42 145.0	42 128.7	40 694.9
Superannuation liability	32 750.8	28 995.5	28 782.8	28 538.3	28 258.0	27 811.1
Net debt plus superannuation liability	57 371.9	64 138.1	67 985.0	70 683.2	70 386.7	68 506.0
Other liabilities (net) ^(c)	6 591.8	6 612.6	6 699.3	6 811.1	6 966.3	7 147.6
Net financial liabilities ^(d)	63 963.7	70 750.7	74 684.3	77 494.3	77 353.0	75 653.6
	(per cent)					
Net debt to GSP ^(e)	7.5	10.2	10.9	11.1	10.5	9.6
Net debt plus superannuation liability to GSP ^(e)	17.4	18.7	18.9	18.6	17.6	16.2
Net financial liabilities to GSP ^(e)	19.4	20.6	20.7	20.4	19.3	17.9

Source: Department of Treasury and Finance

Notes:

- (a) The 2011-12 figure has been restated due to a revision of the State Electricity Corporation of Victoria's investment in Snowy Hydro Ltd.
- (b) 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.
- (c) Includes other employee entitlements, provisions and other liabilities, less other non-equity assets.
- (d) Net financial liabilities is the sum of superannuation, borrowings and other liabilities less financial assets.
- (e) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.

Table 5.4 contains indicators of financial sustainability for the NFPS. These ratios provide important benchmarks for the NFPS sustainability across the budget and forward estimates period.

The State is projected to fully fund capital expenditure from operational cash flows by 2015-16 without relying on borrowings. This is reflected in the ratio of operating cash flow surplus to revenue, which provides an indication of the cash generated from operations, which can be used to fund necessary infrastructure. This ratio is forecast to steadily improve over the forward estimates.

The ratio of gross debt to revenue provides an indication of the level of NFPS indebtedness. After peaking in 2014-15, this ratio will decline as overall debt levels stabilise and revenues continue to grow.

The ratio of interest expense to revenue is important because it shows the extent to which revenue is utilised to service debt obligations. It is important that the State minimises its interest burden, to ensure that revenues can be used to fund essential services and infrastructure, rather than meet debt obligations. The forecasts show that the interest burden will fall in 2015-16 and 2016-17, reflecting reduced growth in debt.

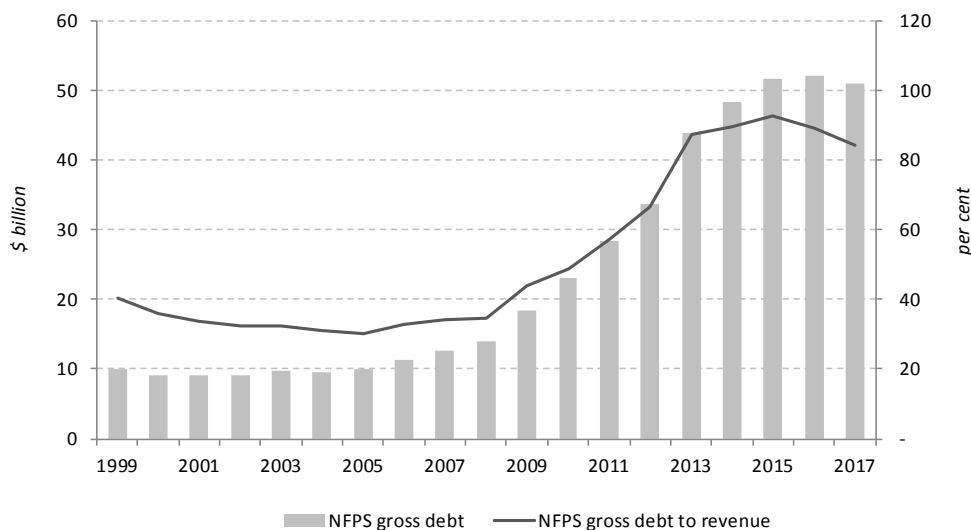
Table 5.4: Indicators of financial sustainability for the non-financial public sector

	(per cent)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Operating cash flow surplus to revenue	7.6	3.4	7.4	8.1	10.5	11.4
Gross debt to revenue	66.5	87.5	89.7	92.6	89.1	84.2
Interest expense to revenue	3.8	4.8	5.5	5.6	5.4	5.3

Source: Department of Treasury and Finance

The chart below shows a longer-term trend of the ratio of NFPS gross debt to revenue, which is forecast to peak in 2014-15 before declining in subsequent periods.

Chart 5.2: Non-financial public sector gross debt to revenue^(a)



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)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Revenue						
Taxation revenue	14 775.9	15 284.1	16 035.5	17 050.7	17 787.0	18 715.4
Dividends, TER and interest ^(b)	1 786.9	1 507.1	1 543.3	1 604.9	1 677.3	1 599.4
Sales of goods and services	12 609.6	12 969.3	14 379.6	14 926.3	15 556.6	16 059.1
Grants	22 476.7	21 601.5	23 180.1	23 786.1	25 061.7	26 096.2
Other revenue	2 808.6	2 372.5	2 508.8	2 373.5	2 448.8	2 498.9
Total revenue	54 457.8	53 734.6	57 647.3	59 741.6	62 531.4	64 968.9
% change	2.3	-1.3	7.3	3.6	4.7	3.9
Expenses						
Employee expenses	18 057.2	18 531.2	18 945.3	19 698.4	20 360.6	20 947.2
Superannuation ^(c)	2 769.7	2 478.4	3 141.8	3 149.4	3 166.5	3 169.4
Depreciation	3 880.4	4 193.1	4 445.1	4 671.7	4 944.2	5 142.2
Interest expense	2 129.6	2 537.0	3 054.7	3 247.1	3 294.9	3 319.5
Other operating expenses	23 233.0	23 606.0	24 282.3	24 862.1	25 101.6	25 809.1
Grants and other transfers	5 635.4	5 124.2	5 268.7	5 449.4	5 659.5	5 904.4
Total expenses	55 705.3	56 469.8	59 138.0	61 078.1	62 527.4	64 291.7
% change ^(d)	3.6	1.4	3.7	3.3	2.4	2.8
Net result from transactions – net operating balance	(1 247.6)	(2 735.2)	(1 490.7)	(1 336.6)	4.0	677.2
Total other economic flows included in net result	(14 714.3)	6 899.1	1 107.6	1 187.2	1 231.6	1 293.0
Net result	(15 961.9)	4 163.9	(383.1)	(149.4)	1 235.6	1 970.2

Source: Department of Treasury and Finance

Notes:

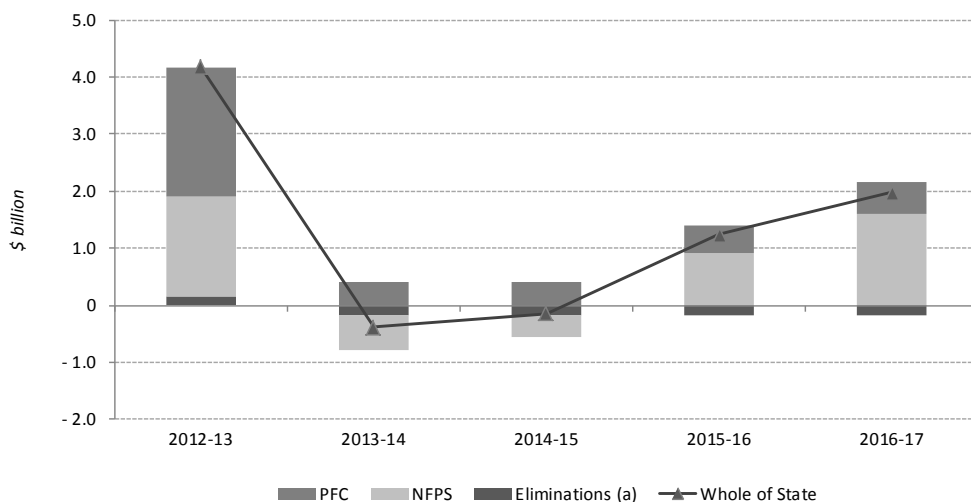
- (a) This is a summary operating statement. The comprehensive operating statement is presented in Budget Paper No. 5 Statement of Finances.
- (b) Comprises dividends, income tax and rate equivalent revenue and interest.
- (c) Comprises superannuation interest expense and other superannuation expenses.
- (d) The estimated expense growth from 2013-14 is derived by excluding the impact of the revised AASB119 Employee Benefits.

The State of Victoria is budgeting to record an average net result of \$668 million over the budget and forward estimates.

This includes gains from other economic flows, which are forecast to contribute \$1.2 billion a year towards the net surplus. Gains from other economic flows include income derived from the PFC sector's investment assets. This investment income is a core revenue source for the sector as it is used to fund emerging liabilities of government insurance entities over time. 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.

As the nature of the PFC sector’s core business includes investment activities, the net result is considered a more meaningful measure of the expected operating position of this sector.

Chart 5.3: 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.

The PFC sector is forecast to record a net surplus of \$2.3 billion in 2012-13, which includes other economic flows of \$3.1 billion. This significant result is mainly attributed to the strong recovery in investment markets during 2012-13, and higher bond rates which have reduced the value of financial liabilities.

Beyond 2012-13, the PFC sector’s performance is expected to remain strong, with net surpluses expected to average \$462 million a year during the four years to 2016-17. This is largely driven by investments which are forecast to grow in line with longer-term trends.

These results are largely driven by the performance of the two largest entities, the Victorian WorkCover Authority and the Transport Accident Commission.

STATE OF VICTORIA – FINANCIAL POSITION

Table 5.6: Financial position of the State of Victoria

	(\$ billion)					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
	Actual	Revised	Budget	Estimate	Estimate	Estimate
Assets						
Financial assets ^{(a)(b)}	39.6	42.7	44.2	46.0	46.0	48.1
Non-financial assets ^(c)	183.0	192.1	201.8	209.1	213.2	215.7
Total assets	222.6	234.7	246.1	255.1	259.2	263.8
Liabilities						
Superannuation	32.8	29.0	28.8	28.5	28.3	27.8
Borrowings	40.6	48.7	53.1	56.5	55.4	54.5
Deposits held and advances received	1.0	2.6	2.6	2.6	2.5	2.6
Other liabilities	35.3	36.9	38.1	39.2	40.5	41.9
Total liabilities	109.7	117.2	122.5	126.9	126.7	126.8
Net assets	112.9	117.5	123.5	128.3	132.5	137.0

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) The 2011-12 figure has been restated due to a revision of the State Electricity Corporation of Victoria's investment in Snowy Hydro Ltd.
- (c) Non-financial assets include inventories, non-financial assets held for sale, land, buildings, infrastructure, plant and equipment, and other non-financial assets.

The State's financial position is forecast to strengthen over the budget and forward estimates period. Ninety per cent of the increase in net assets is explained by the NFPS movements discussed earlier. The remainder is mainly due to actual and forecast increases in investment values in the PFC sector.

APPENDIX A – SENSITIVITY ANALYSIS TABLE

The economic forecasts and assumptions underpinning the *2013-14 Budget* are subject to variation. This section analyses the impact of variations in these parameters on income, expenses and the net result from transactions for the general government sector.

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

While sensitivity analysis provides a useful rule of thumb indication of the fiscal impact of variations in economic conditions, care should be exercised in using these results. The relationship between economic and fiscal aggregates is complex, and typically depends on the specific characteristics of the economic shock. For example, a property-led economic downturn is likely to have a very different fiscal impact to one concentrated in the retail sector, even if the overall impact on gross state product (GSP) and employment is similar.

SENSITIVITY TO INDEPENDENT VARIATIONS IN MAJOR ECONOMIC PARAMETERS

The major economic variables that affect Victoria's net result from transactions are economic growth, employment, consumer prices, wages, enterprise bargaining agreements, domestic and overseas share prices, property prices and volumes and interest rates.

Table A.1 presents the sensitivity of the net result from transactions (and where relevant, the net result) to a one per cent increase in each variable in isolation from any other changes. The impacts shown in the table are broadly symmetrical. That is, the estimated fiscal impact would apply equally in the opposite direction if a one per cent decrease in each variable were considered.

Note also that the fiscal impacts presented in Table A.1 are estimated with a degree of error. The practical implication of this is that there is a range around the estimates that describes the likely fiscal impact of variations in the relevant economic parameter.

Table A.1: Sensitivity of key fiscal aggregates to selected economic indicators being 1 per cent higher than expected in 2013-14^{(a)(b)(c)}

(\$ million)

	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate	2016-17 Estimate
GSP				
Income from transactions	180	186	198	211
Expenses from transactions	8	-1	-9	-17
Net result from transactions	172	187	206	228
Employment				
Income from transactions	51	54	57	60
Expenses from transactions	-1	-4	-7	-9
Net result from transactions	52	58	64	70
Consumer prices^(d)				
Income from transactions	303	314	331	348
Expenses from transactions	62	62	53	40
Net result from transactions	241	252	279	308
Other economic flows	1	1	1	1
Net result	242	253	279	309
Average weekly earnings				
Income from transactions	44	47	49	52
Expenses from transactions	6	5	3	2
Net result from transactions	38	42	46	50
Enterprise bargaining agreements^(e)				
Income from transactions	28	30	31	32
Expenses from transactions	192	236	253	268
Net result from transactions	-164	-207	-221	-236
Domestic share prices				
Income from transactions	..	..	..	..
Expenses from transactions	..	-2	-2	-2
Net result from transactions	..	2	2	2
Overseas share prices				
Income from transactions	..	..	..	..
Expenses from transactions	..	-2	-2	-2
Net result from transactions	..	2	2	2
Property prices				
Income from transactions	42	52	54	58
Expenses from transactions	-1	-4	-7	-9
Net result from transactions	43	56	61	67
Other economic flows	2	2	3	2
Net result	45	58	63	69
Property volumes				
Income from transactions	36	39	41	43
Expenses from transactions	-1	-3	-5	-7
Net result from transactions	37	41	46	50

Table A.1: Sensitivity of key fiscal aggregates to selected economic indicators being 1 per cent higher than expected in 2013-14^{(a)(b)(c)} (continued)

(\$ million)

	2013-14	2014-15	2015-16	2016-17
	Estimate	Estimate	Estimate	Estimate
Interest rates^(f)				
Income from transactions	69	66	68	69
Expenses from transactions	30	346	378	399
Net result from transactions	39	-280	-309	-330

Source: Department of Treasury and Finance

Notes:

- (a) 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 an increase in revenue. A positive number for the net result from transactions and net result denotes a higher surplus or lower deficit. Numbers may not balance due to rounding.
- (b) The sensitivity from a one per cent lower than expected outcome of an economic variable would, in most instances, simply be the opposite of the impact shown in the table. However, for some results the impacts of changes are not symmetrical and therefore care should be exercised when using the table to estimate the impact of lower than expected economic variables.
- (c) Only reasonably quantifiable impacts have been included in the analysis.
- (d) 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.
- (e) Represents a one per cent increase in all government enterprise bargaining agreements.
- (f) Assumes interest rates are one percentage point higher across the entire term structure, i.e. short and long-term rates, over the forward estimates period.

Sensitivity to economic growth

Higher than expected gross state product is associated with higher household consumption, leading to higher goods and services tax (GST) grants revenue and own sourced taxation revenue. This increases the net result from transactions.

Sensitivity to employment

Higher than expected employment results in additional payroll tax revenue and increases the net result from transactions.

Sensitivity to consumer prices

Higher consumer prices lead to higher Commonwealth sourced revenue (due to indexation), and higher GST and own source taxation revenue, as the value of tax bases rise in nominal terms. The higher revenue is partly offset by the higher cost of supplies and services, and some increases in outlays on grants and transfers.

An increase in consumer prices also increases the superannuation expense in the remaining out years.

Reflecting the operation of the departmental funding arrangements, the impact of the increase in expenses is limited to the extent that departments can fund it from increased revenue from specific purpose grants and sales of goods and services. Overall, there is a positive impact on the net result and the net result from transactions in the out years.

Sensitivity to average weekly earnings

A rise in the level of economy-wide wages results in higher payroll tax revenue, contributing to an increase in the net result from transactions. All government enterprise bargaining agreements are assumed to be unchanged over the projection period.

Sensitivity to enterprise bargaining agreements

In the short-term, enterprise bargaining agreements are fixed. Enterprise bargaining agreements can pose a substantial risk to Victoria's budget position in the longer-term. If funded, an across the board increase in wages arising from an enterprise bargaining agreement, which exceeds the wages policy guideline rate, results in a decline in the net result from transactions.

The increased employee entitlements increases the value of the superannuation liability and flows through to an increase in the superannuation expense in the remaining out years.

Sensitivity to domestic and overseas share prices

A rise in share prices increases the net result of the State's public financial corporations (PFCs). The associated impact would be an increase in the income tax equivalents (ITEs) of the Transport Accident Commission (TAC) and Victorian WorkCover Authority (VWA). However as there have been substantial decreases in share and other asset prices in recent years, accumulated carry forward tax losses mean there is little or no impact of share prices on ITEs paid until the losses have been fully used. There is no immediate impact on dividends payable to the State.

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 superannuation liability reduces ongoing superannuation expenses. All of these increase the net result from transactions.

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

Sensitivity to interest rates

An increase in interest rates reduces the valuation of long-term insurance liabilities of PFCs and increases the net profits of these entities. As dividends of the insurance agencies are based on performance from insurance operations, which excludes the impact of discount rate movements, the increase will have little direct impact on dividends. As ITEs of the State's insurance agencies are assessed on net profit, changes in interest rates will potentially impact general government ITEs. However, accumulated carry forward tax losses mean there is little or no impact on revenues through ITEs until those losses have been used.

Higher borrowing costs will result in reduced net profits of public non-financial corporations, lowering dividends and ITEs payable to the State. An increase in the borrowing costs of the general government sector will reduce the net result from transactions.

An increase in interest rates also increases the superannuation expense over the out years, thereby reducing the net result from transactions.

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 variables can be significantly greater than indicated by the sum of each variable's individual impact. This highlights the point that the relationship between economic parameters and fiscal aggregates is 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 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 employment. Real GSP was also underestimated, and there were relatively minor errors in the forecasting of prices and wages.

Table A.2: Actual deviations to key economic variables from 2006-07 budgeted levels

(per cent)

	2006-07 Budget ^(a)	2006-07 Actual	Forecast error ^(b)
Real GSP	3.3	3.8	0.6
Employment	1.3	3.2	2.0
Consumer price index	2.5	2.6	0.1
Wage price index ^(c)	3.5	3.6	0.1

Source: 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 and largely comprises funding 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 impact revenue from this source.

As payroll tax is levied on the stock of employees, forecast error in growth is 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 highlights a disconnect between Victoria's labour market performance and payroll tax collections, and may occur because payroll tax is levied on a small share of Victorian businesses, which may not necessarily be drivers of growth at the time.

Table A.3: Actual deviations to key revenue lines from 2006-07 budgeted levels

(\$ million)

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

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 to key economic variables from 2008-09 budgeted levels

(per cent)

	2008-09 Budget ^(a)	2008-09 Actual	Forecast error ^(b)
Real GSP	3.0	1.1	-1.9
Consumption (unpublished)	2.8	0.3	-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

Source: 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 to the actual outcome. Both revenue and expenditure were underestimated. However, expenditure was underestimated to a greater extent leading to a forecasting 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 the *Building the Education Revolution*, which was mostly distributed by the states.

Much of the overestimate in revenue can be attributed to the weak performance of the property market, where forecasts were over \$900 million higher than the actual outcome. By contrast, the error in the forecast of revenue from employment taxes (payroll tax) 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 sizable 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 have adjusted their behaviour and entered a phase of reducing debt. This has 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 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 matched by increased expenditure as the Commonwealth Government's stimulus payments were spent. Of the \$3.2 billion forecast error for other revenues, approximately \$2.1 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 in 2009-10 following the global financial crisis, since then national GST pool growth has remained below trend. This is consistent with the changes in household consumption. Similarly, following a recovery in land transfer volumes in 2009-10 the property market, turnover has returned to the low levels of the global financial crisis as potential house buyers remain cautious.

Table A.5: Actual deviations to key revenue lines from 2008-09 budgeted levels

(\$ million)

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

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:

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

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