

# Strategy and Outlook

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**2016-17**



Presented by

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Treasurer of the State of Victoria

for the information of Honourable Members

**Budget Paper No. 2**

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Authorised by the Victorian Government  
1 Treasury Place, Melbourne, 3002

Printed by Doculink, Port Melbourne  
Printed on recycled paper

This publication makes reference to the 2016-17 Budget paper set which includes:  
Budget Paper No. 1 – Treasurer’s Speech  
Budget Paper No. 2 – Strategy and Outlook  
Budget Paper No. 3 – Service Delivery  
Budget Paper No. 4 – State Capital Program  
Budget Paper No. 5 – Statement of Finances  
(incorporating Quarterly Financial Report No. 3)

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ISSN 2204-9185 (print)  
ISSN 2204-9177 (online)  
Published April 2016

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## CHAPTER 1 – ECONOMIC AND FISCAL OVERVIEW

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The Government's second budget makes significant and prudent investments in services and infrastructure to ensure Victoria's continued strong growth, prosperity and wellbeing.

The Victorian economy is growing faster and stronger than any other in the country. Since the Government was elected over 112 000 new jobs have been added to the Victorian economy, including the creation of over 71 000 full time jobs. The number of Victorians with a job exceeded 3 million for the first time in March 2016.

In 2016-17 Victoria's gross state product (GSP) growth is forecast to remain above trend at 3 per cent, reflecting solid business investment and household consumption, supported by low interest rates and continued strong population growth. The *2016-17 Budget* underlines the Government's commitment to playing an active role in driving strong, sustainable and inclusive growth for all Victorians. This budget enhances Victoria's natural advantages by investing to support the continued growth and expansion of Victoria's fast emerging priority sectors.

In 2014-15, Victoria's population growth led the nation, increasing by 1.7 per cent over the year or more than 1 900 people each week. Melbourne is consistently ranked among the world's most liveable cities. Additional investment in infrastructure and services is required to maintain Victoria's attractiveness as one of the best places in the world to live and work.

The *2015-16 Budget* invested up to \$22 billion in infrastructure, and this budget enhances the Government's infrastructure agenda. Infrastructure investment will average \$7.4 billion a year over the next four years, with funding for key projects in transport, health and education. These investments, especially in rural and regional Victoria, will create avenues for greater private investment and offer Victorians more job opportunities.

Victoria's rural communities and regional cities are vital to Victoria's prosperity, and make a significant contribution to our economy. The *2016-17 Budget* invests in much needed services and infrastructure to help regional Victoria prosper. This includes \$1.3 billion to commence investment in regional public transport, \$260 million to be specifically invested in regional roads and \$325 million to support regional jobs. This will foster growth in these communities by enabling them to access the services and industries that will drive continued development in the regions.

To meet growing demand across the State and to provide better health outcomes in rural and regional Victoria, \$2.9 billion is being invested across Victoria's health care system. The Government's commitment to the Education State transformation will see \$924 million invested in new and upgraded school infrastructure across the State. This will ensure the needs of vulnerable and disadvantaged Victorians are met, and that social challenges are addressed through creating a safe and supportive environment.

Earlier this year, the nation's first Royal Commission into Family Violence handed down 227 recommendations to fix our family violence system and address Victoria's number one law and order issue. The Government will implement all of these recommendations. The *2016-17 Budget* invests \$572 million in initial funding for the things that couldn't wait, and to ensure that family violence victims are at the heart of reform.

In order to ensure that Victorians continue to enjoy a high quality of life, the Government is expanding its capital planning horizon to the next decade. Sensible use of public debt will ensure the right investments are made in productivity enhancing infrastructure to service the State's growing population. In maintaining net debt at around 6 per cent of GSP, the Government is unlocking future capacity for capital investment and positioning Victoria to maintain its economic momentum into the future.

The *2016-17 Budget* forecasts a strong operating surplus of \$2.9 billion in 2016-17, significantly higher than the forecast in the Government's first budget. With accumulated operating surpluses of \$9.3 billion over the budget and forward estimates, the Government continues to demonstrate its strong financial management credentials, consistent with maintaining Victoria's triple-A credit rating.

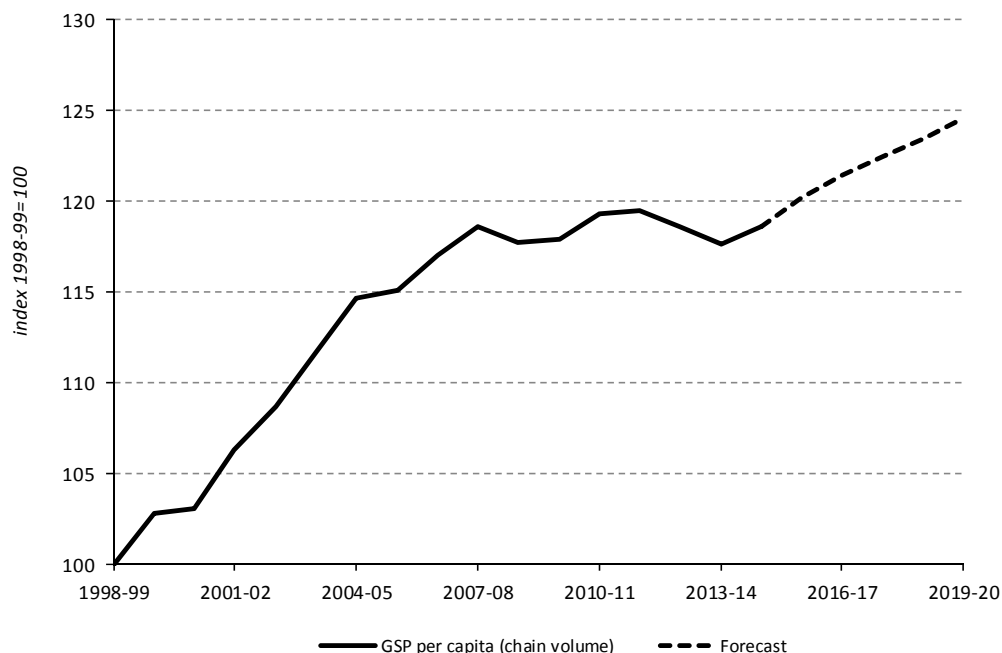
## **A STRONG, DIVERSE ECONOMY**

### **A growing population and economy**

Victoria's diverse economy is well positioned for continuing growth as the national economy rebalances away from mining investment. Macroeconomic conditions continue to benefit the Victorian economy, with the lower Australian dollar delivering a more competitive edge for our exporters. With interest rates remaining at historic lows, Victorian business confidence has risen and investment is strong. Service industries and the knowledge economy will assume greater importance over the coming years. Victoria will enjoy a significant competitive advantage in these areas, and as the national economy rebalances the State will increasingly be seen as an attractive destination for private investment.

Importantly, after two years of declines in 2012-13 and 2013-14, Victoria's economy is once again growing by more than population growth. In 2014-15, GSP per capita grew by 0.7 per cent and growth is expected to continue over the forward estimates (Chart 1.1).

**Chart 1.1: Annual gross state product per capita**



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

Keeping economic growth ahead of population growth is critical to ensuring all Victorians benefit from economic growth, and relies on greater employment and increased productivity.

Victoria’s population growth leads the nation. Forecasts suggest Melbourne could overtake Sydney as Australia’s most populous city in 2030. This means that smart choices need to be made in order to invest in the fundamental drivers of long-term growth. Victoria’s growing population will place greater pressure on our services and infrastructure. The *2016-17 Budget* seeks to pull all the levers of government to further the interests of the community.

In order to build on the positive trends in the Victorian economy, the Government is committing significant funding in the *2016-17 Budget* to ensure Victoria’s economy remains strong. Investing in jobs, services and vital infrastructure will lead to sustained and enduring growth for the Victorian economy.

### **Boosting jobs**

The Government is investing in a range of initiatives to build on the strong increase in Victorian employment and enhance Victoria’s position as a centre of economic growth. There has been significant improvement in Victoria’s labour market. Unemployment has fallen from a peak of 6.9 per cent in mid-2014 to 5.7 per cent in March 2016. Since November 2014, employment has increased by over 112 000 people, with full-time employment up by more than 71 000.

However, there is still much to be done. Many Victorians are struggling to find work, including young Victorians whose rate of unemployment remains approximately twice that of the general population. Many Victorian workers are underemployed, working fewer hours than they would like.

The *2016-17 Budget* will boost trade and investment, productivity and Victoria's visitor economy, including in rural and regional areas. It takes advantage of the diverse portfolio of industries that drive Victoria's economy, including manufacturing, financial services, retail, tourism, education, health care and food and fibre. These investments will support and create new pathways of prosperity. It will ensure that all Victorians share in our continued economic growth, and will grow the wealth of Victorian families.

### ***Building Victoria's future industries***

The Victorian economy includes a diverse portfolio of industries in which we have a competitive advantage such as financial services, retail, tourism, research, education, health care and agriculture.

The *2016-17 Budget* actively supports Victoria's competitive advantages through initiatives that leverage the State's world-class education and research institutions, and support sectors with the potential to drive longer-term economic growth. Building on the work of the last budget, this budget provides \$111 million to the Future Industries Fund to undertake strategic and sector growth projects in our six priority growth sectors:

- Medical Technologies and Pharmaceuticals;
- New Energy Technologies;
- Food and Fibre;
- Transport, Defence and Construction Technologies;
- International Education; and
- Professional Services.

### ***Supporting and developing Victorian skills***

The *2016-17 Budget* provides \$53 million to establish Jobs Victoria. Jobs Victoria will help people find employment more quickly and ensure disadvantaged Victorians remain engaged in the labour market.

Jobs Victoria will be a client-centred employment service that provides coordinated support to disadvantaged job seekers, complementing Commonwealth programs. It will focus on employment services in disadvantaged and rural areas, where finding jobs can be difficult. Continued support will be provided to disadvantaged job seekers and industries in transition, such as through increased work placements for people who are having trouble securing employment, ensuring that everyone is given a fair go.

To help workers transition from the automotive industry to other areas of the labour market, the Government has already committed \$47 million to deliver Victoria's Automotive Transition Plan. The *2016-17 Budget* directs a further \$10 million to give employers incentives to employ affected automotive workers.



Victoria accounted for over a quarter of the national education market in 2014-15. The education industry contributed \$20 billion to Victoria's economy last financial year and employs around 230 000 Victorians. The number of enrolments of international students coming to Victoria grew by 12 per cent in 2015 to a record 195 000. This represented over 30 per cent of national enrolments, well above our population share. The *2016-17 Budget* will provide funding to ensure Victoria remains a global education provider of choice.

In addition, the Government will support businesses through a payroll tax exemption on the wages paid to displaced apprentices or trainees.

### ***Attracting business***

The *2016-17 Budget* will further enhance Victoria's attractiveness as an investment destination. The \$116 million Investment Attraction and Assistance Program will proactively facilitate job creation and private capital investment across the State. In addition, Victorian businesses will be provided with support to promote their investment credentials in international markets to highlight their competitive advantages and grow their profitability.

The Government is reducing the tax burden on business, allowing them to expand, invest and employ more Victorians. The payroll tax exemption threshold is being increased by \$25 000 each year over the next four years. This will see the threshold move from \$550 000 to \$650 000 by 2019-20, saving businesses \$286 million over four years. All 36 600 individual businesses in Victoria that pay payroll tax will benefit from this change, with 2 800 businesses no longer paying payroll tax.

To consolidate and build on the strong relationship that Victoria has with Asia, the Government is undertaking a number of initiatives to improve the accessibility of Asian markets to Victorian businesses. Further, Victorian businesses will be provided with consumer insights and market intelligence to guide product research, development and marketing, which will directly improve the export sales of Victorian businesses.

### ***Supporting small business***

Small businesses play a crucial role in supporting Victoria's economic growth. There are currently around 540 000 small businesses in Victoria. Small business provides significant employment opportunities across a range of industries such as construction; professional, scientific and technical services; as well as accommodation and food services.

The Government is continuing to cut the cost of doing business in Victoria. \$42 million will be provided to keep Victoria a competitive place to do business. This includes \$26 million for the Smart Planning Program to modernise the planning system and reduce delays and \$13 million for other planning related initiatives. Additional funding is also provided for the Small Business Festival Victoria.

The Government remains committed to reviewing unnecessary regulation and cutting the cost of compliance by 25 per cent. A Red Tape Commissioner has been appointed to work closely with industry to identify the most critical areas of regulatory reform and work has commenced on a review of regulation impacting small businesses.

## *Growing Victoria's visitor economy*

Victoria is a leader in major events and a growing visitor destination. This creates jobs and business activity, with over \$21 billion spent in Victoria on tourism in 2014-15. Visit Victoria is receiving \$38 million to highlight and grow the State's visitor economy. A further \$101 million will create the Regional Tourism Infrastructure Fund to boost employment in the regional tourism sector. The fund will focus on strategically targeting priority regional tourism initiatives, and will provide a strong foundation to promote regional Victoria as a premier tourism destination.

## **Building infrastructure**

Our economic and population growth requires infrastructure investment to keep Victoria progressing. In the past five years, Victoria has grown by over 470 000 people. Strong population growth has meant increased pressure on the State's infrastructure.

Infrastructure drives productivity. An accessible and reliable transport network supports the productivity of the labour force, as well as the efficient and timely movement of goods and services.

Transport networks also improve markets and promote competition. They connect consumers to more businesses and bring workers into contact with more opportunities for employment and training.

The Government is already improving the transport network by removing the 50 worst level crossings in the State. This budget fully funds the Melbourne Metro Tunnel – the most important public transport project in the nation.

The *2016-17 Budget* further builds on the Government's infrastructure agenda with a \$10.4 billion infrastructure investment in regional and metropolitan public transport and roads. The Government's investment in infrastructure will create more employment opportunities and better linkages between Victorian families and their jobs. It will boost the efficiency and competitiveness of business by providing faster and better access to markets.

## **Public transport**

The *2016-17 Budget* provides \$3.3 billion to improve Victoria's public transport system, signalling the biggest overhaul of the train network since the construction of the City Loop. This investment will transform the public transport system, reduce congestion and improve safety for everyone.

## **Metropolitan public transport**

To better connect Victorians with their communities and jobs, \$1.9 billion is provided to expand and upgrade the metropolitan rail network, boosting performance and reliability. This includes \$875 million to provide 28 more high capacity trains for the metropolitan train network, \$105 million for five X'Trapolis trains and \$140 million to upgrade the Hurstbridge line.

Funding of \$588 million is provided for the Mernda rail extension project to extend metropolitan rail services from South Morang to Mernda, providing much needed infrastructure for significant population growth in Melbourne’s north.

Frankston station will get a \$50 million upgrade, while a further \$20 million will improve car parking spaces across the network.

The Metro Tunnel is vital to the future of Melbourne, and will relieve congestion in the City Loop and create space for more trains to run in and out of the city. The Metro Tunnel is fully funded (Table 1.1), demonstrating the Government’s commitment to the most important public transport infrastructure project in Australia.

**Table 1.1: Funding allocation for the Melbourne Metro Tunnel**

	2016-17	2017-18	2018-19	2019-20	TEI
\$ million	782	705	667	706	10 900

Source: Department of Treasury and Finance

### **Regional public transport**

The Government’s regional public transport investment will deliver a better public transport network and develop local transport solutions to improve travel for passengers. The *2016-17 Budget* includes \$1.3 billion for a range of measures to better connect people and businesses in regional Victoria.

The Ballarat line will receive \$518 million in upgrades to address demand, punctuality and reliability issues on the line. These infrastructure works will also have flow on improvements in Melbourne’s Western suburbs as well as to the Geelong and Seymour train lines.

To meet growing demand, 27 new VLocity carriages will be added to the regional network. This investment of \$280 million in new carriages and the upgrades to the Ballarat line will result in two extra peak services on the Ballarat line and an additional peak service on the Seymour line.

The Ballarat, Bendigo, Geelong, Gippsland, North East, Shepparton and Warrnambool lines will receive over \$186 million for extra services, track and station upgrades.

To support train punctuality and improve freight across regional Victoria, \$141 million will address the backlog of major periodic maintenance works, with a further \$198 million for V/Line to continue meeting service standards.

### **Roads**

Roads form the backbone of Victoria’s transport system. The *2016-17 Budget* provides \$7.0 billion for Victoria’s road network, ensuring people and freight can move freely across Victoria.

The Western Distributor project, including the Monash Freeway Upgrade and Webb Dock Access Improvement Works, will receive \$1.46 billion over four years. The \$5.5 billion project is anticipated to be funded through a combination of tolls on the new road connections, an extension to the CityLink concession and government contributions.

The Government continues to negotiate with Transurban under the Market-led Proposal Framework to deliver the project.

The project will cut travel time by 20 minutes from Melbourne's west and Geelong, remove up to 6 000 trucks from the West Gate Bridge and create thousands of jobs.

The project will widen the West Gate Freeway from eight to 12 lanes between the M80 and Williamstown Road. It will also build a tunnel under Yarraville, a second river crossing over the Maribyrnong River and construct an elevated road along Footscray Road with direct links to the Port of Melbourne.

In addition, the Monash Freeway will be widened from the EastLink interchange to Clyde Road in Berwick, and provide a network-wide solution to reduce congestion along the M1 from Geelong to Pakenham.

Hoddle Street will also receive \$58 million to improve travel times on one of Melbourne's most congested road corridors, including a continuous flow intersection at Swan Street.

The budget provides \$286 million to upgrade Thompsons Road and Yan Yean Road, dramatically increasing traffic flow, and \$103 million to complete the Drysdale Bypass.

Plenty Road, Dohertys Road and Hallam Road will also receive \$228 million to reduce travel times on these key outer suburban roads.

### ***Road safety***

Victoria is a world leader in road safety. The *2016-17 Budget* invests \$427 million in road safety to help Victorians get home safely. This includes funding to restore and replace unsafe, deteriorating roads around the State and includes funding for infrastructure investment in rural roads to prevent accidents and create safer journeys.

This includes safety infrastructure such as flexible barrier treatments, tactile edge and centre line treatments, as well as enhanced infrastructure for safer travel speeds where serious casualties occur.

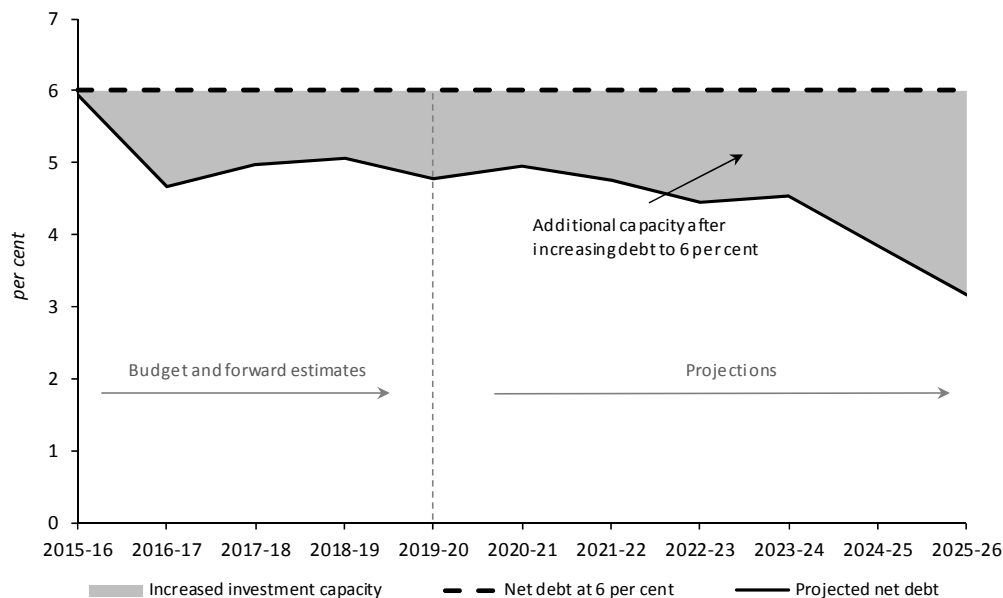
### ***Future infrastructure funding***

The Government is ensuring that its investment in infrastructure is financially sustainable. The Government's infrastructure program is fully funded, and there is capacity for additional investment in the future through prudent borrowing and fair Commonwealth contributions to the costs of Victorian infrastructure.

Net debt is projected to be 4.8 per cent of GSP at June 2020. The Government will consider opportunities to leverage its strong balance sheet and take advantage of current low interest rates, with prudent increases in debt to invest in productivity-enhancing infrastructure, consistent with the State's triple-A credit rating.

Maintaining net debt at around 6 per cent of GSP will provide capacity for additional capital investment by around \$16 billion over the next 10 years to fund further productivity enhancing infrastructure projects (see Chart 1.2).

**Chart 1.2: Investment capacity from increasing general government sector net debt to 6 per cent of GDP**



Source: Department of Treasury and Finance

### **Making better use of the State’s balance sheet**

The Government is using the State’s resources wisely by recycling assets to fund new infrastructure. The Port of Melbourne medium-term lease will generate billions of dollars for reinvestment in new infrastructure.

Lease proceeds will go to the Victorian Transport Fund to be initially invested until needed to fund the removal of the 50 worst level crossings in Metropolitan Melbourne and other infrastructure initiatives in our cities and regions. The initial investment will reduce State debt.

The Fund will also support projects that help improve access to the Port. At least 10 per cent of the Fund will go to projects in rural and regional Victoria.

Other resources currently tied up in mature assets can be recycled to build new assets for the benefit of the community and to achieve policy outcomes that benefit all Victorians. The Government will continue to optimise the management of the State’s balance sheet. This will be the basis for reform to improve the ongoing efficiency and effectiveness of the State’s asset holdings.

## **Commonwealth funding of Victorian infrastructure**

On 8 April 2016, the Commonwealth Government confirmed in writing that the \$1.5 billion previously allocated for the former East West Link project will be retained by the State and allocated to other projects, over and above funding separately committed by the Commonwealth Government. The State has accepted the offer and confirmed that it will work to finalise implementation arrangements.

However, this step alone will not address the clear Commonwealth under-investment in Victoria. Victoria is currently expecting to receive only around 9 per cent of the Commonwealth's infrastructure grants on average over the five years from 2014-15 to 2018-19, relative to a population share of around 25 per cent.

## **ADDRESSING FAMILY VIOLENCE**

Family violence is Victoria's number one law and order issue. It is the leading contributor to death, disability and injury among Australian women under the age of 45. The *2016-17 Budget* provides \$572 million to begin the development of a world-class family violence system and meet urgent service demand.

For years, victims of family violence have been saying that the current system is broken. In response, the Government established Australia's first Royal Commission into Family Violence.

The Royal Commission released its final report in March 2016, and made 227 recommendations to transform the way family violence is addressed in Victoria. The Government is committed to implementing every one of these recommendations, and will deliver a two-stage family violence package.

As part of the first stage, the Government will immediately inject a funding boost of \$572 million over three years to implement some of the recommendations, including key programs and support services facing urgent demand.

This includes \$152 million over three years for a Family Violence Housing Blitz to keep families safe. This will deliver up to 180 new units of crisis accommodation and 40 upgrades of existing crisis accommodation services. It includes \$56 million to help family violence victims live in homes that are safe, giving them the support and resources they need.

Family violence victims will receive greater support with an immediate injection of \$104 million for counselling and case management services to help victims receive the support they need. To keep children safe from harm, \$122 million will be provided to provide intensive support for children in their own home.

A broader reform package will be released in late 2016. This will include major investment to create a world-class system centred around features such as the 17 state wide Support and Safety Hubs and flexible packages that will be co-designed with victims, stakeholders and service providers.

## PROVIDING THE SERVICES THAT PEOPLE NEED

### Health

Victoria's growing population needs a stronger health care system that is able to meet people's needs. Access to reliable and efficient health care will ensure that Victorians continue to enjoy a high quality of life. Following on from the Government's first budget, this budget invests \$2.9 billion in health, including \$335 million to tackle elective surgery waiting lists.

Over \$980 million will be invested in new and upgraded health facilities and associated infrastructure as well as vital health equipment to increase the capacity of our hospitals and health networks and strengthening mental health facilities.

Work will begin on Australia's first specialist stand-alone heart hospital, with \$135 million for the Victorian Heart Hospital at Monash University in Clayton. In addition:

- \$169 million to redevelop the Goulburn Valley Health Shepparton campus including new wards and the expansion of the emergency department;
- \$61 million will be spent on major infrastructure works at the Footscray and Sunshine hospital sites;
- \$60 million for aged care including maintaining capacity and providing access to residential aged care services to meet demand;
- \$59 million is being contributed to the redevelopment of Orygen Youth Mental Health in Parkville, a major clinical and research facility for younger people across Victoria with serious mental illness;
- \$41 million for works across the Austin Hospital campus in Heidelberg;
- \$17 million for a new day surgery centre in Broadmeadows, taking pressure off the Northern Hospital; and
- \$10 million for a new Breast Cancer Centre at the Maroondah Hospital precinct.

Funding of \$247 million is provided for a range of mental health services, including \$28 million for expanding suicide prevention initiatives to reach out to people who need support. Investment in these services ensures continued support for the ongoing mental health and wellbeing of vulnerable Victorians.

The Government is also investing \$143 million in ambulance services to expand and improve response times, expand services and support paramedics' health and wellbeing.

### Education

The *2016-17 Budget* continues Victoria's Education State transformation with a \$924 million investment in school infrastructure.

Victorian schools across the state will be renovated, rebuilt and maintained under an extensive and revitalised school building program. To meet growing demand, new schools will be built around Victoria, and growing schools provided with new relocatable classrooms.

Initiatives include:

- \$287 million to fund land acquisition and construction for new schools;
- \$385 million for upgrades to schools in poor condition or with poor functionality; and
- \$64 million for relocatable classrooms to alleviate immediate pressure in overcrowded schools.

The Government is also investing \$92 million for the establishment of Tech Schools across the State. Up to 100 secondary schools in disadvantaged areas across Victoria will receive \$18 million for purpose-built consultation rooms to deliver general practitioner doctor services. Teachers will also be supported with \$76 million for notebook computers to support planning, assessment and reporting.

The *2016-17 Budget* invests \$151 million in early childhood development, including \$133 million for Maternal and Child Health services and \$10 million to construct new early learning facilities in growth areas.

Continuing the Government's focus on a strong and responsive training system, the *2016-17 Budget* provides funding of \$49 million to support higher education, training and skills. Funding of \$21 million will support senior secondary school students to continue practical vocational and trade based learning through structured workplace learning placements, and ongoing operation of Trade Training Centres in schools.

## **Police**

The safety of all Victorians is paramount. Victoria Police will be strengthened, further enhancing the safety of Victorians. The *2016-17 Budget* provides an additional \$540 million to boost police capacity, preventing crime and prosecuting perpetrators. This funding will add 406 sworn police officers and 52 specialist staff to the force, as well as technology upgrades and expanded forensic capability. In addition, funding of \$37 million is being provided to build seven new police stations in regional Victoria and upgrade a further 15 stations. These new stations and refurbishments will ensure regional police are working in modern facilities, to better support victims, hold perpetrators to account and assist officers in carrying out their critical work.

## **Emergency services**

The Government continues to invest in the men and women who work in emergency services to provide them with the skills and resources they need to do their job. The *2016-17 Budget* provides \$228 million to support emergency services, including \$81 million to audit and upgrade six training facilities and decommission the site of the former Fiskville Training College.



## RESPONSIBLE FINANCIAL MANAGEMENT

The *2016-17 Budget* invests in services and infrastructure for all Victorians while maintaining a responsible fiscal position.

The general government sector operating surplus (net result from transactions) is estimated to be \$2.9 billion in 2016-17, with strong operating surpluses averaging \$2.1 billion across the forward estimates. These surpluses reflect the Government's commitment to provide high quality services for all Victorians in a fiscally responsible manner. Revenue growth is expected to average 3.4 per cent a year over the budget and forward estimates, exceeding average expense growth of 3.3 per cent a year.

The *2016-17 Budget* funds \$6.8 billion of new output initiatives and retains government infrastructure investment at historically high levels. Estimated government infrastructure investment over the budget and forward estimates averages \$7.4 billion a year. The *2016-17 Budget* includes up to \$12.4 billion total estimated investment in new asset initiatives that will improve the long-term productivity and liveability of Melbourne and regional Victoria.

The Government's infrastructure investment program is fully funded and will ensure Victoria keeps pace with its rapidly growing population. Moreover, the Government's commitment to maintaining service levels has been achieved while keeping net debt at sustainable levels. The Government remains committed to maintaining Victoria's triple-A credit rating with net debt now projected to fall to 4.8 per cent of GSP by the end of the budget and forward estimates period.

**Table 1.2: General government fiscal aggregates**

	<i>Unit of measure</i>	<i>2014-15 actual</i>	<i>2015-16 revised</i>	<i>2016-17 budget</i>	<i>2017-18 estimate</i>	<i>2018-19 estimate</i>	<i>2019-20 estimate</i>
Net result from transactions	\$ billion	1.2	1.9	2.9	1.8	2.1	2.5
Government infrastructure investment <sup>(a)(b)</sup>	\$ billion	4.6	4.5	7.5	7.7	7.4	7.1
Net debt	\$ billion	22.3	22.5	18.6	20.9	22.3	22.2
Net debt to GSP	per cent	6.2	5.9	4.7	5.0	5.1	4.8

Source: Department of Treasury and Finance

Notes:

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

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

The *2016-17 Budget* reflects the Government’s long-term financial management objectives (Table 1.3).

**Table 1.3: Long-term financial management objectives**

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

The targets in Table 1.4 measure progress towards these long-term financial management objectives.

**Table 1.4: Financial measures and targets for *2016-17 Budget***

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

Chapter 4 *Budget Position and Outlook* sets out the budget position for 2016-17 and the forward estimate years (2017-18 to 2019-20).

## CHAPTER 2 – ECONOMIC CONTEXT

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- Victoria’s diverse economy is well positioned to take advantage of the transition away from mining investment as the prime driver of Australia’s economic growth.
- Victoria currently has Australia’s strongest growth in state final demand. Real gross state product (GSP) growth is forecast to stay above trend at 3 per cent in 2016-17.
- After remaining flat since the global financial crisis, GSP per capita is expected to grow over the forward estimates.
- Household consumption and business investment are expected to remain above trend in 2016-17, supported by continued low interest rates.
- Dwelling investment is forecast to ease back to trend in 2016-17, following a period of strong growth in line with buoyant sentiment in the property market overall.
- Labour market conditions have continued to improve, with Victoria’s jobs growth leading the nation in 2015. Further improvements are expected in 2016-17 with the unemployment rate continuing to decline.
- Population growth is estimated to remain above the Australian average as Victoria continues to attract a high share of migrants from interstate and overseas.

### VICTORIAN ECONOMIC CONDITIONS AND OUTLOOK

Victoria’s economy continues to improve, reflecting its diversity and resilience in response to shifting national and state conditions. The transition away from mining investment as the main driver of national economic growth is well under way, and Victoria now has Australia’s strongest growth in state final demand.

Household consumption and dwelling investment have remained solid, supported by low interest rates, together with strong asset price and population growth.

The State’s diverse industry structure, its highly skilled workforce and high population growth will help Victoria adapt to global challenges and take advantage of emerging opportunities.

Ongoing structural change is a feature of the Victorian economy. Over the past 20 years, the services sector has increased its share of the economy while the goods sector has declined in relative importance.

Table 2.1 sets out the economic forecasts for the *2016-17 Budget*. The forecasts are projected to revert towards trend over the final two years of the forward estimates.

**Table 2.1: Victorian economic forecasts<sup>(a)</sup>**

	(per cent)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	<i>actual</i>	<i>forecast</i>	<i>forecast</i>	<i>forecast</i>	<i>projection</i>	<i>projection</i>
Real gross state product	2.5	3.00	3.00	2.75	2.75	2.75
Employment	2.1	2.00	1.75	1.50	1.50	1.50
Unemployment rate <sup>(b)</sup>	6.4	6.00	5.75	5.75	5.50	5.50
Consumer price index <sup>(c)</sup>	1.4	2.00	2.25	2.50	2.50	2.50
Wage price index <sup>(d)</sup>	2.7	2.50	2.75	3.00	3.25	3.50
Population <sup>(e)</sup>	1.7	1.8	1.8	1.8	1.8	1.8

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

**Notes:**

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

Projections for 2018-19 and 2019-20 represent trend rates, except for the wage price index which shows a path towards trend in 2019-20.

The key assumptions underlying the economic forecasts include: interest rates that follow movements in market expectations in the short term, and stabilise thereafter; a trade-weighted index of 62.1; and oil prices that follow the path suggested by oil futures.

(b) Year-average.

(c) Melbourne consumer price index.

(d) Wage Price Index, Victoria (based on total hourly rates of pay, excluding bonuses).

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

## Gross state product

Victoria's real GSP growth is forecast to be 3.0 per cent in 2016-17, the same as in 2015-16. The Victorian economy has benefited from a lower exchange rate and low interest rates, which have created favourable conditions for businesses and consumers.

Solid consumption growth is being supported by low interest rates and wealth effects flowing from growth in the value of housing assets. Further, the household savings ratio has generally been declining in recent years, after peaking during the global financial crisis. With stronger consumer sentiment, the savings ratio is expected to continue to fall in the medium term, supporting solid consumption growth despite below trend wages growth.

Dwelling investment grew strongly in 2014-15 and 2015-16, and Victoria had the highest number of dwelling approvals over the past twelve months. Dwelling investment is forecast to revert to trend growth in 2016-17 as the property market moderates.

Business investment grew strongly in 2014-15 and 2015-16, with growth in Victoria exceeding that of the national average for the past two calendar years. Growth is expected to moderate in 2016-17, yet still remain above trend, and return to trend in the following years. Low borrowing costs and solid demand should support capital expenditure.

Merchandise export growth is expected to increase in 2016-17, benefiting from rising demand from the Asian middle class combined with a lower dollar, with Victoria remaining Australia's largest exporter of food and fibre. Service exports growth is also expected to remain robust in 2016-17, with continuing high levels of inbound tourists and students.

Growth in imported goods and services are both forecast to slowly pick up in 2016-17 due to solid consumption and economic growth.

## **Other economic indicators**

### ***Prices and wages***

Inflation in Melbourne is expected to pick up slightly in 2016-17, from the bottom of the Reserve Bank's national target band of 2-3 per cent. The near-term outlook has fallen in recent months, reflecting lower oil prices. In subsequent years, inflation is projected to return to 2.5 per cent. This reflects the gradual improvement in the domestic economy, with an expected easing of spare capacity and the return of moderate price pressures.

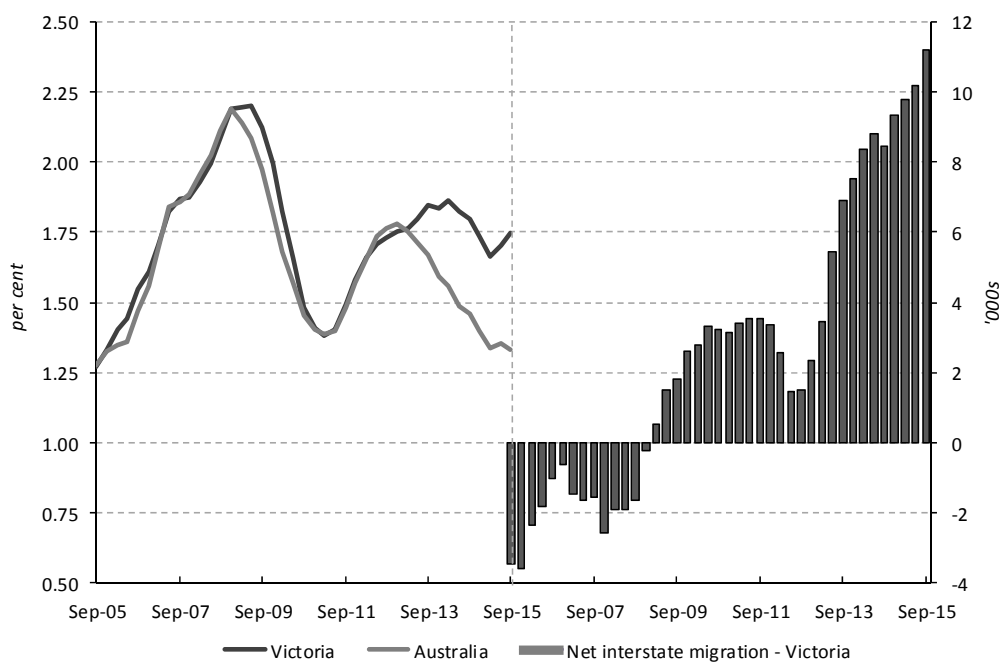
A gradual pickup in the pace of wages growth is forecast to occur from 2016-17, consistent with falling spare capacity in the labour market and the inflation rate moving back towards the middle of the Reserve Bank's national target band.

### ***Population***

Population growth is expected to remain strong over the forward estimates, driven by high net overseas migration. Victoria's population grew by 1.7 per cent over the year to September 2015, the fastest rate of any state.

Victoria accounted for a third of national net overseas migration in the year to September 2015. Victoria also recorded the highest net interstate migration of all jurisdictions, reflecting the attractiveness of Victoria as a place to live and confidence in its economic future (see Chart 2.1). Latest Australian Bureau of Statistics population projections show that Melbourne's population could exceed Sydney's in 2030.

**Chart 2.1: Annual population growth and net interstate migration**



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

## THE VICTORIAN LABOUR MARKET

Victorian labour market conditions strengthened in 2015, with Victoria’s employment growth leading the nation (see Chart 2.2). After four years of persistent weakness, from the latter half of 2015 there are positive signs of growth in full-time employment.

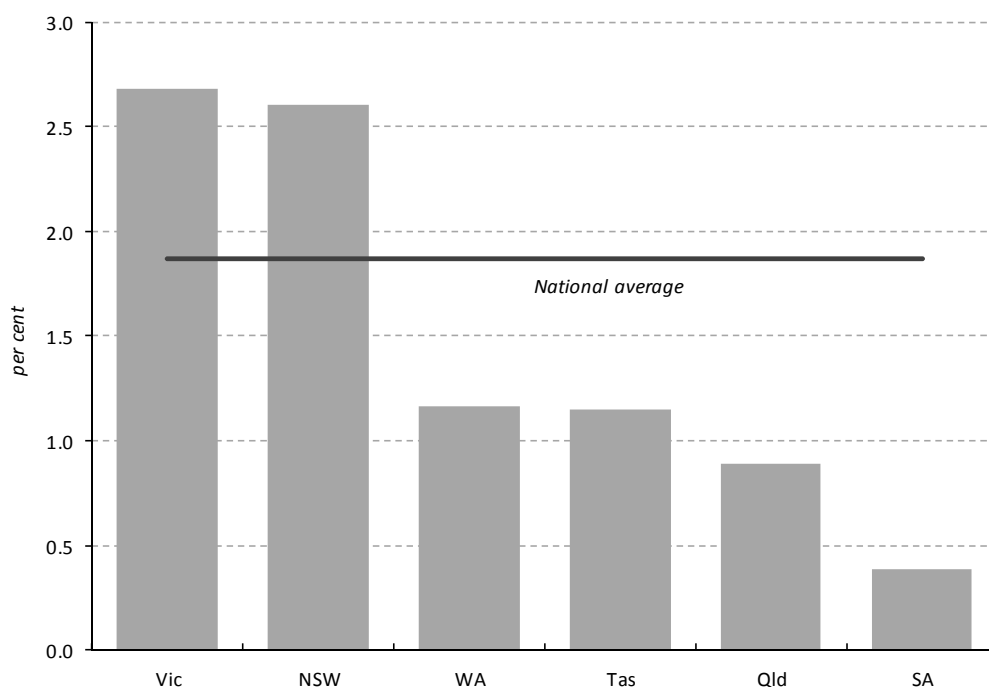
Labour market conditions are expected to continue to improve in 2016-17, with employment growing above trend. Employment is then expected to grow at its long-run average as consumer spending growth returns to trend.

Consistent with above-trend employment growth, the unemployment rate is expected to decline further in 2016-17, to an average of 5.75 per cent. Further falls in the unemployment rate are projected to occur gradually as employment growth steadies and the participation rate moves lower in line with an ageing population.

There have also been signs of improvement in the youth (15-24 years) labour market. Victoria’s youth unemployment rate has fallen from 15.1 per cent to 13.7 per cent over the past year, with the number of unemployed young Victorians decreasing by 9.5 per cent.

Coupled with the improvement in the youth labour market, Victoria continues to have the highest share of young people in full-time education of all states. This pattern reflects the broader trend in the labour market towards skilled occupations and a greater uptake of higher qualifications.

**Chart 2.2: Employment growth by state, 2015**



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

In recent decades, key structural trends across the national economy include rising female labour force participation, the service sectors emerging as the predominant contributor to jobs growth and increasing demand for skilled workers.

The composition of Victoria’s labour market has reflected these trends and is constantly undergoing structural change, which presents a range of challenges and opportunities. The Government is committed to ensuring Victorians are well positioned to take advantage of these trends.

### **Setting up the next generation**

Victoria’s unemployment rate of 6.9 per cent in July 2014 exceeded the immediate post-global financial crisis high and was the culmination of a three-year period in which the unemployment rate trended upwards (see Chart 2.3).

**Chart 2.3: Victorian and national trend unemployment rates**



Source: Australian Bureau of Statistics

Given the weak labour market conditions that prevailed in Victoria, the Government's *2015-16 Budget* made a series of commitments to support jobs growth in the Victorian economy. This included \$100 million for the Back to Work Scheme, \$508 million for the Premier's Jobs and Investment Fund and \$200 million for the Regional Jobs Fund. The Government's second budget builds and expands on these initiatives to ensure continued strong jobs growth in Victoria.

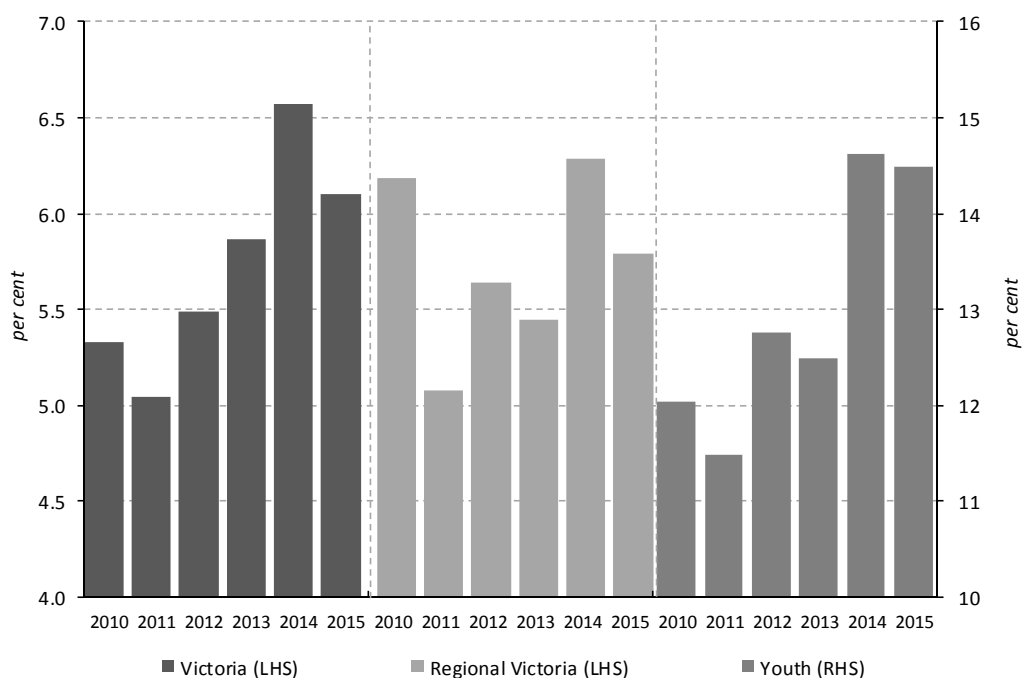
The labour market subsequently improved in 2015, with Victorian jobs growth leading the nation. The unemployment rate continued to trend down and was in line with the national average for the majority of the year. Aggregate hours worked in the Victorian economy rose by 2.8 per cent, having declined by 0.5 per cent between 2011 and 2014.

More than two-thirds of the growth in aggregate hours worked in 2015 could be attributed to the following sectors: construction; professional, scientific and technical services; and accommodation and food services industries.

The state, regional and youth unemployment rates all fell in 2015, and employment prospects for jobseekers improved (see Chart 2.4). The number of job vacancies also surged by 25.2 per cent over this period, with Victorian internet job vacancy indices recording double-digit growth rates. However, spare capacity remains elevated, indicating that while progress has been made, the labour market recovery has further to go.



**Chart 2.4: Year-average unemployment rates**



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

Nearly two-thirds of net jobs growth in Victoria over the past decade can be attributed to the following five industries: health care and social assistance; professional, scientific and technical services; education and training; construction; and public administration and safety. These industries predominantly employ workers with post-school qualifications. Reflecting this trend, the aggregated employment share of these five industries is currently 42.7 per cent, up from 38.2 per cent a decade ago.

The industries driving jobs growth in Victoria increasingly demand higher skills. This reinforces the need for a strong, responsive and high quality training system to develop the skilled workforce required to reduce spare capacity in the labour market.

In addition, the need to comprehensively plan and assist workers in industries in transition is paramount. The Government is helping Victorian automotive businesses, workers and their communities transition to new opportunities and secure jobs.

*Victoria's Automotive Transition Plan* includes initiatives to help businesses identify and capture new opportunities in different markets, strengthen skills, training and job search support for affected workers, and provide incentive payments for businesses employing retrenched automotive workers.

New Skills and Jobs Centres are being established across the TAFE network, providing one-stop-shops to assist workers, including those in the automotive industry, to access training and job support services.

## AUSTRALIAN ECONOMIC CONDITIONS AND OUTLOOK

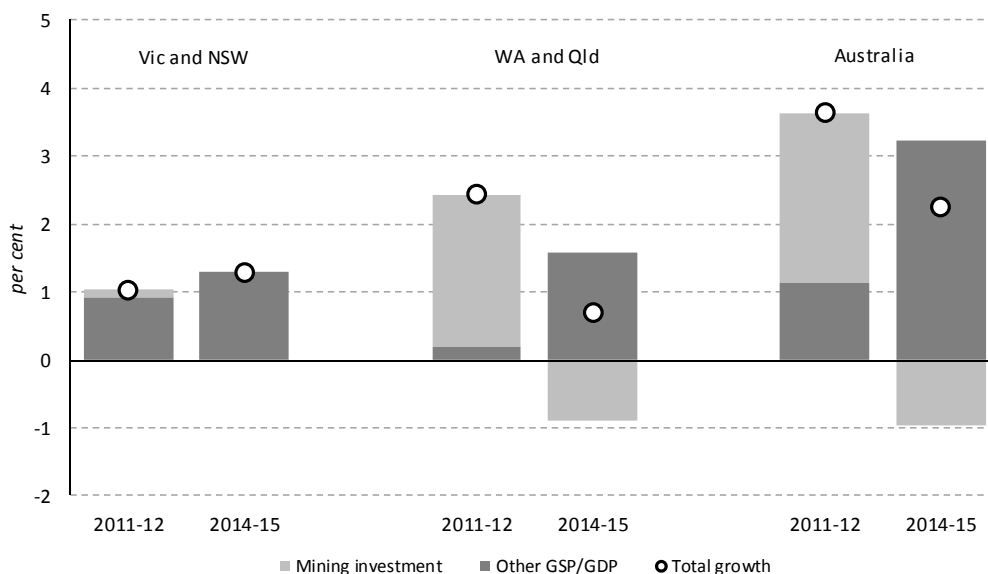
The Australian economy remains resilient amidst an uncertain global backdrop and weak commodity prices.

Following the end of the mining investment boom, the Australian economy is rebalancing toward the more populous states and to areas in which Victoria has a competitive advantage, such as service industries and the knowledge economy.

Mining investment as a driver of national growth has dropped significantly since the end of the mining boom. In 2011-12 mining investment was the most significant driver of national economic growth, whereas in 2014-15 it was a detractor from growth (see Chart 2.5). The two largest – and economically diverse – states contributed more than half of Australia’s economic growth in 2014-15.

Latest data suggest that national economic growth is likely to remain moderate in the near term as the transition away from commodity-related investment towards more balanced growth continues.

**Chart 2.5: Contributions to national growth, 2011-12 and 2014-15**



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

Household consumption growth has been robust, reflecting the sustained improvement in over 2015 in the larger states. Dwelling investment has also increased strongly due to the large pipeline of construction projects. While business investment has remained soft, positive growth was recorded for machinery and equipment and non-residential building investment in the December quarter of 2015. On the other hand, mining investment continues to decline.

Industry data also suggest that the recovery across the non-mining sectors remains on track. Output growth in services industries (financial services, public administration, and health) has been strong, consistent with improvements in business conditions and employment.

Looking forward, the shift towards services activity will underpin employment, and lower petrol prices will improve the cash flow position of most households and businesses.

Consistent with improving domestic economic conditions, underlying conditions in the Australian labour market remain healthy. The trend unemployment rate has been declining, and leading labour market indicators continue to signal reasonable employment growth in the near term, though at a more moderate pace than recorded at the end of 2015.

Jobs growth over the past year has been mainly in service sectors (such as health and retail), confirming that Australia's economic growth continues to transition from the mining to the non-mining sectors of the economy.

National inflation is likely to remain contained over the forecast period due to spare capacity in the labour market and muted inflationary expectations.

## **INTERNATIONAL ECONOMIC CONDITIONS AND OUTLOOK**

Global economic activity has remained subdued since the *2015-16 Budget Update*. Growth in emerging economies has slowed, while a modest recovery continued in advanced economies. The transition towards a consumer-led economy has slowed economic growth in China, as well as the growth prospects of economies with close trade and financial linkages. Lower oil prices have strained the fiscal positions of fuel exporters and weighed on their growth prospects. Furthermore, the pickup in demand by oil importers has so far been weaker than evidence from past episodes of oil price declines would have suggested, possibly reflecting continued financial deleveraging in major advanced economies.

In its *World Economic Outlook* released in April 2016, the International Monetary Fund downgraded its global growth forecast for 2016 (to 3.2 per cent) and 2017 (to 3.5 per cent).

Growth in the United States economy slowed in the December quarter 2015. Despite an increase in growth of disposable incomes, household consumption growth eased. Non-residential fixed investment also fell for the first time in over two years. Net exports detracted from growth, in line with the appreciation of the US dollar.

Going forward, the steady decline in the United States unemployment rate suggests that consumer spending should recover, supporting growth in the near term. Nonetheless, downside risks remain due to soft external demand and weak energy sector investment on account of low oil prices.

Euro zone growth was steady in the latter part of 2015, although lower than in the first half of 2015. The growth outlook has weakened, with downside risks posed by a possible slowdown in the manufacturing sector due to softer export demand, and the potential exit of Britain from the European Union. Further turbulence in euro zone financial markets could also negatively affect the real economy. However, the European Central Bank stands ready to increase the monetary stimulus, which should support economic growth.

The rebalancing of economic activity in China away from infrastructure investment and residential construction towards consumption and services will take time, and Chinese investment and manufacturing are likely to weaken during the transition. This is having negative impacts on other economies due to reduced demand and weaker commodity prices, while also affecting confidence and causing periodic volatility in financial markets. Emerging economies in South East Asia are especially exposed due to their supply chain linkages with Chinese businesses.

The Japanese economy contracted in the last quarter of 2015, driven by a large fall in private consumption. Despite the Bank of Japan recently lowering its benchmark interest rate to below zero, consumers still seem reluctant to spend. However, consumer spending should pick up ahead of another consumption tax increase in April 2017. Industrial production data has also been positive and the tourism industry is strong with high levels of inbound tourists.

Recent economic indicators for New Zealand have been positive, with the labour market showing signs of improvement and stronger than expected growth in the December quarter 2015. Weakness in the dairy sector was more than offset by a pick-up in construction activity and strength in the retail and tourism sectors. Inflation remains low, and coupled with the uncertain global economy, the Reserve Bank of New Zealand has indicated further monetary easing may be needed.

## **RISKS TO THE OUTLOOK**

The Victorian property sector has experienced recent strength, with rising house prices, and high levels of dwelling investment. A sharp price correction would affect consumption and overall growth. With interest rates relatively low and the labour market improving, it would appear that a levelling of house prices in the near term is more likely.

A sharp downturn in Chinese economic activity would have implications for the Australian economy. A reduction in demand for Australian commodity exports would be the likely result, affecting the terms of trade. Victoria's GST grants would also be adversely affected by falls in the price of iron ore, as Western Australia's share of the GST pool would increase over time as compensation for the loss of royalty revenue.

On the other hand, a more rapid transition to growth driven by consumption in China would support Victorian exports.

While there has been just one interest rate rise in the United States so far in the current cycle, a faster than expected economic recovery and raising of rates could increase volatility in financial markets and adversely impact business and consumer confidence. However, further depreciation of the Australian dollar would also likely occur, supporting trade-exposed businesses and shifting consumption towards domestic goods.

Overall, the international outlook remains uncertain, with downside risks dominating, especially due to concerns over the possible extent of the slowdown in economic activity in China. Nonetheless, Victoria's strong financial and economic position means that the economy is well placed to deal with any flow-on effects from events overseas.



## CHAPTER 3 – MEDIUM TERM ASSET INVESTMENT STRATEGY

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- With Victoria maintaining strong economic growth and the highest population growth in Australia, investment in infrastructure is essential to securing the State's economic future.
- To maintain current service levels, new assets are required to keep pace with a rapidly growing population.
- Ageing assets need to be replaced when they no longer support modern service delivery models, or as the cost of maintaining them exceeds their replacement cost.
- Infrastructure drives productivity. Infrastructure that supports a healthy, well-educated workforce, with an efficient and reliable transport network, is essential to improve productivity.
- The Government's investment in infrastructure goes beyond maintaining existing service levels. Melbourne Metro Tunnel and Level Crossing Removal Program are projects of national significance that will improve the productivity of the Victorian economy.
- The Government's current capital program is fully funded, including major productivity-enhancing projects such as Metro Tunnel, Western Distributor and the Level Crossing Removal Program.
- However, the State will need new strategies to fund the investment required over the next decade. Taking on additional prudent levels of debt will free up an additional \$16 billion to spend on productivity-enhancing infrastructure over the next decade.
- This strategy will be supported by also exploring alternative funding sources such as asset recycling and value creation, along with leveraging private sector delivery.
- Infrastructure Victoria is developing a 30-year investment strategy which will inform the Government in prioritising available funding to specific infrastructure projects that best meet the growth in demand for services and drive productivity growth over the long term.

## DEMAND FOR CAPITAL INVESTMENT

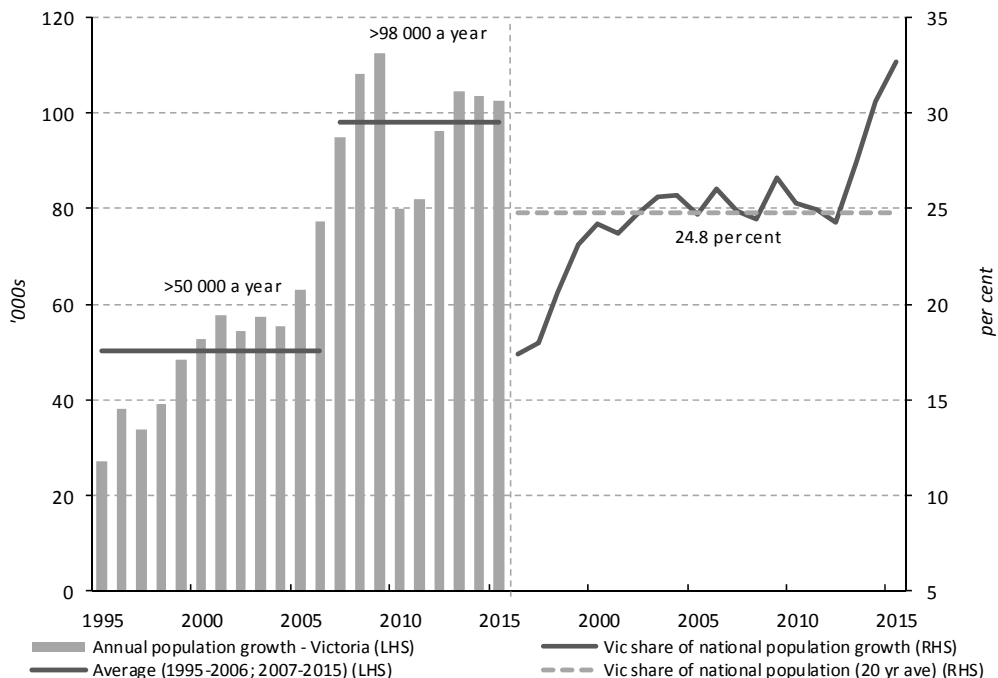
The Government is investing in the immediate infrastructure needs of Victoria, and in the needs of the future so that all Victorians can experience a continuing improvement in economic opportunity.

Whether it is roads, schools, hospitals or public transport, the level of amenity and economic opportunity enjoyed by a community is directly linked to the supporting infrastructure. However, keeping pace poses an increasing challenge as demand for infrastructure investment is driven by an expanding population, ageing infrastructure stock and the changing needs of an economy in transition.

### Population growth

The Victorian population grew by 1.7 per cent over the year to September 2015. Chart 3.1 shows that Victoria's population, which increased by an average of around 50 000 persons per year between the mid-1990s and 2006, has increased by nearly 100 000 persons per year since then. It also shows that after recovering from the recession of the early 1990s, Victoria's population grew in line with its share of the national population for more than a decade but has rapidly accelerated since around June 2013.

**Chart 3.1: Victoria's population growth and national share**



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



Melbourne's population grew by 2.1 per cent over the year to June 2015 and has added more than 360 000 people over the past four years. Melbourne's population growth has been in local government areas such as Casey, Wyndham, Melton, Whittlesea, Hume, Cardinia and the City of Melbourne. Regional cities such as Geelong, Ballarat and Bendigo have also experienced strong growth. This significant population growth is a vote of confidence in the quality of life that Victoria offers.

Victoria has successfully accommodated this population growth because of a large supply of relatively affordable residential-zoned land, especially in the outer suburbs. However, developing new land to meet community needs requires rapid investment in new social infrastructure such as schools, hospitals and community facilities.

In addition, new residents need to be able to access the growing number of jobs in high growth sectors in both the metropolitan and regional areas of the State. This requires developing new transport infrastructure and strengthening existing infrastructure to improve the linkages between where people live and where they work.

Reforms to the planning system are an essential complement to infrastructure provision to support the needs of a growing population. The Smart Planning Program funded in the *2016-17 Budget* will reform and modernise Victoria's planning system. This will make planning rules simpler and more accessible for businesses and communities, and create a more efficient planning system to cater for and facilitate growth. The Government will provide targeted assistance to regional councils to support priority strategic planning work, and build the capability and skills of council planners. The Government is working on strategies to encourage higher urban densities, such as the Plan Melbourne refresh, to make better use of existing infrastructure.

## **Ageing assets**

Maintaining the State's asset stock requires ongoing investment. Assets age and need replacing. Whether this is replacing old and outdated trains and trams, or reconfiguring hospitals with new layouts that are more conducive to modern models of care, maintaining the functionality of the asset stock requires it to be renewed.

Assets need replacing when they become costly to operate and maintain. Although the Government is committed to getting the most out of the State's infrastructure stock, all assets age to a point where the costs of keeping them operational exceeds the costs of replacement.

The replacement of ageing infrastructure, as well as the expansion of the existing asset base to meet the demands of a growing population, affects the level of investment that is required each year to maintain and deliver a given level of service. This core investment is required to ensure infrastructure keeps pace with growth in demand for services. This core investment can be distinguished from the major investments that materially change the way services are delivered and have a significant impact on productivity.

## Transformative infrastructure projects

In addition to meeting the essential needs for transport and social infrastructure, the Government is looking to identify productivity-enhancing infrastructure that could radically improve economic opportunity in Victoria. Large and iconic investments, such as the underground City Loop which was approved for construction in 1970 and completed in 1981, have been instrumental in Melbourne's and Victoria's economic transformation and demonstrated foresight in planning for Melbourne's future.

Such investments are increasingly important given the changes in the Victorian economy. Access to relatively cheap energy and a concentration of manufacturing industries once gave Victoria an edge but these are slowly losing their influence. Our economy is increasingly shifting towards professional and financial services, health care, education, construction, retail, tourism, transport and aspects of agriculture.

As the State's economy transforms, manufacturing in the suburbs and regions is giving way to the growing strength of high skilled service sectors. It is critical that governments provide the infrastructure necessary to drive productivity growth in existing and emerging sectors of the economy. Significantly better connections are needed across Victoria, including between employment clusters, across regional areas, and from regional areas to Melbourne.

Transformational and productivity-enhancing infrastructure will allow Victoria to achieve more rapid and sustained economic growth.

## EXISTING COMMITMENTS

Labor governments have a strong record of investing in infrastructure across Victoria. The Bracks and Brumby governments built many significant projects across the State, including EastLink, the Monash-Westgate widening, the Regional Rail Link and Peninsula Link, and made investments in health infrastructure, including the Royal Children's and Royal Women's Hospitals and the Victorian Comprehensive Cancer Centre.

In its first budget, the Government substantially delivered on its election commitments outlined in Labor's Financial Statement 2014. New investments included in the *2015-16 Budget* total between \$19-22 billion.

The Government's \$5-6 billion program to remove 50 of the most dangerous and congested level crossings in metropolitan Melbourne will help end the traffic nightmare on local roads and get more trains on every line. The program will get Victorians home to their families safer and sooner. It will decrease the time taken to get to and from work, and improve the productivity of the transport sector, which improves Victoria's competitiveness.

In the *2015-16 Budget*, the Government made a significant investment in public transport, commencing the Metro Tunnel. This project will transform the public transport system with the biggest overhaul to the train network since the construction of the City Loop.

The \$10.9 billion Metro Tunnel will build two nine kilometre underground tunnels through Melbourne, from South Kensington to South Yarra. The project will relieve congestion in the City Loop and create space for more trains across the network.

The State's \$220 million contribution to the Murray Basin Rail Project will make the freight network safer and more efficient. This is critical for Victoria as Australia's largest exporter of food and other key exports such as mineral sands. The Murray Basin exports over \$3 billion a year in food, fibre, wine and mineral sands. The investment will enable larger trains to carry more product creating new opportunities and reducing costs.

The regional road network will also be improved with investment in strengthening bridges and improving the safety of high risk level crossings. This will allow freight to be transported more directly and efficiently.

The *2016-17 Budget* builds on that investment, providing a further \$2.9 billion in capital funding to improve Victoria's public transport system, connecting people to communities and employment. The performance and reliability of the metropolitan rail network will be improved, with \$1.9 billion in capital funding being provided for upgrades. This includes \$588 million for the Mernda rail extension project, \$875 million for additional high capacity trains, \$136 million to upgrade the Hurstbridge line and \$133 million for safety upgrades on the City Loop.

Regional public transport is receiving almost \$1.0 billion in capital funding, including \$517 million for Ballarat rail corridor improvements. This will bring greater connectivity to the regions, including upgrades in Bendigo, Gippsland, Ballarat, Geelong and Warrnambool.

The *2016-17 Budget* also invests over \$6.7 billion in Victoria's road network, ensuring that both people and freight can move freely across Victoria. The \$5.5 billion Western Distributor project will provide a much needed alternative to the West Gate Bridge, providing a second river crossing, widening the West Gate Freeway from 8 to 12 lanes, and connections to CityLink and the western edge of the central business district. Investment of \$274 million will be provided to duplicate Thompsons Road and Yan Yean Road, dramatically improving traffic flow. The budget also provides \$103 million to build the Drysdale Bypass.

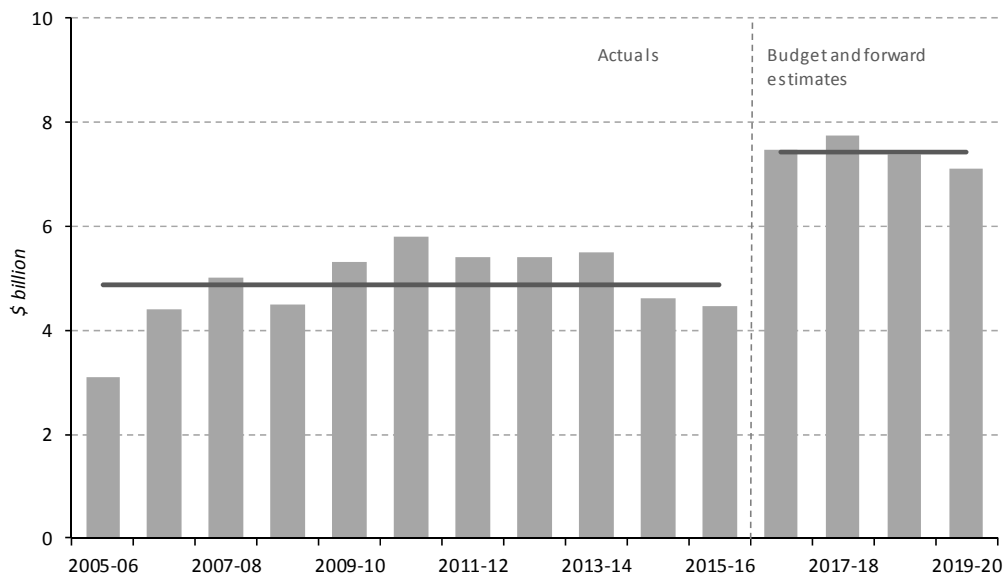
## **Total government infrastructure investment**

After incorporating the new asset investments announced as part of the *2015-16* and *2016-17 Budgets*, including Metro Tunnel, Western Distributor and the Level Crossing Removal Program, government infrastructure investment (GII) increases to an average of \$7.4 billion a year over the budget and forward estimates.

The profile of the Government's existing infrastructure commitments is outlined in Chart 3.2. The projected average of \$7.4 billion a year over the budget and forward estimates is a significant step-up in infrastructure investment compared to the average of \$4.9 billion over the preceding 11 years.

The GII measures infrastructure investment funded or facilitated by the Government, regardless of the delivery or financing arrangement. In contrast to accounting measures such as purchase of non-financial assets, GII incorporates cash flow estimates for projects being delivered by the private sector through public private partnership (PPP) arrangements.

**Chart 3.2: Government infrastructure investment 2005-06 to 2019-20**



Source: Department of Treasury and Finance

### Medium-term projections

Infrastructure projects can be large, complex and take many years from inception to operation. For this reason, the Government is planning for the long term to ensure that the investments needed to support Victoria’s future prosperity can continue to be delivered in a fiscally responsible manner.

The Government has delivered large surpluses as part of the *2016-17 Budget*, providing the platform to ensure surpluses keep growing beyond the forward estimates. Operating surpluses can be used for two broad purposes: to pay down debt or invest in infrastructure.

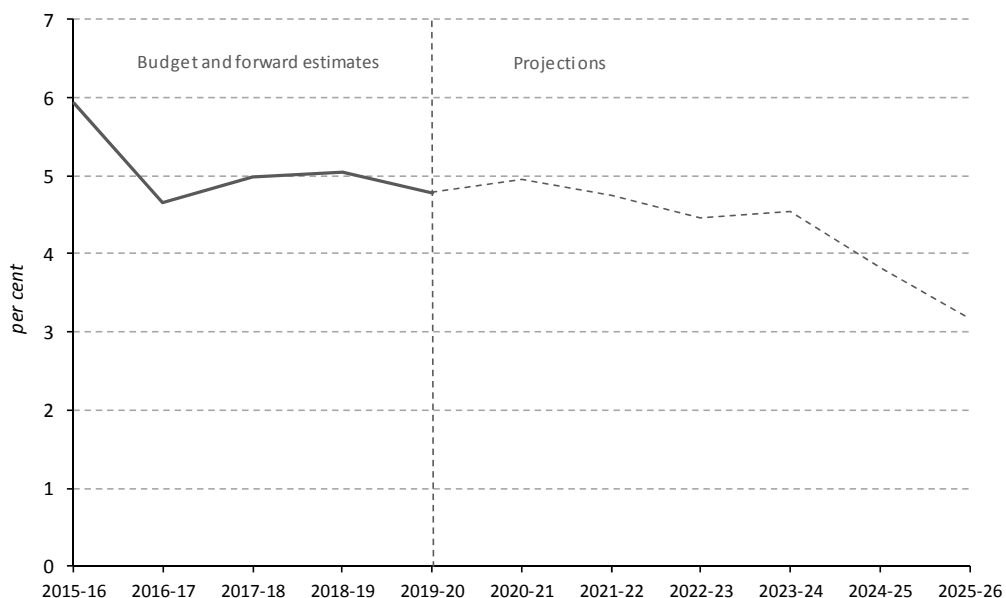
The Government’s announced infrastructure investment program is fully funded, including transformative projects such as the Metro Tunnel, the Level Crossing Removal Program and the Western Distributor. Proceeds from the lease of the Port of Melbourne will go to the Victorian Transport Fund which will fund the Level Crossing Removal Program. The Metro Tunnel is fully funded. As indicated in Table 3.1, this includes \$2.9 billion over the forward estimates to progress construction of the Metro Tunnel, with the balance fully committed in capital expenditure beyond the forward estimates. The budget also includes funding of \$1.46 billion over the forward estimates for the Western Distributor and provision for additional State contributions beyond the forward estimates.

**Table 3.1: Funding allocations for major projects**

	(million)				
	2016-17	2017-18	2018-19	2019-20	TEI
Melbourne Metro Tunnel	782	705	667	706	10 900
Western Distributor	262	139	486	555	5 500

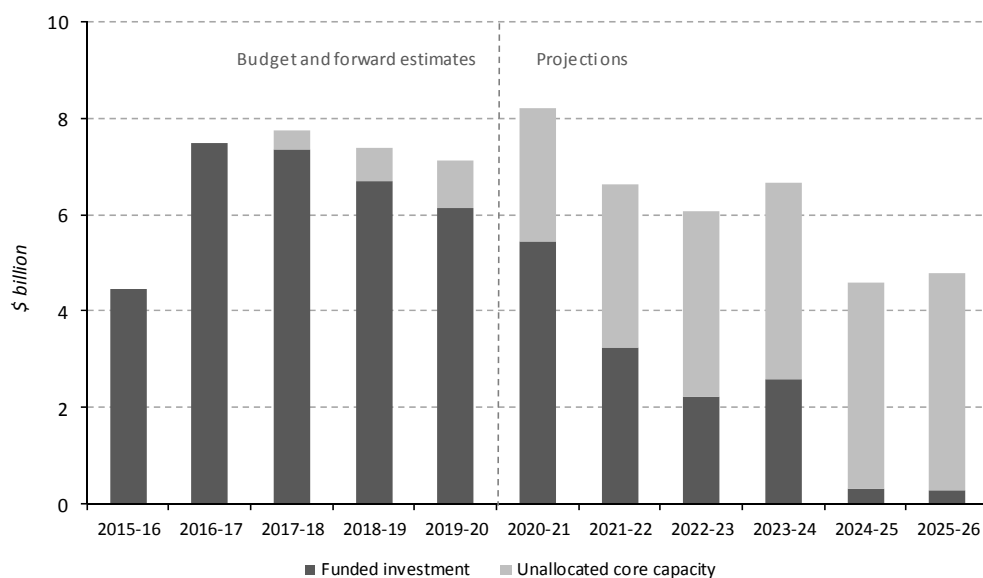
Chart 3.3 shows that net debt is projected to fall from 5.9 per cent of gross state product (GSP) in 2015-16 to around 3.2 per cent of GSP over the next ten years, after taking into account the Government’s significant investments in capital over that period (Chart 3.4).

**Chart 3.3: Net debt to gross state product**



Source: Department of Treasury and Finance

**Chart 3.4: Government Infrastructure Investment, 2015-16 to 2025-26**



Source: Department of Treasury and Finance

## CAPITAL CAPACITY

The Government has been getting on with the task of building infrastructure to transform the State, and there is more to be done.

As Victoria transforms from an economy based on manufacturing to one that is more diversified and service-based, demands on government for new infrastructure will continue.

Investing in transformative infrastructure projects beyond this budget is part of the Government’s medium-term planning and investment strategy. Transformational infrastructure investment is integral to a disciplined financial management strategy. This requires the foresight to make the investments necessary to maximise Victoria’s economic growth, while balancing the need to maintain prudent levels of debt. Maintaining the State’s triple-A credit rating is critical to keeping the financing costs of new infrastructure low.

Traditional approaches to capital budgeting and planning constrain opportunities for the investment in transformational infrastructure.

Traditionally, governments have budgeted for infrastructure investment over a four year planning horizon, in line with the budget cycle. Over the years governments have made a number of infrastructure investments that have committed funding beyond the forward estimates. However, these commitments have often been made in the absence of a clear funding strategy that has considered capital capacity and planned investment within fiscal settings.

A four-year horizon does not support planning to deliver large scale infrastructure investments that place significant demands on the budget, while at the same time funding ongoing replacement and expansion of core infrastructure. The Government is taking a longer term view, given the potential to transform the State, grow the economy and make Victoria an even better place to live.

The Government is therefore extending the capital planning horizon to ten years. This strikes a good balance between investing in infrastructure to maintain existing services, and investing in significant projects that will build Victoria's productivity and competitiveness.

Increasing infrastructure investment will require a range of strategies, including seeking a fair share of Commonwealth grant funding, recycling the State's existing asset base, maximising opportunities for value creation and capture associated with major capital investments and accessing prudent levels of debt.

## **Net debt**

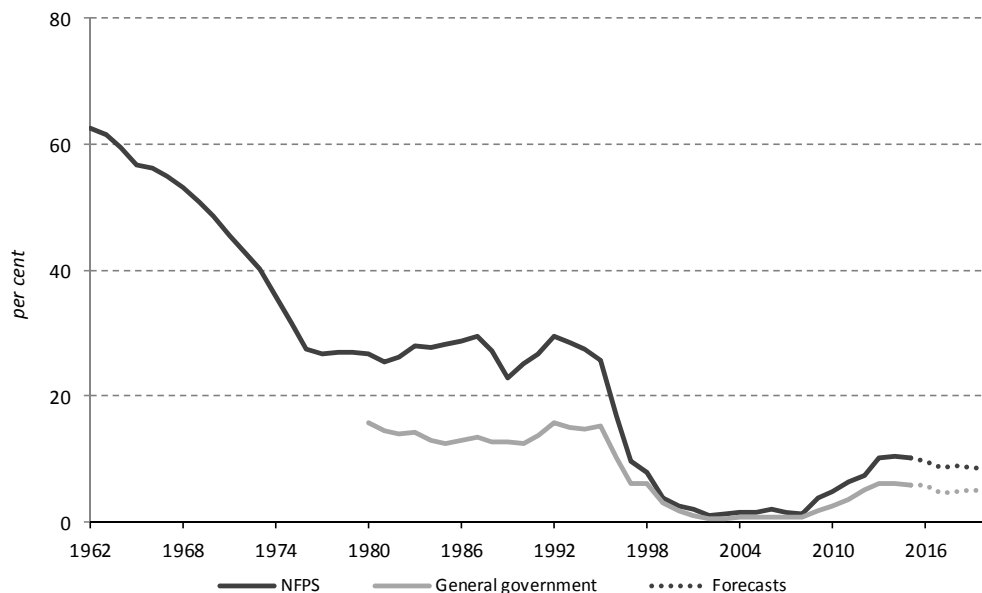
Public debate about government debt has often focussed on the desirability of eliminating net debt. A reluctance to use debt can deter sensible investments in productivity enhancing infrastructure. Intolerance for debt has the potential to slow economic growth and limit opportunities to improve the quality of life of Victorians.

Without debt financing Victoria would not have much of the core infrastructure enjoyed today. This includes the rail and tram networks, road networks and other major infrastructure such as electricity generation and transmission facilities. In the 1930s public sector net debt for all states was around 150 per cent of gross domestic product (GDP).

The International Monetary Fund (IMF) released its annual assessment of the Australian economy in September 2015. It pointed out that infrastructure is under pressure, particularly in urban areas, and that Australia has an infrastructure deficit. The IMF considers that a boost in infrastructure spending funded by borrowing would have short and long-run benefits.

As illustrated in Chart 3.5, in 1962 Victorian public sector net debt was at 63 per cent of gross state product (GSP). While this provides a broader measure of debt than the general government sector, it does provide a useful insight into the trend of public sector debt over the last 50 years. It was this debt that financed the infrastructure that laid the foundations for the economic growth that enabled the State to service debt. Chart 3.5 shows that Victorian general government sector net debt, as a proportion of GSP, is also significantly lower today than in earlier decades.

**Chart 3.5: Non-financial public sector and general government sector net debt to gross state product**



Sources: General government sector net debt to GSP: Department of Treasury and Finance  
 NFPS net debt to GSP: 'Victoria's public balance sheet', Victorian Treasury Information Paper No. 2, 22 September 1992

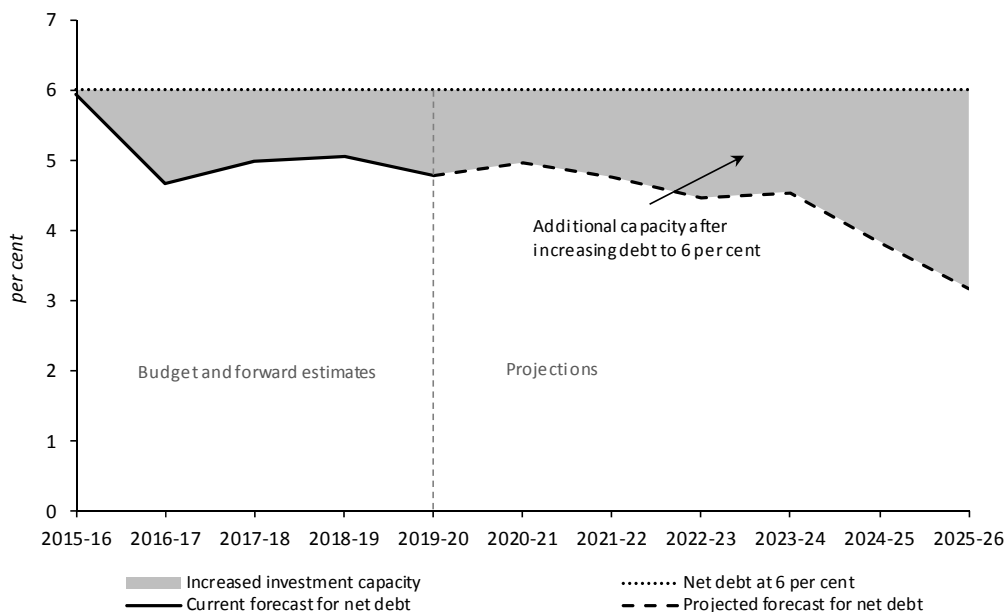
The Government will use debt financing to sustain sensible investment levels. However, this does not mean increasing debt for the wrong reasons. Importantly, the Government will not use debt to meet the cost of recurrent services.

Investments the Government makes today can improve productivity and grow the State's economy, and support services that will serve current and future generations. In the same way the Government will not ask future generations to pay for the services enjoyed today, the Government will not ask this generation to meet all the costs of infrastructure that will benefit future generations.

Net debt for the narrower measure of the general government sector is projected to be 4.8 per cent of GSP at June 2020. This level of net debt remains below the June 2015 peak.



**Chart 3.6: Investment capacity from increasing general government sector net debt to 6 per cent of gross state product**



Source: Department of Treasury and Finance

The Government is committed to maintaining Victoria’s triple-A credit rating. Maintaining general government sector net debt at around 6 per cent of GSP will still keep key financial indicators at prudent levels. If net debt is maintained at around 6 per cent of GSP, additional funding of around \$16 billion would be available over 10 years for transformative infrastructure projects (Chart 3.6).

### Making better use of the State’s balance sheet

Asset recycling is an important source of infrastructure funding. Where it is in the community’s interest, capital tied up in mature businesses can be recycled to build new infrastructure. This is particularly the case where:

- the private sector can operate assets more efficiently;
- assets are no longer being employed to their most productive use; and
- assets that have been held by government for future use are assessed as no longer required.

Proceeds from the 50 year lease of the operations of the Port of Melbourne will go to the Victorian Transport Fund which will fund the Government’s Level Crossing Removal Program and other important transport projects.

The former government sold the Rural Finance Corporation in 2014 and the proceeds will be invested in new productive economic infrastructure including the Murray Basin Rail Project.

Asset recycling is boosted by the Commonwealth Government's asset recycling initiative that gives financial incentives to state and territory governments to divest assets and reinvest the proceeds in new productive economic infrastructure.

The Government will continue to explore opportunities for asset recycling and investing the proceeds in priority infrastructure projects.

## **Creating and capturing value**

Whether it is rail, road or social infrastructure, transformational projects create a legacy much greater than their primary purpose.

The Government will ensure that each transformational project will maximise the value created for the community, whether it is by encouraging the development of more housing options closer to transport and services, or by developing retail, entertainment and community spaces.

Each project presents opportunities to create significant and lasting value for the community. These opportunities will be unique to each location. The Government will seek the right partners with the best solutions to create the most value for the community in terms of public amenities, connectivity to jobs and services, and lasting appeal.

The Government will explore mechanisms to capture a proportion of this value created, including value created through enhanced commercial development opportunities, to help fund important community infrastructure.

## **Innovative financing**

Financing is often raised upfront, usually through government borrowing or private sector debt or equity, to enable infrastructure to be built. However, private financing does not represent an additional funding source for infrastructure. Irrespective of the financing method, new public infrastructure is funded from sources such as general taxes, asset recycling or user or beneficiary charges.

Victoria has led the way in innovative financing of public infrastructure, in particular through a long history of successful PPP projects. This type of procurement uses private finance, comprising debt financing and equity investment. The due diligence, as well as the risk-taking role of debt and equity in a PPP procurement can add value in mitigating risk and incentivising performance, while driving enhanced outcomes through innovation and efficiencies.

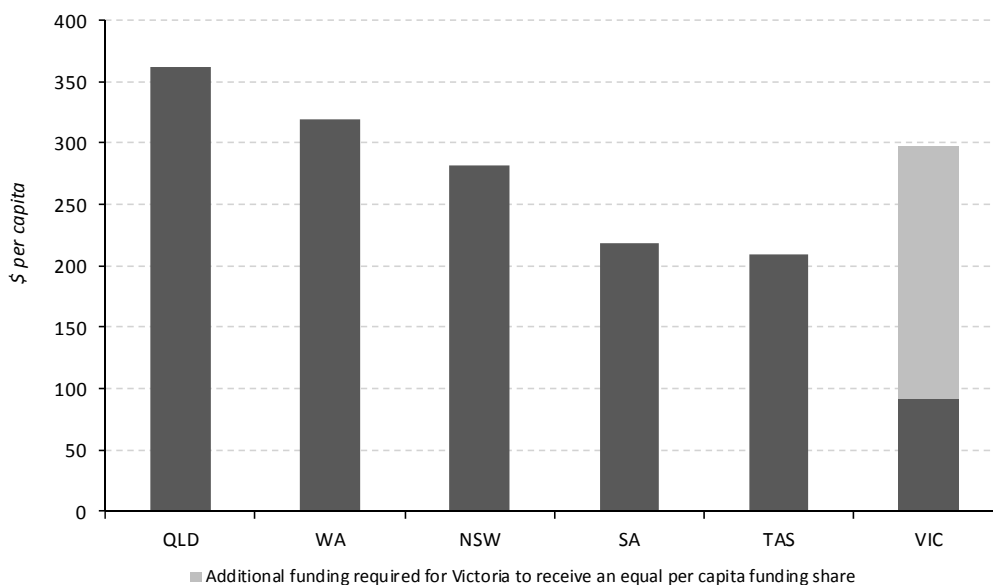
## **Commonwealth infrastructure funding**

On 8 April 2016, the Commonwealth Government confirmed in writing that the \$1.5 billion previously allocated for the former East West Link project will be retained by the State and allocated to other projects, over and above funding separately committed by the Commonwealth. The State has accepted the offer and confirmed that it will work to finalise implementation arrangements. However, the Commonwealth needs to go beyond this to give Victoria its fair share.

Victoria has traditionally not fared well in the Commonwealth’s allocation of infrastructure grants. Victoria is expecting to receive only around 9 per cent of the Commonwealth’s infrastructure grants on average over five years from 2014-15 to 2018-19. This is clearly insufficient and inequitable given Victoria represents around 25 per cent of Australia’s population. In per capita terms, each Victorian will receive an average of \$91 of Commonwealth infrastructure grants each year over this period compared to \$281 for those in New South Wales, \$320 in Western Australia and \$362 in Queensland. Melbourne’s continued economic growth will remain critical to Australia’s future economic prosperity.

Over the five years to 2018-19, Victoria is expected to receive around \$6.3 billion less from the Commonwealth than our population share would provide. Chart 3.7 shows the disparity of funding per capita. This is despite Victoria having major productivity-enhancing projects ready to proceed, such as the Metro Tunnel and Western Distributor.

**Chart 3.7: Per capita infrastructure payments to the states<sup>(a)</sup>**



Sources: 2014-15 Commonwealth Final Budget Outcome; 2015-16 Commonwealth MYEFO; DTF

Note:

(a) Five-year average: 2014-15 to 2018-19. Calculations assume funding for states other than Victoria remains constant, and any increases in Victorian funding also increase the total pool of available infrastructure funding.

If this disparity continues over ten years, Victoria’s level of under-funding from the Commonwealth would total around \$11 billion.

Ensuring sufficient and appropriate investment in infrastructure to support and develop efficient transport networks remains critical to both Victoria’s and Australia’s future economic success. Despite this, Victoria continues to receive significantly below a per capita share of Commonwealth infrastructure funding.

## **10 YEAR CAPITAL PROGRAM**

Funding for the Government's capital program over the next decade comes from a number of sources. Assuming that debt is held at around 6 per cent of GSP, and Victoria is able to secure a conservative share of Commonwealth infrastructure grants, the Government estimates that around \$46 billion will be available to fund infrastructure over the next ten years. This is addition to funding already committed to existing infrastructure projects and includes the existing provisions that have been made within the State's baseline estimates for capital expenditure (unallocated capital). To the extent the Government is successful in realising alternative funding sources, such as through asset recycling and private investment, the State's capital program can be expanded.

### **Core infrastructure**

Melbourne's expanding population is straining the capacity of school infrastructure. Demand for new schools in Melbourne's growth corridors is significant. A proportion of this demand has been met by relocatable classrooms. However, this is a short-term fix and cannot provide the capacity needed to meet the predicted increased demand over the medium term. In addition, a significant number of existing school buildings have been allowed to fall into a state of disrepair, and ongoing investment is required to transform our schools into modernised and innovative learning environments.

Over the past decade there have been high levels of investment in health infrastructure. This investment has seen the establishment and upgrading of several key hospitals including the Royal Women's Hospital, the Royal Children's Hospital, the Victorian Comprehensive Cancer Centre and the Royal Victorian Eye and Ear Hospital. This has expanded capacity as well as modernising critical health assets.

However, demands on the system for additional capacity remain. In particular, pressure on health services in Melbourne's growth corridors will require an expansion and reconfiguration of capacity over the coming decade. In addition, while many of our country hospitals have sufficient capacity to meet projected demand, a significant number are becoming dated and will require investment to update infrastructure for modern models of care.

Notwithstanding significant and ongoing investment in Melbourne’s transport network, road and rail networks continue to strain under steadily increasing demand. The road network is heavily congested, reducing productivity and resulting in lost time for Victorian families. The public transport system provides reasonable coverage over the majority of metropolitan and regional areas, but significant overcrowding during peak periods makes using the system arduous for commuters. Continuing to expand the capacity of the network is a key priority for the Government.

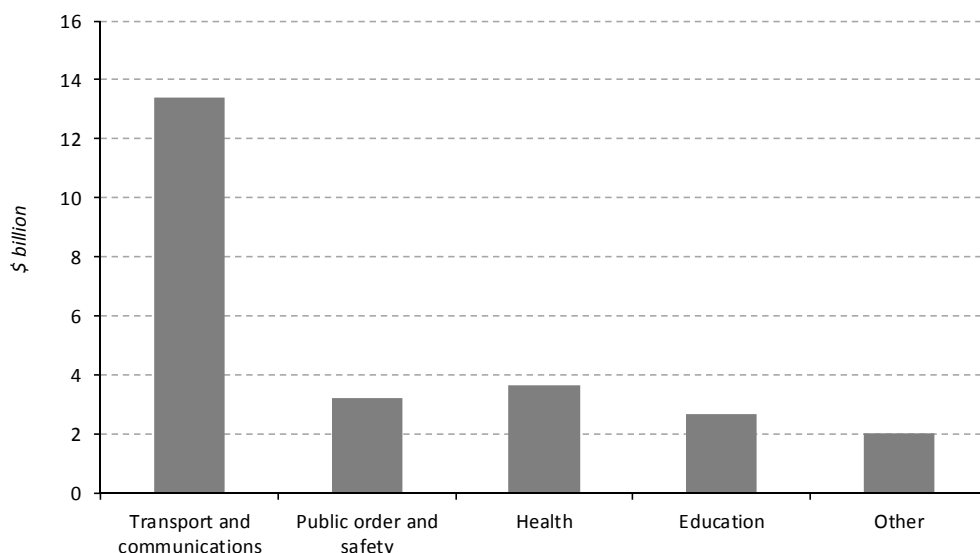
The Government is committed to meeting demand and easing the stress on the health, education and transport systems. To do this, the Government estimates around \$25 billion will be required over the next decade to keep up with the replacement of ageing assets and extend services to meet the demands from population growth.

This estimate is indicative only, but has been developed using both historical levels of investment to predict future demand, as well as using estimates based on the length of useful life of existing assets.

While the actual allocations will be determined through annual budget processes, the Government anticipates that allocations over the coming decade will be in the order of:

- \$2.5–3 billion for new schools and upgraded school facilities;
- \$3.5–4 billion for new and upgraded health facilities across the state;
- \$10–15 billion for upgraded and expanded road and public transport infrastructure; and
- up to \$5 billion to build and maintain other government services, such as public housing.

**Chart 3.8: Estimated core investment over period by sector, 2015-16 to 2025-26**



Source: Department of Treasury and Finance

## **Transformative projects**

If net debt were to increase to 6 per cent of GSP, and assuming a conservative estimate of additional Commonwealth funding, the Government anticipates capacity to fund transformative projects of around \$21 billion between now and 2025-26. This is in addition to the provisions already set aside to meet core infrastructure demands.

Infrastructure is a key determinant of productivity. The Government is committed to using the opportunity this capacity provides to make the kinds of investments that improve Victoria's productivity and support international competitiveness.

Accessible, efficient and reliable transport networks increase the productivity of the labour force, as well as the efficient and timely transport of goods and services. Transport networks also improve markets and promote competition. They connect consumers to a greater number of businesses, and bring workers into contact with more opportunities for employment and training.

A healthy and well-educated workforce is more productive. Investment in the kind of social infrastructure that can result in a step-change in the way health and education services are delivered is an important part of any strategy to improve productivity over the long term. Projects such as the Victorian Comprehensive Cancer Centre can change the way care is provided, with the new hospital providing significantly enhanced research facilities and supporting modern models of care for cancer patients.

## **Making the right investment decisions**

Getting infrastructure investment decisions right is as difficult as it is important. By establishing Infrastructure Victoria as an independent body and tasking it with developing a 30-year infrastructure strategy, the Government is giving Victoria the best opportunity to invest in the infrastructure needed to be a modern competitive economy.

Once received, this strategy will inform the Government as it develops its medium to long-term plan, and in particular in prioritising the allocation of available funding to specific infrastructure projects that best meet the growth in demand for services and drive productivity growth over the next decade.

As a combination of this structured approach to planning, and taking a longer-term view of budgeting for infrastructure investment, the Government will be maximising Victoria's opportunity for future economic growth.

## CHAPTER 4 – BUDGET POSITION AND OUTLOOK

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- The *2016-17 Budget* continues to deliver on the Government’s commitment to improve the longer-term productivity and liveability of Melbourne and regional Victoria with \$6.8 billion in new output initiatives and up to \$12.4 billion total estimated investment (TEI) in new asset initiatives.
- The general government sector operating surplus is estimated to be \$2.9 billion in 2016-17, with strong operating surpluses averaging \$2.1 billion across the forward estimates. These surpluses reflect the Government’s commitment to providing high quality services and investing in necessary infrastructure for all Victorians in a fiscally responsible manner.
- Victoria is expected to collect \$60.4 billion in revenue, and spend \$57.5 billion on service delivery in 2016-17. Revenue growth is expected to average 3.4 per cent a year over the budget and forward estimates, exceeding average expense growth of 3.3 per cent a year.
- Government infrastructure investment (GII) is at historically high levels. Estimated GII over the budget and forward estimates averages \$7.4 billion a year compared with the historical average of \$4.9 billion a year from 2005-06 to 2015-16.
- Net debt is expected to be \$22.2 billion by June 2020. Net debt as a proportion of gross state product (GSP) is projected to decrease from its June 2016 level of 5.9 per cent to 4.8 per cent by June 2020.
- The Government is on track to fully fund the State’s unfunded superannuation liability by 2035.

This chapter outlines the budget position of the general government sector. The broader public sector is covered in Chapter 5 *Position and outlook of the broader public sector*. This budget paper takes into account the financial impacts as at 20 April 2016 of all policy decisions made by the Victorian Government, as well as Commonwealth Government funding revisions and other information that affects the financial statements, unless otherwise stated.

## GENERAL GOVERNMENT SECTOR

### Overview

The 2016-17 *Budget* funds further improvements to key services and infrastructure investments across Victoria. The Government is investing \$6.8 billion in additional service delivery, and up to \$12.4 billion total estimated investment in new asset initiatives.

The operating result (net result from transactions) for the general government sector is forecast to be a surplus of \$2.9 billion in 2016-17, and average \$2.1 billion a year over the forward estimates (Table 4.1). This is in line with the Government's target of maintaining strong operating surpluses in each year over the budget and forward estimates.

The Government has also met its objective to ensure that expenditure growth (3.3 per cent a year) is no greater than revenue growth (3.4 per cent a year), on average, over the budget and forward estimates.

Operating surpluses of this size are designed to insulate the State against revenue shocks, and fund infrastructure investment while maintaining net debt at prudent levels.

**Table 4.1: General government fiscal aggregates**

	<i>Unit of measure</i>	<i>2014-15 actual</i>	<i>2015-16 revised</i>	<i>2016-17 budget</i>	<i>2017-18 estimate</i>	<i>2018-19 estimate</i>	<i>2019-20 estimate</i>
Net result from transactions	\$ billion	1.2	1.9	2.9	1.8	2.1	2.5
Government infrastructure investment <sup>(a)(b)</sup>	\$ billion	4.6	4.5	7.5	7.7	7.4	7.1
Net debt	\$ billion	22.3	22.5	18.6	20.9	22.3	22.2
Net debt to GSP	per cent	6.2	5.9	4.7	5.0	5.1	4.8

Source: Department of Treasury and Finance

*Notes:*

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

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

Government infrastructure investment (GII) over the budget and forward estimates averages \$7.4 billion a year compared with the historical average of \$4.9 billion a year over 2005-06 to 2015-16. The current level of GII, which incorporates estimates for both new investment and the offsetting impacts for asset sales and capital repatriations, reflects government decisions and current estimates for project milestones and delivery schedules.

Net debt as a proportion of GSP is expected to be 5.9 per cent at June 2016 before declining sharply in 2016-17, largely reflecting the receipt of proceeds from entering into a medium-term lease over the operations of the Port of Melbourne. By June 2020, net debt as a proportion of GSP is expected to be 4.8 per cent.

Net debt of 4.8 per cent of GSP provides the headroom to potentially increase borrowings in the future for further productivity-enhancing infrastructure across Victoria, while keeping debt at levels that are consistent with a triple-A credit rating.



## BUDGET AND FORWARD ESTIMATES OUTLOOK

Table 4.2 summarises the operating statement over the budget and forward estimates for the general government sector. A comprehensive operating statement is presented in Table 1.1 of 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<sup>(a)</sup>**

	(\$ million)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	actual	revised	budget	estimate	estimate	estimate
<b>Revenue</b>						
Taxation	18 339	20 079	21 594	21 292	22 468	23 354
Dividends, TER and interest <sup>(b)</sup>	1 940	1 557	1 940	2 292	1 750	1 693
Sales of goods and services	6 482	6 643	6 843	7 036	7 212	7 240
Grant revenue	24 503	25 364	27 424	28 069	28 844	29 957
Other current revenue	2 508	2 828	2 569	2 320	2 331	2 374
<b>Total revenue</b>	<b>53 772</b>	<b>56 470</b>	<b>60 370</b>	<b>61 009</b>	<b>62 604</b>	<b>64 618</b>
% change	2.7	5.0	6.9	1.1	2.6	3.2
<b>Expenses</b>						
Employee expenses	18 834	20 057	21 298	22 121	23 031	23 713
Superannuation <sup>(c)</sup>	3 016	3 008	3 030	3 024	3 032	3 045
Depreciation	2 425	2 506	2 620	2 780	3 039	3 216
Interest expense	2 102	2 134	2 433	2 231	2 254	2 214
Other operating expenses	17 651	18 331	18 669	19 358	19 223	19 923
Grants and other transfers	8 529	8 547	9 451	9 697	9 942	10 036
<b>Total expenses</b>	<b>52 558</b>	<b>54 582</b>	<b>57 501</b>	<b>59 212</b>	<b>60 522</b>	<b>62 147</b>
% change	4.3	3.9	5.3	3.0	2.2	2.7
<b>Net result from transactions</b>	<b>1 214</b>	<b>1 888</b>	<b>2 869</b>	<b>1 797</b>	<b>2 082</b>	<b>2 471</b>
<b>Total other economic flows included in net result <sup>(d)</sup></b>	<b>( 465)</b>	<b>( 250)</b>	<b>( 234)</b>	<b>26</b>	<b>( 241)</b>	<b>( 265)</b>
<b>Net result</b>	<b>749</b>	<b>1 638</b>	<b>2 635</b>	<b>1 823</b>	<b>1 841</b>	<b>2 206</b>

Source: Department of Treasury and Finance

*Notes:*

- (a) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (b) Comprises dividends, income tax and rate equivalent revenue and interest.
- (c) Comprises superannuation interest expense and other superannuation expenses.
- (d) This typically includes gains and losses from the disposal of non-financial assets, adjustments for bad and doubtful debts and revaluations of financial assets and liabilities.

## Revenue outlook

Victoria is expected to collect \$60.4 billion in revenue in 2016-17, with revenue growth averaging 3.4 per cent a year over the budget and forward estimates. This is below average revenue growth of 5.9 per cent a year over the decade to 2015-16.

As outlined in Chapter 2 *Economic context*, despite uncertainty in global economic conditions, Victoria's economic outlook remains positive.

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

## Taxation

State taxation revenue is forecast to be \$21.6 billion in 2016-17, with growth averaging 3.9 per cent a year over the budget and forward estimates.

The boom in Victoria's property market over the past few years has been driven by a strengthening labour market, historically low interest rates, increased investor demand and strong population growth. This has led to land transfer duty revenue growth significantly exceeding expectations, with 23 per cent growth in 2015-16. The strength of land transfer duty revenue accounted for a large share of the 9.5 per cent growth in total taxation revenue for that year.

Specifically:

- land transfer duty revenue is expected to fall by 6.4 per cent in 2016-17 to \$5.7 billion. This follows significant growth in revenue over the past few years. Over the forward estimates land transfer duty revenue is expected to be at trend growth by 2019-20;
- land tax revenue is forecast to increase by 28.3 per cent to \$2.2 billion in 2016-17 as a result of the current land revaluation process. Strong growth in the property market in the two years since the last revaluation suggests that the outcome will reflect a significant increase in the value of land. Land tax revenue growth is expected to average 2.5 per cent a year over the forward estimates;
- payroll tax revenue is expected to grow by 5.3 per cent to \$5.7 billion in 2016-17, with growth averaging 4.7 per cent over the forward estimates. The recovery in revenue following three years of sub-trend growth is driven by increased aggregate hours worked over the past 18 months. Although conditions in the broader economy remain robust with overall employment growing above trend in 2016-17, spare capacity in Victoria's labour market will put downward pressure on wage growth. The Government has recognised there remain areas of concern in the labour market, which it is addressing through initiatives in the *2016-17 Budget*;

- gambling tax revenue is forecast to grow by 2.7 per cent to \$1.9 billion in 2016-17 and by an average of 2.9 per cent a year over the forward estimates. The growth in gambling tax revenue reflects general weakness in nominal consumption expenditure. Gambling expenditure is expected to continue to decline as a share of household consumption, weighing on revenue growth;
- insurance tax revenue is anticipated to grow by 6.3 per cent to \$1.2 billion in 2016-17, slightly below its trend growth rate of 6.8 per cent a year which is expected over the forward estimates. In the past, strong competition in the insurance industry drove down premium rates in the Australian insurance market but competition from low cost and overseas insurers has started to ease due to continuing acquisition and merger activity. As a result, expected premium rates have increased moderately; and
- motor vehicle taxes are expected to grow by 4.6 per cent to \$2.3 billion in 2016-17, and by an average of 3.7 per cent over the forward estimates, in line with trend growth. Despite a period of modest income growth, motor vehicle purchases have remained resilient, supporting solid growth in motor vehicle duties. The Transport and Infrastructure Council recently decided to freeze nominal registration revenue for heavy motor vehicles at 2015-16 levels for two years while the pricing scheme is reviewed.

The 2016-17 growth rate for taxation is also due to the inclusion of an allowance for prepaid port license fees associated with entering into a medium-term lease over the operations of the Port of Melbourne.

### ***Dividends, income tax equivalent and interest***

Dividend and ITE revenue is projected to increase by 39 per cent in 2016-17 to \$1.1 billion, largely due to the impact of lower expected dividends in 2015-16 from the Transport Accident Commission. Over the forward estimates, total dividend and ITE revenues are expected to decline by an average of 9.4 per cent a year to \$787 million in 2019-20, largely due to the declining profile of dividends from the public financial corporations (PFC) sector.

Interest income is earned on holdings of cash and deposits across a number of general government sector agencies including departments, hospitals and schools. Total interest income is projected to increase by 10.9 per cent in 2016-17 largely due the impact of the estimated proceeds of the medium-term lease over the operations of the Port of Melbourne. Across the forward estimates, average interest revenue is expected to remain relatively flat.

## ***Sales of goods and services***

Revenue from the sales of goods and services is expected to grow by 3.0 per cent to \$6.8 billion in 2016-17. This growth largely reflects an increase in the capital asset charge revenue from VicTrack that is associated with an increase in the asset base. Thereafter, growth moderates to an average of 1.9 per cent a year over the forward estimates.

## ***Grants***

Total grants revenue is expected to grow by 8.1 per cent to \$27 billion in 2016-17 and increase by 3.0 per cent a year on average to \$30 billion in 2019-20.

GST revenue is estimated to grow by 6.5 per cent to \$13.9 billion in 2016-17. This reflects an improvement in Victoria's share of the national GST pool, in part, as a result of having above average population growth, and the assessed need to invest more in infrastructure. Over the forward estimates, growth in GST revenue is estimated to be 6.0 per cent.

Commonwealth grants for specific purposes are projected to be \$13.1 billion a year on average across the budget and forward estimates. The Commonwealth provides these grants as contributions towards healthcare, education, disability and other services, and major infrastructure investment. While the outlook is relatively flat across the forward estimates there is significant movement in the underlying components of the grants.

Growth in specific Commonwealth grants across the forward estimates primarily for health and education funding is partially offset by lapsing programs such as the Goulburn-Murray Water Connections Project.

## ***Other current revenue***

Other current revenue includes fines, royalties, donations and gifts, assets received free of charge and other miscellaneous revenues. Other current revenue is projected to decrease by 9.2 per cent to \$2.6 billion in 2016-17 largely due to a large one-off increase in revenue in 2015-16 associated with the High Court of Australia's decision in favour of the State relating to the Tatts Group Limited's 'Gambling Licenses' proceedings. Other current revenue is projected to fall by an average of 2.6 per cent a year across the forward estimates.

Further details of expected movements in the major categories of general government revenue are contained in Budget Paper No. 5, Chapter 4 *State revenue*.

## Expenses outlook

The Government is expected to spend \$57.5 billion in 2016-17 providing services to the community. Total expenses are expected to grow by 3.3 per cent a year on average over the budget and forward estimates to \$62.1 billion in 2019-20.

The level and expected growth in expenses reflects Government investment to meet the growing demand for core services, including on health, education and social services. Specifically:

- grants and other transfer expenses include funding provided to non-government schools, VicTrack and V/Line for operational costs incurred in the provision of transport services, and local governments. Expenses are forecast to increase by 10.6 per cent to \$9.5 billion in 2016-17. Thereafter, growth moderates to an average of 2.0 per cent a year over the forward estimates;
- depreciation expense is projected to grow by 4.6 per cent to \$2.6 billion in 2016-17, increasing by 7.1 per cent a year on average over the forward estimates to \$3.2 billion in 2019-20. This growth over the forward estimates is broadly in line with the Government's increased investment in infrastructure;
- employee expenses (including superannuation), which account for 42 per cent of operating expenditure in 2016-17, are projected to grow by 5.5 per cent to \$24 billion in 2016-17 and by 3.2 per cent a year on average over the forward estimates. The growth in 2016-17 is driven by annual growth in wages, consistent with the Government's wages policy, growth in staffing numbers associated with delivering additional services, growing hospital demand, and increased investment in the education sector;
- other operating expenses include the purchase of supplies and services in the human services, health and transport sectors, and maintenance expenses. Other operating expenses are projected to increase by 1.8 per cent in 2016-17 and grow by an average of 2.2 per cent a year to \$20 billion in 2019-20; and
- interest expense is expected to be higher in 2016-17 and lower thereafter, reflecting an updated program of borrowings associated with the receipt of estimated proceeds from the medium-term lease over the operations of the Port of Melbourne into the Victorian Transport Fund. Growth in interest expense is forecast to average 0.9 per cent a year over the budget and forward estimates as a result of higher borrowings associated with the Government's infrastructure program.

## Reconciliation of estimates to the 2015-16 Budget Update

Relative to the 2015-16 Budget Update, the net result from transactions has been revised up by \$1 325 million in 2016-17 and \$527 million in 2018-19, but fall by \$48 million in 2017-18.

**Table 4.3: Reconciliation of estimates to the 2015-16 Budget Update<sup>(a)</sup>**

(\$ million)

	2016-17 budget	2017-18 estimate	2018-19 estimate
<b>Net result from transactions: 2015-16 Budget Update</b>	<b>1 544</b>	<b>1 845</b>	<b>1 555</b>
<b>Policy decision variations</b>			
Revenue policy decision variations	130	174	165
Output policy decision variations <sup>(b)</sup>	(1 383)	( 896)	( 648)
	<b>(1 253)</b>	<b>( 722)</b>	<b>( 483)</b>
<b>Economic/demographic variations</b>			
Taxation	421	535	773
Investment income <sup>(c)</sup>	89	397	( 40)
	<b>510</b>	<b>932</b>	<b>733</b>
<b>Commonwealth grant variations</b>			
General purpose grants	225	99	( 131)
Specific purpose grants <sup>(d)</sup>	772	( 576)	( 2)
	<b>998</b>	<b>( 477)</b>	<b>( 133)</b>
<b>Administrative variations</b>			
Contingency offset for new policy <sup>(e)</sup>	200	200	200
Other administrative variations	869	18	210
	<b>1 069</b>	<b>218</b>	<b>410</b>
<b>Total variation since 2015-16 Budget Update</b>	<b>1 325</b>	<b>( 48)</b>	<b>527</b>
<b>Net result from transactions: 2016-17 Budget</b>	<b>2 869</b>	<b>1 797</b>	<b>2 082</b>

Source: Department of Treasury and Finance

Notes:

- (a) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (b) This is represented in Table 4.4 as the 2016-17 Budget output policy decisions.
- (c) Investment income includes dividends and income tax and rate equivalent revenue.
- (d) Reflects the change in grant revenue as per Note 5 of Budget Paper No. 5, Chapter 1 Grant revenue less associated expense movements.
- (e) Represents releases from the Funding not allocated to specific purposes contingency associated with demand for government services. Further information on this contingency can be found at Note 12(c) of Budget Paper No. 5, Chapter 1 Estimated financial statements for the general government sector.

## Policy decision variations

Policy variations reflect specific decisions by the Government that have an impact on the budget and forward estimates and are related to a new policy or represent a change in the Government's existing policy position since the previous publication.

## Revenue policy decision variations

New revenue policy decisions have increased the operating result by an average \$156 million from 2016-17 to 2018-19. Details of the specific policy initiatives since the *2015-16 Budget Update* are contained in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

## Output policy decision variations

The *2016-17 Budget* provides \$6.8 billion in new output initiatives over the five years to 2019-20. Table 4.4 shows the impact of new output measures in this budget, with further detail in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

**Table 4.4: Net impact of the 2016-17 Budget new output initiatives<sup>(a)(b)</sup>**

	(\$ million)			
	2016-17 budget	2017-18 estimate	2018-19 estimate	2019-20 estimate
<b>New output initiatives</b>	<b>2 318</b>	<b>1 729</b>	<b>1 320</b>	<b>1 227</b>
Less:				
Funding from reprioritisation of existing resources <sup>(c)</sup>	626	509	464	337
Adjustments <sup>(d)</sup>	282	306	188	137
Savings	26	18	20	21
<b>2016-17 Budget output policy decisions</b>	<b>1 383</b>	<b>896</b>	<b>648</b>	<b>732</b>
Less: contingency offset for new policy <sup>(e)</sup>	200	200	200	200
<b>Net impact</b>	<b>1 183</b>	<b>696</b>	<b>448</b>	<b>532</b>

Source: Department of Treasury and Finance

### Notes:

- (a) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (b) Funding of \$244 million is provided in 2015-16.
- (c) This includes the reprioritisation of resources previously allocated to departments and retained revenues.
- (d) Primarily incorporates the net impact of the creation and release of decisions made but not yet allocated contingencies.
- (e) Represents releases from the Funding not allocated to specific purposes contingency associated with demand for government services. Further information on this contingency can be found at Note 12(c) of Budget Paper No. 5, Chapter 1 Estimated financial statements for the general government sector.

New output initiatives in the *2016-17 Budget* focus on supporting Victoria's most vulnerable people, boosting employment and improving productivity. Specifically:

- it presents a progressive social agenda that invests in key service delivery across health, disability and community services, and responds to social challenges. This includes \$1.0 billion to enable health services to respond to growing patient demand, \$335 million for health services to invest in elective surgery, \$247 million for a range of mental health initiatives, and \$458 million to boost police capacity;
- delivers an immediate family violence package in response to the Royal Commission into Family Violence report of \$572 million. The report made 227 recommendations to transform the way in which we address family violence and the Government is committed to implementing all of these; and
- builds on the strong increase in Victorian employment through initiatives designed to boost trade and investment, productivity and Victoria's visitor economy. This includes \$53 million for the establishment of Jobs Victoria to provide employment outcomes and work experience to Victoria's most disadvantaged and marginalised job seekers.

### ***Economic and demographic variations***

Since the *2015-16 Budget Update*, land transfer duty, land tax and investment income have been the key drivers in expected economic and demographic variations:

- land transfer duty revenue is expected to be around \$463 million a year higher on average across the forward estimates compared with the *2015-16 Budget Update*. Over the past few years, the property market has been on a strong upward trajectory driven by historically low interest rates and strong demand in both the residential and commercial markets. Land transfer duty is expected to contract by 6.4 per cent in the budget year and revert to trend over the forward estimates;
- land tax revenue is forecast to be \$186 million a year higher, on average, across the forward estimates compared with the *2015-16 Budget Update*. This is mainly a reflection of a stronger than expected land revaluation outcome in 2016;
- partly offsetting upgrades to land transfer duty and land tax revenue, payroll tax is expected to be \$75 million lower, on average, across the forward estimates compared with the *2015-16 Budget Update*. While aggregate hours worked have improved over the past 18 months and full-time employment has recently picked up, spare capacity in the labour market remains elevated. This has contributed to the recent weakness in the pace of wages growth which is forecast to improve more gradually than in the *2015-16 Budget Update*. The softer outlook for wages growth outweighs the improvements to aggregate hours worked and stronger near-term employment growth resulting in the downgrade to payroll tax across the forward estimates; and
- total investment income is forecast to be \$243 million a year higher, on average, across 2016-17 and 2017-18 compared with the *2015-16 Budget Update*. This is primarily due to rephasing dividends from the PFC sector.



## **Commonwealth grants variations**

Commonwealth general purpose grants (or GST grants) have been revised up by \$225 million in 2016-17 and \$99 million in 2017-18, but revised down by \$131 million in 2018-19 compared with the *2015-16 Budget Update*. This primarily reflects an increase in Victoria's share of the national GST pool, partially offset by the lower than expected growth in the GST pool over the forward estimates.

Net changes to specific purpose grants has increased the operating result by \$774 million in 2016-17 but decreased it by \$576 million in 2017-18. These movements are largely due to:

- rescheduling asset recycling initiative payments associated with the revised timing of the Port of Melbourne lease; and
- rescheduling Goulburn-Murray Water Connections Project grants from 2015-16 to 2016-17 that corresponds to a rephasing of project timelines and associated state expenditure.

## **Administrative variations**

The release of the *funding not allocated to specific purposes* contingency as part of the *2016-17 Budget* to offset new policy decisions totals \$200 million in each year across 2016-17 to 2018-19.

Other administrative variations have increased the operating result by \$869 million in 2016-17, \$18 million in 2017-18 and \$210 million in 2018-19.

The 2016-17 increase is primarily due to the inclusion of an allowance for prepaid port license fees associated with entering into a medium-term lease over the operations of the Port of Melbourne. Other movements across 2016-17 to 2018-19 include:

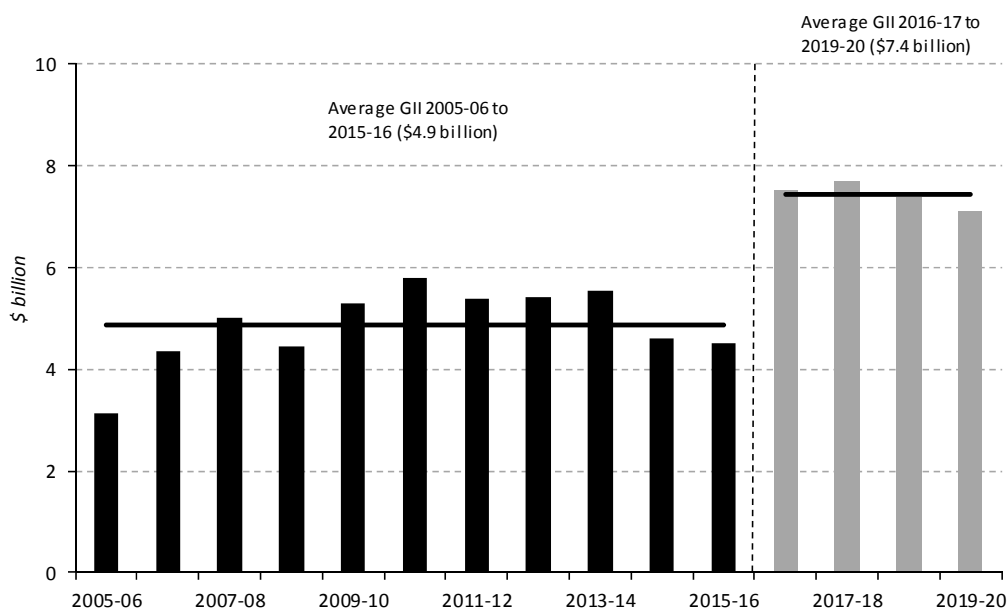
- various changes to revenues including the continuation of the Environmental Contribution Levy;
- higher revenue forecasts for outer-budget entities such as the State's Arts Agencies;
- adjustments to the provision for decisions made but not yet allocated that is outlined in note 12(c) of Budget Paper No. 5, Chapter 1 *Estimated financial statements for the general government sector*. The impact of these changes vary between financial years; and
- lower fees and fines revenue.

## Capital expenditure

The Government is investing in new and upgraded infrastructure to meet the needs of the State’s rapidly growing population and expanding economy. This investment is delivered through a variety of financing and contractual arrangements including projects that are directly managed by Government, and other projects that are delivered by the private sector through public private partnerships (PPPs). The government infrastructure investment (GII) measure provides a comprehensive picture of the investment across Victoria that is funded or facilitated by the Government.

General government infrastructure averages an unprecedented \$7.4 billion across the budget and forward estimates, and demonstrates the Government’s commitment to investment across the State. In contrast, the average expected GII for the 11 years to 2015-16 is \$4.9 billion (Chart 4.1). The spending projected across the budget and forward estimates reflects substantial and ongoing investment in core services such as health, education and public safety, plus significant funding for transformative projects including the Melbourne Metro Tunnel and the Western Distributor.

**Chart 4.1: Government infrastructure investment<sup>(a)(b)(c)</sup>**



Source: Department of Treasury and Finance

**Notes:**

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

## ***New asset initiatives***

The *2016-17 Budget* includes up to \$12.4 billion TEI of new infrastructure investment that will improve the longer term productivity and liveability of Melbourne and regional Victoria.

The *2015-16 Budget* provided funding to advance key asset election commitments including the Metro Tunnel and the Level Crossing Removal Program. This budget builds on that funding to develop an integrated transport network, including:

- to deliver the \$5.5 billion Western Distributor project, designed to provide better travel for local traffic by removing thousands of trucks from local streets, and improve freight access to and from the Port of Melbourne. This project includes up to \$400 million in funding for the Monash Freeway Upgrade;
- \$1.3 billion for regional rail services and infrastructure upgrades designed to better connect people and businesses in regional Victoria and \$1.9 billion to expand and upgrade the metropolitan rail network, boosting performance and reliability; and
- capital funding to meet the demands of a growing population by expanding government school and hospital capacity and investing in public transport rolling stock.

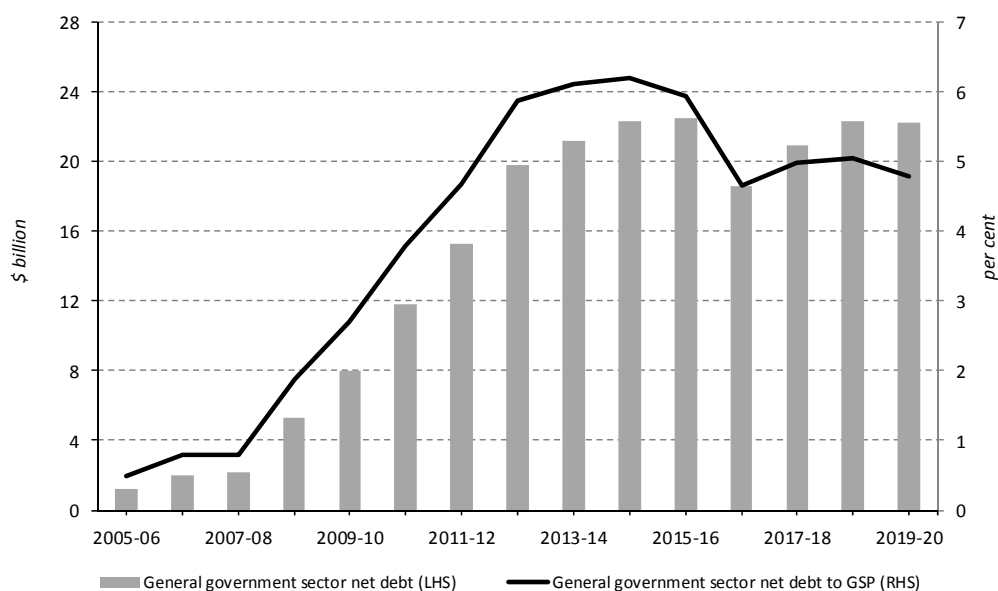
Details of individual asset initiatives can be found in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

## Net debt

Net debt as a proportion of GSP is expected to be 5.9 per cent at June 2016 (Chart 4.2) before declining sharply in 2016-17, largely reflecting the receipt of proceeds from entering into a medium-term lease over the operations of the Port of Melbourne.

Over the forward estimates, net debt to GSP is relatively stable as a result of the Government's infrastructure program being largely funded through surplus operating cash over the period. By June 2020, net debt as a proportion of GSP is expected to be 4.8 per cent.

**Chart 4.2: General government net debt**



Source: Department of Treasury and Finance

The application of cash resources for the general government sector (Table 4.5) outlines the annual movements to net debt. General government sector cash from operating activities is expected to average \$4.8 billion a year over the budget and forward estimates.

Total net investment in fixed assets is also projected to average \$4.8 billion a year over the same period, fully funded from cash from operations over the budget and forward estimates. Other annual movements to net debt primarily reflect the revised timing from entering into a medium-term lease over the operations of the Port of Melbourne.

**Table 4.5: Application of cash resources for the general government sector<sup>(a)</sup>**

(\$ million)

	2014-15 <i>actual</i>	2015-16 <i>revised</i>	2016-17 <i>budget</i>	2017-18 <i>estimate</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>
<b>Net result from transactions</b>	<b>1 214</b>	<b>1 888</b>	<b>2 869</b>	<b>1 797</b>	<b>2 082</b>	<b>2 471</b>
Add back: non-cash revenue and expenses (net) <sup>(b)</sup>	2 605	2 885	2 333	2 562	2 438	2 710
<b>Net cash flows from operating activities</b>	<b>3 819</b>	<b>4 773</b>	<b>5 202</b>	<b>4 359</b>	<b>4 520</b>	<b>5 181</b>
<b>Less: Total net investment in fixed assets<sup>(c)</sup></b>	<b>4 854</b>	<b>3 837</b>	<b>6 328</b>	<b>4 778</b>	<b>4 426</b>	<b>3 650</b>
<b>Surplus/(deficit) of cash from operations after funding net investment in fixed assets</b>	<b>(1 035)</b>	<b>936</b>	<b>(1 127)</b>	<b>( 419)</b>	<b>94</b>	<b>1 531</b>
Finance leases <sup>(d)</sup>	99	1 056	517	647	596	349
Other movements	19	46	(5 536)	1 229	906	1 086
<b>Decrease/(increase) in net debt</b>	<b>(1 153)</b>	<b>( 166)</b>	<b>3 892</b>	<b>(2 294)</b>	<b>(1 409)</b>	<b>97</b>

Source: Department of Treasury and Finance

**Notes:**

- (a) Figures in this table are subject to rounding to the nearest million and may not add up to totals.
- (b) Includes depreciation, movements in the unfunded superannuation liability and liability for employee benefits.
- (c) Includes total purchases of plant, property and equipment, and net capital contributions to other sectors of government net of proceeds from asset recycling.
- (d) The finance lease acquisition in 2015-16 relates to the Victorian Comprehensive Cancer Centre and metropolitan Melbourne buses contract. The 2016-17 estimate relates to the new Bendigo Hospital project, the New Schools PPP project and the metropolitan Melbourne buses contract. The 2017-18 estimate relates to the new Bendigo Hospital project, Ravenhall Prison and the New Schools PPP project. The 2018-19 and 2019-20 estimates relate to the High Capacity Metro Trains Project.

## Unfunded superannuation liability

The Government is on track to fully fund the State's unfunded superannuation liability by 2035. Information on the reported superannuation liability is shown in note 7 of Budget Paper No. 5, Chapter 1 *Estimated financial statements for the general government sector*.

## FISCAL RISKS

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

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

## **General fiscal risks**

### ***State taxes***

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

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

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

### ***Employee expenses***

Employee expenses are always the State's largest expense. Wages policy sets the framework for enterprise agreement negotiations and in part contributes to the projection of employee expenses. The composition and profile of the workforce, and rostering arrangements also contribute to the projection of employee expenses.

### ***Demand growth***

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

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

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

## ***Specific fiscal risks***

### ***National Disability Insurance Scheme***

Victoria hosts a launch site for the National Disability Insurance Scheme (NDIS), which will provide useful information to guide the roll out of the full scheme across the State from July 2016, to be completed by July 2019. On 16 September 2015, the Commonwealth and Victorian Governments signed the Bilateral Agreement for the Transition to a National Disability Insurance Scheme. From 2019-20, Victoria's investment in disability care and support will increase to an estimated \$2.5 billion a year, with the Commonwealth providing around \$2.6 billion a year. Victoria will continue to work with the Commonwealth to monitor and manage any risks associated with implementing the full scheme.

### ***National Injury Insurance Scheme***

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

### ***Commonwealth schools funding***

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

### ***Universal Access to Early Childhood Education***

Commonwealth funding under the National Partnership Agreement on Universal Access to Early Childhood Education provides for one third of the 15 hours per week of pre-school support per student. The *2015-16 Commonwealth Budget* indicated funding due to cease on 1 January 2016 will be continued to 31 December 2017, with ongoing Commonwealth funding uncertain.

## *National Health Reform*

Under the National Health Reform Agreement (NHRA), Commonwealth growth funding is derived from a complex model based on the number of procedures delivered (activity) and an efficient price determined by an independent administrator.

These arrangements were scheduled to cease from 1 July 2017, however, in April 2016 the Commonwealth agreed to continue the NHRA until the end of 2019-20. Conditions attached to the new agreement may increase fiscal risk for the State and are expected to include:

- a national cap on Commonwealth annual expenditure growth of 6.5 per cent (above which the State funds all hospital activity);
- the efficient price paid by the Commonwealth will be adjusted to incorporate quality and safety indicators; and
- coordinated care reforms may expose Victoria to jointly funding primary care programs.

Fiscal risks will become clearer once the details of the new agreement are finalised.

## *Victoria's GST revenue*

The distribution of GST grants between states and territories is determined by the size of the national GST pool and each jurisdiction's population share weighted by its GST relativity. Revenue sharing relativities are determined by the Commonwealth Treasurer, as informed by the recommendations of the Commonwealth Grants Commission (CGC). Revenue drivers of Victoria's GST relativities are discussed in Budget Paper No. 5, Chapter 4 *State revenue*.

There are three specific risks to Victoria's GST revenue.

- Victoria's population growth relative to the national average is a major driver of Victoria's share of the national GST pool. The transition from the mining boom is driving significant shifts in population away from Western Australia in particular. Until these trends in population growth stabilise, this will remain a source of uncertainty for Victoria's GST share. If Victoria's share of net overseas migration remains high, this could see Victoria's share of GST revenue increase.
- The recent strength of the property market has had a positive impact on household wealth and household consumption. The potential for a moderation in growth in the property market creates some uncertainty that could see the national GST pool grow more slowly than anticipated.
- Mining royalties are an important driver for the per capita relativities of each jurisdiction over the forward estimates. Royalty revenue is influenced by commodity prices, the value of the Australian dollar and production and export volumes. Variation in prices, relative to our current forecasts, particularly in iron ore and coal, pose a risk for Victoria's GST revenue.



## CHAPTER 5 – POSITION AND OUTLOOK OF THE BROADER PUBLIC SECTOR

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- The non-financial public sector (NFPS) is estimated to generate operating surpluses over the budget and forward estimates. This reflects the positive outlook in the general government sector which is focused on providing services at the highest level for all Victorians in a fiscally responsible manner.
- NFPS net debt to gross state product (GSP) is estimated to be 9.8 per cent in 2015-16 before declining to 8.4 per cent in 2019-20. The strong outlook for the State's financial position supports Victoria's triple-A credit rating.
- The net result of the public financial corporations (PFC) sector is estimated to be stable over time with surpluses averaging \$600 million a year over the budget and forward estimates.
- The net result from transactions of the public non-financial corporations (PNFC) sector is estimated to be an average deficit of \$477 million a year over the budget and forward estimates.

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

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

**Table 5.1: Summary operating statement for the non-financial public sector**<sup>(a)</sup>

	(\$ million)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
<b>Revenue</b>						
Taxation revenue	17 949	19 659	21 215	20 929	22 044	22 915
Dividends, income tax equivalent and interest <sup>(b)</sup>	1 145	621	963	1 382	867	858
Sales of goods and services	10 596	10 762	10 862	11 167	11 436	11 540
Grants	24 500	25 354	27 418	28 064	28 838	29 951
Other current revenue	3 067	3 449	3 049	2 805	2 824	2 877
<b>Total revenue</b>	<b>57 257</b>	<b>59 846</b>	<b>63 507</b>	<b>64 347</b>	<b>66 010</b>	<b>68 141</b>
<i>% change</i>	<i>2.3</i>	<i>4.5</i>	<i>6.1</i>	<i>1.3</i>	<i>2.6</i>	<i>3.2</i>
<b>Expenses</b>						
Employee expenses	19 859	21 149	22 401	23 234	24 170	24 886
Superannuation <sup>(c)</sup>	3 121	3 104	3 129	3 123	3 134	3 149
Depreciation	4 404	4 617	4 863	5 036	5 398	5 603
Interest expense	2 801	2 711	2 926	2 687	2 737	2 692
Other operating expenses	20 448	21 008	21 805	22 586	22 424	23 021
Grants and other transfers	5 824	5 532	6 509	6 483	6 764	6 854
<b>Total expenses</b>	<b>56 457</b>	<b>58 122</b>	<b>61 634</b>	<b>63 149</b>	<b>64 626</b>	<b>66 205</b>
<i>% change</i>	<i>4.1</i>	<i>2.9</i>	<i>6.0</i>	<i>2.5</i>	<i>2.3</i>	<i>2.4</i>
<b>Net result from transactions</b>	<b>800</b>	<b>1 724</b>	<b>1 873</b>	<b>1 197</b>	<b>1 383</b>	<b>1 936</b>
<b>Total other economic flows included in net result</b>	<b>( 672)</b>	<b>( 232)</b>	<b>( 429)</b>	<b>54</b>	<b>( 194)</b>	<b>( 238)</b>
<b>Net result</b>	<b>128</b>	<b>1 492</b>	<b>1 445</b>	<b>1 252</b>	<b>1 189</b>	<b>1 698</b>

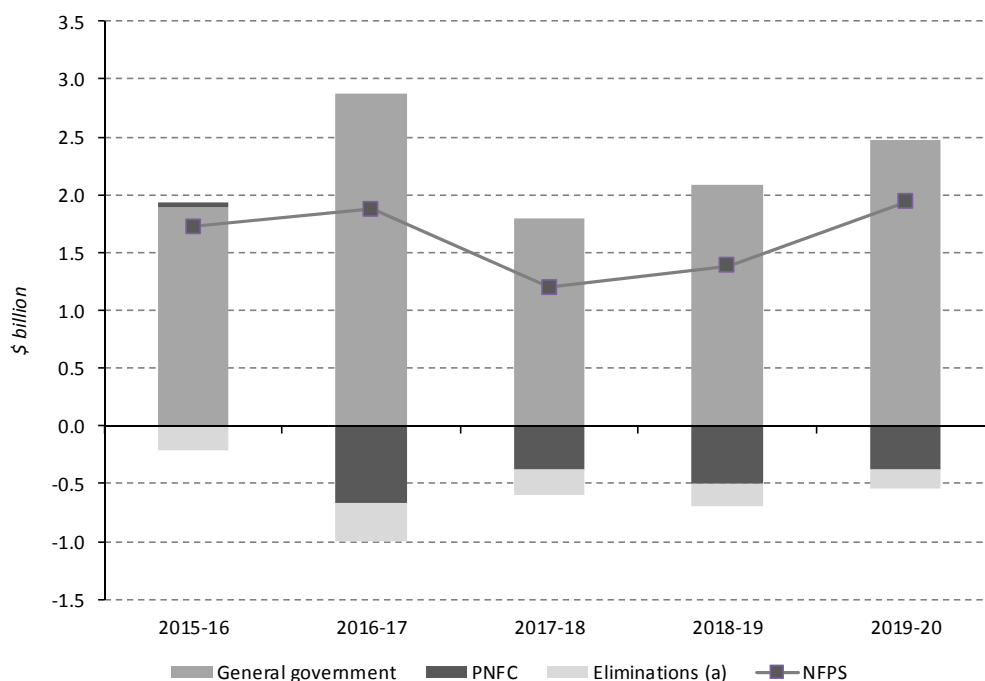
Source: Department of Treasury and Finance

Notes:

- (a) This is a summary operating statement. The comprehensive operating statement is presented in Budget Paper No. 5 Statement of Finances. Figures in this table are subject to rounding and may not add up to the totals.
- (b) Comprises dividends, income tax and rate equivalent revenue and interest.
- (c) Comprises superannuation interest expense and other superannuation expenses.

Table 5.1 shows that the operating performance of the NFPS is forecast to improve over the budget and forward estimates, with the net result from transactions rising to a \$1.9 billion surplus by 2019-20. The improvement is mainly due to the general government sector, which is projected to record a net result from transactions of \$2.5 billion in 2019-20. The components of the NFPS net operating result from transactions are shown in Chart 5.1.

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



Source: Department of Treasury and Finance

Note:

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

The PNFC sector is projected to record an average deficit of \$477.1 million over the budget and forward estimates.

VicTrack is a major contributor towards the operating deficits of the PNFC sector. However over the budget and forward estimates, VicTrack generates significant operating cash flow surpluses averaging \$112.4 million a year. These surpluses do not fully cover depreciation on its significant asset base, resulting in a deficit on the net result from transactions of, on average, \$580.6 million over the budget and forward estimates. However, given the cash flow surpluses, VicTrack is in a financially sustainable position.

Most PNFC entities are projected to record operating surpluses across the budget and forward estimates. The average net result from transactions of the metropolitan water sector is \$242.9 million.

## APPLICATION OF CASH RESOURCES

Table 5.2 shows that the NFPS is projected to generate operating cash flow surpluses averaging \$7.6 billion a year over the budget and forward estimates. The average cash flow surplus in the general government sector is \$4.8 billion and \$3.0 billion in the PNFC sector.

**Table 5.2: Application of cash resources for the non-financial public sector<sup>(a)</sup>**

	(\$ million)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	actual	revised	estimate	estimate	estimate	estimate
<b>Net result from transactions</b>	800	1 724	1 873	1 197	1 383	1 936
Add back: non-cash income and expenses (net) <sup>(b)</sup>	4 419	4 170	10 044	4 567	4 601	4 839
<b>Net cash flow from operating activities</b>	<b>5 219</b>	<b>5 894</b>	<b>11 917</b>	<b>5 764</b>	<b>5 985</b>	<b>6 775</b>
Less:						
Net cash flows from investment in non-financial assets	6 011	5 931	8 548	8 628	8 339	7 373
Net cash flow from investment in financial assets for policy purposes	( 199)	( 368)	( 107)	( 719)	(1 184)	( 661)
<b>Total net investment in fixed assets<sup>(c)</sup></b>	<b>5 811</b>	<b>5 562</b>	<b>8 441</b>	<b>7 909</b>	<b>7 155</b>	<b>6 712</b>
<b>Surplus/(deficit) of cash from operations after funding net investments in fixed assets</b>	<b>( 593)</b>	<b>332</b>	<b>3 476</b>	<b>(2 144)</b>	<b>(1 170)</b>	<b>63</b>
Finance leases <sup>(d)</sup>	99	1 056	517	647	596	349
Other movements	( 129)	(2 118)	(1 028)	(1 283)	(1 185)	( 697)
<b>Decrease/(increase) in net debt</b>	<b>( 622)</b>	<b>( 730)</b>	<b>2 965</b>	<b>(2 781)</b>	<b>(1 758)</b>	<b>( 285)</b>

Source: Department of Treasury and Finance

**Notes:**

- (a) Figures in this table are subject to rounding and may not add up to the totals.
- (b) Includes depreciation and movements in the unfunded superannuation liability and liability for employee benefits.
- (c) Includes total purchases of plant, property and equipment, and capital contributions to other sectors of government net of proceeds from asset sales.
- (d) The finance lease acquisition in 2015-16 relates to the Victorian Comprehensive Cancer Centre and metropolitan Melbourne buses contract. The 2016-17 estimate relates to the new Bendigo Hospital project (stage 1), the New Schools PPP project (tranche 1) and the metropolitan Melbourne buses contract. The 2017-18 estimate relates to the new Bendigo Hospital project (stage 2), Ravenhall Prison and the New Schools PPP project (tranche 2). The 2018-19 and 2019-20 estimates relate to the High Capacity Metro Trains Project.

## Infrastructure

Table 5.2 also provides the estimates of net investment in fixed assets which is infrastructure expenditure net of proceeds from asset sales. Over the budget and forward estimates NFPS total net investments in fixed assets will average \$7.6 billion, of which \$4.8 billion is in the general government sector and \$2.8 billion in the PNFC sector.

The main PNFC sector infrastructure projects under development include:

- investing in transport infrastructure to meet patronage increases, network performance, and developing future capabilities. This includes upgrading regional train services on the Ballarat rail corridor and procuring additional rolling stock with a further 27 VLocity train carriages to meet demand on the regional network. Additional regional rolling stock investments include life-extension works to V/Line trains and carriages. Investment in metropolitan rail infrastructure includes extending rail services to Mernda in Melbourne's northern suburbs, upgrading the Hurstbridge rail corridor and redeveloping the Frankston Station Precinct;
- various water-related infrastructure projects, including Goulburn-Murray Water Connections Project, connecting irrigators to a modernised system of irrigation channels; and
- the Port Capacity project, which includes developing a third international container terminal and a Pre-Delivery Inspection Facility at Webb Dock. This will enhance stevedore competition and ensure that Victoria can continue to respond to trade demand.

## NON-FINANCIAL PUBLIC SECTOR NET DEBT AND NET FINANCIAL LIABILITIES

Table 5.3 details the NFPS net debt and superannuation liabilities. It shows the ratio of net debt to GSP will fall from 9.8 per cent in 2015-16 to 8.4 per cent in 2019-20.

Superannuation liabilities are projected to fall over the forward estimates, resulting in a fall in the net financial liabilities to GSP ratio from 18.6 per cent in 2015-16 to 15.9 per cent in 2019-20.

**Table 5.3: Non-financial public sector net debt and financial liabilities<sup>(a)</sup>**

	(\$ billion)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
<b>Assets</b>						
Cash and deposits	5.4	5.1	5.5	5.5	5.8	6.1
Advances paid	0.1	0.1	0.1	0.1	0.1	0.1
Investments, loans and placements	4.4	4.5	4.4	4.4	4.5	4.6
<b>Total</b>	<b>9.9</b>	<b>9.7</b>	<b>10.0</b>	<b>9.9</b>	<b>10.4</b>	<b>10.8</b>
<b>Liabilities</b>						
Deposits held and advances received	0.6	0.6	0.6	0.6	0.6	0.6
Borrowings	45.8	46.3	43.6	46.4	48.6	49.3
<b>Total</b>	<b>46.4</b>	<b>46.9</b>	<b>44.3</b>	<b>47.0</b>	<b>49.2</b>	<b>49.9</b>
<b>Net debt<sup>(b)</sup></b>	<b>36.5</b>	<b>37.3</b>	<b>34.3</b>	<b>37.1</b>	<b>38.9</b>	<b>39.1</b>
Superannuation liability	26.0	27.9	27.1	26.2	25.2	24.2
<b>Net debt plus superannuation liabilities</b>	<b>62.5</b>	<b>65.2</b>	<b>61.4</b>	<b>63.3</b>	<b>64.1</b>	<b>63.4</b>
Other liabilities (net) <sup>(c)</sup>	5.7	5.4	11.0	10.9	10.8	10.5
<b>Net financial liabilities<sup>(d)</sup></b>	<b>68.2</b>	<b>70.6</b>	<b>72.4</b>	<b>74.2</b>	<b>74.8</b>	<b>73.9</b>
	(per cent)					
<b>Net debt to GSP<sup>(e)</sup></b>	10.1	9.8	8.6	8.8	8.8	8.4
<b>Net debt plus superannuation liability to GSP<sup>(e)</sup></b>	17.2	17.2	15.4	15.1	14.5	13.6
<b>Net financial liabilities to GSP<sup>(e)</sup></b>	18.8	18.6	18.1	17.7	17.0	15.9
<b>Net debt plus superannuation liability to revenue<sup>(f)</sup></b>	109.2	109.0	96.7	98.4	97.1	93.0

Source: Department of Treasury and Finance

Notes:

- (a) Figures in this table are subject to rounding and may not add up to the totals.
- (b) Net debt is the sum of borrowings, deposits held and advances received less the sum of cash and deposits, advances paid, and investments, loans and placements.
- (c) Other liabilities include other employee entitlements and provisions and other non-equity liabilities, less other non-equity financial assets.
- (d) Net financial liabilities is total liabilities less financial assets (excluding investments in other sector entities).
- (e) The ratios to GSP may vary from publications year to year due to revisions to the Australian Bureau of Statistics (ABS) GSP data.
- (f) The sum of non-financial public sector net debt (excluding advances paid) plus the superannuation liability as a proportion of non-financial public sector total operating revenue.

Table 5.4 projects several indicators of financial sustainability for the NFPS which are expected to improve by 2019-20. The improvement is caused by the strengthening of operating cash flow surpluses and receipts from asset sales.

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

The ratio of gross debt to revenue is a measure of indebtedness. The decline in the State's indebtedness compared with 2014-15 and 2015-16 levels are reflected in the improved ratio of interest expense to revenue. This ratio measures the extent to which revenue can be used to fund essential services and infrastructure, rather than to meet debt obligations.

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

	(per cent)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Operating cash flow surplus to revenue	9.1	9.8	18.8	9.0	9.1	9.9
Gross debt to revenue <sup>(a)</sup>	81.0	78.4	69.7	73.1	74.5	73.2
Interest expense to revenue	4.9	4.5	4.6	4.2	4.1	4.0

Source: Department of Treasury and Finance

Note:

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

**Table 5.5: Operating results – State of Victoria<sup>(a)</sup>**

	(\$ million)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
<b>Revenue</b>						
Taxation revenue	17 936	19 644	21 200	20 913	22 030	22 901
Dividends, income tax equivalent and interest <sup>(b)</sup>	1 747	1 886	1 832	1 995	1 971	2 045
Sales of goods and services	13 906	14 192	14 425	14 904	15 300	15 592
Grants	24 377	25 244	27 256	27 931	28 710	29 835
Other current revenue	3 088	3 471	3 072	2 829	2 848	2 902
<b>Total revenue</b>	<b>61 054</b>	<b>64 438</b>	<b>67 786</b>	<b>68 572</b>	<b>70 860</b>	<b>73 275</b>
% change	1.3	5.5	5.2	1.2	3.3	3.4
<b>Expenses</b>						
Employee expenses	19 834	21 124	22 368	23 204	24 111	24 827
Superannuation <sup>(c)</sup>	3 144	3 128	3 153	3 148	3 156	3 171
Depreciation	4 454	4 665	4 911	5 087	5 443	5 642
Interest expense	2 867	2 757	2 979	2 740	2 789	2 745
Other operating expenses	25 544	26 425	27 505	28 618	28 624	29 444
Grants and other transfers	5 822	5 532	6 496	6 470	6 751	6 841
<b>Total expenses</b>	<b>61 665</b>	<b>63 631</b>	<b>67 412</b>	<b>69 267</b>	<b>70 874</b>	<b>72 671</b>
% change	3.7	3.2	5.9	2.8	2.3	2.5
<b>Net result from transactions</b>	<b>( 611)</b>	<b>807</b>	<b>374</b>	<b>( 696)</b>	<b>( 14)</b>	<b>604</b>
<b>Total other economic flows included in net result</b>	<b>661</b>	<b>249</b>	<b>1 191</b>	<b>1 818</b>	<b>1 493</b>	<b>1 518</b>
<b>Net result</b>	<b>51</b>	<b>1 056</b>	<b>1 564</b>	<b>1 122</b>	<b>1 479</b>	<b>2 122</b>

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. Figures in this table are subject to rounding and may not add up to the totals.

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

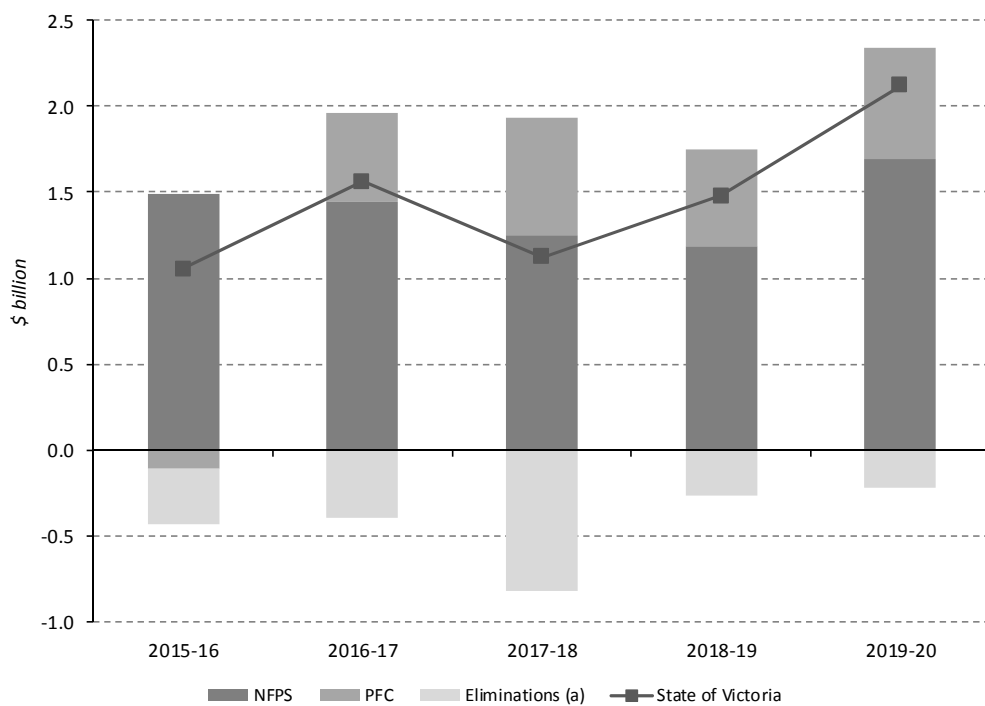
(c) Comprises superannuation interest expense and other superannuation expenses.

Table 5.5 shows the operating result for the State. The net result for the State is projected to be in surplus over the budget and forward estimates. The net result includes other economic flows, which are projected to contribute on average \$1.5 billion a year towards the net surplus over the budget and forward estimates. The other economic flows include projected investment returns of the State’s insurance agencies that are used to service their liabilities.

The PFC sector is forecast to record an average net surplus of \$600 million for the years 2016-17 to 2019-20, primarily due to positive investment returns and valuation gains associated with improved financial market conditions.

The net result, rather than the net result from transactions, is considered a more meaningful measure of the expected operating position of the PFC sector and the State because it includes other economic flows. Other economic flows include valuation gains on revaluation of financial liabilities, which primarily result from movements in bond rates used to value these liabilities.

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



Source: Department of Treasury and Finance

Note:

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



## STATE OF VICTORIA – FINANCIAL POSITION

Table 5.6 shows that the State’s financial position is projected to improve over the budget and forward estimates. Financial assets are estimated to increase by \$7 billion to \$57 billion by 2019-20. Borrowings are estimated to increase from \$52 billion in 2015-16 to \$55 billion by 2019-20. The State’s net assets are forecast to increase from \$142 billion in 2015-16 to \$171 billion by 2019-20.

**Table 5.6: Financial position of the State of Victoria<sup>(a)</sup>**

	(\$ billion)					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	actual	revised	estimate	estimate	estimate	estimate
<b>Assets</b>						
Total financial assets <sup>(b)</sup>	50	50	52	53	55	57
Total non-financial assets <sup>(c)</sup>	210	215	222	234	240	249
<b>Total assets</b>	<b>260</b>	<b>265</b>	<b>274</b>	<b>287</b>	<b>294</b>	<b>306</b>
<b>Liabilities</b>						
Superannuation	26	28	27	26	25	24
Borrowings	52	52	49	52	54	55
Deposits held and advances received	2	2	2	2	2	2
Other liabilities <sup>(d)</sup>	40	42	49	50	52	54
<b>Total liabilities</b>	<b>120</b>	<b>123</b>	<b>127</b>	<b>131</b>	<b>133</b>	<b>135</b>
<b>Net assets</b>	<b>140</b>	<b>142</b>	<b>147</b>	<b>156</b>	<b>161</b>	<b>171</b>

Source: Department of Treasury and Finance

*Notes:*

- (a) Figures in this table are subject to rounding and may not add up to the totals.
- (b) Financial assets include cash and deposits, advances paid, investments, loans and placements, receivables, and investments accounted for using the equity method.
- (c) Non-financial assets include inventories, non-financial assets held for sale, land, buildings, infrastructure, plant and equipment, and other non-financial assets.
- (d) Other liabilities consist of payables, employee benefits and other provisions.



## APPENDIX A – SENSITIVITY ANALYSIS

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The *2016-17 Budget* is predicated on macroeconomic forecasts and assumptions that are subject to variation. This section explores the impact of variations in these parameters on key fiscal aggregates of the general government sector.

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

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

### SENSITIVITY TO INDEPENDENT VARIATIONS IN MAJOR ECONOMIC PARAMETERS

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

**Table A.1: Sensitivity of key fiscal aggregates to selected indicators being 1 per cent higher than expected from 2016-17<sup>(a)(b)(c)(d)(e)(f)</sup>**

(\$ million)

	2016-17 estimate	2017-18 estimate	2018-19 estimate	2019-20 estimate
<b>GSP</b>				
Income from transactions	179	184	197	206
Expenses from transactions	6	(2)	(11)	(20)
<b>Net result from transactions</b>	<b>173</b>	<b>187</b>	<b>208</b>	<b>226</b>
<b>Net debt</b>	<b>(173)</b>	<b>(359)</b>	<b>(567)</b>	<b>(793)</b>
<b>Employment</b>				
Income from transactions	65	62	65	69
Expenses from transactions	(2)	(5)	(8)	(11)
<b>Net result from transactions</b>	<b>67</b>	<b>67</b>	<b>73</b>	<b>80</b>
<b>Net debt</b>	<b>(67)</b>	<b>(134)</b>	<b>(208)</b>	<b>(287)</b>
<b>Consumer prices<sup>(g)</sup></b>				
Income from transactions	293	266	339	387
Expenses from transactions	72	75	65	51
<b>Net result from transactions</b>	<b>221</b>	<b>191</b>	<b>274</b>	<b>336</b>
<b>Net debt</b>	<b>(222)</b>	<b>(423)</b>	<b>(705)</b>	<b>(1 048)</b>
<b>Average weekly earnings</b>				
Income from transactions	33	(17)	32	48
Expenses from transactions	9	8	8	7
<b>Net result from transactions</b>	<b>24</b>	<b>(25)</b>	<b>24</b>	<b>40</b>
<b>Net debt</b>	<b>(24)</b>	<b>1</b>	<b>(23)</b>	<b>(63)</b>
<b>Total employee expenses<sup>(h)</sup></b>				
Income from transactions	33	32	32	33
Expenses from transactions	228	276	296	315
<b>Net result from transactions</b>	<b>(195)</b>	<b>(244)</b>	<b>(264)</b>	<b>(282)</b>
<b>Net debt</b>	<b>195</b>	<b>425</b>	<b>674</b>	<b>942</b>
<b>Domestic share prices</b>				
Income from transactions	2	2	1	5
Expenses from transactions	(0)	(2)	(2)	(2)
<b>Net result from transactions</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>8</b>
<b>Net debt</b>	<b>(3)</b>	<b>(4)</b>	<b>(5)</b>	<b>(11)</b>
<b>Overseas share prices</b>				
Income from transactions	8	5	3	18
Expenses from transactions	(0)	(2)	(2)	(3)
<b>Net result from transactions</b>	<b>8</b>	<b>7</b>	<b>5</b>	<b>21</b>
<b>Net debt</b>	<b>(8)</b>	<b>(13)</b>	<b>(17)</b>	<b>(36)</b>

**Table A.1: Sensitivity of key fiscal aggregates to selected indicators being 1 per cent higher than expected from 2016-17 (continued)**

(\$ million)

	2016-17 estimate	2017-18 estimate	2018-19 estimate	2019-20 estimate
<b>Property prices <sup>(i)</sup></b>				
Income from transactions	99	101	107	112
Expenses from transactions	(3)	(8)	(13)	(18)
<b>Net result from transactions</b>	<b>101</b>	<b>109</b>	<b>120</b>	<b>130</b>
<b>Net debt</b>	<b>(106)</b>	<b>(218)</b>	<b>(342)</b>	<b>(473)</b>
<b>Property volumes</b>				
Income from transactions	58	60	62	66
Expenses from transactions	(1)	(4)	(7)	(10)
<b>Net result from transactions</b>	<b>59</b>	<b>64</b>	<b>70</b>	<b>77</b>
<b>Net debt</b>	<b>(59)</b>	<b>(123)</b>	<b>(193)</b>	<b>(270)</b>
<b>Interest rates <sup>(k)</sup></b>				
Income from transactions	215	164	188	183
Expenses from transactions	6	191	188	169
<b>Net result from transactions</b>	<b>209</b>	<b>(27)</b>	<b>1</b>	<b>14</b>
<b>Net debt</b>	<b>(209)</b>	<b>(377)</b>	<b>(576)</b>	<b>(779)</b>

Source: Department of Treasury and Finance

Notes:

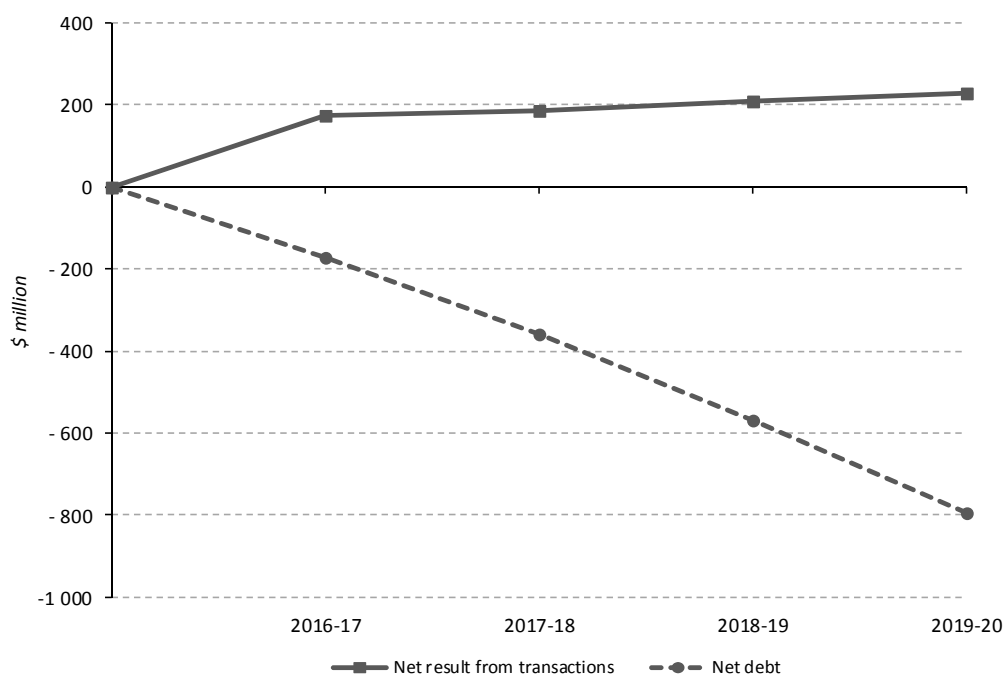
- (a) For the 2016-17 Budget, the Department of Treasury and Finance reviewed the methodology for generating the sensitivity analysis. This resulted in identification of superannuation expense movements which flow through to net debt in more detail, consequently affecting the calculation of the net debt sensitivities to interest rates, consumer prices, employee expenses, domestic and overseas share prices, and property prices.
- (b) Variations are applied to the economic variables in the budget year. For the forward estimates it is assumed that variables' growth rates match those under a no-variation scenario. This implies that economic variables are 1 per cent higher across the budget and forward years compared with a no-variation scenario.
- (c) A positive number for income from transactions denotes an increase in revenue. A positive number for expenses from transactions denotes an increase in expenses (and hence a reduction in the net result from transactions and net result). A positive number for other economic flows represents a gain. A positive number for the net result from transactions and net result denotes a higher surplus or smaller deficit. A positive number for net debt denotes a higher level of net debt in the relevant year compared with a no-variation scenario. Numbers may not balance due to rounding.
- (d) The impact of a 1 per cent lower than expected outcome for an economic variable would, in most instances, simply be the opposite of the impact shown in the table.
- (e) Only reasonably quantifiable impacts have been included in the analysis.
- (f) Estimates of net debt are approximately equal to the cumulative impact of the net result. The difference between the cumulative net result from transactions and net debt is due to non-cash expenses and gross sale proceeds (where applicable).
- (g) A shock to employment is assumed to impact payroll tax revenue to an extent consistent with no change to historical relationships between total employment, part-time/full-time employment shares, and payroll tax revenue.
- (h) Incorporates the impact of departmental funding model arrangements. It is assumed that an increase in consumer prices within the budget year does not affect employee entitlements.
- (i) Represents a one-off 1 per cent increase in total employee expenses relative to a no-variation scenario. This could be generated through a change in the size of the workforce, the price of the workforce (salaries, overtime, allowances and bonuses, long service leave expenses, fringe benefits tax and WorkCover premiums) or through other management decisions regarding the composition and profile of the workforce.
- (j) Other economic flows include gross sale proceeds from land and buildings.
- (k) Assumes interest rates are 1 percentage point higher across the entire term structure (i.e. short and long-term rates, over the budget and forward estimates period).

## Sensitivity to gross state product

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

Based on Table A.1, if GSP was 1 per cent higher than forecast in 2016-17, the net result from transactions would increase by \$173 million. An increase in the net result would lower net debt by the same amount. Over the budget and forward estimates, the increased surpluses would reduce the stock of net debt by \$793 million.

**Chart A.1: Sensitivity of key fiscal aggregates to GSP being 1 per cent higher than expected from 2016-17<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

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

## Sensitivity to interest rates

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

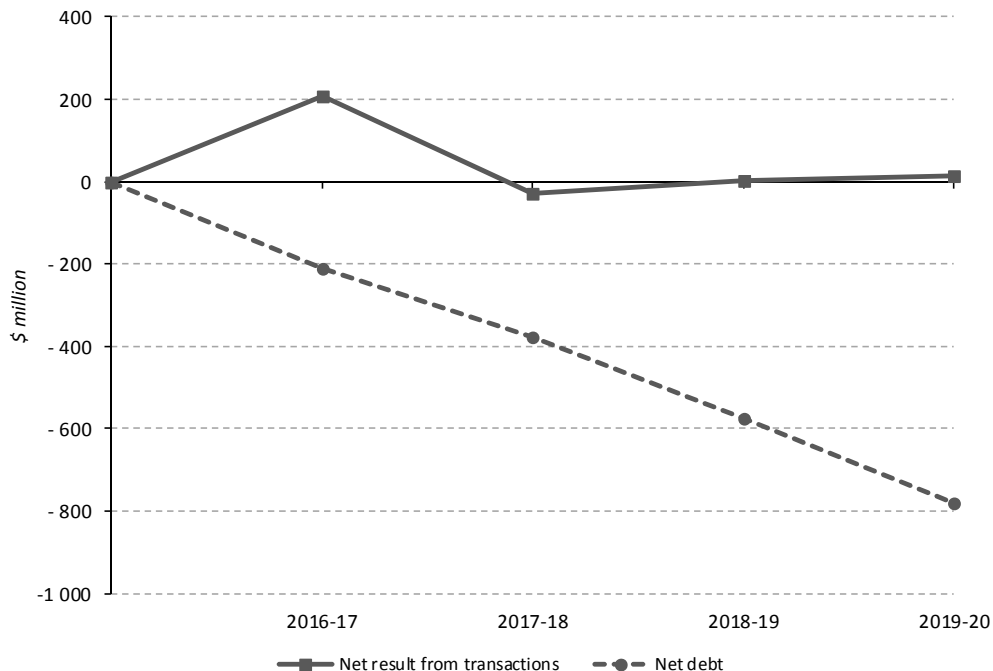
As dividends of the State’s insurance agencies are based on performance from insurance operations, which excludes the initial impact of discount rate movements, the increase in interest rates will have little direct impact on dividends in the budget year. As income tax equivalents (ITEs) of the insurance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

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

An increase in interest rates also increases the superannuation expense and borrowing cost of the general government sector over the forward estimates. The increase in the superannuation expense of approximately \$200 per annum, that is associated with an increase in interest rates, is a non-cash item. Therefore, it does not have an impact on net debt.

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

**Chart A.2: Sensitivity of key fiscal aggregates to interest rates being 1 percentage point higher than expected from 2016-17<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

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

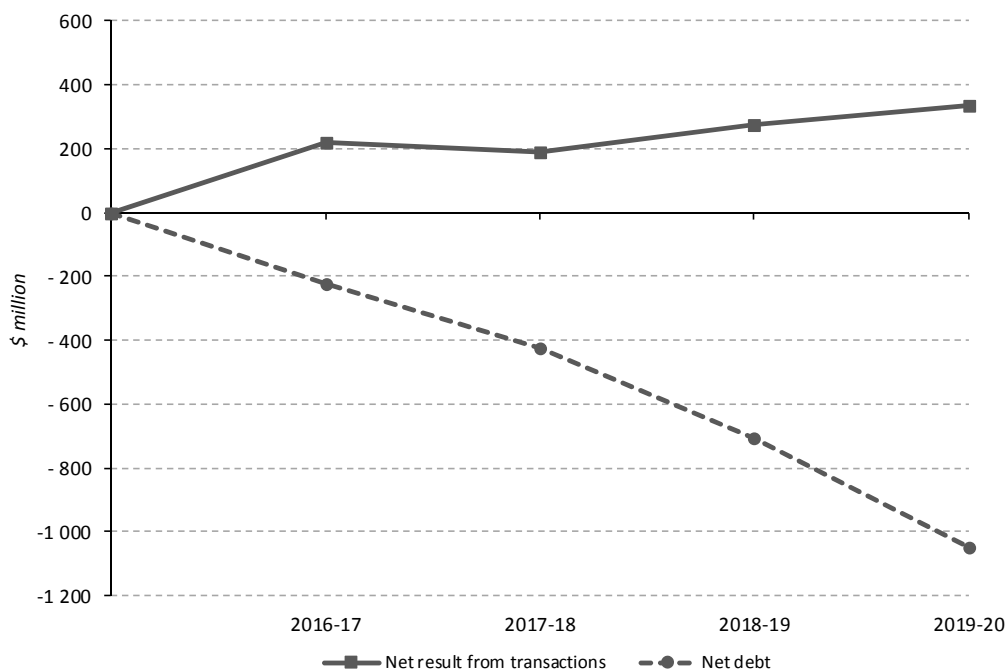
## Sensitivity to consumer prices

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

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

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

**Chart A.3: Sensitivity of key fiscal aggregates to consumer prices being 1 per cent higher than expected from 2016-17<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

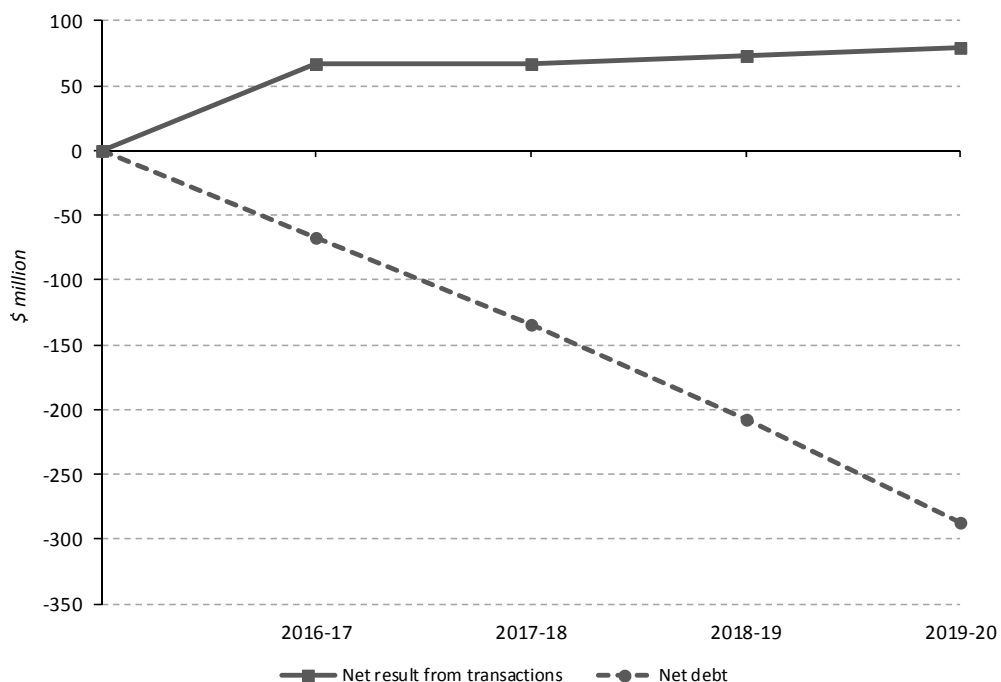
(a) See footnotes for Table A.1 for detailed description of estimates.



## Sensitivity to employment

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

**Chart A.4: Sensitivity of key fiscal aggregates to employment being 1 per cent higher than expected from 2016-17<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

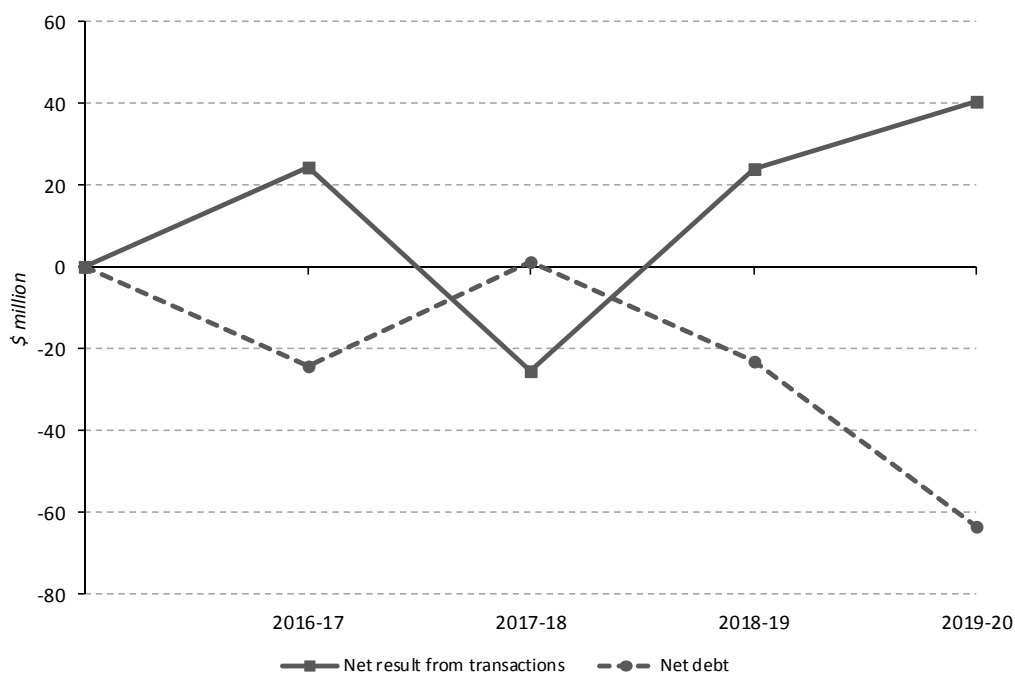
(a) See footnotes for Table A.1 for detailed description of estimates.

## Sensitivity to average weekly earnings

A rise in the level of wages in the economy (but not in the public sector) results in higher payroll tax revenue each year. An increase in the average expense per claim for WorkSafe Victoria reduces ITEs. This is partially offset by increased premium revenue. Overall, these effects lead to a higher net result from transactions over most of the budget and forward estimates.

The negative net result from transactions in 2017-18 is driven by an increase in claims for WorkSafe Victoria. A decline in claims for the following two years results in a positive net result from transactions.

**Chart A.5: Sensitivity of key fiscal aggregates to average weekly earnings being 1 per cent higher than expected from 2016-17<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

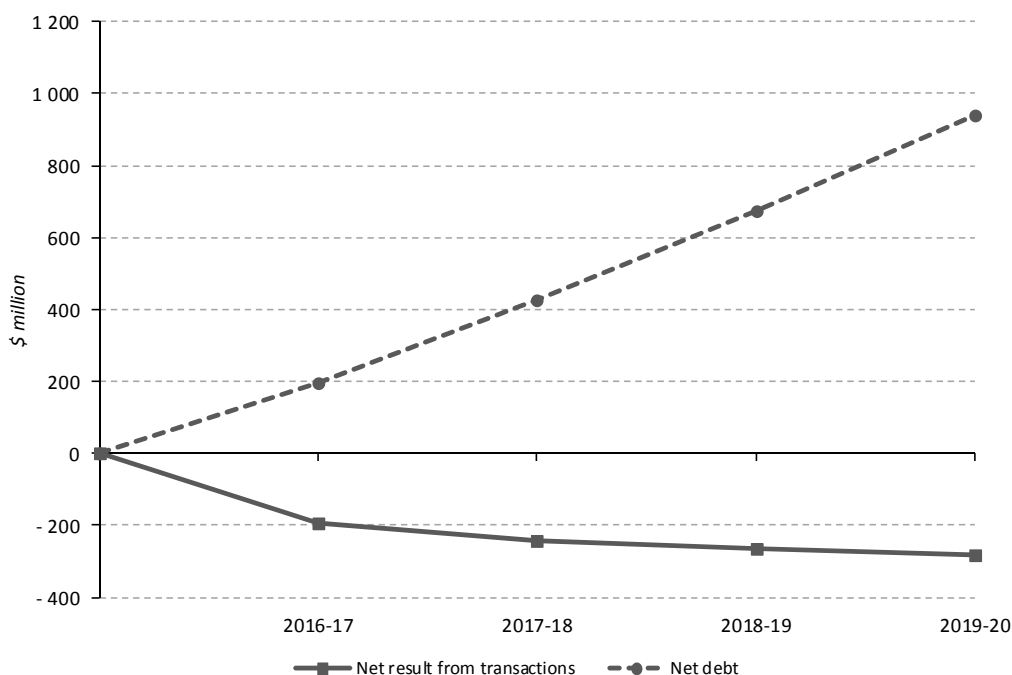
(a) See footnotes for Table A.1 for detailed description of estimates.

## Sensitivity to total employee expenses

An increase in employee expenses above forecast levels could be generated through a policy decision to increase the public sector workforce, a change to the price paid to the workforce, through other management decisions regarding the composition and profile of the workforce, or any combination of these that increases the total employee expenses base by 1 per cent.

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

**Chart A.6: Sensitivity of key fiscal aggregates to total employee expenses being 1 per cent higher than expected from 2016-17<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

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

## **Sensitivity to domestic and overseas share prices**

A rise in share prices increases the net results of the State's insurance agencies. This leads to an increase in the ITEs payable to the State; however the availability of carry-forward tax losses means there is no significant impact on ITEs until 2019-20. There is no significant impact on underlying dividends payable to the State as these are based on the agencies' performance from insurance operations, which excludes the impact of investment returns being higher than the agencies' budgeted long-term rates of return.

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

## **Sensitivity to property prices and volumes**

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

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

## **SENSITIVITY TO VARIATIONS IN THE ECONOMIC OUTLOOK**

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

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

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

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

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

## 2006-07 – economic growth exceeding expectations

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

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

	(per cent)		
	2006-07 budget <sup>(a)</sup>	2006-07 actual	Forecast error <sup>(b)</sup>
Real GSP <sup>(c)</sup>	3.3	3.5	0.2
Employment	1.3	3.2	1.9
Consumer price index	2.5	2.6	0.1
Wage price index <sup>(d)</sup>	3.5	3.6	0.1

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

*Notes:*

(a) Forecast in May 2006 for 2006-07 Budget.

(b) Percentage point variation.

(c) Actual growth rates may differ from those in previous publications due to revisions in Australian Bureau of Statistics data.

(d) Wage Price Index, Victoria (based on total hourly rates of pay, excluding bonuses).

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

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

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

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

(\$ million)

	2006-07 budget	2006-07 actual	Forecast error	Forecast error (%)
Payroll taxes	3 418	3 479	61	2
Land transfer duty	2 424	2 961	537	22
Other own-sourced revenue	5 129	5 262	133	3
<b>Taxation revenue</b>	<b>10 971</b>	<b>11 702</b>	<b>731</b>	<b>7</b>
Other revenue	13 002	14 600	1 598	12
GST	8 469	8 584	114	1
<b>Total revenue</b>	<b>32 442</b>	<b>34 886</b>	<b>2 444</b>	<b>8</b>
<b>Total expenses</b>	<b>32 125</b>	<b>33 521</b>	<b>1 426</b>	<b>4</b>
<b>Net result from transactions</b>	<b>317</b>	<b>1 365</b>	<b>1 018</b>	<b>321</b>

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 GDP and consumption. The impact of the GFC on employment was relatively small due to employers choosing to reduce hours and accept productivity falls rather than lay off staff. As a result, the forecast error of employment was smaller. Consumer prices and wages were less affected by the global financial crisis and consequently the level of forecast error was much lower for these variables.

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

(per cent)

	2008-09 budget <sup>(a)</sup>	2008-09 actual	Forecast error <sup>(b)</sup>
Real GDP <sup>(c)</sup>	3.0	1.5	(1.5)
Consumption (unpublished)	2.8	0.5	(2.3)
Employment	1.5	0.9	(0.6)
Consumer price index	3.0	2.8	(0.2)
Wage price index <sup>(d)</sup>	3.8	4.0	0.3

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

**Notes:**

(a) Forecast in May 2006 for 2006-07 Budget.

(b) Percentage point variation.

(c) Actual growth rates may differ from those in previous publications due to revisions in Australian Bureau of Statistics data.

(d) Total hourly rate excluding bonuses.

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

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

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

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

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

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

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

(\$ million)

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

Source: Department of Treasury and Finance





## STYLE CONVENTIONS

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

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

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

Please refer to the **Treasury and Finance glossary for budget and financial reports** at [dtf.vic.gov.au](http://dtf.vic.gov.au) for additional terms and references.



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