



Getting on with the job

Victorian Budget 17/18 Strategy and Outlook

Budget Paper No. 2
Presented by Tim Pallas MP,
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Strategy and Outlook

2017-18



Presented by

Tim Pallas MP

Treasurer of the State of Victoria

for the information of Honourable Members

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CHAPTER 1 – ECONOMIC AND FISCAL OVERVIEW

The Government's third budget gets on with the job of delivering the infrastructure and services that Victorians need to live healthy and productive lives. The *2017-18 Budget* is underpinned by strong economic management and jobs creation. It builds on the billions already invested in honouring commitments of better schools, better hospitals, better transport, and more jobs.

This budget ensures every Victorian is given the opportunity to prosper by addressing the issues important to families, small businesses, to our kids and students, and to the most vulnerable in our society. It invests in the building blocks of a fair and thriving state where all Victorians are able to live healthy lives, and are able to learn, work and enjoy themselves.

A strong economy is vital for the prosperity of all Victorians. Victoria's economy grew by 3.3 per cent in 2015-16, significantly above the national average. Victorians are sharing in the benefits of growth, with gross state product (GSP) per capita growing at 1.4 per cent in 2015-16 – a vast improvement on the negative per capita growth in 2013-14. Since the election in 2014, more than 200 000 jobs have been created – equating to more than 250 new jobs created every day. This budget enables all Victorians to share in the opportunities and benefits that strong growth creates.

Victoria's finances are in excellent shape, with operating surpluses averaging \$2.4 billion over the forward estimates. This budget prioritises much needed investment in the infrastructure and services that Victorians rely upon now and for the future. This budget continues to highlight the Government's strong belief in playing an active role in driving strong, sustainable growth for all Victorians.

The *2017-18 Budget* consolidates our investment in previous budgets, with an additional \$2 billion for public transport and almost \$2 billion for roads. Investments like these mean Victorians can spend less time commuting and more time with their families. New infrastructure investment announced by this Government is expected to generate more than 50 000 jobs.

The *2017-18 Budget* invests up to \$1.9 billion to continue implementing the recommendations of the Royal Commission into Family Violence. Combined with the single largest investment in Victoria's police force, the Government is making the necessary investments to keep Victorians safe.

This budget provides for the services that Victorians need. It supports education for all, with \$1.3 billion for schools and early childhood. It provides \$2.9 billion for quality health care, including services for mental health and Victorians living with disability. It supports new opportunities for vulnerable members of our community and workers in transition. It invests in initiatives to support Aboriginal and Torres Strait Islander Victorians to ensure that they share in the opportunities that a strong community can deliver. This budget contributes to the Government's vision of a healthy and prosperous society that does not leave anyone behind.

The *2017-18 Budget* builds on the Government's strong record of investing in the regions. Significant investment in services and infrastructure will deliver jobs and new opportunities for Victorians who live in rural and regional communities. In addition, the *2017-18 Budget* invests in key services and infrastructure identified by the Regional Assemblies and Partnerships.

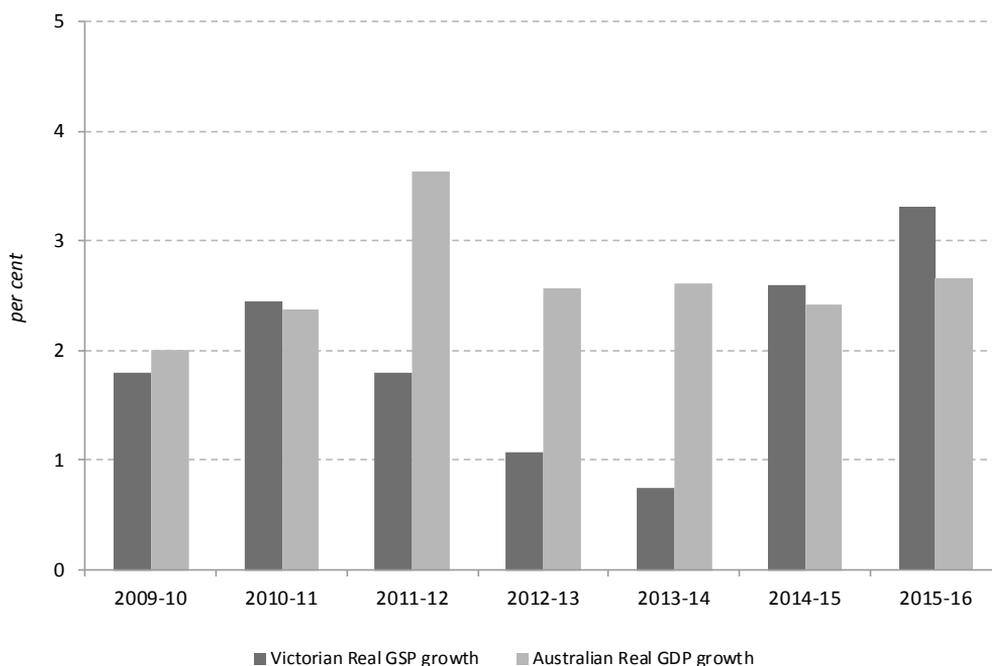
This budget continues the Government's investment strategy to plan capital programs over the medium term with funding allocated beyond the forward estimates. By expanding the capital horizon to 10 years, our strategic planning strikes a balance between investing in infrastructure needed such as the M80 Ring Road and the Mordialloc Bypass, while growing investments in existing services.

A STRONG, GROWING ECONOMY

Strong growth in our economy and population

Victoria's economy remains strong. Victoria's GSP grew by 3.3 per cent in 2015-16, compared with Australian gross domestic product (GDP) growth of 2.7 per cent over the same period (Chart 1.1). Economic growth has picked up significantly since 2014, with GSP consistently outgrowing Australian GDP for the first time in a decade. The budget forecasts robust economic growth to continue over the next four years.

Chart 1.1: Victorian gross state product growth compared with Australian gross domestic product growth, 2009-10 to 2015-16 (chain volume)



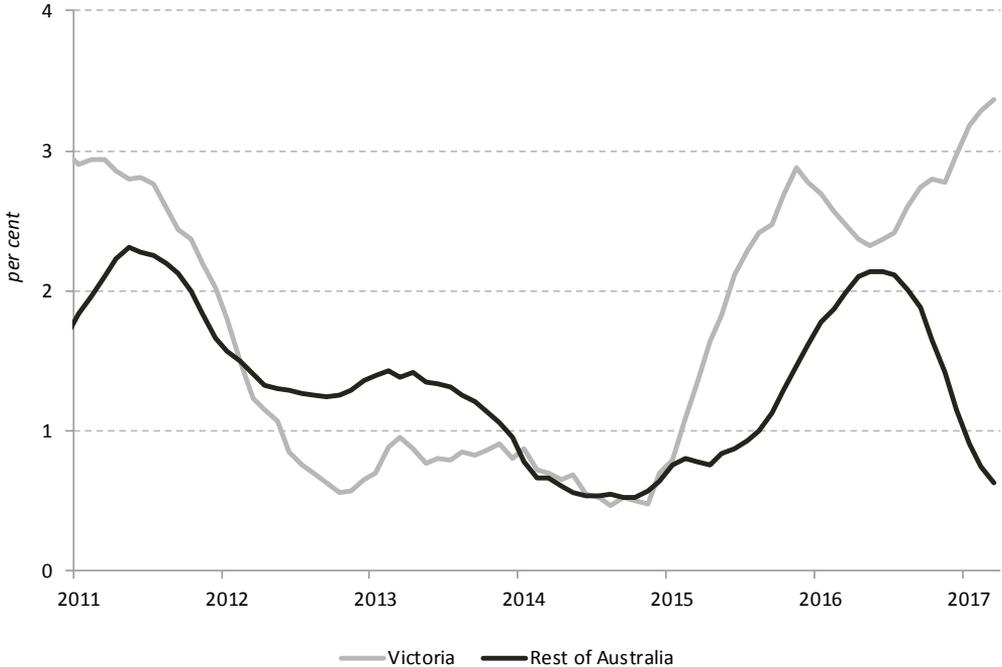
Source: Australian Bureau of Statistics

Continuing to contribute to strong growth in the Victorian economy are household consumption, business investment and dwelling investment supported by low interest rates. Business sentiment has improved. Wages have also been increasing moderately and this is forecast to continue over the next four years. Our exports are rising – service exports grew by 4 per cent in 2015-16 and are expected to continue to grow at trend. These trends underpin continued growth in our economy and in employment.

Victoria's population has been growing quickly at 2.1 per cent over 2015-16, reflecting our economic opportunities and attractiveness as a place to live. Our growing population is a major driver in supporting our economic strength; it injects new skills and new ideas into our communities. The Government is managing Victoria's growth with significant investments in infrastructure and in our people.

Victoria continues to lead the nation in job creation. More than 200 000 jobs have been created in Victoria since this Government was elected. In the year to March 2017, employment grew by an average of 3.4 per cent. This was the strongest among the states, and a stark contrast to average employment growth for the rest of the nation, at only 0.6 per cent (Chart 1.2). Victoria’s regional labour market is one of the strongest in the nation – employment grew by 2.1 per cent in 2016. Demonstrating the significant improvement in Victorians’ job prospects, the labour force participation rate is at its highest since 2011, averaging more than 65 per cent in 2016. Unemployment has declined from the recent highs seen in October 2014.

Chart 1.2: Employment growth, Victoria and rest of Australia, 12-month moving average, 2011-2017



Source: Australian Bureau of Statistics

A financially sound position

The *2017-18 Budget* continues the Government's commitment to maintain a strong fiscal position to set Victoria up for the future, by ensuring revenue growth exceeds expenditure growth, and a net debt to GSP ratio of no more than its peak over the past five years by the end of the forward estimates. This budget invests in services required for a growing population and in the communities where people work and live. It continues to invest in infrastructure to support growth in the long term, recognising the importance of prudent spending and saving when conditions are favourable.

The general government sector operating surplus (net result from transactions) is estimated to be \$1.2 billion in 2017-18, growing to \$2.7 billion by 2020-21, putting Victoria in a stronger fiscal position each year. Over the budget and forward estimates, expenses are expected to grow by 3.2 per cent a year on average compared with revenue growth of 3.7 per cent on average. Net debt as a percentage of GSP remains below the level of 6.2 per cent inherited by this Government.

The *2017-18 Budget* funds \$9.6 billion of new output initiatives, with a socially progressive, inclusive agenda for health, education, family violence, police and housing.

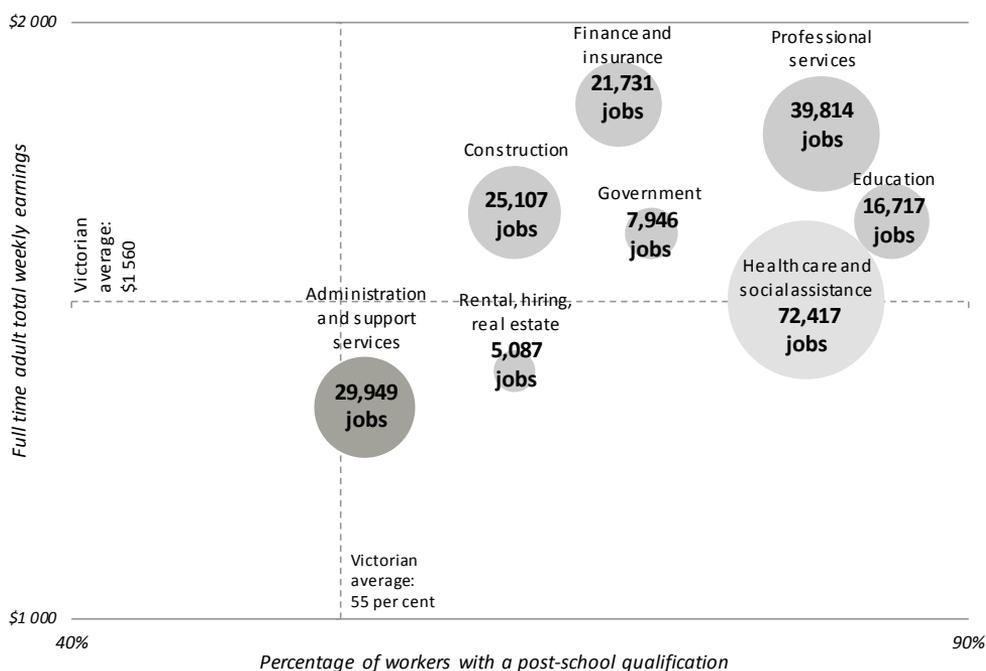
The Government is also investing up to \$6.1 billion in new asset initiatives, continuing to support the Government's track record of investment in infrastructure to improve the lives of all Victorians. Government infrastructure investment will surge over the next four years, averaging \$9.6 billion a year compared with an average of \$5.6 billion a year over the decade to 2016-17.

The decisions taken by the Government in this budget are consistent with the metrics that underpin a triple-A credit rating.

CREATING AND PROTECTING JOBS

The Government has an enviable record of jobs growth, with more than 200 000 new jobs created since November 2014. New jobs have been created across the economy. Chart 1.3 shows the industries in which these new jobs are being created, with the number of new jobs shown by circle size, and industries in the top right quadrant having higher average wages and skills.

Chart 1.3: Number of new jobs in Victoria, by skill and wage characteristics of industries, November 2014 – February 2017 (selected industries) ^(a)



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

Note:

(a) Size of bubble represents the change in the level of employment over a 27-month period. Industries have been excluded where they make up less than 2.75 per cent of State gross value added.

By supporting efficient and reliable infrastructure; skilled, innovative and healthy people; and an economy that allows all families and communities to share in the benefits of growth, the 2017-18 Budget supports growth that delivers for all Victorians.

Infrastructure investment is creating and protecting jobs

The growth in Victoria's population has placed additional demands on our infrastructure, and the Government's response is critical to ensuring that Victorians can access employment, education and public services easily and safely.

The Government's first two budgets prioritised the infrastructure investment that Victoria needed, which will benefit Victorians for many years to come. The Government has a strong infrastructure pipeline, and in 2017-18 the Government will continue its major infrastructure program to build Victoria and deliver services to the community.

The \$5.5 billion West Gate Tunnel Project alone is estimated to add more than 6 000 new jobs, including for apprentices and former auto workers. The \$10.9 billion Metro Tunnel has commenced and is estimated to contribute 4 700 new jobs.

The *2017-18 Budget* invests more than \$2 billion in major infrastructure projects that will create thousands of jobs for Victorians, including in regional areas. In total, this Government has announced new infrastructure investment that is expected to generate more than 50 000 jobs.

The Government's commitment to delivering infrastructure will grow our economy, create and protect jobs and deliver benefits for Victorians well into the future.

Investing in businesses and Victorian jobs

The Government is making prudent investments to support jobs and workers with new opportunities well into the future. The *2017-18 Budget* facilitates investment throughout Victoria, and particularly for Victorians who need additional support. The budget continues to facilitate a pipeline of private sector investment and job creation in Victoria, with \$90 million to support jobs in key strategic and priority sectors, and locations with high levels of disadvantage; and \$10.2 million for Jobs Victoria to increase the impact of social enterprises and assist retrenched workers across Victoria to find new jobs with tailored support services.

This budget supports businesses by bringing forward the payroll tax-free threshold increase by one year, making it easier for approximately 37 800 businesses to invest and create new jobs sooner. The payroll tax-free threshold will now increase to \$625 000 in 2017-18 and \$650 000 in 2018-19, one year earlier than previously scheduled. In an Australian first, the Government will incentivise job creation in regional Victoria by reducing the payroll tax rate from 4.85 per cent to 3.65 per cent for businesses where 85 per cent of their payroll comprises employees working in regional areas. Around 4 000 businesses will be able to reinvest these savings in their local economies, to ensure that the benefits of economic growth are shared with our regions.

Tourism is an important export industry for Victoria. Over the year to December 2016, Victoria welcomed 2.7 million international visitors who spent a total of \$6.9 billion. A further \$24.8 million on tourism initiatives will boost Victoria's economy, attracting interstate and overseas visitors. The funding will enable Visit Victoria to expand and fund campaigns to attract visitors from around the world.

The Government is increasing the reliability, affordability and sustainability of Victoria's energy supplies by providing \$122 million to advance new technologies and build our knowledge and skills in important industries for Victoria's future. The budget includes funding to inform Victorians about improving energy efficiency and comparing prices; help energy consumers and businesses with energy efficiency upgrades; invest in the solar tram program to promote renewable energy; and trial and advance new large-scale energy storage initiatives.

Protecting Victorian jobs

Economic transformation has benefited many Victorians, but there has also been change for some workers and regions. The Government has helped affected regions through these difficult times. Since the reduction of motor vehicle manufacturing in Geelong, the Government's direct assistance has contributed to a reduced unemployment rate in that region in line with the State's average of 6 per cent. The Latrobe-Gippsland labour market has improved in the past six months. In the six months to the March quarter 2017, employment grew by 12.8 per cent.

The Government is continuing to help communities in transition. This budget extends support for businesses with \$15 million through the Future Industries Manufacturing Program (FIMP) and Local Industry Fund for Transition (LIFT) grant programs. These programs respectively support businesses to invest in new manufacturing processes and technologies, and support businesses in the Geelong, north, west and south-east Melbourne regions affected by automotive manufacturing closures. The budget also provides \$110 million for plantation establishment, to support Victorian timber industry workers in the Latrobe Valley.

QUALITY TRANSPORT

The Government is investing to deliver more transport infrastructure. The biggest public transport project in Australia – the Metro Tunnel – is well underway. Victorians are already beginning to see the results of the Government's ambitious Level Crossing Removal Program, with 10 level crossings removed. These projects help to achieve a safer, faster and more efficient road and rail network, which improves productivity and allows Victorians to spend more time with their families.

Public transport

The Government is helping Victorians to get home safer and sooner by investing in Victoria's public transport network.

The *2017-18 Budget* includes a \$1.1 billion regional public transport investment. Along with a number of initiatives to deliver major maintenance, assets and upgrades, the Government is investing in a Regional Rail Revival plan with a \$435 million Gippsland Rail Upgrade to increase frequency, reliability, punctuality, and safety along the Gippsland train line.

This is part of a \$1.5 billion plan, which will better connect communities, mean more frequent and reliable train travel for regional Victorians, and help create thousands of new jobs across regional Victoria. Funding of further initiatives under the plan requires full receipt of Victoria's entitlement under the National Partnership Agreement on Asset Recycling from the Commonwealth (Box 1.1).

This budget invests nearly \$879.5 million in new metropolitan and associated public transport services and infrastructure that will provide more trains, trams and bus services, improve safety and access to stations and plan for future services to address demand growth. Major new initiatives include:

- \$218.1 million over the next four years to order 10 more E-Class trams – built in Dandenong – and provide new infrastructure to support Melbourne's modern tram network;
- extension of the Night Network, with \$193.2 million allocated to provide safe, 24-hour public transport on weekends in Melbourne and some regional locations, to give Victorians more options to work and socialise, improve safety and contribute to the night-time economy;
- \$187.4 million to construct new train stabling facilities at Kananook to prepare for longer term growth of the Frankston Line;
- preparing and planning for network-wide improvements to Melbourne's rail services through a \$84.9 million network transition program;
- adding to services across Melbourne's train, tram and bus network, providing additional station carparks, and investing in Melbourne's busiest stations to reduce travel times and improve the commuter experience, with \$84.4 million; and
- investing \$67 million to improve passenger safety on the train network.

Better rail and public transport in regional Victoria ensures communities are well connected and all Victorians can get where they need to go, regardless of where they live.

Roads

Victoria's growing population is demanding more of our road network. This budget invests over \$1.9 billion in our roads, and, in 2017-18 alone, the Government will spend \$384 million fixing roads across the State to improve safety and reliability, including bridge strengthening and road re-surfacing.

This budget invests in a significant road upgrade package, with \$700 million towards the M80 Ring Road Upgrade. Sections of the M80 will be widened and enhanced with cutting edge traffic management infrastructure to improve safety and combat congestion for 160 000 drivers who use the freeway every day. The Government has committed \$100 million to deliver pre-construction activities for the North East Link, which will help to better connect Melbourne and relieve congestion in Melbourne's north, south and east, complementing the Government's West Gate Tunnel Project. A further \$300 million in funding has been committed for the Mordialloc Bypass.

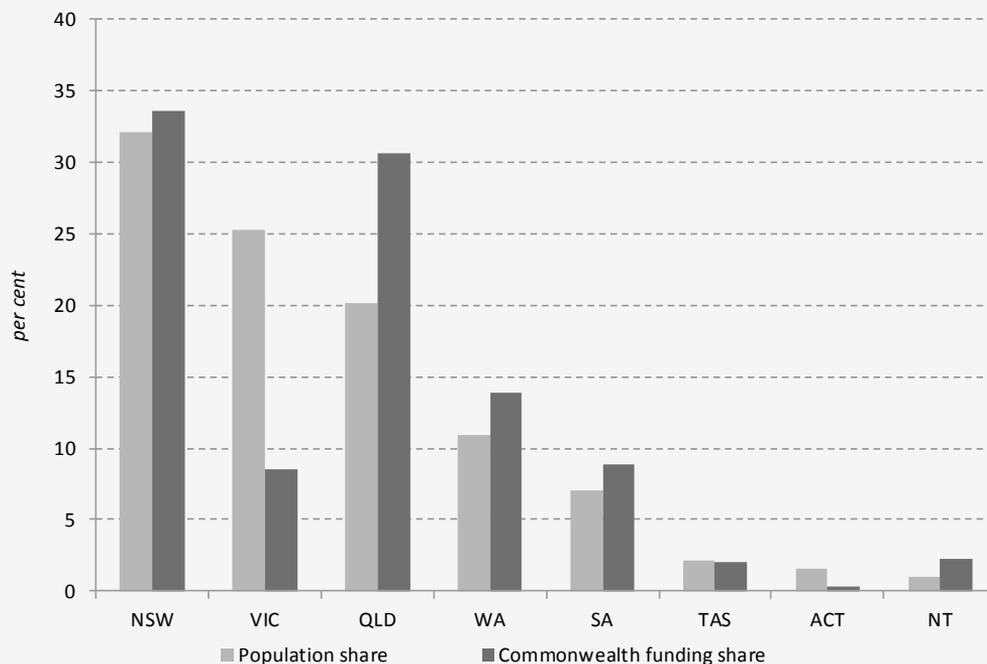
Over the next four years, the Government is also spending \$530.6 million to maintain and upgrade regional roads and bridges. This includes a suite of initiatives to ensure that regional roads are safe and connect Victorians across the State, including the South Gippsland Highway, the Great Ocean Road, roads servicing the Port of Portland, and the Shepparton Bypass. The Government is also developing a pipeline of projects across Victoria to implement its response to Infrastructure Victoria’s 30-year infrastructure strategy.

The Commonwealth Government is providing support towards some of these initiatives, however the level of funding is well below that being received by most other states and territories, especially as a share of population (see Box 1.1).

Box 1.1: Commonwealth funding

Victoria has the fastest growing population in Australia but continues to receive significantly less than its fair share of Commonwealth infrastructure grant funding. Despite accounting for around 25 per cent of the Australian population, Victoria has historically received well below its fair share of Commonwealth infrastructure funding. Based on the latest Commonwealth budget publication, the *Mid-Year Economic and Fiscal Outlook*, Victoria will only receive 8.5 per cent of allocated Commonwealth infrastructure funding to the states and territories between 2015-16 and 2019-20 (Chart 1.4).

Chart 1.4: Share of Commonwealth infrastructure funding 2015-16 to 2019-20



Source: Department of Treasury and Finance

Assuming other states' funding remains the same, Victoria would need to receive an additional \$6.6 billion in Commonwealth infrastructure grant funding over this period to achieve its population share. Payment in full of the \$1.5 billion owed to Victoria under the National Partnership on Asset Recycling would be a first step in addressing this imbalance. The Commonwealth Government has shown that it is unwilling to fully honour the National Partnership on Asset Recycling, which was entered into in good faith.

The clauses in the Asset Recycling National Partnership are unambiguous that the Commonwealth will provide funding to participating states based on the actual value of assets sold – with an initial payment made based on estimated value, and a second payment to adjust for the final result. Despite this, the Commonwealth has yet to provide Victoria with any payment consistent with the terms of the agreement.

These payments are not a windfall gain to the states, but were designed to compensate participating states for the value of lost dividends and income tax equivalent payments when assets are transferred from the public to private sectors. As the Commonwealth receives additional company tax revenue following any asset lease or sale, it is appropriate that this revenue is returned to the states so they are not left worse off for pursuing important reforms. This revenue should be returned to Victoria as originally intended, and as required under the terms of the National Partnership on Asset Recycling.

FAIR, EQUITABLE AND THRIVING COMMUNITIES

Fairness and equity are fundamental building blocks for Victorian society. This Government believes all Victorians deserve the opportunity to thrive – regardless of where they are or what their background is. As Victoria's economy grows, all Victorians must share in the benefits.

Family violence

The *2017-18 Budget* has made dealing with family violence a priority, building on funding \$572 million in last year's budget for housing and modernised crisis refuges to create safe, liveable spaces. It also funded counsellors, prevention programs and provided support for families.

This budget makes an unprecedented investment of an additional \$1.9 billion to implement *Ending Family Violence: Victoria's Plan for Change*, the next stage of a decade-long agenda of action and investment to protect victims, hold perpetrators to account, and change community attitudes.

It will establish Support and Safety Hubs – crucial contact and referral points for survivors to get the support and services they need. They will be established at 17 locations around Victoria, starting with Barwon, Bayside Peninsula, Inner Gippsland, Mallee and north-east Melbourne regions from late 2017, with funding of \$448.1 million. There will also be \$270.8 million made available to assist victims, with after-hours crisis support and financial counselling and therapeutic support, including a focus on children and Aboriginal victims.

Victims of family violence often need a safe place to stay to start their recovery. The budget will provide \$133.2 million on housing support for victims of family violence, to establish long-term social housing and finish the job of modernising family violence refuges. This will include new Aboriginal family violence refuges.

Specialist Family Violence Courts will be funded with \$130.3 million, to provide increased safety, support and services to family violence victim survivors and perpetrators. These will be fully implemented in Ballarat, Frankston, Shepparton, Moorabbin and Heidelberg.

The Government's family violence agenda requires continued effort – both to implement *Free from violence: Victoria's strategy to prevent family violence and forms of violence against women*, as well as continually looking at new ways of preventing family violence. The Government is investing \$50.7 million in this strategy and the establishment of a dedicated prevention agency.

Healthy communities

The *2017-18 Budget* builds on investment in the Government's previous two budgets with an additional \$2.9 billion to ensure Victorians receive world-class healthcare, regardless of where they live.

This includes a massive injection of almost \$1.6 billion over four years (including funding from the Commonwealth) to respond to the growing patient demand across Victoria in all facets of health care including: emergency departments, intensive care and maternity admissions, specialist clinics, palliative care services, chemotherapy treatments, radiotherapy treatments and sub-acute care services.

Improving our hospitals

The budget sets aside funding for a number of upgrades to Victoria's hospitals and equipment. It funds:

- a \$162.7 million expansion of the Northern Hospital, with 96 new in-patient beds, three new operating theatres and space for future expansion;
- \$69.8 million to upgrade key infrastructure at the Austin and Royal Melbourne hospitals;
- \$63.2 million to upgrade the Monash Medical Centre with an emergency department that caters for both adults and children. Upgrades will include an additional 24 emergency department cubicles and an extra 10 short-stay beds;
- \$50 million to improve the current Footscray Hospital and start planning for a new Footscray Hospital to service the growing population in Melbourne's inner west; and
- \$35 million for upgrading specialist medical equipment, including magnetic resonance imaging (MRI) and computed tomography (CT) scanners in metropolitan and regional hospitals.

This budget also provides a total of \$319.9 million to reduce waiting times for elective surgery, including \$174.3 million in 2017-18 to deliver an additional 6 600 procedures.

Better, Safer Care

The *2017-18 Budget* invests \$215 million to implement the *Better, Safer Care* reforms to put patient safety first, eliminate avoidable harm and strengthen quality of health care across the State. This funding will help to implement the Government's vision for quality and safety in Victoria's health system.

Emergency prevention and readiness

This budget invests in a range of initiatives to improve the ability of our health services to respond to emergencies.

Following the tragic deaths of nine people in a freak storm on 21 November 2016, \$15.6 million will be invested in preparing for future thunderstorm asthma and other extreme weather events. Education campaigns will help communities prepare for extreme weather, and the Government will fund investment in better pollen monitoring and research to prevent future outbreaks.

A further \$26.5 million will be invested in ambulance services to meet demand from a growing population and improve community access.

Victorians with disability

People living with disability deserve choice and control over their support services. As part of the *2017-18 Budget*, the Government will invest an additional \$166.2 million in disability-related initiatives, getting Victoria ready for the National Disability Insurance Scheme. We are committed to the success of the scheme for people with disability and their families.

Mental health

In November 2015, the Government launched *Victoria's 10-year Mental Health Plan* to guide investment and drive better mental health outcomes for Victorians. The Government is continuing to implement this plan, boosting mental health services across the State, with \$199.5 million set aside to meet an urgent need for services. This builds on the significant additional investment for mental health in last year's budget. This funding will provide 579 additional inpatient services and tens of thousands of hours of community care.

Forensic mental health services will be expanded with \$45.2 million. This will help to make Victoria safer by improving access to assessment, diversion and appropriate treatment for mental illness. This additional investment is intended to help patients to get the care and treatment they need to stay out of the criminal justice system.

More medical and allied staff in acute admitted settings will be available on weekends to improve continuity of care and provide more timely treatment and discharge of mental health clients.

Treating the victims of alcohol and other drugs

Communities are being hurt by the scourge of drugs, particularly in regional Victoria. To support the impact of the Government's *Ice Action Plan*, this budget commits a further \$78.4 million to treating substance abuse. This includes \$12.4 million to expand services for people transitioning into and out of alcohol and other drug treatment programs, especially those at risk of overdose.

Educated communities

The *2017-18 Budget* commits a further \$1.3 billion over the next four years to continue the revitalisation of our education system for all children across Victoria.

Building and upgrading our schools

A \$685 million capital investment in our schools in 2017-18 expands on funding in the Government's previous two budgets of \$1.8 billion, bringing our total investment in improving Victoria's schools to more than \$2.5 billion – this will make an enormous difference to the lives of children now, and in many years to come. The *2017-18 Budget* will:

- build new schools, by allocating \$269.6 million to construct, plan and buy land for new schools, including many in identified growth areas;
- improve our existing schools, with \$239.6 million for school upgrades – this includes \$64.1 million for rural and regional schools and \$44.4 million to upgrade six special schools across Victoria;
- invest a further \$85 million for asbestos removal, as well as \$75 million for new relocatable classrooms; and
- support improved learning outcomes through reliable access to digital services in classrooms, with \$84.3 million for information technology upgrades across our schools.

Early years

This budget invests a further \$196.7 million for parents and young children to assist early childhood development.

Participating in early childhood programs and kindergarten makes a big difference to children's lives. School readiness funding of \$87.1 million will be invested to support three and four-year olds in funded kindergarten programs to better support educationally disadvantaged children.

More support will be delivered to new parents, including those with babies born prematurely, unsupported young parents, or families facing particular disadvantage. \$81.1 million will be provided over four years to fund enhanced Maternal and Child Health (MCH) services, additional supported playgroups, and an additional MCH visit to identify and support women and children at risk of family violence.

Thriving regional Victorian communities

The Government is investing in regional and rural communities to ensure that all Victorians have the services and support they need to thrive. This budget includes more than \$1 billion in regional and rural infrastructure projects, acquitting the Government's commitment to invest 10 per cent of the proceeds from the successful leasing of the Port of Melbourne across regional Victoria.

Victorians living in the regional and rural communities of our State will benefit from the Government's investments across all areas.

Jobs and infrastructure

The Ballarat GovHub will be developed, with \$47.8 million to house local Victorian public service agencies. These hubs support jobs and growth in our regions, building on the *2016-17 Budget's* investment in a government hub in the Latrobe Valley, expected to bring 150 government jobs to the region. City Deal seed funding will be provided for Latrobe, Bendigo, Ballarat and Geelong.

Agriculture and water

The *2017-18 Budget* is supporting farmers and primary producers to protect Victoria's biosecurity. Biosecurity services will receive \$44.4 million to maintain market access and productivity, and manage the risks to the environment and the community from animal and plant pests and diseases.

The budget also sets aside \$21.5 million to assist sheep and goat farmers to transition to electronic tagging – which will help to reduce risks from disease or a food safety emergency.

The Government is contributing \$19.2 million to a national program to eradicate the red imported fire ant, before it becomes a threat to all of Australia.

The Government is also supporting farmers and primary producers who insure their agricultural products against damage from flood, fire and other accidents, by abolishing insurance duty for these policies.

\$115.7 million will be invested on water initiatives, including *Water for Victoria*, the Government's plan to support more liveable Victorian communities through smarter water management and bolstering the water grid.

Regional Partnerships

The Government is continuing to support the Regional Partnerships process – this budget provides \$29 million to identify, develop and deliver Regional Partnerships priorities, including local infrastructure projects, master plans and programs, in addition to funding a range of initiatives in each of the nine Regional Partnerships areas.

Connecting regional communities

Regional Victorian homes and businesses will be supported to access mobile and broadband technologies and participate in the digital economy, with \$45 million to fund major initiatives, including:

- a Mobile Black Spots Program to increase mobile telephone coverage in flood and fire prone areas with poor coverage;
- support for the adoption of internet enabled on-farm technologies in Victoria's north-west, the Macalister Irrigation District, the Murray-Darling Basin and Serpentine; as well as
- regional enhanced broadband projects in Morwell, North Geelong and Horsham.

Health

As part of our commitment to ensure that all Victorians can access the best health care, the Government is providing significant additional funding across our health system. Specific measures for regional Victoria include \$9.7 million to plan and purchase three new regional sites for drug rehabilitation in the Gippsland, Hume and Barwon regions and \$8.3 million for a new 12-bedroom mental health facility for adults with acute mental illness in Ballarat.

Education

The Government's statewide investment of \$1.3 billion in education will benefit regional Victorians, including by upgrading information technology and digital services in classrooms, providing new relocatable classrooms and removing asbestos.

The *2017-18 Budget* funds a specific package of \$64.1 million for 59 rural and regional school upgrades.

Regional transport

The *2017-18 Budget* will help to ensure safe and productive connections between metropolitan and regional centres, and all over rural and regional Victoria.

The Government is making major investments in regional transport infrastructure, with \$1.1 billion for public transport and \$530.6 million to maintain and upgrade regional roads and bridges, and plan for future expansions to cater for regional growth, as well as improve travel times and safety on Victoria's roads.

Significant public transport projects include:

- a \$435 million investment in Gippsland rail infrastructure. These infrastructure works will create hundreds of jobs in regional Victoria and include track duplication, crossing loops, a second platform at Traralgon, stabling at Morwell and other upgrades;
- boosting major periodic maintenance on the regional rail network with \$316.4 million to further improve service performance and reliability for regional rail commuters;
- investing in additional regional rolling stock, with \$311.1 million to procure 39 additional VLocity carriages; and
- upgrading the Shepparton line and providing additional services.

The Government will also negotiate with the Commonwealth to obtain the funding owed to Victoria under the National Partnership on Asset Recycling which would enable the Regional Rail Revival plan to proceed. If successful, this would enable additional investment in the Surf Coast Rail project and upgrades to the Warrnambool, Ballarat and Bendigo lines.

The *2017-18 Budget* also invests in major projects on regional and rural roads, by:

- making major safety improvements to the South Gippsland Highway;
- improving narrow seal arterial roads in south-western Victoria;
- addressing the impact of rain and flooding on roads, including on the Great Ocean Road;
- strengthening and resurfacing key roads servicing the Port of Portland – including Henty Highway, Portland Ring Road, and the Portland-Nelson Road;
- strengthening and replacing key road bridges and culverts to improve productivity and safety on major freight routes;
- improving the main infrastructure corridor in Phillip Island; and
- commencing Stage 1 of the Shepparton Bypass.

Safe communities

Reducing the harm the Victorian community experiences as a result of crime and improving community safety are key priorities of the Victorian Government. This budget supports Victoria Police, our courts and our prisons to protect our communities.

Police

On 4 December 2016, the Government announced the recruitment of 2 729 new sworn police over four years. This is the biggest recruitment in police history. This comes on top of 406 police funded in the *2016-17 Budget*.

The *2017-18 Budget* cements these commitments and enables Victoria Police to respond to law and order challenges with an additional \$2 billion over four years. This funding allows for the recruitment of these additional police officers, including 415 specialist family violence officers and 42 new youth specialist officers.

It also funds 100 Protective Service Officers for the transport network, replacement of 10 police stations across the State and a new Air Wing unit, including three helicopters and a fixed-wing plane. Measures are funded to improve police capability, increase their connection with the community and hold offenders to account. Aboriginal Community Liaison Officers will be recruited to expand positive engagement with Aboriginal Victorians.

Community safety

The budget also provides funding to ensure serious crimes are punished and offenders are housed safely and effectively. This is evident in the Government's unprecedented commitment to address family violence with \$1.9 billion for comprehensive reforms throughout the system.

The *2017-18 Budget* funds \$308.1 million to deliver more intensive supervision, monitoring and detention of high-risk offenders.

To bolster the broader prison system, \$186.3 million will be provided to help to ensure prisoner, staff and community safety, and reduce the likelihood of reoffending. This includes upgraded security and health services and expanded program capacity in Victoria's prisons.

The budget also includes \$360.7 million to strengthen youth justice precincts in Parkville and Malmsbury, and build a new fit-for-purpose, high security youth justice centre.

Funding of \$7.6 million in this year's budget will be provided for Court Services Victoria to plan for the modernisation and expansion of the Werribee Law Court and Bendigo Law Court as part of the Wyndham Justice Precinct development, so they can manage demand now and into the future.

An additional \$85.2 million will also be allocated to improve public safety and care for those offenders with a mental illness.

Managing emergencies

The Government is investing in the resources the men and women of our emergency services need to do their job. To support specialist services to be ready for any emergency, the Government is providing:

- \$273.3 million to reduce the impact of bushfires on Victorian communities, the economy and the environment by targeting high-risk areas, lifting firefighting capacity, and increasing the use of Aboriginal fire management practices;
- \$72.3 million to respond to community demand for emergency call-taking and dispatch services, and emergency services communications, including radio coverage in the Melbourne Underground Rail Loop and the national telephone warning system; and
- \$34.3 million to the Victorian State Emergency Service to fund new headquarters, vehicles, equipment and facilities to meet growing community demand for its services.

Homes for Victorians

All Victorians deserve the safety and security of a home. *Homes for Victorians* contains a number of initiatives to help Victorians access housing – whether they are looking to purchase their own home, find a secure and affordable rental property, or access social housing or housing services.

The Government recognises that finding a home can be difficult for many young Victorians. To ensure housing is more affordable for around 25 000 Victorians buying their first home, stamp duty is to be abolished for first-time buyers of both new and established homes up to \$600 000, and a tapered discount will apply between \$600 000 and \$750 000.

Doubling the First Home Owner Grant to \$20 000 in regional Victoria for three years will make it easier for thousands of regional Victorians to build and stay in their community and support local jobs.

The Government is contributing to help first home buyers co-purchase a home, bringing *Buy Assist*, a national community sector shared equity scheme, to Victoria. In addition, a new two-year pilot scheme called *HomesVic* will co-purchase properties with up to 400 first home buyers who meet the criteria for a bank loan, but lack a big enough deposit.

To improve the supply of new housing, the Government will extend previous funding to provide further assistance to councils over four years to accelerate planning and approval processes to increase the supply of new housing in Victoria. The existing VicSmart initiative will also be extended to streamline the process for planning permit applications and amendments to introduce categories of minor approvals.

The Government is committed to supporting the growth of the community housing sector and social housing to support vulnerable Victorians. The budget establishes a revolving loan facility to increase the capacity of the community housing sector. It will also enable the transfer of management responsibility for 4 000 public housing dwellings to community housing agencies on a long-term basis. In addition, a \$1 billion Social Housing Growth Fund will be established to support up to 2 200 new social housing places over five years. Victoria's most vulnerable will also be supported into modern, safe and secure accommodation with a \$20 million investment in upgrading rooming houses in both the government and community sectors.

For renters, the Government is working to improve long-term security, by establishing new initiatives to support renters and landlords to take up long-term leases. The government is also introducing a Vacant Residential Property Tax to provide an incentive to reduce the high number of houses and apartments being left vacant in the inner and middle ring of Melbourne. This is intended to increase rental supply and improve affordability.

Protecting our natural resources

Victoria is leading Australia in protecting our precious biodiversity in the face of climate change. In this budget, the Government will invest \$86.3 million on *Biodiversity 2037*, which will protect and re-establish vulnerable ecosystems through targeted actions such as revegetation, predator and pest control, and restoration of shellfish habitat in Port Phillip Bay.

The Environment Protection Agency will be modernised with \$162.5 million, along with an overhaul of the *Environment Protection Act 1970*, to increase the EPA's enforcement capability and ensure it can meet current and future obligations.

Extra resources will be provided for Victoria's parks, forests and wildlife. Protection of these vital assets will be strengthened with \$36.3 million to improve regulatory compliance and enforcement, including addressing increased illegal marketing of endangered Victorian animals; and Parks Victoria will be provided with an additional \$31.8 million to improve usability and provide additional information for park users across the State.

This budget also invests \$12.8 million to help the Government make better decisions in response to climate change, including statewide emission reduction targets and engagement with local governments to contribute to the Government's target of net zero emissions by 2050. It also sets aside \$12.6 million for implementing elements of *Victoria's Climate Change Adaptation Plan 2017-2020*.

Arts and culture

Victoria's arts, culture, screen, music and design sectors ensure our reputation as Australia's creative capital.

The Government is continuing to support our creative industries with \$106.6 million in the *2017-18 Budget*, including to fund summer exhibitions at the National Gallery of Victoria, the Triennial of Contemporary Art and Design, and permanent exhibitions; as well as upgrades to our iconic Arts Centre.

Sport

Victoria is the home of the sporting capital of the world, and Victorians love to watch and participate in sport. This budget supports Victorians' love of sport with \$272 million for the final stage of redevelopment of Melbourne Park, which will secure the Australian Open until 2036.

The budget also sets aside \$20.1 million for a Sports Infrastructure Fund. In 2017-18 and 2018-19, local sporting clubs will be able to access grants to develop new facilities or upgrade their existing facilities. The funding includes an expansion of the existing Female Friendly Facilities Program, so that sporting clubs can build or upgrade additional women's change rooms and facilities.

The budget also sets aside \$6.2 million to increase female participation in sport, including the Change our Game Champions Program to drive change in sporting organisations, promote female role models, and identify and support emerging female sporting leaders and coaches.

Cultural diversity

The Government is proud of Victoria's cultural diversity, and wants to ensure all Victorians, including those who have recently joined us, can proudly call Victoria home. The Government's Multicultural Policy Statement invests \$19.0 million to promote the value of multiculturalism to the general community and to support social cohesion.

Also, Victoria's first government funded migrant workers' centre will be established in Melbourne to advocate for workers who are exploited in the workplace.

Aboriginal and Torres Strait Islander Victorians

The Government is working hard to close the gap between Aboriginal and non-Aboriginal Victorians and is committed to supporting Aboriginal self-determination and empowering Aboriginal communities. The *2017-18 Budget* commits \$100.6 million to achieve long-term generational change and improved outcomes.

The budget provides \$68.2 million to support Aboriginal Victorians to build strong foundations and prepare for self-determination and treaty. This includes establishing an interim Treaty Commissioner, creating an Aboriginal Leadership academy, embedding self-determination across government and administering sector capacity grants to Aboriginal organisations. The Government will further support self-determination by creating an Aboriginal Community Infrastructure Fund to provide funding for significant Victorian Aboriginal community infrastructure projects, and continuing funding for the Koori Youth Council and Local Aboriginal Networks to support current and future generations of leaders.

The budget also includes \$32.4 million in initiatives to support Aboriginal social and emotional wellbeing and mental health through establishment of a culturally appropriate workforce, specialist support for alcohol and drug services in Aboriginal communities, and support for vulnerable young people to develop skills, relationships and networks to keep them connected to culture, families and friends.

LGBTI Victorians

The Government is committed to an equal Victoria for lesbian, gay, bisexual, trans and intersex (LGBTI) Victorians. Funding of \$2 million will deliver a suite of initiatives that support the Government's commitment to an equal Victoria and improve the health and wellbeing of LGBTI Victorians.

The budget also provides \$5.3 million to improve the way that the family violence service system responds to people from LGBTI communities who are experiencing family violence.

RESPONSIBLE FINANCIAL MANAGEMENT

The *2017-18 Budget* prioritises a responsible fiscal position to set Victoria up for the future, while investing in services that people need, in the communities where they live. It continues to invest in infrastructure to support growth in the long term, recognising the importance of prudent spending and saving when conditions are good.

The general government sector operating surplus (net result from transactions) is estimated to be \$1.2 billion in 2017-18, growing to \$2.7 billion in 2020-21.

Net debt as a proportion of GSP is expected to be 4.6 per cent at June 2017 and to increase to 6.0 per cent by June 2021. This increase reflects the Government's significant investment in productivity-enhancing infrastructure, yet maintains manageable levels of net debt consistent with a triple-A credit rating (see Table 1.1).

Table 1.1: General government fiscal aggregates

	Unit of measure	2015-16 actual	2016-17 revised	2017-18 budget	2018-19 estimate	2019-20 estimate	2020-21 estimate
Net result from transactions	\$ billion	2.7	1.3	1.2	2.0	2.4	2.7
Government infrastructure investment ^{(a)(b)}	\$ billion	4.8	9.3	10.1	9.8	10.1	8.4
Net debt	\$ billion	22.3	18.1	23.8	25.1	27.4	28.9
Net debt to GSP	per cent	6.0	4.6	5.8	5.8	6.0	6.0

Source: Department of Treasury and Finance

Notes:

(a) Includes general government net infrastructure investment and estimated cashflows for Partnerships Victoria projects and the State contribution to the West Gate Tunnel Project.

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

The *2017-18 Budget* includes \$9.6 billion in new output initiatives, which focus on improving community safety and supporting better health for Victorians. It also includes new asset initiatives of up to \$6.1 billion total estimated investment (TEI), building on the significant infrastructure investment committed by the Government in the previous two budgets, including for the Metro Tunnel, the Level Crossing Removal Program and the Western Suburbs Roads Package.

The Government continues to prioritise sound financial management, which allows this budget to make prudent investments in services and consolidate our infrastructure investment from our previous two budgets.

The *2017-18 Budget* reflects this Government’s long-term financial management objectives (Table 1.2).

Table 1.2: Long-term financial management objectives

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

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

Table 1.3: Financial measures and targets for the 2017-18 Budget

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

Chapter 4 *Budget Position and Outlook* outlines the budget position for 2017-18 and the forward estimate years (2018-19 to 2020-21).

CHAPTER 2 – ECONOMIC CONTEXT

- Economic conditions in Victoria are strong and growth is forecast to remain robust.
- Real gross state product (GSP) is forecast to grow at 2.75 per cent over the forward estimates, driven by population growth and low interest rates.
- Victoria’s population increased by 2.1 per cent over the year to June 2016, the highest growth rate of all the states, and is forecast to continue to grow at above average rates.
- The near-term outlook for employment is favourable with growth forecast to be above trend in 2017-18 before slowly returning to trend over the forward estimates. This is consistent with a modest improvement in the unemployment rate.
- Global economic growth was lacklustre in 2016, although activity is expected to pick up moderately. Risks are broadly balanced but global policy uncertainty is high.

VICTORIAN ECONOMIC CONDITIONS AND OUTLOOK

Economic conditions in Victoria are strong. In 2015-16, real GSP expanded by 3.3 per cent, while employment grew by an average of 3.0 per cent in the year to December 2016. The national transition from mining investment to broader-based sources of growth, including construction and other service industries, is well underway and benefiting Victoria.

The outlook for the economy is generally positive, with growth forecast to remain robust.

Real GSP is expected to remain strong over the forward estimates. Household consumption, business investment, dwelling investment and the Government’s infrastructure investment are expected to contribute to growth. The drivers of growth include the positive impact of low interest rates and strong population growth.

Household consumption is anticipated to grow steadily, supported by employment growth and higher household wealth. Construction activity will be driven by an improving pipeline of non-dwelling investment.

Victoria has a resilient and dynamic labour market that is positioned to support economic growth over the forward estimates. Employment is forecast to grow at an above-trend pace in 2017-18, driven by strong demand and modest wages growth. With above-trend employment growth in the near term, the unemployment rate is forecast to decline to 5.5 per cent in 2017-18 and remain at that rate over the forward estimates.

Despite trend economic growth, the outlook for inflation is subdued. This is consistent with global trends.

Victoria's wage price index rose by 1.9 per cent over the year to December 2016. The wage price index is forecast to gradually increase, but remain below its estimated trend rate of 3.5 per cent, as more people move into jobs from unemployment or outside the labour force and spare capacity is gradually reduced.

Population growth is forecast to be strong over the forward estimates, although the rate of growth is expected to moderate. Net overseas migration is the largest contributor to population growth and forecast to average around 66 000 persons per year.

Table 2.1 sets out the economic forecasts for the *2017-18 Budget*. The forecasts are projected to revert toward trend over the final two years of the forward estimates.

Table 2.1: Victorian economic forecasts ^(a) (per cent)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	<i>actual</i>	<i>forecast</i>	<i>forecast</i>	<i>forecast</i>	<i>projection</i>	<i>projection</i>
Real gross state product	3.3	3.00	2.75	2.75	2.75	2.75
Employment	2.4	3.25	2.00	1.50	1.50	1.50
Unemployment rate ^(b)	5.9	5.75	5.50	5.50	5.50	5.50
Consumer price index ^(c)	1.6	2.00	2.00	2.25	2.50	2.50
Wage price index ^(d)	2.3	2.00	2.25	2.75	3.00	3.25
Population ^(e)	2.1	2.00	1.90	1.80	1.80	1.80

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 2019-20 and 2020-21 represent trend rates, except for the wage price index, which shows a path towards trend in 2020-21.

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 66.8; 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 2.75 per cent in 2017-18 and remain at that rate over the forward estimates. This reflects growth in household consumption, business investment and dwelling investment.

Household consumption is forecast to grow at trend over the forward estimates. Growth will be supported by solid employment growth and higher household wealth, mostly due to higher house prices and positive equity market returns. Interest rates are assumed to rise marginally, consistent with futures pricing, but to remain low by historical standards.

Dwelling investment grew 11.1 per cent in 2015-16, the highest growth rate since 2002. The large amount of work in the pipeline should continue to support a high level of dwelling investment for some time.

Business investment is forecast to grow in 2017-18 and over the forward estimates, driven by low borrowing costs and consistent with above average surveyed business conditions. Capacity utilisation has increased since 2013 and is currently above the long-term average, which is likely to support investment. The pipeline for non-dwelling construction has improved, including in the retail and office sectors.

Merchandise export growth is expected to recover in 2016-17, mostly due to increased agricultural production. Victoria produced a record winter crop of 10 million tonnes in 2016-17, a 145 per cent increase on 2015-16. The forecasts assume a return to average seasonal conditions in 2017-18. Merchandise exports are forecast to grow at trend in 2017-18 and will likely benefit from the weaker Australian dollar and ongoing economic growth in Australia's major trading partners.

Service exports are forecast to grow above trend in 2016-17, led by an increase in inbound tourists and international students, before returning to trend in the projection years. Tourism is an important export industry for Victoria. Over the year to December 2016, Victoria welcomed 2.7 million international visitors, a 10.4 per cent increase compared to the previous year, spending a total of \$6.9 billion.

Imports of goods and services are expected to grow approximately in line with consumption growth over the forward estimates.

Other economic indicators

Prices

Australian and Melbourne inflation have been weak in recent years. A number of factors have contributed to this, including low inflation expectations and heightened competitive pressure in some product markets.

Melbourne's inflation is forecast to gradually increase towards 2.5 per cent over the forward estimates. This is driven by a gradual normalisation in wages growth and price increases in the utilities, health and insurance sectors. The effect from increased competitive pressure is expected to slowly reduce over the forward estimates as markets stabilise.

Wages

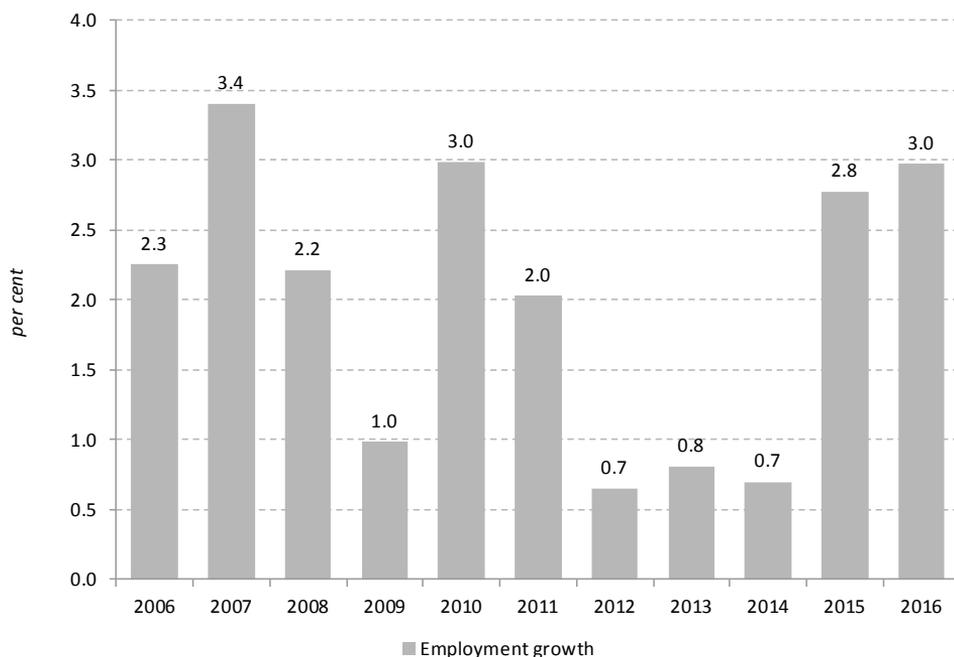
The outlook for inflation and wages growth is tightly linked. The wage price index is forecast to increase gradually, but to remain below its estimated trend rate of 3.5 per cent. With above-trend employment growth in 2017-18, excess capacity in the labour market is expected to be slowly absorbed as more people move into jobs, gradually adding to wage pressure. The forecast 0.5 percentage point increase in the pace of wages growth in 2018-19 is mostly due to the lagged impact of the earlier reduction in the unemployment rate.

The labour market

The Victorian labour market is performing well (Chart 2.1 and Chart 2.2). In 2016, employment grew by an average of 3.0 per cent, the strongest among the states, with positive contributions from both full-time and part-time employment. This reflects strong growth in labour supply, from both interstate and overseas migration, and strong levels of economic activity, including in the construction industry.

Indicators of near-term activity are positive. Surveyed measures of employment conditions have recovered from lows recorded in 2013 and are currently tracking above the average level recorded since the global financial crisis.

Chart 2.1: Victorian employment growth, year on year



Source: Australian Bureau of Statistics

Strong employment growth is encouraging workers back into the labour market. Victoria's labour force participation rate increased to an average of 65.2 per cent in 2016, its highest level since 2011. The unemployment rate has declined from its recent high of 6.9 per cent in October 2014 to average 5.8 per cent in 2016.

Chart 2.2: Total and full-time employment growth by state, 2016



Source: Australian Bureau of Statistics

The strength of the labour market is being reflected in the opportunities provided to Victoria’s youth. Victoria’s youth (15-24 years) unemployment rate declined 0.5 percentage points to an average of 12.7 per cent in 2016.

Opportunities are also increasing in regional Victoria, with employment growing by an average of 2.1 per cent in 2016, above the national average of 1.0 per cent (see Box 2.1: Victoria’s regional labour market for further information about the regional labour force).

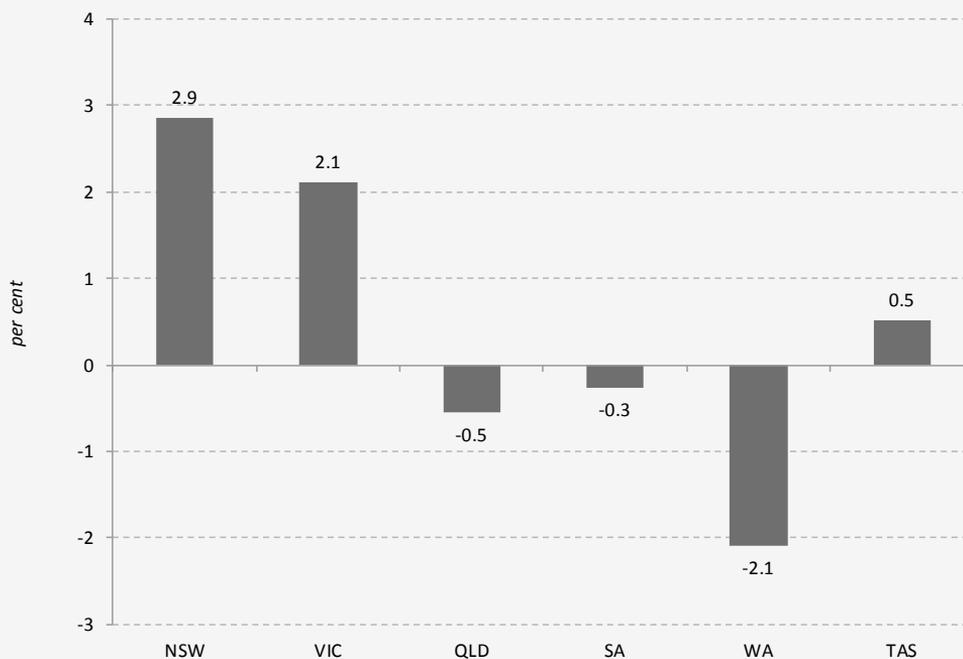
Consistent with above trend employment growth, the unemployment rate is forecast to decline in 2017-18 to 5.5 per cent. The unemployment rate is then forecast to be stable over the forward estimates as employment growth is largely offset by growth in the labour force.

The participation rate is forecast to remain around its current rate in 2017-18. With employment growth returning to trend and the unemployment rate stable, structural factors such as the ageing of the population will gently weigh on the participation rate in the projection years.

Box 2.1: Victoria's regional labour market

Victoria's regional labour market is one of the strongest in the nation (Chart 2.3). In 2016, employment in regional Victoria grew by 2.1 per cent, higher than the national average regional employment growth of 1.0 per cent.

Chart 2.3: Regional employment growth, 2016



Source: Australian Bureau of Statistics

The diversity of Victoria's regional economy is a major reason for the strength in the labour market. Due to the impact of structural change, a high share of employment in regional Victoria is now in service-based industries. The two largest employers in 2016 were the health care and social assistance, and retail trade industries.

Tourism is a significant employer in regional Victoria. This is reflected in the high share of retail trade and accommodation and food services employment. Tourism services in regional Victoria include natural attractions, spa retreats, and food and wine experiences.

Education is an important industry and employer in regional Victoria. In addition to serving local students, in 2015 there were about 5 000 international students living and studying in regional Victoria. A large proportion of these students studied at institutions in Geelong and Ballarat.

Agriculture remains a key source of economic activity and employment in regional Victoria. The agriculture industry employs around 11 per cent of the regional workforce and exported almost \$12 billion of food and fibre products in 2015-16. The medium-term outlook for agriculture production is positive as global demand for premium food and beverage products is expected to grow.

Population

Victoria's population growth has been strong. Over the year to June 2016, Victoria's population grew by 2.1 per cent, the highest growth rate of all the states. Net overseas migration has been the largest contributor to population growth, accounting for more than 50 per cent of the state's population increase over the year to June 2016.

Victoria recorded the highest net interstate migration of all jurisdictions, reflecting the relative attractiveness of Victoria as a place to live and work (see Box 2.2: Victoria's record net interstate migration for further information about trends in interstate migration).

Population growth is forecast to be robust over the forward estimates, although the rate of growth is expected to moderate. Net overseas migration will be the largest contributor to growth and is forecast to average around 66 000 persons per year over the forward estimates. In the longer term, the Australian Bureau of Statistics projects Melbourne's population could exceed Sydney's by 2036 if current trends persist.

Box 2.2: Victoria's record net interstate migration

Based on a comparison with historical census data, Victoria is currently experiencing the highest net interstate migration since about 1961. In 2015-16, Victoria's net interstate migration was 16 700 persons and accounted for almost 14 per cent of total population growth.

The current positive flow of net interstate migration is rare when compared to Victoria's history. Over the past half century, both New South Wales and Victoria have steadily lost population to Queensland and, to a lesser extent, Western Australia.

Chart 2.4: Victoria's net interstate migration, quarterly



Source: Australian Bureau of Statistics

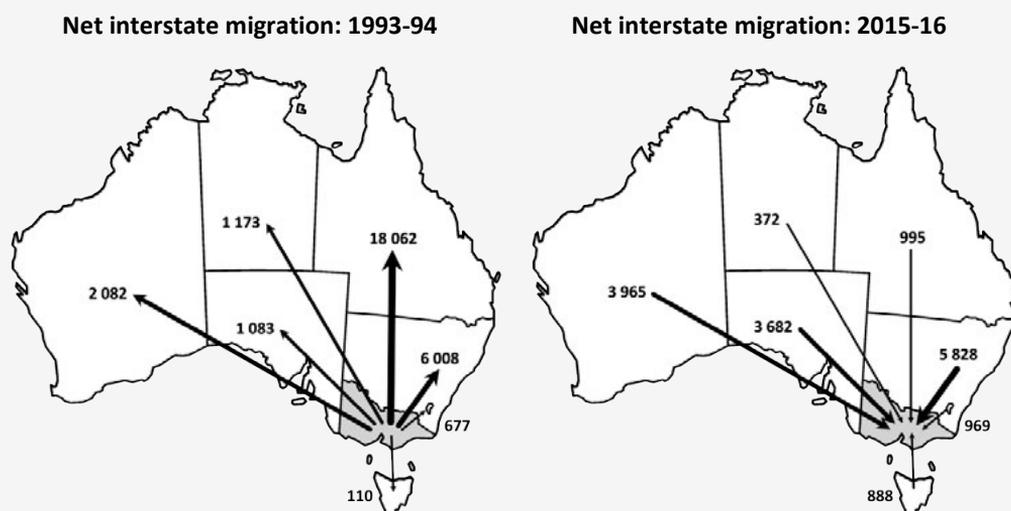
The historical trend masks some large swings in the flow of interstate migration. In the 1970s and 1980s, Victoria typically recorded net interstate migration losses. The peak outflow occurred after the early 1990s' recession, where net interstate migration from Victoria to other states averaged around 7 500 persons per quarter (Chart 2.4).

Since the recovery of Victoria's economy in the late 1990s, there has been a large shift in interstate migration into Victoria. In 1998-99, Victoria saw positive interstate migration of 2 500 persons for the first time since at least 1961. More recently, Victoria has gained net interstate migration from every state and territory with the largest flows from New South Wales and Western Australia (Chart 2.5).

Younger people are by far the biggest movers. Almost two-thirds of arrivals from interstate are aged 15 to 44 years, significantly greater than the overall population share. Older people make up fewer than five per cent of arrivals, much less than their share of population.

Most interstate movers to Victoria settle in Melbourne and the largest flows are recorded in the inner city. Many of these people are likely to be young adults, who tend to be attracted by lifestyle, housing and educational opportunities. In regional Victoria, the most common landing places for interstate movers are the large regional towns of Geelong and Ballarat, and the border towns such as Wodonga and Mildura.

Chart 2.5: Changing interstate migration flows, 1993-94 vs 2015-16



Source: Australian Bureau of Statistics

AUSTRALIAN ECONOMIC CONDITIONS AND OUTLOOK

Economic conditions in Australia are solid and growth is expected to improve as the drag from falling mining investment and the impact from the earlier fall in the terms of trade dissipate.

Australia's gross domestic product (GDP) grew by 2.4 per cent over the year to December 2016. Growth is currently in line with the trend rate of growth observed since 2013 but below the Commonwealth Treasury's estimates of potential economic growth (2.75 per cent). This environment is consistent with moderate employment growth and subdued wages growth.

The transformation of the national economy is still underway. The drag on growth from falling mining investment is weighing on economic conditions in Western Australia and Queensland. Conversely, low interest rates and the depreciation of the Australian dollar have supported growth in Victoria and New South Wales.

Household consumption growth has been solid, supported by low interest rates and rising household wealth. However, much of this growth has been due to a decline in the saving ratio as the pace of real household disposable income growth has been modest. Dwelling investment has been strong in both Victoria and New South Wales. The performance of business investment has been mixed, with declining mining investment and modest growth in non-mining investment.

The Commonwealth Treasury forecasts Australia's GDP to grow by around 2.75 per cent in 2017-18 and 3.0 per cent in 2018-19. The improvement in growth will be supported by low interest rates, the diminishing drag on growth from falling mining investment and rising resource exports.

Despite the improvement in economic growth, the unemployment rate is expected to remain around 5.5 per cent. The recent increase in the terms of trade should boost nominal income, but the impact on employment is expected to be muted as it is not expected to generate new investment.

The outlook for national wages and inflation is subdued. Wage growth is expected to gradually recover as some of the factors weighing on growth dissipate, including the drag from mining-related industries. Measures of underlying inflation are forecast to pick up gradually, to around 2.5 per cent by 2018-19, while headline inflation is expected to pick up slightly quicker, mostly on the back of higher oil and tobacco prices.

INTERNATIONAL ECONOMIC CONDITIONS AND OUTLOOK

Global economic growth was lacklustre in 2016, although activity is expected to pick up moderately over the forward estimates. In its *World Economic Outlook* released in April 2017, the International Monetary Fund (IMF) forecast global economic growth to improve in 2017 and 2018 (Table 2.2).

Table 2.2: Summary of IMF's global economic forecasts ^(a) (per cent)

	2015 <i>actual</i>	2016 <i>estimate</i>	2017 <i>projection</i>	2018 <i>projection</i>
World output	3.4	3.1	3.5	3.6
Advanced economies	2.1	1.7	2.0	2.0
United States	2.6	1.6	2.3	2.5
Euro area	2.0	1.7	1.7	1.6
Japan	1.2	1.0	1.2	0.6
Emerging market and developing economies	4.2	4.1	4.5	4.8
China	6.9	6.7	6.6	6.2
India	7.9	6.8	7.2	7.7
ASEAN-5 ^(b)	4.8	4.9	5.0	5.2

Source: International Monetary Fund's *World Economic Outlook*, April 2017.

Notes:

(a) Not all countries or regions are listed in the table.

(b) ASEAN 5 economies are Indonesia, Malaysia, Philippines, Thailand and Vietnam.

Growth in the advanced economies is projected to accelerate modestly due to higher growth in the United States (US). Growth in emerging market and developing economies is projected to normalise from subdued rates, despite a slowdown in the rate of economic growth in China.

Economic growth is projected to pick up in the US in 2017 and 2018, although forecasts are uncertain in light of potential changes in policy from the new administration. The growth projections assume a fiscal stimulus that boosts growth by a cumulative 0.5 percentage points over 2017 and 2018. Despite the elevated uncertainty, the risks are generally balanced with improvements in the labour market and wages, offset by the impacts of a potentially restrictive trade policy and rising interest rates.

Growth in the euro area is expected to be around 1.7 per cent, below estimates of potential growth. The euro area outlook is dampened by the sluggish pace of structural reform and elevated debt burdens. The risks are generally tilted to the downside and mostly stem from geopolitical instability, the impact of Brexit and the uncertain outcome from elections, such as those in France, the United Kingdom and Germany.

Japan's growth is projected to be relatively weak over the forecast period. Postponement of a consumption tax hike and additional monetary easing will support growth in the near term, partly offsetting the drag from the recent appreciation of the yen. The risks are generally balanced, although Japan's medium-term prospects remain weak, primarily reflecting a shrinking population.

The forecast for emerging market and developing economies reflects a broad-based normalisation in growth from current subdued rates. This is not reflected in the growth outlook for China, which is projected to decelerate over the forecast period.

At the 2017 National People's Congress, the Chinese Premier announced China's GDP growth target would be lowered from 6.7 per cent to 6.5 per cent in 2017. This reflects the challenge of rebalancing the economy and reducing overcapacity in certain heavy industries.

RISKS TO THE OUTLOOK

The risks to Victoria's economic outlook are broadly balanced, although global economic and policy uncertainty is high.

Interest rates are an important driver of Victoria's economic performance. The *2017-18 Budget* assumes that, in the near term, interest rates move in line with market expectations. Higher than expected interest rates could lead to a higher exchange rate, a reduction in asset prices and household wealth, and lower GSP growth. This is mostly balanced with the potential upside risk of lower interest rates in the current low inflation environment.

The labour market has been a source of strength for Victoria's economy. The *2017-18 Budget* forecasts ongoing growth in employment, a modest decline in the unemployment rate and an elevated but gradually declining participation rate. A higher than expected participation rate could lead to higher employment growth, higher GSP growth and lower wages growth. See Appendix A *Sensitivity Analysis* for further information on the estimated fiscal impact of a higher participation rate.

Dwelling investment has been an important driver of Victoria's economy over the past few years. An unexpected downturn in the housing market could lead to lower household wealth, lower employment in construction and related industries, and lower GSP growth.

Globally, economic and policy risks are broadly balanced, although uncertainty is elevated.

The economic outlook for the US is generally positive. Employment growth and a pickup in wages are driving a recovery in household consumption, supporting GDP growth. However, there are significant policy risks including the timing of potential Federal Reserve interest rate hikes and the impact of policy proposals of the new US administration.

A key focus for the new administration has been the US's withdrawal from the Trans-Pacific Partnership and a potential increase in trade protection more broadly. Australia's economic performance is heavily influenced by global economic conditions and international trade. An increase in global tariffs could reduce the competitiveness of Victoria's exports, lower Australia's terms of trade and lower Victoria's GSP growth. See Appendix A *Sensitivity Analysis* for further information on the estimated fiscal impact of a global trade shock.

Growth in China is expected to gradually moderate as the economy rebalances and reduces debt, consistent with a reduction in estimates of potential economic growth. While this rebalancing occurs, the risks of a financial shock are elevated. The Chinese authorities are attempting to balance the short-term need for growth with the longer-term need for structural reform aimed at reducing overcapacity in certain heavy industries and risks associated with the economy's high, and rising, debt-to-GDP ratio. In addition, the economy is highly indebted and partly exposed to a higher US dollar if the Federal Reserve raises rates faster than expected. On the upside, the central government has a sizable foreign currency reserve and a relatively healthy balance sheet that could be used to support the economy if required.

CHAPTER 3 – OPPORTUNITY FOR ALL VICTORIANS

- Victoria’s economy has experienced a resurgence, reflecting strong growth in population, high labour force participation and rising productivity. The strength of the economy is attracting businesses and investment to Victoria.
- Victoria has the highest labour force participation rate of the non-mining states, with rising participation in particular among women.
- Gross state product (GSP) per capita rose by 1.4 per cent in 2015-16 in real terms, and has risen by 37 per cent over the past two decades.
- The gains from this economic expansion have been broadly shared, with household income distribution becoming more equitable in Victoria. This bucks the trend toward greater income inequality observed in many Organisation for Economic Co-operation and Development (OECD) economies.
- The Government has invested in productivity-enhancing infrastructure to support a growing population, and is working to increase the capacity of government services to meet the needs of expanding communities. The Government is getting on with addressing some of the most complex social challenges of our time, and ensuring no Victorian is left behind.

INTRODUCTION

A strong economy is the foundation of prosperity for all Victorians because it means more jobs, more opportunities and a thriving community. In recent years, economic growth in Victoria has improved dramatically, reflecting strong growth in population, high labour force participation, and rising productivity.

Employment has grown by more than 200 000 persons since the Government came to office, with around 60 per cent of this in full-time employment. Employment growth in regional Victoria has also seen a strong increase, by 2.1 per cent in 2016.

The pace of economic growth has accelerated, rising from 0.8 per cent in 2013-14 to 3.3 per cent in 2015-16. GSP rose even faster than population, which itself has grown strongly as a result of high migration of younger, prime working-age individuals. As a result, GSP per capita rose by 1.4 per cent in 2015-16.

Small businesses contribute significantly to the Victorian economy, and the State welcomed an additional 15 000 small businesses in the past 12 months. Visitors are attracted to Victoria, placing Victoria in the number one position in terms of growth in international tourist visitation for the past five years. International visitation has grown by 9.3 per cent annually – far higher than the national average.

The benefits of economic growth in Victoria have been broad-based. This is evident in the high and increasing rates of labour force participation, particularly among women. Lower income households have experienced similar or higher rates of income growth, when compared with higher income households. This is a positive outcome and stands in contrast to rising income inequality seen in many other member countries in the OECD.

The Government's commitment to fiscal discipline in a period of economic expansion has allowed for increased investment in the infrastructure and services that a growing community needs. Today's investments aim to build a strong, sustainable and equitable economy that can provide opportunity for all Victorians into the future.

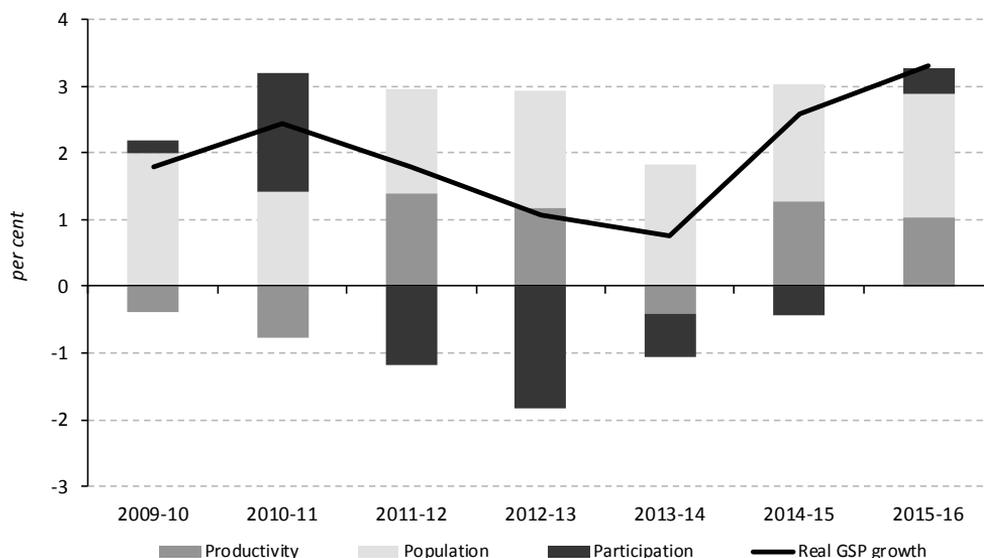
MORE GROWTH MEANS MORE JOBS

Victoria's economic growth is accelerating. After a number of years of sub-trend growth following the global financial crisis, growth has increased dramatically in recent years. As outlined in Chapter 2 *Economic context*, this strong economic performance is expected to continue, with growth forecast to continue at an above-trend rate in the near term.

The three drivers of economic growth – population, participation and productivity – all positively contributed to the State's strong economic performance in 2015-16 (see Chart 3.1).

In particular, overall labour force participation has risen fast enough to contribute to real GSP growth in Victoria in 2015-16 for the first time in five years. In practical terms, this means that the combination of declining unemployment and growing labour force participation is strengthening the economy. This turnaround is all the more impressive having been achieved against the background of an ageing population, which is estimated to reduce participation, as the baby boomer generation increasingly reaches retirement age.

Chart 3.1: Contributions to real GSP growth: population, participation and productivity



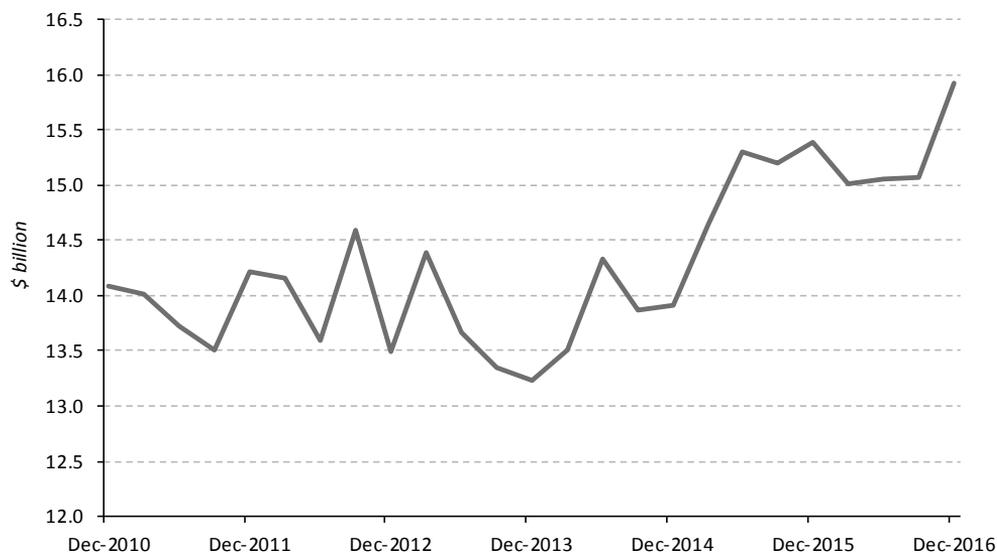
Source: Department of Treasury and Finance; Australian Bureau of Statistics

Employment growth in Victoria is keeping pace with population growth, amid a population boom. Victoria’s population ticked over six million in early 2016, with growth continuing to accelerate. As at the September quarter 2016, Victoria’s population was growing at an annual pace of 2.1 per cent.

An improvement in productivity has also supported recent economic outcomes. Productivity remains the cornerstone of sustainable increases in living standards over the long term, and must be supported by investment in social and economic infrastructure. That’s why the *2017-18 Budget* commits a further \$1.3 billion over the next four years to continue the revitalisation of our education system.

Business conditions have improved steadily over recent years and, combined with the Government’s substantial infrastructure program, is translating to higher levels of investment. Combined business and public investment in Victoria has increased by around 14 per cent since the December quarter 2014 (see Chart 3.2). Rising investment in productivity-enhancing infrastructure and services is positive for Victoria’s longer-term growth prospects.

Chart 3.2: Private business investment and public investment (current prices), Victoria, 2010-2016



Source: Australian Bureau of Statistics

Sharing the benefits of growth

Stronger economic growth means more jobs, and more Victorians who benefit from the State’s economic success. More than 120 000 jobs were created in 2016, which is more than all the other states and territories in Australia combined. More than 200 000 jobs have been created since the Government came to office in November 2014.

The majority of the jobs created have been full-time and have been focused on high-wage, high-skill sectors. Victoria has the highest rate of full-time employment growth of any state or territory in Australia. Full-time employment grew by 3.7 per cent over the course of 2016 and accounts for 60 per cent of the jobs created under this Government.

Importantly, employment growth is being experienced across the State, with employment in regional Victoria growing by 2.1 per cent in 2016 – among the strongest rates of regional growth in the nation – and above national regional employment growth of 1.0 per cent.

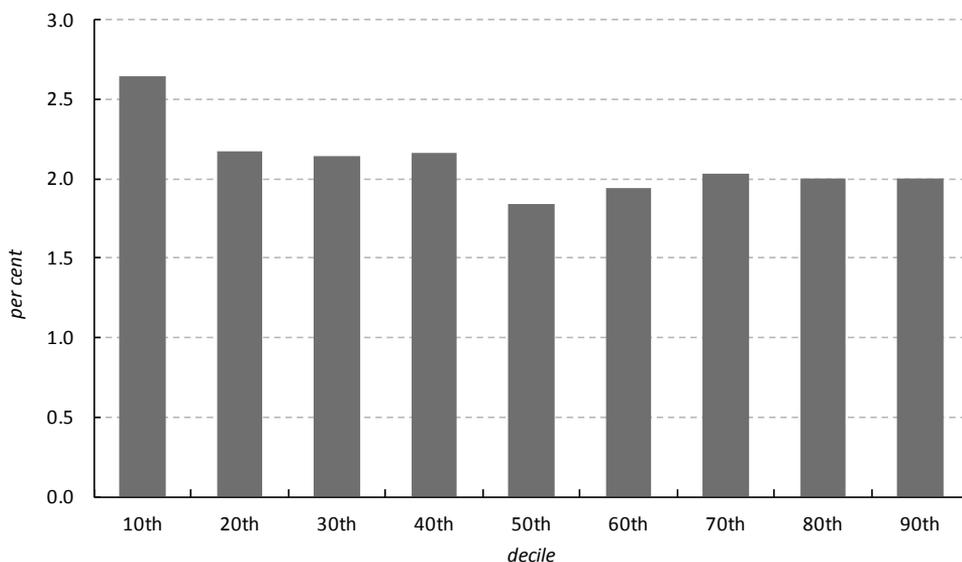
The rising rates of labour force participation are evidence that improved job prospects are enticing more people to seek employment. Victoria’s labour force participation rate – already the highest among the non-mining states – averaged 65.2 per cent in 2016, the highest rate in five years. The combination of increased female labour force participation and increased participation among older age cohorts has outweighed the impact of the retirement of the baby boomer generation.

Female participation in Victoria’s labour force is higher than it has ever been before, increasing by 2.1 percentage points since the Government took office. Greater female participation means greater productive capacity, but also opens up demand in other areas.

Despite the increase in participation, the unemployment rate has continued to decline. For example, Victoria’s unemployment rate has declined from 6.7 per cent when the Government took office to average 5.8 per cent in 2016. The regional unemployment rate has fallen from 6.6 per cent in November 2014 to average 5.7 per cent in 2016.

The broad-based nature of Victoria’s pattern of growth is also evident in the distribution of income across households. In contrast to the recent experience of other economies in the OECD, lower income households in Victoria have experienced similar or higher rates of income growth when compared with higher income households over the 19 years to 2013-14 (see Chart 3.3). In other words, the distribution of income growth to households has become more equitable in Victoria over the past two decades.

Chart 3.3 Victorian average annual household income growth by decile, 1994-95 to 2013-14 ^(a)



Source: Australian Bureau of Statistics

Note:

(a) Latest available data is 2013-14.

INVESTING FOR THE FUTURE

The Andrews Labor Government is getting on with the job and building the projects that Victoria needs. The Government is committed to investing to meet the needs of our growing population and ensure that ongoing economic growth will be shared by all Victorians.

This Government is also investing significantly in public transport, to reduce urban congestion and contribute to a more sustainable transport future. The biggest public transport project in the State's history – the Metro Tunnel – will free up space in the City Loop to allow more trains to enter and exit the city. The project will help meet increased demand as well as improve reliability and commuting times for public transport users.

The Level Crossing Removal Program and the West Gate Tunnel Project are two other significant roads projects aimed at easing traffic and enabling higher productivity and better quality of life.

The *2017-18 Budget* consolidates the infrastructure investment in previous budgets, with further investments in projects with a total estimated investment of \$6.1 billion.

Overall, government infrastructure investment (GII) is anticipated to average \$9.6 billion across the next four years, significantly higher than the average GII for the past decade to 2016-17 of \$5.6 billion. Investment planning and prioritisation is taking place in the context of a refreshed Plan Melbourne and under the strategy developed by Infrastructure Victoria. This investment will help make our State and capital city function more effectively, and serve Victorians better.

Importantly, these investments also build confidence in our economy and create jobs. New infrastructure investment announced by this Government is expected to generate more than 50 000 jobs.

Investment in social services is just as important for our economy and society as investments in physical infrastructure. Social services represent an essential investment in the health, education and wellbeing of people – in the human capital that drives our economy, and that creates Victoria's thriving communities.

This Government is making a concerted effort to restore public and social services, while maintaining fiscal discipline and prudent financial management. The *2017-18 Budget* funds \$9.6 billion in new output initiatives. The Government is investing an additional \$2.9 billion to ensure Victorians receive world-class health care, a further \$1.3 billion to continue the revitalisation of our education system, and an unprecedented commitment to address family violence with \$1.9 billion in comprehensive reforms.

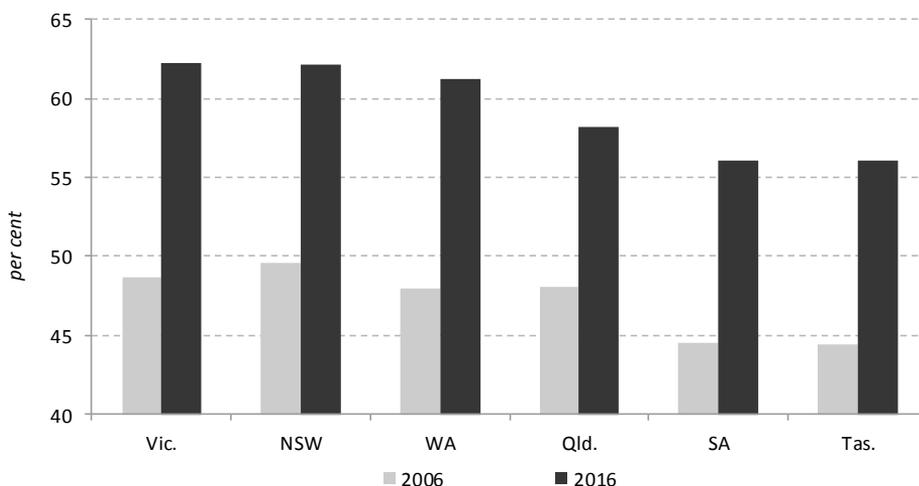
Investing in people

The Government has recognised the importance of investing in people – in human capital – under the Education State initiative. The Education State aims to improve outcomes for students across Victoria, which will position the State well to meet demand for skills in the future.

Victoria is already well placed in terms of the level of education and skills of its citizens. From 1986 to 2016, the share of Victorians aged 20-64 with a bachelor's degree or higher rose from 7.5 per cent to 33 per cent. The share of Victorians with some form of post-school qualification was 62 per cent in 2016, the highest among the states (see Chart 3.4). A strong education system ensures tomorrow's labour force is equipped with the skills required to take the economy forward.

The *2017-18 Budget* includes a further \$685 million to build new schools and upgrade existing facilities across the State, particularly in corridors with high population growth. This funding will benefit students throughout the State and aims to improve educational inclusiveness. The Government is also investing a further \$196.7 million in early childhood development, to help the youngest Victorians get a great start to their education.

Chart 3.4: Victorians aged 20-64 with post-school qualifications, 2006 and 2016



Source: Australian Bureau of Statistics

A quality health system ensures Victorians can live to their full potential and realise the benefits of advances in health care through improved life expectancy and quality of life.

Policy efforts in relation to health are directed at meeting the needs of a growing population with a rising life expectancy through increases in health services capacity. They are also directed towards improving the quality of health care through service delivery reforms in major areas of the health sector. For example, waiting times for 90 per cent of public hospital patients have fallen from 222 days in 2013-14 to 174 days in 2015-16, a decline of 22 per cent in two years.

In addition to improvements to hospitals and patient safety, the Government is increasing funding for mental health services and for treating the victims of alcohol and other drugs.

In addition to representing an essential social service, the health sector is also an area of significant innovation in the Victorian economy, particularly through the growth of health and medical research. Initiatives such as the Drug Discovery Centre and the National Proton Beam Therapy Centre benefit Victorians directly through the advances to medical care that become available, while also attracting future industry investment and jobs to Victoria.

Investing in opportunities for regional Victoria

It shouldn't matter where Victorians live – they should be able to access the opportunities that come from a growing economy.

The Government has an active role in providing assistance and support to families, communities and businesses impacted by a transforming economy. The diversity of the Victorian economy and community has long been a strength of the State, and Victoria's regions are integral to maintaining that into the future.

The Government believes in the importance of regional Victoria to our economy, and in the ability of businesses in regional Victoria to make significant contributions to the State's economy. The *2017-18 Budget* will continue to invest in regional workers, businesses, and infrastructure to deliver equitable growth for all Victorians. Businesses that pay at least 85 per cent of their payroll to employees in regional Victoria will receive a 25 per cent discount on their payroll tax to support regional employers to grow their businesses, and encourage further employment of workers in regional areas.

The Government is currently providing assistance to workers and communities affected by the closure of motor vehicle manufacturers and the Hazelwood Power Station in the Latrobe Valley. This includes \$135.5 million in funding for communities affected by the closure of motor vehicle manufacturing, including those in Geelong and Melbourne's northern and south eastern suburbs, and a \$266 million assistance package for the Latrobe Valley to support communities affected by the closure of the Hazelwood Power Station.

The budget has direct support for regional jobs, particularly those areas directly impacted by economic transition. Funding is being allocated to protect the sustainability of the Latrobe Valley timber industry.

The Government is committed to creating jobs in regional Victoria. Infrastructure investment will generate thousands of jobs and will facilitate access to opportunities for regional Victorians and businesses. Projects that this Government is committed to include: \$1.1 billion in regional public transport, which includes \$435 million investment in Gippsland Rail and \$316.4 million for maintenance of the regional rail network; and \$530.6 million for regional roads.

The impact of the Government's support for the employment prospects of regional Victorians has been evidenced by the growth in regional employment, which grew by 2.1 per cent in 2016, among the strongest in Australia. This direct assistance has contributed to a reduced unemployment rate in Geelong to around 6 per cent, in line with the State's average, despite the structural change to industry and employment in this area.

SECURING VICTORIA'S FUTURE

Victorians are right to be optimistic about their future. The Victorian economy has demonstrated that it is dynamic, and can continue to provide the jobs, services and growth for all Victorians regardless of their location or background. The Government has invested in the infrastructure necessary to support growth in the long term.

The Government has worked to give every Victorian greater opportunity by supporting their efforts to participate in employment and in the community, and to lead healthy and productive lives. This budget gets on with the job of securing Victoria's future.

CHAPTER 4 – BUDGET POSITION AND OUTLOOK

- The *2017-18 Budget* demonstrates the Government’s commitment to invest for growth in the infrastructure and services the State needs, while maintaining a responsible fiscal position.
- The Government has announced \$9.6 billion in new output initiatives and up to \$6.1 billion total estimated investment (TEI) in new asset initiatives.
- The general government sector operating surplus is estimated to be \$1.2 billion in 2017-18, with strong surpluses averaging \$2.4 billion over the forward estimates.
- In 2017-18, Victoria is expected to collect \$63.4 billion in revenue, and spend \$62.3 billion on service delivery. Revenue growth is expected to average 3.7 per cent a year over the next four years, exceeding average expense growth of 3.2 per cent a year.
- Government infrastructure investment (GII) is at historically high levels. Estimated GII over the next four years averages \$9.6 billion a year compared with an average of \$5.6 billion a year over the decade to 2016-17.
- Net debt is expected to be \$28.9 billion by June 2021. As a proportion of gross state product (GSP), net debt is projected to increase from its June 2017 level of 4.6 per cent to 6.0 per cent by June 2021. This is a low level by historical standards and is consistent with maintaining Victoria’s triple-A credit rating.
- The Government is on track to fully fund the State’s unfunded superannuation liability by 2035.
- The *2017-18 Budget* further strengthens the State’s fiscal position, and ensures the Government is equipped to meet our economic challenges.

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 24 April 2017 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 *2017-18 Budget* demonstrates the Government's commitment to invest for growth in the infrastructure and services the State needs. Importantly, these investments are being delivered while maintaining budget surpluses and general government net debt at a sustainable level over the medium term, in line with the Government's fiscal strategy. This budget invests \$9.6 billion in additional service delivery, and up to \$6.1 billion TEI in new asset initiatives.

The operating result (net result from transactions) for the general government sector in 2017-18 is forecast to be \$1.2 billion, and averages \$2.4 billion over the forward estimates (Table 4.1).

Expenditure growth (3.2 per cent a year) is expected to be no greater than revenue growth (3.7 per cent a year), on average, over the budget and forward estimates.

Table 4.1: General government fiscal aggregates

	<i>Unit of measure</i>	<i>2015-16 actual</i>	<i>2016-17 revised</i>	<i>2017-18 budget</i>	<i>2018-19 estimate</i>	<i>2019-20 estimate</i>	<i>2020-21 estimate</i>
Net result from transactions	\$ billion	2.7	1.3	1.2	2.0	2.4	2.7
Government infrastructure investment ^{(a)(b)}	\$ billion	4.8	9.3	10.1	9.8	10.1	8.4
Net debt	\$ billion	22.3	18.1	23.8	25.1	27.4	28.9
Net debt to GSP	per cent	6.0	4.6	5.8	5.8	6.0	6.0

Source: Department of Treasury and Finance

Notes:

(a) Includes general government net infrastructure investment and estimated cash flows for Partnerships Victoria projects and the State contribution to the West Gate Tunnel Project.

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

Infrastructure investment, as measured by GII, will surge over the next four years, averaging \$9.6 billion a year compared with the historical average of \$5.6 billion a year over the decade to 2016-17.

Net debt as a proportion of GSP is expected to be 4.6 per cent at June 2017 and increase to 6.0 per cent by June 2021. This increase reflects the Government's significant investment in productivity-enhancing infrastructure, yet maintains manageable levels of net debt consistent with a triple-A credit rating (Box 4.1).

Box 4.1: Triple-A credit rating

Victoria is currently rated triple-A stable by Moody's Investor Services (Moody's) and triple-A with a negative outlook by Standard & Poor's (S&P). Maintaining a triple-A rating is important as it:

- enhances access to financial markets, particularly in times of market stress when access to funds can be limited. At the height of the global financial crisis, Victoria was able to access funds due to the strong demand for triple-A rated investments;
- minimises the State's cost of debt. The interest rate on Victoria's 10-year borrowings is 0.2 per cent and 0.4 per cent lower than the AA+ rated states of Queensland and Western Australia respectively;
- enhances the financial reputation of the State of Victoria, with the triple-A rating status recognised internationally as the highest credit quality. Internationally, there are only 12 sovereign governments rated triple-A by S&P and 12 rated triple-A by Moody's. The triple-A rating is of particular importance to overseas investors who may be less familiar with the Australian environment; and
- improves business confidence as it reflects a strong economy, fiscal position and financial management.

In order to achieve a triple-A rating, it is necessary to have a diverse economy that is resilient to shifting external conditions. Victoria's broad economic base ensures that it is not reliant on one sector for economic growth. Victoria's comparative advantage in the services and knowledge sectors means the State is positioned to take advantage of changes in the Australian economy.

A second important requirement for a triple-A credit rating is a strong fiscal position with manageable debt levels. The Victorian Government has maintained fiscal discipline by ensuring revenue growth is higher than expense growth on average over the budget and forward estimates, providing capacity to maintain budget and debt settings that support the triple-A rating. The positive economic outlook for Victoria will underpin continued growth in the State's tax base.

In July 2016, S&P revised the credit rating outlook of the Commonwealth of Australia to negative due to the declining prospects of the Commonwealth improving its budgetary performance. As a direct result, S&P applied the sovereign ceiling rule and revised the ratings outlook of Victoria, New South Wales and the Australian Capital Territory from positive to negative, despite there having been no deterioration in Victoria's financial position. S&P has stated that it does not consider that any state or territory in Australia can maintain stronger credit characteristics than the sovereign government in a stress scenario.

The Government believes Victoria should be assessed independently of the Commonwealth's financial position. Over 55 per cent of Victoria's revenue is sourced independently from the Commonwealth. GST, which comprises 23 per cent of total revenue, is a state tax and cannot be varied by the Commonwealth unilaterally. The remaining specific purpose transfers from the Commonwealth are only 22 per cent of total revenue. Most of these grants are for services such as health and education and are covered by existing agreements between the Commonwealth and the states.

Capital grants from the Commonwealth are even smaller, estimated to average only 1 per cent over the forward estimates, meaning Victoria almost entirely self-funds its capital expenditure requirements.

BUDGET AND FORWARD ESTIMATES OUTLOOK

Table 4.2 summarises the operating statement for the general government sector. A comprehensive operating statement is presented in Budget Paper No. 5, Chapter 1 *Estimated financial statements for the general government sector*.

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

	2015-16 <i>actual</i>	2016-17 <i>revised</i>	2017-18 <i>budget</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>	2020-21 <i>estimate</i>
Revenue						
Taxation	19 896	22 189	21 827	23 163	24 475	25 629
Dividends, TER and interest ^(b)	1 634	1 453	2 070	1 456	1 502	1 602
Sales of goods and services	6 671	6 886	7 187	7 465	7 807	8 097
Grant revenue	25 406	27 526	29 818	31 915	31 619	32 280
Other current revenue	3 108	2 657	2 502	2 525	2 544	2 560
Total revenue	56 716	60 711	63 405	66 524	67 947	70 169
<i>% change ^(c)</i>	4.5	8.1	4.4	4.9	2.1	3.3
Expenses						
Employee expenses	20 002	22 060	23 011	24 039	24 722	25 346
Superannuation ^(d)	3 001	3 034	3 108	3 113	3 138	3 139
Depreciation	2 504	2 671	2 788	3 033	3 193	3 394
Interest expense	2 076	2 012	2 181	2 197	2 201	2 258
Other operating expenses	17 905	19 210	19 830	19 291	18 981	20 036
Grants and other transfers	8 564	10 378	11 333	12 876	13 308	13 267
Total expenses	54 052	59 367	62 252	64 549	65 542	67 441
<i>% change</i>	2.8	9.8	4.9	3.7	1.5	2.9
Net result from transactions	2 664	1 344	1 153	1 975	2 405	2 727
Total other economic flows included in net result ^(e)	(847)	(295)	(266)	(143)	(295)	(304)
Net result	1 817	1 049	887	1 832	2 111	2 424

Source: Department of Treasury and Finance

Notes:

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

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

(c) The 2015-16 and 2016-17 per cent change refers to 2015-16 figures, adjusted to remove the one-off receipt of revenue associated with the High Court of Australia's decision in favour of the State relating to the Tatts Group Limited's 'Gambling Licences' proceedings.

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

(e) 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 \$63.4 billion in revenue in 2017-18. Revenue growth over the four years to 2020-21 is projected to average 3.7 per cent a year. This is a solid result but below average revenue growth of 5.9 per cent over the decade to 2016-17.

As outlined in Chapter 2 *Economic context*, the outlook for the economy is positive with growth forecast to remain robust, despite global economic and policy uncertainty.

Over the forward estimates, real GSP is forecast to grow at trend. The positive effect of low interest rates and population growth will drive household consumption and business and dwelling investment.

Taxation

State taxation revenue is forecast to be \$21.8 billion in 2017-18, with growth over the four years to 2020-21 expected to average 3.7 per cent a year. The pace of growth in the near term is expected to ease as revenue from Victoria's land and property taxes moderates. However, this is expected to be offset by overall strength in payroll tax revenue, which is benefiting from a solid labour market and strong population growth. Specifically:

- land transfer duty revenue is expected to grow by 2.4 per cent in 2017-18 to \$6.2 billion. This follows ongoing growth in revenue over the past few years, in line with the low interest rate environment and strong population growth. Reflecting the current market expectations for interest rates going forward, the forecast profile is for a period of more moderate growth from 2017-18 before a return to trend growth by 2019-20;
- land tax revenue is forecast to decrease by 5.3 per cent to around \$2.4 billion in 2017-18, following growth in the previous year as a result of the biennial revaluation process. The buoyant property market is expected to support land tax revenue over the forward estimates;
- payroll tax revenue is expected to grow by 3.0 per cent to \$5.9 billion in 2017-18, and average 5.0 per cent over the following three years reflecting strong growth in both full-time and part-time employment;
- gambling tax revenue is forecast to grow by 2.6 per cent to \$1.9 billion in 2017-18 and by an average of 1.8 per cent a year over the following three years. Gambling revenue has been downgraded over the forecast period to reflect lower than expected growth in lotteries revenue;
- insurance tax revenue is anticipated to grow by 6.0 per cent to \$1.3 billion in 2017-18, slightly below its trend growth rate of 6.8 per cent. Revenue is expected to return to trend over the forward estimates, consistent with growth in the economy and population; and
- motor vehicle taxes are expected to grow by 7.4 per cent to \$2.5 billion in 2017-18, and by an average of 3.5 per cent over the following three years. This reflects the offsetting impacts of higher vehicle registrations due to stronger population growth and lower stamp duty revenue flowing from weaker than expected consumer sentiment.

Dividends, income tax equivalent and interest

Dividend and income tax equivalent (ITE) revenue is projected to increase to \$1.2 billion in 2017-18. This growth is mainly due to an increase in dividends from the State Electricity Commission of Victoria and the Victorian Managed Insurance Authority. In 2018-19, dividends and ITEs are expected to decline but stabilise thereafter.

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 expected to reach \$899 million in 2017-18, and decline by an average of 2.8 per cent a year over the following three years.

Sales of goods and services

Revenue from the sales of goods and services is expected to grow by 4.4 per cent in 2017-18 to \$7.2 billion. This growth largely reflects an increase in the capital asset charge revenue from VicTrack associated with an increase in its asset base, and an increase in TAFE fees for service. Over the forward estimates, growth is expected to average 4.1 per cent a year.

Grants

Total grants revenue is expected to grow by 8.3 per cent to \$29.8 billion in 2017-18 and increase by 2.7 per cent a year on average to \$32.3 billion over the following three years.

GST revenue is anticipated to grow by 8.0 per cent to \$14.7 billion in 2017-18. This reflects an improvement in Victoria's share of the national GST pool, in part due to continued strong population growth relative to other states. Over the forward estimates, GST revenue is estimated to increase on average by 6.9 per cent a year.

Commonwealth grants for specific purposes are projected to be \$14.2 billion a year on average across the next four years. The Commonwealth provides these grants as contributions towards health care, education, disability and other services, and major infrastructure investment.

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 5.8 per cent to \$2.5 billion in 2017-18, driven by a large one-off increase in revenue in 2016-17 from the assets received free of charge associated with the transfer of assets from the Geelong City Council to the Kardinia Park Stadium Trust. Other current revenue is projected to increase by an average of 0.8 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 \$62.3 billion in 2017-18 providing services that Victoria needs. Total expenses are expected to grow by 3.2 per cent a year on average over the four years to \$67.4 billion in 2020-21.

The level and expected growth in expenses reflect the Government's ongoing commitment to create and protect jobs, invest in transport, deliver first-rate education for all children, and ensure Victorians have health care when they need it. It also reflects significant investment in initiatives to build a society free from family violence. Specific movements in expenses include:

- grants and other transfer expenses, such as funding provided to non-government schools, VicTrack and V/Line for operational costs incurred in the provision of transport services, and local governments, are forecast to increase by 9.2 per cent to \$11.3 billion in 2017-18. Thereafter, growth moderates to an average of 5.4 per cent a year over the forward estimates;
- depreciation expense is projected to grow by 4.4 per cent to \$2.8 billion in 2017-18 and increase by 6.8 per cent a year on average over the following three years to \$3.4 billion in 2020-21. This growth is broadly in line with the Government's increased investment in infrastructure;
- employee expenses (including superannuation) are expected to grow by 4.1 per cent in 2017-18 and moderate to an average increase of 2.9 per cent over the following three years to 2020-21 (see Box 4.2);
- other operating expenses are projected to increase by 3.2 per cent in 2017-18 and to grow by an average of 0.3 per cent over the following three years to \$20 billion in 2020-21; and
- interest expense is expected to be \$2.2 billion in 2017-18. Interest expense over the forward estimates is projected to be relatively stable, with declining interest rates being offset by an increase in the level of borrowings to fund infrastructure investment.

Box 4.2: Employee expenses growth

Employee expenses (including superannuation) are projected to grow by \$1.0 billion, or 4.1 per cent, to \$26.1 billion in 2017-18 and by 2.9 per cent a year on average over the forward estimates.

This reflects the largest ever investment in initiatives to end family violence, commencement of the recruitment of 2 729 additional police officers to tackle crime, and increased investments in hospitals to improve access to health care.

Growth in employee expenses also reflects sustainable increases in public sector wages in line with wages policy.

In recent budgets, investments have been made to increase the quantity of services delivered, as well as to continue to improve the quality of service delivery. This includes enacting the Fair Work Commission's work value recommendation on paramedics' pay and providing fair reward to police officers for working unsociable hours such as late nights and weekends.

Reconciliation of estimates to the 2016-17 Budget Update

Relative to the 2016-17 Budget Update, the net result from transactions has been revised down by \$75 million in 2017-18, up by \$197 million in 2018-19 and down by \$219 million in 2019-20 (Table 4.3).

Table 4.3: Reconciliation of estimates to the 2016-17 Budget Update ^(a) (\$ million)

	2017-18 budget	2018-19 estimate	2019-20 estimate
Net result from transactions: 2016-17 Budget Update	1 228	1 778	2 624
Policy decision variations			
Revenue policy decision variations	(43)	13	126
Output policy decision variations ^(b)	(1 882)	(1 421)	(838)
	(1 925)	(1 408)	(712)
Economic/demographic variations			
Taxation	380	475	520
Investment income ^(c)	190	(68)	(144)
	570	406	376
Commonwealth grant variations			
General purpose grants	(12)	(9)	112
Specific purpose grants ^(d)	240	482	(62)
	228	474	50
Administrative variations			
Contingency offset for new policy ^(e)	200	200	200
Other administrative variations	851	525	(133)
	1 051	725	67
Total variation since 2016-17 Budget Update	(75)	197	(219)
Net Result from transactions: 2017-18 Budget	1 153	1 975	2 405

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 2017-18 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 1.2.4 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 1.3.5 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 next four years 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

Since the *2016-17 Budget Update*, new revenue policy decisions have increased the operating result by \$313 million over the five years to 2020-21. Details of the specific policy initiatives since the *2016-17 Budget Update* are contained in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

Output policy decision variations

The *2017-18 Budget* provides \$9.6 billion in new output initiatives over the five years to 2020-21. Table 4.4 shows the impact of the 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 2017-18 Budget new output initiatives ^(a) (\$ million)

	2017-18 budget	2018-19 estimate	2019-20 estimate	2020-21 estimate
New output initiatives	2 857	2 393	2 047	2 147
Less:				
Funding from reprioritisation of existing resources ^(b)	682	533	461	458
Adjustments ^(c)	96	93	396	270
Savings	197	346	353	454
2017-18 Budget output policy decisions	1 882	1 421	838	965
Less: contingency offset for new policy ^(d)	200	200	200	200
Net impact	1 682	1 221	638	765

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 includes the reprioritisation of resources previously allocated to departments and retained revenues.
- (c) Primarily incorporates the net impact of the creation and release of decisions made but not yet allocated contingencies.
- (d) 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 1.3.5 of Budget Paper No. 5, Chapter 1 Estimated financial statements for the general government sector.

Economic and demographic variations

Since the *2016-17 Budget Update*, land transfer duty, land tax and investment income have been most affected by expected economic and demographic variations:

- land transfer duty revenue is expected to be \$377 million a year higher on average from 2017-18 to 2019-20 compared with the *2016-17 Budget Update*. This reflects the continuing strength in the property market, underpinned by historically low interest rates and strong demand in both the residential and commercial markets;
- land tax revenue is forecast to be \$92 million a year higher, on average, from 2017-18 to 2019-20 compared with the *2016-17 Budget Update*. This growth reflects recent strength in the property market and an update to the revaluation estimates;
- gambling revenue is expected to be \$51 million lower, on average, from 2017-18 to 2019-20 compared with the *2016-17 Budget Update*. This largely reflects a downgrade to the outlook for lotteries revenue; and
- total investment income is forecast to be \$7 million a year lower on average, from 2017-18 to 2019-20.

Commonwealth grants variations

Commonwealth general purpose grants (or GST grants) estimates have been revised down by \$12 million in 2017-18 and by \$9 million in 2018-19, but revised up by \$112 million in 2019-20 compared with the *2016-17 Budget Update*.

Net changes to specific purpose grants have increased the operating result by \$240 million in 2017-18 and by \$482 million in 2018-19, but decreased it by \$62 million in 2019-20. These movements are largely due to a rephrasing of project timelines and associated state expenditure for the Goulburn-Murray Water Connections Project.

Administrative variations

Other administrative variations are expected to increase the operating result by \$851 million in 2017-18 and by \$525 million in 2018-19 and decrease it by \$133 million in 2019-20. These movements include:

- additional depreciation related to a revaluation of school assets;
- an increase in superannuation expenses;
- adjustments to the provision for decisions made but not yet allocated that is outlined in note 1.3.5 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
- an expected increase in fees and fines revenue.

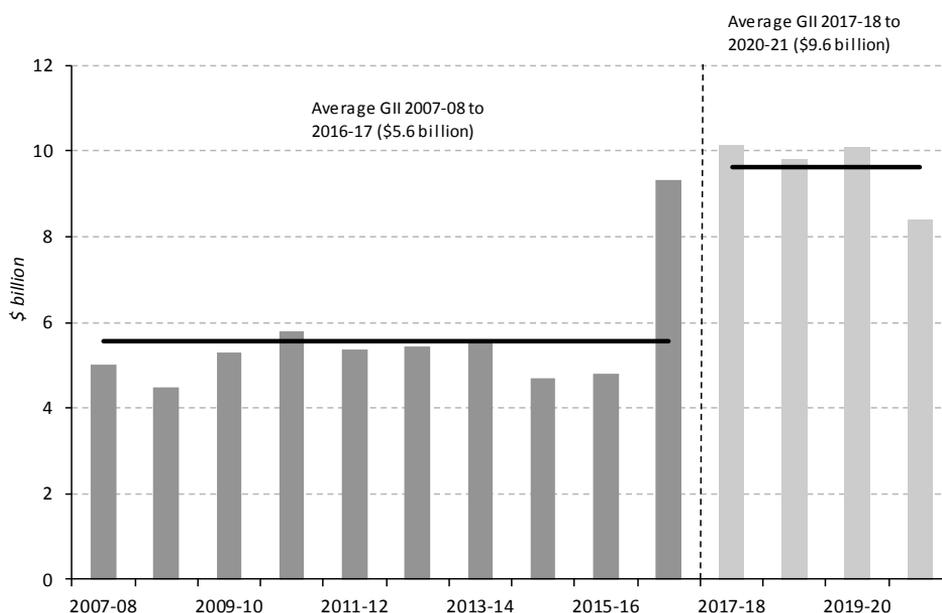
Capital expenditure

The investments in the *2017-18 Budget* reflect a balance between investing in infrastructure to deliver the services Victorians need and the transformational projects that will enhance Victoria’s future prosperity.

Government infrastructure investment (GII) captures investment funded or facilitated by the Government. It includes both the Government’s direct investment and cash flow estimates for projects being delivered by the private sector through public private partnership arrangements.

GII is anticipated to average \$9.6 billion across the next four years, significantly higher than the average GII for the past decade to 2016-17 of \$5.6 billion (Chart 4.1). This reflects the Government’s commitment to substantial and ongoing investment in transformative projects, including Metro Tunnel, the Level Crossing Removal Program, the West Gate Tunnel Project and the Western Suburbs Road Package. The projects announced in the *2017-18 Budget* continue the Government’s commitment to a substantial infrastructure program.

Chart 4.1: Government infrastructure investment ^{(a)(b)(c)}



Source: Department of Treasury and Finance

Notes:

- (a) Includes general government net infrastructure investment and estimated cash flows for Partnerships Victoria projects and the State contribution to the West Gate Tunnel Project.
- (b) Excludes the impact of the medium-term lease over the operations of the Port of Melbourne.
- (c) The figure for 2016-17 is an estimate.

New asset initiatives

The *2017-18 Budget* includes up to \$6.1 billion TEI of new infrastructure investment that will enhance productivity, boost economic growth, and improve the liveability of communities for all Victorians.

Investment in new asset initiatives includes:

- \$685 million to invest in school infrastructure;
- \$673 million for the final upgrade to the M80 Ring Road, which will complement the North East Link;
- \$498 million for new and upgraded health facilities, infrastructure and vital health equipment;
- \$435 million for an upgrade to Gippsland Rail; and
- \$100 million to complete planning and pre-construction for the North East Link.

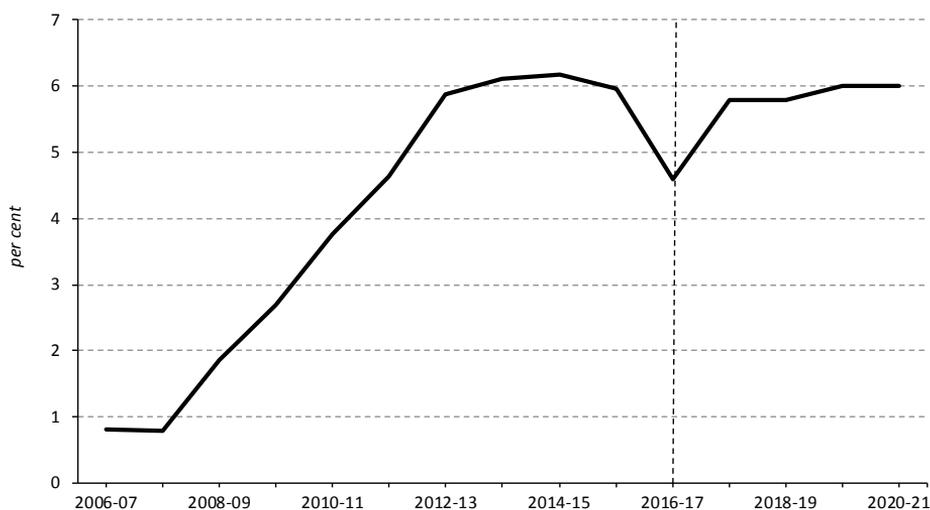
Details of individual asset initiatives can be found in Budget Paper No. 3, Chapter 1 *Output, asset investment, savings and revenue initiatives*.

Net debt

Net debt as a proportion of GDP is expected to be 4.6 per cent at June 2017 (Chart 4.2), rising to 6.0 per cent of GDP by June 2021. This reflects the Government's previously advocated position on the use of debt financing to sustain sensible investment in productivity-enhancing infrastructure that grows the State's economy.

Initiatives in the *2017-18 Budget*, such as the M80 Ring Road upgrade and the Mordialloc Bypass, further add to the previously announced transformative projects of national significance currently being delivered by the Government such as Metro Tunnel, the Level Crossing Removal Program and the West Gate Tunnel Project.

Chart 4.2: General government net debt to GDP



Source: Department of Treasury and Finance

Note: The decrease in 2016-17 reflects the receipt of proceeds from entering into a medium-term lease over the operations of the Port of Melbourne.

The application of cash resources for the general government sector (Table 4.5) outlines the annual movements in net debt. General government sector cash from operating activities is expected to average \$4.6 billion a year over the next four years.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	<i>actual</i>	<i>revised</i>	<i>budget</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Net result from transactions	2 664	1 344	1 153	1 975	2 405	2 727
Add back: non-cash revenue and expenses (net) ^(b)	2 695	2 300	2 448	3 768	1 754	1 997
Net cash flows from operating activities	5 359	3 644	3 601	5 743	4 159	4 725
Less: Total net investment in fixed assets ^(c)	4 137	6 763	5 930	4 902	4 583	3 843
Surplus/(deficit) of cash from operations after funding net investment in fixed assets	1 222	(3 118)	(2 328)	841	(424)	882
Finance leases ^(d)	1 050	517	647	415	312	964
Other movements	153	(7 820)	2 698	1 771	1 475	1 481
Decrease/(increase) in net debt	19	4 184	(5 673)	(1 346)	(2 211)	(1 563)

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 2016-17 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 Ravenhall Prison project, the new Bendigo Hospital project (stage 2) and the New Schools PPP project (tranche 2). The 2018-19 and 2019-20 estimates relate to the High Capacity Metropolitan Trains project. The 2020-21 estimates relate to the High Capacity Metropolitan Trains project and the Western Suburbs Road Package.

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 1.6.3 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.

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*.

In particular, the outlook for interest rates is a key driver of land transfer duty. While the Reserve Bank of Australia's current cash rate is at historic lows, rates are expected to increase only gradually across the forward estimates. This reflects a benign outlook for price and wages growth in the domestic economy. However, if interest rates rise more quickly than currently expected, land transfer duty revenue will be lower than forecast. This risk is reinforced by Australia's high level of household debt and the corresponding sensitivity of households to changes in mortgage repayments. A series of successive rate rises would sharply reduce consumer sentiment and significantly increase the possibility of a slowdown in both property prices and transaction volumes.

A further risk to land transfer duty revenue stems from recent changes to housing finance regulations. In March and April 2017, the Australian Prudential Regulation Authority announced new measures to reduce banks' exposure to investor lending and increase capital reserve ratios. These measures increase the likelihood that banks will raise interest rates independently of any movement in the official cash rate.

Employee expenses

Employee expenses are the State's largest expense. Wages policy sets the framework for enterprise agreement negotiations and in part contributes to the projection of employee expenses. 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 next four years. The contingency provisions are designed to allow for the likely growth in Victoria's population and consequent derived demand for government services.

Specific fiscal risks

National Disability Insurance Scheme

Victoria commenced transition to the National Disability Insurance Scheme (NDIS) on 1 July 2016 and is expected to reach full scheme across the State by July 2019. Once fully implemented, Victoria's investment in the NDIS will be an estimated \$2.5 billion a year, with the Commonwealth providing up to \$2.6 billion a year. Victoria will work with the Commonwealth Government to monitor and manage any risks associated with transition.

Commonwealth schools funding

Commonwealth contributions to school education via *Students First* funding is yet to be determined for the 2018 school year onwards. While the Commonwealth is committed to per student funding for school education, the quantum and conditions of funding are dependent on formal negotiations between the Commonwealth, the states and the non-government schools sector.

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. Funding is due to cease on 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 from 1 July 2017 until 30 June 2020. Conditions attached to the new agreement may increase fiscal risk for the State and include:

- a national cap on Commonwealth annual expenditure growth of 6.5 per cent (above which the State may fund all hospital activity);
- reduced funding to the State for avoidable hospital admissions or unsafe care; and
- the Commonwealth withholding funds until hospital activity data is provided.

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.

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 key driver of Victoria's share of the national GST pool. The transition from the mining boom is driving significant shifts in population between the states and is likely to remain a source of uncertainty in the near term. If Victoria's share of net overseas migration or level of net interstate migration is higher than expected, this would see Victoria's share of GST revenue increase.
- The outlook for the national GST pool reflects the current environment of low price and income growth. If inflation and wages growth do not pick up over the forecast period as expected, there is a risk that the GST pool could grow more slowly than anticipated.
- Mining royalties are an important driver for the per capita relativities of each jurisdiction over the following three years. 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

- The non-financial public sector (NFPS) is estimated to generate operating surpluses over the budget and forward estimates. This reflects the positive fiscal outlook in the general government sector, which is focused on delivering meaningful services to all Victorians in a fiscally responsible manner.
- NFPS net debt to gross state product (GSP) is estimated to average 9.8 per cent over the budget and forward estimates. The strong outlook for the State’s financial position supports Victoria’s triple-A credit rating.
- The net result from transactions of the public non-financial corporations (PNFC) sector is estimated to be an average deficit of \$689 million a year over the budget and forward estimates.
- The net result of the public financial corporations (PFC) sector is estimated to be stable over time, with surpluses averaging \$224 million a year over the budget and forward estimates. The average operating cash flow surplus of the PFC sector is a surplus of \$510 million.

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, and transport 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).

NON-FINANCIAL PUBLIC SECTOR

Table 5.1 shows 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 \$1.8 billion surplus by 2020-21. The improvement is mainly due to the general government sector, which is projected to record a net result from transactions of \$2.7 billion in 2020-21.

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

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Revenue						
Taxation revenue	19 460	21 827	21 468	22 742	24 038	25 335
Dividends, income tax equivalent and interest ^(b)	662	544	863	583	720	786
Sales of goods and services	10 869	10 914	11 293	11 713	12 141	12 812
Grants	25 402	27 518	29 812	31 909	31 613	32 274
Other current revenue	3 814	3 265	3 092	3 094	3 110	3 143
Total revenue	60 206	64 068	66 528	70 042	71 622	74 350
<i>% change</i>	5.2	6.4	3.8	5.3	2.3	3.8
Expenses						
Employee expenses	21 101	23 180	24 196	25 249	25 971	26 628
Superannuation ^(c)	3 110	3 139	3 220	3 227	3 254	3 260
Depreciation	4 658	4 882	5 198	5 586	5 823	6 082
Interest expense	2 659	2 443	2 600	2 678	2 740	2 850
Grant expense	5 649	7 507	8 151	9 750	10 067	10 007
Other operating expenses	20 349	22 382	23 051	22 543	22 209	23 705
Total expenses	57 526	63 533	66 416	69 032	70 066	72 532
<i>% change</i>	1.9	10.4	4.5	3.9	1.5	3.5
Net result from transactions	2 680	535	113	1 010	1 556	1 817
Total other economic flows included in net result	(1 007)	(319)	(224)	(429)	(263)	(288)
Net result	1 673	216	(112)	581	1 294	1 530

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.

The PNFC sector is projected to record an average deficit of \$689 million over the budget and forward estimates. However, the average operating cash flow surplus of the PNFC sector is a surplus of \$1.6 billion.

VicTrack and the Director of Housing are major contributors towards the operating deficits of the PNFC sector. However, VicTrack and the Director of Housing generate net operating cash flow surpluses averaging \$130 million a year over the budget and forward estimates. 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, \$1 billion over the budget and forward estimates. However, given the cash flow surpluses, VicTrack and the Director of Housing remain in a financially sustainable position.

Most PNFC entities are projected to record operating surpluses over the budget and forward estimates. The average net result from transactions of the metropolitan water sector over this period is \$273 million.

Application of cash resources

Table 5.2 shows that the NFPS is projected to generate net operating cash flow surpluses averaging \$5.9 billion a year over the budget and forward estimates.

Table 5.2: Application of cash resources for the non-financial public sector^(a) (\$ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Net result from transactions	2 680	535	113	1 010	1 556	1 817
Add back: non-cash income and expenses (net) ^(b)	4 371	12 921	4 615	6 046	4 014	4 391
Net cash flow from operating activities	7 051	13 457	4 728	7 055	5 570	6 208
Less: Total net investment in fixed assets^(c)	6 003	9 287	11 278	8 482	8 169	7 105
Surplus/(deficit) of cash from operations after funding net investments in fixed assets	1 047	4 169	(6 551)	(1 427)	(2 599)	(897)
Finance leases ^(d)	1 050	517	647	415	312	964
Other movements	27	(24)	2	(10)	(16)	(6)
Decrease/(increase) in net debt	(30)	3 677	(7 200)	(1 832)	(2 894)	(1 855)

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 net capital contributions to other sectors of government net of proceeds from asset sales.
- (d) The finance lease acquisition in 2016-17 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 Ravenhall Prison project, the new Bendigo Hospital project (stage 2) and the New Schools PPP project (tranche 2). The 2018-19 and 2019-20 estimates relate to the High Capacity Metro Trains Project. The 2020-21 estimates relate to the High Capacity Metro Trains Project and the Western Suburbs Roads Package.

Infrastructure

Table 5.2 also provides the estimates of net investment in non-financial assets, which is infrastructure expenditure net of proceeds from asset sales. Over the budget and forward estimates NFPS total net investments in non-financial assets will average \$9.4 billion.

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 infrastructure investment for the Regional Rail Revival – Gippsland Rail Upgrade and procuring additional rolling stock with a further 39 new VLocity train carriages to meet demand on the regional network. Additional regional rolling stock investment also includes sustainment works to V/Line trains and carriages. Investment in metropolitan rail infrastructure includes upgrades to the Frankston Station Precinct and station upgrades to enhance passenger experience and improve access to public transport; and
- various water-related infrastructure projects, including the Goulburn-Murray Water Connections Project, connecting irrigators to a modernised system of irrigation channels.

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 averages 9.8 per cent over the budget and forward estimates.

Superannuation liabilities are projected to fall, resulting in a decline in the net financial liabilities to GSP ratio from 19.3 per cent in 2017-18 to 17.3 per cent in 2020-21.

Table 5.3: Non-financial public sector net debt and financial liabilities ^(a) (\$ billion)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	actual	revised	estimate	estimate	estimate	estimate
Assets						
Cash and deposits	5.6	5.9	6.0	6.5	7.0	7.4
Advances paid	0.2	0.2	0.1	0.1	0.1	0.1
Investments, loans and placements	3.9	4.6	3.6	3.5	3.5	3.6
Total	9.6	10.6	9.8	10.2	10.7	11.2
Liabilities						
Deposits held and advances received	0.8	0.8	0.8	0.8	0.8	0.8
Borrowings	45.4	42.7	49.1	51.3	54.7	57.0
Total	46.2	43.5	49.9	52.1	55.5	57.9
Net debt ^(b)	36.6	32.9	40.1	41.9	44.8	46.7
Superannuation liability	29.4	25.5	24.6	23.6	22.5	21.4
Net debt plus superannuation liabilities	65.9	58.4	64.7	65.5	67.3	68.1
Other liabilities (net) ^(c)	6.1	14.5	14.5	15.9	15.4	14.9
Net financial liabilities ^(d)	72.1	72.9	79.1	81.4	82.7	83.0
	<i>(per cent)</i>					
Net debt to GSP ^(e)	9.8	8.4	9.8	9.7	9.9	9.8
Net debt plus superannuation liability to GSP ^(e)	17.6	14.9	15.8	15.2	14.8	14.2
Net financial liabilities to GSP ^(e)	19.2	18.6	19.3	18.8	18.2	17.3
Net debt plus superannuation liability to revenue ^(f)	109.5	91.1	97.2	93.5	94.0	91.6

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 NFPS net debt (excluding advances paid) plus the superannuation liability as a proportion of NFPS total operating revenue.

Table 5.4 provides projections of several indicators of financial sustainability for the NFPS, which are improving over the forward estimates.

The increase in the operating cash flow surplus to revenue ratio indicates an increasing level of cash generated from operations, which can be used to fund infrastructure. The operating cash flow surplus to revenue ratio is high in 2016-17 due to the receipt of cash proceeds from the medium-term lease of the operations of the Port of Melbourne in 2016-17.

The overall debt burden is demonstrated by the ratio of gross debt to revenue, which is estimated to be 75 per cent in 2017-18. The ratio of NFPS interest expense to revenue ratio is a measure of the State's debt service burden. This ratio is expected to be 3.9 per cent in 2017-18 before declining to 3.8 per cent in 2018-19 and remaining stable thereafter due to lower interest rates and increased revenue.

Table 5.4: Indicators of financial sustainability for the non-financial public sector (per cent)

	2015-16 <i>actual</i>	2016-17 <i>revised</i>	2017-18 <i>estimate</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>	2020-21 <i>estimate</i>
Operating cash flow surplus to revenue	11.7	21.0	7.1	10.1	7.8	8.3
Gross debt to revenue ^(a)	76.8	67.9	75.0	74.4	77.5	77.8
Interest expense to revenue	4.4	3.8	3.9	3.8	3.8	3.8

Source: Department of Treasury and Finance

Note:

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

STATE OF VICTORIA

Table 5.5 shows the operating result for the State. The net result for the State is projected to record an average surplus of \$838 million over the budget and forward estimates. The net result includes other economic flows, which are projected to contribute on average \$1.7 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.

Table 5.5: Operating results – State of Victoria ^(a) (\$ million)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	<i>actual</i>	<i>revised</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Revenue						
Taxation revenue	19 446	21 812	21 453	22 727	24 022	25 318
Dividends, income tax equivalent and interest ^(b)	1 810	1 885	1 892	2 047	2 028	2 054
Sales of goods and services	14 324	14 470	14 998	15 587	16 200	17 065
Grants	25 241	27 259	29 334	31 534	31 086	32 001
Other current revenue	3 835	3 286	3 116	3 119	3 135	3 169
Total revenue	64 657	68 713	70 791	75 014	76 471	79 608
<i>% change</i>	6.1	6.3	3.0	6.0	1.9	4.1
Expenses						
Employee expenses	21 066	23 154	24 173	25 233	25 918	26 576
Superannuation ^(c)	3 134	3 164	3 246	3 253	3 281	3 287
Depreciation	4 706	4 929	5 247	5 633	5 872	6 131
Interest expense	2 730	2 628	2 825	2 900	2 962	3 072
Grant expense	5 657	7 516	8 147	9 747	10 064	10 017
Other operating expenses	25 720	28 005	29 263	29 047	28 881	30 388
Total expenses	63 012	69 396	72 901	75 811	76 978	79 470
<i>% change</i>	2.2	10.1	5.1	4.0	1.5	3.2
Net result from transactions	1 645	(682)	(2 110)	(798)	(507)	137
Total other economic flows included in net result	(3 284)	5 835	1 655	1 447	1 739	1 790
Net result	(1 640)	5 152	(455)	650	1 232	1 927

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.

The PFC sector is forecast to record an average net surplus of \$224 million for the years 2017-18 to 2020-21, 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 realised and unrealised gains and losses from financial instruments at fair value as well as other economic flows. Other economic flows include valuation gains on the revaluation of financial liabilities, which primarily result from movements in bond rates used to value these liabilities.

The whole of State result is mainly driven by the NFPS 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 from \$55 billion in 2017-18 to \$59 billion by 2020-21. Borrowings are estimated to increase from \$55 billion in 2017-18 to \$62 billion by 2020-21. The State’s net assets are forecast to increase from \$169 billion in 2017-18 to \$188 billion by 2020-21.

Table 5.6: Financial position of the State of Victoria ^(a) (\$ billion)

	2015-16 <i>actual</i>	2016-17 <i>revised</i>	2017-18 <i>estimate</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>	2020-21 <i>estimate</i>
Assets						
Total financial assets ^(b)	52	57	55	56	57	59
Total non-financial assets ^(c)	230	238	249	255	267	274
Total assets	282	295	304	311	324	333
Liabilities						
Superannuation	29	25	25	24	23	21
Borrowings	54	51	55	57	60	62
Deposits held and advances received	3	2	2	2	2	2
Other liabilities ^(d)	44	52	53	57	58	59
Total liabilities	130	130	135	138	142	145
Net assets	152	165	169	172	182	188

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

The *2017-18 Budget* is predicated on macroeconomic forecasts and assumptions that are subject to uncertainty. 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 impacts of independent variations in major economic parameters are 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 analysis quantifies the impacts from variations to the macroeconomic outlook. This analysis takes account of the intricate linkages in the Australian economy and the influence of global variables to determine their effects on state economic variables. This provides a better understanding of the aggregate fiscal impact of the general economic environment being materially different from the forecast.

Sensitivity analysis provides a useful indication of the fiscal impact of variations in forecasts or economic conditions, however 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 each forecast error or economic scenario. The results presented here are intended to be used as a guide and are relevant only once the conditions outlined in the assumptions for each specific case are met. A description of the methodology is outlined in Box A.1.

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 the four budget years, 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 2017-18 ^{(a)(b)(c)(d)} (\$ million)

	2017-18 estimate	2018-19 estimate	2019-20 estimate	2020-21 estimate
GSP				
Income from transactions	113	124	131	139
Expenses from transactions	0	(5)	(11)	(17)
Net result from transactions	112	129	142	156
Net debt	(112)	(241)	(383)	(539)
Employment ^(e)				
Income from transactions	79	79	84	88
Expenses from transactions	233	253	268	282
Net result from transactions	(154)	(174)	(184)	(194)
Net debt	154	328	512	706
Consumer prices ^(f)				
Income from transactions	136	259	279	293
Expenses from transactions	204	218	216	226
Net result from transactions	(68)	42	63	68
Net debt	65	15	(57)	(134)
Average weekly earnings				
Income from transactions	(42)	1	39	35
Expenses from transactions	5	6	6	4
Net result from transactions	(47)	(6)	33	31
Net debt	47	53	20	(12)
Total employee expenses ^(g)				
Income from transactions	..	23	81	89
Expenses from transactions	235	289	308	328
Net result from transactions	(235)	(265)	(227)	(239)
Net debt	235	509	802	1115
Domestic share prices				
Income from transactions	6	4	2	1
Expenses from transactions	(0)	(2)	(2)	(3)
Net result from transactions	6	6	4	4
Net debt	(6)	(10)	(12)	(14)
Overseas share prices				
Income from transactions	17	10	6	4
Expenses from transactions	(0)	(3)	(3)	(4)
Net result from transactions	17	13	9	8
Net debt	(17)	(28)	(35)	(41)
Property prices				
Income from transactions	68	86	90	95
Expenses from transactions	(2)	(6)	(10)	(14)
Net result from transactions	70	92	100	109
Net debt	(73)	(170)	(272)	(384)

Table A.1: Sensitivity of key fiscal aggregates to selected indicators being 1 per cent higher than expected from 2017-18 (continued) (\$ million)

	2017-18 estimate	2018-19 estimate	2019-20 estimate	2020-21 estimate
Property volumes				
Income from transactions	64	67	71	74
Expenses from transactions	(2)	(5)	(8)	(11)
Net result from transactions	66	72	79	86
Net debt	(66)	(137)	(216)	(301)
Interest rates ^(h)				
Income from transactions	130	87	90	94
Expenses from transactions	7	248	245	229
Net result from transactions	122	(161)	(155)	(135)
Net debt	(122)	(206)	(297)	(395)

Source: Department of Treasury and Finance

Notes:

- (a) Variations are applied to the economic variables in the budget year. For the four budget years, it is assumed that variables' growth rates match those under a no-variation scenario. This implies that economic variables are 1 per cent higher across the four budget years, compared with a no-variation scenario.
- (b) 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). A positive number for the net result from transactions 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.
- (c) Only reasonably quantifiable impacts have been included in the analysis.
- (d) Estimates of net debt are approximately equal to the cumulative impact of the net result from transactions. The difference between the cumulative net result from transactions and net debt is due to non-cash expenses and gross sale proceeds (where applicable).
- (e) 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.
- (f) 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.
- (g) 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), through other management decisions regarding the composition and profile of the workforce or any combination of these.
- (h) Assumes interest rates are 1 percentage point higher in each year of the forward estimates.

ECONOMIC IMPACTS OF VARIATIONS TO THE ECONOMIC OUTLOOK¹

This section of the sensitivity analysis quantifies some of the key risks described in Chapter 2 *Economic context* and presents analysis describing how these risks might affect state economic parameters. Three scenarios are considered: a negative trade shock to the world's major trading economies – the United States (US), China and the European Union (EU); a positive shock to population growth in Victoria; and a positive shock, where both population growth and Victoria's labour force participation rate remain around recent high levels. The results generated in each scenario are mutually exclusive and non-additive.

A global trade shock

As a medium-sized open economy, Australia's economic performance is influenced by economic conditions abroad. An important risk to the outlook identified in Chapter 2 reflects the recent rise in sentiment towards trade protectionism and inward-looking domestic policies in major economies. Since the global financial crisis, growth in global trade intensity (world exports plus world imports as a share of world output) has slowed, averaging about 1 per cent per annum over the past six years. This weakness has reflected cyclical factors including weak global demand, and structural factors including a small but persistent unwinding of trade liberalisation in many countries. By way of comparison, in the 20 years preceding the global financial crisis, global trade intensity grew at 3.7 per cent per annum on average supported by a strong commitment by the major trading economies to a rules-based multilateral trading system and China's accession to the World Trade Organization.

This scenario is based on recent analysis by the Organization for Economic Co-operation and Development (OECD), which models a 10 percentage point rise in the trade costs of goods in the US, China and the EU.² The effects on growth and trade in these economies, and for the rest of the world, is quantified. According to the OECD, this increase in trade costs is similar to an average increase in tariffs to rates last observed in 2001, when trade negotiations under the Doha Development Round started.³ Based on the OECD's METRO (ModELLing TRade at the OECD) Model, a 10 percentage point rise in the trade costs of goods reduces global trade by 6 per cent and world output by 1.4 per cent.

¹ All three scenarios have been modelled as deviations from a business as usual base case. The analysis relies on applications of the Victoria University Regional Model (VURM), see Box A.1.

² See the *OECD Economic Outlook, Volume 2016 Issue 2*. Trade costs include transportation costs, such as shipping and time in transit. They also capture trade barriers such as tariffs. Together, the US, China and the EU made up almost half of Australia's trade for 2015-16.

³ This scenario captures the direct effects of a rise in the trade costs of goods in the major trading economies. It does not capture other economies imposing additional trade barriers in response or second-round effects such as declines in global confidence, increases in uncertainty in financial markets or the disappearance of global trade chains. If large second-round effects were realised, then the effects on global output, trade and investment would be larger.

To examine the effects on Victoria’s economy, gross domestic product (GDP) in the US, China and the EU declines by 1.8 per cent on a trade weighted basis.⁴ This is then translated as a shock to Australia’s terms of trade, based on the average historical relationship with growth in these economies. The changes in the terms of trade are then applied in VURM – a computable general equilibrium model of the Australian states and territories – and corresponds to a 13 per cent decline in demand, on average, for Victorian exports.⁵

Table A.2 reports the effects on major economic parameters of the above scenario. Export growth for Victoria falls in line with weaker global demand, and growth in real gross state product (GSP) and trade (exports plus imports) is lower with a fall in the terms of trade (Chart A.1). The real exchange rate depreciates and domestic demand moves away from imported goods and services, towards domestic goods and services, although this does not fully offset the decline in demand.⁶

Table A.2: The effect of slower global trade on major economic parameters (per cent)

	2017-18	2018-19	2019-20	2020-21
	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Real GSP	(0.17)	(0.32)	(0.46)	(0.59)
Employment	(0.12)	(0.20)	(0.24)	(0.27)
Consumer Price Index	0.01	0.02	0.03	0.04
Wage Price Index	(0.11)	(0.28)	(0.50)	(0.75)

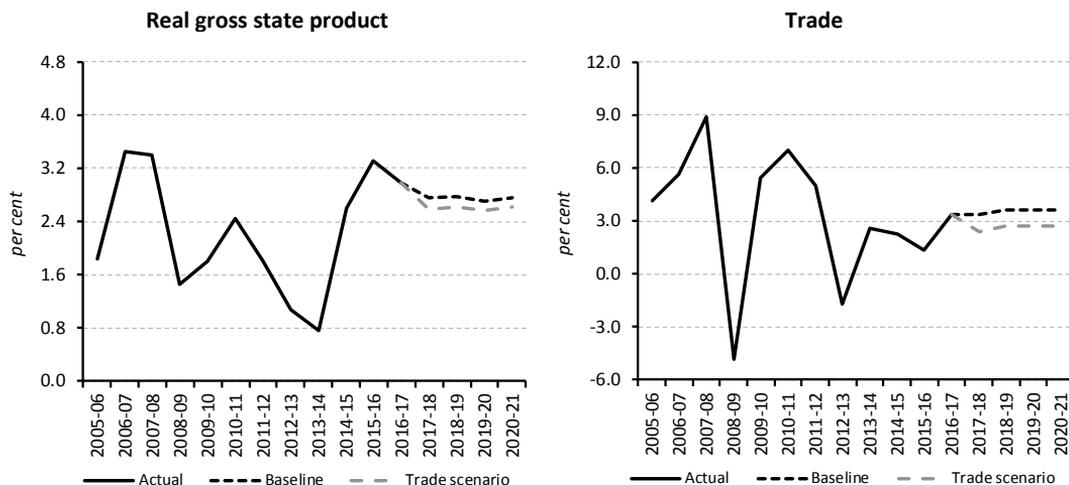
Note: Figures reported are the change in the level of each parameter relative to the baseline of no change in the economic outlook, for each year of the budget. Source: Centre of Policy Studies, Victoria University.

⁴ This reflects the cumulative changes in US, Chinese and European GDP, weighted by their trading shares with Australia (as at December 2016), which are normalised to sum to one.

⁵ Using alternative models provided similar estimated effects on Victorian GSP and employment, but captured different transmission mechanisms.

⁶ Growth of Victoria’s exports such as higher education, tourism and manufacturing fare better in relative terms as the depreciation helps to insulate trade-exposed industries.

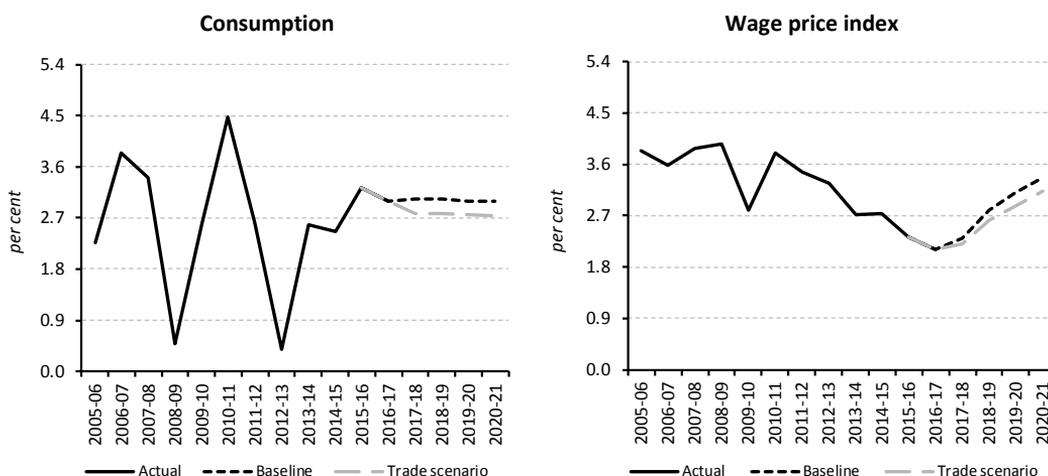
Chart A.1: Lower growth in real gross state product and trade



Sources: Australian Bureau of Statistics; Centre of Policy Studies; Department of Treasury and Finance

Other important channels through which the shock is transmitted are household consumption and the labour market. Growth in household consumption is projected to slow (Chart A.2), reflecting lower growth in household disposable income including lower wage growth and lower asset returns. Slower wage growth is in line with softer labour market conditions as the demand for labour grows by less with an adverse shock to global trade.

Chart A.2: Slower global trade reduces consumption and wages growth



Sources: Australian Bureau of Statistics; Centre of Policy Studies; Department of Treasury and Finance

Table A.3 highlights the fiscal impact of the changes in economic parameters. With slower growth in real GSP, consumption, property prices and wages, income from transactions is lower over the next four years consistent with lower growth in revenue from land transfer duty, payroll tax and lower GST revenue.

Expenses from transactions are also lower as lower wage growth reduces employee expenses and in some cases outlays on grants and transfers. However, offsetting this to some extent is a rise in borrowing costs as income falls by more than expenses. Overall, there is a decline in the net result and an increase in net debt.

Table A.3: Projected fiscal impact of a global trade shock (\$ million)

	2017-18 estimate	2018-19 estimate	2019-20 estimate	2020-21 estimate
Income from transactions	(73.7)	(206.8)	(309.9)	(432.3)
Expenses from transactions	2.0	(18.8)	(81.3)	(143.0)
Net result from transactions	(75.8)	(188.0)	(228.5)	(289.4)
Other economic flows	(1.0)	(2.4)	(2.1)	(2.2)
Net result	(76.8)	(190.4)	(230.6)	(291.5)
Net debt (cumulative)	76.8	262.0	487.0	772.6

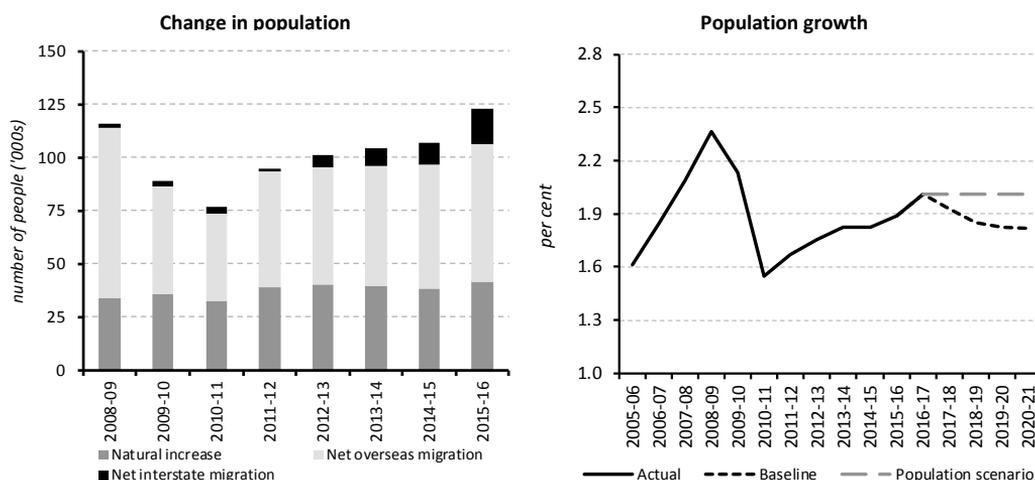
Source: Department of Treasury and Finance

Labour supply scenarios

In this scenario population is stronger than expected

Victoria's population growth has outperformed expectations in recent years (Chart A.3). Net overseas migration is the largest contributor. Along with strong employment prospects, Melbourne has consistently ranked among the world's most liveable cities. As migrants move to Victoria, they bring skills, knowledge and diversity, and support growth of Victorian industries.

Chart A.3: Population growth in Victoria



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

The forecast in Chapter 2 is for population growth to peak at 2 per cent in 2016-17 before moderating over the next four years. An important upside risk is that population growth may be stronger than forecast. To quantify this risk, a continued shock of higher population growth is applied to the model. The shock assumes that population growth remains at 2 per cent per annum over the next four years and that new arrivals bring additional demand for goods and services.⁷

⁷ To implement this, it is assumed that new arrivals are as likely to be employed as the existing population. That is, the scenario envisages an increase in labour supply that is accompanied by greater demand for goods and services, and thus labour as well. Assuming no change in labour demand results in higher unemployment rates for new arrivals, but does not significantly change the overall fiscal impact.

The effects on major economic parameters are reported in Table A.4. Stronger population growth increases demand and results in an increase in the size of the employed workforce that also stimulates growth in real consumption, investment and GSP. With greater supply of labour, pressures on wages and the cost of production are contained so that inflation is lower as well.

Table A.4: The effect of high population growth on major economic parameters (per cent)

	2017-18 <i>estimate</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>	2020-21 <i>estimate</i>
Real GSP	0.05	0.15	0.28	0.42
Employment	0.08	0.23	0.41	0.60
Consumer Price Index	(0.02)	(0.06)	(0.10)	(0.14)
Wage Price Index	(0.09)	(0.26)	(0.45)	(0.64)

Note: Figures reported are the change in the level of each parameter relative to the baseline of no change in the economic outlook, for each year of the budget. Source: Centre of Policy Studies, Victoria University.

Table A.5 summarises the projected fiscal impact. With higher growth in real GSP, consumption, employment and property prices, income from transactions is higher over the next four years. This reflects higher growth in revenue from land transfer duty, payroll tax and higher GST revenue.

The increase in population calls for greater expenditure on public services to meet additional demand. However, lower wage growth and inflation – reflecting stronger growth in labour supply relative to demand – translate into reduced expenses from employee entitlements and superannuation expenses. Overall, expenses rise, though by less than the projected increase in income, resulting in an improvement in the net result and a decline in net debt.

Table A.5: Projected fiscal impact of higher population growth (\$ million)

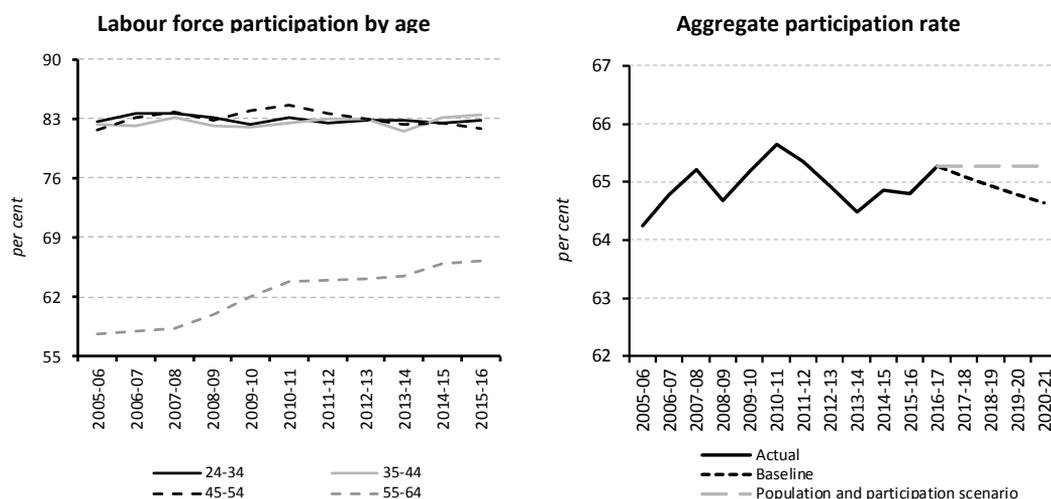
	2017-18 <i>estimate</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>	2020-21 <i>estimate</i>
Income from transactions	35.9	90.8	217.9	425.3
Expenses from transactions	25.6	52.3	69.0	106.5
Net result from transactions	10.3	38.5	148.9	318.8
Other economic flows	0.0	0.0	0.1	0.2
Net result	10.3	38.5	149.0	319.0
Net debt (cumulative)	(10.9)	(51.2)	(204.9)	(533.0)

Source: Department of Treasury and Finance

In this scenario population and participation are stronger than expected

As well as a strong rate of population growth, Victoria has also experienced high rates of labour force participation. This has been underpinned by cyclical factors, including strong job creation, and structural factors such as rising female participation and participation in the 55-64 age cohort (Chart A.4). An upside risk to the budget is that labour force participation also remains stronger over the forecast horizon. For this scenario, both high population growth (2 per cent per annum) and a high labour force participation rate (65.3 per cent) are assumed.⁸

Chart A.4: Labour force participation



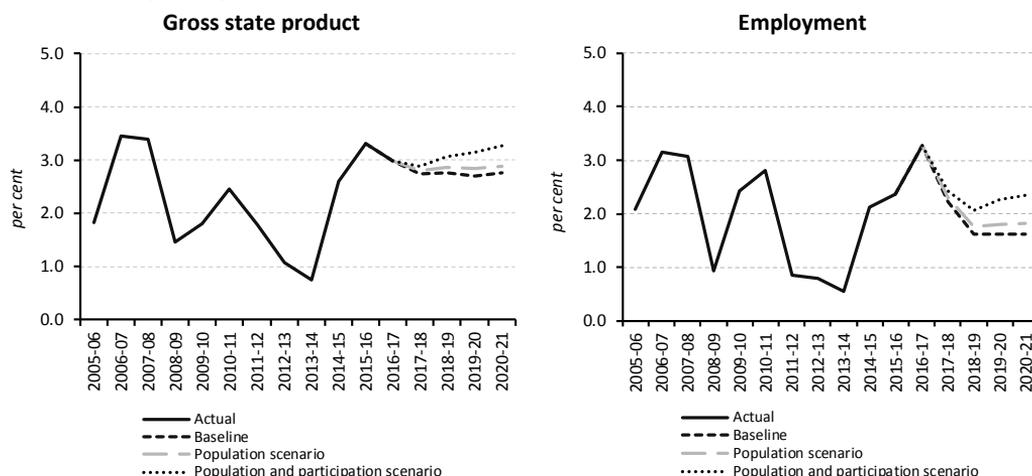
Sources: Australian Bureau of Statistics; Department of Treasury and Finance

Chart A.5 illustrates the impacts on real GDP growth and employment. With strong growth in population and higher workforce participation, the impacts on growth and employment are predictably larger than in the high population growth only scenario. This reflects a greater increase in the size of the workforce, made up of an increase in the number of people in Victoria and an increase in the likelihood that they are employed.

Stronger employment growth stems from both greater demand associated with the increase in population, and also from higher labour force participation. Higher labour force participation lowers wage pressures and labour becomes relatively cheaper when compared with capital. This stimulates firms' demand for labour on average, and capital also becomes more productive. Overall, firms are able to produce more, households consume more and average output per person rises.

⁸ Again, it is assumed that new arrivals have the same employment and labour force participation probabilities as the existing population.

Chart A.5: The effects on growth and employment of stronger population and participation



Sources: Australian Bureau of Statistics; Centre of Policy Studies; Department of Treasury and Finance

The overall economic effects are presented in Table A.6. The direction of the results are similar to those in the high population growth only scenario. However, the magnitudes of the effects are more pronounced. There is a larger pick up in private investment, as capital becomes more productive, and a larger increase in consumption growth. Together these underpin stronger growth in real GSP.

Table A.6: The effect of higher population and labour force participation (per cent)

	2017-18	2018-19	2019-20	2020-21
	estimate	estimate	estimate	estimate
Real GSP	0.13	0.43	0.87	1.39
Employment	0.20	0.65	1.30	2.02
Consumer Price Index	(0.05)	(0.16)	(0.31)	(0.48)
Wage Price Index	(0.24)	(0.75)	(1.43)	(2.16)

Note: Figures reported are the change in the level of each parameter relative to the baseline of no change in the economic outlook, for each year of the budget. Source: Centre of Policy Studies, Victoria University.

Table A.7 summarises the projected fiscal impact of higher population and labour force participation. Similar to the population increase only scenario, land transfer duty and GST revenue increase. The increase in land transfer duty reflects higher housing demand. The effect on employment is even more pronounced as a result of more people entering the labour force than in the population only scenario, and revenue from payroll tax increases by more. Income tax equivalents (ITEs) for the State also rise, reflecting additional revenue from WorkSafe Victoria in line with stronger employment growth.

Lower growth in wages and lower inflation help to mitigate rising expenses associated with additional demand for public services. They also lower superannuation expenses, other operating expenses, and borrowing costs over the next four years. Higher population generates more revenue from grants (excluding GST revenue), although this is partly offset by the effects of lower inflation. Overall, the larger increase in income relative to expenses from transactions supports the net result and leads to a fall in net debt.

Table A.7: Projected fiscal impact of higher population and labour force participation (\$ million)

	2017-18 <i>estimate</i>	2018-19 <i>estimate</i>	2019-20 <i>estimate</i>	2020-21 <i>estimate</i>
Income from transactions	41.5	93.2	216.4	427.2
Expenses from transactions	44.4	64.8	10.7	(22.4)
Net result from transactions	(3.0)	28.4	205.7	449.6
Other economic flows	0.1	0.1	0.4	0.6
Net result	(2.9)	28.5	206.1	450.2
Net debt (cumulative)	2.3	(27.3)	(237.4)	(696.1)

Source: Department of Treasury and Finance

Box A.1: A new method for quantifying economic scenarios

Previous sensitivity analysis focused on independent changes in major economic parameters and historical forecasting experience. In the *2017-18 Budget* a new methodology has been adopted to identify, quantitatively, the effects of some of the key risks to the economic outlook.⁹ This is to better understand the effects of potential changes in the economic outlook, and how the budget may be sensitive to different economic shocks or scenarios.

Importantly, a range of modelling and technical assumptions are required to quantify each scenario, map that scenario into changes in economic parameters, and then into a fiscal impact. Changes to the modelling approach, assumptions or the methodology and data used to map the scenarios into a fiscal impact would all generate variations in the results. The relationships between economic and fiscal aggregates are complex, depend on the specific characteristics of any given scenario, and modelling and technical assumptions may only partially capture important economic effects. Care should be exercised in interpreting the results.

The methodology is undertaken in three stages. First, material risks to the economic outlook are identified and quantified. Second, the quantified risks (economic shocks) are mapped into changes in state-level economic parameters using a dynamic computable general equilibrium model. Third, the effects of changes in economic parameters on major revenue and expenditure lines are calculated using elasticities that underlie the fiscal impacts reported in Table A.1.

⁹ Sensitivity analysis of individual economic parameters is provided in Table A.1.

For the *2017-18 Budget* the first risk identified is a 10 percentage point increase in the trade costs of goods in the US, China and the EU. This risk is designed to capture a reversal of trade liberalisation policies and is similar to an average increase in tariffs to bound tariff rates last observed in 2001 (OECD).

The second risk is a higher than forecast rate of population growth. Victoria has experienced higher than anticipated net interstate and overseas migration in recent years and there is a risk that this experience will continue in the future, particularly if economic conditions in other states do not rebound as quickly as envisaged. Population flows have important effects on budget aggregates.

The third risk identified is a higher than forecast rate of labour force participation, maintaining the assumption of high population growth. Labour force participation has been under-predicted in recent years. There is a risk that the forecast tapering in the participation rate does not materialise and that it remains high.¹⁰

The second stage of the sensitivity analysis is to map each scenario into changes in state-level economic parameters. This is undertaken in conjunction with the Centre of Policy Studies, using the dynamic computable general equilibrium model VURM (Victoria University's Regional Model). VURM is a dynamic economic model of Australia's six states and two territories. It models each region as an economy in its own right. For example, the model contains region-specific prices, consumers and industries.¹¹

With changes in economic parameters in response to each shock identified, the third stage is to map changes in the parameters into changes in revenue and expenditure. This is undertaken using the elasticities that underpin Table A.1. With changes in multiple economic parameters at the same time, the effects are cumulated for major revenue and expenditure items (i.e. reflecting the sum product of all the partial equilibrium elasticities multiplied by the corresponding variations in economic parameters). This approach can be thought of as a log-linear approximation of the overall quantitative impact, and as mentioned above should be treated as indicative.¹²

¹⁰ A higher than forecast rate of labour force participation could reflect: a positive economic outlook in Victoria raising participation rates in groups that are either marginally attached or not in the labour force; larger than anticipated effects of recent changes in federal retirement policy or greater uncertainty about future changes in retirement policy inducing higher participation amongst older age cohorts; and higher than forecast rates of labour force participation among new arrivals to Victoria.

¹¹ Technical documentation of the model's equations and database can be downloaded from: www.copsmodels.com/elecpr/g-254.htm

¹² The elasticities reflect a range of technical assumptions made by the Department of Treasury and Finance and can be based on average historical relationships, internal models that link economic parameters to key revenue or grant or expense lines, economic theory, or assumptions about service delivery to capture the effects on expenditure.

STYLE CONVENTIONS

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

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

n.a. or na	not available or not applicable
1 billion	1 000 million
1 basis point	0.01 per cent
..	zero, or rounded to zero
tbc	to be confirmed
ongoing	continuing output, program, project etc.
(x xxx.x)	negative amount
x xxx.0	rounded amount

Please refer to the **Treasury and Finance glossary for budget and financial reports** at dtf.vic.gov.au for additional terms and references.

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