



DELIVERING FOR ALL VICTORIANS

VICTORIAN BUDGET 19/20 STRATEGY AND OUTLOOK

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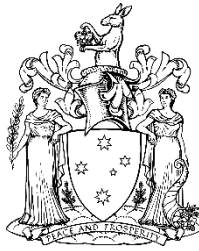
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Strategy and Outlook

2019-20



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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

During its first term, the Government delivered for all Victorians: investing in education and skills; improving healthcare; building new roads and rail; making our community safer; and creating more jobs.

The *2019-20 Budget* builds on the Government's strong economic and fiscal management. It invests in supporting and growing our economy by delivering new and upgraded roads, removing level crossings and overhauling the public transport network – getting people home sooner and creating thousands of jobs. It also invests in education, from the early years with universal three-year-old kinder to expanded Free TAFE, so all Victorians can access opportunities and build a strong economy into the future.

The Budget also invests in the provision of world-class healthcare facilities and services across Victoria. This includes building new hospitals, recruiting more paramedics and starting the work to provide all Victorian Government school students with free dental care.

The Victorian economy is strong, generating new jobs and improving living standards. Real gross state product (GSP) increased by 3.5 per cent in 2017-18, the highest of the states and above national real gross domestic product (GDP) growth of 2.8 per cent. The Victorian economy grew by almost \$55 billion, or 14.8 per cent, in real terms in the four years to 2017-18. Robust economic activity has increased living standards, with real GSP per capita increasing by 4.8 per cent since 2013-14.

Victoria's economic strength means more people have jobs. Since November 2014, more than 450 000 jobs have been created in Victoria, with 70 per cent of these being full-time positions. This growth has been shared across industries and regions, with more than 66 000 new jobs added in the regions since November 2014.

The strength in the labour market is delivering benefits across the State. Labour force participation for women and people aged 65 and over is around all-time highs, youth unemployment has declined and wages are growing faster than the national average. Wages growth is forecast to return to trend of 3.5 per cent over the forecast period.

The *2019-20 Budget* continues the Government's clear fiscal strategy, with Victoria's finances remaining sound despite revenue write-downs, particularly in property-related revenue. The operating surplus is expected to be \$1.0 billion in 2019-20, and to average \$3.4 billion a year over the forward estimates.

Government infrastructure investment will reach \$14.2 billion in 2019-20, and average \$13.4 billion a year over the budget and forward estimates. This is nearly triple the average of \$4.9 billion a year from 2005-06 to 2014-15. The infrastructure investment announced by the Government since 2014 is expected to support the creation of more than 115 000 jobs.

As outlined in *Labor’s Financial Statement 2018*, the Government committed to stabilise net debt at 12 per cent of GSP over the medium term, for the purposes of delivering three major productivity-enhancing capital projects – North East Link, Melbourne Airport Rail and the removal of an additional 25 level crossings by 2025. The Government will deliver these projects while maintaining fiscal and debt settings that support the State’s triple-A credit rating. Victoria remains one of only 10 comparable sub-sovereign governments holding a triple-A credit rating from both Standard & Poor’s and Moody’s Investor Services.

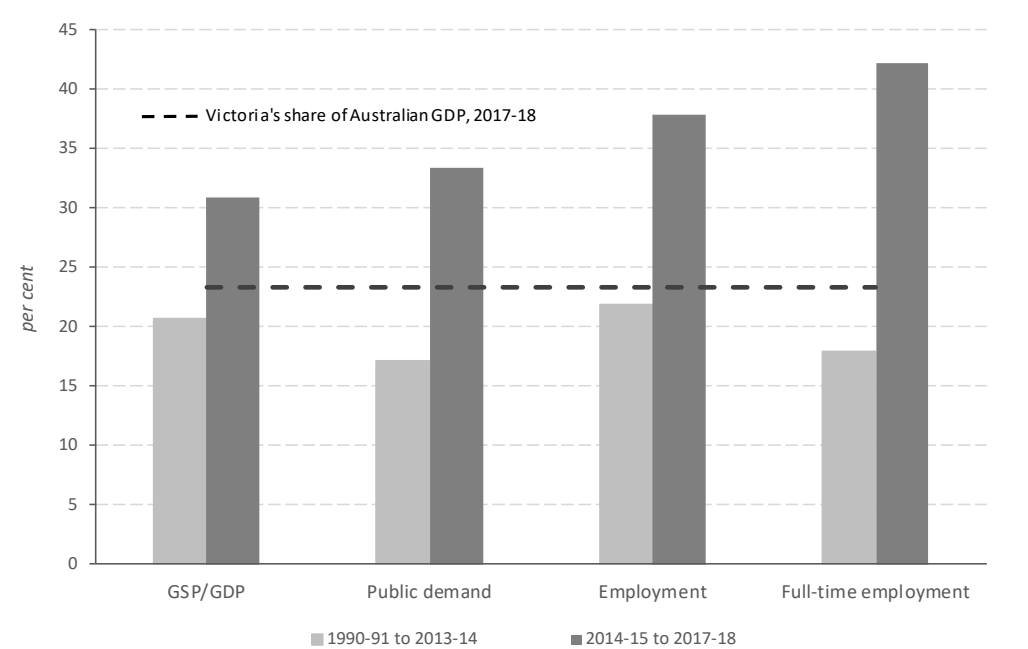
This Budget is about transforming our state and delivering for all Victorians – not just today, but for future generations as well.

A DIVERSE AND GROWING ECONOMY

Victoria’s economy is powering the nation

Victoria has been a major driver of Australian economic growth over the most recent cycle, outperforming the rest of the nation across a broad range of economic indicators, including growth in public demand, employment and economic activity. Victoria’s real GSP growth contributed almost one-third of national GDP growth from 2014-15 to 2017-18, partly driven by an uplift in public demand. Strong economic growth is generating employment, with Victoria contributing nearly 45 per cent of all full-time jobs created nationally over that period (Chart 1.1).

Chart 1.1: Victoria’s contribution to national growth, selected indicators



Source: Australian Bureau of Statistics

Victoria's real GSP growth is forecast to return to trend in 2019-20, following five years of above-trend growth – the longest period since the 1990s – and marking the 28th consecutive year of uninterrupted economic expansion.

The economy has been supported by low interest rates, strong population growth and investment. High dwelling investment and an increase in spending on social services, including in healthcare and education, have contributed to growth. The Government's commitment to further increase public infrastructure investment, combined with strong population growth and high levels of business investment, is forecast to be a key driver of GSP growth in 2019-20.

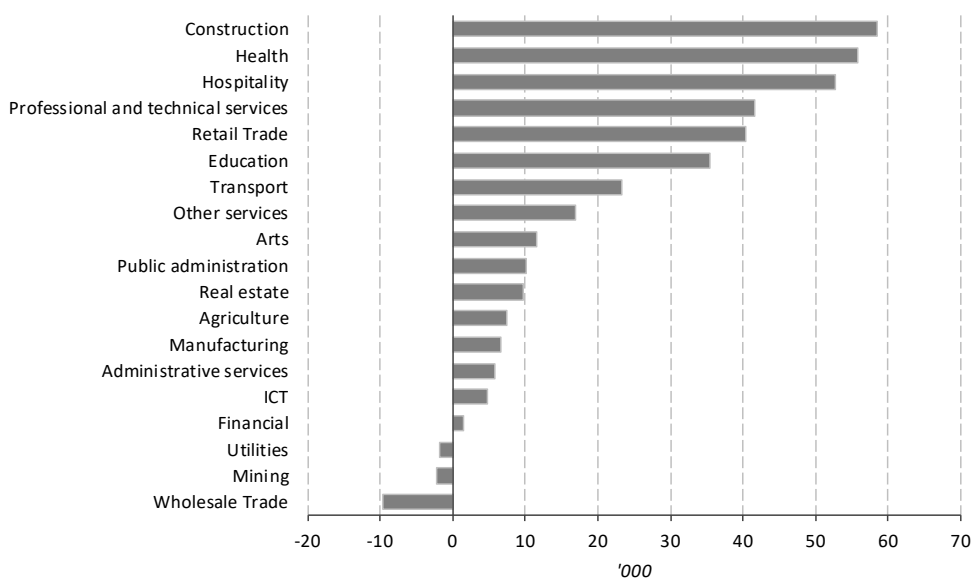
Robust economic activity and above-trend employment growth are increasing living standards. Real GSP per capita rose by 1.2 per cent in 2017-18, the fifth successive rise in GSP per capita. This continues the longest period of sustained growth in living standards since the global financial crisis.

Growing jobs across the economy

Victoria's strong economy has generated record jobs growth over the past four financial years. Since November 2014, the unemployment rate has fallen by 2.1 percentage points to 4.6 per cent in March 2019. The number of jobs has increased by more than 450 000 over the same period, an increase of over 15 per cent, which represents the highest growth rate in the nation. Full-time jobs increased by 330 500, an increase of 16.7 per cent, which is more than double the rate of the rest of the nation.

The strength of the labour market is broad-based across industries, with 16 industry groups expanding from 2013-14 to 2017-18 (Chart 1.2). The construction industry has been the largest contributor to employment growth over the period and has added the largest number of jobs in 2018. This reflects the significant infrastructure and dwelling investment currently underway across the State.

Chart 1.2: Employment growth by industry, 2013-14 to 2017-18



Source: Australian Bureau of Statistics

Jobs growth has also been seen across the State, with a regional unemployment rate of 4.6 per cent in the three months to March 2019 – the lowest regional unemployment rate of the states and down 1.2 percentage points from a year earlier. Since November 2014, more than 66 000 jobs have been created in regional Victoria, including 9 000 jobs in the Latrobe Valley.

Driving new jobs and investment

To help support and create jobs, the *2017-18 Budget* increased the payroll tax-free threshold and introduced Australia's first regional payroll tax rate for employers, which was further reduced in the *2018-19 Budget* to 2.425 per cent.

Building on these initiatives, the *2019-20 Budget* will lift the payroll tax-free threshold across the State to \$700 000 by 2022-23, cut the regional payroll tax rate from 50 per cent to 25 per cent of the metropolitan rate by 2022-23 and provide a 50 per cent discount on land transfer duty on regional commercial and industrial property transactions by 2023-24.

The *2018-19 Budget* provided funding to support the small and medium enterprise sector and grow agricultural exports. The Government also encouraged interstate and international investment in Victoria through a \$55 million boost to the Investment Attraction and Assistance Program.

The *2019-20 Budget* builds on these achievements, and invests \$150 million to establish the Victorian Jobs and Investment Fund, which will:

- support opportunities of State significance to create jobs and promote economic development;
- encourage strategic and footloose private sector investment to the State;
- attract innovation and jobs projects that enhance productivity growth and support the transition of the Victorian economy to high-growth sectors; and
- support the continued operations of LaunchVic.

This initiative builds on Victoria's existing economic strengths and supports investment and innovation, which will help create sustainable jobs for Victorians, and drive long-term economic growth in the State. It also streamlines Victoria's economic development focus and decision-making framework, ensuring that the planning and implementation of development projects is well coordinated across the state.

STRONG FINANCIAL MANAGEMENT

The *2019-20 Budget* continues the Government's demonstrated track record of responsible financial management, which has enabled significant investment in core services and infrastructure, while supporting the State's triple-A credit rating.

Over the previous four years, the Government has consistently delivered operating surpluses, averaging \$2.2 billion a year. This, along with the proceeds of asset recycling and expenditure savings, has enabled the Government to address previous under-investment in infrastructure and public services, such as in health and education.

Going forward, expenditure growth will be restrained to ensure continuing surpluses, despite lower revenue growth. The average annual revenue growth over the next four years is forecast at 4.3 per cent a year, greater than average annual expense growth of 3.1 per cent.

The general government operating surplus (net result from transactions) is forecast to be \$1.0 billion in 2019-20, and average \$3.4 billion a year over the forward estimates. Revenue growth is forecast to moderate, rising by 2.2 per cent in 2019-20, primarily reflecting weaker property market conditions impacting State taxation revenue. Over the forward estimates, revenue growth is expected to average 5.0 per cent per year in line with a projected recovery in the property market from around 2020-21.

Table 1.1: General government fiscal aggregates ^(a)

	<i>Unit of measure</i>	<i>2017-18 actual</i>	<i>2018-19 revised</i>	<i>2019-20 budget</i>	<i>2020-21 estimate</i>	<i>2021-22 estimate</i>	<i>2022-23 estimate</i>
Net result from transactions	\$ billion	2.3	1.1	1.0	1.5	3.9	4.9
Government infrastructure investment ^{(b)(c)}	\$ billion	12.1	12.4	14.2	14.7	12.2	12.6
Net debt	\$ billion	20.0	22.8	39.0	46.9	51.1	54.9
Net debt to GSP ^(d)	per cent	4.6	5.1	8.3	9.5	9.8	10.0

Source: Department of Treasury and Finance

Notes:

(a) The impact of accounting standards changes is shown from 2019-20. The step change increase in net debt includes the requirement to classify operating leases as debt and the treatment for service concession arrangements, including certain public private partnerships.

(b) Includes general government net infrastructure investment and estimated construction costs for Partnerships Victoria projects.

(c) Excludes the impact of the divestment of Victoria's share of Snowy Hydro Limited.

(d) The ratios to GSP may vary from publications year to year due to revisions to the Australian Bureau of Statistics GSP data.

In each of its previous four budgets, the Government adhered to a clear and robust fiscal framework, enabling investments in services and infrastructure to meet the needs of a growing population, while maintaining net debt as a percentage of GSP at a sustainable level.

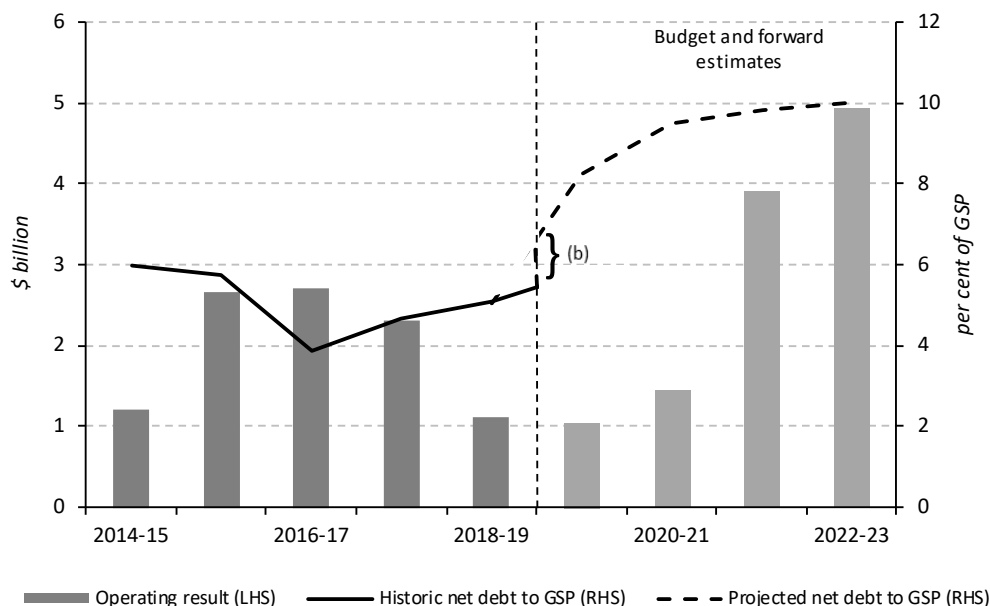
In *Labor's Financial Statement 2018*, the Government committed to stabilise net debt at 12 per cent of GSP over the medium term, for the purpose of delivering three major productivity-enhancing infrastructure projects – North East Link, Melbourne Airport Rail, and 25 additional level crossing removals. It will also accommodate changes in accounting standards from 2019-20.

These investments are required to absorb population growth and will deliver long-term economic benefits. The impact of changes in accounting standards and additional borrowings to fund the three projects, account for 4.0 percentage points of net debt to GSP by June 2023.

The impact of the accounting standards changes require all governments and private businesses to classify most operating leases as debt and also affect the accounting treatment of service concession arrangements, including certain public private partnerships and grant revenue. These changes do not impact the underlying fundamentals of the State's financial sustainability or its cost of borrowing; rather they reflect variations in the composition and timing of recognition of certain transactions in published financial statements.

Since the Government was re-elected, Moody's has confirmed that the proposed increase in net debt to 12 per cent of GSP is manageable within Victoria's current triple-A credit rating.

Chart 1.3: Government operating result and net debt to GSP^(a)



Source: Department of Treasury and Finance

Notes:

- (a) The operating surplus in 2018-19 and 2019-20 is expected to be lower than otherwise due, in part, to a moderation in property-related tax revenues.
- (b) The impact of accounting standards changes is shown from 2019-20. The step change increase in net debt includes the requirement to classify operating leases as debt and the treatment for service concession arrangements, including certain public private partnerships. In 2019-20, the impact of accounting standards changes account for around 1.7 percentage points of the increase in net debt to GSP.

The 2019-20 *Budget* funds \$11.4 billion of new output initiatives, with major funding increases for early childhood education, schools, health, mental health, renewable energy and community safety.

The 2019-20 *Budget* also funds a further \$34.5 billion in new asset initiatives, underscoring the Government's commitment to building productivity-enhancing infrastructure that will create jobs, drive economic growth and improve living standards for all Victorians. Overall, government infrastructure investment is forecast to average \$13.4 billion a year over the budget and forward estimates, nearly triple the average of \$4.9 billion a year from 2005-06 to 2014-15.

The 2019-20 *Budget* reflects the Government's long-term financial management objectives as set out in Table 1.2.

Table 1.2: Long-term financial management objectives

Priority	Objective
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.
Improved 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 toward these long-term financial management objectives is supported by the measures and targets in Table 1.3. These measures and targets remain unchanged from the *2018-19 Budget*.

Table 1.3: Financial measures and targets for the 2019-20 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.

CONTINUING VICTORIA'S BIG BUILD

The *2019-20 Budget* builds on the Government's strong and sustained record of investing in the infrastructure Victoria needs.

Over its first term, the Government committed to the biggest infrastructure investment program in the State's history. More than \$46 billion has been invested in Victoria's road and rail network to get people out of traffic and home sooner.

The *2019-20 Budget* continues this investment, with a further \$29.4 billion in building and improving roads and rail across the State. In total, this means the Government has committed more than \$76 billion since 2014 to delivering transport infrastructure and services.

Building and upgrading Victoria's roads

The Government's previous budgets have delivered significant investment in Victoria's road network, including upgrades to the Monash, Tullamarine and West Gate freeways.

The *2018-19 Budget* committed \$2.2 billion to the Suburban Roads Upgrade in Melbourne's northern and south-eastern suburbs, and builds on the existing investment made in the Western Roads Upgrade. While these upgrades are being delivered, the Government continues to invest in the road infrastructure that Melbourne needs.

Since the *2018-19 Budget*, the Government has fully funded North East Link – the missing link in Melbourne's freeway network – bringing the total investment to \$15.8 billion.

The *2019-20 Budget* invests a total of \$16.2 billion in the metropolitan road network. This includes \$292 million to upgrade Hall Road, Narre Warren North Road, South Road and Western Port Highway of which \$1.6 million has been allocated for planning to ease local congestion.

The *2019-20 Budget* allocates a further \$804 million in Victoria's regional road network.

Building a public transport network for the future

The Government continues to invest in public transport infrastructure to ensure Victorians have a high-quality transport system they can rely on.

Over the past four years, the Government has undertaken an overhaul of Victoria's public transport infrastructure, including building the Metro Tunnel to untangle the entire train network, removing the State's most dangerous and congested level crossings and purchasing new High Capacity Metro Trains to transform the way Victorians travel.

The *2019-20 Budget* invests \$12.3 billion in the State's public transport network to reduce travel times and improve reliability. A further \$6.6 billion will be provided to remove an additional 25 dangerous and congested level crossings across Victoria by 2025, bringing the total number of level crossing removals to 75.

Of the \$12.3 billion investment, \$2.1 billion is provided for upgrades to the Sunbury line to support the end-to-end operation of High Capacity Metro Trains on the Sunbury to Cranbourne-Pakenham corridor. The Budget also includes \$21.5 million to begin planning the upgrades to the Hurstbridge line, a \$547 million project, and \$12.2 million to plan for the duplication of the Cranbourne line, a \$750 million project. These projects will reduce travel times and allow more trains to run.

The *2019-20 Budget* also provides \$340 million for 18 additional VLocity trains and \$166 million for 10 new E-Class trams and supporting infrastructure, tram upgrades, and to design and develop the Next Generation Trams and a new Tram Automatic Vehicle Monitoring System.

The Government is also planning for the future, with transformative infrastructure projects that will set Victoria up for generations to come. The *2019-20 Budget* provides \$1.1 billion for the business case development, design and preconstruction works for Melbourne Airport Rail, Suburban Rail Loop and Western Rail Plan. The Suburban Rail Loop and Melbourne Airport Rail will connect Melbourne's suburbs to the existing network and Tullamarine Airport, improving accessibility for more Victorians.

The Western Rail Plan will support population growth and economic development in regional Victoria and Melbourne's west by planning for the separation of Wyndham Vale and Melton lines from regional lines, and faster links to Geelong and Ballarat.

A WORLD-CLASS EDUCATION SYSTEM

The Government has invested \$14.9 billion across the education portfolios since 2014 and in this Budget to make Victoria the Education State. The Government is investing to ensure every Victorian child has access to a great school, and the opportunities they need for a better life.

The *2019-20 Budget* continues to invest in new schools and upgrade existing ones around the State to make sure every Victorian child can access high-quality, modern facilities in their local community. The Government is providing a \$671 million investment to build 17 new schools as part of its commitment to deliver 100 new schools over eight years, and an additional \$46 million to purchase land for new schools across our growing suburbs and regions.

The *2019-20 Budget* provides \$402 million to build and upgrade non-government schools across Victoria, including the removal of dangerous cladding.

A further \$291 million will be provided for the Relocatable Buildings Program, the School Pride and Sports Fund and continuing the asbestos safety program to improve safety for students and teachers. The Government is also investing \$363 million to upgrade and modernise 59 schools across Victoria, with a further 44 schools receiving funding to prepare for their upgrades.

Box 1.1: Historic reform to deliver three-year-old kinder

The *2019-20 Budget* delivers a social and educational reform of historical significance, including \$882 million to support every Victorian child to access at least five hours per week of subsidised three-year-old kinder by 2022.

Research shows that two years of preschool is crucial in helping children get their best start in life. Preschool programs strengthen the cognitive, social and emotional development of young children. Children experiencing vulnerability or disadvantage benefit the most.

This investment will deliver a play-based educational program for three-year-olds, led by qualified kindergarten teachers. This reform will nearly double the size of the kindergarten sector by full roll out, expanding the number of services, supporting new and upgraded facilities and creating new jobs in the early childhood workforce.

Funding will support kindergartens to deliver high-quality early years education and ensure that all children can participate in a three-year-old kindergarten program regardless of their family's circumstances.

This contributes to the Government's election commitment to provide a full 15 hours of three-year-old kinder over the next decade. Subsidised three-year-old kinder will commence in the following six regional local government areas (LGAs) by 2020:

- Buloke, Hindmarsh, Northern Grampians, South Gippsland, Strathbogie and Yarriambiack.

In 2021, a further 15 LGAs will commence:

- Alpine, Ararat, Campaspe, Central Goldfields, Colac-Otway, Corangamite, East Gippsland, Glenelg, Hepburn, Indigo, Loddon, Murrindindi, Southern Grampians, Towong and West Wimmera.

Skills for jobs of the future

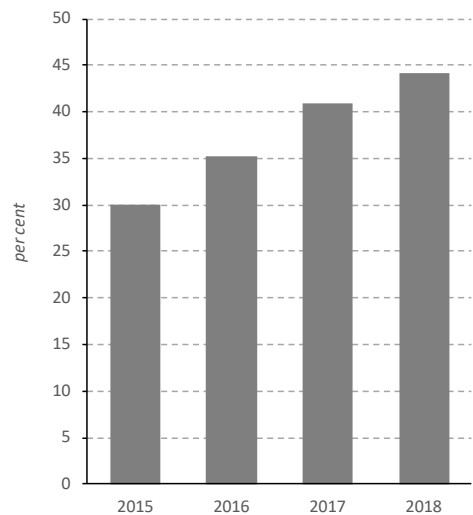
Vocational education and training is crucial to maintaining and growing Victoria's skills base. It provides the next generation of Victorians the skills they need to enter the labour market and the opportunity for workers to re-skill for new careers, industries and jobs of the future. This is critical to supporting strong economic growth, as well as the implementation of key Government priorities, such as 'Victoria's Big Build' and the prevention of family violence.

Since 2015, the Government has invested in reshaping the TAFE and training system to meet these needs. It has removed low-quality providers from the system, introduced tougher contracts and increased oversight, restoring the confidence of students and employers.

TAFEs are at the heart of this quality-focused system. The Government has rebuilt TAFE to provide industry-relevant training that gets Victorians into jobs, while also introducing the Major Projects Skills Guarantee. This provides local apprentices, trainees and engineering cadets with opportunities to gain experience working on some of Victoria’s biggest building and infrastructure projects.

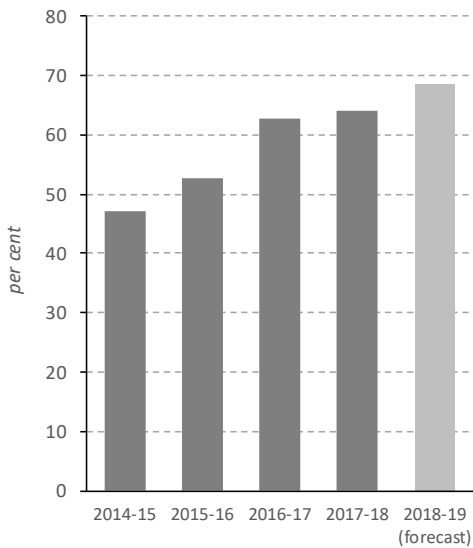
An increasing proportion of Victorian vocational education and training students have chosen to enrol at TAFEs each year since 2015 (Chart 1.4). The TAFE network’s share of state payments to VET providers has progressively increased (Chart 1.5) since the Government was elected.

Chart 1.4: TAFE network enrolments as a proportion of total government subsidised VET enrolments



Source: Department of Education and Training

Chart 1.5: TAFE network share of payments to VET providers



Source: Department of Education and Training

Free TAFE for priority courses commenced from 1 January 2019. The overwhelming response demonstrates the relevance of TAFE offerings to students and employers. By the end of March:

- more than 19 000 Victorians had already commenced priority courses and pre-apprenticeship courses;
- metropolitan commencements in these courses had increased by 102 per cent (relative to the same time last year); and
- regional commencements had increased by 116 per cent (relative to the same time last year).

The 2018-19 Budget invested \$644 million in high-quality training through the TAFE and training sector, including Free TAFE for priority courses.

The *2019-20 Budget* continues this momentum, by ensuring more Victorians can access the right training for the jobs we need most:

- \$82.7 million to continue to support eligible students to access subsidised training and develop skills in the TAFE and training system, including through the Asylum Seeker Vocational Education and Training program;
- \$57 million for a new Building Better TAFE Fund to build bigger and better facilities around Victoria and improve lifelong educational pathways;
- \$41.2 million to respond to strong demand for Free TAFE;
- \$28.5 million to provide Free TAFE for early childhood courses to support the roll out of three-year old kinder; and
- \$5.6 million to develop a suite of higher apprenticeships.

Investing in the early years

Every child deserves the best start in life. The *2019-20 Budget* delivers historic reform of social, economic and educational significance for Victoria. It invests \$882 million to support every Victorian child to access at least five hours per week of subsidised three-year-old kinder by 2022, providing them with the skills and experience they need to be ready for school.

The *2019-20 Budget* also provides \$38.5 million to allow all Victorian children to access an inclusive early childhood education where they are supported to learn and play. This includes \$33.6 million for local councils and eligible providers to build, expand and improve local kindergarten facilities, and provide more inclusive environments for children with disability or additional needs. It also includes \$3.4 million to support children with disability or developmental delay through early childhood intervention services and \$1.6 million for the Kindergarten Inclusion Support program. This will provide minor building modifications, additional staff and training for educators to ensure children with significant disability can participate in kindergarten.

DELIVERING BETTER HEALTHCARE

All Victorians should be able to access quality care close to home.

Over the past four years, the Government has undertaken record investment in healthcare, including building new hospitals, delivering improved mental health services and supporting more paramedics to respond urgently to Victorians needing assistance.

The *2018-19 Budget* invested \$4.2 billion in the Victorian health system, including \$1.2 billion in building and expanding hospitals across the State, \$218 million for an elective surgery blitz to cut waiting times and a record \$705 million investment in mental health services.

The *2019-20 Budget* builds on this investment, with an additional \$5.5 billion investment in health services across Victoria.

Better hospitals for all Victorians

The *2019-20 Budget* invests \$1.6 billion to build and expand hospitals across the State. This includes a total of \$1.5 billion now committed to begin construction of the 504-bed Footscray Hospital, cutting waiting times and allowing almost 15 000 additional patients to be treated.

The *2019-20 Budget* also provides \$6 million to plan the upgrade of Frankston Hospital, including new beds, operating theatres, an oncology ward and a day clinic, expanded child and maternal health and mental health services.

The Government is investing in regional health infrastructure to ensure every Victorian has the quality healthcare they deserve, close to home. This builds on the \$4.3 billion of investment in the *2018-19 Budget* in regional areas.

The *2019-20 Budget* provides a significant investment in regional hospitals. This includes \$59.5 million to build a new rehabilitation centre in Bendigo, \$9.4 million to plan the redevelopment and expansion of the Latrobe Regional Hospital and redevelopment of the Wangaratta Hospital. The Government will also provide \$100 million for the Regional Health Infrastructure Fund to improve the quality and amenity of infrastructure at rural and regional health services.

Backing first responders

The Government's record investment in ambulance services has strengthened the system, with more paramedics, more stations and more ambulances. As a result, ambulances are arriving faster to Victorians in life-threatening situations. Over the past 12 months, 84 per cent of Code 1 ambulances arrived within 15 minutes of call-out, the best result in nine years.

The *2019-20 Budget* builds on this with a \$109 million ambulance and paramedic package, including a 23-vehicle surge fleet to improve emergency ambulance availability and reduce paramedic fatigue.

In addition, the Government is providing \$191 million to support new and ongoing services across Victoria. This funding will also allow for the continuation of Ambulance Victoria's Secondary Triage service and services in Nagambie, Warracknabeal and Wedderburn.

Supporting parents, students and regional Victorians

The *2019-20 Budget* provides \$214 million in support services to Victorian mums and dads. This includes more maternal child health services to help address post-natal depression, isolation and stress for parents, and improve their child's behavioural, mental and physical development.

Students across the State will benefit from a \$322 million investment to roll out the provision of free dental care to all Victorian Government school students.

The *2019-20 Budget* invests \$136 million in specialist care closer to home for regional Victorians. This will ensure more world-class specialists choose to practice in the regions, paving the way for 500 000 more specialist appointments in regional and rural Victoria over the next four years.

Transforming mental health

The *2018-19 Budget* provided a record \$705 million investment in mental health to help Victorians who will experience mental health challenges in their lifetime.

As part of the *2019-20 Budget*, the Government will provide \$13.6 million to establish the first ever Royal Commission into Mental Health, tasked with providing a comprehensive set of recommendations on how best to reform the current mental health system and support Victorians with mental illness, including those at risk of suicide.

The Commission will examine ways to prevent mental illness and intervene earlier, provide better access to high-quality and safe mental health services for people who need them, and connect mental health services with other health and social services.

There is also \$35.3 million for more services at three prevention and recovery care facilities, as well as additional community service hours to support more than 7 000 clients over two years.

INVESTING IN STRONG, SAFE COMMUNITIES

The Government's past four budgets have seen record investments in keeping Victorians safe. This includes 3 135 new police, tackling family violence and supporting our emergency services, which is delivering a lower crime rate and safer Victorian communities.

The Government is continuing to invest in the systems and services that keep Victorians safe, respond to incidents quickly when they occur, and address the societal causes of crime.

Police, protection and prevention

The *2019-20 Budget* builds on record investments in policing and crime prevention. As the Government recruits and deploys an extra 3 135 new police, this Budget further invests in the technology and training needed to tackle crime. It provides \$18.9 million for the Victorian Fixed Threat Assessment Centre to continue to deliver coordinated responses by police and mental health clinicians to serious threats of violence posed by people with complex needs.

The *2019-20 Budget* also provides \$4.7 million to continue the Forensic Drug Intelligence Capability Program. This will ensure our police have access to drug crime intelligence, to assist them to disrupt the scourge of methamphetamine manufacture, supply and distribution in Victoria.

Courts and corrections capacity

The Government is investing in a justice system that works effectively to hold offenders to account, supports the needs of victims and prevents and deters crime. This will ensure Victoria's courts and correctional systems not only respond to crime, but also to the societal causes of crime.

The *2018-19 Budget* invested \$963 million in improving our courts and correction capabilities. The *2019-20 Budget* builds on this by providing \$1.8 billion to increase capacity across the Victorian prison system, including expanding the new Chisholm Road Prison by 548 beds and adding more than 100 beds to the Dame Phyllis Frost Centre. It also invests \$93.2 million for crime prevention and to reduce offending among at-risk women and young people.

The *2019-20 Budget* will also provide \$152 million for the Bendigo law court development, a multi-jurisdictional regional headquarter court facility for Bendigo and the wider Loddon Mallee region to enable access to some specialist court programs.

Strong families, safe children

The Government remains committed to implementing every single one of the 227 recommendations of the Royal Commission into Family Violence, with the *Ending Family Violence: Victoria's Plan for Change* released in 2016 setting out the Government's approach to change the underlying causes of violence and better respond to the needs of victim/survivors.

The Government has invested more than \$2.7 billion to implement the recommendations and, as of 1 January 2019, has implemented 120 of the recommendations and is continuing to progress the remaining 107.

The *2019-20 Budget* provides \$85 million to hold perpetrators to account through behavioural change programs, intensive engagement of perpetrators with complex needs and extending the pilot of the Caring Dads program. The Government is also providing \$28.7 million for the operation of three new Aboriginal Orange Door access points and to expand frontline Aboriginal family violence services.

This Budget invests \$23.9 million to provide 24/7 access to women's refuges, additional places in refuges and support for victim survivors in emergency accommodation. There will also be \$20.9 million provided for family violence and sexual assault therapeutic support, which will include specialised services for Aboriginal Victorians.

SUPPORTING REGIONAL VICTORIA

Victorian regional communities deserve access to a full range of programs and services, so the *2019-20 Budget* invests \$2.6 billion in the Delivering for Regional and Rural Victorians Program to support the projects and services that matter to regional communities. This will support an estimated 4 500 jobs and make regional and rural Victoria an even better place to live, work and invest for new and existing residents.

This includes improving Victoria's road and rail services. The Government is providing \$425 million for regional road maintenance, \$60.8 million to enhance road safety and travel times across Ballarat and \$2 million for design and pre-procurement activities to upgrade rail service track between South Geelong and Waurin Ponds Station. The *2019-20 Budget* also provides \$49.6 million to construct three new stations in and around Bendigo and \$30 million to establish the Regional Car Parks Fund, which will provide 2 000 new car parking spaces across the regions.

The Delivering for Regional and Rural Victoria Program will also make significant investments in healthcare. The Government will provide \$7 million to plan the redevelopment and expansion of the Latrobe Regional Hospital and \$100 million to boost the Regional Health Infrastructure Fund, to improve the quality and amenity of infrastructure at rural and regional health services.

The Government will also provide \$59.5 million to build a new rehabilitation centre at Bendigo Hospital and \$20 million to relocate Barwon Health clinical facilities from the Geelong Cultural Precinct to the Geelong Hospital Precinct, to improve responses to people in crisis and increase access to drug and alcohol treatment facilities.

The Delivering for Regional and Rural Victoria Program will also provide \$152 million for the Bendigo law court development, a multi-jurisdictional regional headquarter court facility for Bendigo and the wider Loddon Mallee region.

The Government will also provide \$11.8 million to upgrade the Eureka Stadium and Ballarat Sport and Entertainment Precinct, \$10 million to restore and redevelop the iconic Her Majesty's Theatre in Ballarat and \$16.7 million to provide free Wi-Fi to regional centres.

People living in regional Victoria will benefit from a broader range of investments, such as the introduction of universal kinder for three-year-olds, funding to build, plan and upgrade a further 33 schools for regional and rural students, investment in facilities and equipment for paramedics and investment in the tourism industry.

STRONGER COMMUNITIES

The Government is committed to better services to cater for growing communities.

The *2019-20 Budget* invests to ensure Victoria continues to be an artistic, sporting and multicultural capital, as well as a great place to live, work and raise a family.

Helping households ease cost-of-living pressures

The *2018-19 Budget* invested \$48 million in the Power Saving Bonus – where Victorian households receive a \$50 payment if they seek out a better electricity deal on Victoria's Energy Compare website. This Budget extends this successful initiative until 30 June 2020.

The *2019-20 Budget* delivers on the Government's election commitment to expand the Solar Homes program by investing \$545 million over five years, forming a significant part of the total \$1.3 billion investment over the next 10 years. This will subsidise the cost of solar panel energy systems, solar hot water systems or battery storage for homes with existing solar panels for 770 000 homes over the next 10 years.

The Budget also extends payroll tax exemptions for wages paid to employees on maternity leave to include all types of parental leave. This provides a fair tax treatment for employers that offer any type of parental leave and encourages employers to give all parents more time to spend with their children. The exemption will apply for up to 14 weeks of wages paid to employees taking parental leave.

Valuing multiculturalism

Victoria has an extraordinary multicultural society, and the *2019-20 Budget* invests further to ensure cultures in our communities continue to prosper. Building on last year's investment of \$43.6 million, the Government is providing a further \$63.1 million in new funding to support Victoria's multicultural community. This includes \$25 million on infrastructure initiatives and operational support and events, as well as a further \$7.5 million to support our state's community language schools.

Supporting Aboriginal Victorians

The *2019-20 Budget* builds on previous investments to support Aboriginal Victorians in establishing treaty and achieving self-determination. The Government is providing \$30.4 million for phase two of the treaty and self-determination process for Aboriginal Victorians, including:

- establishing and funding the operations of the First Peoples' Assembly; and
- ensuring Traditional Owners are equipped and ready for Treaty negotiations.

The Government is committed to innovative, community-based interventions to ending family and sexual violence that consider the unique perspectives and needs of Aboriginal Victorians. The *2019-20 Budget* provides a further \$28.7 million for Aboriginal sexual assault and family violence services, including the *Dbelk Dja: Aboriginal 10-Year Family Violence Plan* and Aboriginal sexual assault support services.

The *2019-20 Budget* also continues to invest in improving outcomes for Aboriginal children in care. The Government is providing \$13.6 million to further support Aboriginal Community Controlled Organisations to care for Aboriginal children and their families. The *2019-20 Budget* also invests \$8.5 million for greater access to mental health services for Aboriginal Victorians.

Fairness, equity and inclusion

All Victorians should be treated fairly and equitably. The Government is committed to ensuring that every Victorian has the same opportunities and is not disadvantaged because of gender, culture, sexual orientation, religion or socioeconomic background.

The *2019-20 Budget* provides \$185 million to make sure survivors of family violence and sexual assault have the support they need to rebuild their lives. The Government is also investing an additional \$5.7 million to ensure family violence survivors with disability are supported appropriately and provides additional support to lesbian, gay, bisexual, transgender and intersex survivors.

In addition, \$256 million will be dedicated to assist inclusion of children with disability in kindergarten and schools.

Young Victorians need to be free to focus on their education, development and growth, and the Government is providing support for gender and identity fairness. The *2019-20 Budget* provides \$20.7 million, in an Australian-first, for access to free tampons and pads in all public schools.

The *2019-20 Budget* also provides \$6.3 million to support Victoria's LGBTI communities. This includes grants for homelessness providers to ensure young LGBTI Victorians can access safe and inclusive services, extending family counselling services and increased mental health support and support to victims of conversion therapy. The Government is also providing \$1.2 million to celebrate Victoria's LGBTI communities, including expansion of the Pride Festivals and Events Fund.

Promoting Victoria

There are thousands of small businesses across Victoria making some of the world's best produce. To help these businesses grow and boost exports to new markets, the *2019-20 Budget* invests:

- \$10.2 million in grants for small-scale agribusiness to help Victoria's artisan food and beverage producers scale up their operations and create new local jobs; and
- \$5 million for an annual wine export symposium, a Victorian wine showcase, trade missions to the United States and Asia and international marketing campaigns to help Victoria's booming wine industry grow.

In addition, the *2019-20 Budget* will help grow the Victorian racing industry with a \$112 million allocation to boost prizemoney and top-up the Victorian Racing Industry Fund, which provides for racing infrastructure, participant welfare and promotional grants support to the racing industry. Investing to grow the racing industry will ensure Victoria can continue to host first-class events and keep jobs and investment in Victoria.

Tourism

The *2019-20 Budget* invests in new recreation opportunities across the State to attract even more visitors from interstate and overseas to enjoy Victoria's world-class landmarks and local produce.

Victorian families will be able to get out on the water more often, with \$82.1 million to boost recreational boating and fishing. As part of this, upgrades and important maintenance will be delivered at the Mordialloc, Queenscliff, Point Richards, Hastings and Rhyll boat ramps as well as Cowes Jetty. Boating infrastructure management in Port Phillip and Western Port will be reviewed to consider ways to reduce congestion. Boat ramp parking and launching fees will also be abolished at public Victorian boat ramps and stocking of fish will increase to 10 million a year by 2022.

Steam trains will return to the Yarra Valley for the first time in 40 years, with a \$3.8 million contribution towards a scenic railway that will run between Yarra Glen and Healesville, connecting the two largest tourist towns in the region. The project is part-funded by a collaborative effort with local residents, community groups and businesses.

The *2019-20 Budget* also invests \$32 million for tourism marketing of Victoria to attract international, interstate and intrastate visitors. This includes funding to provide third-party organisations to deliver tourism marketing activities and tourism industry programs, such as the Victorian Tourism Awards. Regional Tourism Boards also receive partnership funding to support their services in the regions.

DELIVERING ON OUR ELECTION COMMITMENTS

In its first four budgets, the Government delivered on *Labor's Financial Statement 2014*. The *2019-20 Budget* continues this record of delivering on its commitments, funding \$3.7 billion in output initiatives and \$29.8 billion of capital investments related to *Labor's Financial Statement 2018*.

Labor's Financial Statement 2018 included 87 output initiatives with funding scheduled to commence in 2018-19 or 2019-20. The *2019-20 Budget* funds all of these initiatives apart from *Enshrining Public Holidays to protect your penalty rates*, which will be acquitted when the legislation, introduced to Parliament in March 2019, has been enacted. In addition, the *2019-20 Budget* either fully or partially funds 49 of the 52 capital commitments (including Victorian Transport Fund initiatives), allowing infrastructure works to proceed immediately.

Funding has been set aside over the budget and forward estimates to implement election commitments not fully funded in this Budget.

CHAPTER 2 – ECONOMIC OUTLOOK

- Victoria's economy remains strong, with the current expansion resulting in the longest period of above-trend growth in almost two decades. Real gross state product (GSP) growth is forecast to moderate to the trend rate of 2.75 per cent in 2019-20, while the strength of the current economic cycle continues to deliver strong employment growth and a higher standard of living across Victoria.
- Economic growth in 2019-20 will be driven by continued strength in household consumption, supported by population growth, low interest rates, low unemployment and accelerating wages growth. Rising public and business investment – bolstered by the Government's large-scale infrastructure projects – bodes well for future employment and productivity growth.
- Victoria's labour market conditions are among the strongest in the nation. The unemployment rate fell to 4.6 per cent in March 2019, down 0.6 percentage points over the year. Employment growth is forecast to enter a sixth year of above-trend growth in 2019-20, the strongest period since the 1980s, while the labour force participation rate is expected to remain around record highs.
- Wages growth is forecast to rise over the next four years as spare capacity in the labour market is absorbed, supporting household spending.
- Risks to the economic outlook are broadly balanced, although uncertainty is elevated as the economic cycle matures. On the upside, continued momentum in the labour market could boost employment growth and household consumption. On the downside, there is uncertainty about the outlook for the residential property market, and the pace of moderation in population growth.

VICTORIAN ECONOMIC CONDITIONS AND OUTLOOK

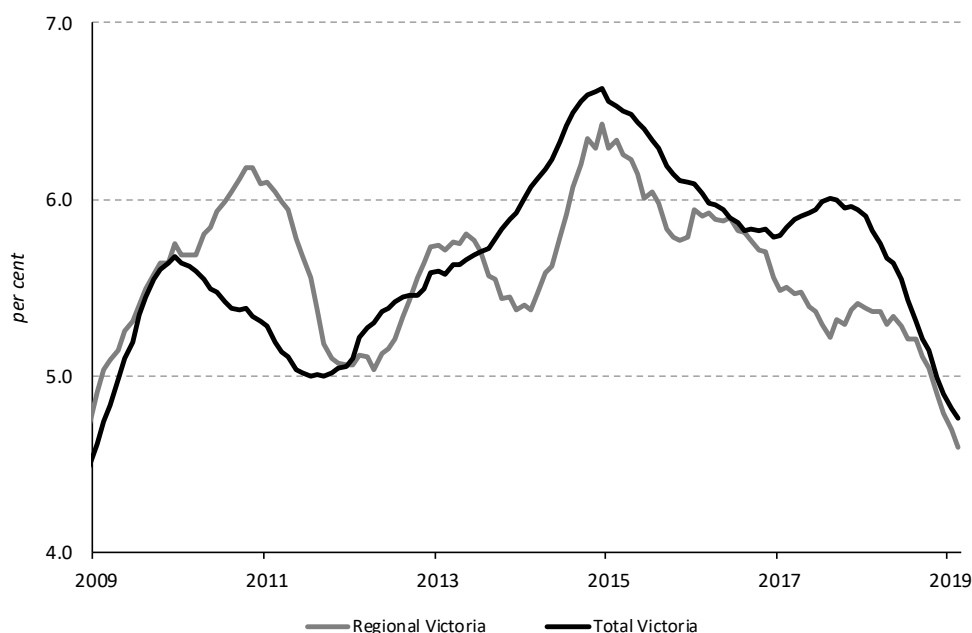
The Victorian economy is strong, generating employment and improving living standards. Economic growth has been above trend for several years, averaging 3.5 per cent a year since 2013-14, the strongest of all the states and well above national economic growth of 2.6 per cent over this period.

Victoria's economic expansion is forecast to continue in 2019-20, with population growth and low interest rates resulting in high levels of investment from the public and private sectors, while stronger wages growth and low unemployment supports solid household consumption.

The sustained economic expansion is generating strong employment growth. Since November 2014, employment has increased by more than 450 000 persons – representing more than a third of all jobs created in the nation – while the unemployment rate has declined by 2.1 percentage points to 4.6 per cent as of March 2019, around its lowest level since 2011 (Chart 2.1). More than 70 per cent of these additional jobs have been full-time.

The strength in the labour market is being shared broadly across Victoria. Over the cycle, the regional unemployment rate has fallen to 4.6 per cent in the three months to March 2019, while labour force participation for females and people aged 65 and over is near record levels.

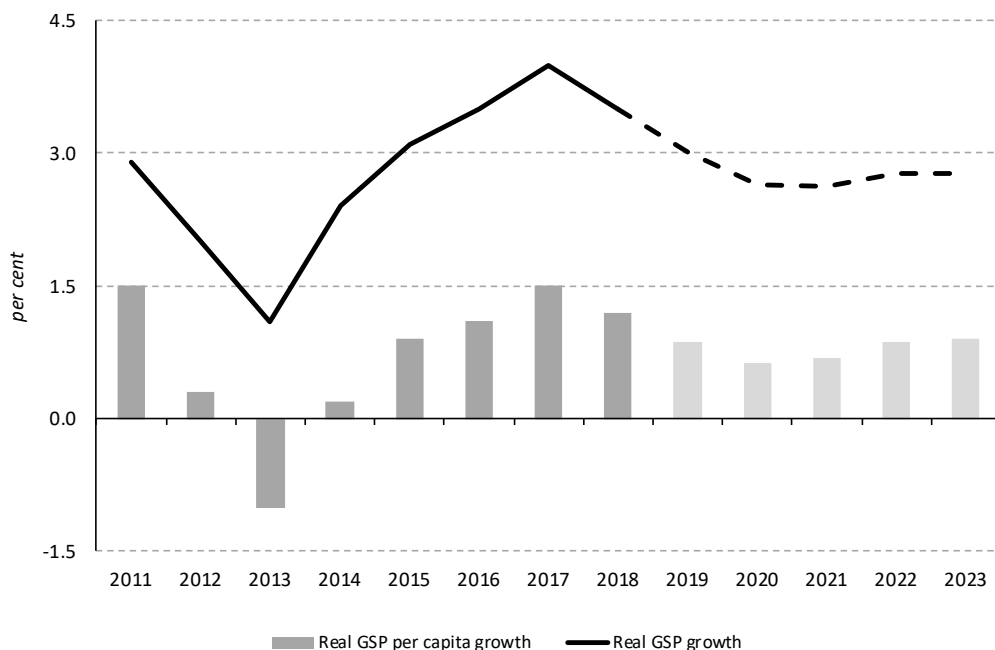
Chart 2.1: Victoria’s unemployment rate, twelve-month moving average



Source: Australian Bureau of Statistics

Public demand has become an important driver of economic activity in Victoria, contributing an estimated 1.1 percentage points of GSP growth in 2018-19. Since 2013-14, public consumption has increased by 21.3 per cent, while public investment has grown by 38.7 per cent. The contribution of public demand to growth is forecast to remain strong as the Government’s infrastructure investment is expected to average \$13.4 billion a year from 2019-20 to 2022-23, nearly triple the average of \$4.9 billion a year from 2005-06 to 2014-15.

Robust economic activity and above-trend employment growth are increasing living standards. Real GSP per capita rose by 1.2 per cent in 2017-18, the fifth successive rise in GSP per capita. This continues the longest period of sustained growth in living standards since the global financial crisis (Chart 2.2).

Chart 2.2: Forecasts of Victoria's real GDP and real GDP per capita

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

The strength of the labour market is expected to remain a feature of this economic cycle. Employment growth is forecast to slow to 2.0 per cent in 2019-20 and 1.75 per cent over the forward estimates as population growth moderates and economic growth returns to its trend rate. Consistent with medium-term projections, the unemployment rate is expected to gradually return to its estimated trend rate by 2022-23. In line with this, wages growth is projected to return to trend of 3.5 per cent over the forward estimates, which will boost the spending power of working Victorians and support household consumption.

Table 2.1 sets out the economic forecasts for the *2019-20 Budget*.

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

	2017-18 actual	2018-19 forecast	2019-20 forecast	2020-21 forecast	2021-22 projection	2022-23 projection
Real gross state product	3.5	3.00	2.75	2.75	2.75	2.75
Employment	2.8	3.25	2.00	1.75	1.75	1.75
Unemployment rate ^(b)	5.6	4.50	4.75	5.00	5.25	5.50
Consumer price index ^(c)	2.3	1.75	2.00	2.25	2.50	2.50
Wage price index ^(d)	2.3	2.75	3.00	3.25	3.50	3.50
Population ^(e)	2.2	2.10	2.00	1.90	1.90	1.80

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

Notes:

(a) Percentage change in year average terms 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 2022-23 represent trend rates.

The key assumptions underlying the economic forecasts include: interest rates that follow movements in market expectations; an Australian dollar trade-weighted index of 62.0; 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).

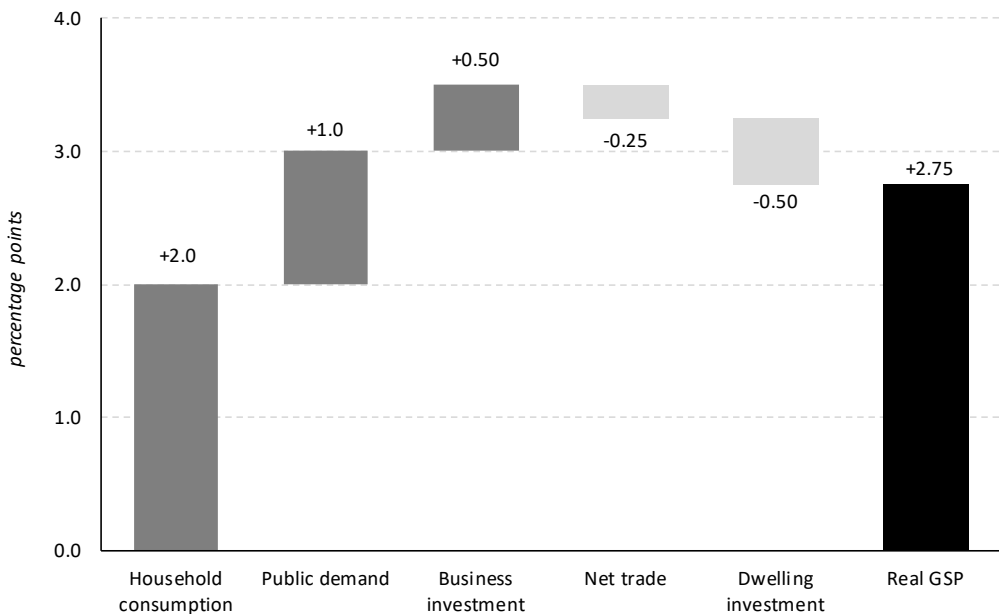
(e) Percentage change over the year to 30 June. Forecasts are rounded to the nearest 0.1 percentage point.

Gross state product

Victoria’s real GSP is forecast to return to its trend growth rate of 2.75 per cent in 2019-20, following five years of above-trend growth – the longest period since the 1990s. This will mark the 28th consecutive year of uninterrupted economic expansion.

Household consumption, public demand and business investment are expected to continue to support economic growth, partly offset by a decline in dwelling investment and a subtraction from net trade (Chart 2.3).

Chart 2.3: Forecast contributions to 2019-20 GSP growth ^(a)



Source: Department of Treasury and Finance

Note:

(a) Rounded to 0.25 percentage points.

Following strong consumer spending in recent years, household consumption growth is forecast to moderate slightly in 2019-20, reflecting the impact of slowing population growth and a stabilisation in the saving ratio. The moderation in the property market, where residential dwelling prices have fallen by 8.7 per cent over the year to April, has dampened consumer sentiment. Nonetheless, the recovery in wages is expected to keep consumption growth at trend levels over the forward estimates.

Dwelling investment is forecast to remain at a high level but decline in 2019-20, consistent with a moderation in the construction pipeline and fall in house prices. The weakness in dwelling investment is anticipated to be relatively modest given Victoria’s strong population growth, which will support demand for new dwelling construction in the medium term (see Box 2.1: Cycles in Victoria’s dwelling investment).

Box 2.1: Cycles in Victoria’s dwelling investment

Dwelling investment has been a strong contributor to the Victorian economy, growing by 8.3 per cent per year over the three years to 2016-17, and remaining at close to record levels in 2017-18. The current cycle has been driven by both detached housing and high-density apartment construction, which has contributed to employment growth and broader economic activity.

New building approvals have fallen in recent months, particularly in the high-density apartment market. Tighter credit availability, and the stricter application of lending standards, has contributed to a recent moderation in residential house prices. As a result, dwelling investment is forecast to decline in 2019-20 and 2020-21. Nevertheless, the downturn in the current cycle is expected to be modest compared with previous cycles (Chart 2.4).

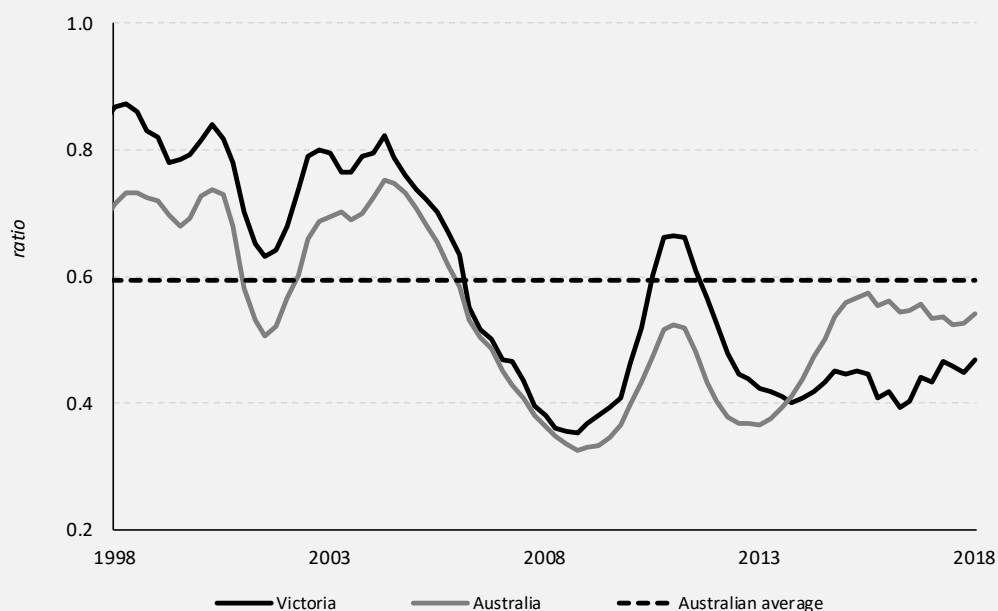
Chart 2.4: Victoria’s dwelling investment



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

The severe construction downturn in the late 1980s occurred during a time of high interest rates (more than 15 per cent), low population growth and a contraction in state final demand. In contrast, the moderation of the current cycle is expected to be relatively modest given the underlying strength of Victoria’s economy. Dwelling completions per new resident remain well below the long-run average, which is expected to provide fundamental support for new housing in the medium term (Chart 2.5).

Chart 2.5: Dwelling completions per new resident



Source: Australian Bureau of Statistics

Partly offsetting the forecast moderation in housing construction, the record level of public infrastructure investment is expected to support construction activity over the forward estimates. A considerable amount of work is already in the pipeline, with the Government's infrastructure investment projected to total \$53.7 billion over the budget and forward estimates. Growth will be supported by large-scale projects, particularly road and rail network upgrades, and non-residential projects such as new schools and hospitals. As a result, public demand in Victoria is forecast to be high in 2019-20 and over the next four years.

Growth in private business investment is forecast to be above trend in 2019-20, driven by the Government's investment through public private partnerships, and solid population growth supporting non-residential building construction. Machinery and equipment investment is expected to remain subdued, partly reflecting the relatively low capital intensity of Victoria's major growth industries, including the services sector.

Net trade is forecast to subtract from growth in 2019-20 and over the forward estimates. Import demand is forecast to be high in 2019-20, as positive domestic conditions support growth in both merchandise and services imports. Export growth is forecast to be strong, supported by continued demand from China and ongoing structural growth in Victoria's education, tourism and professional services sectors. Agricultural production is expected to weigh on export growth in 2019, with Victoria's 2018-19 winter crop affected by poor seasonal conditions.

OTHER ECONOMIC INDICATORS

Prices

Inflation has been subdued in recent years, consistent with the experience of most advanced economies. This primarily reflects weak tradables inflation, as well as spare capacity in the economy and low wages growth.

Tradables inflation has been weighed down by heightened competition in the retail sector, which has been partly offset by the modest depreciation in the exchange rate. Non-tradables inflation has been tracking above tradables inflation, but has recently moderated due to a softening in administered prices and housing-related costs.

The inflation rate is forecast to be 2.0 per cent in 2019-20, 0.50 percentage points lower than forecast in the *2018-19 Budget Update*. Recent inflation outcomes have been weaker than expected and the early signs of improving wages growth are yet to translate into upward price pressure. The weaker outlook for inflation has resulted in lower market expectations for future interest rates. The inflation rate is expected to gradually increase to 2.50 per cent over the forward estimates as the reduction in spare capacity eventually leads to wages growth and increased non-tradables inflation.

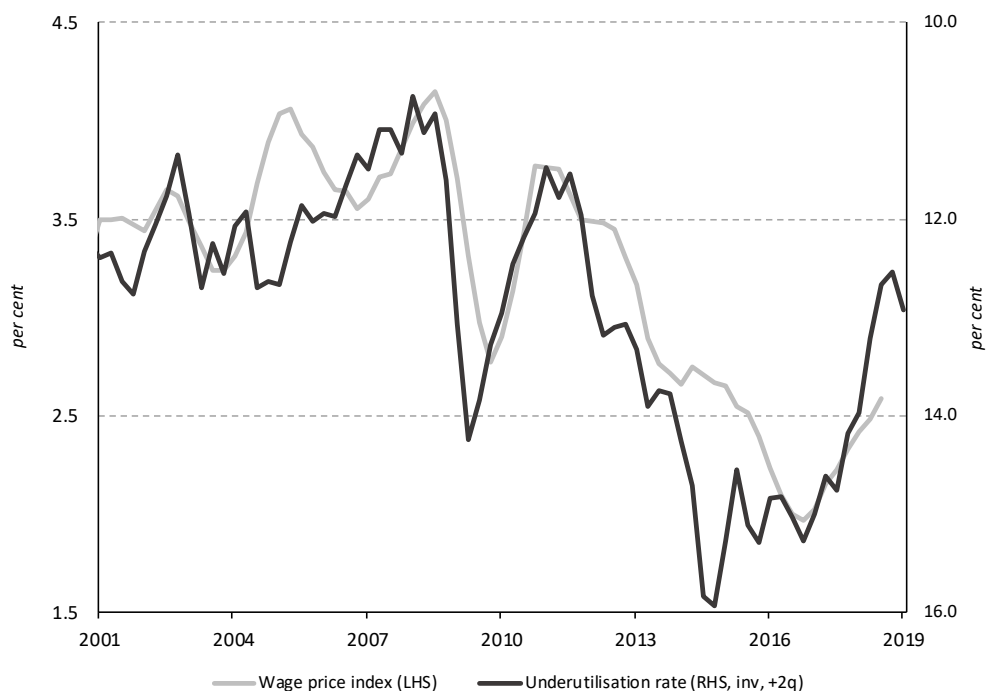
Wages

Victorian wages growth has been below trend over the current economic cycle, consistent with other national and international jurisdictions. That said, Victorian wages growth has begun to accelerate over the past year, reflecting the relative strength of Victoria's labour market and broader economy.

Wages growth has been mixed across industries, with stronger growth in the non-market sector – such as in the 'healthcare and social assistance' and 'education and training' industries – being partly offset by weaker growth in large employing industries such as 'retail trade', 'construction', and 'professional, scientific and technical services'.

Wages growth is expected to return toward a trend growth rate of 3.5 per cent as excess capacity in the labour market reduces. The labour force underutilisation rate has fallen over the past two years (Chart 2.6), driven by a combination of strong labour demand and a tightening in labour supply as population growth moderates.

Chart 2.6: Victorian annual wages growth and labour force underutilisation



Source: Australian Bureau of Statistics

The labour market

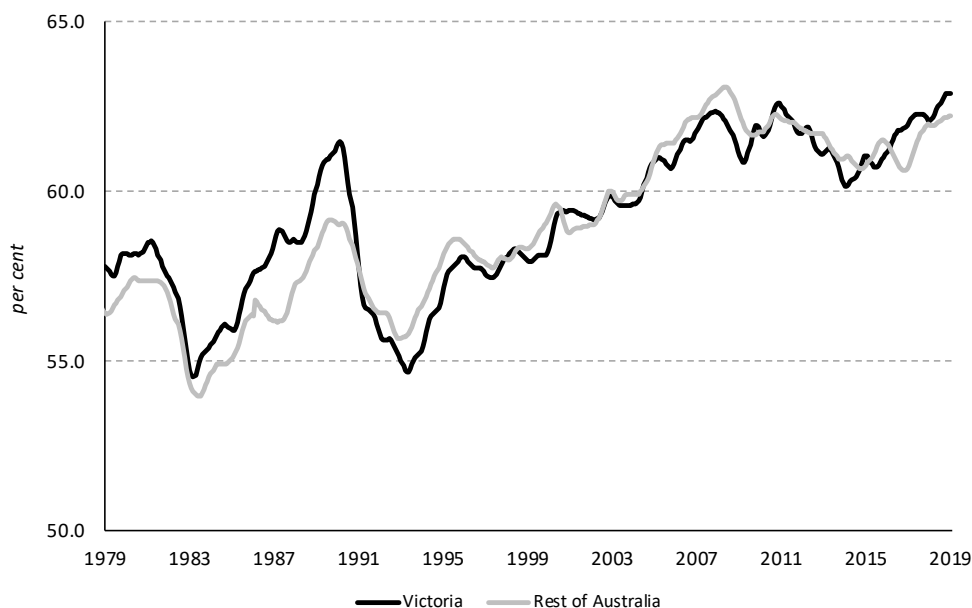
The Victorian labour market has continued its strong momentum, with above-trend employment growth every year since 2013-14 – the longest expansion since the 1980s. Employment grew by 2.8 per cent in 2017-18 and is forecast to grow by 3.25 per cent in 2018-19, extending one of the strongest employment cycles in the State’s history (see Box 2.2: Victoria’s labour market cycle).

Expectations that Victoria’s labour market will remain robust in 2019-20 are supported by solid leading indicators of labour demand, particularly job vacancies and hiring intentions. Labour supply growth is forecast to be high, driven by population growth that is forecast to moderate but remain well above the national average. Employment growth is forecast at 2.0 per cent in 2019-20, which would represent the sixth consecutive year of above-trend growth.

Victorian employment increased by 123 000 persons over the year to March 2019, which was driven entirely by full-time employment. At the same time, the employment-to-population ratio has increased to its highest rate on record (Chart 2.7).

The strength of the labour market is broad-based across industries, with 16 of Victoria’s 19 industry groups expanding from 2013-14 to 2017-18. The construction industry has been the largest contributor to employment growth over the period and has added the largest number of jobs in 2018. This reflects the significant infrastructure and dwelling investment currently underway across the State.

Chart 2.7: Employment-to-population ratio, trend



Source: Australian Bureau of Statistics

In an environment of moderating labour supply growth and strong labour demand, the outlook for the unemployment rate has improved. Victoria's unemployment rate is now forecast to average 4.75 per cent in 2019-20, 0.25 percentage points lower than forecast in the *2018-19 Budget Update*. Further out, the unemployment rate is projected to stay below its estimated trend rate of 5.5 per cent until 2022-23, supporting a gradual recovery in wages growth.

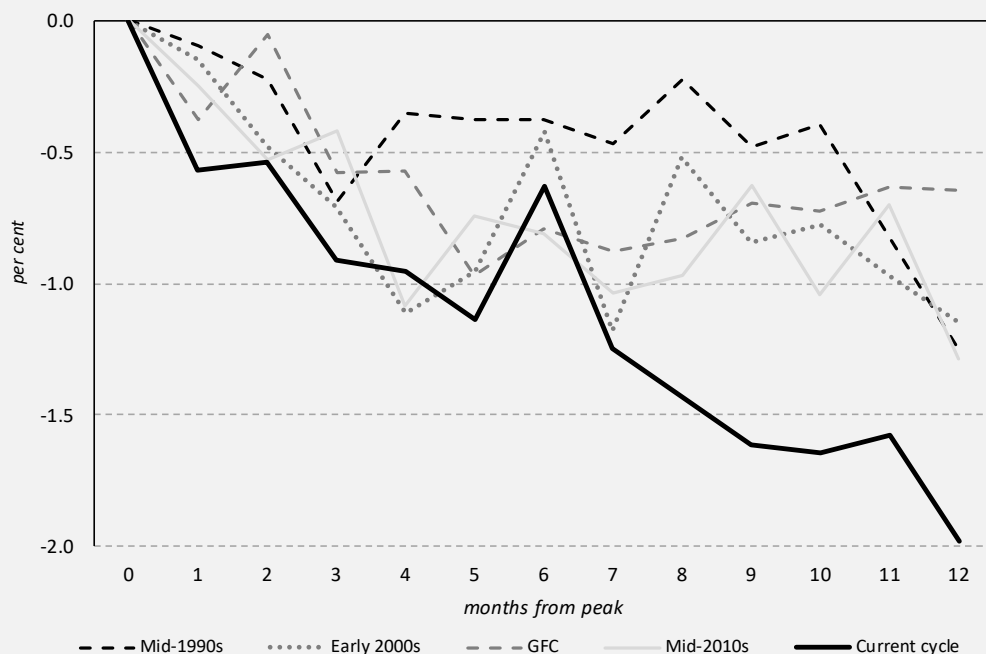
Over the year to March, Victoria's unemployment rate has declined by 0.6 percentage points to 4.6 per cent. The decline in the unemployment rate has been broad-based across metropolitan Melbourne and regional Victoria. The regional unemployment rate was 4.6 per cent in the three months to March 2019 – the lowest regional unemployment rate of the states and down 1.2 percentage points from a year earlier.

The strength of the labour market has benefited different demographic cohorts across Victoria. Victoria's youth (aged 15-24 years) unemployment rate declined by 2.2 percentage points to 10.8 per cent over the year to March (12-month average), the second lowest rate among the states, while the female unemployment rate declined by 0.7 percentage points to 4.8 per cent.

Box 2.2: Victoria's labour market cycle

Victoria's strong labour market performance has exceeded expectations over the cycle. At the *2018-19 Budget*, Victoria's unemployment rate was forecast to reach 5.75 per cent in 2018-19 in year-average terms. Since then, labour market conditions have strengthened, with the unemployment rate falling from 6.2 per cent in December 2017 to 4.2 per cent in December 2018, the largest 12-month fall in more than 20 years (Chart 2.8).

Chart 2.8: Monthly change after peaks in the unemployment rate



Source: Australian Bureau of Statistics

Several factors have helped extend the labour market cycle. Labour demand has been strong, supported by above-trend levels of economic growth. Surveyed hiring intentions are well above the historical average, while job vacancies increased by 16.2 per cent over the year to November 2018. The strength of the investment cycle in 2018 – driven by both dwelling investment and infrastructure projects – has supported employment growth throughout the State, particularly in construction (Chart 2.9).

Chart 2.9: Victoria’s employment growth by 10 largest employing industries, 2018^(a)



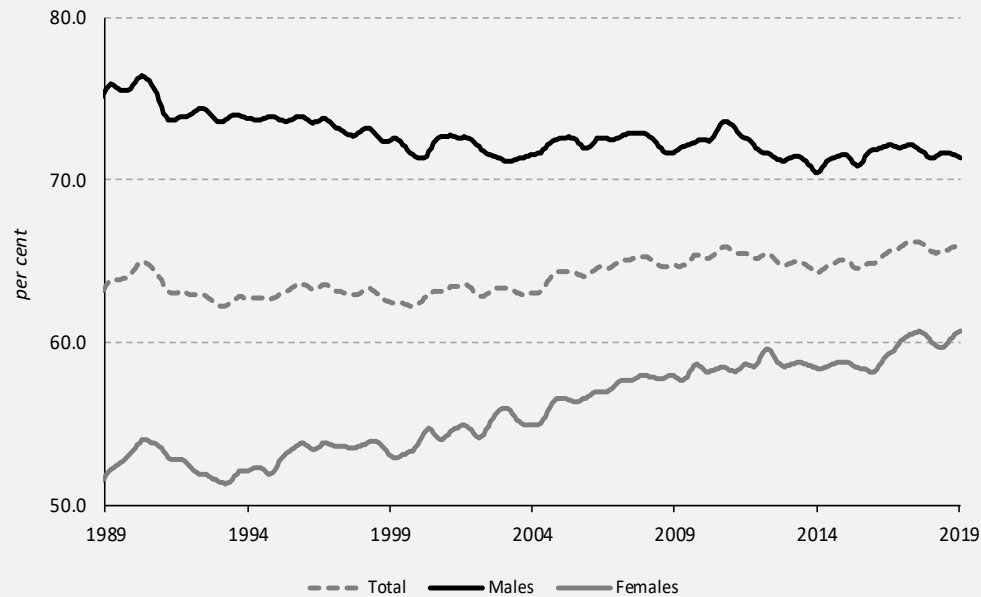
Source: Australian Bureau of Statistics

Note:

(a) Four-quarter moving average, year to November 2018.

Victoria’s unemployment rate fell sharply in 2018, despite high levels of labour force participation. The labour force participation rate averaged 65.9 per cent in 2017-18, the highest rate on record. Increased participation from females and workers 65 years and older have made the largest contribution to the overall increase and helped to offset the effects from the ageing of the population. The female labour force participation rate has increased by 1.8 percentage points since 2013-14 (Chart 2.10).

Chart 2.10: Victoria’s participation rate by cohort, trend



Source: Australian Bureau of Statistics

Population

Victoria's population growth is strong, driven by high levels of net overseas and interstate migration. In the year to September 2018, Victoria's population grew by 2.2 per cent, the highest of all the states and above the national average.

Both net overseas and net interstate migration have been high over the past few years, reflecting Victoria's strong economic and employment growth, as well as the attractiveness of Victoria as a place to live, work and raise a family. Net overseas migration was more than 85 000 persons in 2017-18, while net interstate migration was 14 300 persons.

Population growth is forecast to ease from 2.0 per cent in 2019-20 to 1.8 per cent over the forward estimates, but to remain higher than the long-term average growth of 1.3 per cent.

AUSTRALIAN ECONOMIC CONDITIONS AND OUTLOOK

Australia's real gross domestic product (GDP) rose by 2.8 per cent in 2017-18, supported by accommodative monetary policy, a low Australian dollar and strong labour market conditions.

Economic activity slowed in the latter half of 2018, as falling house prices and tighter credit conditions weighed on dwelling investment and household consumption. As a result, the *2019-20 Commonwealth Budget* downgraded the forecast for real GDP growth by 0.25 percentage points in 2019-20, to 2.75 per cent.

Growth is forecast to be supported by household consumption, exports and non-mining business investment. Mining investment is expected to make a positive contribution to economic growth in 2019-20 for the first time in around seven years.

Growth in household consumption is forecast to improve in 2019-20, supported by solid growth in employment and a modest improvement in wages growth, although a decline in property values, tighter credit conditions or weaker income growth could result in weaker than expected household spending.

The Commonwealth Treasury forecasts national dwelling investment to decline in 2019-20 and 2020-21, driven by a fall in property values, lower building approvals and subdued credit growth. Business investment is expected to improve in 2019-20, as mining firms invest to maintain current production and non-mining investment continues to grow steadily. Public demand is also expected to contribute to growth, driven by infrastructure spending and the rollout of the National Disability Insurance Scheme.

Conditions in the national labour market are strong. Employment growth is particularly high in the eastern states, while the national unemployment rate was 5.1 per cent in March. The outlook for the labour market is positive. National employment is forecast to grow by 1.75 per cent in 2019-20, while the unemployment rate is expected to average 5.0 per cent. Despite the low unemployment rate, the *2019-20 Commonwealth Budget* revised down the forecast for wages growth in 2019-20, reflecting ongoing subdued price pressures in the economy and persistent spare capacity in the labour market.

INTERNATIONAL ECONOMIC CONDITIONS AND OUTLOOK

The outlook for the global economy is positive but has weakened since the *2018-19 Budget Update*, reflecting lower growth in Europe and Asia. Slower momentum in global growth during the second half of 2018 has continued in early 2019 based on the latest global industrial production data and surveys of purchasing managers.

In the April 2019 *World Economic Outlook* (WEO), the International Monetary Fund (IMF) downgraded the global growth forecast to 3.3 per cent in 2019 (Table 2.2), from 3.5 per cent in the January WEO. Although this growth rate is still reasonable, the outlook for some countries is challenging and there is considerable uncertainty in the short term, including from the impact of Brexit as well as trade tensions between China and the United States.

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

	2017 actual	2018 estimate	2019 projection	2020 projection
World output	3.8	3.6	3.3	3.6
Advanced economies	2.4	2.2	1.8	1.7
United States	2.2	2.9	2.3	1.9
Euro area	2.4	1.8	1.3	1.5
Japan	1.9	0.8	1.0	0.5
Emerging market and developing economies	4.8	4.5	4.4	4.8
China	6.8	6.6	6.3	6.1
India	7.2	7.1	7.3	7.5
ASEAN – 5 ^(b)	5.4	5.2	5.1	5.2

Source: International Monetary Fund's World Economic Outlook Update, April 2019

Notes:

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

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

Global growth is forecast to accelerate to 3.6 per cent in 2020, supported by fiscal stimulus in China, recent improvements in global financial market sentiment and the waning of some temporary drags on growth in the euro area. By contrast, activity in advanced economies is projected to continue to slow as the impact of the US fiscal stimulus fades.

RISKS TO THE VICTORIAN OUTLOOK

Risks to the Victorian economic outlook are broadly balanced, although uncertainty is elevated as the economic cycle matures. On the upside, a lower than estimated trend unemployment rate could lead to higher employment and GSP growth, without generating upward pressure on wages or inflation. This would be consistent with the experience of international jurisdictions, including in the United States where the unemployment rate has remained below estimates of trend for some time, without raising inflation expectations.

On the downside, there is uncertainty about the pace and size of the adjustment in the residential property market. If the downturn is deeper or more prolonged than currently forecast, this could lead to further declines in household wealth. This would be expected to weigh on consumer sentiment, and lead to lower household consumption, dwelling investment and overall economic growth.

There is heightened uncertainty around the future path of interest rates. Recent inflation outcomes have been weaker than expected and market expectations for global interest rates have declined. Changes in interest rates could impact economic growth, conditions in the housing market and inflation.

Population growth is forecast to be high but to moderate over the forecast period, although there is uncertainty about the pace of the moderation in growth. External risks such as a reduction in growth or changes in policy could lead to a lower than forecast national net overseas migration pool. This could lead to lower population growth in Victoria, reducing household consumption and overall economic activity.

The risks to the global economy are also skewed to the downside. A faster-than-anticipated slowdown in global growth, which could be caused by a further escalation of global trade tensions or a slowdown in China's domestic demand, could have negative implications for Victoria.

See Appendix A *Sensitivity Analysis* for further information on the estimated economic and fiscal impacts of lower than anticipated population growth and a lower trend unemployment rate.

CHAPTER 3 – INVESTING FOR ALL VICTORIANS

Key points

- Over the past four years, the Government has invested to meet the needs of our growing and changing population, and to ensure all Victorians have the opportunity to share in and contribute to Victoria's future prosperity.
- The economic benefits of this investment are emerging. Public investment has led private business investment in the recent economic cycle, with rising public investment in 2017-18 met by rising private business investment the following year. In 2017-18, total public and private business investment contributed 1.5 percentage points to real gross state product (GSP) growth, the highest contribution in more than a decade.
- The *2019-20 Budget* extends this record, funding \$11.4 billion in output initiatives and \$34.5 billion total estimated investment in new capital investment. Government infrastructure investment is projected to average \$13.4 billion a year across the budget and forward estimates.
- The Government's investment in core services and infrastructure is designed to support economic growth and jobs in the short term, and enhance productivity growth in the medium to long term.
- The *2019-20 Budget* maintains the Government's long-term fiscal management objectives to manage Victoria's finances in a responsible manner to provide capacity to fund services and infrastructure at levels consistent with maintaining a triple-A credit rating. The fiscal discipline of producing operating surpluses has been maintained, even amid a softer revenue growth outlook.
- In *Labor's Financial Statement 2018*, the Government committed to stabilise net debt at 12 per cent of GSP over the medium term. Net debt will increase to fund three major productivity-enhancing capital projects delivered through the Victorian Transport Fund: North East Link; Melbourne Airport Rail; and the removal of an additional 25 level crossings by 2025. It will also accommodate changes in accounting standards from 2019-20. The Government will deliver these projects while maintaining fiscal and debt settings that are consistent with the State's triple-A credit rating.
- The Government will continue to identify new opportunities to build capacity for investment through appropriate savings and efficiencies, asset recycling and value capture. Innovative financing approaches are being explored to support the State's core service delivery and infrastructure requirements.
- The task of delivering the services and infrastructure needed for a growing population is made challenging by continued underfunding by the Commonwealth Government. Where possible, the Victorian Government will work with the Commonwealth to deliver on shared priorities and secure a fair share for Victoria.

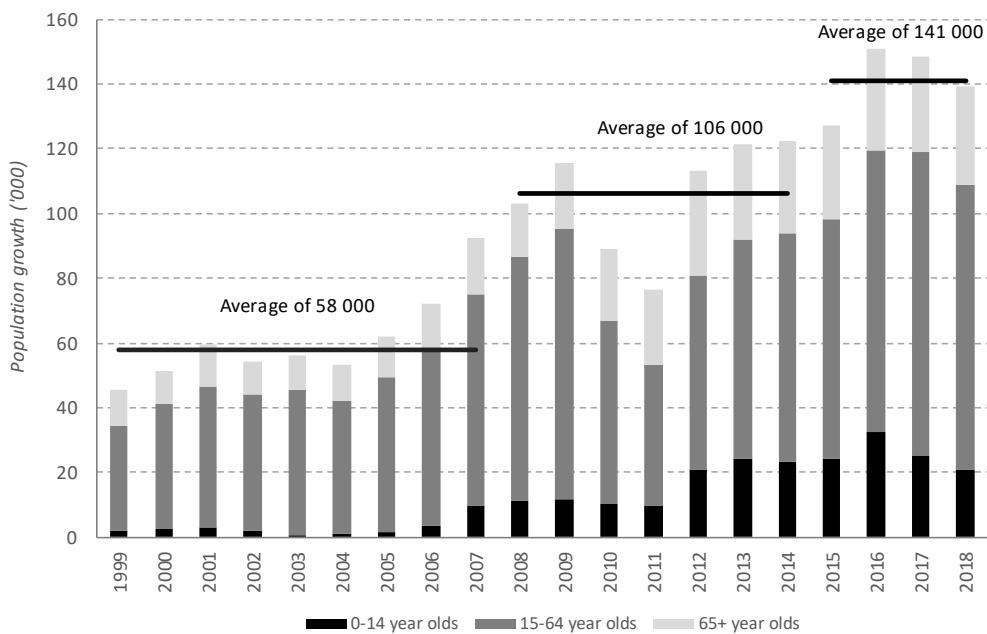
INVESTING IN OUR GROWING STATE

Victoria is growing rapidly, and the Government has stepped up to meet the challenge and maintain the liveability and prosperity of our state.

Victoria’s population growth has accelerated over the past decade as strong economic growth, attractive job opportunities and amenity have made Victoria an increasingly desirable location to live and work. Over the decade to 2007, Victoria added approximately 58 000 new residents a year. Between 2008 to 2014, this increased to 106 000 a year, and more recently, over the four years to 2018, population growth has averaged approximately 141 000 a year (Chart 3.1).

The demographic profile of the State has shifted, with stronger growth across younger age cohorts than was expected in the early 2000s. Between 2008 and 2018, the number of children (0 to 14 years) increased by 20.7 per cent, compared with 4.1 per cent in the preceding decade. Meanwhile, the working age population (15 to 64 years) has grown at compound annual growth rate of 2.0 per cent over the past five years. This has moderated the impact of population ageing on the Victorian economy, but also increased demand for a range of government services and infrastructure.

Chart 3.1: Victoria’s annual population growth, by age group



Source: Australian Bureau of Statistics

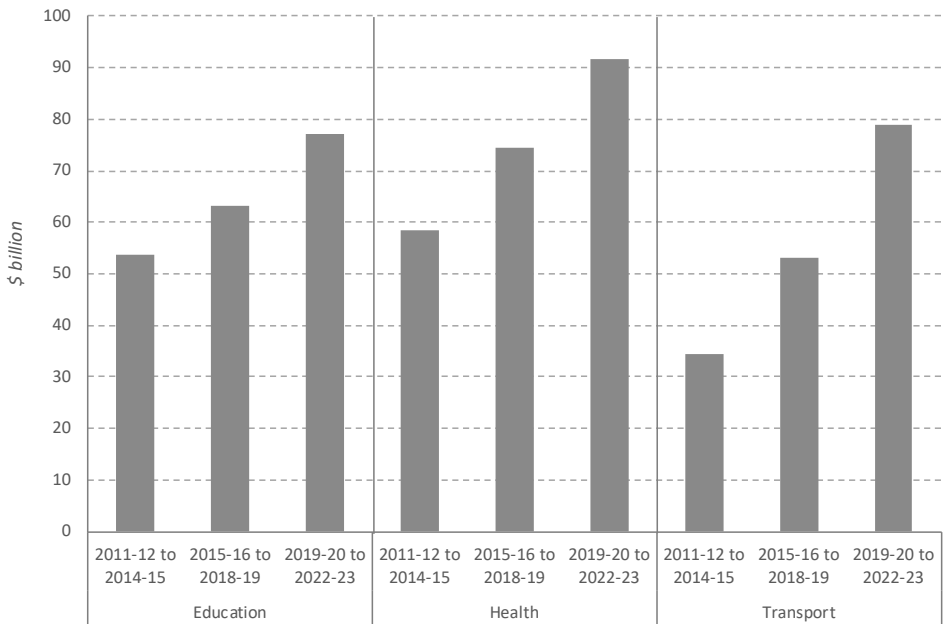
The Government has responded to demographic change, and the imperative to grow Victoria’s prosperity into the future, by ramping up the pace and scale of public investment. During its first term, the Government increased spending in core service areas of education, health and transport by more than \$44 billion to meet the needs of a growing and changing state. This is forecast to continue, with the Government adding a further \$56.9 billion expenditure and infrastructure investment across three core service areas over the next four years (Chart 3.2).

The Government has invested an additional \$10.8 billion over the past four years to make Victoria the Education State and respond to the recent rapid increase in school age children. This includes an investment in vocational education and training of \$172 million, provided in the *2018-19 Budget*, to make priority TAFE and pre-apprenticeship courses free for eligible students.

Over the past four years, the Government has also undertaken renewed investment in healthcare. This has allowed for more responsive ambulance services, more than 4 000 additional nurses and 1 400 doctors and the completion of new and upgraded hospitals such as the Women’s, Children’s and Ballarat hospitals. A record \$705 million investment in mental health was also provided in 2018-19.

In transport, around \$53 billion in output and government infrastructure investment has been committed to Victoria’s road and rail network during the Government’s first term to enable quicker commutes and increased productivity. This has included funding on transformational projects including the Metro Tunnel and the Level Crossing Removal Project, as well as upgrades to the Monash, Tullamarine and West Gate freeways.

Chart 3.2: Government service delivery and capital investment by selected sectors ^(a)



Source: Department of Treasury and Finance

Note:

(a) The Classification of the Functions of Government (COFOG) framework has replaced the former Government Purpose Classification framework under the new ABS GFS Manual. The was implemented for the first time in the 2018-19 Budget. Note 1.7.5 of Budget Paper No. 5 Statement of Finances provides definitions and descriptions of the COFOG.

The *2019-20 Budget* extends this record investment in Victoria's future with a focus on increasing access to the quality services and infrastructure Victorian communities need.

In education, the Government will invest \$882 million to ensure every three-year-old has access to at least five hours per week of subsidised kinder by 2022 – increasing to 15 hours per week over the next decade. This reform will act on research that shows that two years of preschool is crucial in helping children get their best start in life, and will nearly double the size of the kindergarten sector once fully rolled out. Further, the *2019-20 Budget* will provide funding to make two early childhood TAFE courses free for eligible students to ensure Victoria can meet demand for early childhood education. The Government is also investing \$1.4 billion in school capital, reinforcing the Government's commitment to making Victoria the Education State. This includes funding to build 17 new schools, upgrade and modernise 59 schools across Victoria, with a further 44 schools to receive funding to prepare for their upgrades.

The *2019-20 Budget* invests in the provision of more accessible and higher-quality health services, with initiatives such as a \$322 million investment to begin providing all Victorian Government school students with access to free dental care and a total of \$1.5 billion now committed to begin construction of the 504-bed Footscray Hospital. This project will allow almost 15 000 additional patients to be treated.

The Government will also continue Victoria's Big Build in transport. Since the *2018-19 Budget*, the Government has fully funded North East Link and will invest in the removal of an additional 25 level crossing by 2025. Resources have been committed for planning and pre-construction for Melbourne Airport Rail, with a business case under development to confirm the construction costs, staging and associated cash flows. Resources have also been committed to undertake detailed planning activities to deliver the Western Rail Plan and Suburban Rail Loop. These initiatives will help ensure the distribution of population growth in Melbourne and across Victoria (Box 3.1).

Box 3.1: Victoria's dispersed growth

Over the 1980s to 2000s, Melbourne's population growth was concentrated in middle ring suburbs, functioning as a 'doughnut' city. However, the past decade has seen much more distributed growth in where people live and work.

Areas such as Wyndham, Cardinia and Melton have seen some of the strongest population growth, with average annual growth rates over the decade to 2016 of 6.8 per cent, 5.1 per cent and 5.6 per cent, respectively (Census 2016). This growth is occurring alongside employment growth, with Melton, Wyndham, Cardinia, Whittlesea and Casey experiencing the fastest growth in total jobs of all local government areas (LGAs) in Victoria over the 10 years to 2016.

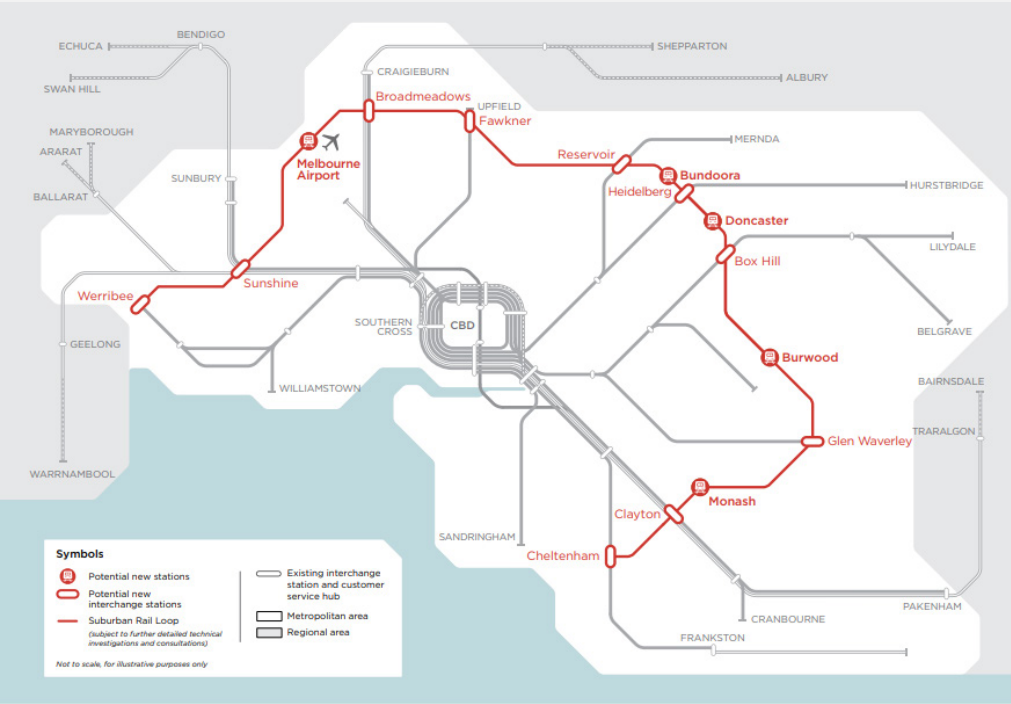
Department of Treasury and Finance analysis of travel options alongside the physical location of jobs confirms the distributed nature of employment opportunities.¹ The outer LGAs of Cardinia and Melton had the highest percentage growth in effective job density of all the metropolitan LGAs, with growth of 60 per cent and 52 per cent respectively.

¹ DTF, 'How can effective job density help our understanding of economic concentration?', *Victoria's Economic Bulletin*, Vol. 2, August 2018.

These results show the importance of moving toward a polycentric transport structure (i.e. a system with more than one centre) to support a larger, more distributed population, ease congestion and enhance living standards. Train trips in Melbourne make up only 5 per cent of all weekly travel, whereas some cities with a polycentric train system attract a comparable mode share of more than 20 per cent.

To support the way in which Victoria’s population and economy is growing, the Government is investing in a more connected and polycentric transport network. The Suburban Rail Loop will transform Melbourne by providing a 90km rail connection circling Melbourne’s major employment, health services and education precincts, allowing people to travel more easily between suburbs or to Melbourne Airport, without the need to travel through the CBD.

Chart 3.3: The Suburban Rail Loop



Source: Victorian Government, Suburban Rail Loop Strategic Assessment.

Regional cities, such as Geelong, Ballarat and Bendigo, have also seen jobs growth outpace population growth. The Government’s investment in regional train and road transport will continue to support flexible employment and economic growth well into the future.

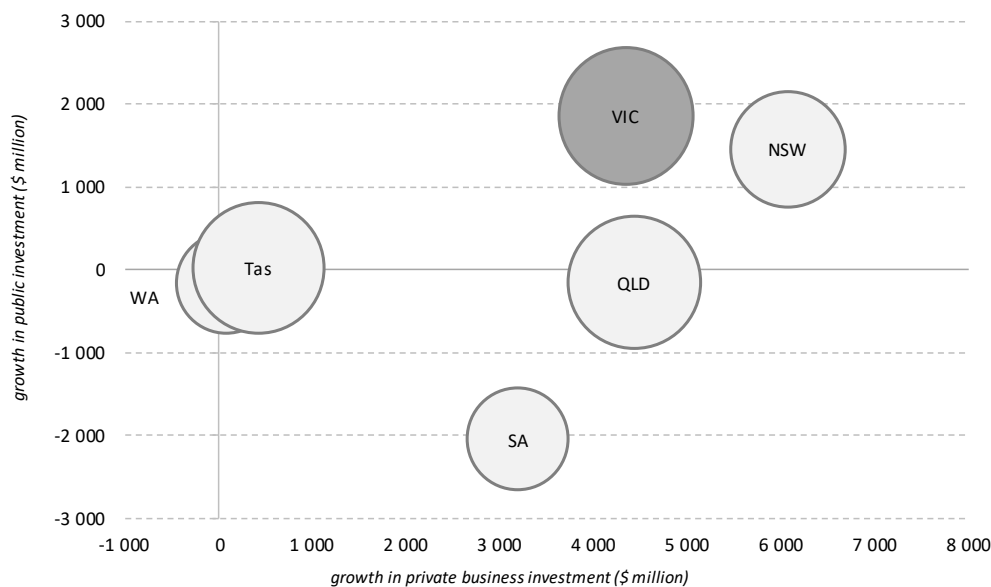
PRODUCTIVITY-ENHANCING GROWTH

Public investment has been instrumental in underpinning economic growth in recent years, and positioning Victoria for sustained economic and productivity growth into the future.

Public investment increased by 10.5 per cent in 2017-18, contributing 0.5 percentage points to Victoria’s real GSP growth, following similar contributions in the previous two years. Public investment, such as major infrastructure projects, also supports investment from private businesses (Chart 3.4). Over the past three years, the contribution of private business investment to real GSP growth has increased from 0.1 of a percentage point in 2015-16 to 1.0 percentage point in 2017-18.

The combined contribution of public and private business investment reached 1.5 percentage points in 2017-18 – the highest contribution of investment since 2005-06.

Chart 3.4: Public and private business investment, 2016-17 to 2017-18^(a)



Source: Australian Bureau of Statistics

Note:

(a) The size of bubble denotes the average rate of real GSP growth.

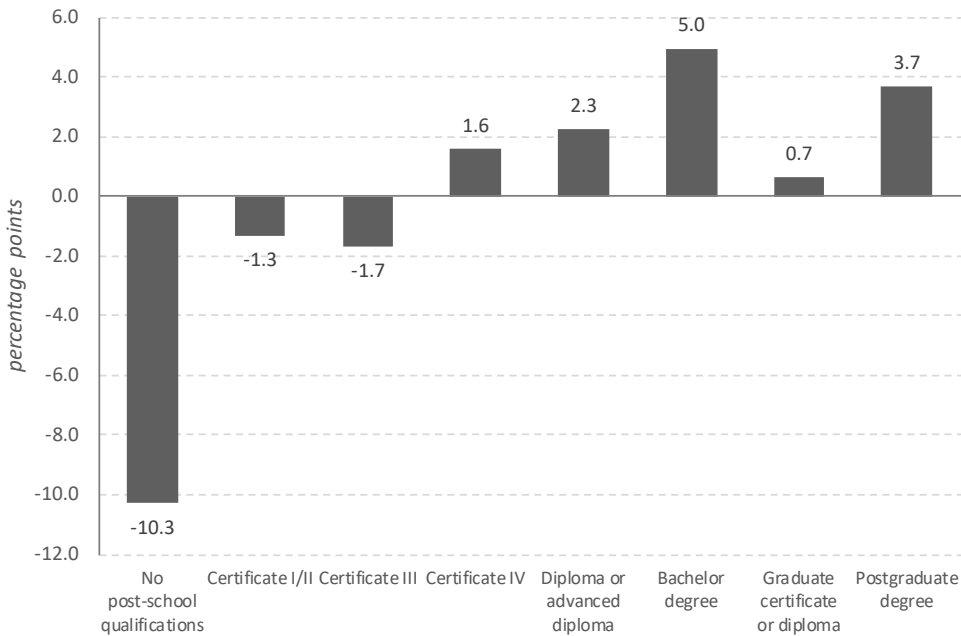
Beyond the immediate economic and employment benefits associated with public spending, there is evidence such investment can have long-run benefits for economies. International institutions including the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) have found public infrastructure spending can stimulate productivity, with the OECD quantifying the multiplier effect of government investment as between 1.1 and 1.3 – that is, a 10-30 per cent return.²

² OECD (2009), ‘Chapter 3: The Effectiveness and Scope of Fiscal Stimulus’, *OECD Economic Outlook*, Interim Report and IMF (2019), ‘Australia : 2018’. *Country Report No. 19/55*.

This reflects that investment in physical infrastructure allows for more efficient matching of employer needs and available workers, collaborative and innovative business activity, and shorter commutes.

There are also significant benefits from government investment in human capital – such as health and education. Growth in workforce skills is key to productivity growth as the economy shifts towards service-based, knowledge-intensive industries (see Chart 3.5). Similarly, the Productivity Commission has recognised the important contribution a healthy workforce makes to productivity.³

Chart 3.5: Change in the proportion of highest skill level attainment, Victorians aged 20 to 64 years of age, 2006 to 2016



Source: ABS 2006 and 2016 Census

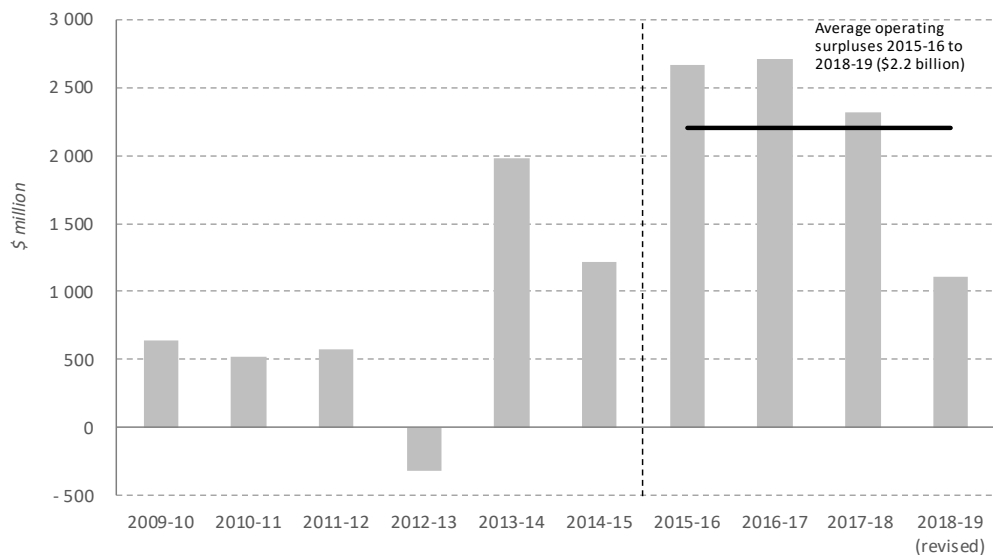
STRONG FINANCIAL MANAGEMENT IS SUPPORTING INVESTMENT

The Government is committed to long-term financial management objectives that include managing Victoria’s finances in a responsible manner to provide capacity to fund services and infrastructure at levels consistent with maintaining a triple-A credit rating. Victoria remains one of only 10 comparable sub-sovereign governments holding a triple-A credit rating from both Standard & Poor’s and Moody’s Investor Services.

In each year of its first term, the Government delivered strong operating surpluses, averaging \$2.2 billion a year (Chart 3.6). These surpluses, along with the proceeds of asset recycling and expenditure savings, have enabled the Government to address previous under-investment in infrastructure and services, while maintaining net debt below 6 per cent of GSP.

³ Productivity Commission (2017) ‘Why a better health system matters’, *5 year Productivity Review*.

Chart 3.6: General government operating result



Source: Department of Treasury and Finance

Strong financial management over the past four years has positioned the Government to continue to invest in new services and infrastructure. This will be achieved through continuing the budget discipline exhibited over the Government’s first term in office, combined with prudent levels of borrowing for productivity-enhancing infrastructure.

Borrowing to invest

In *Labor’s Financial Statement 2018*, the Government committed to stabilise net debt at 12 per cent of GSP over the medium term. Net debt will be increased to fund transformational capital projects delivered through the Victorian Transport Fund (VTF), which was originally established in the Government’s first term to distribute proceeds from the 50-year lease of the operations of the Port of Melbourne to fund 50 level crossing removals and other infrastructure initiatives.

Building on this, the VTF will finance a further three major, productivity-enhancing capital projects: North East Link; Melbourne Airport Rail; and the removal of an additional 25 level crossings by 2025. The increase in net debt will also accommodate changes in accounting standards from 2019-20, which require all governments and private businesses to classify most operating leases as well as financial liabilities for service concession arrangements as part of net debt (see Box 3.2).

Box 3.2: Net debt impact of new accounting standards

Several new accounting standards issued by the Australian Accounting Standards Board have been applied for the first time to the Estimated Financial Statements for 2019-20 onwards.

The two standards that have the most significant impact on net debt in the general government sector are: AASB 16 *Leases* and AASB 1059 *Service Concession Arrangements: Grantor (Service Concession Arrangements)*.

Under AASB 16, most operating leases are now required to be recognised as lease liabilities on the balance sheet, where previously they were recognised by an annual expense through the operating statement.

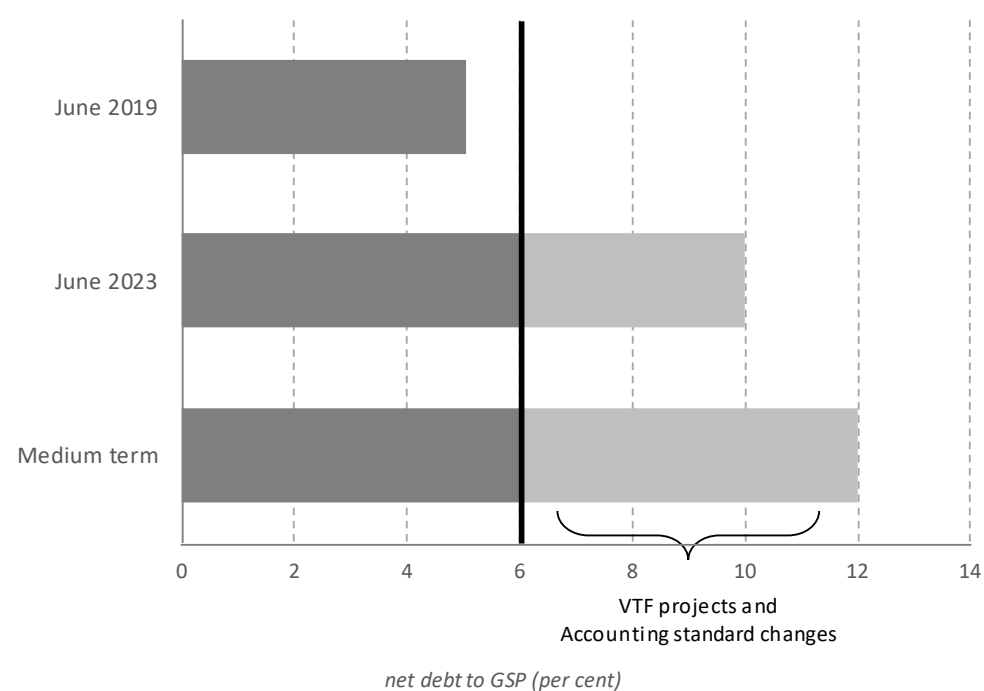
AASB 1059 introduces the requirement to recognise a service concession asset and a financial liability for arrangements that require an operator to provide public services on behalf of the State, using a service concession asset (predominantly social infrastructure public private partnerships (PPPs) such as transport infrastructure). The timing and recognition under the new Standard is earlier and requires the recognition of the asset and the liability progressively during the construction period of a project. This change has the impact of increasing net debt in earlier years.

The recognition of lease liabilities and service concession arrangements on the balance sheet increases net debt to GSP by around 2 percentage points, on average, over the budget and forward estimates.

These changes do not impact the underlying fundamentals of the State's financial sustainability or its cost of borrowing; rather they reflect variations in the composition and timing of recognition of certain transactions in the published financial statements.

The transition toward the new ceiling of net debt at 12 per cent of GSP will commence from 2019-20 but will build gradually. By the end of the forward estimates, net debt is projected to be 10.0 per cent of GSP. The impact of changes in accounting standards and additional borrowings to fund the three VTF projects account for 4.0 percentage points of net debt to GSP by June 2023 (Chart 3.7).

Chart 3.7: General government sector net debt



Source: Department of Treasury and Finance

Note: The impact of accounting standard changes and VTF projects is shown from 2019-20.

The Government will stabilise net debt at 12 per cent of GSP to fund productivity-enhancing infrastructure, and ensure debt remains at a sustainable level over the medium term (see Box 3.3).

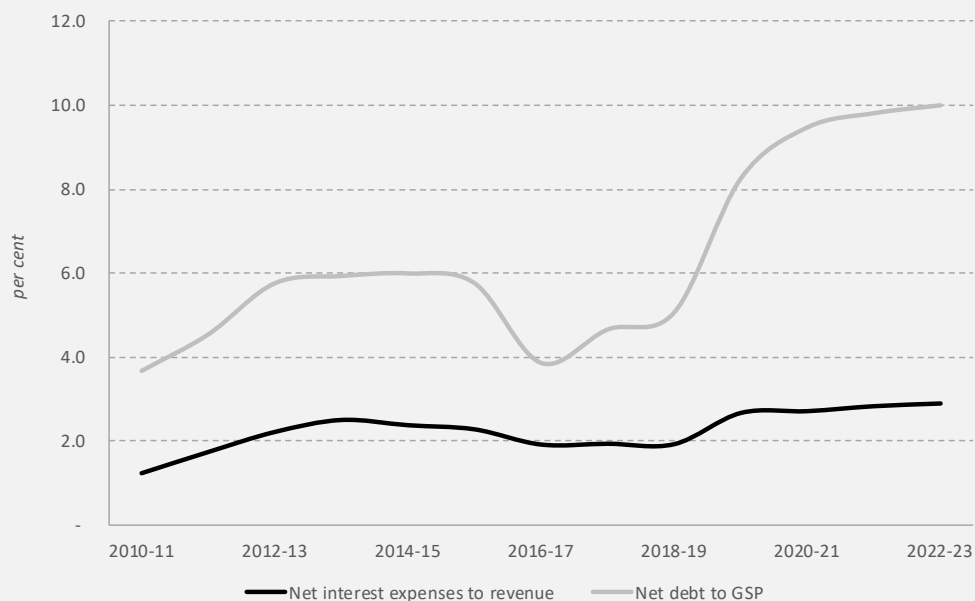
Box 3.3: New medium-term net debt target

The Government’s decision to stabilise net debt at 12 per cent of GSP over the medium term reflects the need to prudently expand capacity to fund a multi-generational infrastructure build that is needed by Victorians now.

The headline measure of a state’s ability to sustainably borrow is its ability to service its debt. With a triple-A credit rating, and with interest rates at historic lows, Victoria is well positioned to increase borrowing while maintaining debt service payments at modest levels. Chart 3.8 shows that despite the projected increase in net debt from 2019-20, net interest expenses as a proportion of revenue are expected to remain modest, broadly in line with historical levels.

External factors that impact on debt servicing costs are also moderated through responsible debt management practices. The Government funds the budget through long-term fixed interest bonds in order to minimise its interest rate risk. This means only around one-tenth of the Government’s debt portfolio is exposed to interest rate changes in any year, ensuring any change in interest costs associated with net debt is gradual.

Chart 3.8: Net interest expenses and net debt



Source: Department of Treasury and Finance

The sustainability of debt is also affected by what the debt will be used for. The *2019-20 Budget* continues to fund recurrent activities from recurrent revenue, and forecasts ongoing operating surpluses over the budget and forward estimates. Looking through the impact of accounting standard changes, additional debt will fund major productivity-enhancing capital projects. This is in keeping with advice from the Productivity Commission that increasing debt can be warranted to fund projects that offer value for the community, provided existing debt levels are carefully managed.⁴

Both Standard & Poor's and Moody's Investor Services have consistently highlighted Victoria's record of strong financial management, with responsible fiscal targets and action to meet them.

Standard & Poor's commented in their last rating report released in September 2018 that 'the ratings on Victoria reflect its wealthy economy and excellent financial management'. They also noted 'Victoria has a culture of long-term planning and transparency'.

Similarly, Moody's, in a credit opinion released in November 2018, noted as a credit strength that '[Victoria's] mature and stable institutional framework underpins fiscal strength and flexibility'.

In conclusion Moody's noted that 'the state government expects total net debt to gross state product to increase to approximately 12 per cent over the medium term, a level that we consider to be manageable within Victoria's current AAA rating and stable outlook.'

⁴ Productivity Commission (2014), *Public Infrastructure*, Inquiry Report No. 71, Canberra.

Maintaining budget discipline

In the *2019-20 Budget*, the Government again demonstrates its commitment to responsible fiscal management by actively responding to changing circumstances to achieve its fiscal targets. Revenue growth is forecast to moderate, rising by 2.2 per cent in 2019-20, primarily reflecting weaker property market conditions impacting state taxation revenue. Over the forward estimates, revenue growth is expected to average 5.0 per cent a year in line with a projected recovery in the property market from around 2020-21.

In response, the Government has taken measures to restrain expense growth to 3.1 per cent a year on average over the budget and forward estimates. This ensures continued operating surpluses and stable ‘underlying’ net debt as a proportion of GSP, while maintaining the high level of service delivery established in the Government’s first term.

Over time, expenditure restraint will be realised through a series of measures focused on improving the effectiveness of departmental spending as well as policy measures, including revisions to wages policy. Further a range of revenue measures recognise the need to progressively protect and diversify the State’s revenue base as property-based revenue growth remains below trend over the forward estimates period. These actions will gradually flow through from 2019-20 onwards, with the operating surplus increasing to \$4.9 billion by the end of the forward estimates.

The Government will continue to deliver reform and invest in our growing state with sustainable expenditure, realising assets and optimising the balance sheet to fund infrastructure and leveraging innovative financing tools to deliver services.

Continuing to deliver reform with sustainable expenditure

A strong public sector is fundamental to achieving service delivery and infrastructure priorities. During the past four years, the Government has delivered measures to protect workers’ rights and entitlements, as well as wage outcomes above inflation for public sector workforces. In the *2019-20 Budget*, the Government has revised its wages policy to moderate base wage outcomes while encouraging public sector agencies to take a more strategic approach to enterprise bargaining. The new wages policy builds upon the Government’s collaborative approach to enterprise bargaining negotiations from its last term.

The Government will continue to review other expenditure to ensure it is best focused to achieve intended policy outcomes. Traditional budget processes have concentrated on allocating new spending, but less so on examining what government is already doing. Departments will deliver a range of efficiency measures over the next four years. This includes aligning indexation of output funding with forecast inflation in 2019-20, along with expanding the General Efficiency Dividend from 2020-21. To support these efficiencies, a comprehensive program of expenditure base reviews will be undertaken across all portfolios.

Realising assets and optimising the balance sheet for priority investment

Over the past four years, the Government has completed a series of commercial transactions that have strengthened the Government's balance sheet and improved budget capacity. Some of these major transactions include the 50-year lease of the operations of the Port of Melbourne, the sale of Victoria's share of Snowy Hydro Limited and the commercialisation of the land titles and registry functions of Land Use Victoria.

The proceeds from these transactions have been used to invest in vital new asset initiatives including the Level Crossing Removal Project, regional infrastructure and services, and other road, rail and school capital projects.

The Government continues to optimise its balance sheet. The State of Victoria has more than \$60 billion invested through the Victorian Funds Management Corporation (VFMC), with the majority of these investments held by the State's insurance agencies. The VFMC has delivered robust investment returns over time, resulting in these insurance agencies building up substantial reserves over and above what is required to meet claims (see Box 5.1 in Budget Paper No. 2, Chapter 5).

To optimise the use of these reserves, the Government is establishing the \$2.3 billion Delivering for All Victorians Infrastructure Fund to invest in much needed infrastructure projects including world-class hospitals, new and upgraded schools, better TAFE's, public transport and local road upgrades.

Innovative funding and financing tools

Government investment creates significant value for the community. Capturing the value created from both planning for infrastructure (e.g. zoning) as well as the roll out of existing and future infrastructure will support better alignment of funding sources with those benefiting from government's decisions. Victoria's *Value Creation and Capture Framework* ensures economic, social and environmental benefits are properly assessed and better value is secured from investment in new infrastructure across the State. These actions may generate alternative revenue streams, assets or other financial value for government, which could assist in funding those investments and activities.

Financing tools that use a mix of public and private financing can help to mitigate and share risk, incentivise efficiency and performance, and provide opportunities to innovate. Victoria has a long history of successful PPP infrastructure projects and is a leader in innovative financing across the spectrum of policy areas. In recent years these have included:

- Victoria's first Green Bonds, launched by the Treasury Corporation of Victoria in 2016 to finance new and existing projects that offer climate change and environmental benefits;
- with Sacred Heart Mission, Anglicare Victoria and VincentCare, the Government launched two pilot Social Impact Investments in 2018 and is now working on two Partnerships Addressing Disadvantage, combining philanthropic and private sector finance to tackle challenging social problems; and
- under the *HomesVic* shared equity scheme, the Government has assisted more than 170 low to moderate income Victorian households to date to own their own home. The Government does this by providing upfront financial assistance in exchange for a proportional interest in those dwellings.

A FAIR SHARE FOR VICTORIA

The Victorian Government's task of maintaining strong financial management is made significantly more difficult by continued underfunding by the Commonwealth Government as well as unnecessary and duplicative policy requirements. Where possible, the Victorian Government will work with the Commonwealth to deliver on shared priorities and secure a fair share for Victoria.

A better deal for Victorians

The National Disability Insurance Scheme (NDIS) – which is among the most significant social policy reforms in Australian history – is an area where the Commonwealth Government has not delivered on its commitment to Victorians. The DisabilityCare Australia Fund (DCAF) was established to reimburse states and territories and the Commonwealth for expenditure relating to the NDIS. Victorian taxpayers have contributed to this fund since 2014, however to date, none of this funding has been provided to Victoria.

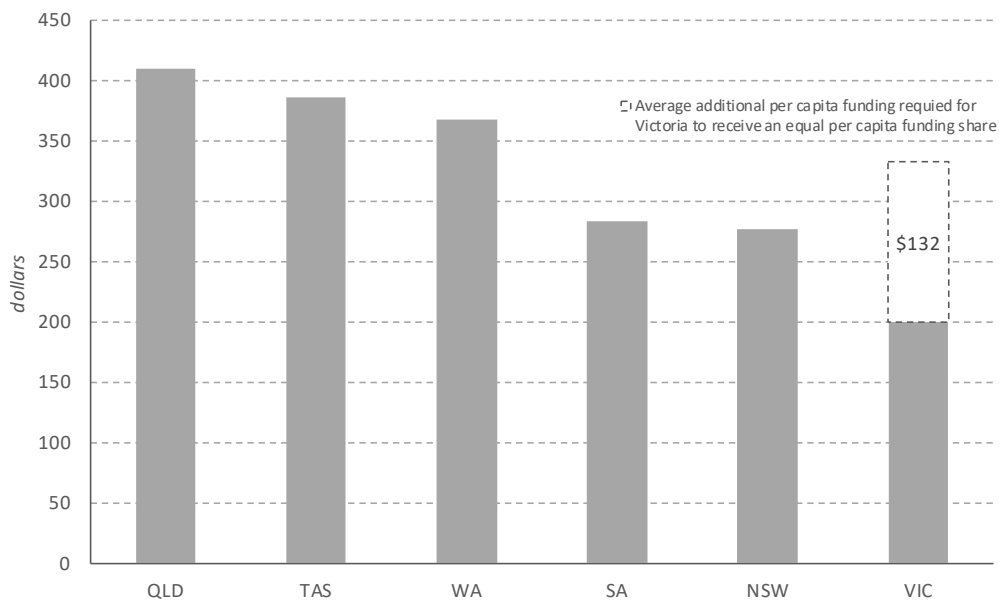
School funding is a significant shared activity between the Commonwealth and states, and funding levels have been based on contributions to the schooling resource standard (SRS), which is a needs-based, per student formula. The Victorian Government will work with the Commonwealth to finalise a funding agreement as quickly as possible to provide certainty to the education sector.

The Commonwealth Government's proposed Heads of Agreement (HOA) for the new five-year National Health Agreement maintains a commitment to activity-based funding and has a focus on improved safety and quality, coordinated care and health innovation. However, in the HOA the Commonwealth commits to fund only 45 per cent of the efficient growth of activity-based services, capped at 6.5 per cent a year. With the best interests of Victorian patients in mind, the Victorian Government will work with the Commonwealth to reach an agreement.

The Commonwealth continues to short change Victorians with respect to infrastructure funding relative to other states and territories. Over the past four years, if Victoria received its per capita share of infrastructure funding, Victoria would have received an additional \$5.7 billion to invest in vital projects. Based on funded commitments in the Commonwealth Budget, it is anticipated Victorians will be underfunded by a further \$4.5 billion over the five years to 2022-23. Victoria is expected to receive on average \$200 per person in infrastructure grants (Chart 3.9) – well below the per capita share of other states, despite having one of the fastest growing populations.

While continuing to campaign for a fairer share of infrastructure funding, the Victorian Government will work with the Commonwealth to deliver on jointly funded projects including Melbourne Airport Rail, North East Link, Suburban Roads Upgrade and the Geelong City Deal.

Chart 3.9: Average per capita Commonwealth infrastructure investment, 2018-19 to 2022-23 (a)(b)



Sources: 2019-20 Commonwealth Budget; Department of Treasury and Finance

Notes:

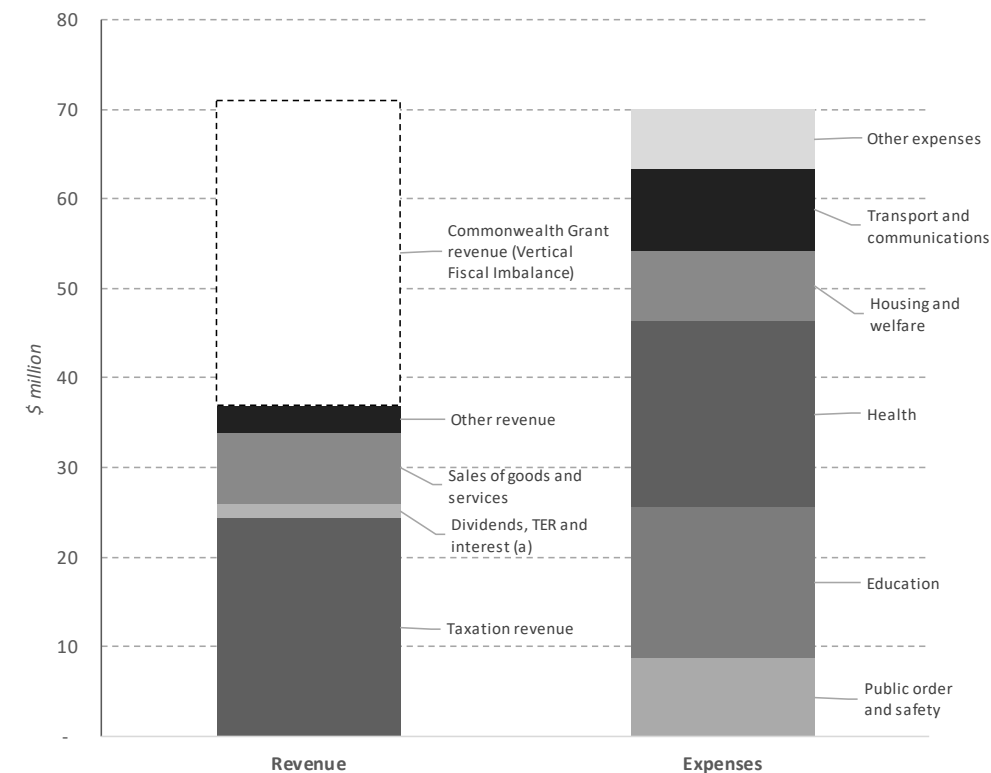
- (a) Five-year average: 2018-19 to 2022-23. Calculations assume funding for states other than Victoria remains constant, and any increases in Victorian funding also increase the total pool of available infrastructure funding. Calculations assume funding for Western Sydney Airport is included in NSW infrastructure investment.
- (b) Based on 2019-20 Commonwealth Budget. Excludes Commonwealth election commitments yet to be negotiated with the Victorian Government.

A better future

Australian federal financial relations are characterised by vertical fiscal imbalance (VFI) (Chart 3.10). While the states and territories are constitutionally responsible for delivering most services, the Commonwealth raises most of the revenue.

In recognition of this imbalance, the Commonwealth provides funding to the states and territories. The *Intergovernmental Agreement on Federal Financial Relations 2008* (IGA FFR 2008) acknowledges the states have primary responsibility for many areas of service delivery. It aims to improve the quality and effectiveness of government services by providing the states with increased flexibility in the way they deliver services to the Australian people, clarify the roles and responsibilities of each level of government and improve the accountability for the achievement of outcomes.

Chart 3.10: Victorian state revenue and expenses by source/function, 2019-20



Source: Department of Treasury and Finance
Note:
(a) Comprises dividends, income tax and rate equivalent revenue and interest.

However, the Commonwealth has increasingly refused to adhere to these principles, becoming more prescriptive in its negotiation of agreements with states and increasing input controls on funding to states.

The Commonwealth has sought to make states and territories accountable to the Commonwealth Parliament, when states are sovereign governments already publicly accountable to their constituents through their own democratic processes.

The Victorian Government knows and understands the needs and priorities of its citizens and is held accountable by voters to deliver what Victorians need. State and territory governments need collaboration and cooperation from the Commonwealth.

The frustrations of Victoria and other states led to the establishment of the Board of Treasurers to advance national reform priorities from a state perspective and foster more constructive and effective engagement with Commonwealth, particularly with respect to federal financial relations.

The Victorian Government intends to continue to lead the push for important reforms through this and other national forums. The Government will continue to pursue a fair share of funding for all Victorians.

CHAPTER 4 – BUDGET POSITION AND OUTLOOK

- The *2019-20 Budget* continues the Government's fiscal strategy of significant investment in core services and infrastructure, while maintaining sustainable fiscal and debt settings that are consistent with the State's triple-A credit rating.
- In this budget, the Government has announced \$11.4 billion in new output initiatives and up to \$34.5 billion total estimated investment (TEI) in new asset initiatives. This includes \$3.7 billion in output initiatives and \$29.8 billion of capital investments outlined in *Labor's Financial Statement 2018*, continuing the Government's record of delivering on its commitments.
- The general government sector operating surplus is estimated to be \$1.0 billion in 2019-20, with annual operating surpluses averaging \$3.4 billion over the forward estimates.
- In 2019-20, the general government sector is expected to collect \$71.0 billion in revenue and spend \$70.0 billion on services. Revenue growth is expected to average 4.3 per cent a year over the budget and forward estimates, exceeding average expense growth of 3.1 per cent a year.
- Government infrastructure investment (GII) is expected to average \$13.4 billion over the budget and forward estimates, nearly triple the average of \$4.9 billion a year from 2005-06 to 2014-15.
- As outlined in *Labor's Financial Statement 2018*, net debt will be prudently increased to fund capital expenditure on three major productivity-enhancing projects delivered through the Victorian Transport Fund: North East Link; Melbourne Airport Rail; and the removal of an additional 25 level crossings by 2025. The increase is also necessary to accommodate changes to accounting standards from 2019-20.
- Net debt is projected to be \$54.9 billion by June 2023. As a proportion of gross state product (GSP), net debt is projected to be 5.1 per cent at June 2019 and increase to 10.0 per cent by June 2023. The impact of changes in accounting standards and additional borrowings to fund the three projects, account for 4.0 percentage points of net debt to GSP by June 2023.
- The Government is on track to fully fund the State's unfunded superannuation liability by 2035.

This chapter outlines the budget position of the general government sector. The broader public sector is covered in Chapter 5 *Position and Outlook of the Broader Public Sector*. This budget paper takes into account the financial impacts as at 13 May 2019 of all policy decisions made by the Government, as well as other information that affects the financial statements, unless otherwise stated. The budget does not account for conditional grants announced by the incoming Commonwealth Government as election commitments, which are subject to negotiation with the Victorian Government.

GENERAL GOVERNMENT SECTOR

Overview

The *2019-20 Budget* continues the Government's fiscal strategy of significant investment in core services and infrastructure, while ensuring the State's triple-A credit rating is maintained.

In this budget, the Government has announced \$11.4 billion in new output initiatives and up to \$34.5 billion TEI in new asset initiatives. This includes \$3.7 billion in output initiatives and \$29.8 billion of capital investments outlined in *Labor's Financial Statement 2018*, continuing the Government's record of delivering on its commitments.

Revenue growth is expected to average 4.3 per cent a year over the budget and forward estimates, exceeding average expense growth of 3.1 per cent a year.

The operating result (net result from transactions) for the general government sector in 2019-20 is forecast to be a surplus of \$1.0 billion, with annual operating surpluses averaging \$3.4 billion over the forward estimates (Table 4.1).

Table 4.1: General government fiscal aggregates ^(a)

	<i>Unit of measure</i>	<i>2017-18 actual</i>	<i>2018-19 revised</i>	<i>2019-20 budget</i>	<i>2020-21 estimate</i>	<i>2021-22 estimate</i>	<i>2022-23 estimate</i>
Net result from transactions	\$ billion	2.3	1.1	1.0	1.5	3.9	4.9
Government infrastructure investment ^{(b)(c)}	\$ billion	12.1	12.4	14.2	14.7	12.2	12.6
Net debt	\$ billion	20.0	22.8	39.0	46.9	51.1	54.9
Net debt to GSP ^(d)	per cent	4.6	5.1	8.3	9.5	9.8	10.0

Source: Department of Treasury and Finance

Notes:

(a) The impact of accounting standards changes is shown from 2019-20. The step change increase in net debt includes the requirement to classify operating leases as debt and the treatment for service concession arrangements, including certain public private partnerships.

(b) Includes general government net infrastructure investment and estimated cash flows for Partnerships Victoria projects.

(c) Excludes the impact of the divestment of Victoria's share of Snowy Hydro Limited.

(d) The ratios to GSP may vary from publications year to year due to revisions to the Australian Bureau of Statistics (ABS) GSP data.

Infrastructure investment, as measured by GII, is expected to average \$13.4 billion over the next four years, nearly triple the average of \$4.9 billion a year from 2005-06 to 2014-15.

As outlined in *Labor’s Financial Statement 2018*, net debt will be prudently increased to fund capital expenditure on three major productivity-enhancing projects delivered through the Victorian Transport Fund: North East Link; Melbourne Airport Rail; and the removal of an additional 25 level crossings by 2025. The increase is also necessary to accommodate changes to accounting standards from 2019-20.

Net debt as a proportion of GSP is expected to be 5.1 per cent at June 2019 and increase to 10.0 per cent by June 2023. The impact of changes in accounting standards and additional borrowings to fund the three projects, account for 4.0 percentage points of net debt to GSP by June 2023.

The *2019-20 Budget* delivers against the Government’s financial measures and targets outlined in Table 4.2.

Table 4.2: Financial measures and targets for the 2019-20 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.

After a period of strong revenue growth, the Government is responding to changing economic conditions by progressively realigning expenditure to target key priority areas. The Government has implemented savings and efficiencies to improve the effectiveness of departmental spending and rebalanced wages policy parameters. Work will continue into 2019-20 to ensure expenditure aligns with the Government’s service delivery priorities.

In this budget, the Government is also implementing a range of expanded revenue measures that recognise the need, over time, to diversify State-sourced revenue as growth in property-based revenues weaken over the short term.

These measures will gradually flow through from 2019-20 onwards, supporting a return to strong surpluses by the end of the forward estimates.

BUDGET AND FORWARD ESTIMATES OUTLOOK

Table 4.3 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 4.3: Summary operating statement for the general government sector ^(a) (\$ million)

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Revenue						
Taxation	22 929	23 814	24 328	25 303	26 620	28 140
Dividends, TER and interest ^(b)	1 626	1 748	1 582	1 246	1 199	1 225
Sales of goods and services	7 339	7 712	8 030	8 682	8 915	9 013
Grant revenue	29 928	33 396	34 093	36 075	37 999	40 389
Other current revenue	2 767	2 825	2 999	3 147	3 252	3 384
Total revenue	64 589	69 495	71 032	74 453	77 984	82 151
% change ^(c)	7.4	7.6	2.2	4.8	4.7	5.3
Expenses						
Employee expenses	23 271	25 096	26 208	27 621	28 302	29 436
Superannuation ^(d)	3 250	3 478	3 526	3 577	3 656	3 736
Depreciation	2 745	2 833	3 748	4 155	4 403	4 731
Interest expense	2 092	2 130	2 611	2 695	2 848	3 004
Grant expense	11 130	13 622	12 934	14 701	15 000	15 584
Other operating expenses	19 789	21 228	20 955	20 251	19 876	20 713
Total expenses	62 276	68 387	69 982	73 000	74 084	77 204
% change	7.0	9.8	2.3	4.3	1.5	4.2
Net result from transactions	2 313	1 108	1 050	1 453	3 901	4 947
Total other economic flows included in net result ^(e)	(827)	(438)	(323)	(332)	(347)	(363)
Net result	1 486	670	726	1 121	3 554	4 584

Source: Department of Treasury and Finance

Notes:

(a) The impact of accounting standards changes is shown from 2019-20. 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 percentage change in 2017-18 refers to the actual figures for 2016-17, adjusted to remove the upfront payment of the Port Licence Fee.

(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

The general government sector is expected to collect \$71.0 billion in revenue in 2019-20, with revenue growth projected to average 4.3 per cent a year over the budget and forward estimates. Property-related revenue has been further downgraded, reflecting weaker conditions in Victoria's property market since the *2018-19 Budget Update*. However, the positive economic backdrop will underpin steady growth in Victoria's non-property tax revenues.

Taxation

State taxation revenue is forecast to grow by 2.2 per cent to \$24.3 billion in 2019-20, with growth expected to average 5.0 per cent a year over the forward estimates. Specifically:

- land transfer duty revenue is expected to contract by 1.6 per cent to \$5.9 billion in 2019-20, following an estimated 13.6 per cent drop in 2018-19, reflecting declining property prices and transaction volumes. The property market is then projected to recover from around 2020-21, with land transfer duty revenue forecast to increase by 5.9 per cent in 2020-21, rising to an increase of 6.3 per cent by 2022-23;
- land tax revenue is forecast to decline by 0.3 per cent to \$3.7 billion in 2019-20, reflecting changes in unimproved land values from 1 January 2018 to 1 January 2019. Looking forward, expectations for the residential land revaluation have eased as observed capital improved property prices have softened;
- payroll tax revenue is expected to grow by 4.1 per cent to \$6.5 billion in 2019-20 and grow at an average of 4.5 per cent a year over the forward estimates. This reflects Victoria's robust labour market, leading to an expected recovery in wages growth;
- gambling tax revenue is forecast to decline by 0.3 per cent to \$2.0 billion in 2019-20, following growth of 6.9 per cent in 2018-19, mostly reflecting an unusually high number of large lottery jackpots. Although gambling revenue continues to decline as a share of consumption, this is partially offset by the introduction of the point of consumption tax;
- motor vehicle taxes are expected to grow by 8.2 per cent to \$2.8 billion in 2019-20 and by an average of 4.2 per cent a year over the forward estimates. Continued population growth in Victoria is anticipated to sustain steady growth in motor vehicle revenue over the forward estimates; and
- insurance tax revenue is expected to grow by 7.3 per cent to \$1.5 billion in 2019-20 and by 6.1 per cent a year on average over the forward estimates.

Dividends, income tax equivalent and interest

Dividend and income tax equivalent (ITE) revenue is projected to be \$863 million in 2019-20 and decrease by an average of 11.7 per cent a year over the following three years. The higher revenue in 2019-20 is largely due to dividends to be received from metropolitan water authorities, the Victorian Managed Insurance Authority, and the Treasury Corporation of Victoria.

Interest income is earned on holdings of cash and deposits. Total interest income is expected to be \$719 million in 2019-20 and is forecast to decline by an average of 4.3 per cent a year over the following three years, largely due to money being drawn down from the Victorian Transport Fund to fund infrastructure.

Sales of goods and services

Revenue from the sales of goods and services is expected to grow by 4.1 per cent in 2019-20 to \$8.0 billion. Over the forward estimates, growth is expected to average 3.9 per cent a year. This growth largely reflects increases in the capital asset charge revenue from VicTrack associated with an increase in its asset base.

Grants

Total grants revenue is expected to grow by 2.1 per cent to \$34.1 billion in 2019-20, and by an average of 5.8 per cent a year over the forward estimates. Total grant revenue growth over the next four years is largely driven by GST revenue.

GST revenue is forecast to grow by 4.9 per cent to \$17.5 billion in 2019-20, reflecting moderate growth in the national GST pool, partially offset by Victoria's assessed GST relativity falling from 0.99 in 2018-19 to 0.98 in 2019-20.

Over the forward estimates, GST revenue is expected to increase on average by 6.9 per cent a year. Victoria's GST relativity is forecast to remain high beyond 2019-20 due to the State's continued need for investment and lower revenue raising capacity compared with other states as growth in property-related taxes slows and royalty revenues remain high in Western Australia and Queensland. The national GST pool is expected to grow at a slower rate over the forward estimates than expected at the *2018-19 Budget Update*, reflecting a forecast decline in national dwelling investment.

Commonwealth grants for specific purposes are projected to average \$16.5 billion a year over the next four years. The Commonwealth provides these grants as contributions toward healthcare, education, disability and other services, and major infrastructure investment.

Commonwealth grants for specific purposes decrease in 2019-20 largely due to the transfer of responsibility for disability services to the National Disability Insurance Agency as part of the full roll-out of the National Disability Insurance Scheme (NDIS).

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 increase by 6.1 per cent to \$3.0 billion in 2019-20 and by an average of 4.1 per cent a year across the forward estimates.

Budget Paper No. 5, Chapter 4 *State Revenue* contains further details of expected movements in the major categories of general government revenue.

Expenses outlook

The Government is expected to spend \$70.0 billion in 2019-20. Total expenses are expected to grow by 3.1 per cent a year on average over the next four years to \$77.2 billion in 2022-23.

Expenses growth in 2019-20 has moderated compared to previous years as the Government seeks to align its expenditure with the more moderate revenue environment.

The growth in expenses reflect the Government's ongoing commitment to investing in services and infrastructure to meet the needs of a growing population, with funding increases for early childhood education, schools, health, mental health, and community safety. Specifically:

- employee expenses (including superannuation) are forecast to grow by 4.1 per cent in 2019-20 and by an average of 3.7 per cent a year over the forward estimates. The growth over the forward estimates reflects increases in the public sector workforce, including in healthcare and hospitals, schools, paramedics and the community safety sector. It also reflects changes in average remuneration levels resulting from enterprise bargaining agreements;
- depreciation expense is forecast to grow by 32.3 per cent to \$3.7 billion in 2019-20 and increase by 8.1 per cent a year on average over the forward estimates. The increase in 2019-20 is principally due to the impact of accounting standards changes, which increase depreciation expense as a result of the additional assets now recognised;
- interest expense is forecast to grow by 22.6 per cent to \$2.6 billion in 2019-20, largely due to the impact of accounting standards changes associated with the first-time technical recognition of additional lease liabilities (which does not increase the cost of borrowings). Growth is then expected to moderate, with interest expense forecast to increase by an average of 4.8 per cent a year over the forward estimates;
- grants expenses are forecast to decline by 5.0 per cent to \$12.9 billion in 2019-20, largely due to a change in the payment schedule for local government assistance grants the State on-passes on behalf of the Commonwealth; and
- other operating expenses are forecast to decrease by 1.3 per cent in 2019-20 and decrease by an average of 0.4 per cent a year over the forward estimates.

Reconciliation of estimates to the 2018-19 Budget Update

Relative to the 2018-19 Budget Update, the net result from transactions has been revised down by \$675 million in 2019-20 and by \$1.2 billion in 2020-21, and revised up by \$916 million in 2021-22 (Table 4.4).

	2019-20 budget	2020-21 estimate	2021-22 estimate
Net result from transactions: 2018-19 Budget Update	1 725	2 677	2 984
Policy variations			
Revenue policy initiatives	172	158	101
Output policy initiatives ^(b)	(2 084)	(1 599)	(505)
	(1 913)	(1 441)	(404)
Economic/demographic variations			
Taxation	(888)	(792)	(721)
Investment income ^(c)	281	(30)	(14)
	(607)	(823)	(735)
Commonwealth grant variations			
General purpose grants	(423)	139	823
Specific purpose grants ^(d)	211	281	660
	(212)	420	1 483
Administrative variations			
Contingency offset for new policy initiatives ^(e)	850	600	300
Other administrative variations	1 206	21	272
	2 056	621	572
Total variation since 2018-19 Budget Update	(675)	(1 223)	916
Net result from transactions: 2019-20 Budget	1 050	1 453	3 901

Source: Department of Treasury and Finance

Notes:

(a) The impact of accounting standards changes is shown from 2019-20. 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 4.5 as the 2019-20 Budget output policy initiatives.

(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 2019-20 Budget new output initiatives. Further information on total output contingencies can be found at Note 1.3.5 of Budget Paper No. 5, Chapter 1 Estimated Financial Statements for the General Government Sector.

Policy variations

Policy variations reflect specific initiatives 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.

The 2019-20 Budget funds \$11.4 billion in new output initiatives over the five years to 2022-23. Table 4.5 shows the impact of the new output initiatives in this budget. New revenue policy initiatives have resulted in an increase in revenue of \$143 million a year on average from 2019-20 to 2021-22.

Details of specific new output and revenue policy initiatives are contained in Budget Paper No. 3, Chapter 1 *Output, Asset Investment, Savings and Revenue Initiatives*.

Table 4.5: Net impact of the 2019-20 Budget new output initiatives ^(a) (\$ million)

	2019-20 budget	2020-21 estimate	2021-22 estimate	2022-23 estimate
New output initiatives	3 714	3 206	1 997	2 160
Less:				
Reprioritisations and revenue offsets ^(b)	685	699	552	571
Adjustments ^(c)	694	395	366	318
Savings	251	513	574	635
2019-20 Budget output policy initiatives	2 084	1 599	505	636
Less: contingency offset for new policy ^(d)	850	600	300	400
Net impact	1 234	999	205	236

Source: Department of Treasury and Finance

Notes:

- (a) The impact of accounting standards changes is shown from 2019-20. 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 revenue offsets.
- (c) Primarily incorporates the net impact of the creation and release of contingencies held for decisions made but not yet allocated.
- (d) Represents releases from the funding not allocated to specific purposes contingency associated with 2019-20 Budget new output initiatives. Further information on total output contingencies 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 *2018-19 Budget Update*, taxation revenue has been revised down by an average of \$800 million a year from 2019-20 to 2021-22. This largely reflects downgrades to land transfer duty revenue, which has been revised down by \$2.8 billion over five years, primarily reflecting the impact of the current slowdown in the residential property market. This is in addition to the \$2.4 billion downgrade reported in the *2018 Pre-Election Budget Update*.

Total revenue from dividends and income tax equivalents is expected to be \$281 million higher in 2019-20 compared to the *2018-19 Budget Update*, largely reflecting a rephrase of dividends from the public financial corporations (PFC) and public non-financial corporations (PNFC) sectors. Thereafter, the estimates decrease marginally relative to the *2018-19 Budget Update*, declining by \$30 million in 2020-21 and \$14 million in 2021-22 driven by lower dividends from the PFC sector.

Commonwealth grants variations

Commonwealth general purpose grants (or GST grants) estimates have been revised down by \$423 million in 2019-20 compared with the *2018-19 Budget Update*, largely due to lower forecast national GST collections as a result of weaker expectations for national consumption and dwelling investment. Thereafter, GST estimates have been revised up by \$139 million in 2020-21 and \$823 million in 2021-22, due to higher royalty revenues in Western Australia and Queensland and a decrease in Victoria's land transfer duty revenue, leading to an increase in Victoria's GST relativity.

Net changes to specific purpose grants have increased the operating result by an average of \$384 million a year from 2019-20 to 2021-22 compared with the *2018-19 Budget Update*. The movements primarily reflect the recognition of additional Commonwealth revenue for major road and rail infrastructure projects.

Administrative variations

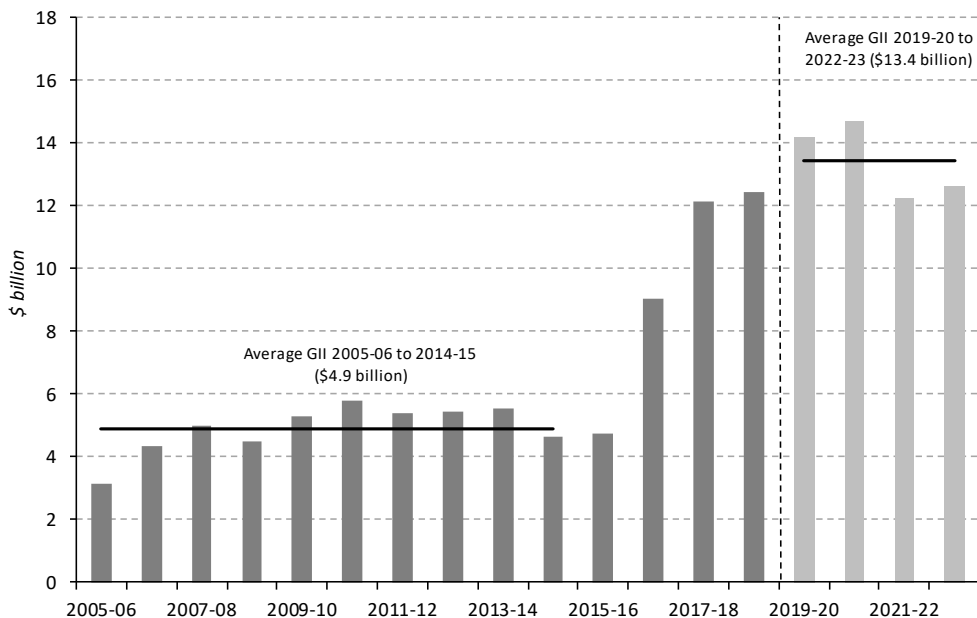
Other administrative variations are expected to increase the operating result by \$1.2 billion in 2019-20, by \$21 million in 2020-21 and by \$272 million in 2021-22. The variations since the 2018-19 Budget Update are largely due to:

- the creation of the Delivering for all Victorians Infrastructure Fund, as outlined in *Labor's Financial Statement 2018*;
- a rephase of grant revenue from the PFC sector from 2018-19 to 2019-20; and
- the operating impact of changes in accounting standards from 2019-20 onwards.

Capital expenditure

GII, which measures investment funded or facilitated by the Government, is expected to average \$13.4 billion over the next four years, nearly triple the average of \$4.9 billion a year from 2005-06 to 2014-15 (Chart 4.1). This includes expenditure on three major productivity-enhancing projects delivered through the Victorian Transport Fund: North East Link; Melbourne Airport Rail; and the removal of an additional 25 level crossings by 2025.

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.
 (b) Excludes the impact of the medium-term lease over the operations of the Port of Melbourne and the divestment of Victoria's share of Snowy Hydro Limited.
 (c) The figure for 2018-19 is an estimate.

New asset initiatives

The 2019-20 *Budget* includes up to \$34.5 billion TEI of new infrastructure investment, underscoring the Government's commitment to building productivity-enhancing infrastructure that will create jobs, drive economic growth and improve living standards.

Investment in new assets include:

- \$15.8 billion for North East Link⁵ which will take thousands of vehicles off local roads, deliver significant travel time savings, increase the capacity of the Melbourne freight network and finally complete the missing link between the Eastern Freeway and the M80 Ring Road;
- \$6.6 billion to plan and deliver an additional 25 level crossing removals by 2025, making communities safer, less congested and creating thousands of jobs;
- \$2.1 billion to transform the Sunbury line, delivering platform, stabling and traction power upgrades to support the roll out of High Capacity Metro Trains and the opening of the Metro Tunnel;
- \$1.5 billion to deliver a new Footscray Hospital⁶ with an increase of nearly 200 beds to meet the growing demand in the inner western suburbs;
- \$1.4 billion for school capital, reinforcing the Government's commitment to making Victoria the Education State;
- \$1.4 billion for increased capacity and supporting infrastructure across the Victorian prison system, to support community safety; and
- \$1.1 billion for planning and pre-construction works for Melbourne Airport Rail, Suburban Rail Loop and Western Rail Plan⁷. This is in addition to the existing Victorian Transport Fund commitment to Melbourne Airport Rail.

Budget Paper No. 3, Chapter 1 *Output, Asset Investment, Savings and Revenue Initiatives* contains details of individual asset initiatives.

⁵ Includes associated output funding. Excludes financing costs.

⁶ Includes funding provided in previous budgets. Excludes financing costs.

⁷ Includes associated output funding.

Net debt

In *Labor’s Financial Statement 2018*, the Government committed to stabilise net debt at 12 per cent of GSP over the medium term, with the additional borrowings directed into three major productivity-enhancing infrastructure projects – North East Link; Melbourne Airport Rail; and the removal of an additional 25 level crossings by 2025.

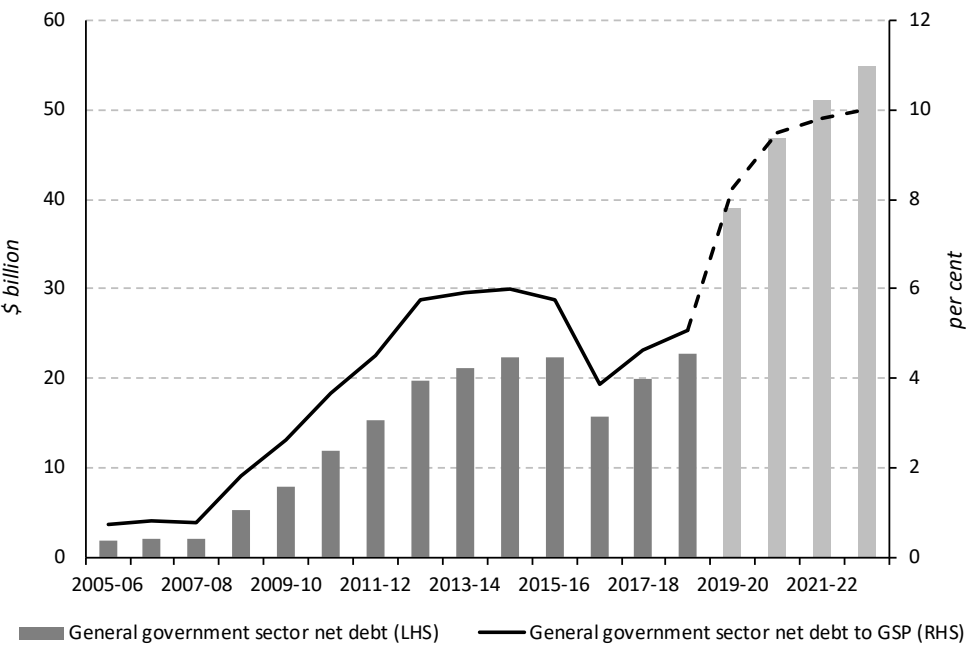
The impact of changes in accounting standards and additional borrowings to fund the three projects, account for 4.0 percentage points of net debt to GSP by June 2023.

The impact of the accounting standards changes require all governments and private businesses to classify most operating leases as debt and also affect the accounting treatment of service concession arrangements, including certain public private partnerships and grant revenue. These changes do not impact the underlying fundamentals of the State’s financial sustainability or its cost of borrowing; rather they reflect variations in the composition and timing of recognition of certain transactions in published financial statements.

Since the Government was re-elected, Moody’s has confirmed that the proposed increase in net debt to 12 per cent of GSP is manageable within Victoria’s current triple-A credit rating.

Net debt as a proportion of GSP is expected to be 5.1 per cent at June 2019 and increase to 10.0 per cent by June 2023 (Chart 4.2).

Chart 4.2: General government net debt to GSP ^{(a) (b)}



Source: Department of Treasury and Finance

Notes:

- (a) 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.
- (b) The impact of accounting standards changes is shown from 2019-20. The step change increase in net debt includes the requirement to classify operating leases as debt and the treatment for service concession arrangements, including certain public private partnerships. In 2019-20, the impact of accounting standards changes account for around 1.7 percentage points of the increase in net debt to GSP.

The application of cash resources for the general government sector (Table 4.6) outlines the annual movements in net debt. General government sector cash from operating activities is expected to average \$6.9 billion a year over the next four years.

Strong operating cash surpluses enable the Government to support the significant investment in the infrastructure and core services the State needs, while maintaining a responsible fiscal position.

Budget Paper No. 2, Chapter 3 *Investing for all Victorians* contains further information regarding the Government's plans to sustainably increase net debt as a share of GSP while maintaining Victoria's triple-A credit rating.

Table 4.6: Application of cash resources for the general government sector ^(a) (\$ million)

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget ^(b)</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Net result from transactions	2 313	1 108	1 050	1 453	3 901	4 947
Add back: non-cash revenue and expenses (net) ^(c)	1 782	4 972	3 552	3 872	4 174	4 736
Net cash flows from operating activities	4 094	6 080	4 602	5 325	8 074	9 683
Less: Total net investment in fixed assets ^(d)	4 863	7 145	9 171	10 083	8 395	10 899
Surplus/(deficit) of cash from operations after funding net investment in fixed assets	(769)	(1 066)	(4 569)	(4 758)	(321)	(1 216)
Leases and service concession arrangements ^(e)	610	452	9 616	1 961	3 393	2 342
Other movements	2 862	1 278	1 991	1 218	492	203
Decrease/(increase) in net debt	(4 241)	(2 796)	(16 177)	(7 937)	(4 206)	(3 761)

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) Movements in 2019-20 include the impact of the new accounting standards. Further information on the impact of these can be found at Note 1.7.2 of Budget Paper No. 5, Chapter 1 Estimated Financial Statements for the General Government Sector.

(c) Includes depreciation, prepayments and movements in the unfunded superannuation liability and liability for employee benefits, as well as operating cash flows not required to be recognised in the operating statement for the respective year.

(d) Includes total purchases of plant, property and equipment, and capital contributions to other sectors of government net of proceeds from asset sales.

(e) Includes operating leases which are now required to be recognised as lease liabilities. Also includes the financial liabilities relating to service concession arrangements and leases for the Bendigo Hospital Stage 2, New Schools PPP Tranche 2, Ravenhall Prison Project, Melbourne Convention and Exhibition Centre – Stage 2 development, High Capacity Metro Trains, Western Roads Upgrade, Metro Tunnel, Casey Hospital Expansion, Northern Roads Upgrade, South Eastern Roads Upgrade, North East Link and the new Footscray Hospital.

Unfunded superannuation liability

The Government is on track to fully fund the State's unfunded superannuation liability by 2035. Note 1.6.3 of Budget Paper No. 5, Chapter 1 *Estimated Financial Statements for the General Government Sector* shows information on the reported superannuation liability.

FISCAL RISKS

This section discusses a number of 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 modelled on the relationships between taxation revenue and projected economic variables. As a result, the main sources of uncertainty to the taxation estimates are unforeseen changes in the economic outlook.

Revenue from property-based taxes, such as land tax and land transfer duty, is subject to unique risks and historically have been volatile. Property markets can exhibit large cycles typically related to changes in official interest rates and/or changes in sentiment. Forecasts for the 2019-20 Budget anticipate a robust economic backdrop with gradual recovery in the property market envisaged from 2020-21, supported by strong population growth and ongoing low interest rates. If property market sentiment were to change abruptly or interest rates differed from current market expectations, or the State's population growth remains at historically elevated levels, revenue from property-based taxes would vary from these forecasts, as discussed in Budget Paper No. 5, Chapter 4 *State Revenue*, Box 4.1.

Further detail about the fiscal implications of variations in economic parameters from forecasts are outlined in Appendix A *Sensitivity Analysis*.

Employee expenses

Employee expenses are the State's largest expense. Two important determinants of employee expenses are wages growth and the number of employees.

Other factors contributing to projected employee expenses include the composition and profile of the workforce as well as rostering arrangements.

Demand growth

Another key uncertainty is growth in demand for government services exceeding or being below 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 sized to allow for the likely growth in Victoria's population and consequent derived increased demand for government services.

Note 1.3.5 and Note 1.3.6 of Budget Paper No. 5 Chapter 1 *Estimated Financial Statements for the General Government Sector* discloses general government output and asset contingencies not allocated to departments.

Capital program risks

A substantial infrastructure pipeline is in place, with a large existing program together with new investments during and beyond the forward estimates.

With a significant national infrastructure program anticipated for the next 10 years, market capacity to supply labour, materials, construction industry participants and advisers could represent a challenge to delivery. If the market is unable to continue to absorb the rate of this economic stimulus, this could place pressure on delivery timetables and costs.

Specific fiscal risks

National Disability Insurance Scheme

Victoria commenced transition to the NDIS on 1 July 2016 and is working towards reaching full roll-out by 1 July 2019. The current transition agreement between Victoria and the Commonwealth ends on 30 June 2019. Estimated ongoing costs of the NDIS have been factored into the forward estimates, however negotiations with the Commonwealth on a bilateral full scheme agreement from 1 July 2019 are ongoing.

Commonwealth schools funding

In June 2017, the Commonwealth Government passed amendments to the *Australian Education Act 2013* to implement a new national school funding model. Victoria has signed the National School Reform Agreement (NSRA), however negotiations for a Victorian bilateral agreement to accompany the NSRA are ongoing. The quantum and conditions of future funding are dependent on the outcome of those negotiations. Funding for renewal of some existing and new education initiatives will be considered following the finalisation of an agreement.

Universal Access to Early Childhood Education

The Commonwealth's financial contribution to assist the states and territories in providing 15 hours a week of preschool support per student is supplied under the National Partnership Agreement on Universal Access to Early Childhood Education. Funding under this agreement was extended for the 2020 calendar year, but ongoing Commonwealth funding arrangements are 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 performed (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 agreement may increase fiscal exposure for the State and include:

- a national cap on Commonwealth annual expenditure growth of 6.5 per cent (above which the State will be required to 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.

A Heads of Agreement was proposed by the Commonwealth at the Council of Australian Governments on 9 February 2018 and has been signed by all states except for Victoria and Queensland. Victoria remains active in negotiations on the new National Health Agreement.

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.

Over the forward estimates, there are downside risks to growth in the GST pool if consumer prices and wages growth do not pick up as forecast, or if growth in dwelling investment is slower than expected. Movements in the household savings ratio, particularly in the context of current property market conditions, are a source of uncertainty for consumer spending and the GST pool outlook.

If Victoria's population growth is higher than forecast compared with other states, Victoria's share of GST revenue could increase. Conversely, should other states have higher population growth than expected compared with Victoria this would negatively affect Victoria's GST revenue. Victoria's share of Commonwealth grants payments can also affect its GST revenue.

Unforeseen movements in the property market may impact Victoria's share of the national GST pool through changes in property market related revenues relative to other states. Variations in commodity prices relative to current forecasts, particularly in iron ore and coal which affect royalty revenue in resource states, also pose uncertainties for Victoria's GST revenue.

CHAPTER 5 – POSITION AND OUTLOOK OF THE BROADER PUBLIC SECTOR

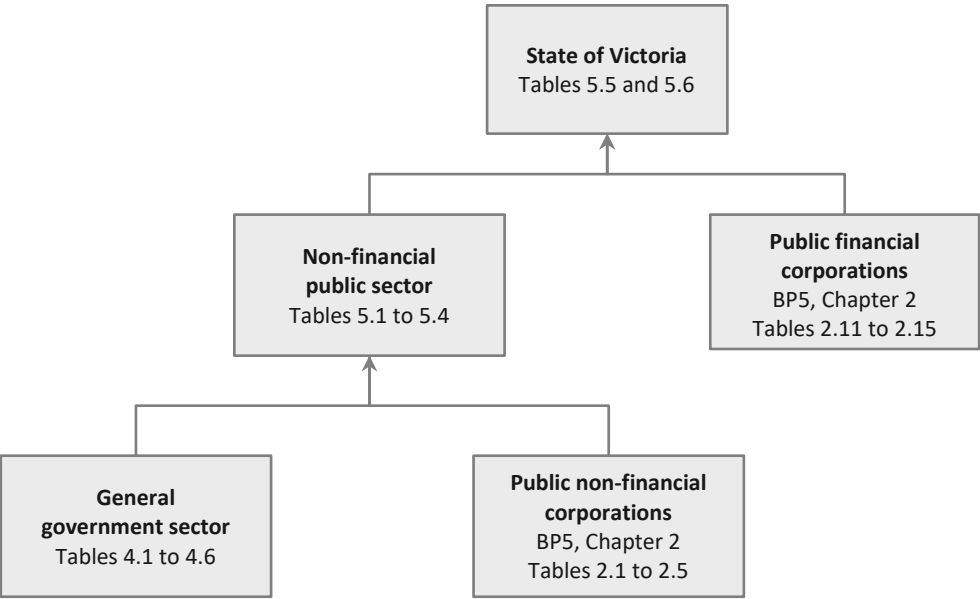
- The non-financial public sector (NFPS) is expected to achieve an average operating surplus of \$2.0 billion over the budget and forward estimates. This reflects the strong fiscal outlook in the general government sector.
- The net result from transactions of the public non-financial corporations (PNFC) sector is anticipated to be an average deficit of \$663 million a year over the budget and forward estimates, while the average operating cash flow surplus is expected to be \$1.7 billion over this period.
- The net result of the public financial corporations (PFC) sector is forecast to improve over the budget and forward estimates from a deficit of \$1.4 billion in 2019-20 to a deficit of \$874 million by 2022-23. The average operating cash flow surplus of the PFC sector over this period is \$290 million.
- NFPS net debt (which includes both general government and PNFC sectors) as a proportion of gross state product (GSP) is estimated to average 13.0 per cent over the budget and forward estimates. This is consistent with the government's fiscal strategy.

This chapter overviews the activities of the broader public sector, comprising:

- the NFPS, which consolidates the general government and the PNFC sectors. 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 main services provided by PNFCs include water, housing, and transport services; and
- the State of Victoria, which consolidates the NFPS and the PFC sectors. PFCs can be categorised into two broad types: those that provide services to the general public and businesses (such as WorkSafe Victoria, the Transport Accident Commission and State Trustees Limited), 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).

This chapter comments on each of the sectors but includes tables with data for the State of Victoria and the NFPS only. The equivalent information for the PFC and PNFC sectors can be found in Budget Paper No. 5, Chapter 2 *Supplementary Uniform Presentation Framework Tables*.

The following chart shows the relationship between the various sectors of the State and indicates the relevant tables that disclose the data on these sectors within this budget paper and Budget Paper No. 5.



NON-FINANCIAL PUBLIC SECTOR

The net result from transactions of the NFPS in 2019-20 is forecast to be a surplus of \$260 million before increasing to a surplus of \$3.9 billion in 2022-23. This increase is largely due to the growing surpluses of the general government sector, which are forecast to increase from \$1.0 billion in 2019-20 to \$4.9 billion in 2022-23.

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

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Revenue						
Taxation revenue	22 575	23 392	23 891	25 006	26 307	27 815
Dividends, income tax equivalent and interest ^(b)	509	839	512	419	416	409
Sales of goods and services	11 317	11 525	12 076	12 690	13 144	13 237
Grants	29 917	33 393	34 095	36 076	38 000	40 388
Other current revenue	3 613	3 580	3 539	3 681	3 776	3 924
Total revenue	67 930	72 730	74 113	77 872	81 643	85 773
% change	5.6	7.1	1.9	5.1	4.8	5.1
Expenses						
Employee expenses	24 510	26 415	27 545	28 988	29 712	30 884
Superannuation ^(c)	3 375	3 614	3 665	3 720	3 806	3 888
Depreciation	4 996	5 154	6 217	6 795	7 216	7 716
Interest expense	2 499	2 523	3 068	3 208	3 381	3 548
Grant expense	7 661	9 907	9 161	10 876	11 091	11 575
Other operating expenses	22 939	24 552	24 196	23 649	23 456	24 237
Total expenses	65 980	72 165	73 853	77 237	78 662	81 848
% change	6.1	9.4	2.3	4.6	1.8	4.1
Net result from transactions	1 950	564	260	636	2 981	3 925
Total other economic flows included in net result	(360)	(485)	(386)	(409)	(341)	(410)
Net result	1 590	80	(126)	226	2 640	3 516

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 net result from transactions is projected to record an average annual deficit of \$663 million over the budget and forward estimates. The average net result from transactions of \$298 million for the metropolitan water authorities is the largest surplus-generating component of the PNFC sector over this period.

The overall deficit in the PNFC sector is mainly due to VicTrack and the Director of Housing, which average net result from transaction deficits of \$859 million and \$106 million respectively over the budget and forward estimates. Contributing to these deficits is the depreciation expense on their large asset bases. Depreciation expenses of the PNFC sector are not funded from the general government sector.

VicTrack and the Director of Housing generate a combined net operating cash flow surplus averaging \$176 million a year over the budget and forward estimates. These cash flow surpluses indicate VicTrack and the Director of Housing remain in a financially sustainable position. The PNFC sector overall is projected to record an average operating cash flow surplus of \$1.7 billion over the budget and forward estimates.

Application of cash resources

Table 5.2 shows the NFPS is projected to generate net cash flows from operating activities averaging \$8.4 billion a year over the budget and forward estimates, funding on average 65 per cent of the projected net investment in fixed assets. Net cash flows from operating activities were higher in 2018-19 due to the receipts from commercialising part of Victoria's land titles and registry functions.

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

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget^(b)</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Net result from transactions	1 950	564	260	636	2 981	3 925
Add back: non-cash income and expenses (net) ^(c)	3 940	6 769	5 708	6 024	6 567	7 334
Net cash flows from operating activities	5 890	7 333	5 968	6 660	9 548	11 259
Less:						
Total net investment in fixed assets^(d)	9 804	11 102	13 802	13 693	11 062	13 233
Surplus/(deficit) of cash from operations after funding net investments in fixed assets	(3 914)	(3 768)	(7 834)	(7 033)	(1 513)	(1 974)
Leases and service concession arrangements ^(e)	610	452	9 622	1 983	3 367	2 335
Other movements	(186)	(127)	264	(45)	(86)	43
Decrease/(increase) in net debt	(4 338)	(4 093)	(17 720)	(8 971)	(4 794)	(4 352)

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) Movements in 2019-20 include the impact of the new accounting standards. Further information on the impact of these can be found at Note 1.7.2 of Budget Paper No. 5, Chapter 1 Estimated Financial Statements for the general government sector.
- (c) Includes depreciation, prepayments and movements in the unfunded superannuation liability and liability for employee benefits, as well as operating cash flows not required to be recognised in the operating statement for the respective year.
- (d) Includes total purchases of plant, property and equipment, and capital contributions to other sectors of government net of proceeds from asset sales.
- (e) Includes operating leases which are now required to be recognised as lease liabilities. Also includes the financial liabilities relating to service concession arrangements and leases for the Bendigo Hospital Stage 2, New Schools PPP Tranche 2, Ravenhall Prison Project, Melbourne Convention and Exhibition Centre – Stage 2 development, High Capacity Metro Trains, Western Roads Upgrade, Metro Tunnel, Casey Hospital Expansion, Northern Roads Upgrade, South Eastern Roads Upgrade, North East Link and the new Footscray Hospital.

Infrastructure

Table 5.2 also provides estimates of net investment in non-financial assets, which is infrastructure expenditure net of proceeds from asset sales. The total net investments in non-financial assets by the NFPS will average \$13.5 billion over the budget and forward estimates.

The main PNFC sector infrastructure projects under development are:

- investment in transport infrastructure to meet patronage growth and improve network performance. This includes improvements to the metropolitan rail network including upgrades to the Sunbury line to support the Metro Tunnel, planning and pre-construction work for the Melbourne Airport Rail, Suburban Rail Loop and Western Rail Plan; and
- various water and sewer related infrastructure projects, such as the Boneo Water Recycling Plant Upgrade, the Large Scale Renewable Energy at Eastern Treatment Plant, the Lockerbie Main Sewer, the Lonsdale Street Sewer Upgrade, the Melton Recycled Water Plant Upgrade, the Goulburn-Murray Water Connections Project, and the modernisation of various irrigation systems by Southern Rural Water.

Non-financial public sector net debt and net financial liabilities

Table 5.3 details the NFPS net debt and superannuation liabilities. It shows net debt is expected to increase from \$38.3 billion at 30 June 2019 to \$74.1 billion by 30 June 2023. NFPS net debt as a proportion of GSP averages 13.0 per cent over the budget and forward estimates. The majority of this increase is due to changes in accounting standards⁸ and additional borrowings to fund the Victorian Transport Fund projects in the general government sector where net debt as a proportion of GSP is forecast to increase to 10.0 per cent by June 2023. The forecast NFPS net debt remains consistent with the government's fiscal strategy.

Superannuation liabilities are projected to fall, resulting in a decline in the net financial liabilities to GSP ratio from 23.1 per cent in 2019-20 to 22.3 per cent in 2022-23. This fall is mainly driven by the budget contributions that are made annually as part of the Government's commitment to fully fund the unfunded superannuation liability by 2035.

⁸ Further information on the impact of accounting standard changes can be found at Note 1.7.2 of Budget Paper No.5, Chapter 1 *Estimated Financial Statements for the general government sector*.

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

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Assets						
Cash and deposits	7.7	9.4	7.5	7.3	7.5	7.5
Advances paid	0.4	0.5	0.4	0.5	0.5	0.5
Investments, loans and placements	5.2	3.2	3.2	3.4	3.4	3.6
Total	13.3	13.1	11.2	11.2	11.5	11.6
Liabilities						
Deposits held and advances received	1.6	1.3	1.3	1.3	1.3	1.3
Borrowings	45.9	50.1	65.9	74.8	79.9	84.4
Total	47.4	51.4	67.2	76.1	81.3	85.7
Net debt ^(b)	34.2	38.3	56.0	65.0	69.8	74.1
Superannuation liability	25.2	27.2	26.1	25.0	24.0	23.0
Net debt plus superannuation liabilities	59.4	65.5	82.1	90.0	93.8	97.1
Other liabilities (net) ^(c)	17.6	20.2	26.8	27.1	26.6	25.3
Net financial liabilities ^(d)	77.0	85.7	108.9	117.1	120.3	122.5
(per cent)						
Net debt to GSP ^(e)	7.9	8.5	11.9	13.1	13.4	13.5
Net debt plus superannuation liability to GSP ^(e)	13.8	14.5	17.4	18.2	18.0	17.7
Net financial liabilities to GSP ^(e)	17.9	19.0	23.1	23.7	23.1	22.3
Net debt plus superannuation liability to revenue ^(f)	87.5	90.0	110.8	115.6	114.9	113.2

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. Movements in 2019-20 include the impact of the new accounting standards. Further information on the impact of these can be found at Note 1.7.2 of Budget Paper No. 5, Chapter 1 Estimated Financial Statements for the General Government Sector.
- (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 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 projects several indicators of financial sustainability for the NFPS over the budget and forward estimates.

The operating cash flow surplus to revenue ratio is an indication of the level of cash generated from operations that can be used to fund infrastructure. This ratio is higher in 2018-19 mainly due to cash receipts from commercialising part of Victoria's land titles and registry functions. This ratio increases strongly from 8.1 per cent in 2019-20 to 13.1 per cent by 2022-23 due to improving operating cash flow surpluses over the budget and forward estimates. This reflects the impact of improving revenue growth and a reduction in expenditure growth for the general government sector in line with the Government's strategy to implement efficiencies to improve the effectiveness of departmental spending.

The overall debt burden is evidenced by the ratio of gross debt to revenue, which is estimated to be 90.7 per cent in 2019-20. The NFPS interest expense to revenue ratio is a measure of the State's debt service burden. This ratio increases in 2019-20 in line with the increased debt. However, the rate of increase is lower over the forward estimates as a lower new debt requirement is financed at historically low interest rates.

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

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Operating cash flow surplus to revenue	8.7	10.1	8.1	8.6	11.7	13.1
Gross debt to revenue ^(a)	69.8	70.6	90.7	97.8	99.5	99.9
Interest expense to revenue	3.7	3.5	4.1	4.1	4.1	4.1

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 results for the State. The net result from transactions is projected to improve from a deficit of \$2.9 billion in 2019-20 to a surplus of \$1.2 billion in 2022-23. This improvement is driven mostly by expense growth being held below total revenue growth over the forward estimates.

The net result from transactions excludes other economic flows, which are projected to average \$1.1 billion a year over the budget and forward estimates. Other economic flows include projected capital gains on the investments of the State's insurance agencies that are used to service the agencies' liabilities.

When other economic flows are included, the State's net result improves to an average surplus of \$59 million over the budget and forward estimates, increasing from a deficit of \$1.9 billion in 2019-20 to a surplus of \$2.5 billion in 2022-23. Other economic flows are negative in 2018-19 due to the impact of falling bond rates, which are used as discount rates to value liabilities, and poor investment market returns in the December 2018 quarter.

Delivering for all Victorians Infrastructure Fund

As foreshadowed in *Labor's Financial Statement 2018 (LFS)*, the State's insurance agencies will make contributions totalling \$2.3 billion to the Delivering for all Victorians Infrastructure Fund (DVIF) over four years. Funds from the DVIF will be used to fund priority projects in the State's capital program.

The LFS also stated that it would be 'Government policy to calculate target funding ratios for the State insurers using an actuarial estimate of the long-term returns of invested funds minus a conservative bias'.

The funding ratio is simply the assets of the entity divided by the liabilities and it provides a measure of capital adequacy. A ratio of greater than 100 per cent means assets exceed liabilities. For reporting purposes, the insurers currently value their claims liabilities using a Commonwealth bond yield as the discount rate and also include a prudential margin. This measure of liabilities is used to determine what is known as the Accounting Funding Ratio. The new measure proposed in the LFS will value claims liabilities using the expected long-term rate of return on investments as the discount rate and include a conservative bias. This is akin to the Economic Funding Ratio which uses the long-term investment return as the discount rate. The average expected rate of return on investments for the three insurers is approximately 7.0 per cent. This compares with a Commonwealth bond yield of about 2.5 per cent as at 31 December 2018. The historical average investment return achieved by the insurers over the past 10 years is approximately 8.8 per cent a year so the expected investment return used in calculating the funding ratio is reasonably conservative compared to past experience.

The insurers' funding ratios, calculated on the two bases, at 30 June 2018 were as follows:

	Per cent
TAC	
Accounting funding ratio	93
Economic funding ratio	165
WorkSafe	
Accounting funding ratio	123
Economic funding ratio	170
VMIA	
Accounting funding ratio	136
Economic funding ratio	207

Source: TAC, WorkSafe and VMIA

The insurers rely on premium revenue and investment income to meet claims costs. The move to an economic funding ratio, which uses the long term expected investment return as the discount rate to value the claims liability, provides a more realistic measure of financial sustainability as it more closely reflects the expected returns from investments held to fund claims.

On an economic basis, each of the insurers hold capital in excess of what is required to fund the expected claims liabilities. Consequently, the decision was taken to decapitalise the insurers and use the funds for priority projects.

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

	2017-18 <i>actual</i>	2018-19 <i>revised</i>	2019-20 <i>budget</i>	2020-21 <i>estimate</i>	2021-22 <i>estimate</i>	2022-23 <i>estimate</i>
Revenue						
Taxation revenue	22 559	23 377	23 875	24 990	26 290	27 798
Dividends, income tax equivalent and interest ^(b)	2 006	3 417	2 154	2 115	2 326	2 393
Sales of goods and services	15 136	15 450	16 199	17 015	17 680	17 994
Grants	29 590	32 730	32 520	34 730	36 711	39 670
Other current revenue	3 632	3 599	3 561	3 708	3 804	3 953
Total revenue	72 923	78 573	78 309	82 558	86 809	91 807
<i>% change</i>	6.0	7.7	(0.3)	5.4	5.1	5.8
Expenses						
Employee expenses	24 483	26 389	27 526	28 961	29 684	30 858
Superannuation ^(c)	3 402	3 644	3 695	3 751	3 837	3 919
Depreciation	5 041	5 197	6 306	6 908	7 359	7 868
Interest expense	2 770	2 623	3 183	3 265	3 436	3 602
Grant expense	7 639	9 925	9 181	10 896	11 108	11 582
Other operating expenses	29 598	31 587	31 350	31 180	31 600	32 734
Total expenses	72 933	79 365	81 240	84 960	87 024	90 564
<i>% change</i>	7.2	8.8	2.4	4.6	2.4	4.1
Net result from transactions	(10)	(792)	(2 932)	(2 402)	(215)	1 243
Total other economic flows included in net result	2 080	(4 391)	1 051	1 040	1 226	1 226
Net result	2 070	(5 182)	(1 881)	(1 363)	1 011	2 469

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 whole of State result is mainly driven by the NFPS sector, but includes the PFC sector, which is forecast to record an average deficit in the net result from transactions of \$3.0 billion over the budget and forward estimates.

As previously discussed, other economic flows arising largely from projected capital gains on insurance investments are generated within this sector and average \$1.7 billion over the budget and forward estimates. When these are included, the average net result in the PFC sector improves to a \$1.3 billion deficit over the budget and forward estimates.

Table 5.6 shows the State's financial position is projected to improve over the budget and forward estimates. Overall, the State's net assets are forecast to increase from \$192.9 billion in 2019-20 to \$213.8 billion by 2022-23. Financial assets are estimated to increase from \$56.9 billion in 2019-20 to \$61.3 billion by 2022-23. Non-financial assets, including infrastructure, are estimated to increase from \$310.7 billion in 2019-20 to \$350.3 billion by 2022-23.

The superannuation liability is projected to fall from \$26.1 billion in 2019-20 to \$23.0 billion in 2022-23 reflecting the contributions the Government is making to fully fund the liabilities of the former state superannuation fund by 2035.

Offsetting these improvements in net assets is a projected increase in borrowings from \$73.1 billion in 2019-20 to \$92.6 billion by 2022-23.

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

	2017-18 actual	2018-19 revised	2019-20 budget	2020-21 estimate	2021-22 estimate	2022-23 estimate
Assets						
Total financial assets ^(b)	58.0	62.8	56.9	57.2	60.7	61.3
Total non-financial assets ^(c)	265.1	277.2	310.7	328.0	338.8	350.3
Total assets	323.1	339.9	367.6	385.2	399.5	411.6
Liabilities						
Superannuation	25.2	27.2	26.1	25.0	24.0	23.0
Borrowings	49.8	60.2	73.1	82.5	89.6	92.6
Deposits held and advances received	2.3	2.1	2.1	2.1	2.1	2.1
Other liabilities ^(d)	57.8	64.6	73.3	76.3	78.5	80.1
Total liabilities	135.2	154.0	174.6	185.8	194.2	197.8
Net assets	187.9	185.9	192.9	199.4	205.3	213.8

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 *2019-20 Budget* relies on forecasts and judgements about the economic, operating and financial conditions for the Victorian general government sector. Uncertainty in these conditions, for example as a result of international developments and other risks to the national economy, may cause the actual results to differ from projections.

This sensitivity analysis explores the impact of variations in the macroeconomic outlook on key fiscal aggregates of the general government sector using two alternative approaches.

The first quantifies the fiscal impacts of scenarios involving simultaneous variations in economic parameters that represent key risks to the economic outlook described in Chapter 2 *Economic Outlook*. These scenarios were selected to cover plausible shocks that could affect Victoria over the medium term, and the modelling takes account of linkages between key international, Australian and Victorian economic aggregates.

The modelled outcomes are intended to be used as a guide and care should be exercised in interpreting the results. In particular, economic shocks tend to be idiosyncratic in nature, with the modelled scenarios unlikely to completely reflect any future shock that could occur. Departures from these scenarios would be expected to result in different impacts on the budget. Furthermore, the modelled results of the shocks do not incorporate any policy responses to the shocks or to the change in the economic outlook.

The second approach considers the fiscal impacts of independent variations in major macroeconomic parameters, holding all parameters other than the indicator of interest constant. This analysis may be useful for assessing the impact on fiscal aggregates of a forecast error in a single economic parameter. In practice, economic variations rarely occur in isolation, and scenario analysis is likely to be more appropriate to illustrate the fiscal impacts of an economic environment materially different from that presented in the budget papers.

FISCAL IMPACTS OF VARIATIONS TO THE ECONOMIC OUTLOOK

This part of the sensitivity analysis quantifies some of the key risks identified in Chapter 2 *Economic Outlook* and presents how these risks might affect the State's economic and fiscal aggregates. Two scenarios are considered: a negative shock to population growth that affects growth in employment and household consumption; and a positive shock to Victoria's labour market, modelled as a reduction in the assumed trend rate of unemployment, which results in higher employment and investment activity.⁹

The economic impacts of both scenarios have been modelled as deviations from a business as usual base case generated from the Victoria University Regional Model (VURM).¹⁰ The changes in economic indicators resulting from the modelled shocks are then mapped into estimated revenue and expenditure impacts using elasticities that describe the historic relationship between fiscal outcomes and major macroeconomic parameters in Table A.5.¹¹

Downturn in Victorian population growth

Population growth has been a key driver of Victoria's recent economic performance and remains significantly above its long-term average. The central forecasts are for population growth to moderate over the forward estimates period, consistent with an assumed decline in the national net overseas migration pool. However, any significant changes in economic growth in source countries of immigration, or changes to policy, could lead to a lower than forecast national net overseas migration (NOM) pool. This would directly impact population growth in Australia and Victoria.

To model a lower population growth scenario, a negative shock that lowers national NOM by 75 000 persons relative to the base case (from a forecast 230 000 in 2018-19 to 155 000 in 2022-23) has been applied in VURM. This shock has been calibrated to lower the ratio of annual NOM to the national population to its long-run average of 0.7 per cent. In this scenario, national NOM in the budget year falls by 30 000 persons, with more incremental falls over the forward estimates period to 2022-23. A national shock has been applied since the triggers for this type of downturn would likely apply to all states and territories, rather than Victoria in isolation. The scenario also assumes a reversion in Victoria's share of national NOM from its current level of 35 per cent back to its historical average of 27 per cent.¹²

⁹ The results generated in each scenario are mutually exclusive and non-additive.

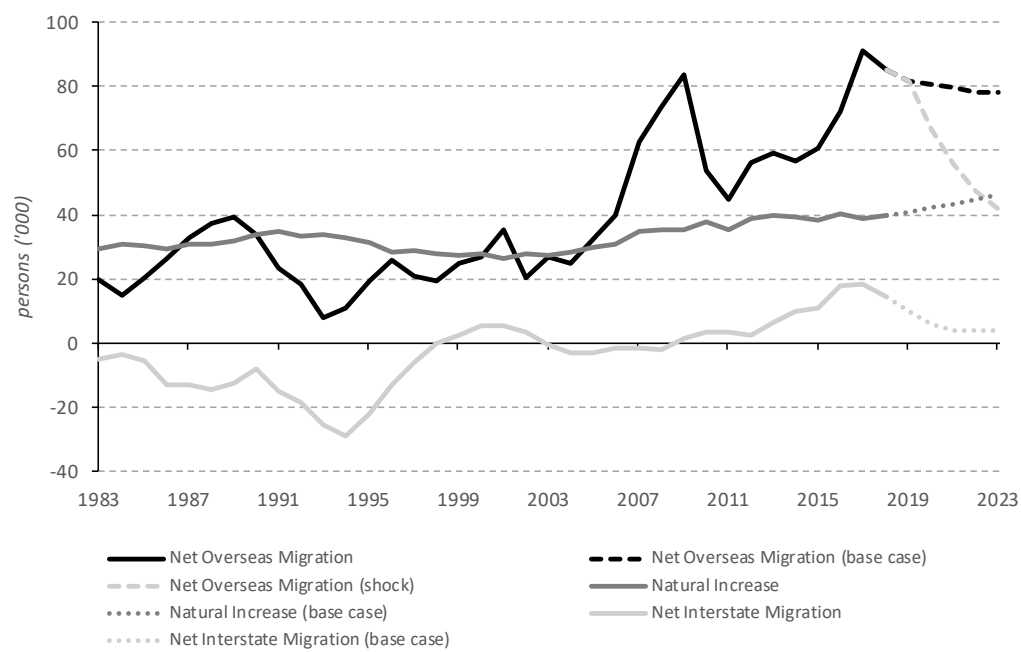
¹⁰ VURM is a dynamic computable general equilibrium model of Australia's six states and two territories, with each region modelled as an economy in its own right. See Philip, A., Dixon, J., & Horridge, M. (2015), 'The Victoria University Regional Model (VURM): Technical Documentation, Version 1.0', CoPS/IMPACT Working Paper Number G-254 for a more detailed description of the model (available from www.copsmodels.com/ftp/workpapr/g-254.pdf).

¹¹ The Department of Treasury and Finance maintains a comprehensive set of elasticities covering the relationship between major economic parameters and all revenue and expenditure lines, including superannuation, and dividends and income tax equivalents from the public financial and non-financial corporations.

¹² For the calculation of revenue impacts, population estimates for states other than Victoria have been adjusted such that the decrease in Victoria's population share is absorbed as an increase in other states' populations in proportion to their share of the Australian population (excluding Victoria) in the base case. The demographic, geographic and socioeconomic distribution of the states' populations are assumed as unchanged in the shock.

These factors imply a reduction in annual NOM flows into Victoria of around 41 000 persons by the end of the forward estimates (from a forecast 82 000 in 2018-19). This lowers the contribution to population growth from NOM to around forecast levels from natural increase (Chart A.1). Similar to the national shock, most of the fall in Victorian NOM is experienced in the budget year. This shock is similar to the reduction in Victorian NOM experienced during the global financial crisis. The shock implies that the Victorian population would be around 110 000 persons lower (cumulatively) in 2022-23 relative to the base case.

Chart A.1: Victorian population components under the base case and scenario



Sources: Australian Bureau of Statistics, Centre of Policy Studies, Victoria University, and the Department of Treasury and Finance

Table A.1 summarises the economic effects of this downside scenario on the Victorian economy. Lower population growth decreases demand in the economy, with employment and gross state product (GSP) lower over the forward estimates period relative to the base case. A lower supply of labour also results in a small increase in the wage price index relative to the base case. Falls in household consumption, and both dwelling and non-dwelling investment, are partly offset by a boost to Victoria’s trade balance as a result of a lower demand for imports. Overall, real GSP is lower by 0.21 per cent in 2022-23. Inflation is slightly lower over the forward estimates period, which reflects that lower overall demand in the economy more than offsets the rise in wage costs.

Table A.1: The effect of a downturn in population growth on major economic parameters ^(a)
(per cent)

	2019-20 estimate	2020-21 estimate	2021-22 estimate	2022-23 estimate
Real GSP	(0.03)	(0.09)	(0.15)	(0.21)
Employment	(0.04)	(0.13)	(0.22)	(0.30)
Consumer price index	(0.02)	(0.03)	(0.03)	(0.02)
Wage price index	0.02	0.07	0.16	0.25

Source: Centre of Policy Studies, Victoria University

Note:

(a) 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.

Table A.2 summarises the fiscal impacts of this scenario. With slower growth in real GSP and employment, income from transactions is lower over the forward estimates. This largely reflects reduced GST grants revenue because of a smaller national GST pool, and a lower Victorian population share, relative to the base case. Lower demand for housing also results in a reduction in property related revenues. Expenses from transactions are marginally lower in the scenario relative to the base case, consistent with a smaller population and slightly lower consumer prices. Overall, the impact on revenue more than offsets the lower expenses, resulting in a negative net result.

Table A.2: Projected fiscal impact of lower Victorian population growth (\$ million)

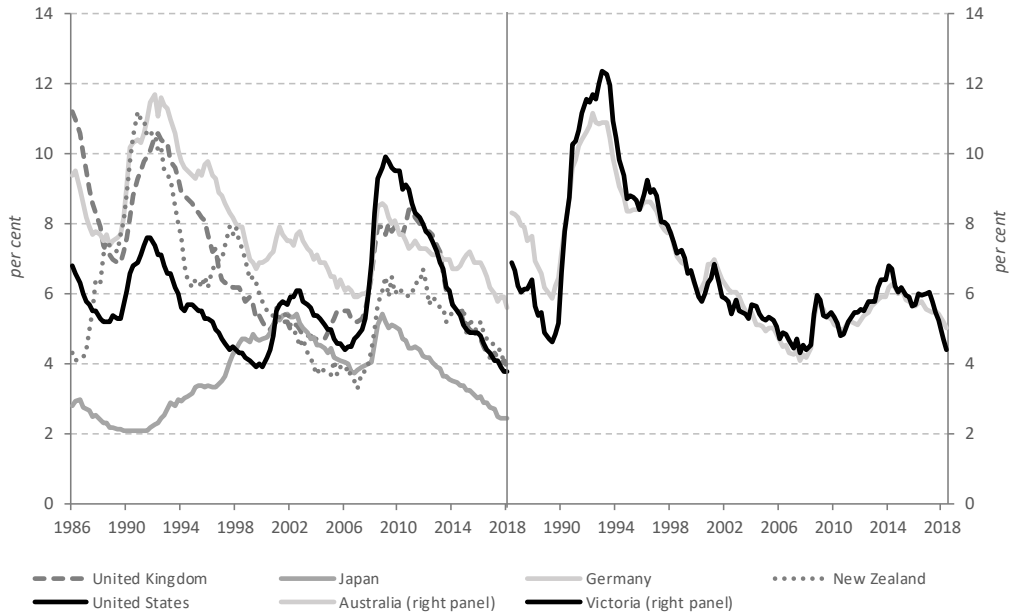
	2019-20 estimate	2020-21 estimate	2021-22 estimate	2022-23 estimate
Income from transactions	(24.7)	(92.1)	(204.7)	(358.3)
Expenses from transactions	(21.1)	(51.7)	(52.8)	(42.8)
Net result from transactions	(3.6)	(40.4)	(151.9)	(315.5)
Other economic flows	(0.4)	(0.3)	(0.6)	(0.8)
Net result	(4.0)	(40.7)	(152.6)	(316.3)
Net debt (cumulative)	4.0	44.7	197.3	513.6
Net debt to GSP ratio (percentage point difference)	0.00	0.01	0.04	0.09

Source: Department of Treasury and Finance

A lower trend rate of unemployment in Victoria

The past few years have seen large and sustained falls in unemployment rates across a range of advanced economies, including in Victoria and Australia (Chart A.2). This suggests these economies may be approaching capacity constraints and businesses may find it more difficult to find suitably skilled employees.

Chart A.2: Unemployment rates for select advanced economies, Victoria and Australia ^(a)



Sources: Deutsche Bundesbank, U.S. Bureau of Labor Statistics, Japanese Ministry of Internal Affairs and Communications, United Kingdom Office for National Statistics, Australian Bureau of Statistics and the Department of Treasury and Finance.

Note:

(a) Data are quarterly seasonally adjusted averages.

One way of assessing the degree of spare capacity in the labour market is to analyse the difference between the observed unemployment rate, and the trend rate of unemployment. A widely used indicator of trend unemployment is the non-accelerating inflation rate of unemployment (NAIRU).¹³ The current budget estimate of the Victorian NAIRU is 5.5 per cent, slightly above the current national estimate of 5.0 per cent¹⁴, and above the quarterly average Victorian unemployment rate to March 2019 of 4.7 per cent.

¹³ The term NAIRU refers to the rate of unemployment at which the rate of inflation is stable. That is, prices are changing, but not (necessarily) accelerating. The NAIRU is also slightly different from the concept of a 'natural rate of unemployment', which is a broader concept that refers to the rate of unemployment that exists when an economy is in long-run equilibrium and not affected by cyclical unemployment driven by short-run rigidities in both labour and product markets.

¹⁴ For discussion of estimates of the national NAIRU, see Cusbert, T. (2017), 'Estimating the NAIRU and the Unemployment Gap', RBA Bulletin, June Quarter, and Ellis, L. (2018), 'Three Questions about the Outlook', Reserve Bank of Australia Address to the ABE Conference, Sydney. Also, Grant, A., Fazzzone, P. & Moore, A. (2017), 'Key drivers of wage growth', Analysis of wage growth, Chapter 3, Commonwealth Treasury, November.

Economic theory suggests that when the observed unemployment rate is above the NAIRU, there is an excess supply of workers relative to the equilibrium level of employment, which implies that there will be downward pressure on wages growth and inflation. In this situation, firms can source labour more easily, and competition among workers for roles leads to some accepting lower wage offers. Conversely, when the observed unemployment rate is below the NAIRU, there is a shortage of workers, resulting in upward pressure on wage growth because firms need to bid up wages to find suitably skilled employees.

The difference between the NAIRU and the observed rate of unemployment – the unemployment gap – is therefore an important input to the central economic forecasts for the labour market and for prices, which assume that the labour market is in equilibrium in the long run, and that the rate of inflation is stable.¹⁵

Since March 2018, Victoria's quarterly average unemployment rate has remained below the budget estimate of the NAIRU. However, inflation and wages growth in Victoria have also remained below trend. Other jurisdictions and countries, such as New South Wales, the United States and the United Kingdom, have also seen a divergence of labour market strength and wages growth. The prolonged period of low wages growth across many countries has given rise to some debate about whether the theoretical relationship between the NAIRU and wages growth still holds, whether the true unobserved NAIRU is lower than previously estimates, or whether low wages growth reflects other factors.

There are several explanations for why wages growth may be low at a time of low unemployment. For example, much of the recent reduction in spare capacity has come about through additional hours worked by existing workers, and from additional workers previously outside the labour force, with both growth in hours worked and the participation rate in Victoria currently at elevated levels. This additional supply is likely to have placed some downward pressure on wages.

There is also a degree of uncertainty around estimates of the NAIRU itself. There are several ways to model it in practice, and each method can provide different results. These models rely on data on unemployment and inflation, and measurement issues associated with these data need to be considered. They are, for example, often revised and subject to one-off events, not all of which may indicate a structural change in the labour market.¹⁶

To date, there is no clear evidence that the current budget estimate of the Victorian NAIRU is inaccurate, particularly given a significant proportion of the fall in the unemployment rate only occurred recently, and higher wage demands can take time to be negotiated and take effect. Recent research by the Reserve Bank of Australia (RBA) suggests the theoretical relationship between the unemployment gap and wages has not changed dramatically in many countries and it remains a valid framework for assessing wage pressures in the economy.¹⁷

¹⁵ The estimated Victorian NAIRU is incorporated into the central forecasts as the trend unemployment rate achieved in the final year of the forecasts, when the labour market is assumed to be in equilibrium. The trend rate of inflation is the midpoint of the RBA's cash rate target band, or 2.5 per cent.

¹⁶ Another consideration is that the labour market may exhibit 'hysteresis' effects, meaning that any transmission of short-run deviations in the unemployment rate to the long-run unemployment rate needs to be taken into account. 'Hysteresis' refers to instances where single, short-run, disturbances in the economy affect the long-run trajectory of economic growth. In the labour market, these types of disturbances can impact estimates of the NAIRU. An example of this in the Australian context is the large increase in long-term unemployment as a result of the 1991-92 recession.

¹⁷ Arsov, I. & Evans, R. (2018), 'Wages growth in advanced economies, *RBA Bulletin*, March Quarter.

Nonetheless, there are a number of factors that can result in changes to the NAIRU over time. These include changes in the nature of workplace bargaining, more workers being employed on a part-time basis, as well as greater efficiency in the labour market itself (through better technology and job matching). These factors suggest trend unemployment – that is, the true unobserved NAIRU – may have declined over time. This would mean the economy can sustain a lower rate of unemployment without inducing inflationary pressure.

As such, it is useful to explore the economic and fiscal implications of a lower-assumed trend rate of unemployment. To analyse the impact of a lower NAIRU in VURM, a shock is applied to the base case by lowering the trend rate of unemployment in Victoria by 0.5 percentage points. This is modelled through an increase in the assumed rate of long-run full employment in the model closure. The forecasts in Chapter 2 *Economic Outlook* assume the unemployment rate will rise gradually over the forward estimates period, consistent with a reversion of the economy to trend. This scenario thereby assumes a gradual rise in the Victorian unemployment rate, but to a lower trend level by 2022-23.

The effects of this scenario on major economic parameters are reported in Table A.3. Relative to the base case, a lower NAIRU results in stronger employment growth, with employment higher by 0.29 per cent in 2022-23. The rise in employment improves the productivity of capital in the short run, attracting more investment, and resulting in higher real GSP over the forward estimates period. Because a lower NAIRU implies there is more labour capacity than in the base case, upward pressure on wages is reduced, resulting in slower real wages growth. Relative to the base case, this scenario implies wages are lower by 0.78 per cent in 2022-23.

While employment is higher, the slower growth in real wages weighs on household income, and the net effect on consumption growth is relatively minor. Slower real wages growth also lowers production costs, resulting in lower inflation relative to current forecasts.

Table A.3: The effect of lower unemployment on major economic parameters^(a) (per cent)

	2019-20	2020-21	2021-22	2022-23
	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>	<i>estimate</i>
Real GSP	0.06	0.10	0.14	0.17
Employment	0.10	0.19	0.25	0.29
Consumer price index	(0.12)	(0.21)	(0.27)	(0.30)
Wage price index	(0.32)	(0.54)	(0.69)	(0.78)

Source: Centre of Policy Studies, Victoria University

Note:

(a) 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.

Under this scenario, general government sector revenue is lower, as shown in Table A.4. Lower wages growth weighs on Victorian household consumption, which lowers the GST pool.¹⁸ Lower wages growth also offsets higher employment which weighs on payroll and property related tax collections. While higher public sector employment raises costs, the lower wages in the scenario more than offset this, resulting in lower net expenses over the forward estimates period. These impacts reflect the assumed relationship between private and public sector employment and wages in the model; namely that public sector employment is a fixed share of overall employment, and public sector wage growth corresponds to private sector wage growth. By 2022-23, the decrease in expenditure offsets the reduction in taxes, boosting the net result.

Table A.4: Projected fiscal impact of lower trend unemployment in Victoria (\$ million)

	<i>2019-20 estimate</i>	<i>2020-21 estimate</i>	<i>2021-22 estimate</i>	<i>2022-23 estimate</i>
Income from transactions	(59.3)	(120.1)	(159.5)	(187.2)
Expenses from transactions	0.9	(64.3)	(151.9)	(199.9)
Net result from transactions	(60.2)	(55.7)	(7.7)	12.7
Other economic flows	(1.4)	(0.8)	(1.7)	(2.2)
Net result	(61.6)	(56.6)	(9.4)	10.6
Net debt (cumulative)	61.6	118.8	128.8	118.9
Net debt to GSP ratio (percentage point difference)	0.01	0.02	0.02	0.02

Source: Department of Treasury and Finance

¹⁸ The decrease in GST revenue reflects the direct impact of lower consumption on the Victorian GST pool. The model used does not consider second-round effects that could alter Victoria's GST relativity over the forward estimates.

SENSITIVITY TO INDEPENDENT VARIATIONS IN MAJOR ECONOMIC PARAMETERS

Table A.5 presents the sensitivity of financial aggregates where the levels of key economic parameters are 1 per cent (or, for interest rates, 1 percentage point) above the forecast for each year of the budget and forward estimates, holding all else constant. The impacts shown are broadly symmetric; that is, the estimated fiscal impacts would apply approximately equally in the opposite direction where there is a decrease in the parameter. Differences may arise to the extent that the impact on income tax equivalent income may not be symmetric because that line item is subject to a floor of zero, and the impact on dividends may be affected by some entities facing caps on the share of profits that can be returned to the general government sector.

Table A.5: Sensitivity of key fiscal aggregates to selected indicators being 1 per cent higher than expected from 2019-20 ^{(a)(b)(c)(d)} (\$ million)

	2019-20 estimate	2020-21 estimate	2021-22 estimate	2022-23 estimate
GSP				
Income from transactions	119	127	135	144
Expenses from transactions	1	(4)	(10)	(16)
Net result from transactions	118	131	145	160
Net debt	(118)	(250)	(394)	(554)
Employment ^(e)				
Income from transactions	74	78	81	84
Expenses from transactions	266	289	304	325
Net result from transactions	(192)	(211)	(223)	(240)
Net debt	192	403	627	867
Consumer prices ^(f)				
Income from transactions	280	298	312	328
Expenses from transactions	213	207	200	203
Net result from transactions	67	90	112	124
Net debt	(67)	(163)	(281)	(411)
Average weekly earnings ^(g)				
Income from transactions	77	81	86	89
Expenses from transactions	3	(0)	(3)	(7)
Net result from transactions	74	81	89	95
Net debt	(74)	(155)	(244)	(340)
Total employee expenses ^(h)				
Income from transactions	..	25	86	93
Expenses from transactions	268	328	346	368
Net result from transactions	(268)	(303)	(260)	(275)
Net debt	268	555	799	1057
Domestic share prices				
Income from transactions	..	..	..	..
Expenses from transactions	..	(1)	(1)	(1)
Net result from transactions	..	1	1	1
Net debt	..	..	..	..

	2019-20 estimate	2020-21 estimate	2021-22 estimate	2022-23 estimate
Overseas share prices				
Income from transactions	..	..	..	..
Expenses from transactions	..	(1)	(1)	(1)
Net result from transactions	..	1	1	1
Net debt	..	..	..	..
Property prices				
Income from transactions	73	125	134	144
Expenses from transactions	(2)	(6)	(12)	(18)
Net result from transactions	75	131	146	162
Net debt	(82)	(216)	(366)	(533)
Property volumes				
Income from transactions	57	60	63	67
Expenses from transactions	(1)	(4)	(6)	(9)
Net result from transactions	58	64	70	77
Net debt	(58)	(122)	(192)	(268)
Interest rates ⁽ⁱ⁾				
Income from transactions	78	59	77	91
Expenses from transactions	9	120	117	111
Net result from transactions	69	(61)	(40)	(20)
Net debt	(69)	(121)	(193)	(281)

Source: Department of Treasury and Finance

Notes:

- (a) Variations are applied to the economic variables effective from the first day in the budget year (1 July 2019). It is assumed that each variable's growth rate matches that under a no-variation scenario for the forward estimates period. This implies economic variables, other than interest rates, are 1 per cent higher in levels terms across the four years compared with a no-variation scenario (that is, not 1 percentage point higher in growth terms). Interest rates are assumed to be 1 percentage point higher in each year of the budget and forward estimates.
- (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. Both public and private sector employment levels are assumed to be 1 per cent higher across the four years; the rise in public sector employment boosts general government sector employee expenses.
- (f) Incorporates the impact of departmental funding model arrangements. It is assumed an increase in consumer prices within the budget year does not affect employee entitlements.
- (g) A positive shock to average weekly earnings increases the expenses of public financial and non-financial corporations and reduces the general government sector's income from dividends and ITEs.
- (h) 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), other management decisions regarding the composition and profile of the workforce or any combination of these.
- (i) Interest rates are assumed to be 1 percentage point higher in each year of the budget and forward estimates.

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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