ECONOMICS OUTLOOK

Victoria: state economy and State Budget, 2016-17

Victorian economy: outlook, opportunities and risks

The Victorian Government expects growth in real state output (GSP) will accelerate to 3.0% p.a. in 2015-16 (from 2.5% p.a. in 2014-15) due to the current strength of Victoria's house building cycle (new houses, apartments and renovations), household spending on local goods and services, international education, parts of manufacturing, wholesale trade and other services. This growth spurt is being supported by low interest rates, the lower dollar, stronger employment growth (around 2.0% p.a. in 2016) and relatively strong population growth, at 1.8% p.a. versus around 1.3% nationally.

The Government expects growth rates in state output and employment will slow from 2017-18, as the dwelling construction cycle eases off. Even with this slower growth profile however, it expects GSP per capita (a key measure of productivity) will rise by around 5% over the next four years after remaining relatively flat since 2007. This improvement is expected to occur largely as a result of structural and industrial changes and especially the rise of more productive services activities as a share of Victoria's economy.

Key risks to this positive growth outlook for Victoria are:

- a sharper than expected decline in house building activity (considered unlikely while interest rates and unemployment rates remain low);
- a higher than expected Australian dollar and/or a sharper than expected deceleration in the Chinese economy, either of which could reduce international student numbers and export earnings;
- a deeper than expected fallout from the exit of automotive assembly from Victoria in 2017, in terms of local manufacturing activity and employment.

Due to these risks and other factors, the private sector economics forecasters are less optimistic than the Victorian Government. Deloitte Access Economics expects the Victorian economy (GSP) to grow by 2.6% in 2015-16, just 1.9% in 2016-17 and 2.8% in 2017-18 (DAE, *Business Outlook*, March 2016). ANZ Research expects Victorian GSP to grow by 2.6% in 2015-16 and 2.5% in 2016-17 (ANZ, *States and Territories Chartpack*, Feb 2016). Both suggest Victorian population growth could slow from the current rate of 1.7%.

Table 1: Victorian Government forecasts for the state economy

% change p.a.	*2014-15 actual*	*2015-16 forecast*	*2016-17 forecast*	*2017-18 forecast*	*2018-19 projection*	*2019-20 projection*
Real GSP	2.5	3.00	3.00	2.75	2.75	2.75
Employment	2.1	2.00	1.75	1.50	1.50	1.50
Unemployment rate	6.4	6.00	5.75	5.75	5.50	5.50
CPI	1.4	2.00	2.25	2.50	2.50	2.50
WPI	2.7	2.50	2.75	3.00	3.25	3.50
Population	1.7	1.8	1.8	1.8	1.8	1.8

Sources: DTF (Vic), ABS.

Chart 1: Victorian Government forecasts for state output (GSP) per capita

Victorian Budget: revenue, expenditure, balance and debt

Revenue to the Victorian Government is expected to grow by an average of 3.4% p.a. over the next four years, while expenses are expected to grow by 3.3% p.a. (nominal growth).

On the revenue side, the Victorian state government is collecting more money than expected from land transfer duty (stamp duty on property sales, up 23% in 2015-16) and from land tax (up 28.3% in 2016-17) due to price increases and increased activity in the residential property market. Revenue from payroll tax is expected to grow by 5.3% in 2016-17 and 4.7% p.a. over the next four years, in line with employment growth.

Government expenses are growing due to increased grants to non-government operators of transport, schools and other services, as well as due to increased staffing as health, education and safety services grow. Direct Government staffing costs will grow by 5.5% in 2016-17 and 3.2% p.a. over the following three years.

The Government expects to maintain a surplus of around $2.1 bn per year over the next four years. This surplus will be used to "fund infrastructure investment while maintaining net debt at prudent levels".

Net debt is currently around $22bn. This will fall to $18.6bn in 2016-17 due to the proceeds of the Port of Melbourne lease, before rising back to around $22bn again in order to fund new infrastructure projects.

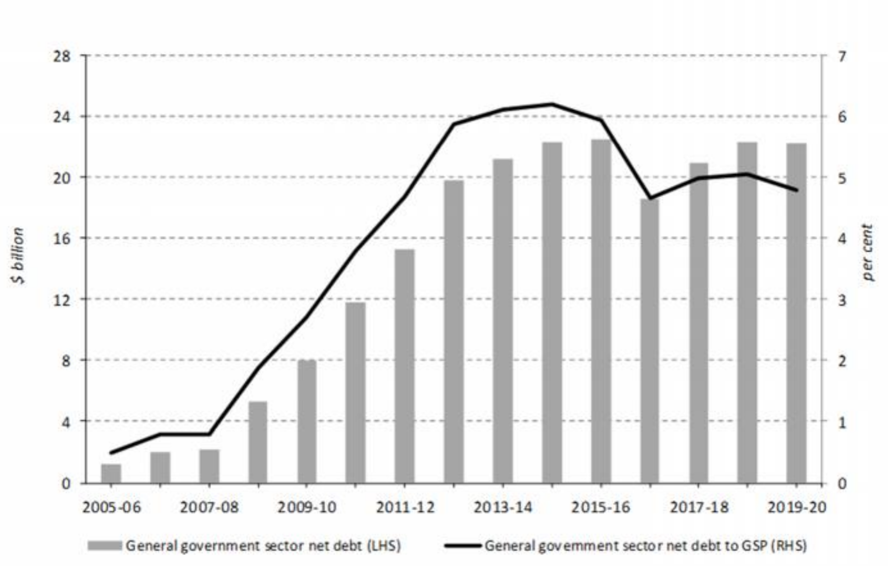
Net debt as a proportion of GSP (a key metric in determining the state's credit rating) will fall to 4.7% of GSP in 2016-17 and is expected to settle at 4.8% by 2019-20. The Budget papers note that a debt ratio under 6% "*provides the headroom to potentially increase borrowings in the future for further productivity enhancing infrastructure across Victoria while keeping debt at levels that are consistent with a AAA credit rating*" (*Budget Paper No 2*, p. 44). Maintaining this AAA credit rating helps to contain the interest charged on state debt.

Table 2: General Government fiscal position

.	*2014-15 actual*	*2015-16 revised*	*2016-17 budget*	*2017-18 estimate*	*2018-19 estimate*	*2019-20 estimate*
Operating revenue, % change	2.7	5.0	6.9	1.1	2.6	3.2
Operating expenses, % change	4.3	3.9	5.3	3.0	2.2	2.7
Operating balance, $bn	749	1,638	2,635	1,823	1,841	2,206
Infrastructure investment, $bn	4.6	4.5	7.5	7.7	7.4	7.1
Net debt, $bn	22.3	22.5	18.6	20.9	22.3	22.2
Net debt ratio, % of GSP	6.2	5.9	4.7	5.0	5.1	4.8

Source: DTF (Vic).

Chart 2: General Government net debt, Victoria



6.2%

Ratio of net debt to GSP 2014-15 (actual)

4.8%

Ratio of net debt to GSP, 2019-20 (expected)

Victorian Government measures for business and industry

On the revenue side, the Government is changing business costs for:

- payroll tax thresholds will increase from the current threshold of $550,000 to $650,000 in progressive increments of $25,000 over the next four years. The Government estimates this will eventually benefit around 36,000 businesses who will no longer pay this tax, saving them around $312mn over four years;
- Payroll tax exemptions will be granted from 1 July 2016 for the wages payable to displaced apprentices;
- The royalty (or levy) payable on brown coal produced from Victoria's four brown coal mines will be increased by a further $72mn per year. This additional cost will add to the cost of electricity generation from brown coal. The revenue will be used to "support the transition to cleaner energy sources".

Changes to State Government programs that affect business and industry include:

- extra funding for the Future Industries Fund for six 'priority growth sectors' ($20-$35mn per year);
- Support for regional industries, such as $4.2mn for an Innovation Lab in Ballarat and $40mn for a Hi-Tech precinct in Morwell and economic development in the La Trobe Valley. An additional $10.9mn will help implement the recommendations of the Hazelwood mine fire inquiry in the La Trobe Valley;
- $25mn to begin to address some of the regulatory burden on property development, beginning with a reduction in average planning application times from 120 days to 60 days;
- An additional $50mn for the Premiers jobs and investment fund (taking total to $558mn);
- An additional $12mn for the Victorian Industry Participation Policy (VIPP) to promote local content in major Government infrastructure projects and procurement programs.

Victorian Government measures for jobs, skills and training

The Victorian Government is reviewing the state's VET system, so few changes were announced this year:

- An additional $10mn in 2016-17 to retrain and support employment for displaced automotive workers;
- $92mn towards establishing 10 new tech schools in regional and outer suburban locations;
- Industry advisory bodies re-established to advise the new Skills Commissioner on skills for the VET sector.

Table 3: Victorian Government payroll tax thresholds

	$
Current	$550,000
2016-17	$575,000
2017-18	$600,000
2018-19	$625,000
2019-20	$650,000

Table 4: Victorian Government "priority growth sectors"

Future Industries Fund	
1 Medical technologies and pharmaceuticals	
2 Food and fibre	
3 Professional services	
4 Transport, defence and construction technologies	
5 International education	
6 New energy technologies	

Table 5: Victorian Government industry programs: new funding

Confirmed or additional funding	*$mn, to 2019-20*
Investment attraction and assistance	+116.0
Future Industries Fund	+111.4
Premiers jobs and investment fund	+50.0
La Trobe Valley transition program	+39.9
Globally connecting business	+24.0
Jobs and innovation in resource recovery	+21.1
Driving growth in renewable energy	+12.3
Back to Work – automotive workers	+10.0
Climate change innovation and jobs	+7.4
Ballarat Innovation Lab	+4.3
Sector Growth Program (no change to existing $)	20.0
New Energy Jobs Fund (no change to existing $)	20.0
Manufacturing Program (no change to existing $)	5.0

Source: DTF (Vic).

Victorian Government infrastructure construction program

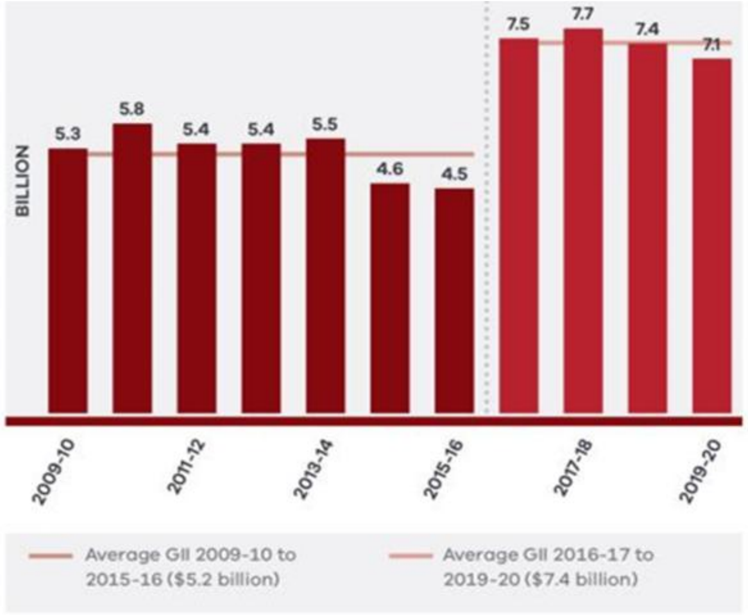
Over the next four years, state government investment will increase from a recent average of $5.2bn p.a. to $7.4bn p.a. This will include building programs for roads, rail, schools, hospitals and other facilities.

The single largest infrastructure project will be the Melbourne Metro Tunnel. The Government 'guarantees' $10.9bn in funding for this project in this year's Budget, including $2.86bn allocated over the next four years.

Over the next four years, the Government has budgeted to build:

- $1.46bn towards the construction of a new 'Western Distributor' tollroad, which will connect Webb Dock and the Port of Melbourne to CityLink and the Monash Freeway. The total cost of the project is estimated to be $5.5bn. Pending agreement with Transurban, the balance of "*the project will be funded through a combination of tolls on the new road connections, an extension to the CityLink concession and Government contributions*" (*Budget Paper No 4*, p. 3).
- $924mn for new and upgraded state school buildings including primary and high schools plus 10 new Tech Schools (and including $28 mn for asbestos removal in state school buildings);
- $875mn for an additional 28 high capacity suburban trains (taking the total to be ordered to 65 trains) and $105mn for 5 additional X'Trapolis trains and $280mn for 27 new VLocity regional train carriages;
- $675mn for various suburban and outer metropolitan road upgrades;
- $588mn to extend the South Morang train line to Mernda;
- $518mn for rail duplication and station upgrades on the Ballarat train line;
- $298mn for upgrades to hospitals in Footscray, Sunshine, Heidelberg, Broadmeadows and Maroondah.
- $260mn for various regional road upgrades;
- $169mn to redevelop the Goulburn Valley Heath campus in Shepparton;
- $141mn for additional regional rail maintenance plus $186mn for regional track and station upgrades;
- $140mn for rail upgrades on the Hurstbridge train line;
- $134mn for safety upgrades on the City Loop;
- $50mn for Frankston railway station.

Chart 3: Annual infrastructure investment spending



Source: Department of Treasury and Finance

Ai Group Economics and Research Team

Julie Toth	Chief Economist
David Richardson	Senior Economist
Jesse Oliver	Economist
Colleen Dowling	Senior Economics Research Coordinator
Elle Spyropoulos	Economics Research Assistant

economics@aigroup.com.au
T: 03 9867 0111