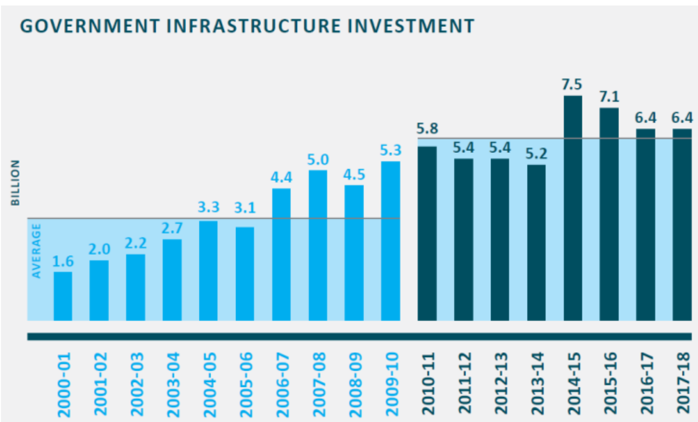
Bank of Melbourne

Wednesday, 7 May 2014

Victorian State Budget 2014-15

Infrastructure the Centrepiece

- **Infrastructure spending was at the front and centre of Victoria's Budget. The government announced it will spend up to $27bn on infrastructure over the next 4 years. Four key projects forming the core of the infrastructure programme.**
- **The infrastructure initiatives will help boost business spending and economic activity through the important multiplier effects infrastructure spending has in an economy. These effects include promoting confidence, creating jobs, improving productivity and spurring housing investment. It will also make the movement of people and goods around our city and state easier.**
- **Business investment has been a notable drag on the Victorian economy over the past year. So the large infrastructure programme, together with the cut to payroll tax, is encouraging. A cut in the payroll tax from 4.90% to 4.85% on 1 July will benefit nearly 39k employers and help make Victoria more competitive. Victoria will have the second lowest payroll tax rate in Australia.**
- **Economic activity is forecast to gain momentum in 2014-15 and 2015-16, as infrastructure spending lifts. The Government forecasts Gross State Product (GSP) to grow by 2.50% in 2014-15 and by 2.75% in 2015-16.**
- **The budget surplus and the recycling of existing assets will help fund the infrastructure programme. A 40-year lease on the Port of Melbourne will be entered into and the Rural Finance Corporation will be sold.**
- **The Victorian government has delivered a solid fiscal position of $0.9bn for 2013-14 with $1.3bn expected for 2014-15. The stronger fiscal result reflects better expectations for revenue growth.**
- **Net debt is expected to peak at a lower rate of 6.3% in 2014-15 and decline faster in subsequent years. Not surprisingly, this year's Budget will help sustain Victoria's favourable triple-A credit rating.**



The Victorian Government handed down its 2014-15 Budget yesterday in the lead-up to an election this November. The centrepiece of this year's Budget was a big infrastructure programme. The government will spend up to $27bn on infrastructure over four years, a record amount. It will kick off with $7.5bn in 2014-15, the election year, and average $6.6bn over the forward estimates. The infrastructure programme included the government delivering on some projects that have been talked about for many years.

The infrastructure initiatives will help boost business spending and economic activity through the important multiplier effects infrastructure spending has in an economy. These effects include promoting confidence, creating jobs, improving productivity, developing new suburbs and the housing that goes with it, and making the movement of people and goods around the city and state easier. There is also a positive impact on liveability.

A cut in the payroll tax from 4.90% to 4.85% on 1 July will also underpin a lift in business spending. Nearly 39k employers will benefit. Victoria will have the second lowest payroll tax in Australia, behind QLD.

Low interest rates, a strong rate of population growth and a more moderate exchange rate should also help growth in the Victorian economy over the coming years.

Four new multi-year infrastructure projects form the core of the infrastructure programme. These are:

- The Melbourne Rail Link,
- The Cranbourne-Pakenham Rail Corridor project,
- The East West Link completion of the Western section, and
- The Citylink – Tulla widening.

These infrastructure projects combined with others announced will start construction over 2015-2016. At their collective peak they will add nearly 12k jobs to the Victorian economy.

Victoria maintains its strong fiscal position, which will sustain its triple-A credit rating.

While the ace card in this year's Budget was infrastructure, two other cards also rounded out the key initiatives in the Budget. These included continued spending on social policy initiatives in the core areas of education and health.

Details on the Infrastructure Programme

Four new multi-year infrastructure projects form the core of the infrastructure programme. These four projects are the Melbourne Rail Link, the Cranbourne-Pakenham Rail Corridor project, the completion of the Western section of the East West Link, and the Citylink – Tulla widening.

Melbourne Rail Link

- This project is the jewel in the crown of the infrastructure programme. It will be the biggest infrastructure project since the City Loop.
- It will involve an investment of up to $11bn.
- Construction is set to start in mid 2016 and last until 2026, creating 3.7k jobs at the peak of construction.

- As part of the Melbourne Rail Link, a new rail tunnel will be constructed from Southern Cross Station to South Yarra Station via Fishermans Bend. Two new underground stations will be constructed at Domain and Montague (Fishermans Bend) and new underground platforms will be built at both South Yarra and Southern Cross Stations to enable interchange with other services.

- The development of Fishermans Bend will supplement new residential and business addresses in Docklands and Southbank. Fishermans Bend will add 250 hectares to the edge of the CBD and is projected to house up to 80k residents and 40k workers by 2050.

- This project will also deliver the Airport Rail Link and is expected to transform the rail network, significantly increasing capacity and reliability and providing better interchanges between the train and tram networks.

East-West Link

- Investment of $8-10bn to complete the delivery of the East-West Link, adding to the $6-8bn investment made in the 2013-14 Budget.

- Construction is expected to start in late 2015 and end in 2023, and create 3k jobs at the peak of construction.

- The East-West Link will extend from the end of the Eastern Freeway to the Western Ring Road, giving a vital alternative to the M1 and relieving the inner north and the west of traffic congestion.

Upgrade of the Cranbourne-Pakenham Rail Corridor

- Investment of up to $2.5bn in this project.

- Construction is expected to start in 2015 and conclude in 2018.

- This project will deliver additional rail services to a major growth corridor and one of Melbourne's busiest suburban lines.

CityLink-Tulla Widening

- Investment of approximately $850mn and to be fully financed by Transurban.

- Construction is expected to start in 2015 and be finished in 2016 and create 700 jobs at the peak of construction.

- This widening project will also complement the airport rail link with new lanes.

The Government also announced other infrastructure projects. These include, but are not limited to:

- Murray Basin Rail Project - commitment of up to $220mn over 4 years to undertake major country rail freight upgrades and standardise the Mildura to Geelong rail link. Support 300 jobs at the peak of construction.

- Princess Highway upgrade for Western Victoria (Winchelsea to Colac).

- Removal of four more level crossings.

Health

The Government has continued to invest in health by delivering more than $328mn of new spending in 2014-15 and $1.4bn over a four-year period. As part of this health package, there will be $73mn spent on LaTrobe Hospital as well as $28 million to develop the new Barwon Health-North Facility and $14mn for the Boort Hospital redevelopment.

The Budget includes $190mn in additional spending to boost elective surgery. It includes an additional $156m over the four years to support those with mental illness and drug and alcohol addiction. In addition, $121mn will be spent on support packages for Victorians with a disability.

While health spending is likely to keep pace with demand, it will do little to significantly alleviate some systemic pressures on health.

Education

The Budget includes an additional $1.6bn over five years on education spending. There will be $500mn for new schools, upgrades to schools and land acquisitions in areas of population growth. Twelve new schools are to be created, including eleven under public-private partnership and more than 70 schools are to receive upgrades and works.

The Budget includes an additional $270mn over the next four years in additional funding to government schools to support students with disabilities, as well as $32mn for bus services to transport students with disabilities. Included in the Budget is $564mn for schools to raise performance, with targeted funding for disadvantaged students.

There is also $30mn over two years to retrain employees in the automotive sector and the supply chain.

Business

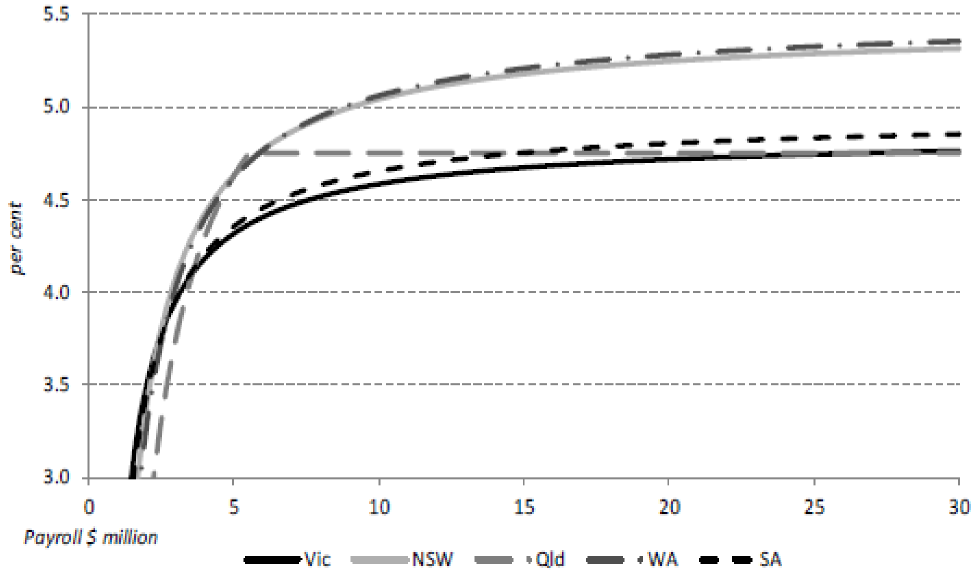
For all businesses, the improvement in jobs, productivity and growth delivered from the infrastructure programme will provide a more favourable and stable business environment over the medium term.

The cost of doing business will also drop with a cut in the payroll tax to 4.85%, helping to make Victoria a more competitive place to do business. This measure will benefit approximately 39,000 Victorian employers, who employ an estimated 1.6mn people, and will mean that businesses in Victoria with payrolls between $4.7mn and $26.7mn will pay the lowest payroll tax in Australia. In terms of the payroll tax rate, it will be the second lowest, behind Queensland.

For small business, there will also be support provided by enhanced access to business information, tools and assistance. Small business operators will have access to seminars, workshops and mentoring programs. The government will provide $4.5mn for small business in 2014-15 and in each of the years in the 4-year period.

Some new programs were announced in the budget that will benefit particular industries. These include the Global Health Plan that aims to leverage Victoria's competitive advantages in health and medical research, and Food and Agriculture into Asia that will help capitalise on opportunities for Victorian producers in the food and fibre industry. Food and fibre exports are one of Victoria's top 5 industry groups; the others are international education, tourism, financial & insurance services and freight & logistics.

Average Payroll Tax Rate for Individual Businesses



Source: Department of Treasury and Finance

Economic Forecasts

(per cent)

	2012-13 Actual	2013-14 Forecast	2014-15 Forecast	2015-16 Forecast	2016-17 Forecast	2017-18 Forecast
Real gross state product	1.6	2.00	2.50	2.75	2.75	2.75
Employment	0.8	0.75	1.25	1.50	1.50	1.50
Unemployment rate (b)	5.7	6.25	6.25	6.00	5.75	5.50
Consumer price index (c)	2.2	2.75	2.25	2.50	2.50	2.50
Wage price index (d)	3.3	2.75	3.25	3.50	3.50	3.50
Population (e)	1.9	1.8	1.8	1.8	1.8	1.8

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

For 2013-14, the Government is forecasting GSP growth of 2.0%. The Victorian economy might struggle to achieve that. After that, the GSP is forecast by the Government to improve, as greater infrastructure spending helps drive an improvement in economic activity. GSP is expected to strengthen to 2.5% in 2014-15 and 2.75% in 2015-16. These forecasts seem reasonable and should be achieved. Low interest rates, improved global economic conditions, a more moderate exchange rate level and strong asset price growth should help support economic activity together with the lift in infrastructure spending.

For the unemployment rate, it stood at 12-year highs of 6.4% in March 2014. The government expects the unemployment rate to average 6.25% in 2013-14 and not start to improve until 2015-16 after or during which the bulk of the major infrastructure projects would have started. The unemployment rate is forecast to fall to 5.50% by 2017-18.

Population growth is expected to remain strong. Indeed, the population has been growing above the national rate in Victoria with hefty gains from net interstate migration. The latest data shows that over the year to September 2013, Victoria received its highest net interstate migration in at least 30 years.

Risks to the outlook are more balanced than they were in 2013. Downside risks from the world economy have eased, which reflects improvements in the outlook of Victoria's trading partners. But domestic risks remain. The Australian and Victorian economies' response to low interest rates has been slower than in the past. The benefits to Victoria are expected to flow through over the next year or two. As the Australian and world economic outlook improves, the response in private demand to low interest rates could be firmer than expected.

Funding

Infrastructure spending will be funded by realising assets, depreciation and government budget surpluses.

An important source of funding is the Commonwealth's new initiative of recycling existing assets. This initiative involves divesting assets, of which the proceeds are reinvested by the State government in productive infrastructure; the Commonwealth will top up funding by 15% of the proceeds.

The recycling of existing assets in this year's budget focuses on:

- The Government entering into a medium-term lease of 40 years over the Port of Melbourne's operations, and
- Selling the Rural Finance Corporation to Bendigo & Adelaide Bank (net proceeds of $400mn).

Large operating surpluses and cash flows from operations will fund a record program of infrastructure. Government infrastructure investment is projected to be $7.5bn in 2014-15 and average $6.6bn over the forward estimates.

By 2015-16, net infrastructure spending is forecast to be fully funded by cash from operations.

Budget Position

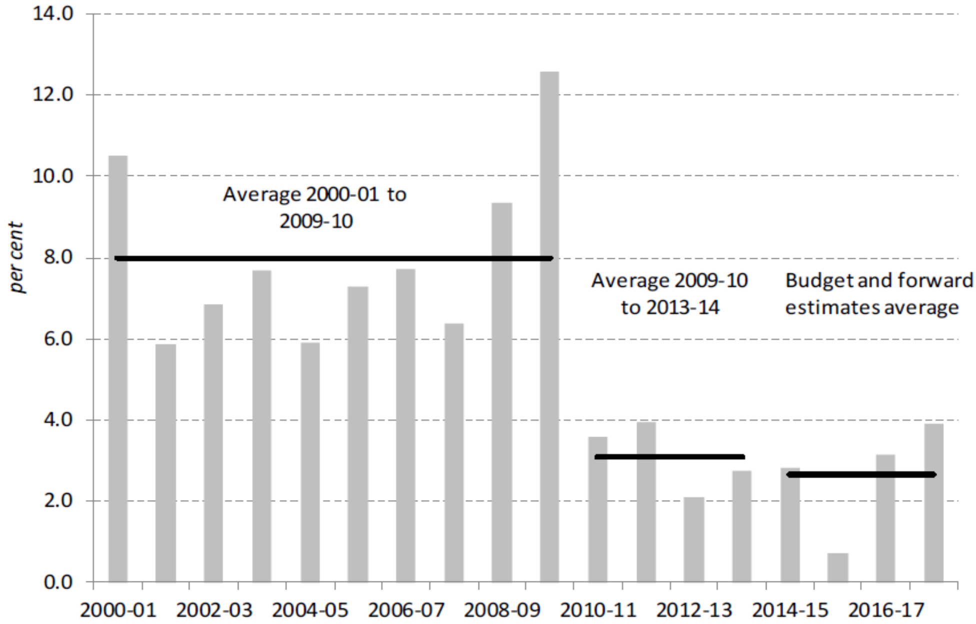
The Government has achieved a strong fiscal position, meeting one of the government's medium-term priorities of maintaining a reasonable sustainable budget position. It also assists in Victoria maintaining its triple-A credit rating.

The general government sector operating surplus is estimated to be $1.3bn in 2014-15, from an estimated $0.9bn in 2013-14. The surplus is expected to grow further over the years, reaching $3.3bn in 2017-18.

The better financial performance forecast in the budget reflects ongoing expenditure restraint over the medium term and greater-than-expected revenue growth from taxes and Commonwealth capital grants.

Expenses are projected to grow by 2.8% in 2014-15 and an average of 2.6% a year over the forward estimates period. This represents a further decline in expenses growth compared with the past 4 years (when expenses grew by an average of 3.1% a year) and is a significant drop from the 8.0% average over the decade to 2009-10.

Annual Expenses Growth



Source: Department of Treasury and Finance

Revenue is expected to grow by 3.5% in 2014-15 and by 3.7% a year on average over the forward estimates. These expectations reflect a recovery in revenues from several years of slower growth. While revenue is expected to improve and maintain a steady trend over the forward estimates, it is not projected to return to rates of around 7.3% experienced over the decade to 2009-10.

The recovery in revenues has been helped by strong growth in State taxation revenue. It is expected to grow by 7.2% in 2014-15, driven by growth in land tax and transfer duty. Over the forward estimates, growth is forecast to average 4.4% a year as the economy returns to trend growth. These revenue forecasts are based on:

Payroll tax expected to grow by 4.2% in 2014-15 and by an average of 5.6% a year over the forward estimates. These estimates are consistent with trend growth in wages and the labour market and take into account the cut to payroll taxes from 1 July 2014.

Land tax revenue is expected to rise by 16.9% in 2014-15, from the land revaluation process that occurs every second year.

Land transfer duty is expected to be up 6.0% in 2014-15 and by an average of 6% a year over the forward estimates.

Gambling taxes are expected to grow by 8.3% in 2014-15 and by an average of 3.3% a year over the forward estimates.

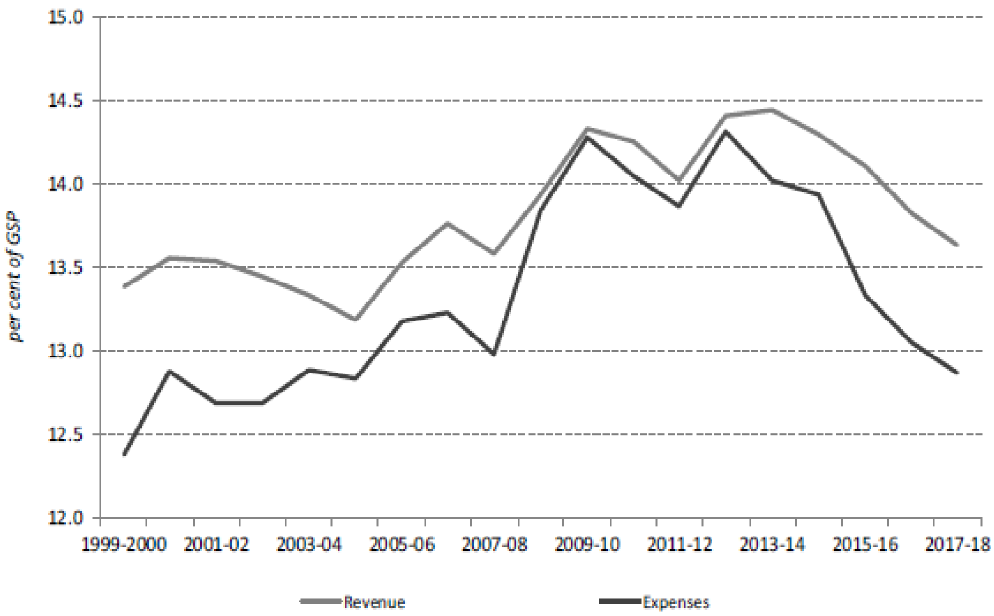
Taxes on insurance are expected to grow by 4.4% in 2014-15, underpinned by solid economic growth but moderated by an expected slowdown in insurance premium rate increases and the abolition of life insurance duty from 1 July 2014.

Motor vehicle taxes are expected to grow by 12.3% in 2014-15 and by an average 4.3% a year over the forward estimates.

In 2014-15, it is estimated that 53% of general government sector revenue will be sourced from the state's own revenue base, while the remaining 47% is expected to be sourced from Commonwealth grants. GST revenue is a large chunk of the Commonwealth grant. While State revenues are growing solidly, GST revenues are not.

GST grants to Victoria are expected to record only modest growth of 2.4% in 2014-15, reflecting the decline in Victoria's share of the national GST pool. In 2014-15, Victoria's GST share of 22% is the lowest share since 2005-06 and means every Victorian will receive $256 less than their population share of GST in 2014-15. Over the 10 years to 2014-15, Victoria will have received approximately $10.9bn less than its population share of GST revenue. The Victorian government is an advocate of receiving GST revenue on a per capita basis because Victoria is substantially disadvantaged under the current system, especially compared with Queensland and NSW.

General Government Sector – Revenues and Expenses



Source: Department of Treasury and Finance

Net Debt and Net Financial Liabilities

Net debt is projected to peak at a lower level, of 6.3% of gross state product in 2014-15. This compares with 6.6% estimated in last year's budget. It is also expected to decline over the next four years and more rapidly than predicted last year.

The fall in net debt reflects the ongoing restraint in expenses, up-front receipt of Commonwealth grants for East-West Link, the receipts of proceeds from entering into a medium-term lease over the operations of the Port of Melbourne, and the divestment of the Rural Finance Corporation.

	Unit of measure	*2012-13 Actual*	*2013-14 Revised*	*2014-15 Budget*	*2015-16 Estimate*	*2016-17 Estimate*	*2017-18 Estimate*
Net result from transactions	$ million	316	935	1 327	3 030	3 183	3 330
Net debt	$ billion	19.8	21.5	23.4	18.5	19.0	19.5
Net debt to GSP	per cent	5.9	6.1	6.3	4.7	4.6	4.5
Government infrastructure investment [(a)(b)]	$ billion	5.4	5.2	7.5	7.1	6.4	6.4

Source: Department of Treasury and Finance

Contact Listing

Chief Economist

Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist

Hans Kunnen
kunnenh@bankofmelbourne.com.au
(02) 8254 8322

Senior Economist
Josephine Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

Economist
Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898