



Victorian Economic and Financial Statement

April 2011

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VICTORIAN ECONOMIC AND FINANCIAL STATEMENT

INTRODUCTION

The Victorian Government is committed to delivering strong economic management, underpinned by sound public finances. A sustainable fiscal position is the platform for the delivery of core services such as community safety, public transport, health and education, as well as for maintaining high levels of business confidence so that the economy continues to grow.

However, the current position contains some underlying weaknesses, including significant program and capital project cost pressures.

This has left Victoria's financial position exposed to vulnerabilities, which will form the backdrop to the Government's 2011-12 budget. These challenges will not be solved overnight. Rather, they will require ongoing, disciplined management.

This statement outlines those key fiscal and economic challenges, and the broad direction of reform which the Government will need to pursue in order to address them over time.

The vulnerability of the financial position inherited by the Government comes from a number of sources, including:

- a range of capital projects beset by inadequate management and very significant cost overruns;
- a rise in public debt to finance capital projects;
- a reliance on Commonwealth one-off funding; and
- a pattern of spending growth exceeding revenue growth.

The pattern of project cost overruns is widespread and significant in its fiscal impact. In total, the funding required to address capital project cost pressures inherited by the Government is in the order of \$2 billion.

These underlying weaknesses have not previously been fully identified in the budget position.

In addition, since the *2010-11 Budget Update*, Victoria has experienced an unprecedented reduction in Commonwealth revenue and significant flood repair expenditures. Specifically, the Victorian budget position will be impacted by:

- a \$2.5 billion reduction in Victoria's goods and services tax (GST) over four years based on the Commonwealth Grants Commission's recommendations;
- a further delay to the Commonwealth's funding contribution to major infrastructure projects such as the Regional Rail Link (\$500 million) and the Victorian Comprehensive Cancer Centre (\$50 million); and
- significant repair and reconstruction costs associated with the flood events across Victoria in late 2010 and early 2011.

Together, these underlying budget weaknesses and external factors amount to an unprecedented impact on the Victorian budget which will exceed \$5 billion.

Table 1: Pressures on the current budget position

(\$ billion)	
	<i>4 year fiscal impact ^(a)</i>
<i>Budget vulnerabilities</i>	
Project cost pressures	2.00 ^(b)
<i>Recent fiscal impacts</i>	
GST revenue reduction by Commonwealth	2.50
Commonwealth project funding delays	0.55
Estimated budget impact	5.05

Note:

(a) For the period 2011-12 to 2014-15.

(b) Estimated potential cost pressure.

As a result, Victoria faces significant financial challenges.

Dealing with these challenges will be an important aspect of the 2011-12 and future budgets. This will have implications for levels of spending and key fiscal aggregates.

The Government is putting in place a fiscal strategy to deal with these inherited and new challenges. The Government will need to adopt a measured and responsible approach to spending to ensure the State's financial sustainability is maintained in the medium to long term.

The 2011-12 budget will deliver on the Government's election commitments and outline a clear plan to address the above funding pressures, move the State's finances to a more sustainable long-term position and maintain Victoria's triple-A credit rating.

ECONOMIC CONTEXT AND FISCAL IMPLICATIONS

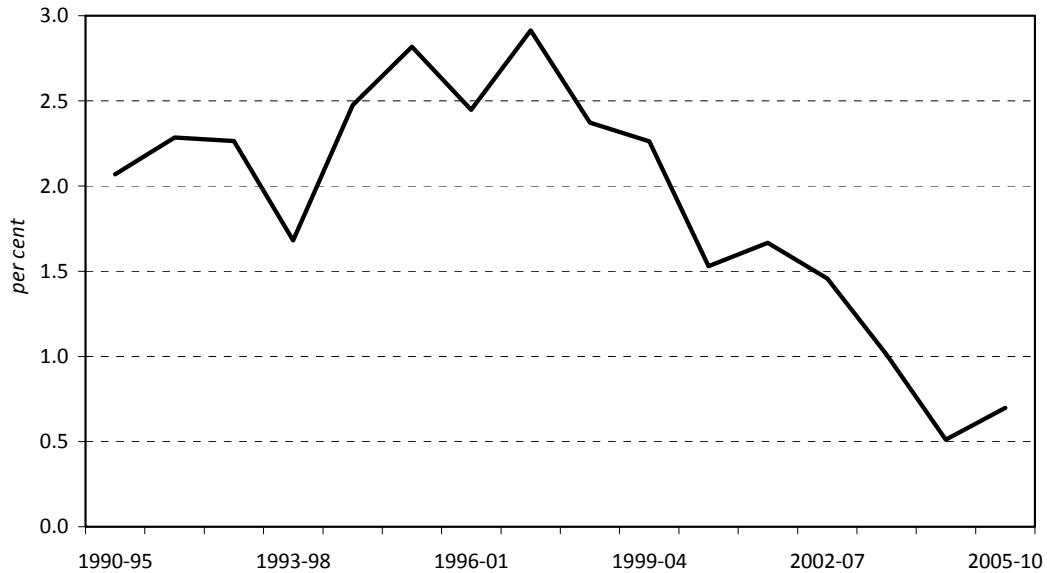
Victoria's economy faces a number of challenges which have implications for the fiscal outlook.

The 2011-12 budget will present revised economic projections for Victoria. The projection of future growth in gross state product (GSP) will be shaped by influences such as the high Australian dollar, a shift in investment towards the resources sector and changed patterns of household saving. There is also a potential risk of uneven global economic recovery, as well as capacity constraints in the national economy contributing to inflationary pressures.

Business investment and consumer spending are likely to grow slightly below trend. On the upside, Victoria's labour market has remained buoyant with employment growth outpacing the national average in the year to March 2011. However, there remains some slack in the labour market from underemployment.

A key policy priority for the Government is to translate these strong employment gains into stronger productivity growth, in order to drive increases in GSP per capita. As a general trend, Victoria's rate of labour productivity growth has been falling since the late 1990s, as demonstrated in Chart 1.

Chart 1: Victorian labour productivity growth^(a)



Source: Department of Treasury and Finance

Note:

(a) Five-year rolling average annual rate of growth.

To improve this performance, the Government has announced an aim of promoting Victoria's competitiveness and boosting productivity growth, identifying the following key broad areas of focus:

- reducing business costs through competition and regulation reform, including through implementing its election commitment to reduce regulatory red tape by 25 per cent;
- creating more efficient, responsive and transparent public services; and
- enhancing Victoria's knowledge, skills base and provision of infrastructure.

These will be important policy priorities into the future, and they will underpin Victoria's continued economic growth.

The medium-term economic outlook means that Victoria's budget strategy should not rely on the prospect of windfall revenue gains. The steep rises in property tax revenue which characterised the early years of the last decade have subsided and are unlikely to be repeated in the near term.

As a result, future patterns of government spending must be consistent with more modest revenue growth. This will require efforts to prioritise between alternative spending options.

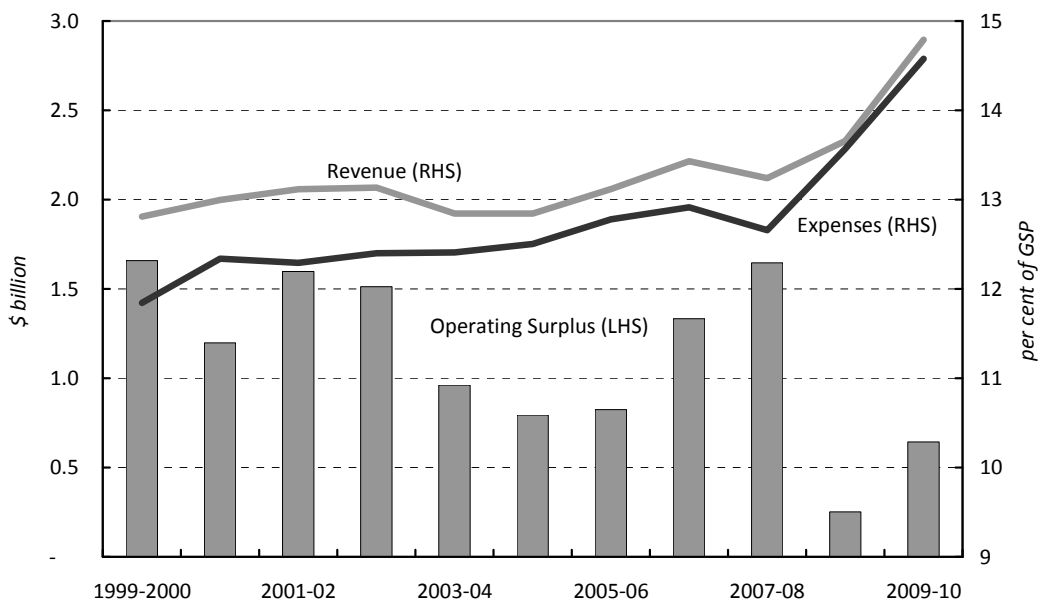
RECENT FISCAL PERFORMANCE

A sustainable fiscal policy has a number of elements. At a minimum it requires that spending grows in line with long-term revenue growth. However, it should also ensure that capacity exists to fund necessary infrastructure and build a buffer to deal with unanticipated economic and fiscal shocks.

Chart 2 illustrates that government as a share of the economy has been growing, with government expenditure increasing from around 11.8 per cent of GSP a decade ago, to nearly 14.6 per cent in 2009-10.

Over the first half of the previous decade, strong economic growth generated revenue growth of 6.2 per cent per annum on average. During the same period, however, expenditure grew by 7.3 per cent per annum on average. In the second half of the decade, this ongoing expenditure growth continued and exceeded revenue growth during the global financial crisis.

Chart 2: General government budget aggregates



Source: Department of Treasury and Finance

Notes:

(a) Ratios to GSP may vary from publication year to year due to revisions to the ABS GSP data.

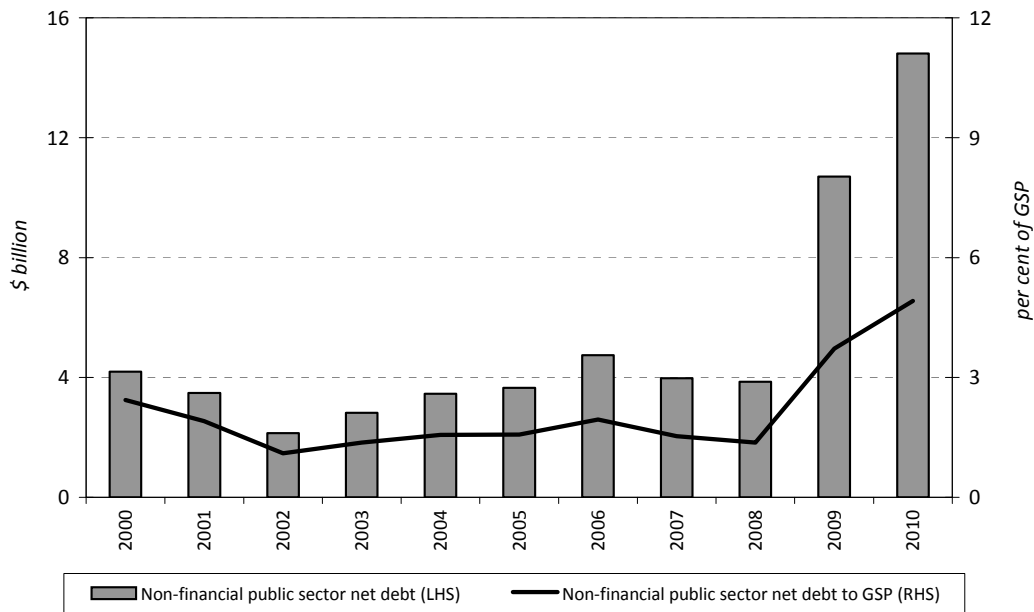
When this was combined with an increase in infrastructure spending, the result was accelerating debt and government representing an increasing share of the State's economy. Chart 3 shows that net debt to GSP for the non-financial public sector (NFPS) has increased from 1.4 per cent (\$3.9 billion) in 2007-08 to 4.9 per cent (\$14.8 billion) in 2009-10.

While revenue increased between 2007-08 and 2009-10, a significant factor was the Commonwealth Government's fiscal stimulus, which included grants to the states for a range of capital projects. These grants payments had the effect of increasing State operating revenue with expenditure being made by the State as capital.

This has created a fiscal imbalance such that the maintenance of an operating surplus since the global financial crisis has relied upon Commonwealth grants provided for capital purposes.

The lack of substantive action to correct this fiscal imbalance as the Victorian economy emerged from the global financial crisis has left the State's overall budget position vulnerable to fiscal impacts.

Chart 3: Non-financial public sector net debt^{(a)(b)}



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

Notes:

(a) Figures represent yearly actual data as at 30 June.

(b) Ratios to GDP may vary from publication year to year due to revisions to the ABS GSP data.

INFRASTRUCTURE AND PROJECT COST PRESSURES

The vulnerability of the budget position has been exacerbated by significant cost pressures across a number of high-value and high-risk infrastructure projects.

The significant scale of these projects and the cost pressures associated with them constitute a serious and concerning pattern. The Government has acted quickly to address this issue through:

- an immediate review of several high risk projects with potential significant further exposure to ensure ongoing risk and exposure is mitigated;
- implementation of a series of higher governance and management processes;

- investigation of failures in oversight, management and project implementation to determine mitigation strategies and optimal ways forward; and
- more rigorous oversight by the Department of Treasury and Finance to ensure greater focus in future on ensuring major projects are delivered within budget and project timeframes.

The aggregate impact of these new cost pressures is estimated to be in the order of \$2 billion. Table 2 lists some of these projects, with their approved project funding and the aggregate estimated cost pressure across all the projects.

Table 2: Major project cost pressures

(\$ million)

	Approved project funding	Cost pressure
<i>myki</i> ^(a)	1 351.0	nfp ^(b)
Regional Rail Link	4 317.0	nfp ^(b)
Melbourne Wholesale Market redevelopment	218.3	nfp ^(b)
LINK police database	60.5	nfp ^(b)
HealthSMART ^(c)	351.4	80
West Gate Bridge rehabilitation	240.0	60
Olivia Newton-John Cancer and Wellbeing Centre ^(d)	144.0	45
Royal Children's Hospital ICT	..	25
State Sports Facilities Project	53.8	15
Total	6 736.0	2 000 ^(e)

Source: Department of Treasury and Finance

Notes:

- (a) Approved funding includes \$890.1 million in operating expense.
 (b) Estimate not for publication due to ongoing negotiations.
 (c) Approved funding comprises upfront capital and annual operating costs.
 (d) Approved funding includes a Commonwealth contribution of \$25 million and fundraising of \$25 million.
 (e) Indicates current total cost pressure subject to upward revision following further investigation.

myki

myki is a smartcard ticketing system to replace the current Metcard and V/Line ticketing systems across Victoria. The project has an approved project budget of \$1.35 billion comprising upfront capital cost and annual operating costs to 2017. *myki* was designed to enable Victorian public transport users to pay for fares across metropolitan trains, trams, buses, V/Line train and coach, and major regional town bus services.

This project has encountered technical difficulties resulting in a three year project delay, and the need to extend the operation of the Metcard ticketing system. The project is exposed to additional significant cost pressures which have not been previously identified. The Government has identified a number of future project options and is committed to ensure the delivery of an efficient and reliable public transport ticketing system to Victorians.

Regional Rail Link

The Regional Rail Link (RRL) project will deliver up to 50 kilometres of new rail track, two new dedicated regional service platforms at Southern Cross Station, construction of two new regional stations, transformation of two existing stations and construction of a new rail bridge over the Maribyrnong River. The total estimated investment for the project was announced at \$4.3 billion.

The project is being jointly funded by the Commonwealth (\$3.2 billion) and the State (\$1.1 billion). The Commonwealth contribution is capped and consequently the State is solely responsible for all costs above this amount including any cost overruns.

The project was announced by the previous government. The project is exposed to cost overruns for critical design aspects that were not fully considered or costed by the previous government prior to project announcement. These cost pressures relate to signalling, land acquisition and civil works, including the cost of grade separating two major level crossings at Andersons Road, Sunshine which were not funded.

While the RRL project will provide the track capacity for additional metropolitan and regional trains, additional rolling stock is also required to fully realise these benefits. The scope of the RRL project did not include the cost of purchasing additional V/Line railcars. Additional funding required to acquire the rolling stock necessary to fully realise the project's intended benefits is expected to exceed \$250 million. Without additional rolling stock, no additional regional services are able to be provided, reducing project benefits to improvements in reliability.

The project has also been impacted by the Commonwealth Government's decision to delay its funding contribution by \$500 million. In addition, the decision to include the RRL in the Commonwealth Grant Commission's assessments of GST revenue sharing effectively reduces the value of the Commonwealth's contribution from \$3.2 billion to \$1.9 billion and places pressure on other areas of the State's budget to meet the shortfall.

Melbourne Wholesale Market redevelopment

This project involves relocation of Melbourne's wholesale fruit, vegetable and flower market to a new site in Epping and its redevelopment into a modern, innovative and efficient fresh produce trading and distribution precinct. The previous government provided \$218 million in funding for the project.

As a result of the failure to implement the project under multiple delivery models, in April 2009 the project was provided additional funding of \$193 million, which was financed in significant part through a debt facility on the expectation that the borrowings could be recouped through future rental income.

In June 2009 an unsuccessful commercial transaction process (via a Memorandum of Understanding) with Victoria Fresh Markets Pty Ltd was brought to an end.

Due to the cumulative impact of prolonged project development, multiple changes in delivery methods and optimistic assumptions regarding private sector participation and future rental income, the project continues to face significant delivery risks with increasing budget and timing pressures. Significant additional capital funding is required to complete the project based on the current scope, and the Government is likely to bear significant demand risk on development of a new market facility.

The Government has commenced a strategic review to investigate options for the project's future direction. The strategic review will also take account of the complex contract arrangements that were entered into.

All options for the future of the project are likely to have significant cost implications.

LINK police database

Victoria Police's operations management IT system (LEAP) supports its activities by logging incidents and tracking and analysing offences. LEAP has been in use since 1992. A decision to replace LEAP was taken in 2005 after highly publicised reports of unauthorised access to and inappropriate use of the system. This led to the commencement of the LINK project which was allocated \$61 million in funding in August 2005 with completion scheduled for 2010.

In March 2010 the project was suspended after Victoria Police discovered a number of risks to the project schedule and costs due to a failure to properly scope the original project requirements and timeframes. Under-costing, timeframe delays and concerns over compatibility with existing programs have all been identified.

An independent review of the project was commissioned prior to the Government taking office. It is expected that options to proceed with this project would require the allocation of significant additional funding.

HealthSMART

HealthSMART was announced in 2003 and has an approved project budget of \$351 million, comprising upfront capital and annual operating costs, to implement state of the art e-health applications, including a clinical application, at ten major health services across Victoria.

The entire suite of HealthSMART applications was to be fully functional at all ten health services by the end of December 2010.

There have been complications in rolling out the application. The clinical application is currently only partially functional in two health services – Eastern and the Royal Victorian Eye and Ear Hospital.

Significant additional funding is required to complete the original scope of the project. In addition, further information and communications technology (ICT) funding may also be required to enable major capital projects that are currently underway to be HealthSMART compatible.

Further work is being undertaken to examine critical issues and risks of this project. The potential cost overrun in relation to the capital element of this project is estimated at up to \$80 million.

West Gate Bridge rehabilitation

The key driver for this \$240 million project is to strengthen the West Gate Bridge to improve its long-term sustainability as well as safety improvements and increased traffic capacity.

While the project is due for completion in mid-2011, budget pressures have emerged in relation to the steel works component of the project. Cost increases are attributable to a range of factors, including an expansion in project scope to include the removal of lead paint, inclusion of additional safety features and the need for custom built design solutions when variations to the bridge structure were required.

The potential cost overrun on this project is estimated at up to \$60 million.

Olivia Newton-John Cancer and Wellness Centre

The previous government committed \$94 million for the Olivia Newton-John Cancer and Wellness Centre which, when completed, will provide better treatment for cancer patients, expanded research capacity and an increase in palliative care and inpatient beds.

While the original project funding covered a range of works including decanting and completion of the building structure, including shell floors for Oncology, Haematology and Palliative Care inpatient accommodation, funding was not allocated to complete the full fit out of the facility.

The Government has now been required to provide a further \$45 million in funding to enable the fit-out of all remaining clinical areas delivered in Stages 1 and 2a, including Multidisciplinary Outpatient Clinics, two acute inpatient wards, Cancer Administration and Clinical Trials as well as the fit-out of research accommodation.

This additional funding was necessary to ensure that the facility could deliver the service outcomes which were originally envisaged and announced.

Royal Children's Hospital ICT

The budget for the new Royal Children's Hospital only included provision for ICT capacity at a level consistent with that at the old hospital. Additional funding is required to modernise the ICT capacity to enable the new Royal Children's Hospital to implement HealthSMART clinical processes.

The cost to make the new Royal Children's Hospital HealthSMART compatible is estimated at up to \$25 million.

State Sports Facilities Project

The previous government announced this project with an approved total investment of \$54 million. The project involves the construction of athletics facilities at Lakeside Oval, Albert Park.

The original project scope included the demolition of the Olympic Park athletics facility. However, this will now be funded by the Melbourne and Olympic Parks Trust, freeing up funding for works at Lakeside Oval.

There are major risks of delays in project completion and cost overruns. The Government has been advised that additional funding is required to continue the construction and complete the project and provide facilities for all athletics bodies as originally intended. This is largely due to increased scope and design variations approved by the previous government.

The potential cost overrun in relation to this project is estimated at up to \$15 million.

OTHER REVENUE AND COST PRESSURES SINCE 2010-11 BUDGET UPDATE

The vulnerability of the budget position has been compounded by an unprecedented proposed cut in Victoria's GST revenue, reductions in other Commonwealth grants and the need to repair communities and assets in the wake of recent floods.

Reduction in GST

The Commonwealth Grants Commission (CGC) *Report on GST Revenue Sharing Relativities – 2011 Update (2011 Update)* has recommended a redirection of GST away from Victoria of \$500 million in 2011-12, reducing Victoria's share of the GST pool from 23.4 per cent to 22.5 per cent, compared to a population share of almost 25 per cent. In per capita terms, the average Victorian currently contributes an estimated \$123 to the rest of Australia – a figure that would rise to \$206 per Victorian under the proposed redirection.

This exposes Victoria to an estimated revenue reduction of \$2.5 billion over the next four years.

The Victorian Government has strongly opposed this reduction. The Treasurer has released an analysis of the *2011 Update* identifying several methodological weaknesses in the current formula. These flaws include:

- a decision to make several data revisions retrospectively;
- a failure to take account of Victoria's service delivery costs in areas such as urban growth and culturally and linguistically diverse communities;
- a treatment which effectively redistributes more than \$1.3 billion in project funding for Victoria's Regional Rail Link project to other jurisdictions;
- penalisation of Victoria for the early abolition of state taxes under the original GST agreement; and
- a long-term disincentive to undertake significant economic reform.

Of significant concern is the fact that the CGC's proposed outcome – reducing Victoria's GST share by an unprecedented amount while improving the allocations to resource-rich States – is inconsistent with underlying economic realities.

The Victorian Government believes that the *2011 Update* lacks transparency and undermines the principle of horizontal fiscal equalisation on which the formula is based.

The Commonwealth Government's recent announcement that the formula will be reviewed is an effective admission of the weaknesses of the existing approach and the results it has produced. It is Victoria's position that the proposed cut in GST revenue should have been suspended while the review is underway. However, the Commonwealth Treasurer has given no indication that there will be any shift in the recommended GST relativities.

Delayed Commonwealth funding

The Commonwealth has announced an intention to delay its agreed funding contribution to two major Victorian projects.

The Commonwealth has announced an intention to delay its contribution to the Regional Rail Link, effectively reducing its payments to Victoria by \$500 million over the next four years. In addition, the Commonwealth intends to delay \$50 million in funding over the next four years to the Victorian Comprehensive Cancer Centre, partly due to changes to timelines by the previous government.

These two decisions have a combined impact of reducing revenue to Victoria by \$550 million over four years.

Flood response

The recent flood events in late 2010 and early 2011 have had far reaching impacts on a number of communities in regional Victoria.

The floods have resulted in substantial damage to state and local government assets, as well as to homes and businesses. The Government stepped in at an early stage to support economic activity in affected towns and to assess the damage to infrastructure.

The gross cost of responding to flood damage is being assessed, and will be fully outlined by the Government in the lead up to the 2011-12 budget. The costs will include repairs to roads, hospitals, levees, a range of community infrastructure and natural assets on public land.

Some of these funds will be recovered through insurance, as well as through the National Disaster Relief and Recovery Arrangements. However, there will be a significant net contribution from the Victorian Government, which is committed to ensuring that those local communities affected are assisted through asset repair and ongoing strategies to retain their economic independence.

RESPONDING TO THE CHALLENGES – THE GOVERNMENT’S FISCAL STRATEGY

Dealing with the inherited budget weaknesses and new external fiscal impacts will not be easy nor will it be achieved overnight.

It requires a long-term fiscal strategy to ensure Victoria lives within its means while also being able to deliver high quality services and critical infrastructure. The Government’s strategy has several important elements:

- establishing an independent review of state finances to fully explore the State’s fiscal outlook beyond the forward estimates and recommend long-term reform options to strengthen Victoria’s finances;
- implementing the \$1.6 billion in savings outlined in the Coalition’s election commitments, allowing resources to be devoted to frontline service delivery in an efficient and cost effective manner; and
- introducing more rigorous oversight by the Department of Treasury and Finance to ensure major projects are delivered on time and on budget in order to prevent future cost overruns of the breadth and magnitude of those inherited from the previous government.

The independent review of state finances was announced by the Treasurer on 25 January 2011. The interim report of the independent review, due later this month, will advise on a comprehensive financial management plan for the State's finances and the outlook for the Victorian budget beyond the forward estimates period.

The final report of the independent review, in February 2012, will also advise on opportunities to improve the efficiency and effectiveness of service delivery, infrastructure and governance of the public sector. This will provide the context for the 2012-13 budget as the Government moves to shore up the fiscal and economic future of the State.

Action has been taken immediately to implement a substantial savings agenda to the value of \$1.6 billion over five years. This includes reducing the number of ministerial and media staff, stopping the funding of politically based government advertising and opinion polling, as well as capping head office staffing.

Opportunities are also being identified to improve the efficiency and responsiveness of the government sector through the greater use of competition, better procurement processes and further consolidation of back office functions through the use of shared services. These initiatives will reduce costs and allow greater focus on the quality of frontline services.

The Government's focus on high-value and high-risk projects reflects a strong view that a more rigorous oversight of major projects is needed. This approach will aim to ensure that best-value projects are selected and that the most efficient and appropriate procurement and governance models are used. To this end, the Department of Treasury and Finance will become more involved in the scoping, cost-benefit analysis, business case development, cost control and procurement of major projects undertaken by all departments and agencies.

These strategies form an important complement to the Government's other fiscal commitments, including:

- delivering an annual minimum \$100 million budget surplus to help finance necessary infrastructure and services;
- delivering its election commitments, including savings; and
- moving to a sustainable level of public debt over time, and maintaining a triple-A credit rating.

This fiscal strategy is a considered and disciplined response to the budget situation which the Government has inherited. It will also involve a rigorous assessment of priorities and hard decisions will need to be made. It emphasises the importance of the Government's policy of having no wage outcomes greater than 2.5 per cent unless it is funded by productivity gains.

Just as the 2011-12 budget will be framed against the context of significant fiscal challenges, it will also serve to outline important steps in the implementation of the Government's fiscal and economic strategy, aimed at improving the long-term sustainability of Victoria's public finances.

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