



VICTORIA ON THE EDGE

DEBT, DEFICITS AND UNSUSTAINABLE GROWTH

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 **Institute of
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Executive summary

Since the goldrush of the 1850s and throughout the bulk of the 20th century, Victoria has been the economic and cultural centre of Australia.

Victoria's vast wealth was generated by an abundance of natural resources, agriculture and the ability for manufacturers to access affordable and reliable energy from the Latrobe Valley.

The recession of the early 1990s was followed by a period of growth and rejuvenation owing, in part, to significant structural and institutional reform implemented by the Victorian state government throughout the mid-1990s.

Yet in 2022, on all critical indicators of financial management, Victoria is now the worst performing state in Australia by a significant and growing margin.

Today, Victoria has the largest state budget deficit in the nation and the largest state government debt level in absolute terms and as a share of the economy.

Victoria also has the highest level of taxation as a share of the economy, the fastest growing state government spending rate as a share of the economy in the nation, the fastest growing public sector wages in the nation, as well as the fastest growing public sector workforce on mainland Australia.

Victoria's debt, in both absolute terms and as a share of the economy, is now higher than at the peak of the economic fallout from the early-1990s' Cain-Kirner economic collapse.

Specifically, Victorian state government debt already sits at \$101 billion, which is over five times higher than the post-Cain-Kirner recession peak of \$18.8 billion in 1995. And debt is expected to increase even further, to \$259 billion by 2035.

Debt per Victorian is now approximately \$15,000 and is expected to increase to at least \$30,000 by the year 2035, up from \$3,500 in 2014.

Victoria's debt exposure is particularly of concern at a time when rising interest rates will lead to significant increases in the costs of servicing the debt.

Every extra dollar needed for debt servicing will be at the expense of alternative and productive uses. Conversely, if the Victorian Government does not address the budget deficit and the rising debt levels, Victoria could face a debt trap in which even more drastic action is required.

The Suburban Rail Loop is the critical tipping point which will make Victorian state debt unsustainable. Without the rail loop, debt by the middle of next decade – while far too high – is expected to plateau at approximately \$209 billion in year 2035.

But even just stage one of the three-staged loop will push debt to at least \$259 billion by 2035, instead of \$209 billion without the loop, and with an unsustainable upward trajectory.

And this is just for stage one. Modelling prepared by the Victorian Parliamentary Budget Office estimated the total cost of the first two stages of the Suburban Rail Loop to be \$200.2 billion.

Economic vision and leadership will be required to address these significant challenges.

Unlike the 1990's, the sale of public assets to pay down the debt and reduce the deficit is not available as an option, as major public assets have already been sold and their proceeds spent.

The Australian economy faces the greatest series of financial risks in decades, as the odds of a global recession continue to increase. The crisis in Ukraine, the energy crisis in Europe and Australia, the after-effects of COVID-related measures, and continued disruptions to global supply chains are darkening the economic outlook. Inflation expectations are being reset and interest rates are rising, with market expectations of future interest rates well beyond official forecasts.

As this paper demonstrates, the Victorian economy is particularly vulnerable to the economic shocks that are coming its way, because of the growth in the size of the state and the dramatic increase in the public sector wage roll, financed in part by increased taxes and asset sales, but also by a massive increase in the level of debt.

Introduction

The Australian economy faces the greatest series of financial risks in decades, as the odds of a global recession continue to increase. The crisis in Ukraine, the energy crisis in Europe and Australia, the after-effects of COVID-related measures, and continued disruptions to global supply chains are darkening the economic outlook. Inflation expectations are being reset and interest rates are rising, with market expectations of future interest rates well beyond official forecasts.

As this paper demonstrates, the Victorian economy is particularly vulnerable to the economic shocks that are coming its way, because of the growth in the size of the state and the dramatic increase in the public sector wage roll, financed in part by increased taxes and asset sales, but also by a massive increase in the level of debt.

On critical indicators of financial management, Victoria is now the worst performing state in Australia by a significant and growing margin.

Victoria has the largest debt (in absolute terms and as a share of the economy), the biggest budget deficit, the highest taxes as a share of the economy, and the fastest growing government spending as a share of the economy, along with the second fastest growing public service workforce (behind Tasmania) and the fastest growing public sector wages of all the states in Australia.

Victoria's debt, in both absolute terms and as a share of the economy, is now higher than at the peak of the economic fallout from the early 1990s' Cain-Kirner economic collapse. Specifically, Victorian Government debt has leapt to \$101 billion, which is over five times higher than the Cain-Kirner recession peak of \$18.8 billion in 1995. Debt is expected to further skyrocket to \$259 billion by the year 2035.

Debt per Victorian is now approximately \$15,000 and is expected to increase to at least \$30,000 by the year 2035. This is up from approximately \$3,600 in 2014 and \$4,200 in 1995. This is particularly of concern at a time when rising interest rates will lead to significant increases in the costs of servicing the debt. Every extra dollar needed for debt servicing will be at the expense of alternative and productive uses. Conversely, if the State Government does not address the budget deficit and the rising levels, Victoria could face a debt trap in which even more drastic action is required.

Economic vision and leadership will be required to address these significant challenges. The sale of public assets to pay down the debt and reduce the deficit is not available as an option, as major public assets have already been sold and their proceeds spent. Bolder thinking will be required. Some potential reforms include:

1. Implementing a 1% cut to total government spending each year until the budget is in surplus.
2. Implementing a freeze on all public sector hiring.

3. Rejuvenating Victoria's ability to attract new businesses and grow the manufacturing base by putting reliability and affordability as the objective of energy and climate policy.
4. Cutting red tape to incentivise business growth and investment, particularly for those small to medium enterprises least able to manage the crushing burden of government regulation.
5. Committing to no new taxes and to not raising existing taxes to improve market confidence.

The broader context is that Victorians have experienced a structural shift in the role of their government. Unless drastic action is taken, Victorians face a permanently bigger government with more and higher-paid public servants, higher taxes, higher spending, and significantly higher debt than prior to 2014. Victoria's economy is more dominated by the state government than at any time since World War Two.

A public which is more dependent on government support and unaware of the real costs and risks associated with debts and deficits are likely to continue to support the growth of government, and see the public service and government-dependent industries as a preferable source of employment compared to starting a small business. The state sector crowds out value-creating activities in the private sector, reducing investment and jobs, and further reducing the economic activity needed to bankroll state expenditures.

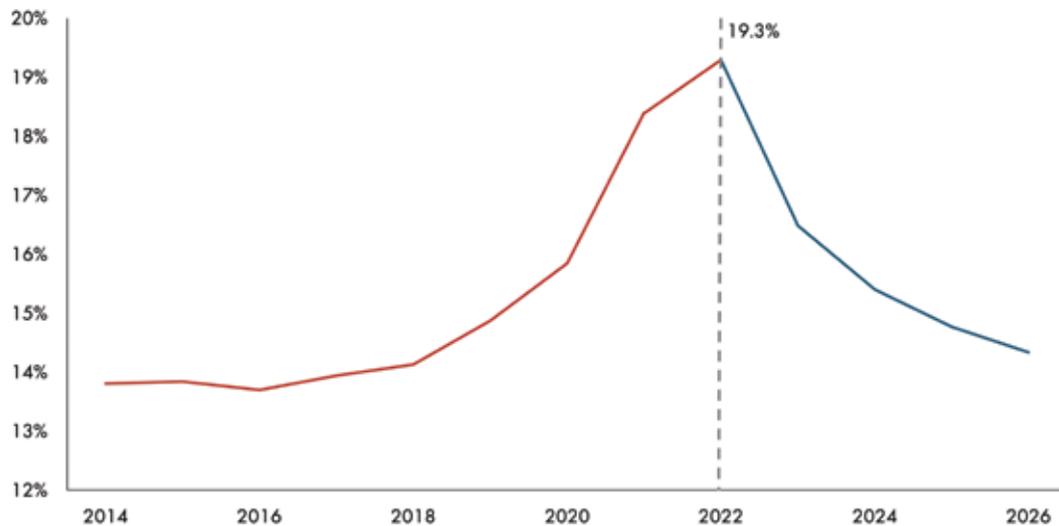
There are historical parallels. The collapse of the Victorian economy under the Cain-Kirner governments of the 1980s and early 1990s caused a permanent, structural decline to small business and self-employment, a larger public service, and a diminished civil society. Remedial action then took years, and was not fully effective. This ultimately provided the conditions for a big expenditure government which came to power in 2014.

Government spending

- The Victorian Government has the fastest growing government spending of any state.
- Since 2014, spending has increased by approximately 10% per year, compared with the non-Victorian average of 6%.

The Victorian Government's spending as a percentage of GSP has dramatically increased since 2014. By the Victorian Government's own estimate, gross spending is set to peak this year at \$100 billion, which amounts to approximately one-fifth of the state's entire economy. Furthermore, the official projections of a reduction in future government spending post 2022, shown below, are not credible as there are no associated commitments to remedial action.

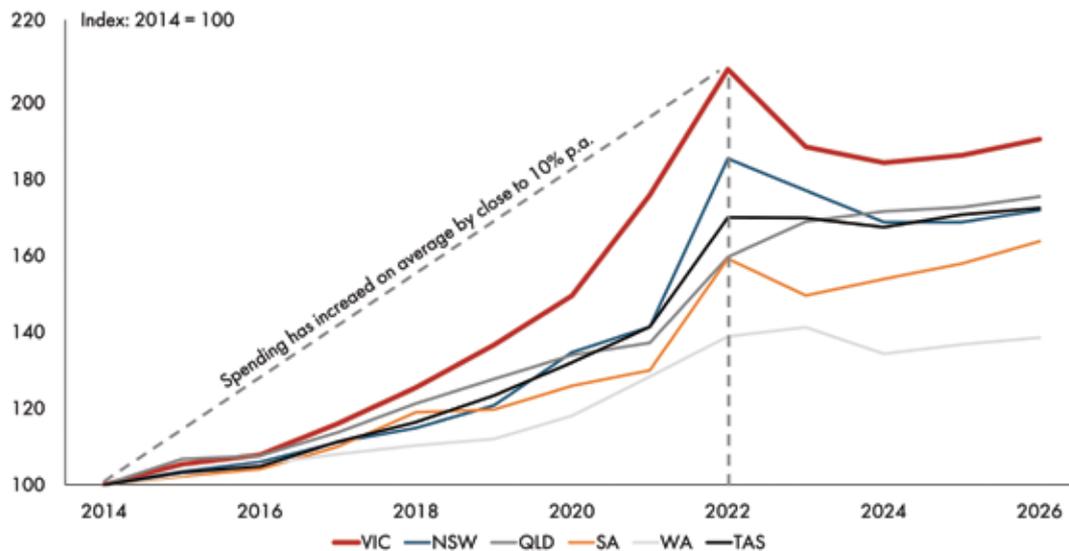
Chart 1: Victorian Government spending as a percentage of gross state product



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

In percentage terms, government spending has increased by 109% since 2014, more than any other state, with the non-Victorian average sitting at 63%. This equates to an average annual increase in spending, in Victoria, of close to 10% per year, compared to the non-Victorian average of 6%. New South Wales is the state with the next fastest growing spending with an 85% increase since 2014.

Chart 2: Comparison of state government spending growth



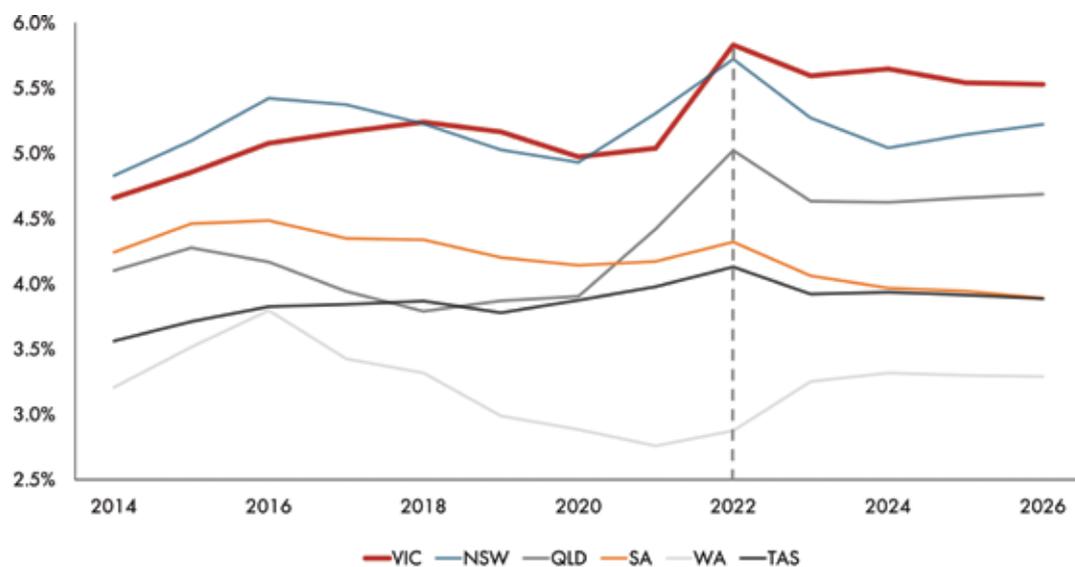
Source: State budgets, ABS, IPA

Taxation

- Victoria is expected to become the highest taxing state as a share of GSP this year, and to remain the highest taxing state in Australia until at least 2026.

Victoria has always been a high-taxing state, alternating between being the highest and second highest with NSW since 2014. From 2022, Victoria is expected to, again, become the highest taxing state in Australia as a share of GSP, with taxes expected to reach 5.8%, slightly above NSW, and up from 5% in 2021. Victoria's place as the highest taxing state is expected to remain in place until at least the year 2026.

Chart 3: State government tax as a percentage of gross state product



Source: State budgets, ABS

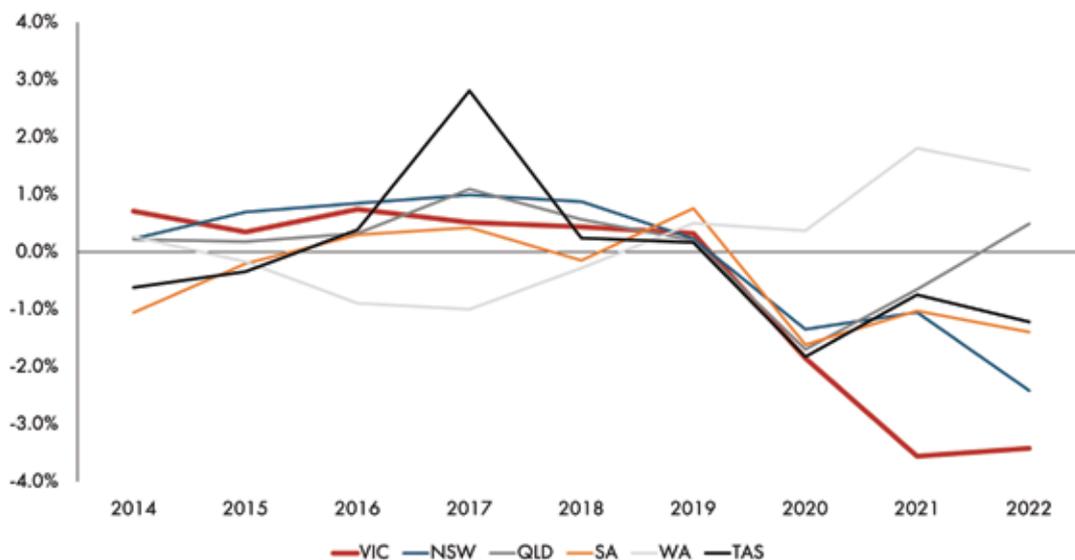
Budget deficit

- Victoria has the largest budget deficit in the nation, and is not expected to return to surplus until 2026 at the earliest, based on very optimistic economic growth forecasts.

The Victorian Government’s net operating balance (annual revenue minus annual expenditure) is in the negative and its budget is by far in the worst position in the country compared with the other states.

Victoria’s budget deficit as a percentage of GDP has plummeted to 3.6% from a surplus of 0.2% in 2019. The next worst performing state is NSW with a budget deficit of 2.4% of GDP. Even the Victorian Government’s own budget estimates, based on rosy economic growth forecasts, do not expect the Victorian budget to balance until at least 2026.

Chart 4: State government budget surplus/deficit as a percentage of gross state product



Source: State budgets, ABS

Table 1: State government budget surplus/deficit as a percentage of gross state product – future projections

	VIC	NSW	QLD	SA	WA	TAS
2022	-3.4%	-2.4%	0.5%	-1.4%	1.4%	-1.2%
2023	-1.4%	-1.5%	-0.3%	0.2%	0.5%	-1.2%
2024	-0.6%	-0.4%	-0.3%	0.4%	1.1%	0.0%
2025	-0.2%	0.1%	0.0%	0.4%	0.8%	0.1%
2026	0.1%	0.2%	0.0%	0.4%	0.8%	0.1%

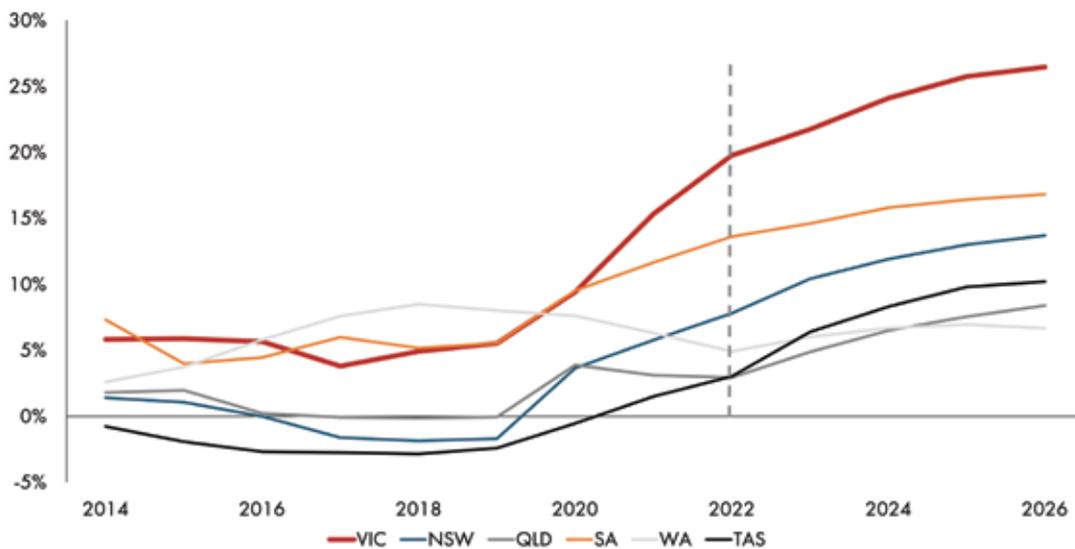
Source: State budgets, ABS

Government debt

- Victorian state government debt already sits at \$101 billion, which is over five times higher than the post-Cain-Kirner recession peak of \$18.8 billion in 1995.
- Debt is expected to increase even further, to at least \$259 billion by 2035.
- Debt per Victorian is now approximately \$15,000 and is expected to increase to at least \$30,000 by the year 2035, up from \$15,000 today and \$3,500 in 2014.

Since 2014, net Victorian Government debt as a percentage of GSP has quadrupled from 5% to 20% today. This is expected to increase to 25% by the middle of the decade. Debt as a percentage of GSP is already 1.5 times the size of the next most debt-ridden state (South Australia).

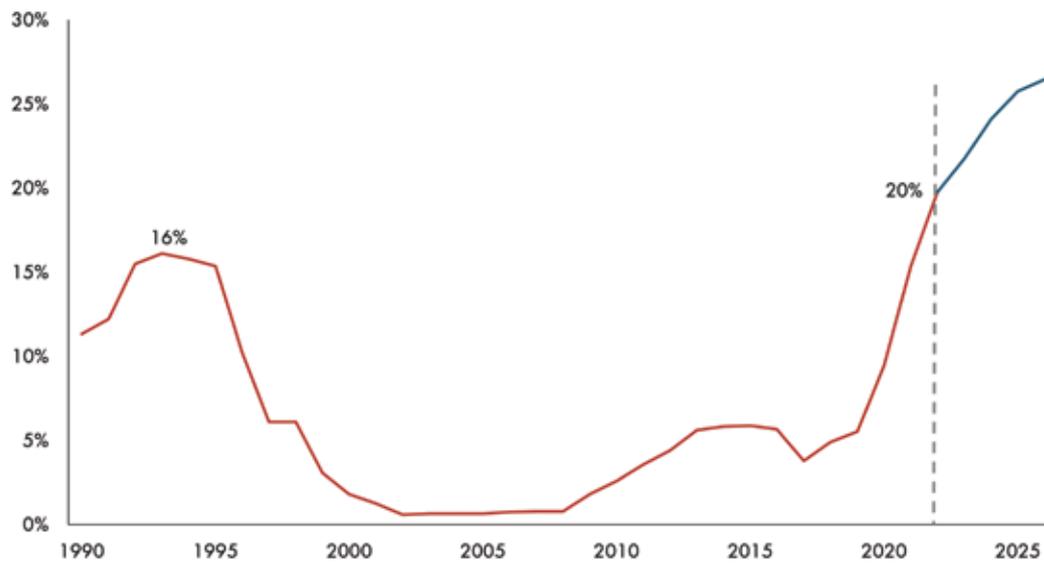
Chart 5: Net state government debt as a percentage of gross state product



Source: State budgets, ABS

Victoria's debt as a percentage of GSP is now higher than it was at the peak of the economic fallout from the Cain-Kirner recession, where debt reached 16% of GSP in 1993. And by 2026, debt will be close to double that figure.

Chart 6: Victorian net government debt as a percentage of gross state product



Source: VicDTF, ABS

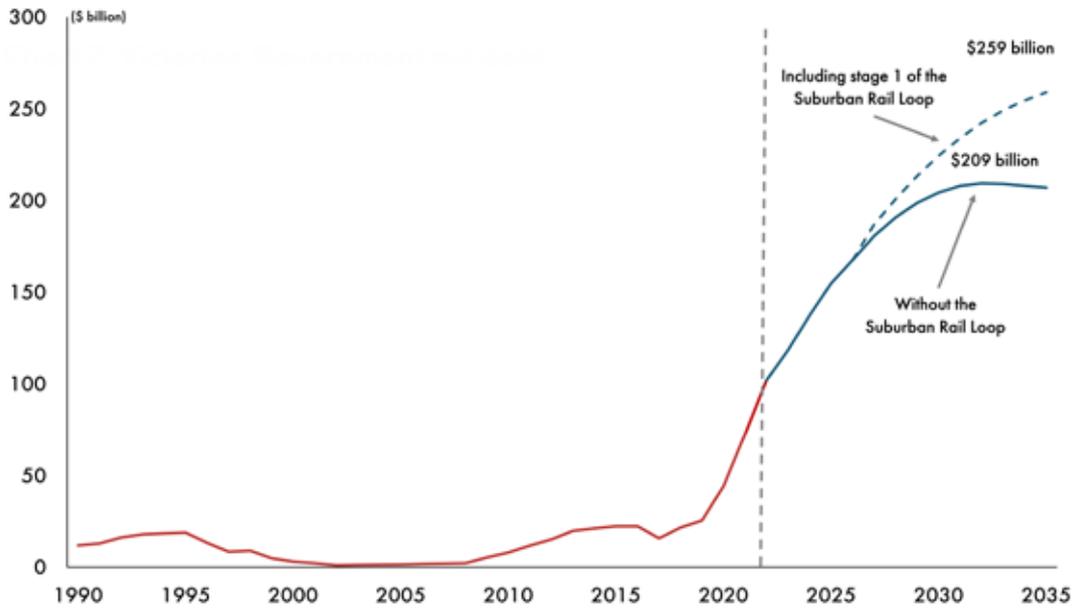
Similarly, in absolute terms, Victoria’s government debt now sits at \$101 billion, which is over 400% higher than the Cain-Kirner recession peak of \$18.8 billion in 1995. Debt is expected to grow to \$168 billion by the year 2026.

Based on existing data and government forecast into 2025, we estimate that, under the current trajectory, net government debt will plateau at \$209 billion in 2032 before tapering to approximately \$207 billion by 2035.

The added cost of the Suburban Rail Loop, however, the biggest transport cost in the state’s history, is expected to result in debt continuing to spiral – to \$259 billion by 2035. This estimate is in accordance with the expected completion date of stage one of the project and does not include subsequent phases, which will further add to the state’s debt.¹

¹ Our analysis is based on the following sources: *Parliamentary Budget Office (2022) Suburban Rail Loop East and North: Value of Continued Investment*, PBO: Melbourne; *Parliamentary Budget Office (2022, August 18) Advice: Suburban Rail Loop East and North – Building and operating costs*, Parliamentary Budget Office, <https://pbo.vic.gov.au/response/2820>. It incorporates expected additional costs based on the average TEI variance of key projects featured in VAGO’s September 2021 report: *VAGO (2021, September) Major Projects Performance: Independent assurance report to Parliament 2021-2022*, Victorian Auditor-General’s Office: Melbourne; Matt Johnston, Kieran Rooney & Tess Ikononou (2021, September 22) *Big Build projects in Victoria \$6 billion over budget*, Herald Sun, <https://www.heraldsun.com.au/news/victoria/taxpayers-fork-out-billions-for-major-project-budget-blowouts/news-story/61aa2e3758d8b53f43a87bcfad4f28c2>

Chart 7: Victorian Government net debt



Source: VicDTF, PBO, IPA

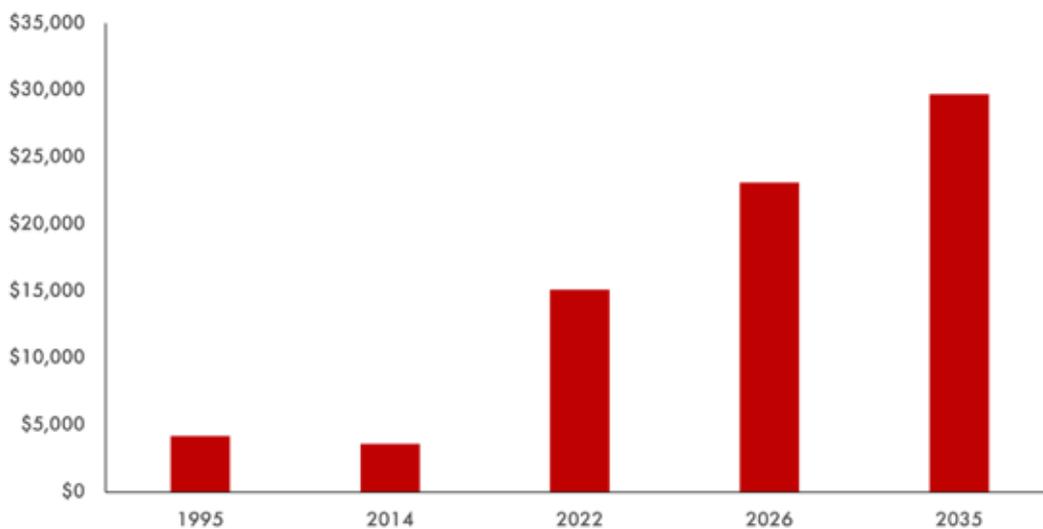
Debt per Victorian is now \$15,119 and is expected to increase to at least \$23,110 by the year 2026.

With the additional debt that the state is expected to incur in the construction of stage 1 the Suburban Rail Loop, debt per Victorian will spiral further to at least \$29,692 by 2035.

What it represents for a couple is a debt of \$59,384 – and for a family of four, \$118,768.

To give context, debt per Victorian was \$3,596 in 2014 and \$4,180 in 1995.

Chart 8: Debt per Victorian



Source: VicDTF, ABS

Public service

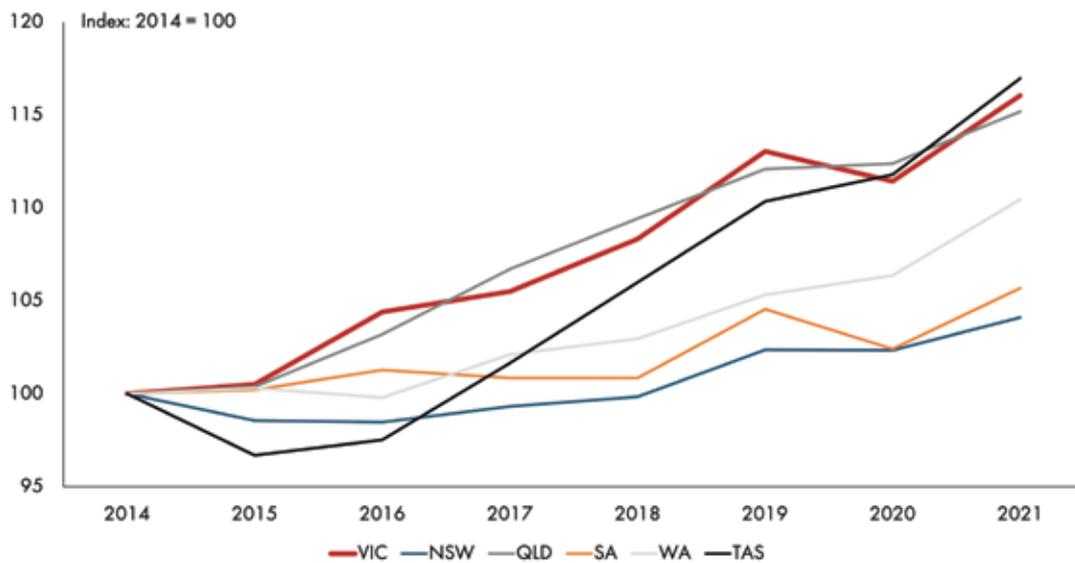
- Victoria has the second fastest growing public sector workforce, behind Tasmania.
- Since 2014, the Victorian public sector workforce has grown by 16%, compared with the non-Victorian average of 9%.
- Victoria has the fastest growing public sector wages in Australia, with an average annual growth rate of 3.7% since 2014, compared with the non-Victorian average of 2%.

Victoria has the second fastest growing public sector workforce behind Tasmania. Since 2014, the public sector workforce in Victoria has grown by 16%, behind Tasmania with 17%. For purposes of comparison, the average of the rest of the states is 9%.

Victoria also has the fastest growing public sector pay in the nation. Since 2014, Victorian public service wages have grown by an annual average of 3.7%, well above the non-Victorian average of 2%.

The next fastest growing state is QLD where public sector wages have grown by 2.4% per year on average since 2014.

Chart 9: Growth of public sector workforce



Source: ABS

The increasing growth of public sector workers has not necessarily translated to better services for the residents of Victoria. Ambulance ramping, for instance, is a massive issue for the state's healthcare system. It describes a scenario whereby a patient cannot be offloaded from an ambulance because of delays in the hospital. In the December quarter of 2021, 33.9% of ambulances in Victoria waited over 40 minutes for access to hospital beds, up from 27% five years ago.²

² Adeshola Ore and Tamsin Rose (2022, May 7) Healthcare system in distress: How ambulance ramping became a major problem, *The Guardian*, <https://www.theguardian.com/australia-news/2022/may/07/health-system-in-distress-how-ambulance-ramping-became-a-major-problem>

A study by Ambulance Victoria, Monash University, Royal Melbourne Hospital, Alfred Health and the Baker Heart Research Institute finds that, just like state government debt, ambulance ramping was on the rise well before the start of the pandemic.³

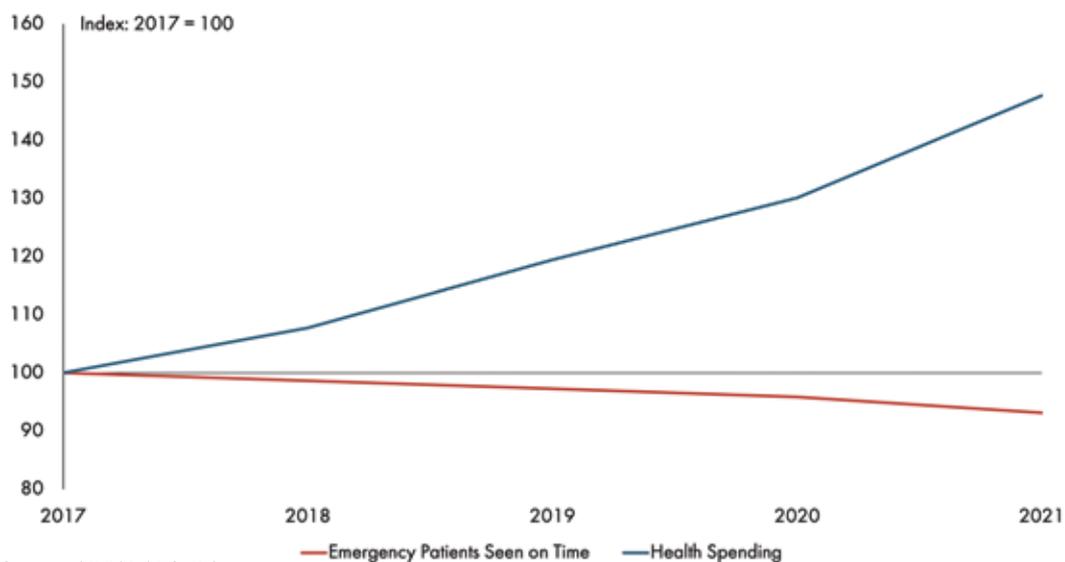
The median time it took for an ambulance to offload a patient to a hospital bed increased from 21 minutes in 2015 to 24 minutes in the first half of 2019. In the first six months of 2022 there were six 'code reds', which are situations where there are no ambulances available to respond to call-outs. Only nine code reds were recorded in the four years between 2017 and 2021.⁴

The Victorian Government has set aside \$124 million in the 2022/23 budget to recruit 90 extra paramedics for Ambulance Victoria to address the issue. But the state's health spending has already almost doubled since the current government took office (from \$13.60 billion in the 2013/14 financial year to \$24.51 billion in the 2020/21 financial year).⁵

The number of people working in Victoria's healthcare and social assistance sector, according to the ABS, totalled around 343,000 in November 2014. It has grown by almost 50% to 508,000 by May 2022.

The following chart compares the drastic increase in the state's health spending against the percentage of emergency patients seen on time by a medical professional.⁶ It shows that while health spending has increased by close to 50% in the last five years, emergency departments' performance has declined by close to 7%.

Chart 10: Growth of health spending vs percentage of emergency patients seen on time



Source: AIHW, ABS, IPA

3 Ashleigh Barraclough (2022, June 30) Deadly ambulance ramping at Victorian hospitals was on the rise before COVID-19, study finds, ABC News, <https://www.abc.net.au/news/2022-06-30/deadly-ambulance-ramping-victorian-hospitals-rising-before-covid/101195828>

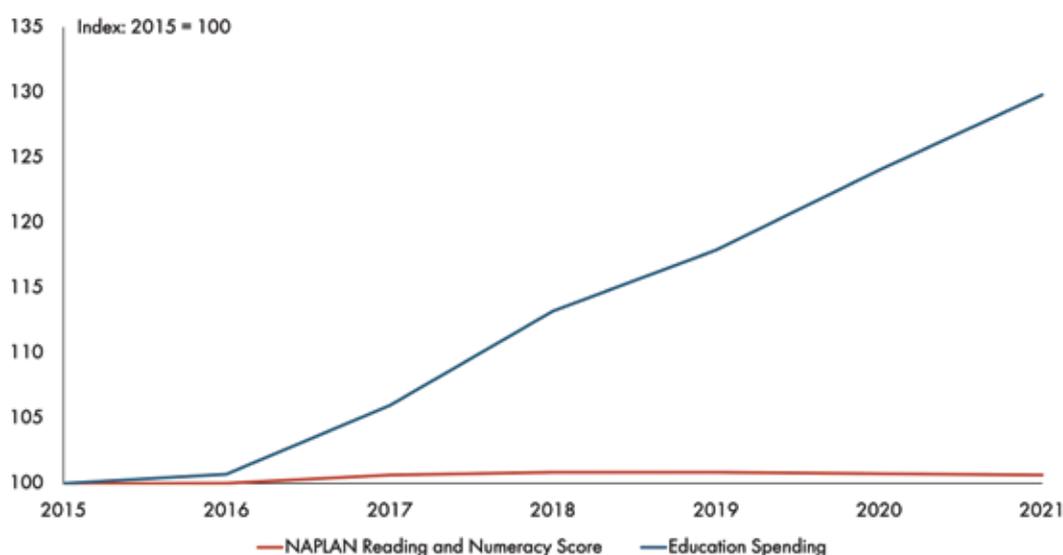
4 Ibid.

5 ABS Government Finance Statistics: Victoria State General Government Expenses by Purpose.

6 The earliest available data from the Australian Institute of Health and Welfare was from 2017.

The Victorian Government has also increased the state’s education spending - by 30% since 2014 (from \$10.73 billion in the 2013/14 financial year to \$14.13 billion in the 2020/21 financial year). Any improvement in outcome, as measured by the state’s NAPLAN test results, however, has been underwhelming. The chart below compares the increase in education funding against the state’s NAPLAN reading and numeracy performance since 2015.⁷ It shows that the considerable increase in education funding has not translated to material improvement in student performance. In fact, NAPLAN scores across the reading and numeracy components for the state has improved by less than 1% since 2015.

Chart 11: Growth of education spending vs NAPLAN scores across the reading and numeracy components



Source: ACARA, ABS, IPA

The Victorian Auditor General’s Office’s *Major Projects Performance September 2021* report reveals \$6 billion worth of cost blowouts in its audit of 110 major projects in Victoria in the financial years ending 2020 and 2021. The largest was a 224% increase in the cost of the Department of Transport’s commuter car park programme, which was initially estimated to cost \$150 million and ended up costing taxpayers \$486 million.

Forty two out of the 110 major projects included in the scope of the audit were found to suffer from budget overruns. The audit did not include Melbourne’s West Gate Tunnel project, which was meant to be completed by 2023 at the cost of \$5.5 billion but is more likely to be finished in 2025 at the total cost of \$10 billion – amounting to a \$4.5 billion budget overrun and delayed by two years.⁸

⁷ State by state breakdown in NAPLAN performance data is only available for reading and numeracy and cover the years 2008, 2015, 2016, 2017, 2018, 2019 and 2021. For the purpose of constructing the chart, we have started in 2015 and used the average of the 2019 and 2021 scores as a substitute for the missing 2020 data.

⁸ Paul Sakkal (2022, April 13) The hole story: New details of West Gate Tunnel progress revealed, *The Age*, <https://www.theage.com.au/national/victoria/the-hole-story-new-details-of-west-gate-tunnel-progress-revealed-20220406-p5abdz.html>

Melbourne CBD's Metro Tunnel rail project is also facing a considerable budget blowout amounting to at least \$1.88 billion.⁹

The Suburban Rail Loop, initially projected to cost \$50 billion in its entirety, is expected to cost at least \$150 billion more – with the state parliament's budget office publishing a report in August that just the north and east sections of the loop (accounting for about two-thirds of the entire project) will cost more than \$200 billion.¹⁰

⁹ Patrick Hatch (2022, June 22) Warning on further Metro Tunnel cost blowouts in next 'risky' phase', *The Age*, <https://www.theage.com.au/national/victoria/warning-on-further-metro-tunnel-cost-blowouts-in-next-risky-phase-20220622-p5avqv.html>

¹⁰ Parliamentary Budget Office (2022, August 18) Advice: Suburban Rail Loop East and North - Building and operating costs, *Parliamentary Budget Office*, <https://pbo.vic.gov.au/response/2820>

Conclusion

On critical indicators of financial management, Victoria is now the worst performing state in Australia by a significant and growing margin.

Victoria has the largest debt in absolute terms and as a share of the economy, the biggest budget deficit, the highest taxes as a share of the economy, and the fastest growing government spending as a share of the economy, along with the fastest growing mainland public service workforce and the fastest growing public sector wages out of all the states in Australia.

Economic vision and leadership will be required to address these significant challenges. The sale of public assets to pay down the debt and reduce the deficit is not available as an option, as major public assets have already been sold and their proceeds spent. Bolder thinking will be required. Some potential reforms include:

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Unless drastic action is taken, Victorians face a permanently bigger government with more and higher-paid public servants, higher taxes, higher spending, and significantly higher debt than prior to 2014.

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Daniel previously worked at the Commonwealth Department of the Prime Minister and Cabinet where he analysed global and domestic macroeconomic policy. Prior to that he held positions at the Commonwealth Department of Finance where he worked on regulatory reform.

Daniel holds an honours qualification in economics and a degree in international studies from the University of Adelaide, and is currently undertaking a Master of Business Administration at the Melbourne Business School.

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