Victoria has become one of Australia's 'poor states'

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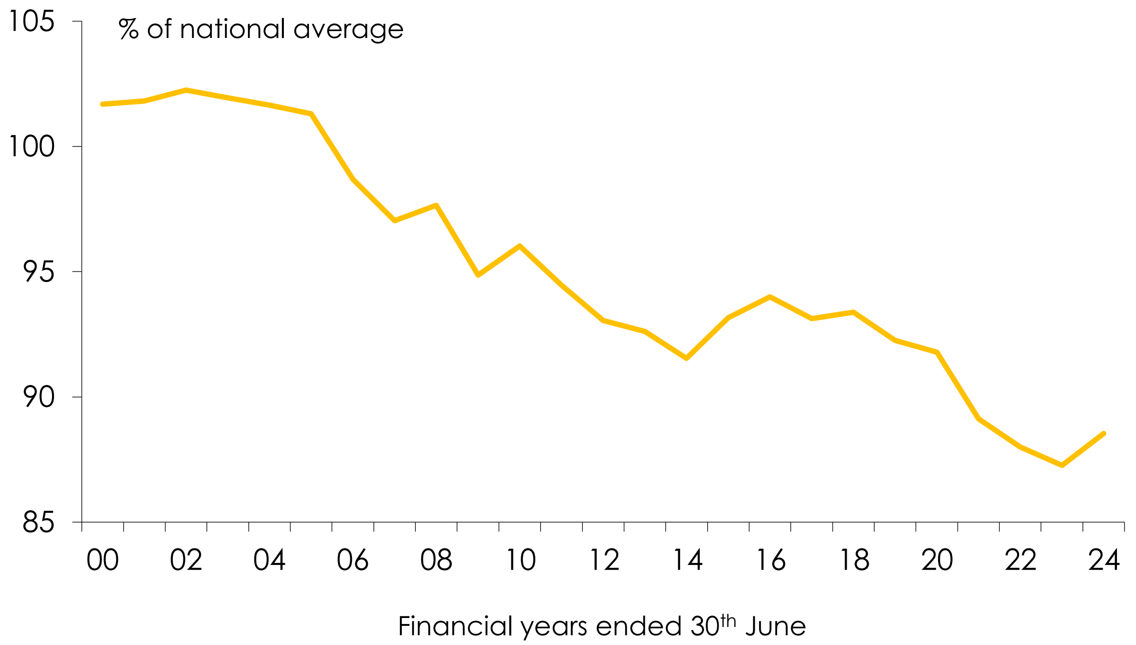
Throughout most if not all of the twentieth century, Victorians thought of their state as the richest and most powerful in the nation. Victoria was able to foist its economic model of high tariffs and centralized wage fixation on the rest of the country at the time of Federation. Melbourne served as Australia's capital until 1927; and many Federal departments remained headquartered there for decades after Parliament shifted to Canberra. The High Court maintained its Principal Registry in Melbourne until 1973. Victorian MPs served as Prime Minister for 60% of the twentieth century.

But since the turn of the century Victoria's status as one of Australia's most prosperous and powerful states has been steadily eroded. It now ranks alongside South Australia and Tasmania as "cellar-dwellers" in terms of relative economic performance; it is the most indebted state or territory as a proportion of its economy; and it's been almost 33 years since a Victorian was last living in The Lodge.

More importantly, Victoria's per capita gross product has declined from 1.7% above the national average in 1999-2000 to 11.5% below the national average in 2023-24 (Chart 1) – ahead of only South Australia and Tasmania (Chart 2).

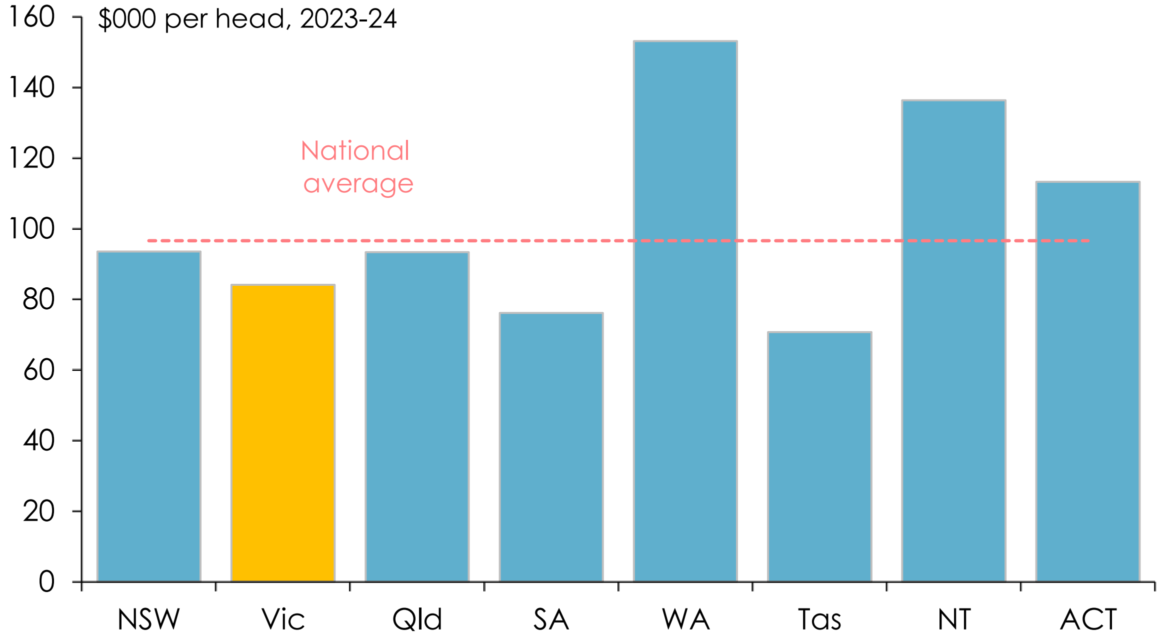
Chart 1: Victoria's per capita gross product as percentage of the national average



Source: ABS, *Australian National Accounts: State Accounts*, 2023-24.

The national average per capita gross product has of course been inflated by the enormous increases in the volumes and prices of mineral and energy exports from Western Australia over this period, which have resulted in WA's per capita gross product exceeding that of the rest of Australia by a much bigger margin than any other state's or territory's has ever done. But even excluding WA, Victoria's per capita gross product relative to that of the 'eastern states' has fallen from over 3% above in the early 2000s to 5% below in 2023-24.

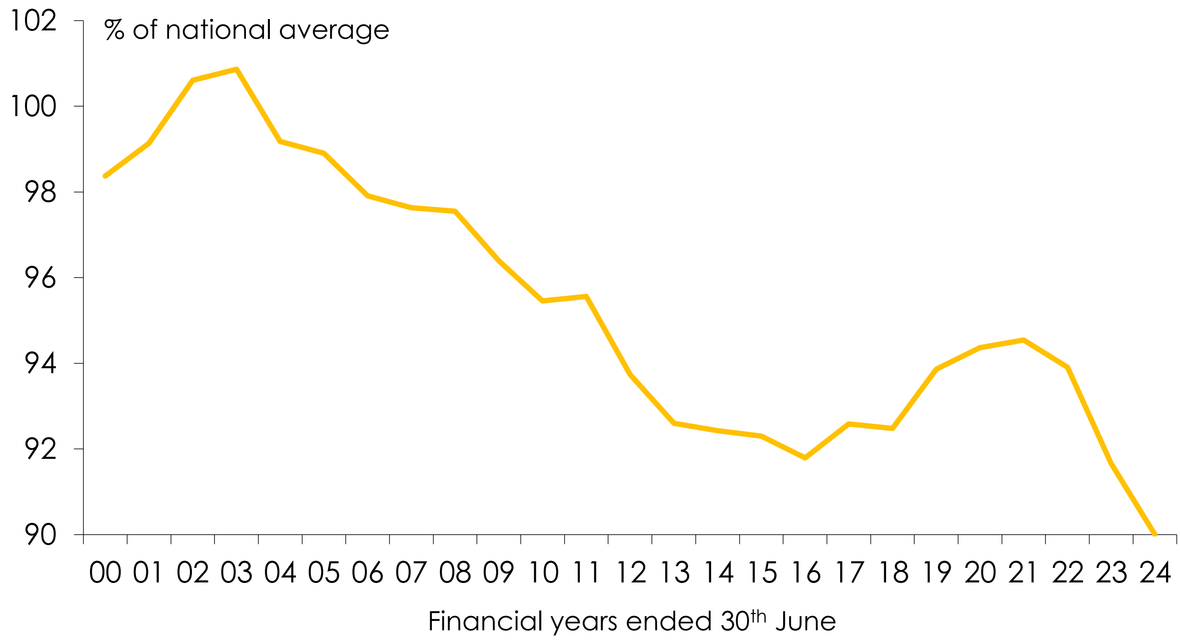
Chart 2: States and territories per capita gross product, 2023-24



Source: ABS, *Australian National Accounts: State Accounts*, 2023-24.

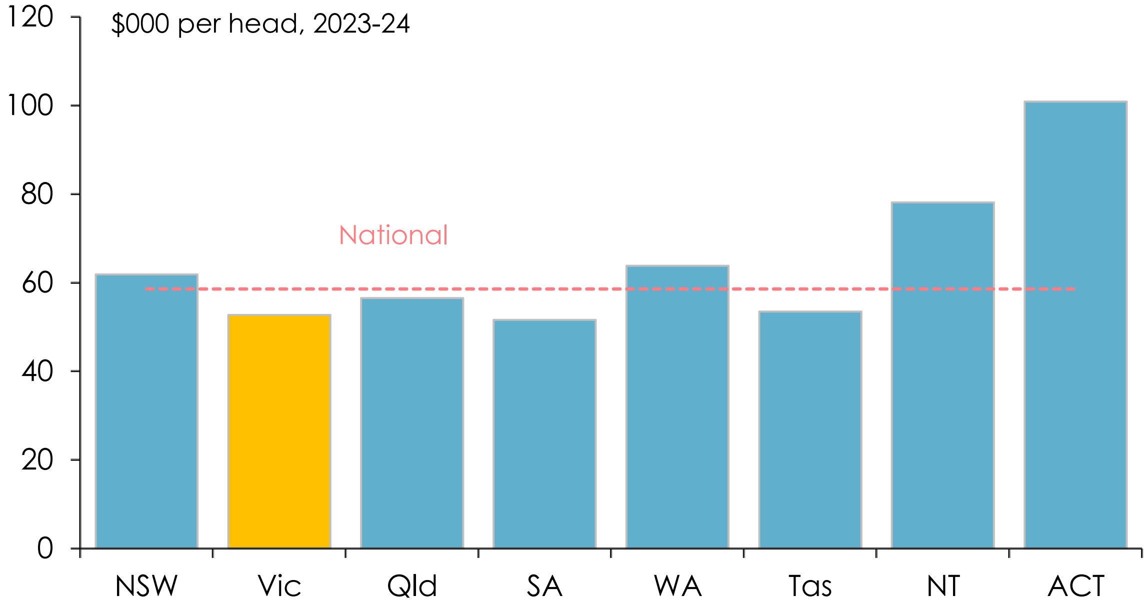
While the decline in Victoria's per capita gross product relative to the rest of Australia might not be readily apparent to ordinary Victorians, the same trend is evident in Victorian per capita household disposable income. At the turn of the century, this more obvious measure of Victorians' individual material well-being was just above the national average: in 2023-24 it was 10% below the national average (Chart 3), the second lowest in the nation, behind even Tasmania and ahead of only South Australia (Chart 4).

Chart 3: Victoria's per capita household disposable income as percentage of the national average



Source: ABS, *Australian National Accounts: State Accounts*, 2023-24.

Chart 4: States and territories per capita household disposable income, 2023-24

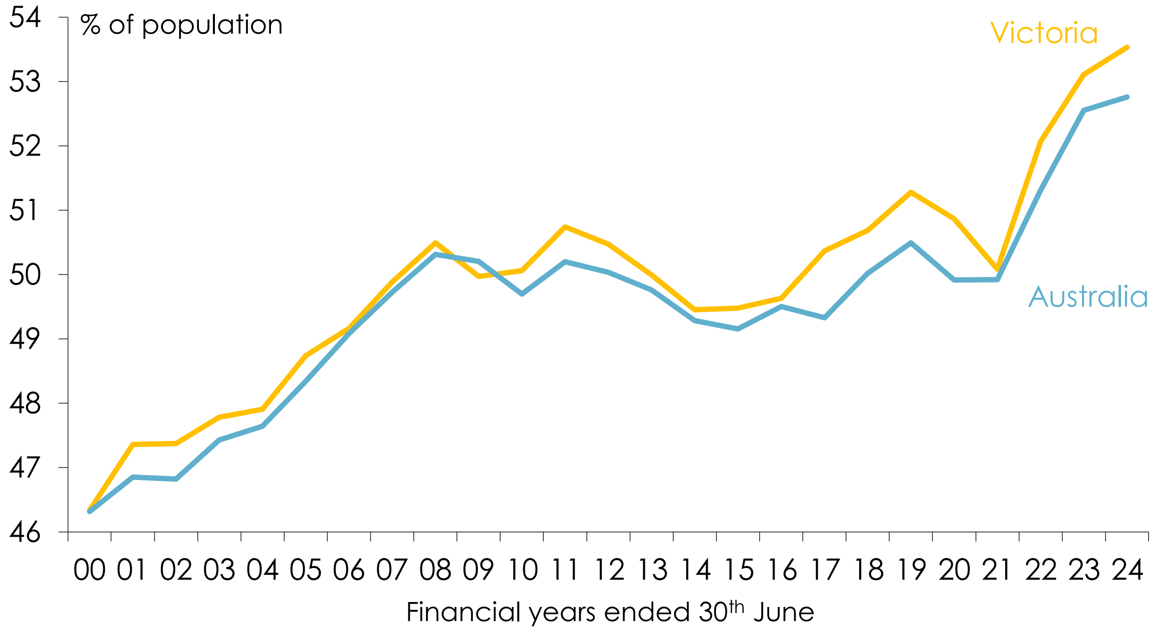


Source: ABS, *Australian National Accounts: State Accounts*, 2023-24.

The reasons for the decline in Victoria's relative economic position can be readily identified using the same "three Ps" (population, participation and productivity" framework as has been used in the Intergenerational Reports prepared and published by the Federal Treasury since 2001.

Victoria's relative decline hasn't been because a smaller proportion of its population is working. On the contrary, the percentage of Victorians who are employed has risen by more than the national average so far this century, and in 2023-24 exceeded the national average by 0.7 pc point (Chart 5).

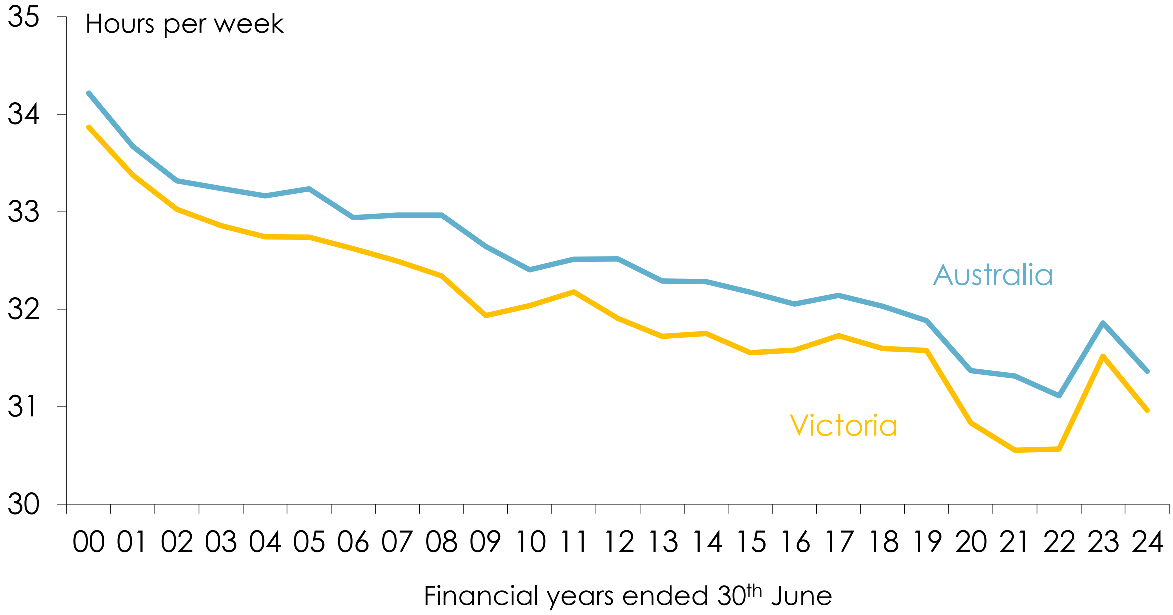
Chart 5: Employment as a percentage of population, Victoria and Australia



Source: ABS, *Labour Force, Australia*, September 2024.

Nor is it the result of a greater decline in average hours worked by Victorians than by other Australians. Although Victorians do work fewer hours than other Australians, on average, the difference hasn't materially changed over the past 24 years (Chart 6).

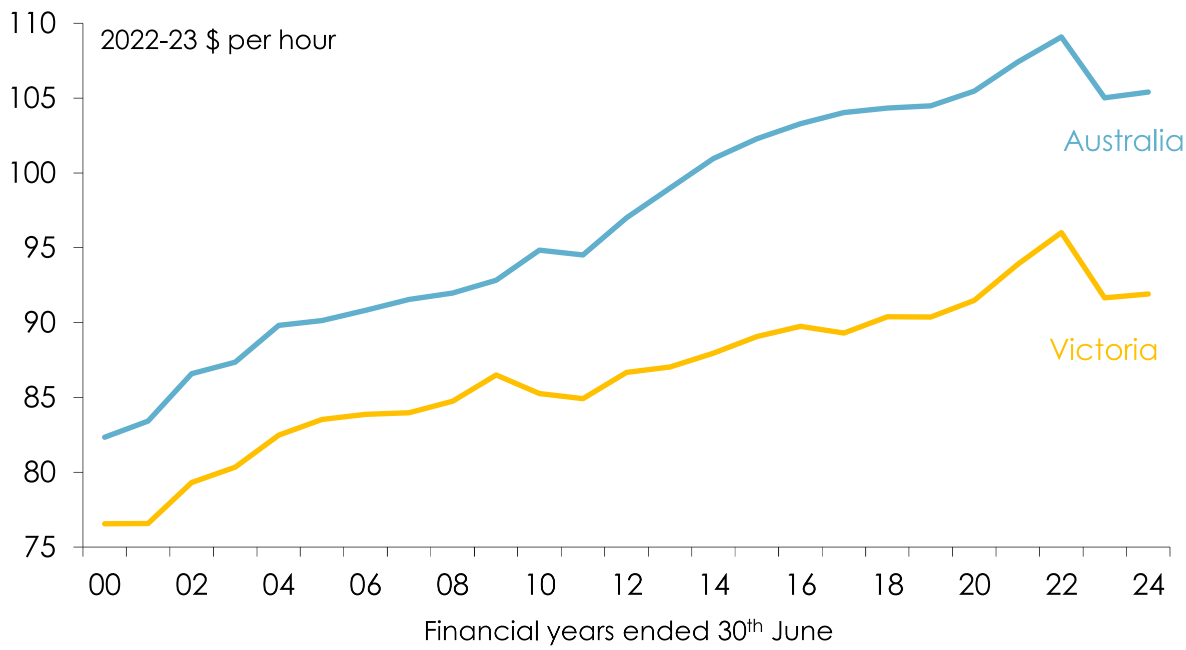
Chart 6: Average hours worked, Victoria and Australia



Source: ABS, *Labour Force, Australia, Detailed*, August 2024.

Rather, the decline in Victoria's economic standing, relative to other states and territories, is entirely the result of a cellar-dwelling productivity performance. Since the turn of the century, labour productivity in Victoria has risen at an average annual rate of 0.8% per annum, the slowest of any state or territory, and well below the national average of 1.1% per annum (Chart 7).

Chart 7: Labour productivity, Victoria and Australia



Sources: ABS, *Australian National Accounts: State Accounts*, 2023-24, and *Labour Force, Australia, Detailed*, August 2024.

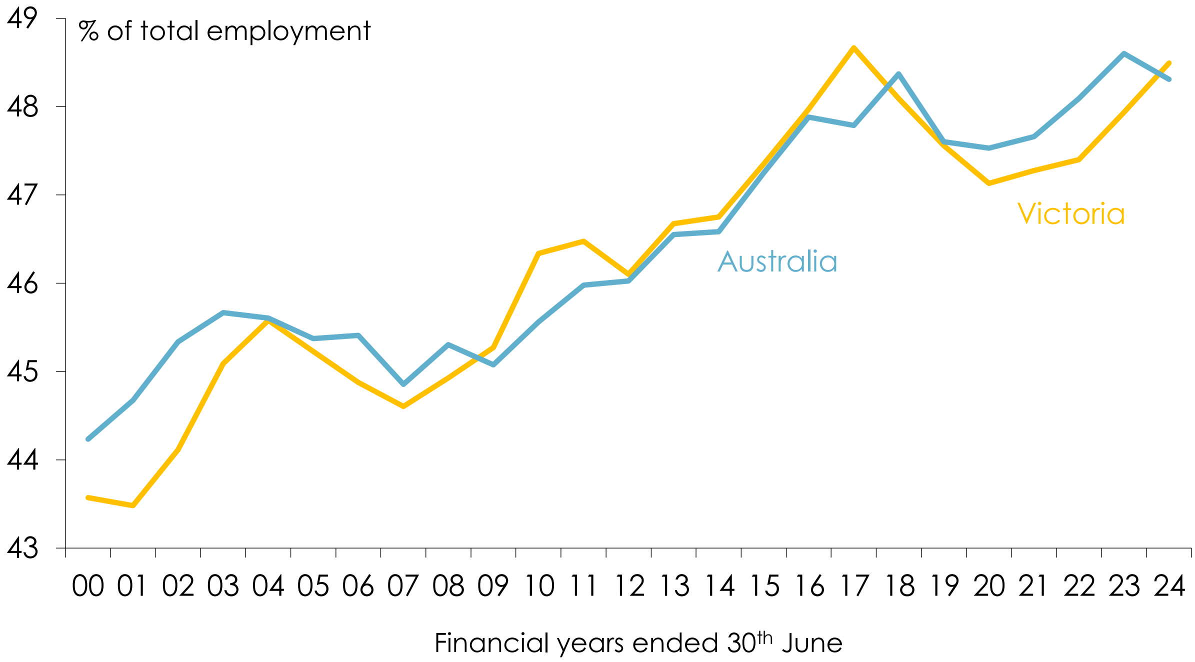
Victoria's labour productivity has fallen by 5.6 percentage points relative to the national average since 1999-2000.

There are two reasons why Victoria's labour productivity performance has been so poor, relative to the rest of Australia, since the turn of the century.

First, in 13 of the 19 sectors into which the ABS divides the Australian and each state and territory economy, labour productivity has grown more slowly in Victoria than the national average.

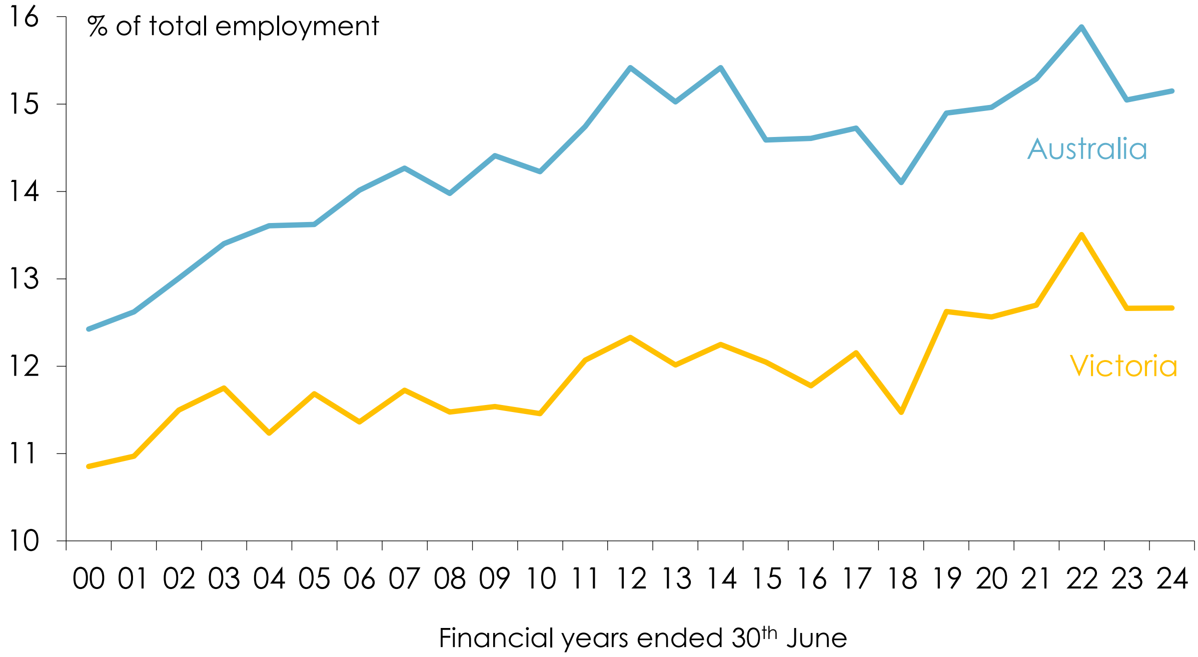
Second, the share of employment in intrinsically labour-intensive, and hence low-productivity, industries (retail trade, accommodation and food services, administration and support services, education and training, health care and social assistance, art and recreation services, and other services) has risen by relatively more in Victoria (4.9 percentage points) over the past 24 years than in Australia as a whole (4.1 percentage points); whereas the share of employment in intrinsically high-productivity industries (mining, financial and insurance services, utilities, rental, hiring and real estate services, and public administration and safety) has risen by less in Victoria (1.8 percentage points) than in Australia as a whole (2.7 percentage points) (Charts 8 and 9).

Chart 8: Employment in intrinsically low-productivity sectors as a share of total employment, Victoria and Australia



Note: 'Intrinsically low-productivity sectors' are retail trade, accommodation and food services, administration and support services, education and training, health care and social assistance, art and recreation services, and other services. *Sources:* ABS, *Australian National Accounts: State Accounts*, 2023-24, and *Labour Force, Australia, Detailed*, August 2024.

Chart 9: Employment in intrinsically high-productivity sectors as a share of total employment, Victoria and Australia



Note: 'Intrinsically high-productivity sectors' are mining, financial and insurance services, utilities, rental, hiring and real estate services, and public administration and safety. *Sources:* ABS, *Australian National Accounts: State Accounts*, 2023-24, and *Labour Force, Australia, Detailed*, August 2024.

There's not a lot that Victoria can do about not having been as blessed by nature with large deposits of valuable mineral resources as Western Australia (or having already exploited the ones which it did have). But Victoria clearly needs to find ways of fostering investment and employment in other high-productivity industries, and of encouraging faster productivity growth in the industries (both high- and low-productivity) which it does have.

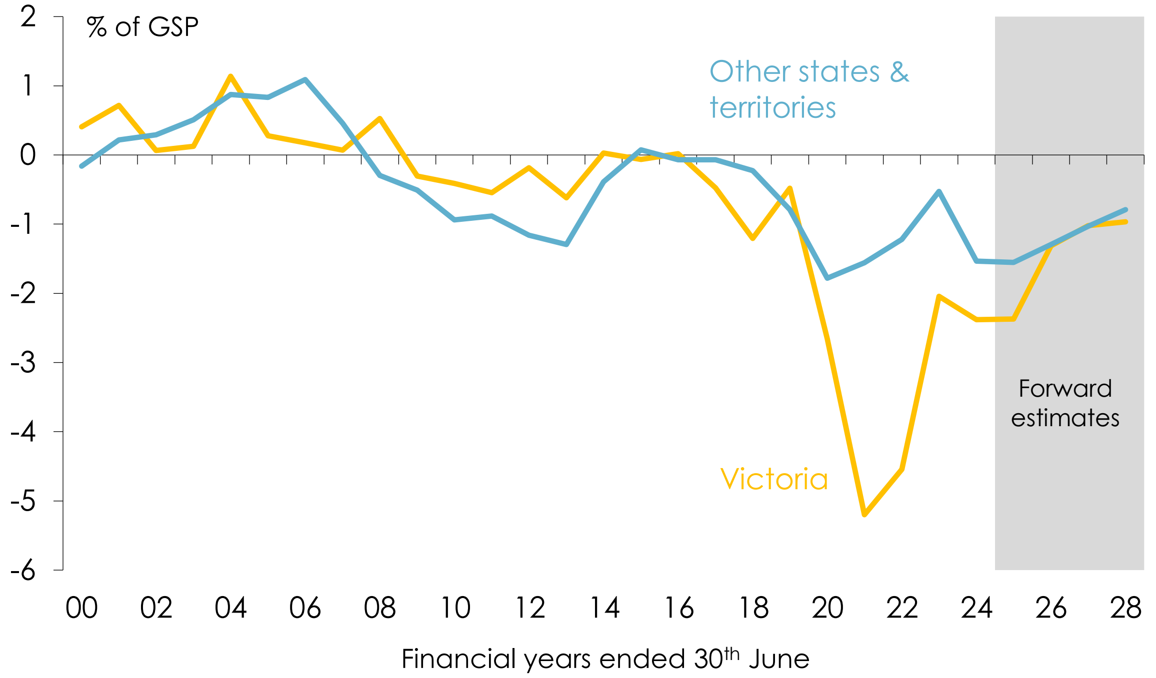
Victoria has made a mess of its public finances

One of the darkest clouds on Victoria's economic horizon is the seeming inevitability that a future State Government will need to undertake some combination of swingeing expenditure cuts and tax increases in order to put its finances onto a sustainable trajectory.

Under Labor's Steve Bracks and John Brumby, Victoria's 'general government' sector ran cash surpluses up until the onset of the global financial crisis. But over the past decade, under Dan Andrews, Jacinta Allan and Tim Pallas, Victoria's general government sector has incurred cash deficits totalling $97 billion. That's equivalent to 1.9% of Victoria's gross state product over this period – more than double the corresponding figure for all the other states and territories, of 0.8% of GSP (Chart 10).

Over the next four years, Victoria plans to run cash deficits totalling a further $39 billion, equivalent to 1.4% of forecast GSP over this period, compared with deficits equivalent to 1.2% of GSP in the other states and territories.

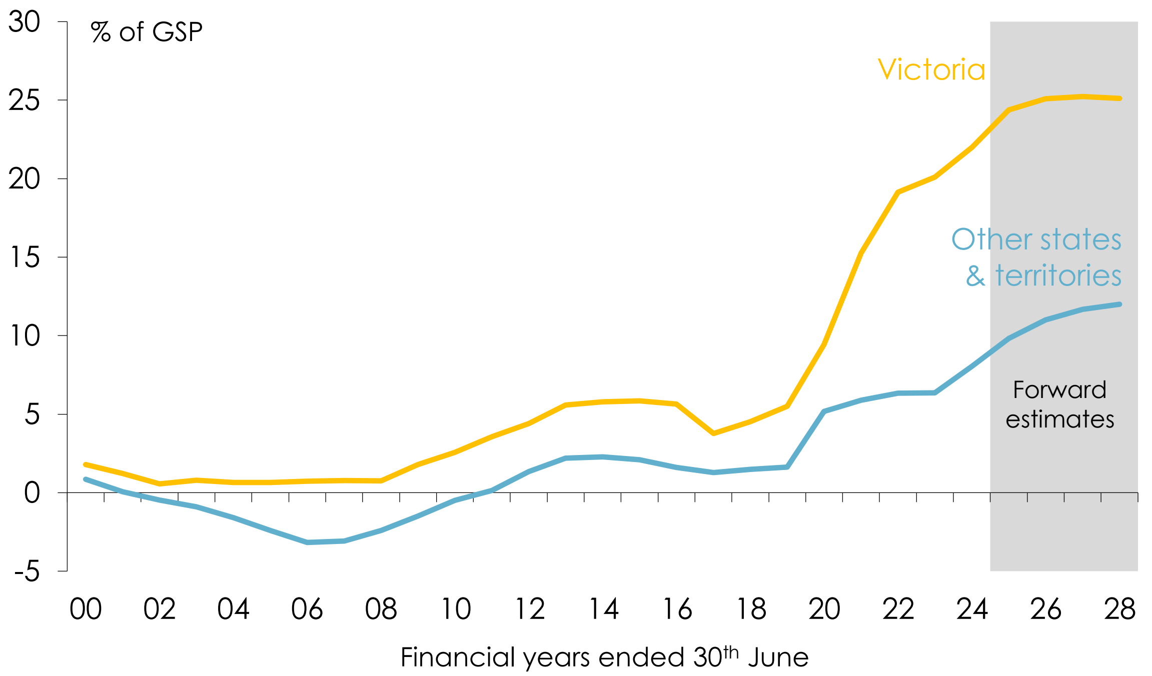
Chart 10: General government cash balances, Victoria vs other states and territories



Sources: State and territory annual financial reports and Budget Papers; ABS, *Australian National Accounts: State Accounts*, 2023-24.

As a result of having run persistently larger cash deficits over the past decade than any other state or territory, Victoria has run up the highest level of general government sector net debt of any state or territory, relative to the size of its economy (Chart 11).

Chart 11: General government net debt, Victoria vs other states and territories



Sources: State and territory annual financial reports and Budget Papers; ABS, *Australian National Accounts: State Accounts*, 2023-24.

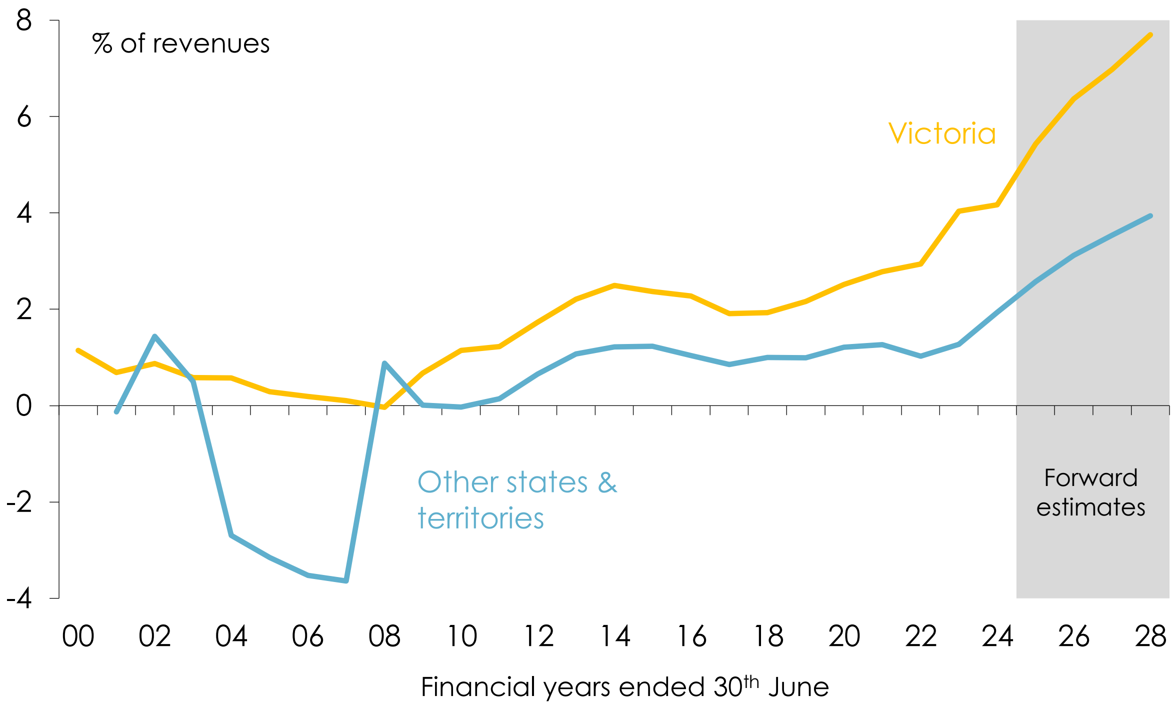
Indeed as a proportion of gross state product, Victoria's general government sector net debt is 5½ percentage points higher than it was in the early 1990s, in the aftermath of the Cain-Kirner debt binge. Much of that debt was paid off through the Kennett Government's privatisation program, which raised around $28 billion. That option is no longer available.

As a result of having run up so much debt over the past decade, net interest payments accounted for 4.2 cents of every dollar of Victorian Government revenue in 2023-24, compared with 1.9 cents of every dollar of other state and territory governments' revenue. And on current forward estimates, that's set to rise to 7.7 cents out of every dollar of Victorian Government revenue by 2027-28, compared with 3.9 cents in every dollar of revenue for the other seven state and territory governments (Chart 12).

Victoria finds itself in this fiscal pickle because, for the past decade, it has consistently spent more than it has collected in revenue, either from its own sources (in particular, state taxes) or from grants from the Federal Government (including its share of GST revenues).

Operating expenses – that is, the ongoing cost of providing government services (of which the largest component is wages and salaries of public sector employees) and running government operations – have risen at an average annual rate of 6.8% over the past decade. That's faster than for any other jurisdiction except Tasmania, and half a percentage point above the average for all states and territories.

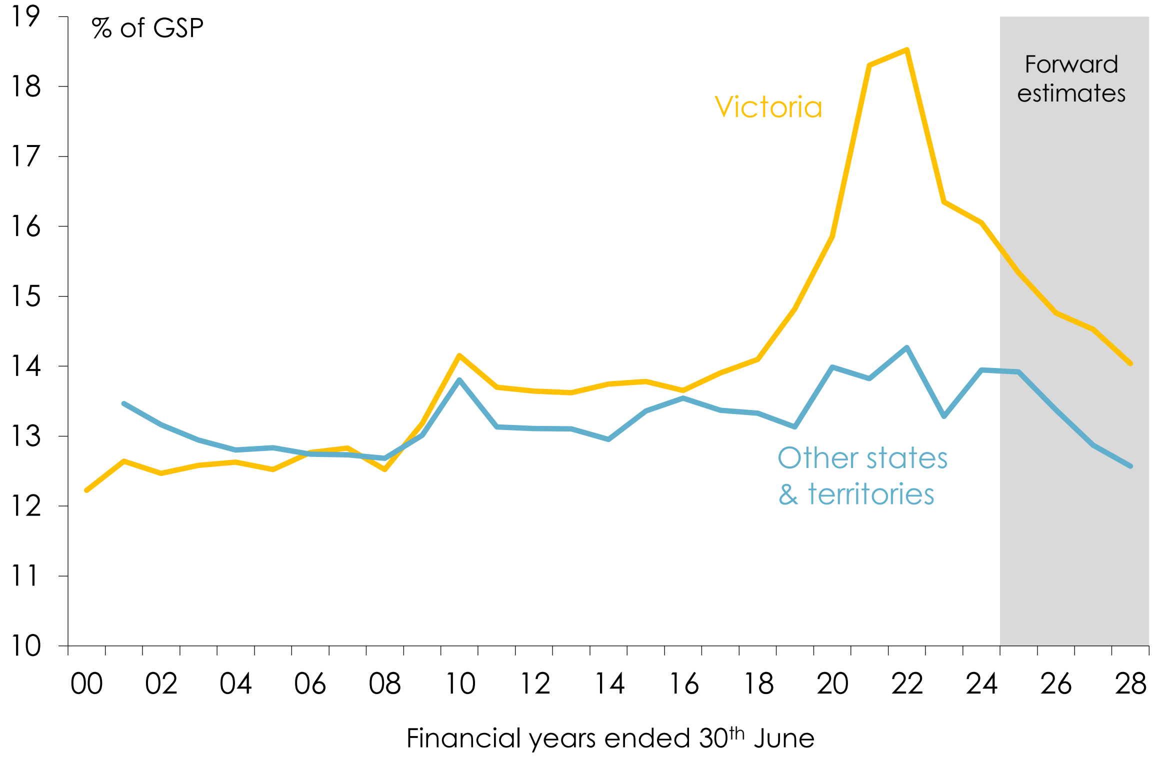
Chart 12: General government net interest payments, Victoria vs other states and territories



Sources: State and territory annual financial reports and Budget Papers.

Over the past decade, Victoria's general government operating expenses have average almost 2 percentage points of GSP higher than the average for the other seven states and territories – a margin which blew out to 4½ percentage points during the pandemic – and which is still expected to average 1½ percentage points of GSP over the next four years (Chart 13).

Chart 13: General government operating expenses, Victoria vs other states and territories



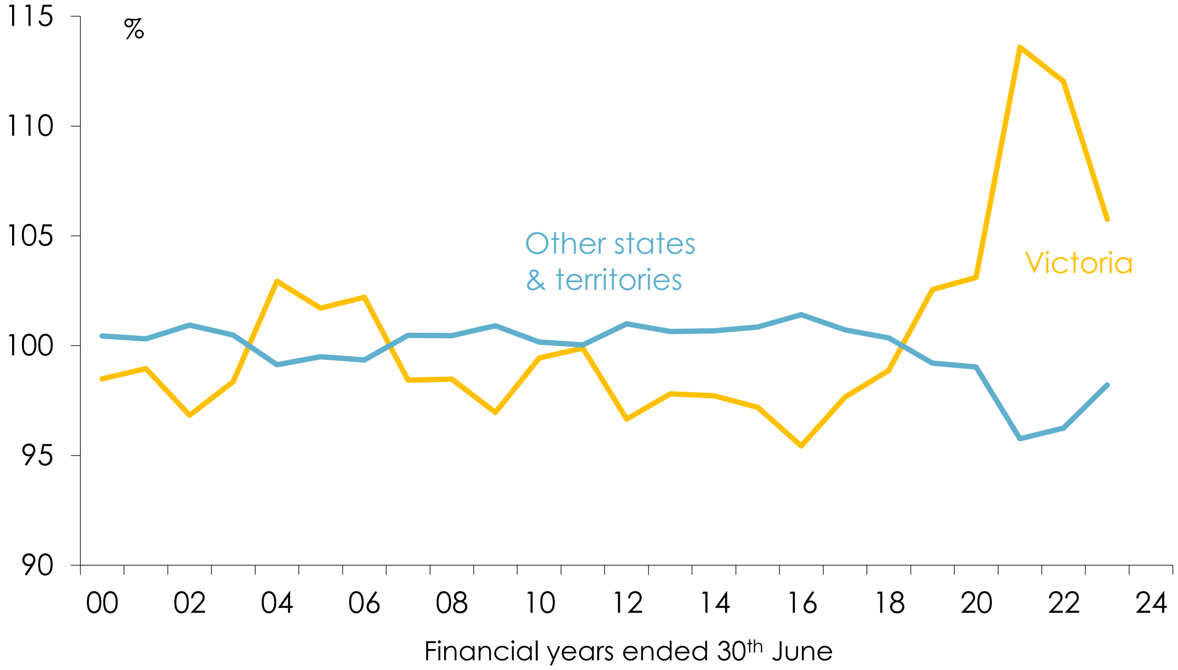
Sources: State and territory annual financial reports and Budget Papers; ABS, *Australian National Accounts: State Accounts*, 2023-24.

Since the 2018-19 financial year, Victoria has spent an average of 7.4% more than the Commonwealth Grants Commission's annual assessments (undertaken as part of its determinations of each state and territory's share of revenue from the GST) of what it has needed to spend in order to provide the same range and quality of services, with the same level of efficiency, as the average of all states and territories (Chart 14).

Victoria's level of 'over-spending', relative to the Grants Commission's benchmarks, was higher than for any other jurisdiction except the ACT (which undertakes functions which are the responsibility of local governments in the states).

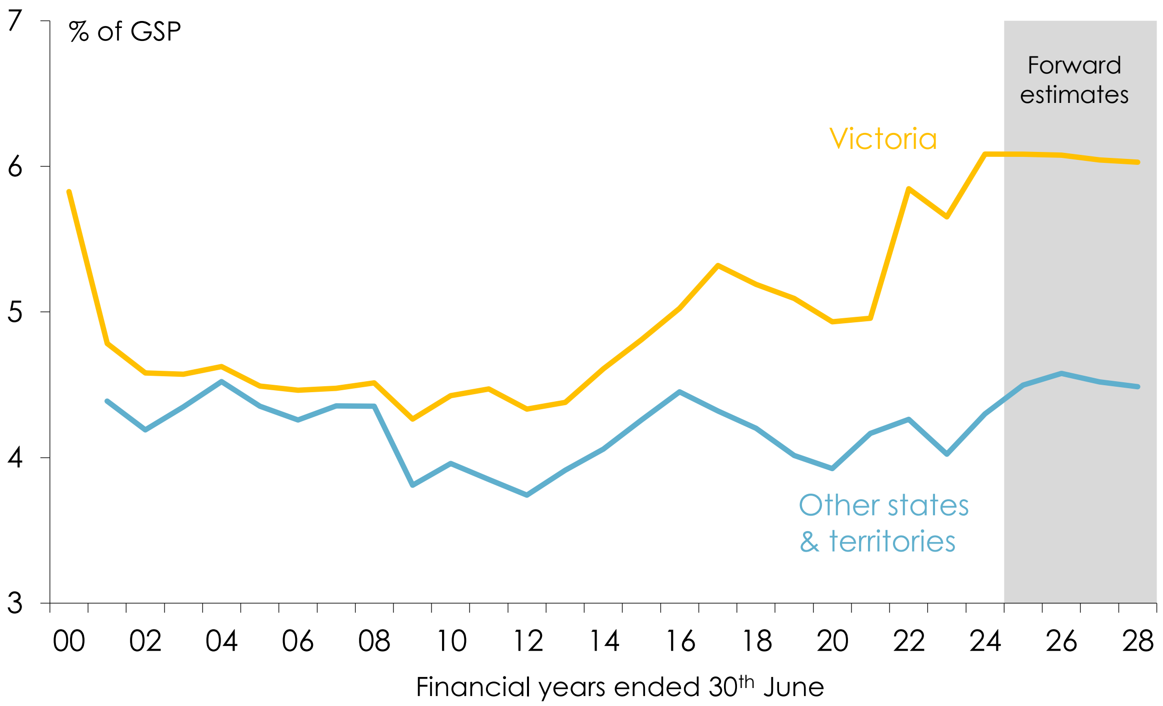
Under former Labor Premiers Steve Bracks and John Brumby, Victoria's state taxation revenue was, as a proportion of gross state product, in line with the average of other states and territories. But over the past decade, it has averaged over 1 percentage point more of GSP than the average of the other states and territories, with that gap widening to 1.8 percentage points of GDP in 2023-24 (Chart 15).

Chart 14: 'Level of service provision ratios', Victoria vs other states and territories



Note: The 'level of service provision ratio' is the ratio of actual operating expenses to the level of expenses assessed by the Commonwealth Grants Commission as being required to provide a level of services equivalent to the average of all states and territories, after taking account of difference in the 'need' for various types of services and the cost per head of providing them. *Source:* Commonwealth Grants Commission, Reports for Government, 2024 and previous years.

Chart 15: State taxation revenue, Victoria vs other states and territories



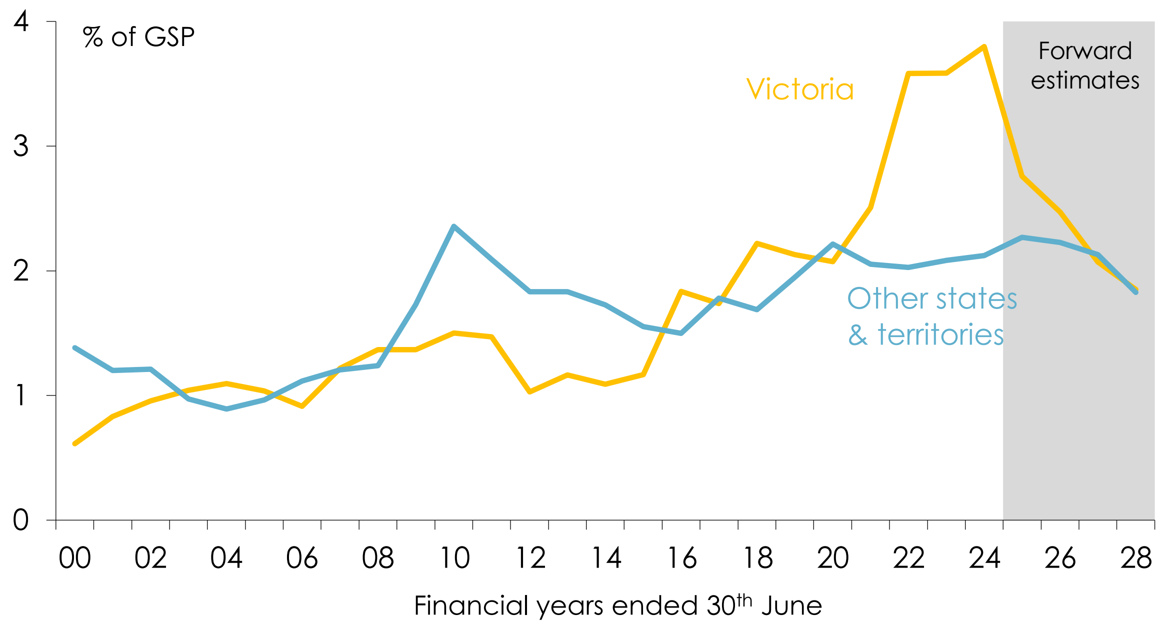
Sources: State and territory annual financial reports and Budget Papers; ABS, *Australian National Accounts: State Accounts*, 2023-24.

Over the next four years, state taxation is projected to absorb 6.1% of Victoria's GSP, compared with 4.5% of the GSP of the other seven states and territories. And that's despite the fact that Victoria is currently projected to receive a higher share of revenue from the GST over the next four years than it ever has previously.

In addition to spending more than the other states and territories on 'operating' expenses, Victoria has also run a relatively larger infrastructure investment program than other jurisdictions.

Victoria's 'general government' purchases of non-financial assets have averaged 2.5% of GSP over the past decade, as against 1.9% of GSP for the seven other states and territories, and will continue to be larger by this benchmark than for the rest of Australia over the next four years (Chart 16).

Chart 16: General government purchases of non-financial assets, Victoria vs other states and territories



Sources: State and territory annual financial reports and Budget Papers; ABS, *Australian National Accounts: State Accounts*, 2023-24.

Victoria has the lowest credit rating of any state or territory from one of the major credit rating agencies and the equal second lowest (ahead of only the Northern Territory) from the other. Although both agencies say that their ratings of Victoria are 'stable', S&P have observed that Victoria's financial management practices are "lagging those of many highly rated domestic and international peers", while more recently Moody's have warned that "interest payments in excess of 8.5% of operating revenue" – a figure which Victoria will reach in 2027-28, on current forward estimates, when its GBEs are included - "may be inconsistent with a rating at its current level".

While a further credit rating downgrade wouldn't be the end of the world, it would almost certainly imply higher interest rates on new debt, and would probably also represent a further blow to business, consumer and investor confidence in Victoria.

Since Victoria no longer has assets to sell in order to pay down debt – even if there were the political will to do so (which there isn't) – at some point, possibly under a different Government, Victorians seem bound to face a combination of cuts in government spending and increases in taxation. The latter has already started to happen – state tax revenue has risen by 56% in Victoria over the past three years, compared with 33% in the rest of Australia. And if a meaningful start on the former doesn't happen soon, there's bound to be even more increases in state taxes.