Strategy and Outlook

Budget Paper No. 2

0809

Presented by John Lenders MP
Treasurer of the State of Victoria
on the occasion of the Budget 2008-09





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2008-09

Presented by

John Lenders, M.P.

Treasurer of the State of Victoria

for the information of Honourable Members

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INTRODUCTION

Budget Paper No. 2, *Strategy and Outlook*, describes the state's current economic and financial position and outlook. It shows how the state's fiscal strategy is to use operating surpluses to underwrite increased investment in productive infrastructure to support key services. It also shows how the government's economic reform agenda will meet the challenges to Victoria's ongoing economic prosperity.

MACHINERY OF GOVERNMENT CHANGES – DEPARTMENT OF TRANSPORT

The government recently announced the creation of a new Department of Transport which takes over responsibility for most of the functions of the former Department of Infrastructure. However, certain functions, in particular relating to Major Projects Victoria, have been transferred to the Department of Innovation, Industry and Regional Development. The new administrative arrangements came into effect on 30 April 2008 through Administrative Arrangements Order No. 199 of 2008. For financial reporting purposes, these transfers do not take effect until after the end of the current financial year 2007-08.

There is no net impact of these changes on the aggregate budget, however the full impact of these changes on the 2008-09 departmental estimates is yet to be quantified. Therefore, this machinery of government change has not been reflected in the 2008-09 Budget Papers. Any consequent adjustments to the departmental estimates and re-allocation of appropriations will be made at a later date.

Budget Paper No. 2 consists of the following chapters and appendices.

CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

Chapter 1 focuses on the government's five financial policy objectives and strategies, which embody the principles of sound financial management.

The chapter provides a rational for, and progress against, each objective, along with a discussion as how the initiatives in the 2008-09 Budget will contribute towards the achievement of these goals.

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

Chapter 2 provides an overview of the current economic conditions in Victoria in the context of the international and Australian economic environment. It provides a detailed discussion on the projected economic trends in the key measures of economic growth: gross state product, employment, unemployment rate, inflation, wages and population. The chapter also details the key risks and challenges to the Victorian economy.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

Chapter 3 outlines the general government (GG) current budget position and the future outlook. It shows how the government's financial policy objectives and strategies, discussed in Chapter 1, will impact on the GG sector's financial performance and position in the context of the economic environment, as discussed in Chapter 2.

The chapter includes a summary of the forecast movement in key financial aggregates across the forward estimates, along with the major factors behind these movements. Further, this chapter discusses the financial assumptions underpinning the financial projections and comments as to their sensitivity to fiscal risks.

CHAPTER 4 – FISCAL SUSTAINABILITY OF THE STATE

Chapter 4 presents the financial performance of the broader public sector, through the addition of the state's public non-financial corporations (PNFCs) to the GG sector's financial information, as presented in Chapter 3.

The PNFC sector is comprised by government entities that are not funded by government resources, but rather operate in a cost-recovery manner in the provision of goods and services to the public.

CHAPTER 5 – ECONOMIC REFORM AGENDA

Chapter 5 summarises the government's economic reform program, the objective of which is to foster economic growth for the state.

The chapter provides a brief overview of what reforms have been implemented by the government, and their outcomes. It then moves to the strategies government will employ to meet the challenges to economic growth. An important aspect of economic reform that is detailed in this chapter is the relationship of reforms to intergovernmental relations and how Victoria is doing its part in the implementation of national reforms.

APPENDIX A – OPERATING STATEMENT RECONCILIATION

Appendix A reconciles the movement in the state's financial estimates over the three years from 2008-09 to 2010-11 from when they were published in the *2007-08 Budget Update* to the estimates published in the 2008-09 Budget. As part of this reconciliation, explanations are provided on the key elements driving the movements in estimates.

APPENDIX B – SENSITIVITY ANALYSIS TABLE

Appendix B details the economic indicators and assumptions underpinning the forward estimates and illustrates the impact that changes to these assumptions will have on the state's budget position.

CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

- Victoria's good fiscal outcomes in recent years have contributed to the strength of the economy, enabling the government to provide more services and to deliver new asset investment projects, while maintaining Victoria's strong fiscal position. In response to an increasingly uncertain economic environment, the Victorian Government remains committed to ongoing economic reform to maintain the prosperity of current and future generations.
- The government has changed its short-term operating surplus target from at least $100 million to at least 1 per cent of revenue each year, ensuring the surplus target grows in line with revenue. It will also allow the government to fund its substantial infrastructure program and continue to provide services to the Victorian community, while maintaining prudent levels of debt.
- In the 2008-09 Budget, the government is forecasting an operating surplus of $828 million in 2008-09 and an average of $907 million a year over the forward estimates.
- The budget period provides net funding for new output initiatives of $182 million in 2008-09, and an average $127 million each year over the forward estimates period. This is in addition to the net funding provided in the *2007-08 Budget Update* of $83 million a year on average from 2008-09 to 2010-11.
- The increased operating surpluses will enable the government to continue significant investment in infrastructure, maximising economic, social and environmental benefits for all Victorians. This budget provides funding for new asset projects with a total estimated investment (TEI) of $3.2 billion. This is in addition to $1.1 billion TEI provided for infrastructure investment in the *2007-08 Budget Update*.
- The 2008-09 Budget includes tax reforms, worth over $1 billion over the forward estimates, which build on earlier reforms and will maintain Victoria's tax competitiveness. The cost burden on Victorian businesses is further reduced by the fifth consecutive cut to WorkCover insurance premiums from 1 July 2008.
- The government has continued to maintain a AAA credit rating. By implementing sound fiscal strategies, the government is able to keep net financial liabilities at modest and sustainable levels.

FINANCIAL STRATEGY, OBJECTIVES AND PRIORITIES

This chapter sets out the Victorian Government's financial policy objectives and strategies as required by the *Financial Management Act 1994* (the Act). The financial policies and objectives are built on the following principles of sound financial management, which are set out in the Act:

- manage financial risks faced by the state prudently, having regard to economic circumstances;
- pursue spending and taxing policies consistent with a reasonable degree of stability and predictability in the level of the tax burden;
- maintain the integrity of the Victorian tax system;
- ensure that government policy decisions have regard to their financial effects on future generations; and
- provide full, accurate and timely disclosure of financial information relating to the activities of the government and its agencies.

With the broad strategic priority of promoting sustainable growth across the whole state on a sound and stable financial basis, the government will continue to deliver world-class infrastructure to drive economic growth and improve quality, access and equity in key services to all Victorians, while maintaining a sound financial position.

The government's short-term and long-term financial objectives and targets are summarised in Table 1.1 below. The rationale for, and progress against, each of the five objectives is discussed in the following sections of this chapter, including how the 2008-09 Budget will continue to support the achievement of the objectives.

Table 1.1: 2008-09 Financial objectives and strategies

Objective	*Short-term target*	*Long-term target*
Operating surplus	At least 1 per cent of revenue in each year	Maintain a substantial budget operating surplus that allows for the delivery of the government's infrastructure objectives
Infrastructure	Implement strategic infrastructure projects	Deliver world-class infrastructure to maximise economic, social and environmental benefits
Service delivery	Implement the 2006 election commitments	Provide improved service delivery to all Victorians
Taxation	Implement reforms	Provide a fair and efficient tax system that is competitive with other States
Net financial liabilities	Maintain a AAA credit rating	Maintain State government net financial liabilities at prudent levels

Source: Department of Treasury and Finance

OBJECTIVE ONE: OPERATING SURPLUS

The Victorian Government's good fiscal outcomes in recent years have contributed to the strength of the economy. Importantly, these fiscal outcomes have ensured that the operating surpluses delivered by the government are strong and have enabled the delivery of important services and the provision of key infrastructure, while keeping finances in a solid position.

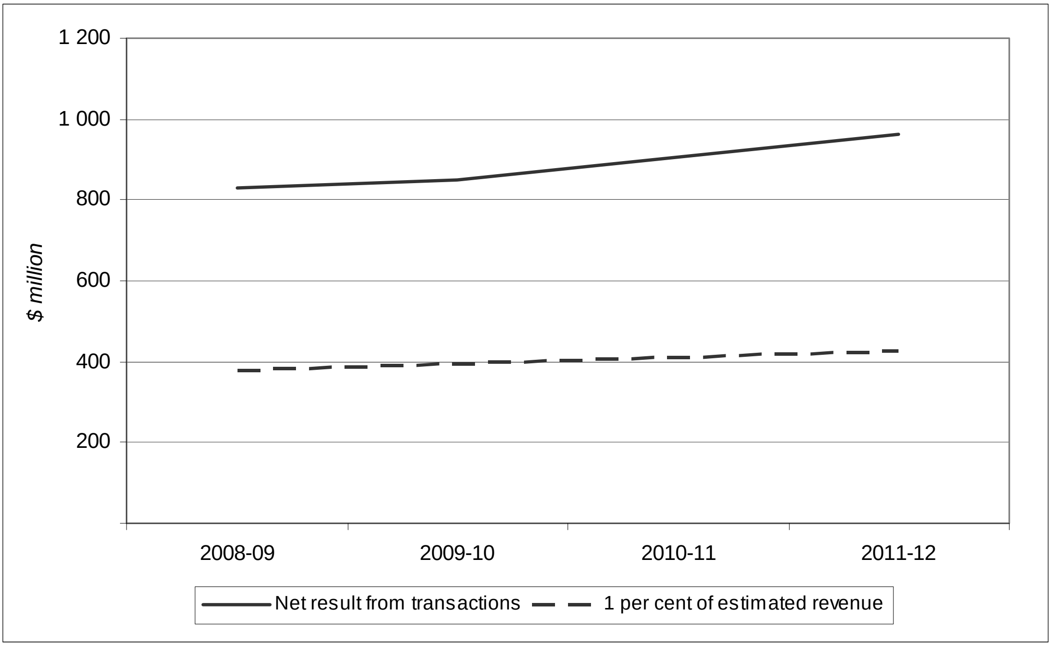
In 1999, when the government came into office, it set itself an operating surplus target of at least $100 million in each year, which at the time represented just under 0.5 per cent of revenue. In 2008-09, a $100 million operating surplus target is forecast to represent 0.3 per cent of operating revenue, 0.2 percentage points below 1999-2000 levels.

The government has reassessed its operating target to ensure it remains relevant in the current fiscal environment. In this context, the government has set a new target of at least 1 per cent of revenue each year, which will allow the operating surplus target to grow in line with operating revenue. In 2008-09, 1 per cent of operating revenue is projected to be $378 million.

The government is forecasting an operating surplus of $828 million in 2008-09 and an average of $907 million a year over the forward estimates, significantly above the new target. The government's fiscal strategy is to maintain high surpluses that will enable current and future generations to benefit from further infrastructure investment, while continuing to maintain Victoria's AAA credit rating. The government's infrastructure investment is funded from surplus cash generated from operating activities and prudent levels of additional borrowing.

Chart 1.1 compares the forecast operating surplus with the government's new operating surplus target for the budget and forward years.

Chart 1.1: General government sector net result from transactions



Source: Department of Treasury and Finance

Alternative measures of operating performance

From the 2008-09 Budget, the new accounting standard issued by the Australian Accounting Standards Board in October 2007, AASB 1049 *Whole of Government and General Government Financial Reporting* will be implemented. Under this standard, the report for the general government sector must include key fiscal aggregates determined in a manner consistent with the Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS) manual. Consistent with the government's desire for continuous improvement, the implementation of this standard will further enhance the transparency and accountability of Victoria's resource management.

In addition to the operating surplus, the government also uses other financial results to measure its performance. Table 1.2 below presents these alternative measures.

Table 1.2: Alternative budget measures

($million)

	2008-09 Budget	*2009-10 Estimate*	*2010-11 Estimate*	*2011-12 Estimate*
Net operating balance/Net result from transactions	827.5	851.1	906.0	962.6
Net result	716.9	711.5	771.8	840.1
Net lending/(borrowing) [(a)]	(441.7)	(351.9)	(626.8)	(1 836.2)
Cash surplus/(deficit) [(b)]	10.2	(450.7)	(580.9)	(979.9)

Source: Department of Treasury and Finance

Notes:

(a) Net borrowing, or fiscal balance, includes net capital expenditure but excludes depreciation, thereby giving a measure of the state's call on financial markets. Net borrowing also equals net transactions in financial assets less net transactions in liabilities.

(b) Cash surplus/(deficit) equals the net cash flows from operating activities less investments in non-financial assets.

The *net operating balance* is the terminology used by the ABS and is equivalent to the net result from transactions. Both measures exclude the effects of revaluation (holding gains or losses) arising from changes in market prices and other changes in the volume of assets. The net operating balance/net result from transactions is now the basis for measuring the budget estimates on an accrual basis in all other Australian states and the Commonwealth, and provides comparability with these jurisdictions.

The *net result* is obtained by adding various revaluation gains and losses on assets and liabilities to the net result from transactions.

The *net lending/borrowing* is a GFS key fiscal aggregate and is equal to the net operating balance less net acquisitions of non-financial assets. Net borrowing represents, in broad terms, the extent to which the general government sector's net acquisition of physical assets has been funded by incurring liabilities to other sectors. As it takes into account total net spending on fixed assets, assets received free of charge and assets acquired under finance lease agreements during the period, rather than just the current year's expense, it is generally lower than the net operating balance/net result from transactions. The government has a net borrowing position of $442 million in 2008-09, and an average $938 million a year over the forward estimates, reflecting the financing of a portion of the substantial infrastructure investment. The magnitude of the net borrowings is appropriate in the context of the state's strong balance sheet.

The *cash surplus/deficit* result is equal to net cash flows from operating activities, less net cash investment in non-financial assets. Although both net borrowing and the cash surplus include the immediate impact of expenditure on fixed assets, the cash surplus removes non-cash revenues and expenses (including the superannuation interest cost and employee benefits, and assets received free of charge and assets acquired under finance lease) and allows for cash contributions made to the unfunded superannuation liability. The cash position is expected to be a $10 million surplus in 2008-09 and then to be in deficit by an average $671 million a year over the forward years. These cash deficits enable the government to invest in significant assets while maintaining net debt at prudent levels.

In summary, the net result from transactions and other measures of operating performance show that Victoria's financial performance remains sound.

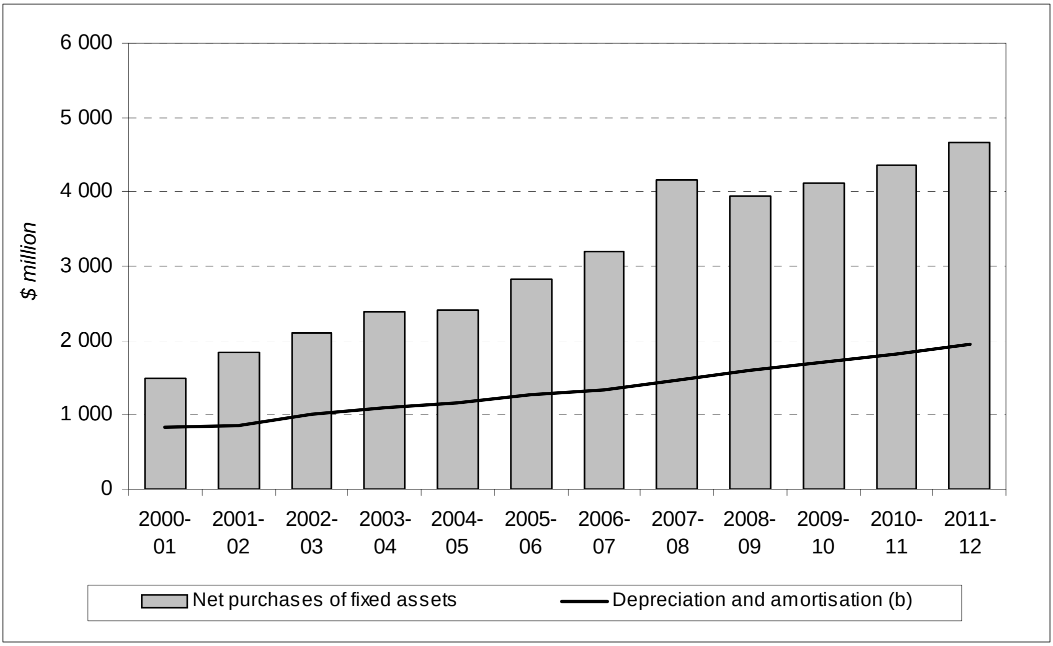
OBJECTIVE TWO: INFRASTRUCTURE

Victoria's growing population necessitates a greater ongoing investment in important infrastructure by the government. The provision of an effective infrastructure base is a key driver of economic growth as it facilitates the relief of congestion and the transportation of freight. It also supports the delivery of quality services and provides facilities that ensure the future development of the state. From 1999-2000 to 2006-07, the government has invested over $17 billion to the delivery of world-class infrastructure, representing an average investment of over $2.2 billion a year.

This substantial infrastructure investment is forecast to continue with a projected net investment of $4.0 billion in 2008-09. Net capital commitments over the forward estimates period, are currently expected to average $4.4 billion a year.

Chart 1.2 shows the growth in the net infrastructure investment by the general government sector since the beginning of the decade, together with projected net infrastructure investment to 2011-12.

Chart 1.2: General government sector net infrastructure investment[a]

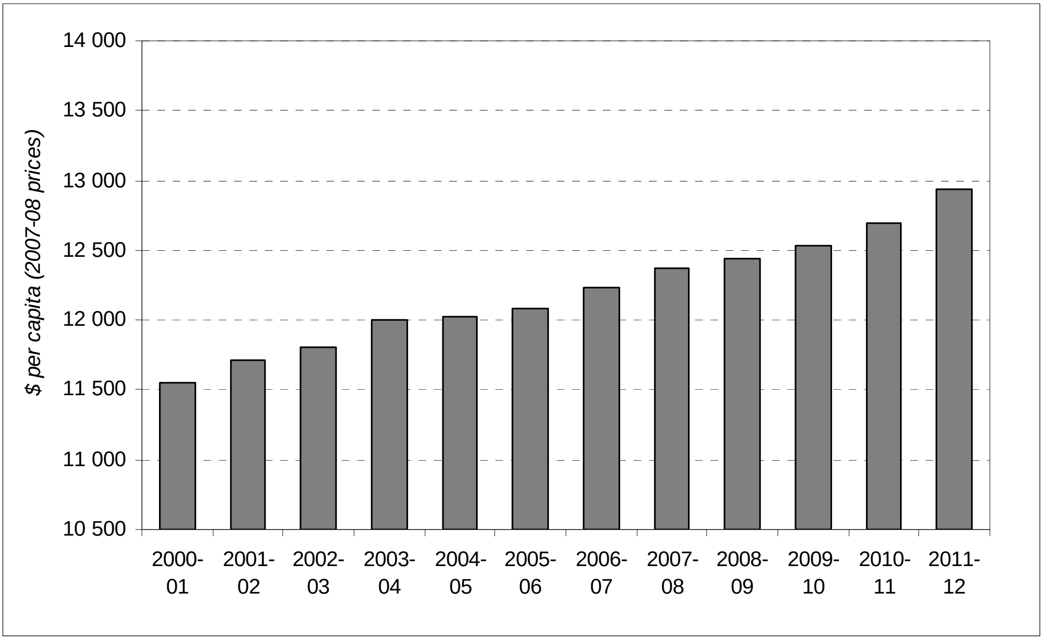


Source: Department of Treasury and Finance

Notes:
(a) *Includes purchases of property, plant and equipment and net contributions to other sectors of government less proceeds from sale of property, plant and equipment. The 2005-06 net investment figure excludes $600 million return of surplus TAC capital.*
(b) *Includes depreciation and amortisation of fixed assets within the general government sector only.*

Over the period 2008-09 to 2011-12, general government net infrastructure investment will exceed estimated depreciation by an average of around $2.5 billion a year, which translates to a 10.8 per cent growth in real capital stock over the four years to June 2012. As this growth rate is significantly more than the 6.0 per cent projected population growth over the same period, the average stock of public infrastructure for each Victorian will increase from $11 486 in 2000 to $12 936 by June 2012. This trend is illustrated in Chart 1.3.

Chart 1.3: General government sector real capital stock per capita as at 30 June[(a)]



Source: Department of Treasury and Finance

Note:
(a) Due to a change in methodology by including the revaluation of the capital stock, effective from the 2007-08 Budget, this chart is not directly comparable with similar charts shown in previous years.

To date, the state's strong fiscal position has enabled the government to significantly boost Victoria's capital assets. This is set to continue as the surpluses projected over the forward estimates will enable further substantial investment in infrastructure, while maintaining debt at prudent levels.

Around 64 per cent of the government's infrastructure program over the four years to 2011-12 will be funded by the cash generated from operating activities. The remainder of the infrastructure program will be funded by using the strength of the balance sheet.

The 2008-09 Budget provides funding for new asset investment projects with a TEI of $3.2 billion. This is in addition to $1.1 billion provided for infrastructure investment in the *2007-08 Budget Update*.

The 2008-09 Budget continues the government's commitment to investing in health, community and aged care facilities, to ensure more Victorians stay healthy and have access to quality care and treatment.

Substantial investment funding has also been allocated to a range of projects that will upgrade and expand the rail and road network in metropolitan and regional Victoria. These projects will contribute towards the provision of efficient and safe transport connections across the state and will address increased transportation demands.

In addition, the 2008-09 Budget includes substantial infrastructure funding allocated towards the modernisation, regeneration and replacement of government schools across Victoria, including in provincial areas. This investment, together with other education service initiatives, will improve educational outcomes for the state.

A comprehensive discussion of the impact of asset investments on the state's balance sheet is included in Chapter 3, *Budget Position and Outlook.*

Further discussion on major infrastructure projects is provided in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*. Information on the initiatives listed above, and all the asset initiatives committed to since the *2007-08 Budget Update*, can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

OBJECTIVE THREE: SERVICE DELIVERY

The government remains committed to improving the quality, access and equity of services that are important to all Victorians.

Victoria continues to pursue a program of state-based reform in key areas, including infrastructure and business competitiveness. To meet future challenges to economic growth, investments have also been made in initiatives that respond to climate change and ensure water security. A description of the government's wider reform agenda can be found in Chapter 5, *Economic Reform Agenda*.

The Victorian Government has now delivered, or commenced the delivery of, all its 2006 election output commitments and made further substantial progress towards its asset commitments. Funding provided in the 2008-09 Budget is aimed at ensuring significant progress is made towards achieving the goals in *Growing Victoria Together*. This investment will build on successes to date, including:

- in 2006, Victoria was at or above the national average against the benchmark level for reading, writing and numeracy for years 3 and 5 and had a higher result than any other state or territory in year 3 and year 5 writing, and equal highest in year 5 numeracy. In 2003 the government achieved its target of reducing average Prep to year 2 class sizes to 21 students from 24.3 in 1999. Since then, this has been further reduced to 20.7;
- as a result of the government's investment in health and community services, between 1999-2000 and 2007-08, over 300 000 additional hospital patients are now being treated each year, hospitals are employing 8 000 more nurses and 1 800 more doctors, and more assistance is being provided to people with a disability. Over the same period, the government has boosted hospital funding by $3.3 billion;
- implementation of significant improvements in the public transport system, including the completion of the Regional Fast Rail project and Southern Cross Station. In 2006-07, there was an increase of 14.5 per cent in the number of regional rail services. In the year up to 2006-07, regional rail patronage increased by 31.7 per cent; and

- significant investments have been made since 2003-04 which have addressed disadvantage and created opportunity, with 41 new children's centres delivering a range of children's services. Victorian immunisation rates for children have increased steadily since 1999, and in 2007 Victoria was the only state in Australia to achieve greater than 90 per cent in all 3 age cohorts for each quarter.

In order to deliver on the government's service delivery objectives, the 2008-09 Budget provides net funding for new output initiatives of $202 million in 2008-09, and an average $143 million each year over the forward estimates. This is addition to the net funding provided in the *2007-08 Budget Update* of $83 million a year on average from 2008-09 to 2010-11.

This budget boosts investment in maternal and child health and improves education services, which will enable Victorian children to get the best start in life as well as provide key services that families need. Support is also provided towards the continued growth of provincial communities, with a strong focus being placed on reshaping and strengthening services and assistance for farmers and rural communities.

Funding has also been allocated to increase the level of assistance provided for vulnerable Victorians and their families, which will further strengthen communities and address disadvantage. The government will also boost public transport services in outer urban and regional areas to improve access to workplaces and services, relieving social isolation.

A discussion of the service delivery initiatives is provided in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*. Information on the initiatives listed above, and the output initiatives committed to since the *2007-08 Budget Update*, can be found in Budget Paper No. 3, Appendix A, *Output*, *Asset Investment and Revenue Initiatives*.

OBJECTIVE FOUR: TAXATION

The government will continue to implement a range of tax reforms to provide a fair and efficient tax system that is competitive with other states. Victoria's competitiveness and productivity growth depend upon reforms and initiatives that reduce the cost of doing business and support business innovation and competition.

Since 1999, the government has shown leadership in tax reform through the implementation of a range of initiatives, including being the first State to abolish all inter-governmental agreement taxes. Together, these reforms have resulted in over $4.5 billion worth of tax cuts. These have been included in *Better Business Taxes* (April 2001), *Building Tomorrow's Business Today* (April 2002) and the government's Economic Statement, *Victoria: Leading the Way* (April 2004), as well as in individual budget initiatives.

These reforms have enabled the government to meet its aim of ensuring Victoria's taxes are competitive with the national average. Along with tax relief, businesses have also benefited from significant reductions in WorkCover insurance premiums.

The 2008-09 Budget will provide further tax relief for business, including new reductions to payroll tax, land tax and stamp duty on land transfers, as well as the provision of targeted exemptions to land tax and stamp duty on land transfers.

In addition to the changes made to the taxation system, the government has also extended the First Home Bonus by $3 000 for newly constructed homes in rural and regional Victoria. This is designed to support population growth and will make regional Victoria a more attractive place for young families to buy their first home. It will also have the added benefits of boosting construction and employment in the regions. This brings the first home assistance for newly constructed first home purchases in regional areas to $15 000.

These new taxation initiatives will provide tax relief to Victorian taxpayers of more than $1 billion over four years, including further targeted assistance for first home buyers and enhanced stamp duty on land transfer concessions for pensioners. These reforms take the total value of tax cuts announced by the government since 1999 to over $5.5 billion and will ensure Victoria's taxes on business remain competitive with that of other States.

The 2008-09 reforms ensure Victoria's land tax and payroll tax rates compare favourably with those of the other States. Victorian businesses effectively pay the second-lowest land tax for landholdings valued between $0.4 million and $5.7 million and the lowest payroll tax for payrolls valued between $4.0 million and $13.5 million.

Further information on tax reforms and initiatives can be found in Chapter 3, *Budget Position and Outlook* and Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

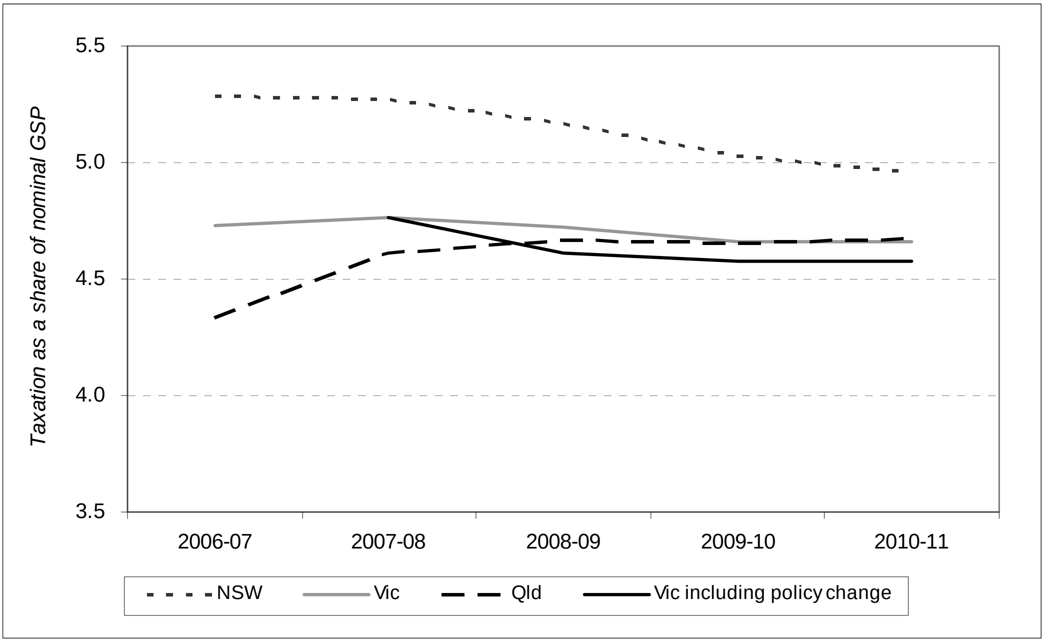
Tax competitiveness

Victoria's tax regime is competitive against the national average despite not receiving its full per capita share of GST revenue and other grants from the Commonwealth. Tax competitiveness is measured as taxation revenue as a share of nominal gross state product (GSP). This measure aligns the level of state taxation to economic capacity.

Chart 1.4 provides a comparison of Victoria's taxation competitiveness with New South Wales (NSW) and Queensland based on estimates, published at a similar time, in the *2007-08 Budget Update* (or equivalent publication) of these jurisdictions. Over the period 2006-07 to 2010-11 Victoria maintains a lower tax to GSP ratio than NSW, and is expected to close the gap with Queensland by 2009-10.

The effect of the 2008-09 Budget measures can clearly be seen in Chart 1.4 as the projected GSP ratio of Victoria is set to fall below that of Queensland (based on comparable estimates). If this eventuates it would be a significant milestone in Victoria's taxation competitiveness as it will be the first time that Victoria's tax to GSP ratio will fall below Queensland for the period that data is available.

Chart 1.4: Taxation revenue as a percentage of GSP(a)



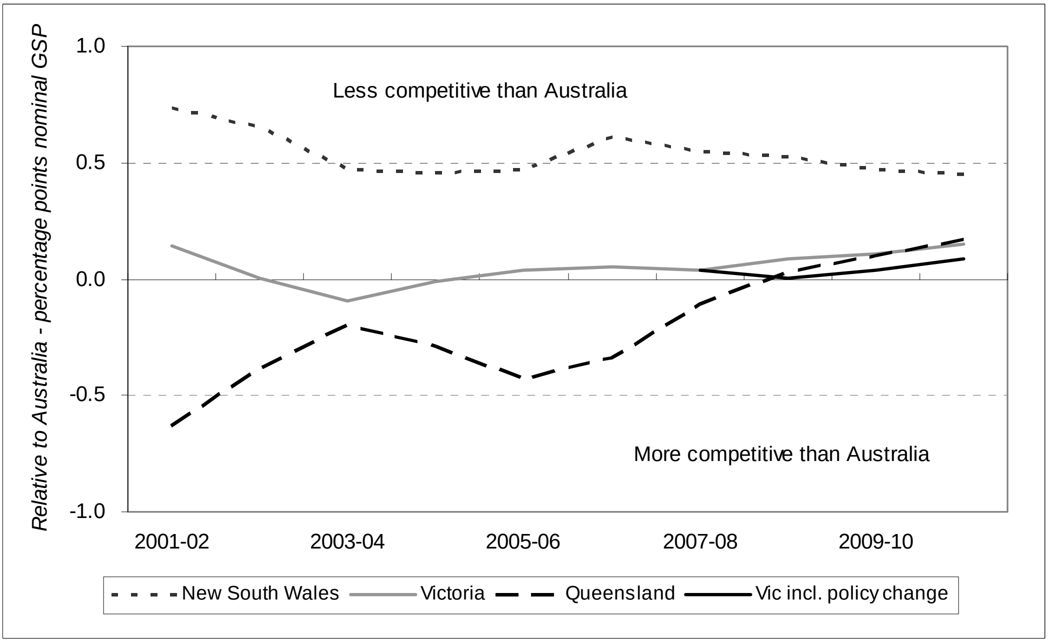
Sources: Australian Bureau of Statistics, Department of Treasury and Finance and various state publications (refer to note below)

Note:

(a) Historical taxation data to 2006-07. Thereafter, taxation data are 2007-08 Budget Update (or equivalent publication) estimates, being the latest forward estimates available on a consistent basis across all jurisdictions. The line 'Vic incl. policy change' is the same as 'Vic' except that the estimated value of taxation policy changes announced in the 2008-09 Budget is included.

Chart 1.5 presents the same information as in Chart 1.4, but over a longer time period and shows the taxation to GSP ratio relative to the average taxation to GSP ratio of all states and territories. Chart 1.5 shows that Victoria's tax to GSP ratio remains competitive particularly when the taxation initiatives announced in this budget are taken into account. Victoria's tax to GSP ratio remains far more competitive than NSW and the budget measures reinforce this position.

Chart 1.5 Taxation revenue relative to the Australian average[(a)]



Sources: Australian Bureau of Statistics, Department of Treasury and Finance and various state publications (refer to note below)

Note:

(a) Historical taxation data to 2006-07. Thereafter, taxation data are 2007-08 Budget Update (or equivalent publication) estimates, being the latest forward estimates available on a consistent basis across all jurisdictions. The line 'Vic incl. policy change' is the same as 'Vic' except that the estimated value of taxation policy changes announced in the 2008-09 Budget is included.

WorkCover reform

While tax competitiveness is an important part of business decision-making, low WorkCover insurance premiums are another factor that improves the attractiveness of Victoria as a business location. The 2008-09 Budget provides a further 5 per cent reduction in the WorkCover insurance average premium rate. This brings Victoria's average premium rate to 1.387 per cent of wages and ensures the WorkCover scheme continues to have the second-lowest average premium rate in Australia. The latest 5 per cent cut will save Victorian employers an additional $88 million in 2008-09. As a result of five successive cuts, Victorian employers will benefit from accumulated savings of $775 million in 2008-09.

OBJECTIVE FIVE: NET FINANCIAL LIABILITIES

Victoria's finances are strong and provide the basis for the government to continue to deliver its substantial infrastructure program. Prudent financial management will position the government to absorb potential fiscal shocks and meet financial obligations, in an increasingly uncertain economic environment.

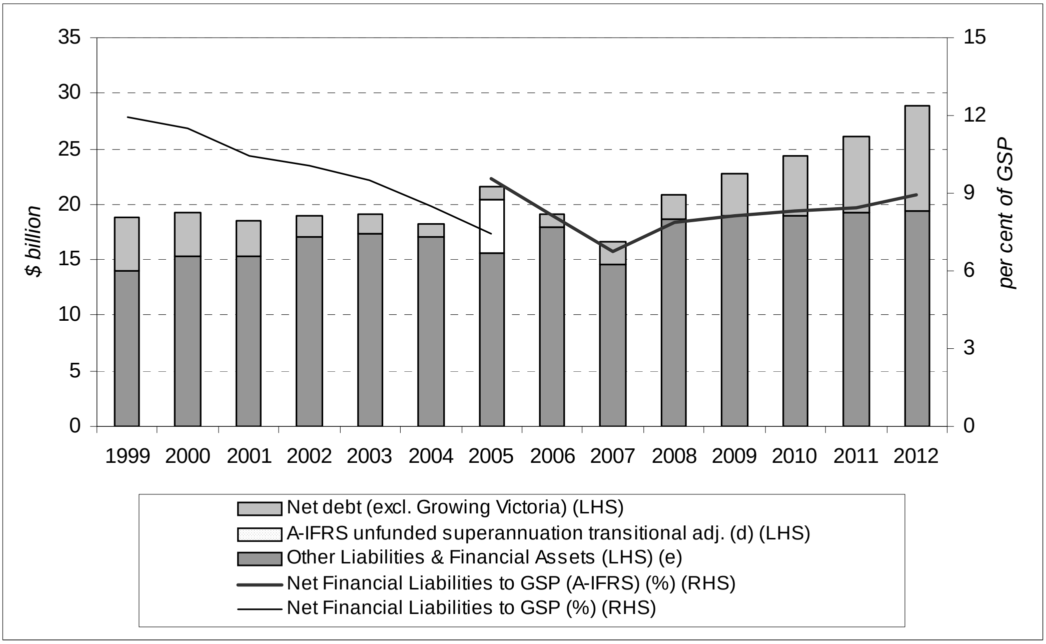
Victoria's strong balance sheet is evident in its AAA credit rating, which was reaffirmed by international credit rating agencies Standard & Poor's in September 2007 and Moody's Investors Service in April 2008. Both agencies cited Victoria's strong fiscal position, modest debt levels and prudent financial management as the key factors behind the AAA credit rating.

Over the budget and forward estimates period, around 64 per cent of the general government sector infrastructure program will be financed by the net cash inflow from operations, which is equivalent to the operating surplus less depreciation and other non-cash provisions. For the remainder, the government will use the strength of its balance sheet to fund key public investment projects that provide long-term economic and social benefits to Victoria.

With the adoption of the new accounting standard relating to government reporting as adopted in the revised Uniform Presentation Framework, the measure of net financial liabilities is broader than that used by Victoria in the past. Rather than the measure being net debt plus the net unfunded superannuation liability, it now includes total liabilities less all financial assets, excluding equity investments in other sectors. While the absolute measures are different than in the past, the overall trend for Victoria remains unchanged.

Chart 1.6 below shows that the ratio of net financial liabilities (total liabilities less financial assets, other than equity in public non-financial corporation and public financial corporation sectors) to GSP is set to decline from 11.9 per cent in June 1999 to 7.9 per cent in June 2008, and is expected to remain stable in the forward estimates period. This represents a reduction in net financial liabilities as a percentage of GSP by 4.0 percentage points, which is equivalent to more than $10 billion in real terms.

Chart 1.6: General government net financial liabilities, as at 30 June[(a)(b)(c)]



Source: Department of Treasury and Finance

Notes:

(a) General government net financial liabilities are calculated as total liabilities less financial assets, other than equity in PNFC and PFC.

(b) Net debt is calculated as gross debt less liquid financial assets. In the years applicable, Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.

(c) Due to a change in methodology regarding how net financial liabilities are calculated, this chart is not directly comparable to similar charts shown in previous years.

(d) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liability in 2004-05.

(e) Unfunded superannuation liability between 1999 and 2004 are calculated under the old Australian accounting standards, whereas from 2005 onward the relevant A-IFRS standard has been applied.

The prudent strategy of using available cash surpluses to pre-pay superannuation liabilities and retire gross debt has meant that even with a substantial infrastructure program, the state’s net financial liabilities to GSP is significantly lower than when the government came to office.

General government net debt is projected to increase from $2.3 billion at June 2008 to $9.5 billion at June 2012. The projected general government net debt of $9.5 billion in 2012 is equivalent to 2.9 per cent of GSP, compared with 3.0 per cent in 1999.

In addition, superannuation liability will ease over the forward estimates period. As a proportion of GSP, superannuation liability is forecast to decline from 4.9 per cent in June 2008 to 4.1 per cent in June 2012.

Detailed information on net debt and financial liabilities can be found in Chapter 3, *Budget Position and Outlook*.

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- The outlook for the Victorian economy remains solid, although growth is projected to be moderately lower than forecast in the *2007-08 Budget Update*.
- Victorian gross state product is expected to grow by 3.25 per cent in 2007-08 and by 3 per cent in 2008-09. Growth is expected to be relatively broad-based, with contributions from household spending, dwelling investment and the business sector.
- Victoria is enjoying fast population growth, the highest of the non-resource states. Employment growth has been strong to date, resulting in historically low unemployment and near record labour force participation, although the outlook is for more modest employment growth in line with slower growth in the economy.
- While wage growth has so far been remarkably stable given the tightness of the labour market, the risks to wage growth are clearly on the upside. Forecasts for wage growth and consumer price inflation have been revised up.
- High world commodity prices, supporting Australia's terms of trade, continue to have an uneven impact on the state economies. Growth has been very strong in the resource-rich states of Western Australia and Queensland, but more moderate in the other states. Victoria recorded the strongest growth of the non-resource states in 2006-07.
- The global outlook has weakened, with economic growth expected to slow to below-trend rates in the major developed economies. However, emerging economies such as China and India, while expected to slow moderately, are still likely to exhibit strong growth.
- Risks to the economic outlook are primarily on the downside. The main short-to-medium term risks include higher inflation and interest rates, the uncertainty surrounding the global economy and financial markets, exchange rate movements and recovery in the rural sector.

VICTORIAN ECONOMIC PROJECTIONS

The Victorian and national economies have grown quite strongly in recent times. This growth has been supported by very strong population growth, the need to expand the economy's capital stock, and historically high terms of trade and associated income gains. These fundamental drivers of growth are expected to persist over the coming years. At the same time, this strong growth – after 16 consecutive years of expansion – has led to rising inflationary pressures. Both monetary policy and federal fiscal policy are currently aimed at slowing the growth of domestic demand to reduce inflationary pressures. The global economy and financial markets are also exerting a moderating influence on the domestic economy. These two broad forces underpin and influence the Victorian economic outlook.

The Victorian economy is expected to grow by 3.25 per cent in 2007-08. The main contributors to domestic demand growth are expected to be household consumption and non-residential construction. Export growth is expected to be moderate, with solid services exports growth offsetting weaker merchandise export growth. The rural sector has partly recovered from the drought conditions experienced in 2006-07, so agricultural production will make a moderate contribution to economic growth.

Economic growth is forecast to ease to around 3 per cent in 2008-09 and remain around that rate throughout the forward estimates period. This represents slower near-term growth than envisaged in the *2007-08 Budget Update*. In response to heightened inflationary pressures, the Reserve Bank of Australia (RBA) has lifted the official cash rate four times since mid-2007 to 7.25 per cent in March 2008. The impact of these higher interest rates, combined with a higher exchange rate, is likely to be felt more strongly in Victoria than in some other states due to its large manufacturing base and limited mining resources.

Growth in Victorian gross state product (GSP) in 2008-09 will be supported by solid, albeit slower, growth in household consumption, dwelling investment and business investment as well as continued recovery in the farm sector (assuming a return to average seasonal conditions). Although employment growth is likely to slow from its recent strong pace, the labour market is expected to perform solidly and will be supported by population growth and high rates of labour force participation. Near-term growth in wages and consumer prices has been revised up, but is forecast to gradually ease towards trend rates by the end of the forecast period.

The Victorian economic projections are sensitive to a number of risks, including wage and inflation pressures (and their effects on interest rates), the uncertainty regarding the global economy and financial markets, exchange rate movements and the prospects for the rural sector. These risks are of greater magnitude than usual, and hence the outlook is less certain than has been the case in recent years.

The economic projections used in the 2008-09 Budget are in Table 2.1. They assume constant exchange rates and that oil prices follow the path implied by oil futures contracts. The remainder of this chapter contains an overview of the international, national and Victorian economic conditions and outlook, and a discussion of key risks to the Victorian economic outlook.

Table 2.1 Victorian economic projections[(a)]

	2006-07 Actual	2007-08 Forecast	2008-09 Forecast	2009-10 Forecast	2010-11 Forecast	2011-12 Forecast
Real gross state product	2.7	3.25	3.00	3.00	3.00	3.00
Employment	2.7	2.75	1.50	1.50	1.50	1.50
Unemployment rate [(b)]	4.8	4.50	4.75	4.75	4.75	4.75
Consumer price index	2.7	3.25	3.00	2.75	2.50	2.50
Wage price index [(c)]	3.6	3.75	3.75	3.75	3.50	3.50
Population [(d)]	1.5	1.50	1.50	1.50	1.40	1.40

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

Notes:
(a) Year-average per cent change on previous year unless otherwise indicated. All economic projections are rounded to the nearest 0.25 percentage point, except population projections which are rounded to the nearest 0.1 percentage point.
(b) Year-average level, per cent.
(c) Total hourly rate excluding bonuses.
(d) June quarter, per cent change on previous June quarter.

ECONOMIC OVERVIEW

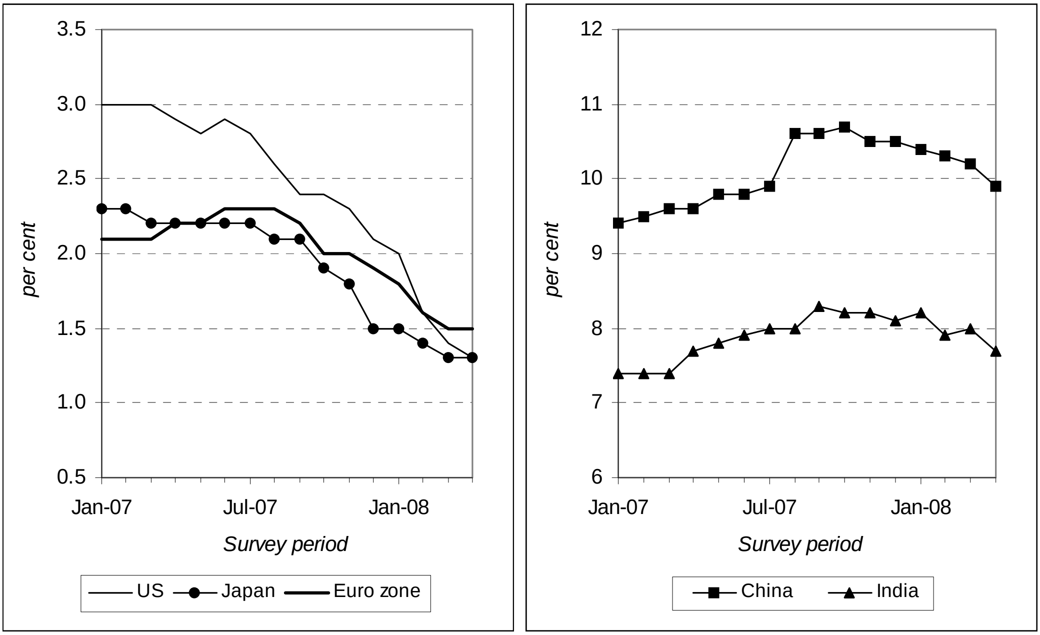
International economic conditions and outlook

After a sustained period of above-trend growth, the world economy is expected to slow markedly in 2008, weighed down by a weak United States economy and continuing financial market turmoil. Most advanced economies outside the United States are also expected to record slower growth, but growth in emerging economies should continue to be relatively strong, albeit slower than in 2007. The International Monetary Fund's (IMF) April *World Economic Outlook* forecasts world growth to slow from 4.9 per cent in 2007 to 3.7 per cent in 2008 and 3.8 per cent in 2009. Consensus Economics have also become more pessimistic, progressively revising down growth forecasts as the weakness in the United States economy became more apparent (see Chart 2.1).

Global financial markets have deteriorated and become more volatile over recent months, due to developments stemming from the sub-prime mortgage crisis in the United States. There has been a general widening of credit spreads, reflecting a re-pricing of risk, and difficulty for private borrowers in accessing capital markets. A lack of liquidity has persisted in the financial system to date, despite efforts by major central banks to inject liquidity into money markets. Equity markets of the major advanced economies have been volatile and equity prices fell significantly in early 2008. This reflects significant write-downs reported by a number of major financial institutions, growing concerns about the global economic outlook and uncertainty about further losses from sub-prime related investment products.

The main area of weakness in the United States is the housing market. House prices have fallen, mortgage foreclosures are rising and housing construction is down sharply. Further, it appears that this weakness is spilling over into other sectors of the economy, with recent data showing weaker consumer spending, industrial output and employment. On a more positive note, the depreciating US dollar is contributing to strong export growth. In response to the weakening economy, the US Federal Reserve has cut official interest rates sharply and the United States government has delivered a major fiscal stimulus package designed to provide a boost to household and business spending. Yet despite these interventions, the outlook for the United States economy is relatively poor. The IMF forecasts the United States to grow by only 0.5 per cent in 2008 and 0.6 per cent in 2009, although the Consensus Economics panel of forecasters is somewhat more optimistic (see Chart 2.1).

Chart 2.1: Estimated economic growth in 2008 as at each survey period



Source: Consensus Economics

Growth is also slowing in Europe's major economies, although not to the same extent as in the United States. The IMF is forecasting growth in the euro area of 1.4 per cent in 2008 and 1.2 per cent in 2009. Consumer spending has slowed and there are risks to export growth from the appreciating euro, although activity is still strong in the capital goods sector, especially in Germany. There has been a marked shift in observers' expectations regarding the United Kingdom economy, which until recently had outperformed its continental neighbours. The United Kingdom, as a major financial centre, has been heavily affected by the financial market turbulence, and conditions in the established housing market have deteriorated significantly.

In Japan, economic growth has remained relatively modest, despite a pick-up at the end of 2007. In recent months, both consumer and business sentiment have deteriorated. Like Europe, Japan's growth has been heavily driven by the export-oriented business sector, while domestic demand has been subdued. The sustainability of this narrow, export-led growth is uncertain, especially in light of the appreciation of the yen. However, exports should be supported by continued robust demand from emerging Asian economies, which have become more important to Japanese trade in recent years. According to the IMF, growth in Japan will slow to 1.4 per cent in 2008 and 1.5 per cent in 2009, following growth of 2.1 per cent in 2007.

While not totally immune from the weakness in the advanced economies, emerging economies in Asia, led by China and India, are nonetheless expected to continue growing strongly. The rapid process of industrialisation in this region, which is underpinned by structural economic improvements, has significant momentum. In addition, being net savers, the emerging Asian region is also no longer heavily reliant on developed economies for capital, reducing the likely impact of the financial market turbulence in the advanced economies.

In China, the economy continues to be driven by broad-based growth, and the IMF is forecasting growth of 9.3 per cent in 2008 and 9.5 per cent in 2009, down from 11.9 per cent in 2007. Consumption and capital investment are expected to continue growing at a rapid pace, although there are some downside risks to export growth from slowing external demand. China is experiencing high inflation, mainly driven by rising food prices, which is prompting government efforts to restrain growth. Growth was strong in India in 2007, at 9.2 per cent, in part due to strong business investment. Some easing is expected, although growth will remain strong at 7.9 per cent and 8.0 per cent in 2008 and 2009 respectively.

High inflation remains a concern across much of the globe. World food prices have increased due to strong demand in emerging economies, supply shortages due to adverse weather in a number of countries and rising demand from the biofuels industry. Crude oil prices have recently reached record highs of above US$100 per barrel. Other commodity prices, such as coal and iron ore, are also rising strongly, partly in response to insatiable demand from China. Rising inflation at a time of slowing economic growth is limiting the scope for policymakers to stimulate demand using expansionary monetary policy, further contributing to the uncertain outlook for the world economy.

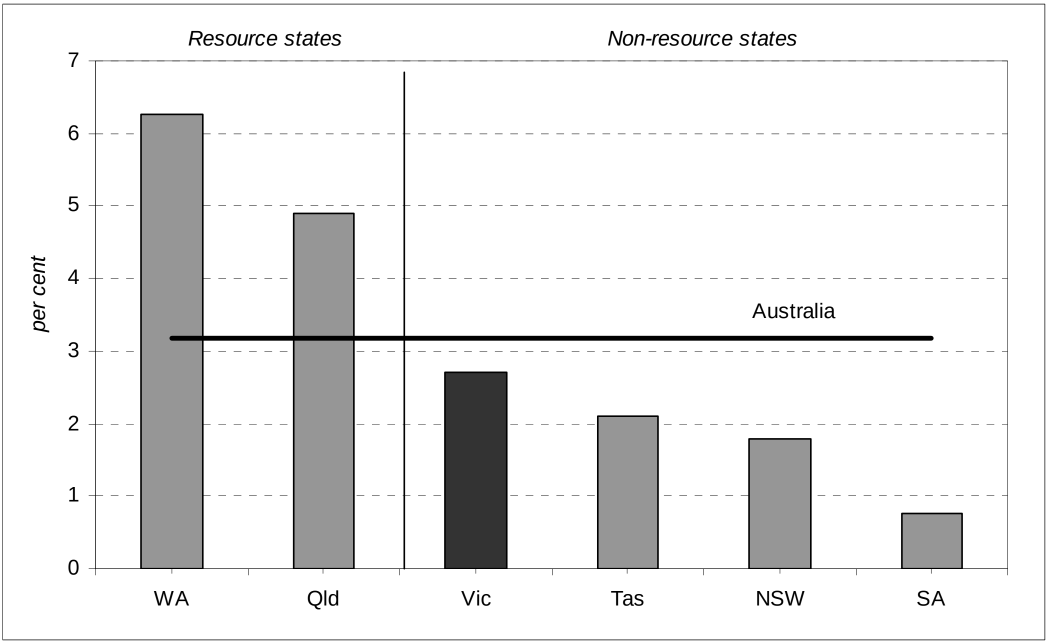
Australian economic conditions and outlook

The Australian economy grew by a strong 3.9 per cent over 2007. Domestic demand has been significantly outpacing the economy's productive capacity, growing by 5.7 per cent over the year. This has driven up inflation, and excess demand has been met by higher imports. Economic growth across the states has been divergent, with the benefits of the commodity boom skewed heavily to those states with significant mineral deposits, namely Western Australia and Queensland. Non-resource states are growing more slowly, with non-mineral exporters and import-competing sectors less competitive due to the high Australian dollar. All non-resource states grew at rates below the national average in 2006-07, with Victoria recording the strongest growth of the non-resource states (see Chart 2.2).

The strong national economic growth in 2007 was driven mainly by stronger household spending, while dwelling investment rose for the first time in three years. Business investment growth was also strong in 2007. Engineering construction grew at a double-digit rate for the third year in a row, partly as the resources boom continued to drive the construction of infrastructure projects. Yet despite this booming demand for Australian resources, growth in exports has been far outstripped by import growth, which has led to a widening of the current account deficit to 7 per cent of GDP.

The Australian labour market has performed strongly over the past year. Employment growth has been strong, at 2.8 per cent over the year to the March quarter. Over this period, the number of full-time jobs grew by 2.6 per cent. The unemployment rate is around a 30-year low of 4.1 per cent and labour force participation remained close to record highs at 65.2 per cent. Despite such low unemployment, wage growth has been relatively stable, at 4.2 per cent over the year to December.

Chart 2.2: Gross state product growth, 2006-07



Source: Australian Bureau of Statistics

After 16 consecutive years of economic growth, capacity constraints in the economy are becoming more pronounced. The unemployment rate has declined to the lowest rate in over three decades, and businesses continue to report high levels of capacity utilisation. These constraints are flowing through to higher consumer prices, with underlying inflation now well above the RBA‘s target band, at 4.25 per cent over the year to March. The strength of inflation in recent months has led the RBA to raise the official interest rate four times since mid-2007 to 7.25 per cent, the highest rate in over a decade.

This more restrictive monetary policy should affect the national economy in 2008-09, with growth in household demand in particular likely to slow. Nonetheless, growth should still be solid. Australia will continue to benefit from Asia’s strong demand for commodities, and the terms of trade are forecast to record at least double-digit growth this year. The Consensus Economics panel of forecasters expects Australian GDP growth to ease from 3.7 per cent in 2007-08 to 3.2 per cent in 2008-09. The IMF expects Australia to record growth of over 3 per cent in 2008 and 2009. Inflation is likely to remain relatively high in the near term, before easing in response to macroeconomic policy changes.

Victorian economic conditions and outlook

Victorian economic growth is expected to be solid in 2008-09, underpinned by broad-based growth. However, the Victorian economic outlook is subject to increased challenges – particularly in relation to higher inflation, higher interest rates, a weaker global outlook and financial market turbulence – and increased uncertainty.

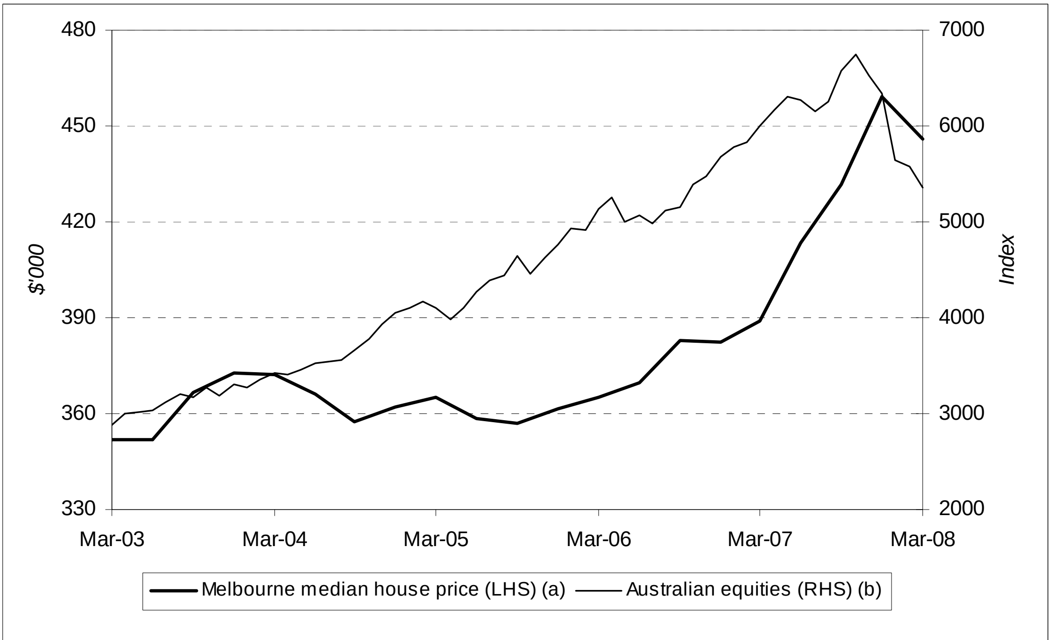
Economic growth forecasts have been revised down modestly since the *2007-08 Budget Update*. After forecast growth of 3.25 per cent in 2007-08, Victorian GSP is expected to moderate to around trend growth of 3 per cent in 2008-09. This largely reflects more moderate household consumption growth in light of higher interest rates and petrol prices. Higher interest rates will also constrain the strength of the dwelling investment recovery. Business investment, which has grown strongly in recent years, is also expected to grow more moderately, with non-residential building construction the main driver of near-term business investment growth. Further recovery is expected in the farm sector, assuming a return to average seasonal conditions in 2008-09.

Consumer spending

Victorian consumers have appeared to be resilient to higher petrol prices and rising interest rates, with strong growth in consumption throughout 2007. Consumption has been supported by solid employment and population growth, wage growth and income tax cuts. However, consumers are likely to be more cautious in the near term, leading to lower forecasts for consumption growth. Partial indicators of consumption have eased in the early part of 2008.

Household wealth benefited from strong house price growth over the past year, which was around 14 per cent in Melbourne. However, households have also been affected by a recent decline in equity values (see Chart 2.3). Over the first three quarters of 2007-08, the Australian sharemarket declined by around 15 per cent. Falls in the sharemarket, higher interest rates and uncertainty about the economic outlook have also dampened consumer sentiment considerably in recent months. Further, high levels of household debt will affect household budgets as interest rates have become more restrictive. On the other hand, the impact on Victorian households may not be as large as on households in the rest of the country, with Victoria's debt-servicing ratio lower than the Australian average.

Chart 2.3: Asset price growth – houses and equities



Sources: Australian Securities Exchange; Department of Treasury and Finance; Real Estate Institute of Victoria

Notes:
(a) Seasonally adjusted by the Department of Treasury and Finance.
(b) S&P/ASX 200.

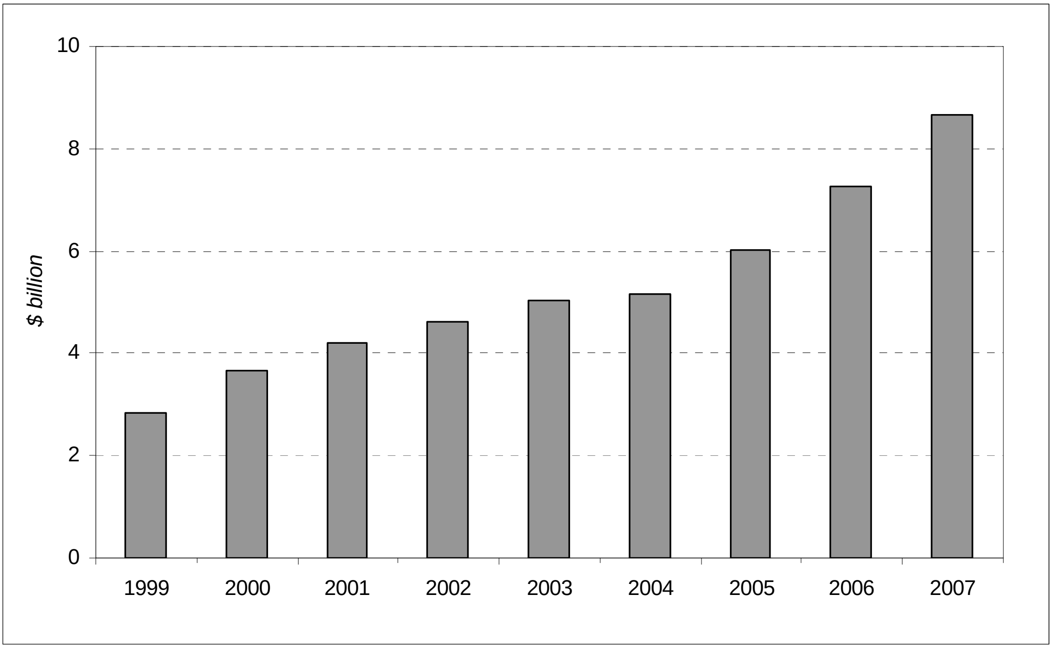
Dwelling investment

In recent quarters, Victorian dwelling investment has exhibited solid growth, outpacing national growth. Nonetheless, housing commencements are below estimates of underlying demand for dwellings. This pent-up demand for housing, due to strong population growth, and low residential vacancy rates that are pushing up housing rents, should support a recovery in dwelling investment. However, recent interest rate rises and declining affordability are likely to make the recovery in dwelling investment more delayed and protracted than previously expected.

Business investment

Business investment in Victoria is at a very high level, following particularly strong growth in recent years. Recent growth has been driven mainly by non-residential building construction, while engineering construction has eased, and machinery and equipment investment has grown moderately. Business investment conditions generally remain favourable, with strong business credit growth, solid company profits and high levels of capacity utilisation. A strong pipeline of work yet to be done should support non-residential building in coming years, which has been driven by record high building approvals in 2007 (see Chart 2.4) and continued strength in the early part of 2008. While capital expenditure expectations suggest further solid growth in machinery and equipment investment, there may be some tempering of these expectations by the more uncertain global outlook, as well as higher borrowing costs. Engineering construction is expected to drive business investment growth towards the end of the forecast period, supported by major public sector-driven water projects.

Chart 2.4: Victorian non-residential building approvals



Source: Australian Bureau of Statistics

International trade

Victorian services exports performed strongly in 2006-07, rising by over 8 per cent in volume terms, the second fastest growth of any state. Victoria's education-related service exports have grown particularly strongly, to become the state's third-largest export. Victorian merchandise exports, however, increased only moderately. Exports have been hampered by a strong Australian dollar, which was 11 per cent higher against the US dollar, on average, in 2007 compared with 2006, and agricultural exports continued to be held back by poor seasonal conditions. Both merchandise and services imports have grown strongly, supported by the high Australian dollar and the strength of domestic demand.

Looking ahead, weaker global growth may dampen demand for Victorian exports, and the high Australian dollar will continue to put pressure on manufacturing exporters. On the other hand, the anticipated recovery from the drought should support agricultural exports in the near term. Farm incomes will also be buoyed by the strength of agricultural commodity prices. Overall, Victorian merchandise exports are expected to grow only modestly in the near term. However, the outlook for Victorian service exports appears more positive given the strength of demand in key export markets such as China and India.

Labour market

The Victorian labour market continued to perform well over the past year, with strong growth in employment and a fall in the unemployment rate over the previous year. Over the year to the March quarter, Victorian employment grew by 2.7 per cent, broadly in line with the national average. Employment growth has been strongest in the property and business services, cultural and recreational services, and retail trade industries. The Victorian unemployment rate remained historically low at 4.3 per cent in the March quarter, and the Victorian participation rate of 65.0 per cent is around record high levels. This high rate of labour force participation has been supported by a long-term trend of rising participation amongst women, as well as a reversal of the trend decline in male participation in recent years.

However, employment growth has started to ease, and this is consistent with the moderation evident in the leading indicators of employment. Looking ahead, the labour market is expected to perform solidly, but will be tempered by weaker domestic demand. Employment growth is expected to slow from recent above-trend rates to grow broadly in line with the growth of the working age population. The unemployment rate is expected to increase slightly to 4.75 per cent over the forecast period.

Wages

Despite the tightness of the labour market, wage growth in Victoria has continued to be relatively contained and remains below the national average, at 3.9 per cent over the year to the December quarter. Strong wage growth still persists in the resource states, particularly in Western Australia, which is consistent with the strong demand for labour in the mining and construction sectors in those states.

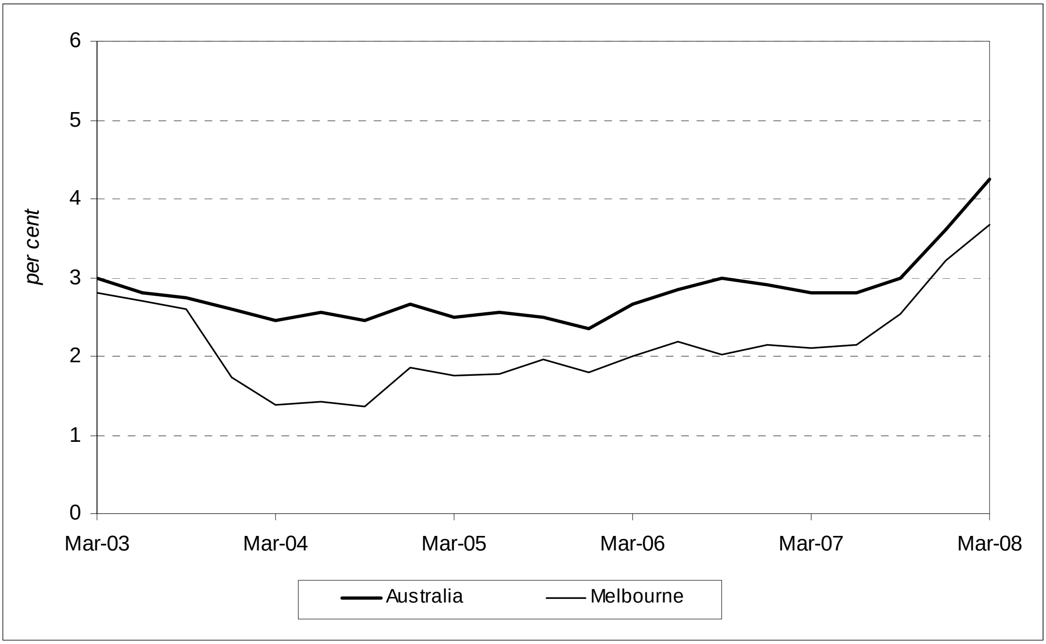
However, the heightened inflationary environment has led to upward revisions to wage growth in 2007-08, 2008-09 and 2009-10. The projections reflect the upside pressures on wages from the historically low unemployment rate, higher inflation expectations and business surveys that indicate firms continue having difficulty in finding and retaining labour. In the December quarter, annual Victorian private sector wages growth was the strongest in two years. This may be an indication that wages growth is set to accelerate further, putting upside risks to the wage growth forecasts, particularly in 2008-09. More generally, there is also the risk that higher inflation expectations and wage demands become entrenched.

Inflation

Inflationary pressures have intensified since the *2007-08 Budget Update*. National underlying inflation was 4.25 per cent over the year to March, while the equivalent figure for Melbourne was 3.7 per cent (see Chart 2.5).

Price rises have been relatively broad-based, with more than two-thirds of the national consumer price index basket rising by more than 2.5 per cent over the past year. Rents are growing strongly due to very low residential vacancies, and petrol prices have been driven higher by rising crude oil prices. Global food prices have been rising, due to poor seasonal conditions in major agricultural production regions and increasing demand for biofuels, while utility costs have also risen considerably. More broadly, capacity utilisation is around record highs, despite strong business investment in recent years. This, coupled with strong domestic demand, has led to strong price growth. The RBA expects national inflation to remain high, before moderating as macroeconomic policy settings reduce demand. Melbourne consumer price inflation is expected to gradually ease from a relatively high rate of 3.25 per cent in 2007-08, settling at an average of 2.50 per cent from 2010-11, although the risks are to the upside.

Chart 2.5: Underlying inflation[(a)]



Sources: Department of Treasury and Finance; Reserve Bank of Australia

Note:
(a) Average of weighted median and trimmed mean measures, four quarter-ended percentage change.

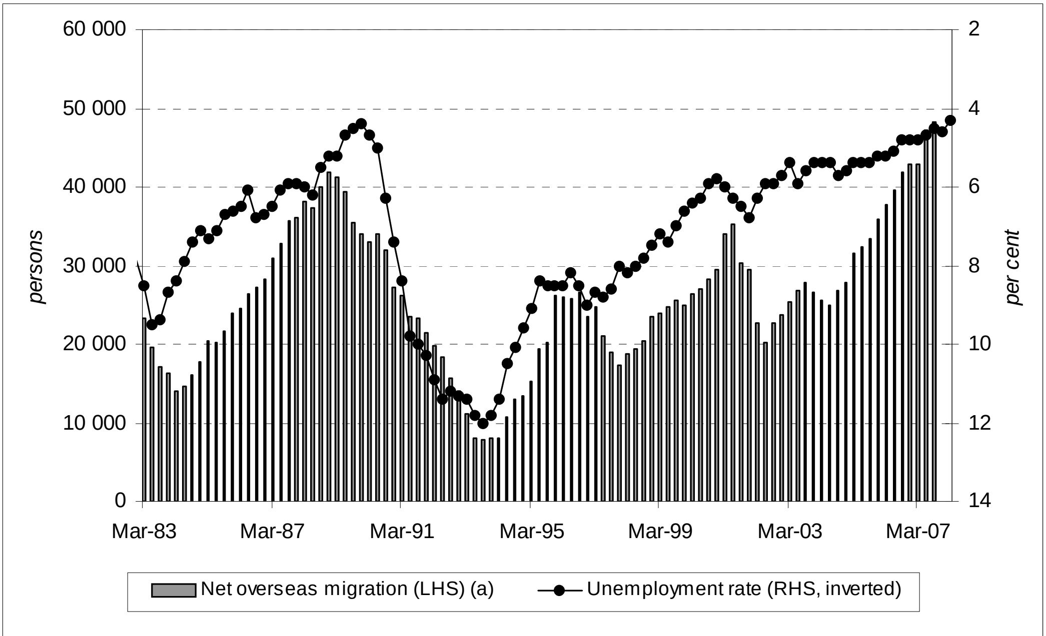
Population

Victoria's population continues to grow strongly, with growth of 1.5 per cent over the past year. Victoria's population growth was below that of Queensland and Western Australia, but was the highest of the non-resource states. Victoria's population stood at over 5.2 million in the September quarter 2007.

The increase in Victoria's population has been driven primarily by net overseas migration, which is at a record high and accounted for more than 60 per cent of growth in the year to September 2007. The strength of migration to Victoria is likely driven by the strength of Victoria's labour market, with immigration historically rising during periods of low unemployment, as well as by Victoria's overall liveability (see Chart 2.6).

Population growth is projected to be slightly higher than previously expected over the short-to-medium term, mainly due to higher forecast net overseas migration.

Chart 2.6: Victorian net overseas migration and unemployment rate



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

Note:
(a) Rolling annual sum.

Provincial Victoria

Provincial Victoria is experiencing solid population and employment growth, where economic activity has been supported by high levels of building activity and a partial recovery in the agricultural sector.

Employment in regional Victoria has grown solidly, by 1.8 per cent over the year to the March quarter. The unemployment rate in regional Victoria has fallen to 4.7 per cent, while the regional Victorian participation rate is 62.9 per cent, around record high levels. There was a record value of regional Victorian building approvals in 2007, in line with the solid population and employment growth. According to Building Commission data, the value of regional building approvals reached $4.1 billion in 2007.

The latest Australian Bureau of Agricultural and Resource Economics forecast for Victorian winter crop production is 3.8 million tonnes in 2007-08, up 112 per cent on drought-affected 2006-07, but still well below the five-year average. This partial recovery in the rural sector is expected to contribute around 0.3 percentage points to GSP growth in 2007-08 (around half the contribution expected from a full recovery).

It is expected that a return to more normal climatic conditions will contribute to a further recovery in the agricultural sector in 2008-09. According to the Bureau of Meteorology, Victoria experienced around average rainfall over summer, and rainfall levels are expected to be around average in coming months.

Farm incomes have been supported by rising prices for a number of agricultural commodities, particularly grains and dairy, but conditions remain challenging due to rising input costs such as fuel, financing, chemicals and fertilisers, in addition to low water allocations. Long-term rainfall deficiencies persist across much of Victoria.

RISKS TO THE OUTLOOK

Downside risks dominate the short-to-medium term economic outlook. The main risks to the Victorian economic projections are from higher inflation and interest rates, financial market volatility, global economic developments, exchange rate movements and prospects for the rural sector.

The strength of inflation is one of the key risks to the economic outlook. The near-term inflation outlook is particularly sensitive to petrol prices, which have been high and volatile. Global crude oil prices have surpassed US$100 per barrel, partly in response to supply disruptions and more speculative activity in commodity markets. Further increases in oil prices would increase input prices and inflationary pressures in Australia and abroad.

With underlying inflation set to remain above the RBA’s target band in the near term, unexpectedly high inflation readings in the future may lead to further monetary policy tightening. The potential for higher wage claims, in the context of a tight labour market and rising inflation expectations, is also a risk for the inflation outlook.

Global financial markets remain fragile. Prolonged dislocation in credit markets, reflecting uneasiness about liquidity and counterparty risk, may lead to further rises in borrowing costs and credit rationing, as well as further declines in confidence. This would have a negative impact on business investment and household spending decisions.

Even after the latest downward revisions to global growth forecasts, risks to the global economic outlook remain on the downside, primarily due to the potential impact of financial market strain on advanced economies. Further, there is a risk that emerging Asian economies will slow more than currently anticipated, due to trade and financial linkages with the slowing advanced economies, or in response to domestic policy tightening. Given Victoria's, and Australia's, growing trade exposure to these emerging economies, the impact on the Victorian economy could be significant.

The exchange rate has exhibited considerable volatility since the emergence of the sub-prime mortgage crisis in late July 2007, driven in part by swings in investor sentiment. But the fundamental drivers remain strong. The Australian dollar is supported by high terms of trade, a large interest rate differential between Australia and most other developed economies, and a comparatively solid economic outlook. These drivers have pushed the Australian dollar to around 24-year highs against the US dollar, placing further pressure on Victoria's non-mineral exporters and import-competing industries. Any further appreciation of the exchange rate will likely weaken growth in Victoria's trade-exposed sectors.

The rural sector has only partially recovered from drought conditions. The economic projections assume a return to normal seasonal conditions in 2008-09, but should poor conditions continue in the rural sector, this will place downward pressure on economic growth.

Beyond the immediate risks facing the Victorian economy, there are several challenges facing Victoria that will have a longer-term impact, and require policy action to address them. These longer-term challenges relate primarily to workforce productivity and participation, and addressing the potential impacts of climate change and water supply constraints. These issues are discussed in more detail in Chapter 5, *Economic Reform Agenda*.

Overall, the 2008-09 Budget economic forecasts are characterised by more uncertainty than usual, with risks, on average, being on the downside. Yet the central projection is that the Victorian economy will prove largely resilient to the challenges it currently faces and record solid growth over the forecast period, due to sound fundamentals.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

- The Government is budgeting to achieve an operating surplus (net result from transactions) of $828 million in 2008-09 and an average of $907 million a year over the forward estimates period. This is consistent with the government's new short-term operating target of a surplus of at least 1 per cent of revenue each year.
- Expenses are projected to rise by 3.3 per cent in 2008-09 and by an average of 4.1 per cent a year over the forward estimates, while revenue is projected to rise by 2.8 per cent in 2008-09 and by an average of 4.1 per cent a year over the forward estimates.
- The strong operating performance underpins the government's substantial infrastructure investment to support service delivery and economic growth.
- Net infrastructure investment is projected to be $3.9 billion in 2008-09 and projected to average $4.4 billion a year over the forward estimates.
- Consistent with sound financial management, net debt will remain at low levels and is projected to be 0.9 per cent of gross state product (GSP) by 30 June 2008 and to increase to 2.9 per cent of GSP by 30 June 2012.

BUDGET ESTIMATES AND OUTLOOK

This chapter provides an overview of the budget position for the period 2008-09 to 2011-12 for the general government (GG) sector.

The budget and forward estimates are based on the economic projections outlined in Chapter 2, *Economic Conditions and Outlook*, and reflect the accounting policies and assumptions documented in Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*. Unless otherwise stated, the estimates take into account the financial impacts of all policy decisions taken by the Victorian Government, as well as Commonwealth funding revisions and other information that affect the projected GG sector financial statements as at 30 April 2008. Specific policy decisions that have been made since the 2007-08 Budget and which affect the budget position have been summarised in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

The 2008-09 Budget and forward estimates years, 2009-10 to 2011-12, represent planning projections based on unchanged policy and other assumptions throughout the forecast period. Outcomes will differ from these projections for many reasons, including any materialisation of risks, such as the impact of changed economic conditions as described in Chapter 2, *Economic Conditions and Outlook* and the sensitivity of the budget to these risks as noted in Appendix B, *Sensitivity Analysis Table*.

FISCAL OVERVIEW

The Government will continue to deliver strong operating surpluses, providing a firm foundation for investment in key infrastructure to support economic growth, while continuing to deliver its election commitments made in *Labor's Financial Statement 2006* and achieving its new short-term operating target of a surplus of at least 1 per cent of revenue each year.

As shown in Table 3.1, the government is budgeting to achieve an operating surplus of $828 million in 2008-09. Over the three years to 2011-12, operating surpluses are projected to average $907 million a year. In the long-term, the government is committed to maintaining a substantial budget operating surplus that allows for the delivery of its infrastructure objectives while maintaining net debt at prudent levels.

Compared with the estimates published in the *2007-08 Budget Update*, the operating surplus is expected to be $13 million higher in 2008-09, and $51 million a year higher on average from 2009-10 to 2010-11. Although economic growth is expected to be moderately lower, revenue has been revised up since the *2007-08 Budget Update*. This reflects strong revenue collections in 2007-08, increased GST revenue from the Commonwealth and the impact on the tax base of higher inflation and wages growth.

As shown in Table 3.1 and Chart 3.1, growth in revenue and expenses is closely aligned over the budget and forward estimates. Both revenue and expenses are projected to grow by 4.1 per cent a year on average from 2008-09 to 2011-12.

Table 3.1: Net result from transactions 2008-09 to 2011-12[(a)]

($ million)

	2008-09 Budget	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
Revenue				
Taxation	13 382.9	13 795.9	14 504.2	14 977.2
Dividends, TER and interest [(b)]	1 072.1	1 137.3	1 211.3	1 210.7
Sales of goods and services	4 334.5	4 453.3	4 520.3	4 585.8
Grants	17 555.0	18 495.5	19 448.9	20 431.1
Other current revenue	1 465.6	1 438.7	1 432.1	1 441.7
Total revenue	**37 810.0**	**39 320.8**	**41 116.8**	**42 646.4**
% change	2.8%	4.0%	4.6%	3.7%
Expenses				
Employee expenses	14 225.6	15 107.0	16 059.1	16 845.4
Superannuation	1 858.2	1 901.7	1 971.3	2 000.4
Depreciation	1 609.4	1 712.7	1 826.3	1 946.4
Interest expense	499.4	576.9	695.0	804.0
Other operating expenses	12 350.4	12 806.1	13 206.7	13 588.8
Grants and other transfers	6 439.4	6 365.2	6 452.2	6 498.7
Total expenses	**36 982.4**	**38 469.6**	**40 210.7**	**41 683.7**
% change	3.3%	4.0%	4.5%	3.7%
Net result from transactions	**827.5**	**851.1**	**906.0**	**962.6**
Total other economic flows included in net result	**(110.6)**	**(139.6)**	**(134.3)**	**(122.5)**
Net result	**716.9**	**711.5**	**771.8**	**840.1**

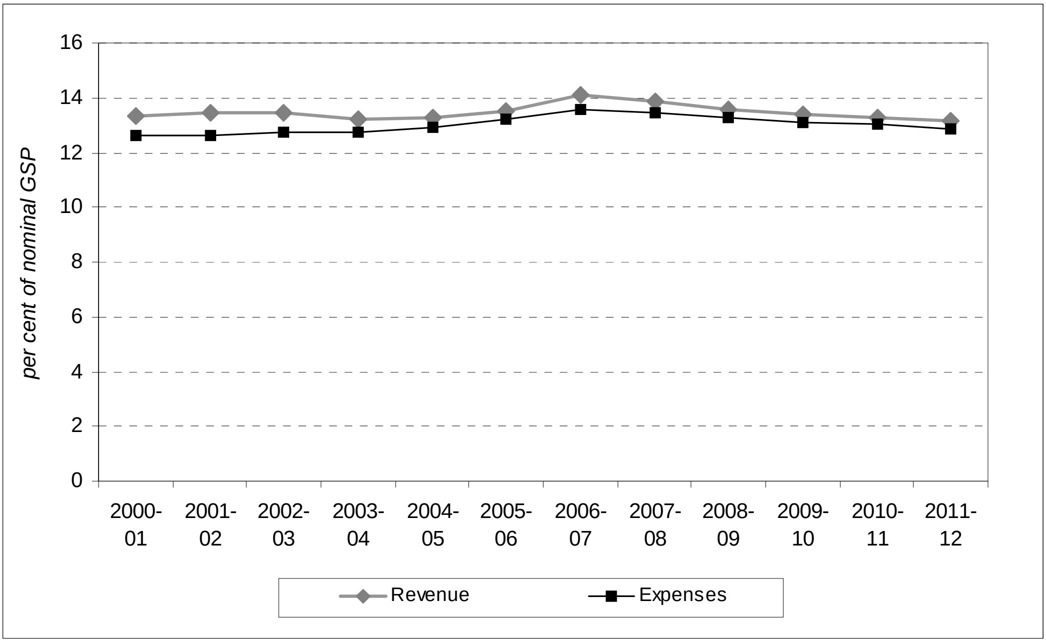
Source: Department of Treasury and Finance

Notes:

(a) This is an abbreviated operating statement. The full statement is shown in Budget Paper No. 4, Chapter 1, Estimated Financial Statements and Notes, and provides additional information on economic flow measurements which, when added to the net result from transactions, yields the net result.

(b) Comprises dividends, income tax and rate equivalent revenue and interest.

Chart 3.1: Revenue and expenses relative to nominal GSP



Source: Department of Treasury and Finance

OPERATING STATEMENT ANALYSIS

Revenue

Total revenue is forecast to increase by $1.6 billion, or 4.1 per cent, a year on average over the budget and forward estimates. Compared with the estimates published in the *2007-08 Budget Update*, total revenue is forecast to be $797 million higher in 2008-09 and $879 million a year higher on average over the period 2009-10 to 2010-11.

Grants

Grants, mainly from the Commonwealth, represent the largest source of revenue, accounting for 46 per cent of total revenue in 2008-09. Grants are expected to increase by 5.2 per cent a year on average from 2008-09 to 2011-12. This primarily reflects:

- an increase in GST grants of 6.1 per cent a year on average as a result of forecast increases in the national GST pool and an anticipated increase in Victoria's share. The latter is based on Victoria's projected population share and a projection of Victoria's assessed relativities (where actual relativities are provided by the Commonwealth Grants Commission (CGC));
- growth of 5.3 per cent a year on average in specific purpose operating and capital grants for on-passing, largely for non-government schools; and
- growth in other specific purpose grants to Victoria of 3.4 per cent a year on average.

At the 26 March 2008 Council of Australian Governments (COAG) meeting, the Prime Minister, Premiers and Chief Ministers, and Treasurers agreed to allocate an additional $500 million grant from the Commonwealth to the public hospital system. Victoria anticipates an additional $121 million from the Commonwealth in 2007-08 under the Australian Health Care Agreement. As a result, the state has been able to invest in maintaining health system performance, long-term reform of the sector and improved health outcomes for Victorians.

Further details of additional revenue are provided in Budget Paper No. 4, Chapter 4, *State Revenue*.

Taxation revenue

Taxation is forecast to provide around 35 per cent of GG revenue in 2008-09. Taxation revenue is projected to be $13.4 billion in 2008-09, an increase of $385 million or 3.0 per cent on the 2007-08 revised estimate. The growth in taxation revenue in 2008-09 principally reflects the positive impact of continuing strength in employment and overall economic growth as well as an increase in land tax revenue due to increases in land values, partially offset by the revenue initiatives announced in this budget, as shown in Table 3.2.

Taxation revenue is expected to grow, on average, by 3.8 per cent a year between 2008-09 and 2011-12 with:

- payroll tax revenue projected to grow by 5.9 per cent a year on average, reflecting expected employment and wages growth;
- stamp duty on land transfer revenue projected to increase by 1.3 per cent a year on average, with growth restrained by an expected re-alignment of property prices to economic fundamentals, and limited growth in volumes;
- revenue from gambling taxes projected to increase by an average of 4.9 per cent, largely reflecting expected growth in household consumption; and
- slow growth (on average) in land tax revenue, reflecting expectations of a modest growth in land valuations for the two years to 2010-11, offset by the ongoing disaggregation of land holdings.

2008-09 Budget revenue initiatives

Table 3.2 shows the 2008-09 Budget revenue initiatives.

Table 3.2: 2008-09 Budget tax initiatives[(a)]

($ million)

	2007-08 Budget	*2008-09 Budget*	*2009-10 Estimate*	*2010-11 Estimate*	*2011-12 Estimate*
Land Tax Cuts	..	-122.3	-119.1	-125.3	-122.0
Land Transfer Duty	..	-149.5	-87.9	-90.3	-93.9
Payroll Tax Cut	..	-36.6	-42.2	-44.6	-47.2
Total tax relief	**..**	**-308.4**	**-249.2**	**-260.2**	**-263.1**
Other revenue initiatives					
Motorcycle Safety Levy	3.7	5.1	5.4	5.8	
Total revenue initiatives	**3.7**	**-303.3**	**-243.8**	**-254.4**	**-263.1**

Source: Department of Treasury and Finance

Note:
(a) A negative figure indicates reduced revenue.

Land Tax Relief

The 2008-09 Budget will consolidate the government's recent land tax reforms and provide ongoing stability for the land tax system. From the 2009 land tax year there will be an upward adjustment to land tax thresholds of approximately 10 per cent and the top land tax rate will be further reduced from 2.5 per cent to 2.25 per cent.

The current land tax exemption for aged care facilities, supported residential care services and rooming houses announced in the 2005-06 Budget will be extended to include facilities which cater for young people with disabilities.

Stamp Duty on Land Transfer

For contracts entered into on or after Budget day, there will be a reduction of approximately 10 per cent to all stamp duty on land transfer thresholds.

The package also provides targeted assistance to first homebuyers by enabling them to receive both the First Home Bonus and the principal place of residence concession for the first time. Up until this point, first homebuyers have been required to choose between these two forms of assistance.

The 2008-09 Budget also includes two specific exemption arrangements:

- an exemption for homes transferred into special disability trusts in recognition of the particular nature of the arrangements for persons with a severe disability; and
- a corporate reconstruction exemption to provide relief to listed property trusts in circumstances that are consistent with the Commonwealth Government's arrangements concerning Capital Gains Tax rollover relief.

Payroll Tax Cut

The 2008-09 Budget reduces the payroll tax rate to 4.95 per cent, effective 1 July 2008. Under previous reforms announced by the government, the payroll tax rate was already scheduled to fall from 5.05 per cent to 5.0 per cent from that date. The 2008-09 Budget introduces a further 0.05 percentage point reduction. This additional reduction benefits more than 28 000 businesses by a further $170 million over the next four years and brings the total payroll tax cuts announced by the government since 1999 to 22 per cent.

Motorcycle Safety Levy

This initiative continues the Motorcycle Safety Levy beyond 30 September 2007. The funds raised from the levy are dedicated to motorcycle safety initiatives.

Dividends, income tax and rate equivalent, and interest revenue

Dividend, income tax and rate equivalent and interest revenue is projected to be $1.1 billion in 2008-09 and to grow by an average of $46 million (or 4.2 per cent) a year over the forward estimates period.

This growth is largely driven by the public financial corporations (PFC) sector, reflecting anticipated growth in vehicles insured with the Transport Accident Commission (TAC) and a rise in Victorian employee numbers covered by the Victorian WorkCover Authority. In calculating income tax equivalents and dividends for PFCs that hold financial assets, an assumption is made that investment earnings from 2008-09 will revert to the long-term average.

The 2008-09 Budget includes the fifth consecutive cut to WorkCover insurance premiums, reducing the cost burden on Victorian businesses and reducing income tax equivalent receipts to the state. This 5 per cent cut brings Victoria’s average premium rate to 1.387 per cent of wages and ensures the WorkCover scheme continues to have the second-lowest average premium rate in Australia. The latest cut will save Victorian employers an additional $88 million in 2008-09. As a result of five successive cuts, Victorian employers will benefit from accumulated savings of $775 million in 2008-09.

Other revenue

Together, grants, taxation revenue, dividends, income tax equivalent and interest account for approximately 85 per cent of Victoria’s revenue. The remainder is made up of sales of goods and services and other income including fines and regulatory fees. These sources of income are estimated to increase by 1.3 per cent a year on average between 2008-09 and 2011-12. This includes a downward revision to fine revenue since the *2007-08 Budget Update* of approximately $50 million a year as a result of improved driver behaviour.

Further information on Victoria’s revenue sources can be found in Budget Paper No. 4, Chapter 4, *State Revenue*, with detailed analysis and explanations on the differences between the forecast for 2008-09 to 2010-11 at the time of the *2007-08 Budget Update* and the revised forecast provided in Appendix A, *Operating Statement Analysis*.

Expenses

The 2008-09 Budget builds on previous budgets to improve service delivery and to continue to realise the government's vision set out in *Growing Victoria Together*.

Total expenses from transactions are forecast to be $37 billion in 2008-09, representing an increase of $784 million, or 2.2 per cent, compared with the estimates in the *2007-08 Budget Update*.

Consistent with the forecast growth in total revenue over the forward estimates period, total expenses are projected to increase by an average of $1.6 billion, or 4.1 per cent, a year over the forward estimates period.

Employee expenses

Employee expenses (including superannuation) are forecast to be $16.1 billion in 2008-09, with employee expenses accounting for 43 per cent of total expenses in 2008-09.

Growth in employee expenses over the forward estimates period is expected to average $921 million, or 5.4 per cent, a year which is consistent with historical growth. This primarily reflects the government's wages policy and output policy initiatives, including 2008-09 Budget initiatives. It also reflects flow-on expense impacts of increased Commonwealth specific purpose grants and expenditure associated with own source revenue by GG entities such as schools, TAFEs and hospitals.

Other operating expenses

Other operating expenses are forecast to be $12.4 billion in 2008-09, representing 33 per cent of total expenditure in 2008-09.

These expenses are projected to increase by an average of $413 million (or 3.2 per cent) a year across the forward estimates. This growth mainly reflects government's policy initiatives including new initiatives in the 2008-09 Budget and projected growth in revenue over the forward estimates. Further increases relate to flow-on expense impacts of increased Commonwealth specific purpose grants and expenditure associated with own source revenue by entities such as schools, TAFEs and hospitals.

Grants and other transfers

Grants and other transfers are forecast to be $6.4 billion in 2008-09 which represents 17 per cent of total expenses in 2008-09. Over the forward estimates, grants and other transfers are projected to increase by an average of $20 million (or 0.3 per cent) a year. This primarily reflects the on-passing of additional Commonwealth Government revenue to non-government schools, grants to public non-financial corporations such as VicTrack, V/Line, and housing and grants to local government and the private sector.

Depreciation expenses

Depreciation expenses are projected to be $1.6 billion in 2008-09 and to grow by 6.5 per cent a year on average over the forward estimates as a result of the government's significant investment in infrastructure and forecast revaluations of existing assets.

Interest expenses

Interest expenses are estimated to increase by an average of $102 million, or 17 per cent, a year over the forward estimates, with a projected expense of $804 million in 2011-12. This reflects an increase in the servicing cost of the anticipated rise in borrowings over the period.

The additional borrowings will augment cash flows generated by operating activities to fund the government's social and economic infrastructure program. Servicing costs remain at prudent and financially responsible levels.

Further information on the differences between the forecast for 2008-09 to 2010-11 at the time of the *2007-08 Budget Update* and the revised forecast is provided in Appendix A, *Operating Statement Analysis*.

New output initiatives by department

As shown in Table 3.3, in order to deliver the government's policy objectives, the 2008-09 Budget new output initiatives have a net impact on the operating surplus of $182 million in 2008-09, and an average of $127 million a year from 2009-10 to 2011-12. This is in addition to the net impact of $83 million a year on average from 2008-09 to 2010-11 from *2007-08 Budget Update* output initiatives.

Table 3.3: Net impact of 2008-09 Budget new output initiatives[(a)]

($ million)

	2008-09 Budget	*2009-10 Estimate*	*2010-11 Estimate*	*2011-12 Estimate*
Education and Early Childhood Development	55.4	63.3	68.4	65.8
Human Services	485.3	336.3	354.8	378.1
Infrastructure	136.5	140.5	170.6	174.9
Innovation, Industry and Regional Development	166.2	179.6	165.8	152.5
Justice	188.5	223.9	250.8	268.6
Planning and Community Development	42.8	44.9	55.9	56.2
Premier and Cabinet	6.9	7.8	7.7	4.3
Primary Industries	10.4	7.8	6.9	7.8
Sustainability and Environment	106.3	42.9	24.9	25.6
Treasury and Finance	18.7	..	..	..
Parliament	6.5	7.3	7.9	8.1
Government wide	202.7	181.4	175.9	170.5
Subtotal	**1426.3**	**1235.8**	**1289.6**	**1312.4**
Less funding from demand contingency and other efficiencies	1244.2	1093.9	1150.3	1213.4
Net impact of 2008-09 Budget new output initiatives	**182.0**	**141.9**	**139.3**	**99.0**
Add: net impact of 2007-08 Budget Update output initiatives [(b)]	89.6	82.8	75.3	na
Net budget impact of output initiatives since 2007-08 Budget	**271.6**	**224.7**	**214.6**	**99.0**

Source: Department of Treasury and Finance

Notes:

(a) These numbers show the net impact on the general government sector net result from transactions and differ from Budget Paper No. 3, Appendix A, as amounts funded from internal reprioritisation or other existing sources have been deducted in the figures above.

(b) Net impact of 2007-08 Budget Update output initiatives is net of funding from demand contingency and other efficiencies.

Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*, provides more detail on the government's service delivery and strategy, while Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, provides a detailed list and description of all service delivery initiatives announced in this budget.

Other economic flows

Differences between the net result from transactions and the net result are due to other economic flows. This includes actuarial adjustments, gains and losses on the disposal of physical assets and other income and expenses from other economic flows.

Total other economic flows included in the net result from 2008-09 to 2011-12 primarily relate to provisions for doubtful receivables reflecting fines related to enforcement activities.

FISCAL RISKS

Economic risks are outlined in Chapter 2, *Economic Conditions and Outlook*. In addition to these risks, the government's projected financial performance may also be affected by specific major revenue and/or expenditure risks outlined below.

Revenue risks

Commonwealth grants

Commonwealth grants are a major source of revenue for the Victorian Government with estimated grants income of approximately $18 billion in 2008-09. Commonwealth grants include general purpose grants (GST grants) and specific purpose payments (SPPs).

The level of SPP funding received by Victoria is determined by the policies of the Commonwealth Government. In 2008 the majority of current SPP funding will be renegotiated, in line with reforms agreed by COAG in March 2008. Many current SPPs will be combined into a smaller number of new national SPP agreements, without a reduction in total Commonwealth funding for these activities. COAG also agreed to the provision of new National Partnership payments, to facilitate and reward reforms of national importance. These reforms are outlined in Chapter 5, *Economic Reform Agenda*. New funding agreements will generally commence from 1 January 2009. In the interim, estimates of SPP funding are based on current funding levels and growth rates.

The level of GST grants is affected by the general level of activity in the Australian economy and the GST revenue sharing relativities calculated by the CGC.

The CGC provides updates of its GST revenue sharing relativities in February each year. These are then subject to the approval of the Commonwealth Treasurer at the annual Ministerial Council for Commonwealth State Financial Relations. Any changes to economic conditions in the budget and forward estimates will have a direct impact on the amount of GST revenue to be distributed among the states.

Commonwealth grants revenue estimates represent the latest information available to the Victorian Government at the time of finalisation of the 2008-09 Budget.

Taxation revenue

The State's tax revenues are, for the most part, forecast on an assumed or estimated relationship between taxation revenue and projected economic variables. As a result, there are two main sources of risk to the taxation estimates. Firstly, changes in economic conditions from those projected will affect taxation revenue. For example, higher than expected economic activity or inflation will tend to lead to higher taxation revenue. This is the risk that is quantified in Appendix B, *Sensitivity Analysis Table*. Secondly there is a risk of changes in the relationship between the economic variables and taxation revenue.

Moreover, some state taxes, such as stamp duty on land transfer, are sourced from tax bases which are particularly volatile and revenue from these sources is subject to substantial annual variation.

Expenditure risks

General expenditure risks, such as unforeseen changes in the size and structure of the Victorian population, can be broadly classified into those affecting all government departments and those that are department specific.

The main risks to specific departmental expenditures relate to growth in the demand for government services, government commitments contingent on external factors, and government responses to unforeseen events such as natural disasters and bushfires.

The 2008-09 Budget estimates include a contingency provision to allow for the likelihood that some of the expenditure risks will eventuate during the budget year or over the course of the forward estimates. The contingency includes a provision for:

- growth in Victoria's population, and consequent derived demand for government services;
- an allowance for depreciation expenditure associated with future infrastructure investment, which is funded from the capital provision approved but not yet allocated (subject to government approval); and
- other expenditure risks which were unforeseen or not quantifiable, or that were not formalised at the time of construction of the budget estimates.

In addition, the 2008-09 Budget estimates include a contingency from 2009-10 that acknowledges funding for a number of existing programs that will conclude in 2008-09 or the following years. A provision is made on the basis that government may endorse a number of these programs to continue or be replaced to meet service delivery priorities.

The inclusion of an operating contingency provision in the budget estimates mitigates the potential impact of expenditure risks on the overall budget position. Realised expenditure risks will only affect total expenditure, and consequently the annual budget position, to the extent that these cannot be accommodated within the contingency provision built into the budget estimates. The aggregate level of the contingency provision is shown in Table 3.1, Budget Paper No. 4, Chapter 3, *Departmental Financial Statements*.

Sensitivity analysis

In addition to the fiscal risks outlined above, Appendix B, *Sensitivity Analysis Table*, quantifies the impact on revenue, expenses and the net result from transactions associated with variations to forecasts of selected economic and financial variables.

USE OF CASH RESOURCES

The government's infrastructure investment program underpins the provision of services to the people of Victoria such as health, housing and education services. It also supports economic growth by expanding the productive capacity of the economy through investments in transport infrastructure.

Table 3.4 provides a summary of cash generated through the operations of Victorian Government departments and other GG sector agencies, and how that cash is applied to infrastructure investment, and the associated impact on net debt.

Table 3.4: Application of cash resources

($ million)

	2007-08 Revised	*2008-09 Budget*	*2009-10 Estimate*	*2010-11 Estimate*	*2011-12 Estimate*
Net result from transactions	**996.0**	**827.5**	**851.1**	**906.0**	**962.6**
Add back: Non-cash income and expenses (net) [(a)]	2 925.7	1 866.7	1 614.0	1 872.9	1 963.3
Net cash flow from operating activities	**3 921.7**	**2 694.2**	**2 465.1**	**2 778.9**	**2 926.0**
Less:					
Net investment in fixed assets					
Expenditure on approved projects	4 377.2	4 092.2	3 445.8	2 889.9	2 268.5
Capital provision approved but not yet allocated	..	..	607.0	1 146.4	1 904.0
Meeting Our Transport Challenges Reserve to be allocated in future [(b)]	..	..	222.0	444.0	666.0
Proceeds from asset sales	(212.1)	(153.8)	(167.2)	(130.8)	(166.8)
Total net investment in fixed assets	**4 165.2**	**3 938.4**	**4 107.5**	**4 349.5**	**4 671.6**
Finance leases [(c)]	..	231.4	..	..	840.1
Other investment activities (net)	(31.5)	(7.9)	(23.7)	(24.2)	(24.6)
Decrease/(increase) in net debt	**(211.9)**	**(1 467.6)**	**(1 618.7)**	**(1 546.3)**	**(2 561.2)**

Source: Department of Treasury and Finance

Notes:

(a) Includes depreciation and movements in the unfunded superannuation liability and liability for employee benefits.

(b) Further information on the Meeting Our Transport Challenges Reserve can be found in Budget Paper No. 4, Appendix B.

(c) The finance lease recognised in 2008-09 is in relation to the redevelopment of the Royal Women's Hospital. The finance lease recognised in 2011-12 is in relation to the redevelopment of the Royal Children's Hospital.

The government's net infrastructure investment program (which includes total purchases of property, plant and equipment, capital contributions to other sectors of government and net proceeds from sale of assets) is projected to be $3.9 billion in 2008-09 and to average $4.3 billion over the forward estimates. Around 64 per cent of the $17.1 billion infrastructure program over the four years to 2011-12 will be funded from the cash surpluses from operating activities. The remainder of the infrastructure program will be funded by borrowings.

Total net investment in infrastructure includes expenditure on new projects approved in the 2008-09 Budget. Table 3.5 shows the net asset funding by department in 2008-09 which includes projects such as the further redevelopment of hospitals, additional funding for new and modernised schools and significant investment in rail and road projects. The government's commitment to infrastructure investment supports the delivery of efficient and effective government services and contributes to ongoing economic growth and development. Projected infrastructure spending also includes an approved capital provision that will be allocated to specific projects in future budgets. This is in accordance with existing budget practice to ensure realistic forward projections of infrastructure investment.

Over the budget and forward estimates, GG net debt is projected to rise by $1.8 billion a year on average. As a percentage of GSP, net debt will remain low at 2.9 per cent as at June 2012 and compared with 3.0 per cent in 1999.

Table 3.5: 2008-09 Budget new asset funding

($ million)

	2008-09 Budget	*TEI [(a)]*
Education and Early Childhood Development	233.9	592.3
Human Services	144.2	524.3
Infrastructure	212.3	1402.2
Innovation, Industry and Regional Development	14.4	49.8
Justice	118.3	443.7
Planning and Community Development	17.4	65.4
Premier and Cabinet	7.2	11.2
Primary Industries	2.8	13.9
Sustainability and Environment	45.4	91.6
Treasury and Finance	1.9	1.9
Parliament	0.9	3.8
Government wide	23.7	45.9
Total 2008-09 Budget asset funding	**822.4**	**3246.0**
Add: 2007-08 Budget Update asset funding	228.3	1128.6
Asset funding since the 2007-08 Budget	**1050.7**	**4374.6**

Source: Department of Treasury and Finance

Note:

(a) Total estimated investment. Includes projects which are to be delivered through the public non-financial corporations sector on behalf of the government.

Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives* includes a detailed list and description of all asset initiatives announced in this budget.

FINANCIAL POSITION

Table 3.6 presents the GG sector balance sheet which comprises assets and liabilities of all government departments and other bodies that provide services free of charge or at prices significantly below their cost of production. The GG net asset position, measured by subtracting liabilities from assets, is an important indicator of the sector's financial strength. A strong net asset position provides the capacity and the flexibility to absorb financial and economic shocks.

At 30 June 2007 the state had total assets of $109.9 billion offset by liabilities of $25.6 billion, leaving a net asset position of $84.3 billion. Net assets are projected to grow strongly to $106.2 billion by 30 June 2012, as growth in total assets exceeds growth in total liabilities. This is primarily due to a substantial proportion of the government's infrastructure program being funded from cash surpluses from operating activities, as previously discussed, along with forecast asset revaluations.

The largest asset categories within the GG sector are non-financial assets which comprised 55 per cent at 30 June 2007, and the state's equity investment in other sector entities which comprised 37 per cent, with the remaining 8 per cent comprising financial assets.

The largest liabilities within the GG sector are superannuation, which comprised 40 per cent at 30 June 2007, and borrowings which were 28 per cent. Trends in the key asset and liability categories are discussed below.

Table 3.6: General Government sector statement of financial position as at 30 June

($ billion)

	1999 Actual AAS	*2007 Actual A-GAAP*	*2008 Revised GFS-GAAP*	*2009 Budget GFS-GAAP*	*2010 Estimate GFS-GAAP*	*2011 Estimate GFS-GAAP*	*2012 Estimate GFS-GAAP*
FINANCIAL POSITION							
Assets							
Non-financial assets	32.4	60.0	66.1	69.6	75.8	80.5	86.8
Financial assets	3.3	9.1	7.2	7.8	7.8	7.8	7.8
Investments in other sector entities							
PNFC [(a)]	21.9	35.8	38.8	40.5	41.4	42.4	43.2
PFC [(a)]	1.2	5.0	5.0	5.0	5.0	5.1	5.1
Total assets	**58.8**	**109.9**	**117.1**	**122.9**	**130.1**	**135.7**	**142.9**
Liabilities							
Superannuation	11.4	10.1	12.9	13.1	13.1	13.2	13.2
Borrowings	7.1	7.2	7.3	9.4	11.2	12.9	15.6
Other liabilities	3.6	8.3	7.8	8.0	7.8	7.9	8.0
Total liabilities	**22.2**	**25.6**	**28.1**	**30.5**	**32.2**	**33.9**	**36.7**
Net assets	**36.7**	**84.3**	**89.0**	**92.4**	**98.0**	**101.8**	**106.2**

Source: Department of Treasury and Finance

Note:
(a) PNFC: Public non-financial corporations, PFC: Public financial corporations

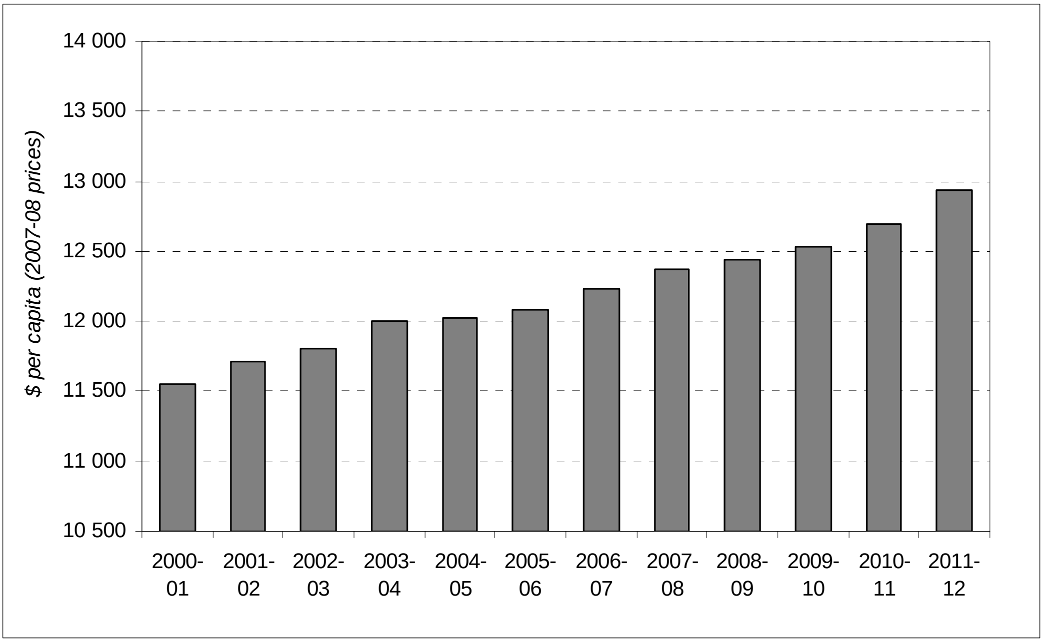
Assets

GG sector assets are forecast to be $117.1 billion by 30 June 2008 and to rise by a further $25.8 billion by 30 June 2012, at an average growth of 5.1 per cent a year.

Non-financial assets

Non-financial assets are projected to be $66.1 billion at 30 June 2008 and projected to grow to $86.8 billion by 20 June 2012. This growth is driven by the government's infrastructure investment program, which is forecast to average $4.3 billion a year over the four years to 2011-12, exceeding depreciation by an average of $2.5 billion. Chart 3.2 shows that there has been strong growth in the real capital stock in recent years and this is expected to continue over the forward estimates.

Chart 3.2: General Government sector real capital stock per capita as at 30 June[(a)(b)]



Source: Department of Treasury and Finance

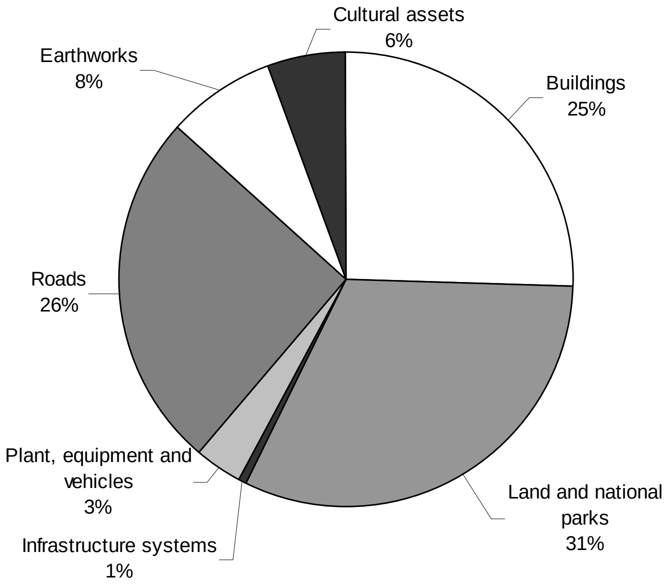
Notes:

(a) Due to a change in methodology by including the revaluation of the capital stock, effective from the 2007-08 Budget, this chart is not directly comparable to similar charts shown in previous years.

(b) Capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets.

Chart 3.3 shows the GG's $66.1 billion capital stock as at 30 June 2008 by asset class. The four largest classifications comprise land and national parks (31 per cent of the total capital stock), buildings (25 per cent), roads (26 per cent) and earthworks (8 per cent).

Chart 3.3: General Government sector capital stock as at 30 June 2008[(a)]



Source: Department of Treasury and Finance

Note:

(a) Capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets.

Due to a change in methodology by including the revaluation of the capital stock, effective from the 2007-08 Budget, this chart is not directly comparable to similar charts shown in previous years.

Investments in other sector entities

The new government sector reporting accounting standard requires investments held by the GG sector in State business enterprises to be reported in the statement of financial position. Table 3.6 shows this investment classified into the public non-financial corporations sector and the public financial corporations sector.

An increase in this item over the forward estimates is driven by equity in public non-financial corporations which is expected to increase from $38.8 billion as at 30 June 2008 to $43.2 billion as at 30 June 2012, a rise of $4.4 billion. This growth predominantly reflects the revaluation of non-financial assets and equity investments by the GG sector.

Financial and other assets

The GG sector also holds financial assets and other assets, including receivables, prepayments and inventories. Financial assets are expected to remain stable over the forward estimates period at around $8 billion after falling from $9.1 billion as 30 June 2007. This fall reflects the utilisation of deposits to fund infrastructure investment as well as a decline in receivables.

Liabilities

GG liabilities are projected to be $28.1 billion at June 2008 and are projected to modestly rise to $36.7 billion by 30 June 2012.

Superannuation liability

The State recognises a liability in respect of its defined benefit superannuation schemes, based on the difference between the assets of these schemes and the present value of the underlying obligation to members. After decreasing by $2.8 billion in 2006-07, largely due to strong investment returns on scheme assets, the state's superannuation liability is projected to increase by $2.8 billion in 2007-08 to $12.9 billion as at 30 June 2008. This increase is primarily due to lower than expected returns on the assets invested by the state's superannuation schemes.

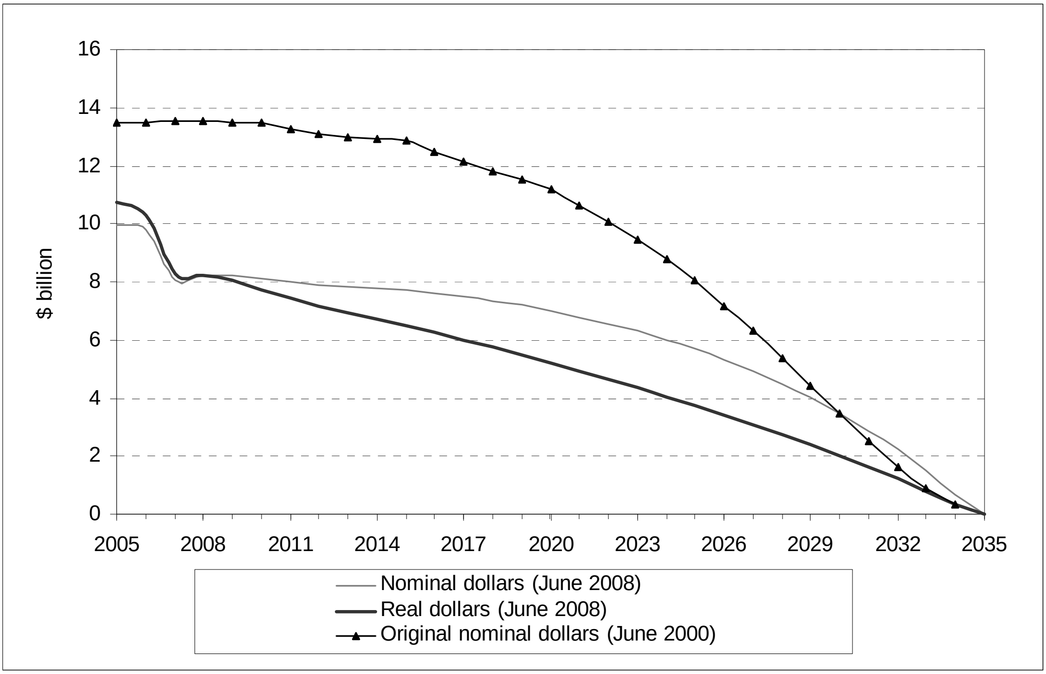
While investment returns have been lower than expected for the 2007-08 year to date, this follows strong growth over the five years to 30 June 2007, where the average net investment return for the State Superannuation Fund (SSF) was 13 per cent a year compared with the current assumed long term investment return of 8 per cent a year. Given the long-term nature of superannuation it is appropriate to maintain a strategy with a long-term focus rather than attempting to predict, and react to, short-term volatility. The government does not seek to forecast investment market movements.

Beyond 2007-08, the superannuation liability is expected to remain fairly stable between $13 billion and $13.2 billion. This slight increase is due to the fact that some of the schemes are only partially funded and so the return on assets is not sufficient to offset the growth in accrued liabilities. This effect will diminish as the schemes approach full funding.

A-IFRS accounting standards require the value of the superannuation liability to be determined using the Commonwealth government bond rate as the discount rate. Consequently changes in the Commonwealth bond rate can have a significant impact on the value of this liability. However, unlike asset related variations, these changes are driven by reporting requirements and do not affect the contributions actually required to finance superannuation liabilities. The actual funding requirements of the scheme are determined based on the scheme's expected long-term investment return.

Chart 3.4 below shows the expected profile of the unfunded superannuation liability of the SSF up until 2035, using the scheme's assumed long-term investment return as the discount rate.

Chart 3.4: General government sector unfunded superannuation liability of the Emergency Services Superannuation Scheme (State Superannuation Fund section) – long-term projections[(a)]



Source: Department of Treasury and Finance

Note:

(a) The government is committed to fully funding this superannuation liability by 2035. The chart above shows funding by this date but the actual progress toward this target may vary depending on a range of factors including investment market conditions.

Based on current projections, the state remains on track to achieve full funding of the unfunded superannuation liability in respect of the SSF by the target date of 2035.

Borrowings

GG sector gross debt is expected to rise from $7.3 billion at June 2008 to $15.6 billion at June 2012. The proceeds from those borrowings will be applied to funding the government's infrastructure program over this period and will remain at prudent and fiscally responsible levels.

KEY FINANCIAL INDICATORS

Details of the key financial indicators are shown in Table 3.7.

Table 3.7: General Government sector net debt, net financial liabilities and key ratios as at 30 June

	1999 Actual AAS	*2007 Actual A-GAAP*	*2008 Revised GFS-GAAP*	*2009 Budget GFS-GAAP*	*2010 Estimate GFS-GAAP*	*2011 Estimate GFS-GAAP*	*2012 Estimate GFS-GAAP*
				($ million)			
Net Debt [(a)]	4 791.8	2 059.0	2 270.9	3 738.6	5 357.3	6 903.6	9 464.8
Net Financial Liabilities	18 759.7	16 708.8	20 883.5	22 688.3	24 374.2	26 132.5	28 908.4
				(per cent)			
Net Debt to GSP [(b)]	3.0	0.8	0.9	1.3	1.8	2.2	2.9
Net interest to total revenue [(c)]	2.1	0.2	0.2	0.3	0.4	0.6	0.9
Net Financial Liabilities to GSP [(b)]	11.9	6.8	7.9	8.1	8.3	8.5	8.9
Net interest + superannuation interest expense to total revenue	4.6	1.4	1.0	1.6	1.7	1.9	2.1

Source: Department of Treasury and Finance

Notes:
(a) Net debt is the sum of deposits held, advances received and borrowings less the sum of cash and deposits, advances paid, and investments, loans and placements
(b) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
(c) Net interest equals interest expense less interest revenue

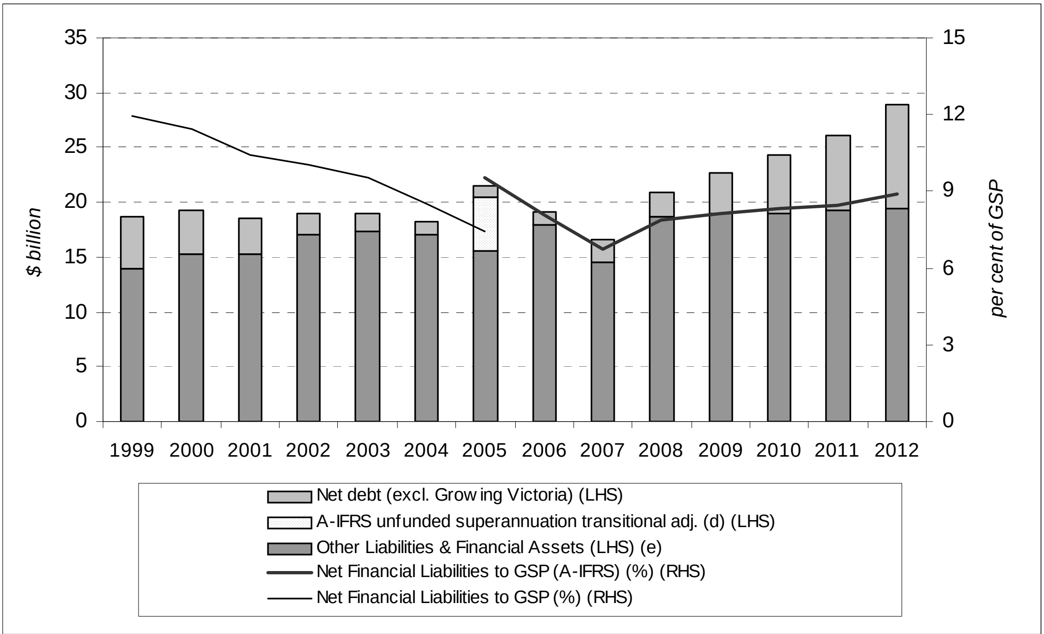
Net debt

Net debt is determined by deducting liquid financial assets from gross debt. The rationale for deducting liquid financial assets is that, in a period of financial difficulty, liquid assets would be readily available to repay debt and therefore reduce the government's obligation to investors.

GG net debt will increase from $2.3 billion at June 2008 to $9.5 billion at June 2012. As a proportion of GSP, net debt will continue to remain at historically low levels, increasing from 0.9 per cent of GSP at 30 June 2008 to 2.9 per cent of GSP at June 2012. This remains below the level of 3.0 per cent at June 1999.

Net financial liabilities

Chart 3.5: General government sector net financial liabilities as at 30 June



Source: Department of Treasury and Finance

In examining the liabilities of governments, analysts and ratings agencies tend to focus on net financial liabilities as it is a broader, more comprehensive measure of indebtedness.

In March this year the Uniform Presentation Framework (UPF) was updated as a result of the harmonisation of the accounting frameworks under the GFS-GAAP convergence process. As a result of the update, the UPF framework now includes a definition of net financial liabilities which differs from the calculation historically used by Victoria.

The new definition states that net financial liabilities comprises total liabilities less financial assets, but excludes equity investments in other sectors of government. Note that this definition is wider than the calculation used previously. For comparative purposes historical net financial liabilities prior to 2008 shown in Table 3.7 and Chart 3.5 have been recast.

Table 3.7 shows that net financial liabilities of the GG sector are projected to increase from $20.9 billion at 30 June 2008 to $28.9 billion at 30 June 2012. As a proportion of GSP, net financial liabilities also remain at historically low levels, increasing from 7.9 per cent to 8.9 per cent over the same period. The net interest plus superannuation interest cost to total revenue is projected to increase slightly from 1.0 per cent of total revenue in 2007-08 to 2.1 per cent in 2011-12. This is significantly below the level of 3.8 per cent in 1998-99.

Between 1999 and 2008 the government has reduced net financial liabilities as a percentage of GSP by 4.0 percentage points, equivalent to a reduction in the liability of more than $10 billion in real terms.

CHAPTER 4 – FISCAL SUSTAINABILITY OF THE STATE

- This chapter describes the financial performance of the broader public sector in Victoria. This adds the state's public non-financial corporations (PNFCs) to the general government sector to provide forward estimates of the non-financial public sector (NFPS).
- The NFPS maintains a strong financial position in the face of increasing financial and economic uncertainty, supporting investment in key infrastructure necessary to meet the challenges of climate change, rapid population growth and the service delivery standards required of a 21st century society.
- Infrastructure investment by the non-financial public sector over the four years from 2008-09 will total $29.4 billion, substantially higher than the $17.8 billion invested over the four years to 2007-08.
- The government continues to utilise a range of procurement methods for capital expenditure, including public-private partnerships (PPPs) through the *Partnerships Victoria* framework. Three *Partnerships Victoria* projects with a combined value of approximately $3.5 billion are currently under procurement or being prepared for procurement.
- Net debt of the non-financial public sector, while rising, will remain at low levels by historical, interstate and international standards and will reinforce maintenance of the state's AAA credit rating. Net debt of this sector will rise from 2.2 per cent of GSP at June 2008 to 7.1 per cent by June 2012.
- The broader ratio of net financial liabilities to GSP is expected to increase more moderately over the same period, rising from 9.6 per cent of GSP in June 2008 to 13.2 per cent of GSP in June 2012.
- Net debt servicing and superannuation interest costs as a proportion of total revenue are forecast to rise from 1.8 per cent in 2007-08 to 3.9 per cent in 2011-12. Nevertheless, the sustainability of Victoria's fiscal position is reinforced by the maintenance of a strong cash surplus from operating activities.

INTRODUCTION

The government's budget strategy and fiscal targets are concentrated on the general government sector, which mainly includes those departments and agencies that are funded by the appropriation process from the public account. The general government sector also reflects the departments and services for which ministers are directly accountable.

This chapter builds on the information presented previously to provide a more comprehensive analysis of the activities of the broader public sector, through the addition of the state's PNFCs to the general government sector, thereby producing the NFPS. The fiscal aggregates reported in this chapter are not targeted by the government's budget strategy, although they do contribute to the government's objective to maintain net financial liabilities at prudent levels, including the maintenance of a AAA credit rating.

The chapter concludes with a discussion of the key financial indicators, which highlight the ongoing financial sustainability of the public sector in Victoria.

FINANCIAL PERFORMANCE OF THE PUBLIC NON-FINANCIAL CORPORATIONS SECTOR

The financial position of the NFPS is derived from the estimated operating outcomes for the PNFC sector, which are added to the results for the general government sector.

The PNFC sector comprises a wide range of entities that provide goods and services (of a non-financial nature) to the public while meeting commercial principles through cost recovery via user charges and fees. Over 90 significant PNFCs are incorporated in the forward estimates compiled as part of the Budget and reporting processes. The most significant of the Victorian PNFCs are those providing water, housing, transport and port services.

Following the implementation of competition reform during the 1990s, a number of Victorian PNFCs pay dividends, income tax equivalents, and financial accommodation levies to the general government sector, ensuring a level playing field with the private sector. Some entities are provided with transfers from the general government sector to support their operations where warranted for reasons of public policy, or where market failure means that full cost recovery is not feasible. The PNFC sector comprises over one third of the total non-financial public sector when measured in terms of total assets.

Table 4.1 shows the summary operating statement for the public non-financial corporations sector.

Table 4.1: Public non-financial corporations operating statement for the financial year ending 30 June[(a)]

($ million)

	2008-09 Budget	*2009-10 Estimate*	*2010-11 Estimate*	*2011-12 Estimate*
Revenue				
Interest	85.8	77.9	79.2	78.8
Dividends income tax equivalent and rate equivalent revenue	5.1	34.1	39.9	45.9
Sales of goods and services	3 841.8	4 327.3	4 717.5	5 183.6
Grants	1 947.5	1 962.7	1 981.1	1 965.3
Other current revenue	436.1	484.7	502.8	507.7
Total revenue	**6 316.4**	**6 886.6**	**7 320.5**	**7 781.4**
Expenses				
Employee expenses	768.4	792.4	814.4	840.6
Superannuation interest expense	..	..	..	..
Other superannuation	53.8	55.3	56.9	58.2
Depreciation	968.2	1 067.4	1 105.3	1 231.1
Interest expense	540.5	729.5	897.3	1 002.9
Other operating expenses	3 704.3	3 845.5	3 939.7	4 149.9
Grants and other transfers	184.0	178.5	176.0	97.6
Other property expenses	93.8	96.9	118.0	106.8
Total expenses	**6 312.9**	**6 765.5**	**7 107.6**	**7 487.0**
Net result from transactions – Net operating balance	**3.4**	**121.2**	**212.9**	**294.4**

Source: Department of Treasury and Finance

Note:
(a) This is an abbreviated operating statement. The full statement is shown in Budget Paper No. 4, Chapter 2, and provides additional information on economic flow measurements which, when added to the net result from transactions, yields the net result.

Revenue

Total revenue is projected to be $6.3 billion in 2008-09. Over the forward estimates period, total revenue is projected to reach $7.8 billion in 2011-12 (averaging 7.2 per cent a year growth).

Revenue from the sales of goods and services in 2008-09 represents 61 per cent of total revenue. Over the forward estimates period, sales of goods and services are projected to grow by an average 10.5 per cent a year, primarily reflecting Essential Services Commission decisions on pricing for 2008-09 and requirements on the water sector to fund the infrastructure spending included in *Our Water, Our Future*.

Revenue from grants, which are mainly from the general government sector, represent an estimated 31 per cent of total operating revenue. This is projected to decline to 25 per cent by 2011-12, as other revenue sources (primarily sales of goods and services) account for an increasing share of total revenue. Victorian Rail Track and Housing are the main recipients of the grants.

Expenses

Total expenses are projected to be $6.3 billion in 2008-09 and are projected to rise to $7.5 billion (an average annual growth of 5.9 per cent) over the forward estimates period.

In 2008-09, other operating expenses represent an estimated 59 per cent of total expenses. These consist mainly of operating supplies and consumables of the water sector. By 2011-12, the share of other operating expenses will fall to 55 per cent as interest expenses rise reflecting increases in total debt levels over the period to fund the capital investment chiefly in the water sector. Similarly, depreciation expense will increase by an average of 8.3 per cent a year.

In 2008-09, employee expenses are projected to increase 5 per cent, before moderating to 3 per cent increases a year over the remainder of the forward estimates period.

Net operating balance

In 2008-09, a small operating surplus of $3.4 million is forecast across the sector as a whole. Going forward, improved net surpluses will be driven by the sustained growth in sales of goods and services by the metropolitan and rural water sectors. In addition, the moderation in various cost categories, including employee expenses and other operating expenses, assist in the improved result.

FINANCIAL PERFORMANCE OF THE NON-FINANCIAL PUBLIC SECTOR

Table 4.2 below shows the summary operating statement for the non-financial public sector as a whole, combining and consolidating the results for the general government and public non-financial corporation sectors. Transactions between the general government and PNFC sectors are eliminated, including dividends payable by public non-financial corporations.

Table 4.2: Non-financial public sector operating statement for the financial year ending 30 June(a)

($ million)

	2008-09 Budget	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
Revenue				
Taxation revenue	13 214.5	13 607.3	14 300.8	14 764.3
Interest	471.7	477.2	487.8	484.9
Dividends and income tax equivalents and rate equivalents	298.5	364.5	446.8	506.6
Sales of goods and services	7 129.6	7 647.6	8 097.7	8 586.8
Grants	17 553.5	18 496.2	19 445.3	20 425.4
Other current revenue	1 851.2	1 872.8	1 884.3	1 898.9
Total revenue	**40 519.0**	**42 465.7**	**44 662.6**	**46 666.9**
Expenses				
Employee expenses	14 961.5	15 866.1	16 839.2	17 651.1
Superannuation interest expense	518.6	520.6	520.5	519.7
Other superannuation	1 393.4	1 436.4	1 507.7	1 538.9
Depreciation	2 577.5	2 780.1	2 931.6	3 177.5
Interest expense	1 027.6	1 271.6	1 557.3	1 774.0
Other operating expenses	14 896.1	15 361.3	15 826.6	16 388.5
Grants and other transfers	4 608.9	4 506.7	4 574.5	4 543.5
Other property expenses	..	..	..	..
Total expenses	**39 983.6**	**41 742.7**	**43 757.4**	**45 593.2**
Net result from transactions – Net operating balance	**535.4**	**723.0**	**905.2**	**1 073.8**
less Net acquisition of non-financial assets from transactions	5 278.7	5 470.8	4 268.0	4 340.6
Net Lending/ (borrowing)	**(4 743.2)**	**(4 747.8)**	**(3 362.8)**	**(3 266.8)**

Source: Department of Treasury and Finance

Note:
(a) This is an abbreviated operating statement. The full statement is shown in Budget Paper No. 4, Chapter 2, and provides additional information on economic flow measurements which, when added to the net result from transactions, yields the net result.

Total revenue is expected to grow by an average of 4.8 per cent a year over the next four years. The two largest components, taxation and grants, have been discussed in the previous chapter. Sales of goods and services are expected to grow by an average of 6.4 per cent. Sales growth reflects changes already identified for the general government sector and the anticipated increase in charges by the water authorities.

Total expenses are expected to show an average of 4.5 per cent growth a year over the next four years. This indicates that expenses will remain constant in real per capita terms, continuing the government’s commitment to sound finances.

The net operating balance for the combined sectors will be a surplus of $535.4 million in 2008-09, and continue to rise steadily, averaging just over $900 million a year from 2009-10 to 2011-12. This is largely driven by the result for the general government sector.

CASHFLOWS OF THE NON-FINANCIAL PUBLIC SECTOR

Table 4.3 shows the cashflow statement of the non-financial public sector, and how the cash surpluses will be used in financing the acquisition of new fixed assets.

Table 4.3: Non-financial public sector cashflow statement[(a)]

($ million)

	2008-09 Budget	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
Cash receipts from operating activities	40 315.9	41 932.6	44 331.3	46 343.5
Cash payments from operating activities	(37 069.4)	(38 684.2)	(40 551.0)	(42 188.2)
Net cash flows from operating activities	**3 246.5**	**3 248.4**	**3 780.3**	**4 155.2**
Purchases of non-financial assets	(7 916.4)	(8 479.9)	(7 374.0)	(6 700.7)
Sales of non-financial assets	310.7	316.9	252.0	231.1
Net cash flows from investing in non-financial assets	**(7 605.7)**	**(8 163.0)**	**(7 121.9)**	**(6 469.6)**
Net cash flows from investments in financial assets for policy purposes	565.8	27.3	15.5	16.1
Net cash flows from investments in financial assets for liquidity purposes	59.2	(83.0)	26.9	8.4
Net cash flows from investments in financial assets	**684.2**	**(138.7)**	**69.4**	**32.9**
Advances received (net)	(0.7)	(0.7)	(0.8)	(0.8)
Net borrowings	3 548.4	5 020.8	3 426.7	2 358.1
Deposits received (net)	(18.8)	(7.4)	0.2	(0.6)
Other financing (net)	..	..	..	..
Net cash flows from financing activities	**3 528.9**	**5 012.7**	**3 426.1**	**2 356.7**
Net increase/(decrease) in cash and cash equivalents	**(205.3)**	**42.4**	**126.9**	**66.9**

Source: Department of Treasury and Finance

Note:
(a) This is an abbreviated cashflow statement. The full statement is shown in Budget Paper No. 4, Chapter 2.

Investment in non-financial assets

Net investment in infrastructure (purchases less sales of non-financial assets) by the NFPS is estimated to be $7.6 billion in 2008-09, and reach a total of $29.4 billion for the four years to 2011-12. This compares with $17.8 billion over the four years to 2007-08, and demonstrates the government's commitment to upgrading the infrastructure of the state to meet the challenges of climate change and population growth. It should be noted however, that under the accounting standards, approximately $3.5 billion of expenditure currently shown in Table 4.3 for purchases of non-financial assets is likely to be undertaken as *Partnerships Victoria* projects and as such cashflow forecasts will be revised when the projects are awarded.

Of the forecast expenditure by the NFPS on new fixed assets over the next four years 49 per cent will be funded from cash operating surpluses. This is lower than the ratio for the general government sector, due to the greater need for borrowings for projects undertaken by the PNFC sector. The servicing and repayment of this debt is allowed for in the determination of prices in this sector. As these projects generate long-term positive benefits to the community, the use of debt finance is appropriate as it distributes the burden equitably across beneficiaries over time.

The government has already announced significant infrastructure investments for the PNFC sector, including $4.9 billion to diversify and secure water supplies for the long term. Key components of the government's plan include:

- the first stage of the $1 billion Food Bowl Modernisation Project upgrading major irrigation infrastructure in northern Victoria will create water savings of an average of 225 gigalitres a year to be shared equally by irrigators, environment and Melbourne by 2012. The state government is contributing $600 million, Melbourne Water Corporation $300 million and the irrigators $100 million. The first water savings will be available from 2010 for Melbourne;
- the $625 million Sugarloaf interconnector which will link the Goulburn River to the Melbourne system and transfer a share of the water savings obtained through the Food Bowl Modernisation Project to Melbourne from 2010. Melbourne Water Corporation will finance the delivery of this Project; and
- the Wonthaggi Desalination Project at an estimated capital cost of $3.1 billion is expected to be delivered under the government's *Partnerships Victoria* framework (see below).

Other initiatives for the PNFC sector included in the 2008-09 Budget include:

- $256 million for the purchase of another eight metropolitan trains, stabling and associated operating costs to address the growing demand on the metropolitan rail network. This procurement is in addition to the purchase of ten metropolitan trains announced in the 2007-08 Budget. This initiative is funded from the *Meeting Our Transport Challenges* reserve;
- $272.9 million for the delivery of works to address congestion on the metropolitan train network, including upgrades to Craigieburn and Laverton stations and associated track and the Dandenong rail corridor: Westall rail upgrade.

Projected infrastructure spending from 2009-10 includes an unallocated capital provision that will be used to fund new projects in future budgets.

The substantial level of infrastructure spending, as well as supporting economic activity in the short-term, will ensure that Victoria has the appropriate productive infrastructure into the future to support continued economic growth over the longer term. In turn, this long-term economic expansion will underpin the state's capacity to pay for the infrastructure over the longer term without the need to compromise on service delivery.

Procuring New Infrastructure

Once government determines that there are sufficient grounds and priority for a new project then an analysis is undertaken as to the preferred method of delivery. These methods include utilising cash reserves, operating surpluses or the use of long-term borrowings that match the expected life of the project. Projects can be procured either by traditional methods or via the *Partnerships Victoria* method of public-private partnerships (PPPs).

Partnerships Victoria is most useful in major and complex capital projects with opportunities for innovation, risk transfer, appropriate third-party usage of facilities and the integration of design, construction, and maintenance over the life of an asset, within a single project package. The approach allows for the delivery of key infrastructure projects using private sector expertise to benefit the public sector.

To date, 18 projects with a capital investment of over $5.5 billion have been contracted with private parties. Twelve of these projects have reached commissioning and are now operational, and a further three projects are expected to reach commissioning in 2008.

Future Partnerships Victoria Projects

Three *Partnerships Victoria* projects with a combined value of approximately $3.5 billion are currently under procurement or being prepared for procurement. In each case, the project will only proceed as a PPP if this provides best value compared with what the same project could achieve under a more traditional procurement method. These projects are:

- Schools – The *Partnerships Victoria* in Schools Project involves the delivery of 11 new schools on separate greenfield sites in Melbourne’s growth areas that will provide high quality, flexible, world class teaching and learning environments to drive excellence in education outcomes. The private sector partner will design, construct, finance and maintain the facilities over the contract period. Core educational services will be retained by the state. Five of the schools (Taylors Hill Primary, Derrimut Primary, Cranbourne North East Primary, Point Cook North Prep to year 9, and Casey Central Secondary College) are expected to be opened in time for the start of the 2010 school year. The other six schools (Mernda Central Primary, Craigieburn West Primary, Lyndhurst Primary, Kororoit Creek primary, Truganina South Primary and Cranbourne East Prep to year 12) are planned to open for the start of the 2011 school year.
- Wonthaggi Desalination Project – The successful private sector proponent will be responsible for the design, construction, financing, operations and maintenance of the facility. Construction is scheduled to commence in 2009 with the first water due to be supplied by the end of 2011.

- BioSciences Research Centre – The state, through the Department of Primary Industries, in joint venture with La Trobe University (La Trobe), is investing in the development of a biosciences research facility, to be known as the Biosciences Research Centre (BRC) and located at La Trobe's Bundoora campus. In the 2007-08 Budget, the state committed $180 million to fund capital costs and specialised equipment for the Project. La Trobe has committed $50 million towards the Project together with the land on which the BRC will be constructed. A private sector consortium will be responsible for the financing, design, construction, commissioning and maintenance of the new BRC. In 2008, key documentation will be finalised and the project will be put to the market. An invitation to the market for Registration of Capability was released on 30 April 2008. The BRC is expected to be completed by the fourth quarter of 2011 and fully operational by the end of the first quarter of 2012.

FINANCIAL POSITION OF THE NON-FINANCIAL PUBLIC SECTOR

Table 4.4 shows the summary balance sheet of the non-financial public sector. Net assets are projected to stand at $90.9 billion as at 30 June 2008 and to grow to $108.2 billion by 30 June 2012. This is driven by the significant capital investment program which was discussed previously and the fact that it is substantially funded by operating surpluses. In June 2008, assets of $127.0 billion, primarily consisting of physical (non-financial) assets, as well as significant financial assets, more than offset liabilities of $36.1 billion, consisting mainly of borrowings and unfunded superannuation. Equity in other sectors consists of the net assets of the state's public financial corporations, the largest of which are the Transport Accident Commission and the Victorian WorkCover Authority.

Table 4.4: Financial position of the non-financial public sector

($ million)

	1999 Actual AAS	2007 Actual A-GAAP	2008 Revised GFS-GAAP	2009 Budget GFS-GAAP	2010 Estimate GFS-GAAP	2011 Estimate GFS-GAAP	2012 Estimate GFS-GAAP
Assets							
Non-financial assets [(a)]	57.0	101.2	111.3	120.4	131.0	138.3	146.0
Financial assets [(b)]	7.2	14.4	10.7	10.1	10.0	9.9	9.7
Investments in other sector entities [(c)]	1.2	5.0	5.0	5.0	5.0	5.1	5.1
Total assets	**65.4**	**120.7**	**127.0**	**135.6**	**146.1**	**153.3**	**160.7**
Liabilities							
Superannuation	11.4	10.2	13.0	13.1	13.1	13.2	13.2
Borrowings	9.9	12.8	13.4	18.2	23.3	26.7	30.0
Other liabilities	6.2	10.2	9.7	9.9	9.7	9.5	9.3
Total liabilities	**27.5**	**33.1**	**36.1**	**41.2**	**46.1**	**49.4**	**52.5**
Net assets	**37.9**	**87.6**	**90.9**	**94.4**	**99.9**	**103.8**	**108.2**

Source: Department of Treasury and Finance

Notes:
(a) Physical assets include land and buildings, plant and equipment, roads and earthworks, cultural collections and other non-current assets.
(b) Financial assets include cash assets, investments, loans and placements, receivables, prepayments and inventories.
(c) Consists of investment in public financial corporations.

Non-financial assets are expected to grow from $111.3 billion in June 2008, to $146.0 billion in June 2012 as a result of the substantial level of infrastructure spending targeted over the next four years.

Borrowings of the non-financial public sector are expected to rise from $13.4 billion at June 2008 to $30.0 billion at June 2012, supporting the state’s $29.4 billion new infrastructure program. Of the new borrowings expected to be incurred over the four years to June 2012, almost 54 per cent will be by the PNFC sector where it will largely be serviced through sales revenue.

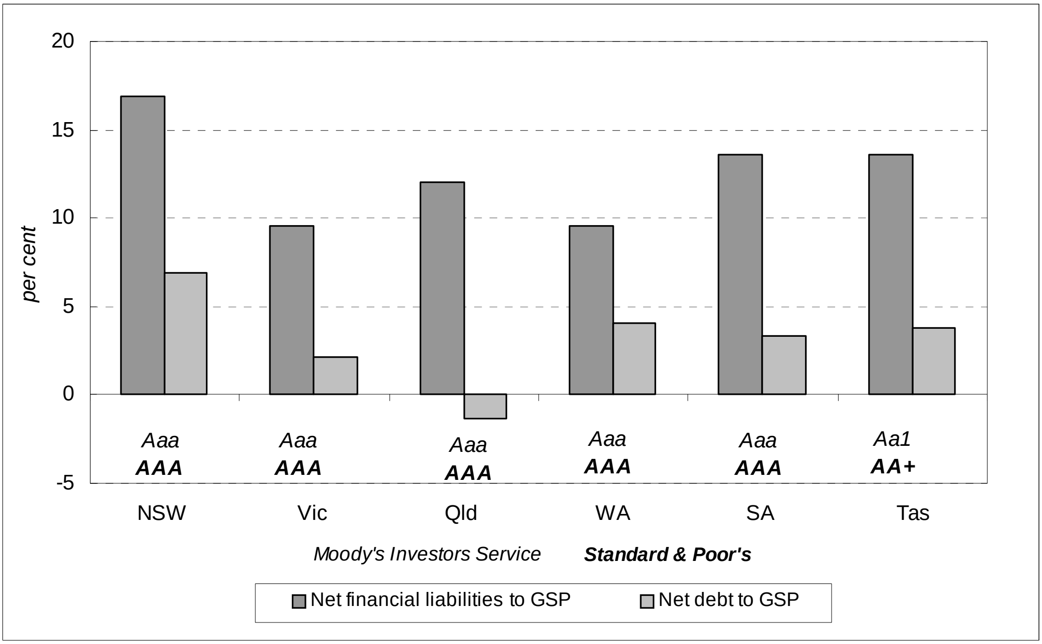
Virtually all the state’s public non-financial corporation sector employees are in fully funded superannuation schemes. Hence the superannuation obligation for the non-financial public sector largely reflects that of the general government sector, the details of which were discussed in the previous chapter.

FINANCIAL SUSTAINABILITY

The government is committed to maintaining net debt and financial liabilities at prudent levels and retaining the state's AAA credit rating. Ratings agencies use a variety of measures when examining the credit worthiness of states, or more specifically in rating the securities issued by them. This includes both net debt and net financial liabilities of the general government sector and the non-financial public sector which are measures of overall indebtedness. They also look at the capacity of jurisdictions to service the obligations arising from these measures.

Chart 4.1 summarises the credit ratings and key financial indicators of the Australian states as at 30 June 2008.

Chart 4.1: 2008 state financial indicators and credit ratings



Source: Victoria: Department of Treasury and Finance
Other states: various 2007-08 Budget Update reports from state Treasuries

Moody's Investors Service and Standard and Poor's have both cited Victoria's low debt levels, high degree of financial flexibility, strong fiscal position, the government's commitment to prudent financial management, and the broad based economy as the key drivers for Victoria's AAA credit rating.

Table 4.5: Key financial indicators of the non-financial public sector

	1999 Actual AAS	2007 Actual A-GAAP	2008 Revised GFS-GAAP	2009 Budget GFS-GAAP	2010 Estimate GFS-GAAP	2011 Estimate GFS-GAAP	2012 Estimate GFS-GAAP
				($ million)			
Net Debt	6 058.3	4 000.3	5 715.0	11 011.0	16 068.2	19 562.7	22 872.0
Net Financial Liabilities	20 833.8	20 056.8	25 391.5	31 084.4	36 090.5	39 558.5	42 804.2
				(per cent)			
Net debt to GSP [(a)]	3.9	1.6	2.2	3.9	5.5	6.3	7.1
Net interest to total revenue [(b)]	2.3	0.7	1.0	1.4	1.9	2.4	2.8
Net financial liabilities to GSP [(a)]	13.2	8.1	9.6	11.1	12.3	12.8	13.2
Net interest + superannuation interest expense to total revenue	4.6	1.8	1.8	2.7	3.1	3.6	3.9

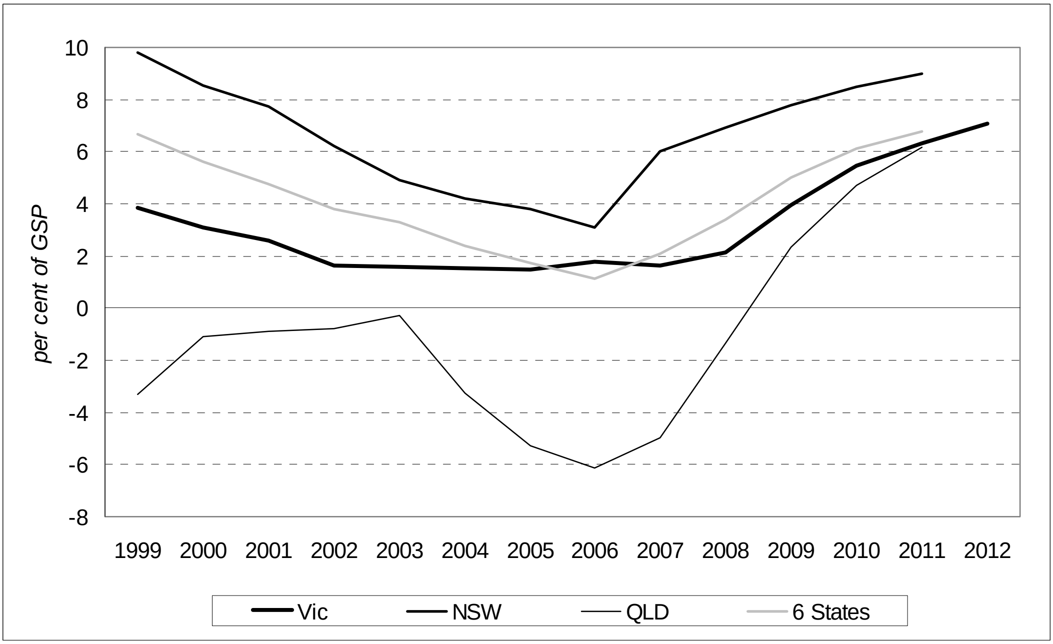
Source: Department of Treasury and Finance

Notes:
(a) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
(b) Net interest equals interest expense less interest revenue.

Net Debt

Non-financial public sector net debt comprises general government sector net debt and public non-financial corporations sector net debt. While general government sector net debt is expected to rise by $7.2 billion over the four years to June 2012, net debt of the PNFC sector will rise by $10 billion over the same period.

Chart 4.2: Net debt of the non-financial public sector as at 30 June



Source: Victoria: Department of Treasury and Finance.
Other states: ABS Cat.No.5512: Government Financial Statistics, 2006-07 for 1999 to 2007 and various 2007-08 Budget Update reports from state Treasuries for data from 2008 to 2011.

As a proportion of GSP, net debt of the NFPS will rise from 2.2 per cent in June 2008 to 7.1 per cent in June 2012. Although net debt of the Victorian NFPS is rising as a proportion of GSP, Chart 4.1 shows it is expected to remain below the state average through until 2011. A number of other jurisdictions, including NSW, Queensland and Western Australia have announced high levels of capital expenditure for the four years ended 2011. These trends are expected to continue as other jurisdictions bring down their 2008-09 Budgets in coming months.

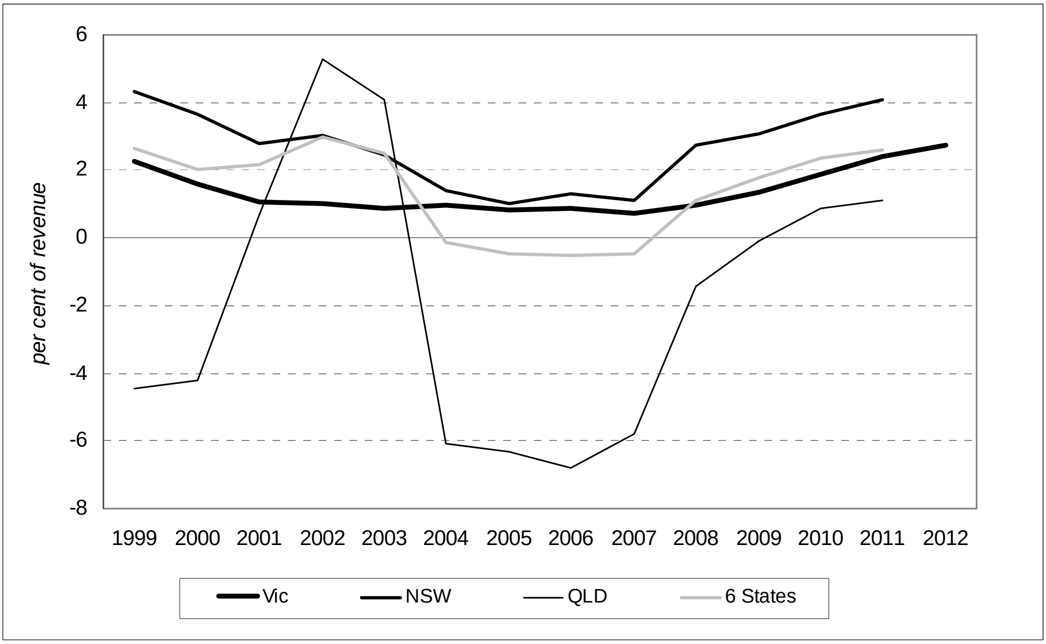
Service Costs on Net Debt

Management of the debt portfolio continues to be based on the key objectives of achieving relative certainty of interest costs, while minimising borrowing costs and refinancing risk, and managing the financial and operational risks in a prudent manner.

Victoria minimises its interest rate risk primarily by borrowing at fixed rates from the Treasury Corporation of Victoria, which largely matches the debt with borrowings from the private sector. The state's debt portfolio is structured to maintain a relatively even maturity profile over a term structure out to 10 years, but with some longer dated securities being held where liquidity is available. This profile ensures a relatively small proportion of the debt portfolio is subject to repricing and uncertainty in any one period which assists in stabilising servicing cost.

As a result of the increase in net debt projected over the forward estimates period, servicing costs are expected to rise as a proportion of revenue, although like the increase in debt itself, these increased costs will largely be within the PNFC sector. Following a period of prolonged stability at around 1 per cent, net interest (interest expense less interest income) as a proportion of revenue for the NFPS is forecast to rise from 1.0 per cent in 2007-08 to 2.8 per cent in 2011-12. For the PNFC sector, the ratio will rise from 5.2 per cent to 11.9 per cent in 2011-12.

Chart 4.3: Service cost of net debt of the non-financial public sector: year ended 30 June[(a)]



Source: Victoria: Department of Treasury and Finance.
Other states: ABS Cat.No.5512: Government Financial Statistics, 2006-07 for 1999 to 2007 and various 2007-08 Budget Update reports from state Treasuries for data from 2008 to 2011.

Note:
(a) Service cost equals net interest to net revenue.

Chart 4.2 shows that Victoria's interest burden is likely to remain below that of the states from 2008-09 to 2010-11.

Net financial liabilities

This year, the adoption of the new accounting standard AAS1049 means the measure of net financial liabilities is broader than that used by Victoria in the past: rather than the measure being net debt plus the net unfunded superannuation liability, it now includes total liabilities less all financial assets, excluding equity investments in other sectors. While the absolute measures are different than in the past, the overall story shown for Victoria is the same.

Based on the new measure, net financial liabilities of the non-financial public sector are projected to be $25.4 billion as at 30 June 2008 (9.6 per cent of GSP) and are forecast to increase to $42.8 billion (13.2 per cent of GSP) by 30 June 2012. This increase is largely attributable to the significant increase in borrowings by the public non-financial corporations sector.

Chart 4.4: Net financial liabilities of the non-financial public sector as at 30 June

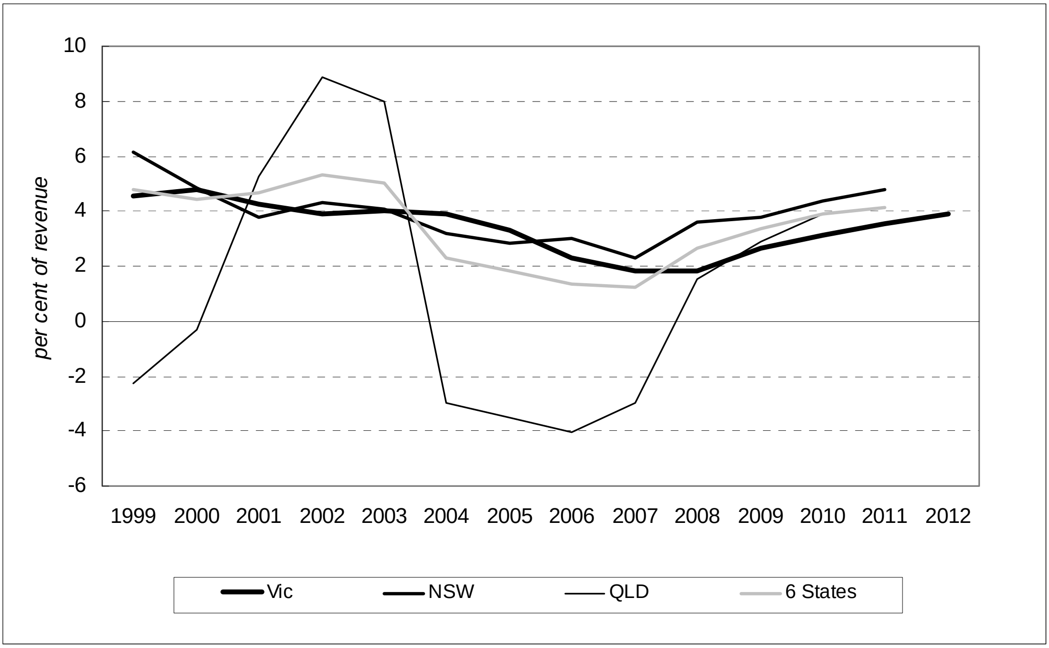
Source: *Victoria: Department of Treasury and Finance*
Other states: ABS Cat.No.5512: Government Financial Statistics, 2006-07 for 1999 to 2007 and various 2007-08 Budget Update reports from state Treasuries for data from 2008 to 2011.

Victoria's ratio of net financial liabilities to GSP is expected to remain well below the average of the states, at 12.7 per cent by 30 June 2011, compared with an average of the states of 15.1 per cent (based on latest available state data).

Service cost of net financial liabilities

Given the broader measure adopted for net financial liabilities under the new accounting standard there is now no single servicing measure that reflects the cost of meeting this obligation over time. A useful, but not complete, proxy measure is to look at the sum of meeting the servicing cost of the superannuation liability and net interest paid as a proportion of total operating revenue. Focusing on servicing costs as a proportion of revenue (rather than GSP) provides a more direct indicator of a state's capacity to service its liabilities, and is an important indicator of the sustainability of a state's fiscal position considered by ratings agencies.

Chart 4.5: Superannuation interest expense and net interest of the non-financial public sector to total revenue: year ended 30 June



Source: *Victoria: Department of Treasury and Finance*
Other states: ABS Cat.No.5512: Government Financial Statistics, 2006-07 for 1999 to 2007 and various 2007-08 Budget Update reports from state Treasuries

After trending down each year to 2007, reaching a low point of 1.8 per cent, superannuation interest expense and net interest are expected to rise as a proportion of revenue, reaching 3.9 per cent of revenue in 2011-12.

Victoria's servicing costs are following a similar pattern to the other states, although in 2010-11 (the latest year for which data is currently available for all jurisdictions), Victoria's ratio is expected to be below the average of the other states.

CHAPTER 5 – ECONOMIC REFORM AGENDA

Effective economic management has enabled the Victorian economy to achieve strong growth and weather the challenges presented by local and global uncertainties.

The government's objective is to maintain Victoria's economic growth by:

- continued investment and reform in key areas, including skills, infrastructure and business competitiveness;
- advocating national reform to boost economic growth in all states; and
- taking action to meet challenges to economic growth, including those presented by climate change and water supply constraints.

Council of Australian Governments (COAG) processes present the opportunity to achieve key national reform goals previously advocated by Victoria as part of the National Reform Agenda, including:

- a more effective framework for Commonwealth – State financial relationships, including wide-ranging reform to increase the flexibility and reduce the administrative cost of specific purpose payments, and the introduction of incentive payments to drive reforms of national importance; and
- better policy outcomes in areas of shared interest leading to stronger growth outcomes.

Victoria has enjoyed strong economic growth over the last decade, supported by continuing population growth, productivity growth and a rising participation rate. Looking ahead, Victoria faces a number of challenges to economic prosperity, including an ageing population, slowing productivity growth, changing global fortunes and environmental issues. These challenges highlight the importance of getting the most from Victoria's potential sources of growth – especially productivity growth and workforce participation – by continuing an active program of Victorian and national reform.

Victoria's reform program is designed to foster economic growth by:

- improving workforce participation and productivity by improving people's skills;
- investing in preventative health measures to provide for a healthy workforce;
- improving business competitiveness; and
- continuing to improve the quality and timely provision of infrastructure.

Policies are also aimed at meeting challenges to economic growth by:

- responding to climate change; and
- ensuring water security.

Victoria continues to pursue a program of state-based reform. In many areas, however, the shared objectives and overlapping responsibilities of governments, and the imbalance between their spending and taxing powers, makes collaboration between the Commonwealth and state governments essential to significant reform. The Victorian Government has consistently advocated such action.

COAG includes first ministers and treasurers from the Commonwealth and all states and territories and will meet quarterly, throughout 2008, to develop an ambitious program in key reform areas. These include health and ageing, the productivity agenda (including education, skills, training and early childhood development), climate change and water, infrastructure (including transport), business regulation and competition, housing and indigenous reform and, through treasurers, Commonwealth-State financial relations. Intergovernmental working groups have been established to oversee reform in each of these areas.

Forward work programs for these groups were agreed at the March 2008 meeting of COAG. This meeting also marked significant achievements in selected reform areas, with governments agreeing to a single governance framework for the Murray Darling Basin, additional funding for public hospitals, a national registration and accreditation system for health professionals, an accelerated regulation reform agenda and a program for expanded competition reforms. COAG also substantially reshaped Commonwealth – State financial relationships through the reform of specific purpose payment arrangements. Importantly, COAG agreed to the provision of new National Partnership reform payments to facilitate and provide incentives for governments to undertake wide ranging reforms in areas of joint responsibility, having regard to the economic benefits of proposed reforms.

Victoria's reform agenda includes areas of responsibility shared with the Commonwealth but there are also areas where Victoria is taking action alone, or leading activity in intergovernmental forums. The main reform areas are discussed in more detail below.

FOSTERING ECONOMIC GROWTH

Improving business competitiveness

Continued reduction of business costs, including tax changes, reductions in red tape, improvements to infrastructure and an emphasis on innovation and research and development will improve the national and international competitiveness of all Victorian businesses and help foster economic growth.

In July 2006, the government announced the *Reducing the Regulatory Burden* initiative, Victoria's policy for reducing the cost of regulation for businesses and not-for-profit organisations. The government announced that it would:

- cut the existing administrative burden of regulation by 15 per cent over three years and 25 per cent over five years;
- ensure the administrative burden of any new regulation is met by an offsetting simplification in the same or related area; and
- undertake a program of reviews to identify the necessary actions to reduce compliance burdens.

In terms of administrative burden, this translates into a net reduction equivalent to savings to business and not-for-profit organisations of $154 million a year by July 2009 and $256 million a year by July 2011. The productivity boost from reducing red tape has the potential to expand Victoria's economy by up to $747 million a year (in 2005-06 prices) by 2016.

All departments now have three-year administrative burden reduction plans in place. Provisional estimates indicate that Victoria is on track to meet the July 2009 target. A detailed update on further prospective reductions as a result of changes implemented during 2007-08 will be released later in the year.

For example, implementation of the Victorian Government's food regulation reforms, in response to an inquiry undertaken by the Victorian Competition and Efficiency Commission, will deliver an estimated $20 million a year in administrative savings to business and not-for-profit organisations.

Reviews have also commenced to deliver on the government's commitment to reduce the number of principal Acts of Parliament by 20 per cent by 2010. A total of 70 Acts have been repealed to date, and further repeal bills will be introduced for consideration by the Victorian Parliament during 2008.

Victoria is at the forefront of ongoing multi-jurisdictional action to reduce the burden of regulation. Victoria has taken a leading role in discussions within COAG, the Council for the Australian Federation, numerous Ministerial Councils, and bilaterally with other states, aimed at increasing harmonisation in regulatory definitions and administration, and minimising the cost of regulation to businesses, not-for-profit organisations, and individuals.

For example, New South Wales and Victoria have harmonised payroll tax legislation, including common definitions and exemptions, that will reduce payroll tax paperwork for around 8 000 businesses with operations on both sides of the Murray River. All jurisdictions have committed to joining the Victorian/New South Wales model as soon as practicable, with Queensland and Tasmania due to do so from 1 July 2008.

COAG's Business Regulation and Competition Working Group, established in December 2007, will drive the agreed COAG agenda for reduction of the regulatory burden on business by accelerating and broadening regulation and competition policy reforms and improving processes for regulation making and review.

At its meeting on 26 March 2008, COAG endorsed an accelerated reform agenda covering 27 existing and new areas of regulatory reform, in which harmonisation of occupational health and safety legislation is the top priority. An intergovernmental agreement on occupational health and safety harmonisation will be finalised by May 2008 and COAG will consider an accelerated implementation timetable in July 2008.

Infrastructure investment

Victoria faces a number of challenges in the effective management of its existing infrastructure assets as well as the planning and construction of new assets needed to support the state's ongoing economic growth and productivity. The government has recognised this through a significant investment program where almost $30 billion will be spent over the next four years alone on infrastructure projects across the state. The government is investing heavily in social infrastructure, including modernising hospitals and schools, as well as economic infrastructure such as roads, rail lines and port facilities.

The 2006 Census of Population and Housing has highlighted the challenges facing Victoria from higher than anticipated population growth, especially for metropolitan Melbourne. This is expected to continue and requires careful planning and timely decisions about Victoria's infrastructure needs over the next 20 years. Other demographic challenges facing the state include the ageing population, changes in household composition and population movements across Victoria, all of which need to be considered in determining infrastructure requirements.

The government is currently making a number of significant investments to improve the efficiency of the freight transport network. Deepening the shipping channels of Port Phillip Bay will allow the Port of Melbourne to accommodate the global trend towards larger container ships. This will assist Melbourne to remain the leading container port in Australia.

The government commissioned the *East West Link Needs Assessment* to develop options to address future demands on transport connections across Melbourne's east-west corridor given the expected growth in freight and passenger movements. The advice prepared by Sir Rod Eddington was publicly released in April 2008 and submissions on its findings have been invited. Public comment will inform government decision making on future transport links in metropolitan Melbourne.

An example of this government's commitment to social infrastructure is a long-term program of rebuilding or modernising every Victorian government school over a 10 year period. The *Victorian Schools Plan* will transform education infrastructure by ensuring all Victorian government schools are equipped to provide high quality education to their students.

A number of new schools are being developed under the program through public-private partnerships, which offer an opportunity to combine the skills of the public and private sectors. The private sector is responsible for the design and construction of the new school facilities and the ongoing asset condition and performance over the life of the buildings, while the state retains responsibility for the delivery of all core education and curriculum services.

More broadly, the COAG process presents a new opportunity to tackle the infrastructure investment challenges across jurisdictions. Efficiency gains will be accrued through collaborative action to streamline planning processes, removal of regulatory duplication and the creation of a national market to facilitate infrastructure investment and construction. The first step in this process involves an assessment of the adequacy of the nation's economic infrastructure to inform future funding decisions for infrastructure projects that are agreed national priorities. Victoria has called on the Commonwealth Government to increase its funding contribution to meeting national infrastructure requirements.

Increasing skill levels

The education and skills of Victoria's population are strong influences on both the prosperity of the state, and the opportunities of individuals.

Labour force and productivity growth are the key determinants of Victoria's long-run economic growth, and thus the prosperity of the state. Over the coming decades, an ageing population means that economic reform will need to deliver higher labour force participation and stronger productivity growth if Victoria's prosperity is to be sustained.

The knowledge and skills of Victoria's workforce influence both labour force participation and productivity. Those with higher skills are more likely to participate in the workforce and to work to an older age. They are also more productive and innovative, and better able to adapt and contribute to changing circumstances.

Higher levels of education deliver a range of lifetime benefits to individuals, including higher incomes, lower rates of unemployment and better health and wellbeing. Reforms that improve education outcomes and encourage more people to stay in or re-enter education and training therefore also have important implications for equity, helping to improve the distribution of the benefits of economic growth.

Vocational education and training

The Victorian vocational education and training (VET) system has undergone significant reform over the past two decades, through the introduction of a nationally unified training system and substantial reforms driven at the state level. As a result, the Victorian public training system is the most devolved in the country and Victorian Technical and Further Education (TAFE) institutions lead against most national benchmarks.

However, Victoria faces a number of challenges to its future economic prosperity: increased global competition; slowing productivity growth; an ageing population; and intensifying skill shortages.

Challenges within the current training system also have to be overcome to ensure the right mix of skilled workers. The Centre for the Economics of Education and Training has projected that stronger demand for higher level skills will require a change in the mix of training – away from lower level qualifications and towards diplomas, advanced diplomas and higher level certificate courses – if the state’s skill requirements are to be met.

Further reform is also needed to make the system more outward looking and responsive, and to improve its ability to address skill shortages.

The Victorian Government has recently released a discussion paper which proposes ambitious reforms in response to these challenges. The reforms are designed to achieve four objectives:

- boosting numbers of individuals and businesses accessing training, which will increase the skills of Victoria’s workforce;
- developing a VET system that engages more effectively with individuals and businesses and is easier to navigate;
- ensuring the system is more responsive and flexible to the changing skill needs of businesses and individuals; and
- creating a stronger culture of lifelong learning.

The proposed reforms include:

- increasing access for eligible Victorians to a government supported training place and increasing investment from those who benefit most from training: government, businesses and individuals;
- strengthening the capacity of the TAFE and Adult, Community and Further Education sectors;
- improving choice and contestability by enabling individuals and businesses to access government supported training at a broader range of public, private and community providers; and
- improving information to make it easier for individuals and businesses to understand and use the training system.

COAG has also endorsed goals that reflect the need to broaden and deepen the skills of the working age population and improve the match between the supply of skills and changing labour market demands.

Schools and early childhood

The essential building blocks for lifelong learning and skill building are established in early childhood and at school.

These are areas where Victoria already performs well by national and international standards, but continuing reform will be needed to ensure that Victorian children keep pace with the best in the world.

Future reform priorities include continued improvement in the quality and reach of early childhood education services and the quality of teaching, supported by strong accountability systems, and more accessible and comprehensive information for parents.

The recent establishment of the Department of Education and Early Childhood Development has provided an opportunity to improve and integrate early childhood services and schools across Victoria. The government is developing a *Blueprint for Early Childhood Development and School Reform*, with community input, that builds on earlier reforms to establish integrated strategic directions, actions and targets for the education of Victorian children from birth.

The *Blueprint's* proposed five-year reform agenda aims to improve educational health and wellbeing outcomes, provide an accessible high-quality service system for early childhood and schools, and reduce the effects of disadvantage on children and young people's learning and development. The *Blueprint* will include a range of actions to enhance partnerships with parents and communities, strengthen system development and design, and build workforce capacity. Key actions proposed for the *Blueprint* include:

- engaging families of children of all ages and providing guidance on supporting learning and development;
- developing schools as community hubs through better cross-sectoral planning, co-locating of services and more community use of school facilities;
- building greater continuity in the approach to the learning and development of children up to eight years old and improving transitions to school;
- publishing information on provider performance and broadening parental choice; and
- improving coordination, professional development and use of non-teaching staff.

At the national level, all governments have agreed for the first time on a common framework for reform of education, including a comprehensive set of aspirations, outcomes, progress measures and future policy directions.

COAG has also agreed to the development of a National Partnership agreement focused on the particular educational needs of low socioeconomic status school communities. This partnership will form part of the national education funding agreement to be introduced at the beginning of 2009.

A healthy workforce

In addition to being better for the lives of Victorians, improving the health of the population is essential to maintaining Victoria's economic growth.

Dealing with the rise of chronic disease remains a particular challenge for government, and one where the pay-off of effective reform to improve prevention is likely to be substantial. Chronic diseases account for a large proportion of Victoria's health spending and have a high cost in terms of lower workforce participation and reduced productivity. Cancer is the leading cause of death in Victoria, with around 500 Victorians diagnosed with cancer every week. Mental illness imposes significant costs, totalling over $5 billion a year in Victoria through both direct costs and the costs associated with reduced workforce participation and productivity. Type 2 Diabetes accounts for 1.6 per cent of total health system expenditure in Australia.

The government is committed to a coordinated approach to improving prevention of chronic disease, and recent initiatives are designed to begin reducing the incidence of the most common diseases.

For example, income from a $600 million fund to be set aside from *WorkSafe's* surplus funds will provide funding for a new *WorkHealth* initiative to target the connection between chronic disease and workplace injury by providing information, advice and work-place screening to assess workers at risk of developing chronic diseases such as diabetes and heart disease.

This budget commits $150 million over four years to the *Victoria's Cancer Plan 2008-2011* initiative which will focus on improving survival rates and build on innovation in early diagnosis, prevention, treatment and research. A key element of this initiative is funding for the Victorian Cancer Agency and Victorian Cancer Biobank, to ensure that cancer care is informed by the latest technology and research.

The development of a Victorian mental health strategy aims to provide a comprehensive systemic response to mental health for the whole population, with a focus on awareness promotion and prevention. The 2008-09 Budget commits around $77 million over four years and $34 million in capital funding to improving mental health services and facilities.

Although the focus on prevention is increasing, it is clear that much more effort will be required in coming years, including at a national level. A key priority of the newly established COAG Health and Ageing Working Group is enhancing the fitness and health of Australians through improved primary prevention.

This work will need to be informed by a strong evidence base that identifies effective interventions. The long-term campaign to cut smoking rates in the community may provide models for dealing with other risk factors and chronic diseases. Further work in this area will require the efforts not just of Victoria, but also other states and territories and the Commonwealth, to turn local health promotion and preventative initiatives and ideas into proven and well supported programs.

MEETING CHALLENGES TO ECONOMIC GROWTH

Responding to climate change and water

Over coming decades, climate change will create a number of economic challenges for Victoria. For example:

- as rainfall declines and becomes more variable, there will be more pressure on water supplies and primary production, with consequent cost impacts;
- more extreme weather events and possible sea level rise will increase risks to infrastructure assets, coastal settlements and tourism; and
- mitigating greenhouse gas emissions through the introduction of an emissions trading scheme will put more pressure on energy costs, with impacts on both industry and households.

The Victorian Government began a process of public consultation on 4 April 2008, with the Climate Change Summit and the release of the summit paper, *A Climate of Opportunity*. This is to be followed by a Green Paper, and finally a White Paper setting out a climate change policy framework for Victoria.

Governments in general will need to act in three broad areas: measures to mitigate climate change by reducing emissions, adaptation to the effects of unavoidable climate change and assisting with the necessary structural adjustment to a low carbon economy. Governments face the challenge of setting a policy environment that enables emissions abatement to occur at least cost and facilitates adaptation to the unavoidable impacts of climate change.

Mitigation

The challenge of addressing climate change is significant, but not incompatible with continued strong economic growth. Economic modelling from a range of sources, such as the Stern Review of the economics of climate change, the States and Territories' National Emissions Trading Taskforce, the Australian Bureau of Agricultural and Resource Economics, and the recent Garnaut review draw similar conclusions, namely that with efficient policy responses, even substantial cuts in emissions should have only a modest impact on economic growth over the longer term.

The key to reducing emissions with minimal impact on living standards will be the use of market-based instruments to target least-cost emissions abatement. A national emissions trading scheme will form the centrepiece of the mitigation effort. However, because emissions prices are likely to ramp up over time, at least in the early years an emissions trading scheme alone may not drive abatement at lowest cost. Complementary policies will need to be considered to target other market failures such as lack of information about energy efficiency opportunities, or under-incentives to invest in research and development.

Commonwealth, state and territory governments will each have a part to play in the delivery of these complementary measures. In October 2007 the Victorian Government announced the *Victorian Energy Efficiency Target* scheme, a market-based measure that will encourage households to increase their energy efficiency, cutting greenhouse emissions and utilities bills. Innovation in the energy sector is being driven by the Energy Technology Innovation Strategy, which supports accelerated development of low-emission energy technologies such as clean coal and large-scale solar power that will be essential to future abatement.

The introduction of a carbon price at the national level will necessarily drive up energy costs, particularly affecting low-income households who are constrained in their ability to adapt to rising prices. As with complementary measures, Commonwealth, state and territory governments will have a role to play in addressing these impacts. Victoria has a generous concession program targeting concession card holders with the aim of increasing affordability of household utilities. However, the Commonwealth administered tax-transfer system is the best mechanism for addressing the impact of increased energy prices on low income households in the future.

Adaptation

Regardless of efforts to reduce greenhouse gas emissions, some degree of climate change now appears inevitable. Over 2008, Victoria will work with other jurisdictions through COAG to review the *National Climate Change Adaptation Framework* and develop an implementation plan. The revised Framework will include possible actions to assist the most vulnerable sectors and regions to adapt to the impacts of climate change.

Climate change will bring challenges and opportunities for the agriculture industry. Farmers' ability to manage climate change risks will be central to reducing their vulnerability to the new climate and remaining competitive. In addition, structural adjustment will become more rapid. State and Commonwealth government agricultural policies will need to work in synergy and actively facilitate structural adjustment.

To support the agriculture sector through this change, the Victorian Government has reshaped and strengthened its services and policies to assist farm businesses and rural communities to meet the challenges ahead and capture new opportunities. The *Future Farming* strategy, recently announced by the Premier and the Minister for Agriculture, will assist farmers to build competitive and productive businesses that are sustainable in the face of unprecedented change. Victoria will seek similar change in Commonwealth Government policy, including through input into the Commonwealth review of Exceptional Circumstances assistance.

Managing risks from climate change

Climate change will create new risks and opportunities and will also increase risks associated with, for example, more frequent and intense droughts, floods and bushfires. Government has a role in providing information on climate related risks. However, where there are private benefits from doing so, business and individuals are best placed to take reasonable steps to manage their exposure to climate-related risks.

The Victorian Government will give particular emphasis to protecting public assets, building knowledge and sharing information about climate change impacts, raising awareness of adaptation options and discouraging unnecessary risk taking. The Victorian Government has already commenced this work, commissioning climate change impact assessments for Victoria's infrastructure assets and conducting regional level climate change projections and regional pilots to raise awareness and encourage the development of adaptation action plans.

While individuals and businesses are best placed to manage their own exposure to climate change risks, there may be instances where these risks are beyond the capacity of the community to manage.

Water security and flexibility

With climate change expected to bring greater uncertainty about future rainfall patterns, Victoria is investing in diverse and flexible strategies to manage the state's water supply, and ensure the security of supply at least cost to society.

Urban water reform

Our Water Our Future, The Next Stage of the Government's Water Plan, identifies $4.9 billion in projects to diversify and secure water supplies in the long term. The creation of alternative sources of bulk water supply (along with greater interconnection) presents new opportunities to provide a more modern, dynamic and efficient water supply system for the future.

To inform the government on such system reform, in 2007 the government directed the Victorian Competition and Efficiency Commission (VCEC) to carry out a review for improving the structure of the metropolitan retail water sector. The government also asked the Essential Services Commission (ESC) to review water tariff structures to complement the VCEC review. The government response to the VCEC review is to be released by no later than August 2008.

Rural water reform

Ongoing reform of rural water management in Victoria has helped to prepare the state's regional communities for climate change. In July 2007 irrigation water rights were unbundled from land titles, creating a water share (defining an irrigator's entitlement to a share of water), a delivery share (giving irrigators an entitlement to have water delivered to their property) and a water use licence (defining an irrigator's authority to use water for irrigation on their property). Unbundling has also enabled termination fees to replace exit fees, so that when irrigators sell water entitlements they can choose to retain their delivery share (and pay fixed charges associated with that share) or pay a termination fee. This flexibility minimises barriers to trade whilst ensuring appropriate cost-recovery for existing infrastructure. The Water Register, which went live on 1 July 2007, also stimulates the expansion of water trade and should in future ensure reliable and streamlined approval processes for intra and interstate water trading.

The opening up of Victoria's water trading system has helped to lessen the burden of the recent long drought by providing a mechanism to manage risk. Buyers and sellers can trade either permanent entitlements or seasonal allocations depending upon their individual needs and preferences.

While the net value created by trade is overwhelmingly positive, the impacts of trade are complex and vary across regions. The resulting structural adjustment will need to be managed without unduly constraining opportunities for trade, since trade itself provides an important adjustment mechanism.

The very substantial program now underway in northern Victoria to modernise ageing irrigation infrastructure is expected to generate an estimated 225 gigalitres (GL) of water savings, to be split three ways between irrigators, Melbourne and the environment and will provide further opportunities for reform.

The Memorandum of Understanding for Murray Darling Basin reform, signed at the March 2008 COAG meeting, was a major step forward, with the Commonwealth agreeing to Victoria's proposals with respect to Basin governance and appropriate protections for existing property rights. Victoria has long advocated reform of water management arrangements in the Murray Darling Basin, including giving the Commonwealth greater power to set and enforce sustainable diversion limits, and to enforce market rules that ensure a level playing field in interstate water markets.

In addition, Victoria and the Commonwealth have agreed on a plan for water security in the Murray Darling Basin, which will provide for further modernisation works in the Northern Victorian region. This is expected to generate a further 200 GL in water savings to be split equally between irrigators in the region and the environment. A key issue for reform into the future through the COAG process is investigation into the most appropriate measures to facilitate structural adjustment in water intensive industries and communities.

The health of Victoria's rivers and water ways is also under stress under the current climatic conditions. Encouraging private investment and using market mechanisms, including water trading and tenders, in both regulated and non-regulated rivers, can be an efficient and effective means of recovering water for the environment.

Water markets present opportunities for water to be allocated to its highest value use. This increases efficiency in the urban and rural sectors and for accessing environmental water. Combining this with a diverse and flexible water supply will best equip Victoria for the uncertain climatic years ahead.

REFORM TO COMMONWEALTH-STATE FINANCIAL RELATIONS

Reform of Commonwealth-State financial structures, including improved efficiency and accountability, provides an opportunity to support increased economic growth in Victoria. The need for this reform is heightened by Australia's relatively high degree of vertical fiscal imbalance and the significant degree of overlap in responsibilities between levels of government.

Vertical fiscal imbalance reflects the mismatch between the spending responsibilities and revenue raising capacities of governments. States are responsible for providing the majority of core services – in areas such as health, education, transport and law and order – while the Commonwealth has primary capacity to raise revenue (through taxation) to fund them.

This imbalance has grown with High Court rulings on the unconstitutionality of state franchise fees and the abolition of state taxes (in return for the receipt of Goods and Services Tax (GST) revenue) under the *Intergovernmental Agreement on Reform of Commonwealth – State Financial Relations*. Grants from the Commonwealth have grown from less than 40 per cent of Victoria's revenue in 1996-97 (when franchise fees were removed) to 46 per cent in 2008-09. Victoria, like other states, is now increasingly reliant on funding from the Commonwealth to provide core services. This challenge is compounded by the fact that Victoria receives significantly less than its population share of Commonwealth grants.

Victoria currently receives two main types of Commonwealth grants: specific purpose payments (SPPs) and GST revenue. These are detailed in Budget Paper No. 4, Chapter 4, *State Revenue*. In early 2008, COAG agreed to undertake major reform of SPPs creating a new architecture for Commonwealth-State funding. Governments have also continued to work on the 2010 Commonwealth Grants Commission (CGC) review of methodology for distributing GST revenue, pursuing a simpler, more transparent and more efficient system.

Specific Purpose Payments

SPPs include payments 'to' the states, retained by state governments for their own use, and payments 'through' the states, which are passed on to other bodies and individuals on behalf of the Commonwealth. Total SPPs (including those for on-passing) account for around 40 per cent of Commonwealth funding to Victoria, and around 20 per cent of Victoria's total revenue.

SPPs provide essential contributions to funding for state services, including health, education, housing, roads and community welfare. They are also an important vehicle through which governments can develop agreed objectives and reform priorities in areas of shared responsibility. For this reason, Victoria, along with other states, has sought for many years to have the design of SPPs reflect the flexible and efficient environment necessary to maximise achievement of real outcomes.

In March 2008, COAG agreed to a new architecture for Commonwealth – State funding. Overall, this new architecture will provide a solid foundation for efficient delivery of core services and strengthened incentives for reform.

From January 2009, the large number of existing SPPs (around 90 grants nationally) will be restructured into two new funding streams: new generation SPPs and National Partnerships (NP).

Five or six new broad based, outcome focussed SPPs will be developed in the areas of health, education, skills, housing and community-disability services. These will be structured very differently from existing SPPs. Input controls – the prescriptive conditions which have constrained state flexibility in the past – will be removed and replaced by high level objectives to deliver agreed, shared outcomes. These 'Statements of Objectives and Outcomes' will be supported by new standardised accountability frameworks, which focus on timely reporting to the community on outcomes and streamline the detailed and onerous reporting of administrative data. Rather than having fixed terms, these grants will be ongoing, with periodic review of outcomes and funding adequacy. New generation SPPs will provide states with greater ongoing financial certainty (in base funding and growth factors), give states the flexibility to deliver agreed outcomes in the most efficient and locally effective way, and remove the restrictions of detailed input based conditions and reporting.

A second form of funding, NP payments, will also be developed. These arrangements will be used where governments agree to undertake specific projects or reforms. NP reform payments may include payments to states to assist with the up-front costs of reform, as well as to reward states for progress and share the economic benefits of reform. Progress against reform milestones will be assessed by an independent body, and reward payments paid in line with achievement. This is similar to the National Competition Policy process and payments, which successfully drove a program of micro-economic reform in the mid 1990s. Where one-off projects or reform-based initiatives have proven ongoing benefits, these can then be rolled into the relevant broader SPP, providing a balance between the need to pilot specific new projects and approaches to broader funding flexibility.

Other existing SPPs will be variously terminated or cashed out, converted into untied or general revenue assistance or reclassified as Commonwealth own-purpose expenses.

Victoria strongly supports these reforms, which provide a solid architecture for Commonwealth-State funding arrangements. The challenge now facing governments is to agree to objectives, funding and accountability frameworks for each of the new grants. To fulfil the potential of progress achieved to date, these reforms must reflect a shared commitment to improved outcomes, with investment and risks allocated fairly across governments.

MAINTAINING THE MOMENTUM

Victoria has enjoyed strong economic growth and in order to sustain this growth into the future the government has invested in many sectors, including infrastructure, skills, improving business competitiveness and a healthy workforce, and further reform is in prospect in these areas. The government is also taking action to mitigate the risks to growth from climate change and to secure Victoria's water supplies.

At a national level, Victoria is working with the Commonwealth to improve Commonwealth-State funding arrangements and community outcomes in the areas of joint responsibility.

The government is taking action now to meet the challenges of the future, and has a clear plan for addressing ongoing reform priorities.

APPENDIX A – OPERATING STATEMENT RECONCILIATION

INTRODUCTION

This appendix supports the commentary provided in Chapter 3, *Budget Position and Outlook* by providing a reconciliation and explanations of the key movements in the 2008-09 to 2010-11 estimates since these estimates were published in the *2007-08 Budget Update*.

Table A.1: Reconciliation of *2007-08 Budget Update* to 2008-09 Budget estimates[(a)]

($ million)

	2008-09 Estimate	2009-10 Estimate	2010-11 Estimate
Net result from transactions: 2007-08 Budget Update	**814.5**	**846.0**	**808.7**
Plus: Variations in income from transactions since 2007-08 Budget Update			
Revenue policy decision variations	**(303.3)**	**(243.8)**	**(254.4)**
Economic/demographic variations			
Taxation	558.3	446.5	527.7
Investment income [(b)]	69.0	39.2	(41.0)
Total economic/demographic variations	**627.3**	**485.6**	**486.7**
Commonwealth grant variations			
General purpose grants	208.7	393.8	526.8
Specific purpose payment grants	43.5	45.3	11.2
Total Commonwealth grant variations	**252.2**	**439.1**	**538.0**
Increase in own-source revenue	**100.0**	**83.7**	**68.1**
Administrative variations [(d)]	**120.5**	**217.6**	**(63.5)**
Total variation in income from transactions since 2007-08 Budget	**796.8**	**982.3**	**774.9**
Less: Variations in expenses from transactions since 2007-08 Budget Update			
Policy decision variations [(c)]	**182.0**	**141.9**	**139.3**
Commonwealth variations	**111.1**	**39.5**	**32.5**
Variations due to changes in own-source revenue	**75.4**	**74.5**	**70.3**
Administrative variations			
Superannuation variations	173.8	185.1	200.9
Other administrative variations [(d)]	241.5	536.2	234.7
Total administrative variations	**415.2**	**721.3**	**435.6**
Total variation in expenses from transactions since 2007-08 Budget Update	**783.8**	**977.2**	**677.6**
Revised net result from transactions	**827.5**	**851.1**	**906.0**

Source: Department of Treasury and Finance

Notes:

(a) Totals may not add due to rounding.
(b) Investment income includes dividends, income tax and rate equivalent revenue and interest.
(c) Policy decisions are net of funding from contingencies and other efficiencies.
(d) Includes a reduction in revenue and expenditure, with a nil impact on the net result from transactions, due to an adjustment to the estimates by DEECD in 2010-11.

Variations to income from transactions

Relative to the estimates published in the *2007-08 Budget Update*, total income from transactions is expected to be $797 million higher in 2008-09 and $879 million a year higher on average in 2009-10 and 2010-11.

Revenue policy decisions arising from initiatives in the 2008-09 Budget have resulted in a decrease in overall taxation revenue of $303 million in 2008-09, and $249 million a year on average over 2009-10 and 2010-11. The revenue initiatives include reductions to land tax, stamp duty on land transfers and payroll tax. Further detail on these initiatives is provided in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiative*.

Favourable economic and demographic changes over the three year period from 2008-09 to 2010-11 have driven upwards revisions of $511 million a year on average in taxation revenue estimates, with major changes relating to:

- an upwards revision to payroll tax revenue estimates (up $133 million on average) as the result of strong revenue collections during the first half of 2007-08, and higher than expected wages growth over the forward estimates period; and
- an upwards revision to stamp duty on land transfer revenue estimates of $380 million in 2008-09, thereafter shifting to $263 million a year on average, largely reflecting the base effect of higher than expected revenue in 2007-08.

Investment income has been revised upwards by $69 million in 2008-09 and $39 million in 2009-10, and is then lower by $41 million in 2010-11, reflecting an expected return to a more normal level of income tax equivalent payments across the forward estimates, and the recognition of dividends from the State Electricity Commission of Victoria.

Commonwealth grants have been revised upwards by $252 million in 2008-09 and upwards by $489 million a year on average over the next two years primarily relating to Goods and Services Tax (GST) grants. These arise from the strength in household consumption, an increase in Victoria’s share of the population and an increase in the GST pool as a result of more favourable relativities from the Commonwealth Grants Commission.

Own source revenue for 2008-09 has been revised upwards by $100 million and by an average of $76 million higher from 2009-10 to 2010-11 since the *2007-08 Budget Update* primarily as a result of increased third party revenue relating to health and ambulance services, and nursing homes within the Department of Human Services.

Administrative variations to revenue estimates have been revised upwards by $121 million in 2008-09 and $218 million higher in 2009-10, with a downwards revision of $64 million in 2010-11. These revisions include the impact of:

- recalculation of insurance contributions to the Country Fire Authority (increasing by $44 million in 2008-09 rising to $74 million in 2010-11);
- a higher capital asset charge applied from 2008-09 to VicTrack ($27 million in 2008-09 averaging $67 million in 2009-10 and 2010-11) as a result of the improvement in its net asset position;
- recognition of notional interest revenue for the Melbourne Convention and Exhibition Centre (revenue of $17 million in 2008-09 rising to $34 million in 2010-11);
- a downwards revision of revenue and fines in the Department of Justice of around $50 million each year mainly due to a decrease in the number of traffic infringements reflecting improved driver behaviour; and
- a downwards adjustment of $216 million in 2010-11 in the Department of Education and Early Childhood Development. This adjustment has no impact on the net result from transactions as there is a corresponding downwards revision in expenditure.

Variations to expenses from transactions

When compared with the estimates published in the *2007-08 Budget Update*, total expenses are estimated to be $784 million higher in 2008-09 and $827 million higher on average in 2009-10 and 2010-11.

New output policy initiatives taken since the *2007-08 Budget Update* account for additional expenses of $182 million in 2008-09. Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*, provides more detailed information on the government's service delivery and strategy, while Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, provides a detailed list and description of all service delivery initiatives announced in this budget.

Revisions to Commonwealth grant funding are projected to increase expenditure by $111 million in 2008-09 and $36 million a year on average in 2009-10 and 2010-11. This primarily relates to extension of the Exceptional Circumstances program to 30 September 2008, expenditure related to Caring for our Country grants (formerly known as the National Heritage Trust grants) and additional grants for on-passing to local governments.

Revisions associated with own source revenue generating activities described above are projected to increase expenditure by $73 million a year on average from 2008-09 to 2010-11, primarily relating to the health sector.

Administrative variations are expected to increase by $415 million in 2008-09 and by an average of $578 million higher over 2009-10 and 2010-11. This primarily reflects an increase in the contingency provision not allocated to departments. The provision takes into account the growth in demand for government services due to the anticipated strong population growth and possible funding for programs that may need to continue to meet service delivery priorities. Other changes include:

- an upwards revision of $187 million a year on average to superannuation expense due to the flow on impact of the decline in investment markets in 2007-08 which decreases the value of assets invested by the schemes;
- an upwards revision in the Country Fire Authority's expenditure funded by higher insurance contributions to fire brigades ($58 million in 2008-09 rising to $87 million in 2010-11);
- an upwards revision in the Department of Infrastructure's depreciation expense ($33 million in 2009-10 and 2010-11) associated with the revaluation of VicRoads assets, offset by a reduction in operating expenses of $22 million due to a reclassification between output and capital expenditure; and
- a downwards revision of $216 million in 2010-11 in the Department of Education and Early Childhood Development which offsets the downward revision in income noted previously.

APPENDIX B – SENSITIVITY ANALYSIS TABLE

INTRODUCTION

The sensitivity analysis estimates the impact on income, expenses and the net result from transactions associated with variations to forecasts of selected economic and financial variables. The major variables that affect Victoria's net result from transactions are economic growth, employment, consumer prices, wages, enterprise bargaining agreements, domestic and overseas share prices, property prices and volumes and interest rates.

To assess sensitivity to change, the level of the economic variable in each case is assumed to be one per cent higher than expected in the budget year, before continuing to grow at the previously forecast rate. For interest rates, the assumption is that they are one percentage point higher than assumed in the budget year and remain one percentage point above the budget assumptions in subsequent years.

It is assumed during the analysis of each variable that all other variables follow their forecast growth. As such, the analysis captures the effect of changing only one variable at a time, and does not allow for the likelihood that other variables would also change. For example, an increase in consumer prices could be expected to affect interest rates, wage claims and other economic variables.

The sensitivity analysis in Table B.1 presents the sensitivity of both the net result from transactions and the net result to selected economic and financial indicators.

Table B.1: Impact on the general government fiscal results of selected economic indicators being one per cent higher than expected from 2008-09[(a)(b)(c)]

($ million)

	2008-09 Estimate	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
GSP				
Income from transactions	164	174	185	195
Expenses from transactions	-4	-11	-17	-23
Net result from transactions	**168**	**185**	**202**	**218**
Other economic flows	..	..	..	..
Net result	**168**	**185**	**202**	**218**
Employment				
Income from transactions	49	47	50	53
Expenses from transactions	-1	-4	-7	-10
Net result from transactions	**51**	**51**	**57**	**62**
Other economic flows	..	..	..	..
Net result	**51**	**51**	**57**	**62**
Consumer prices [(d)]				
Income from transactions	266	279	292	305
Expenses from transactions	103	106	105	104
Net result from transactions	**163**	**173**	**187**	**201**
Other economic flows	-116	..	..	..
Net result	**47**	**173**	**187**	**201**
Average weekly earnings				
Income from transactions	44	47	50	53
Expenses from transactions	-1	-4	-7	-9
Net result from transactions	**46**	**51**	**56**	**62**
Other economic flows	..	..	..	..
Net result	**46**	**51**	**56**	**62**
Enterprise bargaining agreements [(e)]				
Income from transactions	..	..	..	..
Expenses from transactions	147	189	210	229
Net result from transactions	**-147**	**-189**	**-210**	**-229**
Other economic flows	-165	..	..	..
Net result	**-311**	**-189**	**-210**	**-229**
Domestic share prices				
Income from transactions	3	..	..	..
Expenses from transactions	-0	-4	-4	-4
Net result from transactions	**3**	**4**	**4**	**4**
Other economic flows	51	..	..	..
Net result	**54**	**4**	**4**	**4**

Table B.1: Impact on the general government fiscal results of selected economic indicators being one per cent higher than expected from 2008-09[(a)(b)(c)] (continued)

($ million)

	2008-09 Estimate	*2009-10 Estimate*	*2010-11 Estimate*	*2011-12 Estimate*
Overseas share prices				
Income from transactions	4	..	..	..
Expenses from transactions	-0	-4	-4	-4
Net result from transactions	**4**	**4**	**4**	**4**
Other economic flows	46	..	..	..
Net result	**50**	**4**	**4**	**4**
Property prices				
Income from transactions	52	52	71	70
Expenses from transactions	-2	-6	-9	-13
Net result from transactions	**54**	**58**	**80**	**84**
Other economic flows	18	..	..	..
Net result	**72**	**58**	**80**	**84**
Property volumes				
Income from transactions	37	37	39	39
Expenses from transactions	-1	-3	-5	-7
Net result from transactions	**38**	**40**	**44**	**46**
Other economic flows	..	..	..	..
Net result	**38**	**40**	**44**	**46**
Interest rates [(f)]				
Income from transactions	121	36	38	39
Expenses from transactions	-3	47	53	62
Net result from transactions	**124**	**-11**	**-16**	**-23**
Other economic flows	2 727	..	..	..
Net result	**2 852**	**-11**	**-16**	**-23**

Source: Department of Treasury and Finance

Notes:

(a) A positive number for income from transactions denotes an increase in revenue. A positive number for expenses from transactions denotes an increase in expenses (and hence a reduction in the net result from transactions and net result). A positive number for other economic flows represents an increase in revenue. A positive number for the net result from transactions and net result also denotes an increase in revenue. Numbers may not balance due to rounding.

(b) The sensitivity from a one per cent lower than expected outcome of an economic variable, would in most instances, simply be the opposite of the impact shown in the table. However, for some results, the impacts of changes are not symmetrical and therefore care should be exercised when using the table to estimate the impact of lower than expected economic variables.

(c) Only reasonably quantifiable data has been included in the analysis.

(d) Reflecting the departmental funding model, it is assumed that an increase in consumer prices within the Budget year does not impact on employee entitlements.

(e) Represents a one per cent increase in all government enterprise bargaining agreements.

(f) Assumes a one percentage point increase across the entire term structure, i.e. short and long rates, over the forward estimates period.

Sensitivity to economic growth

Higher than expected gross state product (GSP) is assumed to be associated with higher household consumption, leading to higher goods and services tax (GST) grant revenue and taxation revenue. This would increase both the net result from transactions and the net result.

Sensitivity to employment

Higher than expected employment is assumed to result in additional payroll tax revenue, and would increase both the net result from transactions and the net result.

Sensitivity to consumer prices

The impact of higher consumer prices is assumed to lead to higher Commonwealth-sourced revenue (due to indexation), as well as higher GST and taxation revenue as the value of tax bases rises in nominal terms. However, the higher revenue is partly offset by the higher cost of supplies and services, and some increases in outlays on grants and transfers. Reflecting the operation of the departmental funding model, this increase in expenses is limited to the extent that departments can fund it from increased revenue from specific purpose grants and sales of goods and services. Overall, there is a positive impact on the net result from transactions.

The increase in consumer prices would also result in an immediate increase in the superannuation liability which would adversely affect the net result by way of an actuarial loss. In subsequent years the now higher superannuation liability also increases the superannuation expense slightly.

Sensitivity to average weekly earnings

A rise in the level of economy-wide wages would result in higher payroll tax revenue, contributing to an increase in the net result from transactions and net result. The government's enterprise bargaining agreements are assumed to be unchanged over the projection period.

Sensitivity to enterprise bargaining agreements

Enterprise bargaining agreements have the potential to pose a substantial risk to Victoria's budget position. The government's public sector wages funding policy seeks to maintain the real value of wage increases and seeks productivity offsets for higher wage outcomes to minimise the risk to the budget. An across-the-board rise in the government's enterprise bargaining agreements in excess of the level set out in its wages policy would result in an increase in employee entitlements and a corresponding decline in the net result from transactions.

The increased employee entitlements would increase the value of the superannuation liability and result in a reduction in the net result for the budget year. The higher superannuation liability would flow through to an increase in the superannuation expense in the remaining out-years.

Sensitivity to domestic and overseas share prices

The State's public financial corporations (PFCs) and superannuation funds have holdings of domestic and international shares as part of their respective investment portfolios. Higher domestic and international share prices therefore raise the profits of the PFCs and reduce the value of the superannuation liability due to the increase in superannuation fund assets.

The net result from transactions responds positively to increases in share prices as PFC income tax equivalents (ITEs) rise with profits. Furthermore, the higher than expected level of superannuation fund assets also reduces the superannuation expense beyond the budget year, thereby improving the net result from transactions.

Sensitivity to property prices

Higher property prices have an immediate impact on the net result from transactions through increased collections of stamp duty on land transfer revenue. At the same time, the value of the superannuation liability decreases (due to the increased value of holdings of property in the investment portfolio of superannuation funds) which gives rise to an actuarial gain thereby increasing the net result. In later years, the higher property prices continue to be reflected in higher stamp duty on land transfer and land tax revenues, while the previous increase in superannuation assets reduces ongoing superannuation expenses, all of which increase the net result from transactions.

Sensitivity to property volumes

Higher property transaction volumes would increase stamp duty on land transfer revenue leading to a rise in the net result from transactions and net result.

Sensitivity to interest rates

A one percentage point increase in interest rates is assumed to reflect an increase in the cash rate of one percentage point over the entire forward estimates period, resulting in a one percentage point increase across the entire term structure.

The increase in interest rates reduces the valuation of long term liabilities of the PFCs and raises measured profits of these entities for distribution to the general government (GG) sector through ITEs. This is partly offset by lower public non-financial corporation dividends due to higher borrowing costs, as well as an increase in the borrowing costs of the GG sector.

At the same time, the increase in interest rates reduces the value of the superannuation liability, giving rise to an actuarial gain. In terms of ongoing superannuation expenses, the impact of a higher discount rate on service costs is more than offset by an increase in the annual interest expense on the superannuation liability going forward, leading to an increase in the superannuation expense. Accordingly, both the net result from transactions and the net result fall by the end of the forward estimates.

STYLE CONVENTIONS

Figures in the tables and in the text have been rounded. Discrepancies in tables between totals and sums of components reflect rounding. percentage changes in all tables are based on the underlying unrounded amounts.

Budget and forward estimates period refers to the period 2008-09 through to 2011-12, where as the forward estimates period only refers to the period 2009-10 through to 2011-12.

The notation used in the tables and charts is as follows:

LHS	left-hand-side
RHS	right-hand-side
s.a.	seasonally adjusted
n.a. or na	not available or not applicable
Cat. No.	catalogue number
1 billion	1 000 million
1 basis point	0.01 per cent
nm	new measure
..	zero, or rounded to zero
tbd	to be determined
ongoing	continuing output, program, project etc.
(xxx.x)	negative numbers

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State Government Victoria
Department of Treasury and Finance