2007-08 Strategy and Outlook

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Budget Paper No. 2

Strategy and Outlook

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Presented by the Honourable John Brumby MP
Treasurer of the State of Victoria
on the occasion of the Budget 2007-08

Victoria
The Place To Be

The Secretary
Department of Treasury and Finance
1 Treasury Place
Melbourne Victoria 3002
Australia

Telephone: +61 3 9651 5111
Facsimile: +61 3 9651 5298
Website: www.budget.vic.gov.au

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The Honourable John Brumby, M.P.

Treasurer of the State of Victoria

For the information of Honourable Members

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CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

- Victoria continues to enjoy solid economic growth, enabling the Government to provide more services and to deliver new asset investment projects, while maintaining Victoria's strong financial position. In response to a rapidly changing economic landscape, the Victorian Government remains committed to ongoing economic reform to maintain the prosperity of current and future generations.
- The Government will continue to meet its $100 million budget surplus target, ensuring that businesses and families in Victoria have a stable financial environment in which to invest and plan for their future. A surplus of $324 million is budgeted in 2007-08, averaging $424 million over the forward estimates period.
- The Government is supporting economic growth through significant investments in infrastructure projects. This budget provides funding for new asset investment projects with a total estimated investment (TEI) of $2.9 billion. This is in addition to $397 million TEI provided for infrastructure investment in the *2006-07 Budget Update*. Over the next four years, the general government real capital stock will grow by 7.9 per cent, significantly more than the estimated rate of population growth.
- The budget provides net funding for new output initiatives of $447 million in 2007-08, and an average of $242 million each year over the forward estimates period. This is in addition to net funding provided in the *2006-07 Budget Update* of $173 million a year on average from 2007-08 to 2009-10.
- With this budget, the Government has now commenced delivery of all of its election output commitments and just under half of the number of asset initiatives. This includes $2.3 billion of output and $1.5 billion of asset initiatives, with the remaining $1.8 billion of asset funding to be provided in future budgets.
- Land tax has been further reformed and average WorkCover premiums have been reduced again in addition to a cut in motor vehicle duty. Victoria's overall tax level as a share of GSP remains at the Australian average and well below that of NSW.
- The Government maintains modest and sustainable levels of net financial liabilities, consistent with its triple-A rating. The Government is using its strong balance sheet and budget position to fund key investment projects that generate long-term benefits.

FINANCIAL STRATEGY, OBJECTIVES AND PRIORITIES

This chapter sets out the Government's financial policy objectives and strategies as required by the *Financial Management Act 1994*. The Act outlines a set of sound financial management principles. These are to:

- manage financial risks faced by the State prudently, taking into consideration economic circumstances;
- pursue spending and taxation policies that are 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 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 providing a sound and stable financial basis from which growth can be promoted across the whole State, 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 and long-term financial objectives are summarised in Table 1.1. The rationale for, and progress against, each of the five objectives is discussed in the following sections of this chapter.

Table 1.1: 2007-08 Financial objectives

Objective	*Short-term target*	*Long-term target*
Operating surplus	At least $100 million in each year	Maintain a substantial budget operating surplus
Infrastructure	Implement strategic infrastructure projects	Deliver world-class infrastructure to maximise economic, social and environmental benefits
Service delivery	Implement 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 triple-A credit rating	Maintain State government net financial liabilities at prudent levels

OBJECTIVE ONE: OPERATING SURPLUS

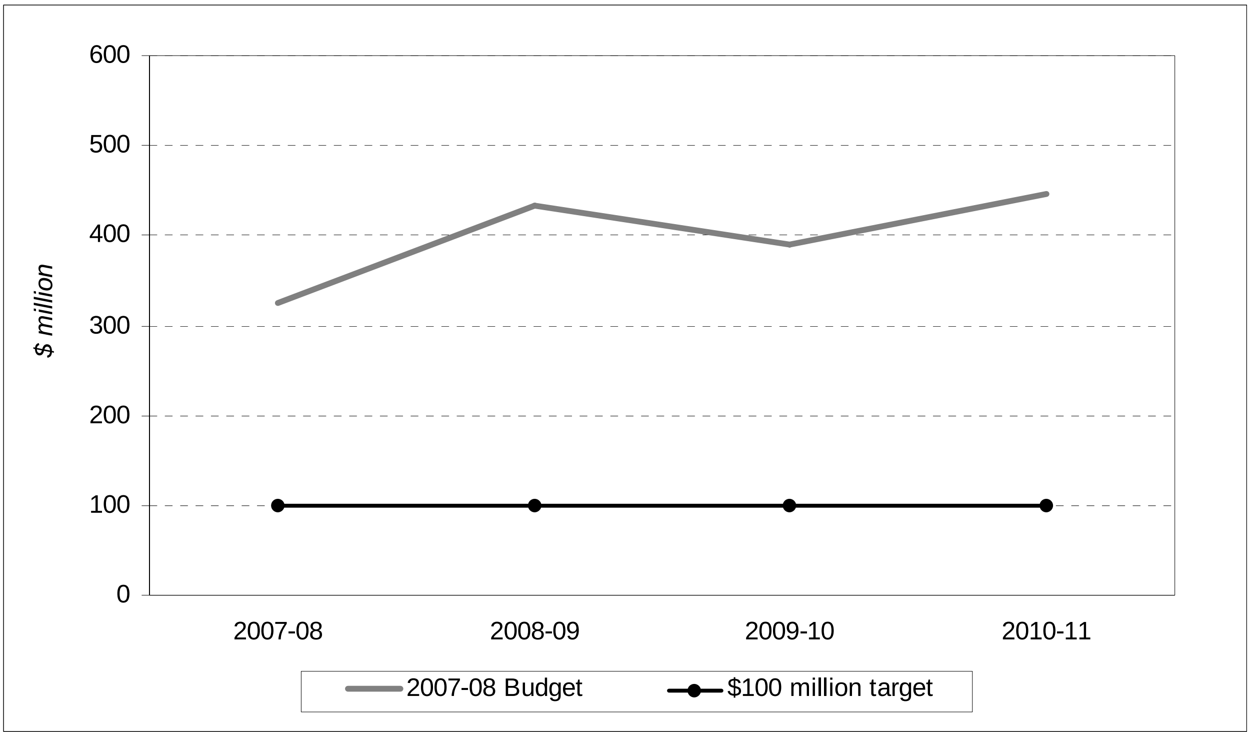
Prudent financial management, including a substantial operating surplus, has contributed to economic stability and business growth in Victoria. The Government continues to deliver important services and provide key infrastructure while keeping the State's finances in a solid position.

The Government continues to meet its target of maintaining an operating surplus of at least $100 million. While achieving this objective, the Government has also reduced the tax burden, increased investment and maintained net financial liabilities at prudent levels.

Chart 1.1 shows the surplus for the current and forward years. The net result from transactions is forecast to be $324 million in 2007-08 and to average $424 million over the forward estimates. The increase in the net result from transactions in 2008-09 is mainly due to a one-off increase in non-cash income resulting from the transfer of assets free of charge to VicRoads upon the completion of EastLink. The Government's fiscal strategy is to maintain a buffer above the $100 million minimum operating surplus to allow for unforeseen circumstances and provide budget flexibility.

Chapter 3, *Budget Position and Outlook*, provides further detail, including the main contributions to the change in the surplus.

Chart 1.1: General government sector net result from transactions



Source: Department of Treasury and Finance

Alternative measures of operating performance

As shown in Table 1.2, the GFS net operating balance, used by the Australian Bureau of Statistics (see Budget Paper No. 4, Chapter 6, *Uniform Presentation of Government Finance Statistics*), is the same as the A-IFRS 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 GFS net operating balance is the conceptual basis for budgets in most other Australian states and the Commonwealth, and provides comparability with these jurisdictions.

Table 1.2: A-IFRS and GFS budget measures

($ million)

	2007-08 Budget	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
A-IFRS net result from transactions	324	434	390	447
A-IFRS net result	303	407	362	420
GFS net operating balance	324	434	390	447
GFS net lending/(borrowing)	(929)	(1 366)	(474)	(34)
GFS cash surplus/(deficit) [a]	(642)	(1 171)	(678)	(210)

Source: Department of Treasury and Finance

Note:

(a) International Monetary Fund/GFS cash surplus/deficit equals the net cash flows from operating activities less investments in non-financial assets, and excludes acquisitions under finance leases.

When various revaluation gains and losses on assets and liabilities and provision for doubtful debts are added to the A-IFRS net result from transactions, the *A-IFRS net result* is obtained. In the budget and forward years, these revaluations are expected to be quite small; however, in 2006-07, gains and losses have the potential to add substantial volatility to the A-IFRS net result.

The *GFS net lending/borrowing* result is equal to the GFS net operating balance less net acquisitions of non-financial assets. GFS 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 the net lending/borrowing takes into account total spending on fixed assets during the period, rather than just the current year's expense, it is lower than the GFS net operating balance and the net result from transactions. Reflecting the Government's substantial infrastructure investment, GFS net borrowing in 2007-08 is $929 million. In the forward estimates period, the GFS net borrowing averages $625 million a year. The magnitude of the net borrowings is appropriate in the context of the State's strong balance sheet.

The *GFS cash surplus/deficit* result is equal to net cash flows from operating activities, less net cash investment in non-financial assets and excludes acquisitions under finance leases. 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 imputed superannuation interest cost and employee benefits) and allows for cash contributions made to the unfunded superannuation liability. The GFS cash position is expected to be in deficit by $642 million in 2007-08 and by an average of

$686 million over the forward years. The moderate GFS cash deficits are financially responsible and enable the Government to invest in significant assets.

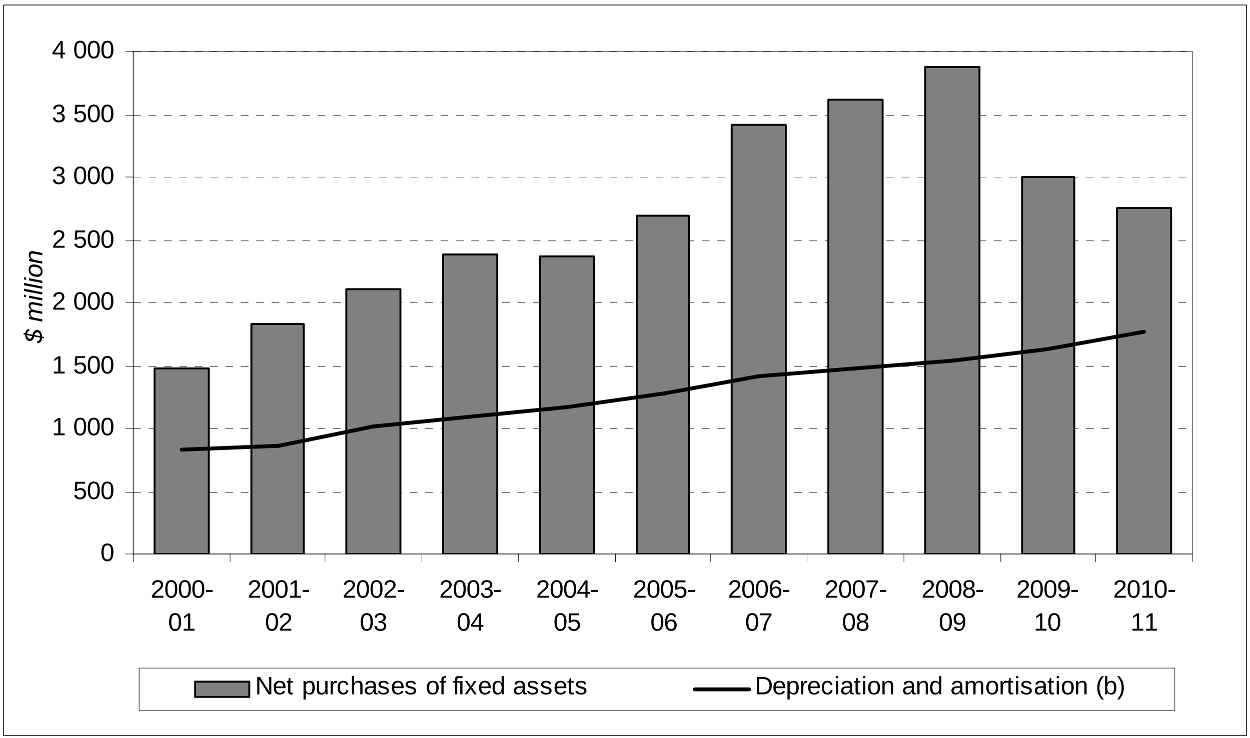
In summary, the A-IFRS net result from transactions and other measures of operating performance show that Victoria's financial performance remains sound.

OBJECTIVE TWO: INFRASTRUCTURE

Over the period 2000-01 to 2006-07, the Government will have invested over $16 billion in infrastructure, averaging over $2.3 billion a year. This is more than double the average annual investment in the six years prior to 2000-01.

Chart 1.2 shows the general government net infrastructure investment since the beginning of the decade, together with projections for the forward estimates period. The Government is increasing its spending on assets to improve the productive capacity of the economy and liveability of the State. Net infrastructure investment is projected to be a record $3.6 billion in 2007-08. Over the period 2007-08 to 2010-11, net infrastructure investment is expected to average $3.3 billion a year.

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



Source: Department of Treasury and Finance

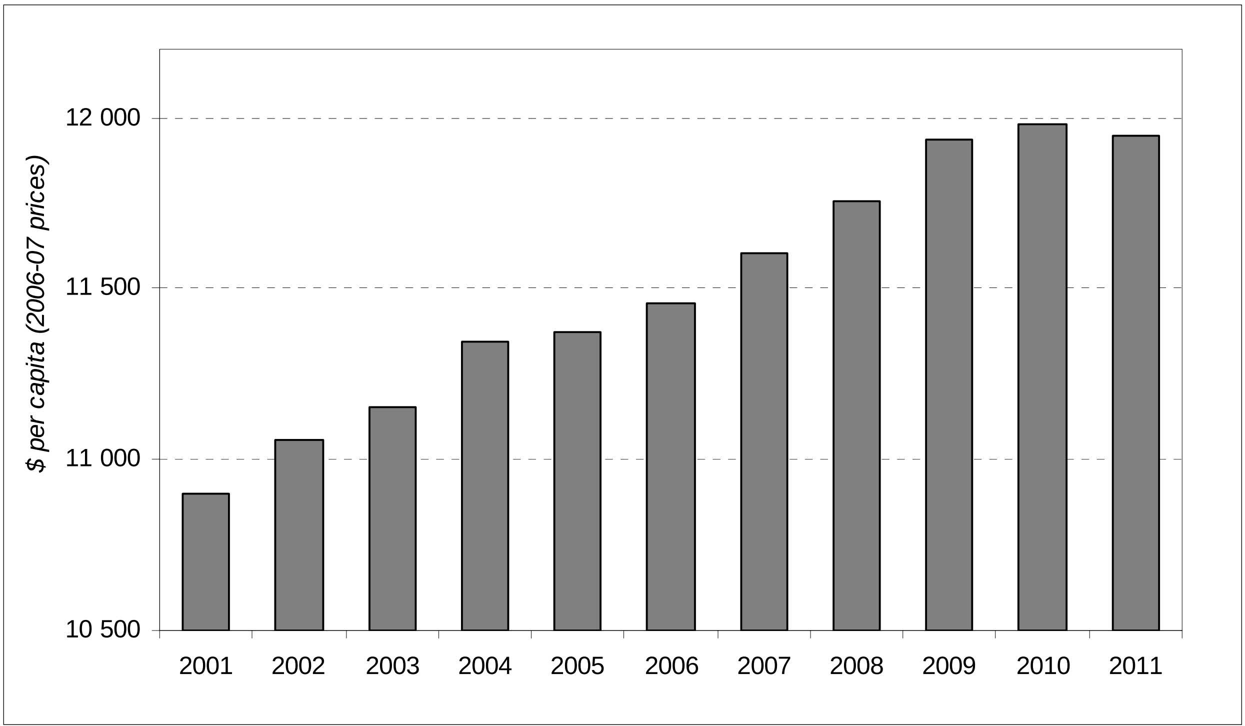
Notes:

(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 2007-08 to 2010-11, general government net infrastructure investment will exceed estimated depreciation by an average of around $1.7 billion a year, resulting in 7.9 per cent growth in the real capital stock over the four years to June 2011. This is significantly more than the 4.8 per cent projected population growth over the same period. Chart 1.3 shows that, in real per capita terms, the average stock of public infrastructure for each Victorian will grow from $11 059 in 2002 to $11 946 by 2011.

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, this chart is not directly comparable to similar charts shown in previous years.

The 2007-08 Budget provides funding for new asset investment projects with a total estimated investment (TEI) of $2.9 billion. This is in addition to $397 million provided for infrastructure investment in the *2006-07 Budget Update*.

The 2007-08 Budget provides:

- $200 million TEI and $300 million in grants in 2006-07 to fund the purchase or construction of 1 150 new rental homes for low-income families and the replacement of 1 200 poor quality existing public housing dwellings;
- $555 million TEI to improve Victoria's education infrastructure. This includes $360 million TEI for the modernisation, regeneration and replacement of schools. This investment is the first stage of the $1.9 billion TEI schools and TAFE capital program, the largest in the State's history. Other initiatives include the construction of new schools in growth areas and the development of a statewide online teaching and learning system called Ultranet;

- $583 million TEI for hospitals, health, aged care and community services capital works, including $234 million TEI for medical equipment including new MRI machines and infrastructure works across Victoria;
- a range of initiatives for new and upgraded road and rail infrastructure. Investments of $236 million TEI provided for new and upgraded road infrastructure will ensure that our transport network continues to underpin Victoria's attractiveness as a place in which to live and invest. A total of $709 million TEI has been provided to improve Victoria's rail network. This includes $340 million TEI for metropolitan rail service capacity enhancements, including procurement of ten new metropolitan trains and associated infrastructure costs;
- $180 million TEI towards the establishment of a biosciences research centre to protect the State's vital agricultural industries from plant and animal diseases, such as avian flu. Importantly, this centre will maintain Victoria's leadership in biotechnology research; and
- $167 million TEI to strengthen the justice and emergency services systems, including $86 million TEI for new and upgraded police stations in nine locations.

A comprehensive discussion of the impact of asset investments on the State's balance sheet is included in Chapter 4, *Balance Sheet Management and Outlook.* Further information on the above major projects can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

OBJECTIVE THREE: SERVICE DELIVERY

This budget continues the path of improvement and reform commenced by this Government in 1999. The 2007-08 Budget continues to invest in areas of high priority.

Boosting investment in priority areas of education will enhance the knowledge and skills of Victoria's workforce. At the same time, allocating funds for the prevention and early detection of disease should improve the health of the population and contribute to greater workforce participation and productivity. A description of the Government's wider reform agenda can be found in Chapter 7, *The Economic Reform Agenda*.

Funding provided in the 2007-08 Budget is aimed at ensuring that significant progress is made towards achieving the goals in *Growing Victoria Together*. This investment will also build on successes to date such as:

- in 2005, 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 writing and Year 5 writing and 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 20.8 students;
- the Government's investment in creating pathways for young people has raised the proportion of 20-24 year olds completing year 12 or equivalent from 82.9 per cent in 1999 to 85 per cent in 2005, higher than the Australian average of 82.7 per cent;

- as a result of the Government’s investment in health and community services, between 1999-2000 and 2006-07 an additional 300 000 hospital patients are now being treated each year, hospitals are employing 7 200 more nurses and 1 500 more doctors, waiting times have reduced, and more assistance is being provided to people with a disability. Over the same period, the government has boosted hospital funding by 83 per cent;
- implementation of significant improvements in the public transport system, including the completion of the Regional Fast Rail project and Southern Cross Station; and
- since 1999, the Government has increased police numbers by 1 400.

The Government is continuing to improve quality, access and equity in service delivery to all Victorians through the implementation of its 2006 election commitments. With this budget, the Government has now commenced delivery of all of its election output commitments and just under half of the number of asset initiatives. This includes $2.3 billion of output and $1.5 billion of asset initiatives, with the remaining $1.8 billion of asset funding to be provided in future budgets.

In order to deliver the Government’s service delivery objectives, the 2007-08 Budget provides funding for net new output initiatives of $447 million in 2007-08 and an average of $242 million over the forward estimates. This is in addition to net funding provided in the *2006-07 Budget Update* of $173 million a year on average from 2007-08 to 2009-10.

Key output initiatives include:

- $349 million over five years for education initiatives, including the provision of 300 teacher assistants, 256 primary welfare officers and grants towards the purchase of mathematics and science equipment;
- $692 million over five years for hospital services to treat more patients sooner, expand elective surgery, ease pressure on emergency departments and meet growing demand in hospitals;
- $318 million over five years to strengthen the justice system, including additional police and forensic officers, and improved support for victims of crime; and
- $199 million over five years to improve support for people with a disability and $166 million over four years to give children the best start in life and help for working families.

Details on these new initiatives can be found in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*.

OBJECTIVE FOUR: TAXATION

The Government's commitment to the continued reduction of business costs and red tape will improve national and international competitiveness of all Victorian businesses and help foster economic growth. This will attract business investment, support job growth and sustain a high standard of living across Victoria. In addition, the Government's tax reform agenda is aimed at reducing the tax burden on Victorian homebuyers, investors, self-funded retirees, and business; and enhancing the security of Victoria's tax base.

A key financial objective of the Government is to provide a fair and efficient tax system that is competitive with other states. To achieve this, the Government continues to implement a range of reforms to strengthen incentives for business to grow, workforce participation to expand and population to increase.

Since 1999, the Government has announced significant tax reductions. 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). This has 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 2007-08 Budget delivers further tax relief for business:

- land tax – cutting the middle brackets of 1.2 per cent and 1.8 per cent to 0.8 per cent and 1.3 per cent respectively, and cutting the top rate from 3.0 per cent to 2.5 per cent; and increasing the tax-free threshold. These changes are worth $508 million over four years and benefit over 40 000 taxpayers;
- motor vehicle duty – reducing the effective duty rate to 2.5 per cent on passenger vehicles valued between $35 000 and $57 009, which provides $177 million worth of tax relief over five years on the purchase of new passenger cars;
- payroll tax – bringing forward to 1 January 2007 the reduction in the payroll tax rate from 5.15 per cent to 5.05 per cent by 1 July 2007, saving businesses $26 million in 2006-07; and
- land transfer duty – reducing the marginal rate for properties valued between $115 000 and $400 000 from 6 to 5 per cent on 1 January 2007, which provides homebuyers with a saving of $305 million over five years.

The taxation reform measures announced in the 2007-08 Budget will provide net tax relief to Victorian taxpayers of $498 million over four years. Detailed information on these initiatives can be found in Chapter 3, *Budget Position and Outlook;* Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives;* and Budget Paper No. 4, Chapter 3, *State Revenue*.

Tax competitiveness

The competitiveness of Victoria's tax regime plays an important role in underpinning economic growth and investment. Consistent with the Government's strategic priority of promoting growth across the whole of the State, the Government aims to ensure that Victoria's taxes remain competitive with the Australian average.

Victoria's preferred measure of tax competitiveness is state taxation expressed as a share of nominal gross state product (GSP). This measure relates the level of taxation revenue to economic capacity. Taxation revenue as a share of nominal GSP projected to 2009-10 for Victoria, New South Wales, Queensland and the Australian average is shown in Chart 1.4. In 1999, Victoria's tax ratio fell sharply as Victoria abolished several taxes as part of the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations* (IGA) when the GST was introduced. Since then, the ratio has generally continued to fall steadily.

In 2007-08, Victoria's tax ratio is budgeted to fall to 4.50 per cent, an estimated 0.42 percentage points ($1.1 billion) which is below that of New South Wales and at the Australian average. Over the forward estimates period, Victoria's taxation as a share of nominal GSP is forecast to decline further to 4.36 percentage points of nominal GSP by 2009-10.

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

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

Note:

(a) Historical taxation data from 1990-91 onwards, revised estimates for 2006-07 and forecasts for the forward estimates period. Victorian data represent 2007-08 Budget estimates. Data for all other jurisdictions represent their 2006-07 Budget Update estimates.

Workplace 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 2007-08 Budget provides for the fourth consecutive 10 per cent reduction in the WorkCover insurance average premium rate. This brings Victoria's average premium rate to 1.46 per cent of wages, an historic low, and ensures the WorkCover scheme retains the second lowest average premium rate in Australia. The latest 10 per cent cut will save Victorian employers an additional $167 million in 2007-08. As a result of four successive cuts, Victorian employers will benefit from accumulated savings of $687 million in 2007-08.

Over the last six years, there have been significant and sustained decreases in the rate of workplace deaths and injuries. In 2006, more than 41 000 visits to workplaces were undertaken by WorkSafe inspectors, which contributed to the lowest ever injury rate being recorded and a decrease in the number of workers visiting hospital because of injury.

OBJECTIVE FIVE: NET FINANCIAL LIABILITIES

Victoria's finances are strong and provide the basis for the State to continue to deliver infrastructure investment needed for Victoria to grow and prosper. Prudent financial management will also provide the State with a solid buffer to absorb a fiscal shock and still meet its financial obligations.

Victoria's strong balance sheet is evident in its triple-A credit rating, which was reaffirmed by international credit rating agencies Standard & Poor's in December 2006 and Moody's Investors Service in January 2007. Both agencies cited Victoria's strong fiscal position, low debt levels and prudent financial management as the key factors behind the triple-A credit rating.

Over the budget and forward estimates period, about 60 per cent of the general government 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 and strong budget position to fund key public investment projects that provide long-term economic and social benefits to Victoria.

Chart 1.5 shows that the ratio of net financial liabilities (the sum of net debt and unfunded superannuation liabilities) to GSP is set to decline from 10.6 per cent in June 1999 (AAS basis) to 6.1 per cent in June 2007 (A-IFRS basis), and is expected to remain stable in the forward estimates period. The proportion of general government income directed towards servicing net financial liabilities, and therefore not available for service provision, is expected to remain below 7 per cent over the forward estimates period.

The Government has reduced net financial liabilities as a percentage of GSP by 4.6 percentage points, which is the equivalent of a reduction in liability of more than $11 billion in real terms.

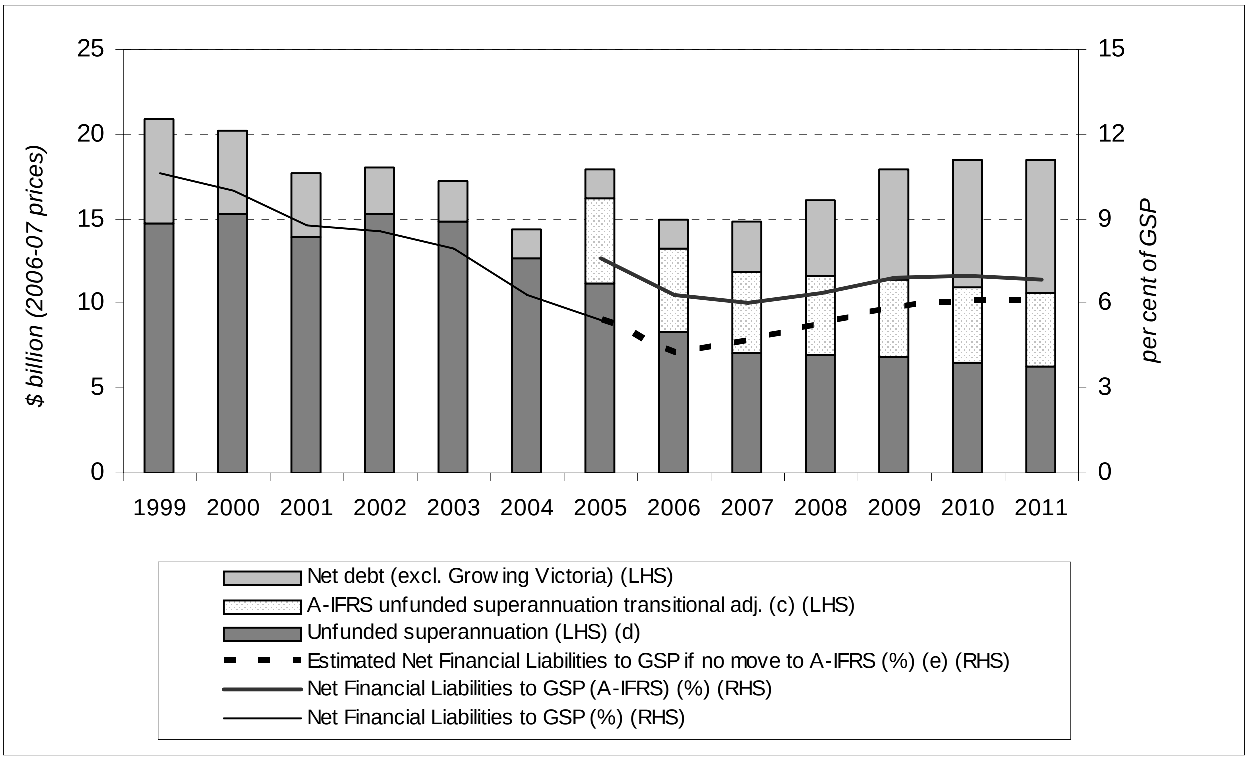
The prudent strategy of using available cash surpluses to pre-pay superannuation liabilities and retire gross debt has meant that even with the largest capital program in the State's history, the State's net financial liabilities are still significantly lower than when the Government came to office.

In addition, the servicing burden of the State's largest liability, its unfunded superannuation, will ease over the forward estimates period. As a proportion of GSP, unfunded superannuation liabilities are forecast to decline from 4.8 per cent in June 2007 to 3.9 per cent in June 2011. This reduction approximates the servicing costs of rising net debt used to fund infrastructure investment.

General government net debt is projected to increase from $3.0 billion at June 2007 to $7.9 billion at June 2011 in real terms. The projected general government real net debt of $7.9 billion in 2011 is equivalent to 2.9 per cent of GSP, compared to 3.1 per cent in 1999.

Detailed information on net debt and financial liabilities can be found in Chapter 4, *Balance Sheet Management and Outlook.*

Chart 1.5: General government real net financial liabilities, as at 30 June(a)(b)



Source: Department of Treasury and Finance

Notes:

(a) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.

Notes (continued)

(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) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liabilities in 2004-05 has also been separately identified in the period 2005 to 2011.

(d) Unfunded superannuation liabilities between 1999 and 2004 are calculated under the old Australian accounting standards, whereas between 2005 and 2011 the relevant A-IFRS standard has been applied.

(e) The net financial liabilities to GSP (as calculated applying the old Australian accounting standard) between 2005 and 2011 are estimates, and should be used for illustrative purposes only.

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- Victoria’s economy continues to grow solidly despite a number of challenges. Growth of Victorian gross state product is expected to be 2.75 per cent in 2006-07, rising to 3.25 per cent in 2007-08 and 2008-09 and then settling at a trend growth rate of around 3 per cent.
- The growth of the economy in 2006-07 reflects some rebalancing in the drivers of growth, from the business sector toward the household sector. The increase in growth in 2007-08 and 2008-09 will be driven by a rebound in the dwelling sector and a recovery in the rural sector.
- Victoria has both very low unemployment and close to record high labour force participation. Despite the strong labour market, wage growth appears to be moderate and headline inflationary pressures have eased.
- The world economic outlook remains sound, with growth expected to be above trend and more broadly based across countries than in recent years.
- There are several short to medium-term risks to the economic projections, including drought conditions, wage and inflationary pressures, the exchange rate and developments in the global economy.
- Longer-term growth prospects will also be influenced by the ageing of the population, productivity slowdown and climate change. Future prosperity is dependent on reforms that boost productivity and participation and respond to climate change.

VICTORIAN ECONOMIC PROJECTIONS

The Victorian economy is expected to grow by around 2.75 per cent in 2006-07, broadly in line with the national average growth rate. Economic growth in 2006-07 reflects some change in the drivers of growth, away from the business sector toward the household sector. Growth of the non-farm economy has been solid, but the recent drought has severely reduced output in the farm sector.

Following this moderate expansion in 2006-07, economic growth is forecast to increase in 2007-08 and 2008-09 before settling at a trend growth rate of around 3 per cent in the forward years. The recovery in the next two years is expected to be driven by a rebound in dwelling investment and a recovery in the rural sector. Solid consumption growth and ongoing high levels of business investment are also expected to underpin the economy. The labour market is expected to perform solidly and will be supported by population growth and high rates of labour force participation. Growth of wages and consumer prices is expected to be moderate.

The Victorian economic projections are sensitive to a number of risks, including drought conditions, wage pressures and exchange rate movements. Beyond the short and medium term, the main determinant of Victoria's longer-run growth potential is the economy's productive capacity. With the economy operating at or near full capacity, the main constraints to future growth are likely to come from shortages of productive capacity rather than lack of demand. This highlights the importance of the reform agenda focus on productivity and labour force participation (see Chapter 7, *The Economic Reform Agenda* for more details).

The economic projections used in the 2007-08 Budget are set out in Table 2.1. These projections 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 issues and risks to the Victorian economic outlook.

Table 2.1 Victorian economic projections[(a)]

	2005-06 Actual	*2006-07 Forecast*	*2007-08 Forecast*	*2008-09 Forecast*	*2009-10 Forecast*	*2010-11 Forecast*
Real gross state product	2.7	2.75	3.25	3.25	3.00	3.00
Employment	1.7	2.25	1.25	1.25	1.25	1.25
Unemployment rate [(b)]	5.3	5.00	5.00	5.00	5.00	5.00
Consumer price index	3.1	3.00	2.50	2.50	2.50	2.50
Wage price index [(c)]	3.8	3.50	3.50	3.50	3.50	3.50
Population [(d)]	1.4	1.20	1.20	1.20	1.20	1.20

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

The world economy recorded strong growth in 2006, with output increasing by an estimated 5.4 per cent according to the International Monetary Fund's (IMF) latest *World Economic Outlook*. Growth is forecast to moderate in 2007 and 2008, but remain robust at 4.9 per cent in both years. If realised, this would be five years of above-trend growth, the longest period of such growth for the world economy in over 30 years. Importantly, growth is expected to be more broadly based than in recent years, with less dependence on US growth.

The IMF forecasts growth in the United States to slow to 2.2 per cent in 2007. This forecast is largely driven by a weak housing sector, although consumption has been supported by a strong labour market. Inflationary pressures have eased but remain firm. US growth is forecast to improve to 2.8 per cent in 2008.

Developing countries are continuing to grow at a rapid pace, led by China and India. The IMF is forecasting the Chinese economy to grow at 10.0 per cent in 2007 and 9.5 per cent in 2008. However, the Chinese government has expressed the desire to moderate growth as it has become increasingly imbalanced, driven disproportionately by investment and growing trade surpluses. The Chinese authorities have undertaken a number of macroeconomic tightening measures, including raising official interest rates. The Indian economy is also expected to continue growing strongly, with the IMF forecasting growth of 8.4 per cent in 2007 and 7.8 per cent in 2008.

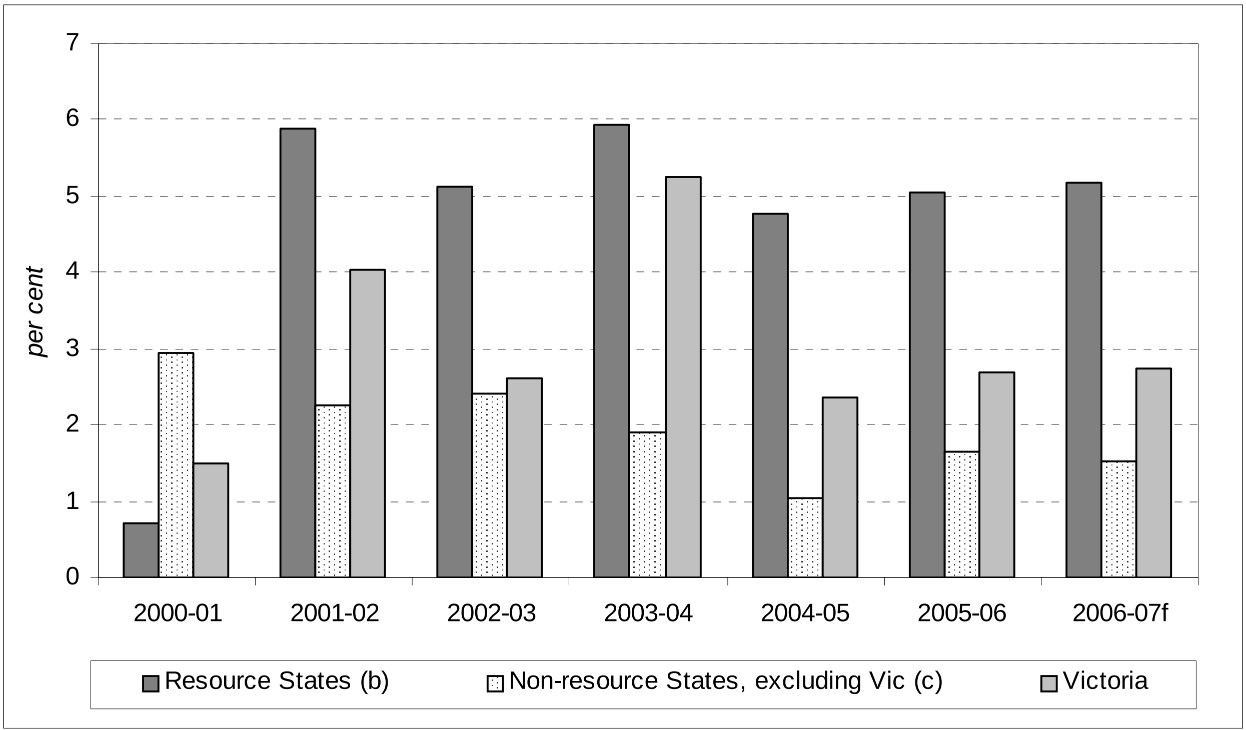
After a long period of stagnation, Japan has experienced an encouraging economic recovery and is forecast by the IMF to grow by 2.3 per cent in 2007. To date growth has been largely underpinned by the corporate sector and exports, while consumption growth has been more modest, due partly to low wage growth. European economic growth picked up significantly in 2006 and is expected to remain solid in 2007 and 2008, at 2.8 per cent and 2.7 per cent respectively. This is largely due to stronger growth in Germany, France and the United Kingdom in 2006, and has been associated with high business and consumer confidence, and falling unemployment.

The continuing strong growth of the global economy has led to the absorption of spare capacity, leading to inflationary pressures. In 2006 headline inflation in many of the advanced economies rose above the targeted levels of central banks, partly due to the rise in oil prices. This development has seen the major central banks tightening monetary policy.

Australian economic conditions and outlook

The Australian economy grew by 2.8 per cent over 2006 with the non-farm economy expanding faster, by 3.5 per cent. The drought led to around a 20 per cent fall in farm gross domestic product (GDP) over the second half of 2006. Overall, the Australian Bureau of Statistics expects the drought to directly reduce GDP growth by 0.6 percentage points in 2006-07. Despite the improvement in non-farm growth over 2006, there is still evidence of capacity constraints, with excess domestic demand spilling over to higher imports and inflation. The national result also reflects ongoing divergences between the State economies, with the resource States continuing to perform above average (see Chart 2.1).

Chart 2.1: Economic growth comparison[(a)]



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

Notes:

(a) Gross state product, chain volume measure. Forecasts based on latest State budget documents.
(b) Resource States include Queensland, Western Australia and Northern Territory.
(c) Non-resource States include New South Wales, South Australia, Tasmania and Australian Capital Territory.

GDP growth during 2006 was dominated by a strong domestic economy. Despite a rise in export volumes over 2006, import volumes grew faster and net exports continued to detract from growth. The expansion in domestic demand reflected rising consumption growth offsetting some moderation in machinery and equipment investment. Dwelling investment appeared to stabilise following a modest downturn, and non-dwelling construction activity grew very strongly, supported by record engineering construction, especially in the resource States. However, despite the significant business investment over the past few years, business surveys continue to report that capacity utilisation is at or near record levels.

The labour market performed very strongly in 2006 and the economy is operating at or close to full employment. Employment grew by 3.0 per cent over 2006 leading to the unemployment rate falling to 4.5 per cent, the lowest level in around 30 years. The participation rate also increased strongly over 2006 to a record high 65.0 per cent. The largest increase in participation has occurred for persons aged between 55 and 64 years. This increased participation has played an important role in expanding the labour supply despite the historically low unemployment rate.

Although the economy is operating at or close to full employment, wage growth has not accelerated, and was 4.0 per cent over 2006. Wage pressures appear to be largely confined to the mining and construction industries, particularly in the resource States, with limited evidence of spill-overs to other industries and States.

Headline inflation has eased in recent quarters, driven by falls in petrol prices and the unwinding of the spike in fruit prices. However, measures of underlying inflation remain at the upper end of the Reserve Bank of Australia's (RBA) target band of 2 to 3 per cent. Higher inflation in the first half of 2006 saw the RBA raise the cash rate three times in 2006, to 6.25 per cent.

An expected recovery in the rural sector and dwelling investment, and stronger export growth, should see the national economy expand faster in 2007-08. The Consensus Economics panel of private forecasters expects Australian GDP growth to pick up from 2.7 per cent in 2006-07 to 3.3 per cent in 2007-08.

Victorian economic conditions and outlook

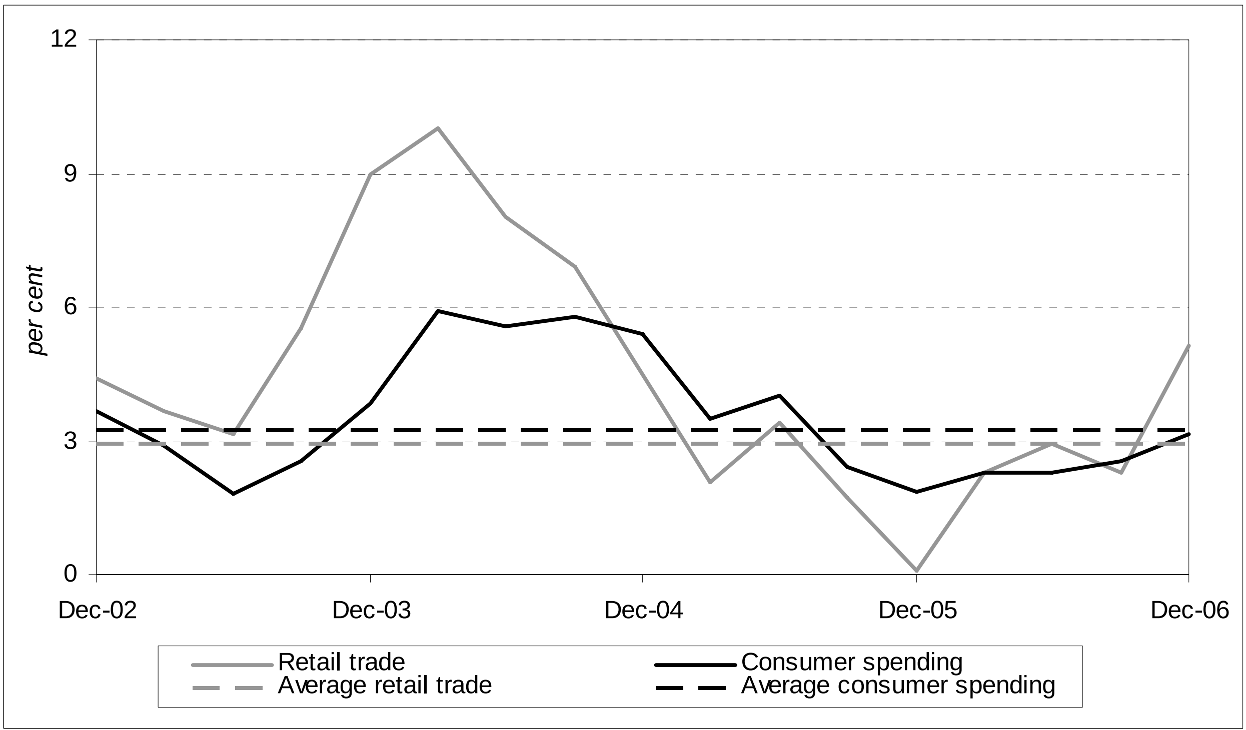
Victoria's economy continues to grow solidly, despite several challenges. After a moderate expansion in 2006-07, Victorian gross state product (GSP) is expected to record stronger growth in 2007-08 and 2008-09, before settling at trend growth of around 3 per cent. The increase in growth is expected to be driven by a rebound in dwelling investment and a recovery in the rural sector. Solid consumption growth and high levels of business investment are also expected to underpin the expansion. After a number of years of quite rapid growth, averaging more than 10 per cent per annum over the past six years, business investment is expected to advance at a more moderate pace, making a smaller contribution to growth. In contrast, the contribution from consumption and dwelling investment is expected to increase.

Consumer spending

Household consumption growth increased over 2006, following weaker growth over 2005 that was partly related to household debt consolidation and the softness in housing prices. The annual growth rate of retail trade volumes in the December quarter 2006 was the highest in over two years (see Chart 2.2). This more positive outlook is also reflected in consumer sentiment, which has regained ground that was lost after the interest rate and petrol price rises of 2006, to be firmly positive in early 2007.

Although high levels of household debt and the lagged effect of interest rate rises may keep consumers relatively cautious, there is continued support for spending from strong labour market outcomes and steady income growth.

Chart 2.2: Victorian real retail trade and consumer spending[a][b]



Source: Australian Bureau of Statistics

Notes:
(a) Four quarter-ended percentage change.
(b) Averages calculated over last 20 years.

Dwelling investment

Victoria continues to lead the nation in housing activity, reflecting strong population growth and the best affordability on the eastern seaboard. Victoria recorded the highest housing starts of any State over the past two years, and this is likely to continue over the next three years according to Housing Industry Association forecasts.

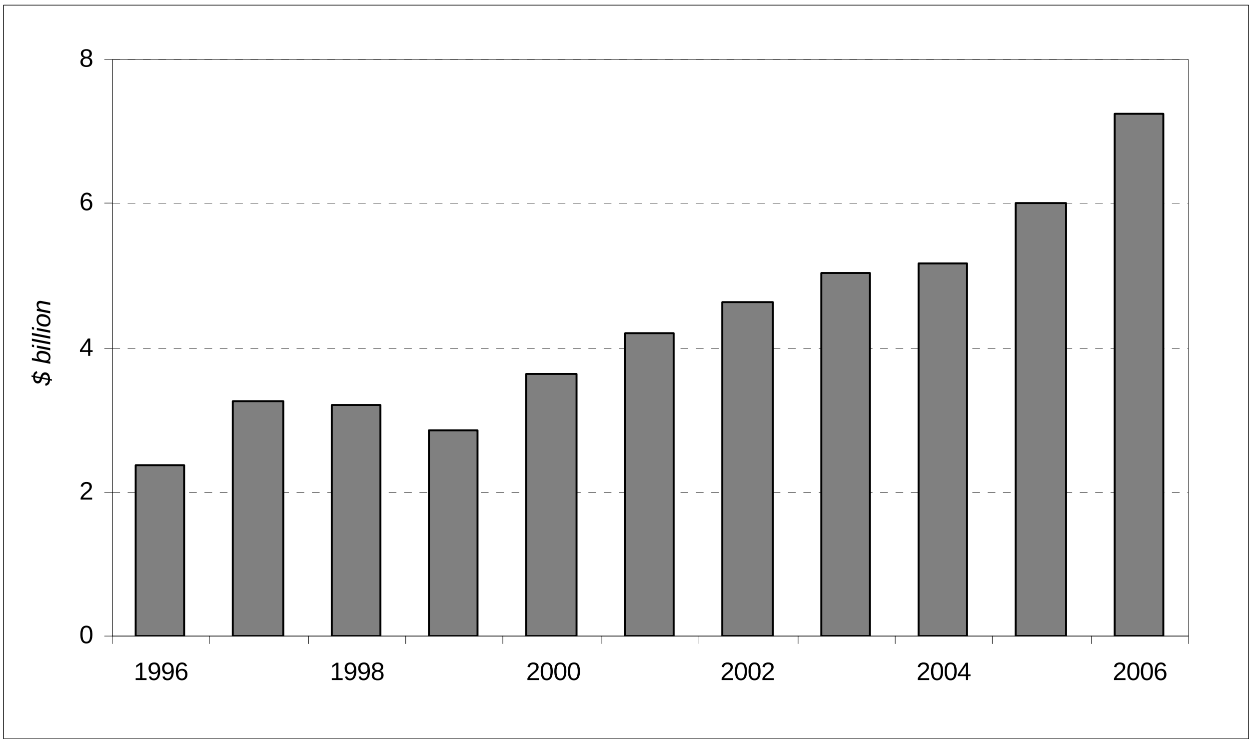
In aggregate, dwelling investment is expected to increase marginally in 2006-07 with some gains in the second half of 2006 likely to be offset by falls during the first half of 2007. However, conditions continue to support a recovery in 2007-08, as residential building activity appears to be running below underlying demand requirements, particularly given strong population growth. Very low residential vacancy rates, which are pushing up housing rents, are also likely to support a recovery in residential construction.

Business investment

Although growth moderated through 2006, business investment remains at very high levels and is expected to continue to contribute to the productive capacity of the economy. The current business environment remains conducive to maintaining high levels of investment, with a strong global economy, high capacity utilisation, and strong business profitability and balance sheets.

Record non-residential building approvals and levels of work yet to be done provide a basis for strong growth in non-residential building in coming years. The value of Victorian non-residential building approvals grew by 20 per cent in 2006 and was higher than in any other State (see Chart 2.3). There was broad-based strength across the commercial, industrial and other non-residential sectors. More modest growth is expected for machinery and equipment investment, and the completion of EastLink will also factor into easing engineering construction activity.

Chart 2.3: Victorian non-residential building approvals



Source: Australian Bureau of Statistics

International trade

Despite weaker cereal exports in the latter part of 2006, total Victorian goods exports recorded strong growth in 2006, up 5.1 per cent over the year. Several manufacturing sectors recorded very strong volume growth over the year, particularly beverages, pharmaceuticals and road vehicles. Dairy exports proved resilient in 2006, despite current drought conditions, with the volume of exports in the December quarter the highest observed in the past four years. Service exports have also been performing well, rising by 5.0 per cent in 2005-06, with notable strength in education and other travel services.

Victorian merchandise imports fell slightly over the year to the December quarter 2006, the first time this has occurred in over five years. This easing in imports appears to be consistent with the slowdown in machinery and equipment investment, which accounts for around half of Victoria's merchandise imports.

Looking ahead, the drought is likely to exert further downward pressure on Victoria's exports. More generally, the high Australian dollar will continue to place pressure on Victoria's non-mineral exporters. Combined with an increase in imports, it is likely that net exports will detract more significantly from growth in 2007-08 than in 2006-07.

Labour market

Victorian labour market outcomes have continued to be positive. Employment growth is strong, at 2.8 per cent over the year to March, labour force participation is at close to record highs at 64.8 per cent, and the unemployment rate has been very low at around 5 per cent. The expansion in employment over the past year has been entirely in full-time employment. Employment growth has been particularly strong in finance and insurance, wholesale trade and construction.

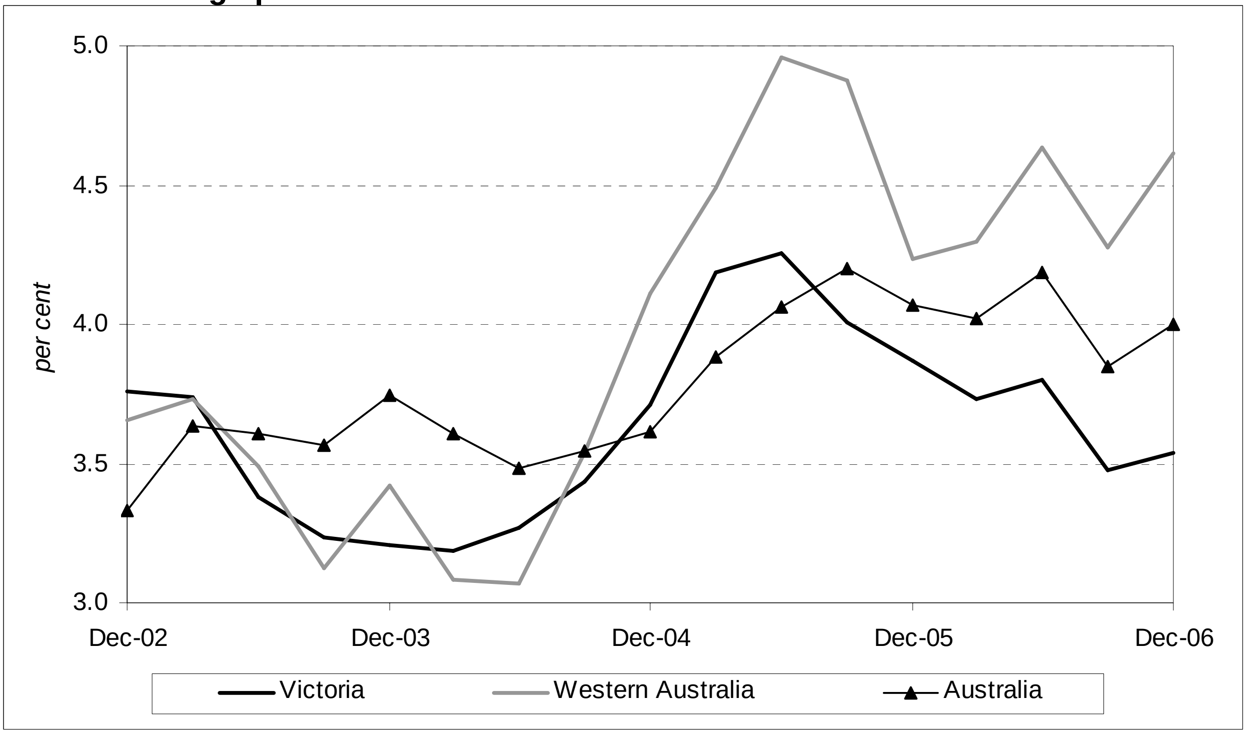
Over the forecast period, employment growth is expected to slow from recent above-trend rates to grow in line with the growth of the working-age population, and the unemployment rate is expected to stay around 5 per cent. High labour force participation should be supported over the forecast period by demographic and policy changes. These include delayed retirement and greater participation from older workers, the increase in skilled migration and the general attractiveness of the current labour market.

Wages and inflation

Although wage pressures appear relatively moderate in light of the tight labour market, wage growth remains at the upper end of the range that has been observed since the late 1990s. Recent data have also been more difficult than usual to interpret, due to the delayed granting of award wage rises associated with the introduction of the Australian Fair Pay Commission and the consequent disruption to the previous seasonal pattern of wage setting. Wages in Victoria grew by 3.5 per cent over 2006, 0.5 percentage points below the national growth rate (see Chart 2.4).

Wage growth is projected to be stable over the forecast period. This is despite the low unemployment rate and reports that firms are having difficulty finding suitable labour. Some of the moderating influences are coming from the high participation rate, well-anchored inflation expectations as well as increased competition from labour in developing economies. Nonetheless, wage pressures remain a risk to the economic outlook.

Chart 2.4: Wage price index[(a)]



Source: Australian Bureau of Statistics

Note:
(a) Four quarter-ended percentage change.

Headline inflation has eased back from the peak in mid-2006, mainly reflecting more moderate petrol and fruit prices. Underlying inflation is at the upper end of the RBA's target band and there are several factors exerting upward pressure. Housing rents have accelerated, consistent with the tight rental market. Ongoing labour market tightness is likely to keep wage growth at current above-average levels. Capacity utilisation is high and expected to ease only modestly. Potential increases in oil prices also remain a risk.

Looking ahead, the RBA expects national underlying inflation to remain at the upper end of the RBA target band over the next two years. National headline inflation is expected to ease further in the near term before settling at a rate between 2.5 and 3.0 per cent by the second half of 2008. Victorian inflation is expected to average 2.50 per cent over the forecast period. Inflationary pressures have been less pronounced in the non-resource States.

Population

Victoria's population growth has been strong over the past two years, supported primarily by overseas migration. Victoria's population grew by 1.4 per cent over the year to the September quarter 2006, stronger than the national growth rate of 1.3 per cent. Over 2005-06, Melbourne recorded the largest increase in population of the capital cities, expanding by 49 000 persons, followed by Sydney (37 200 persons), Perth (29 900 persons) and Brisbane (29 500 persons).

More than half of the increase in Victoria's population over the past year was due to net overseas migration, and Victoria's share of total national net overseas migration was 29 per cent, which is above its population share (25 per cent). Also, a rise in the birth rate has led to a larger natural increase in the population. Victoria continues to record a net outflow of people to other States, but it is small by historical standards. In 2005-06 the net outflow was around 2 000 persons, compared to an average of around 20 000 persons per annum in the first half of the 1990s.

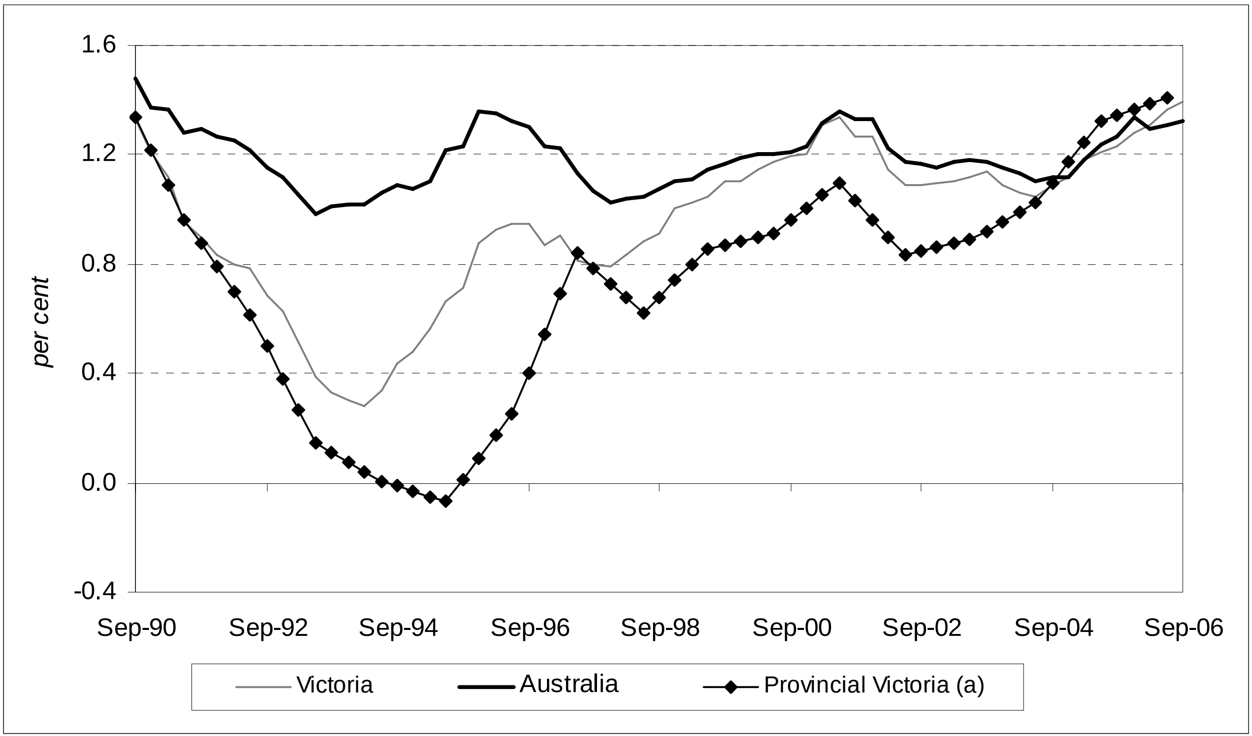
It is expected that population growth will ease back slightly in the short to medium term, but will remain strong at around 1.2 per cent, above the average annual growth rate of the past ten years of 1.1 per cent. Population projections are based upon continued strong net overseas migration and small outflows from net interstate migration.

Provincial Victoria

Despite the negative effects of the drought and summer bushfires, expansion in provincial Victoria is being underpinned by strong population and employment growth, and high levels of building activity.

Population growth in regional Victoria has been strong, with growth in 2005-06 of 1.4 per cent, the highest regional growth behind the resource States of Western Australia and Queensland, and above growth in metropolitan Melbourne (see Chart 2.5). Mildura, Bendigo, Ballarat and Shepparton recorded the fastest population growth of all inland statistical districts across Australia during 2005-06. Regional Victoria employment growth was strong over the year to the March quarter, at over 5 per cent, and the country Victoria unemployment rate has fallen by over one percentage point over the past year to 5.2 per cent.

Chart 2.5: Victorian and Australian annual population growth



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

Note:

(a) For provincial Victoria, annual population growth is interpolated to a quarterly basis.

In 2006 there was a record value of regional Victorian building approvals, in line with the strong population and employment growth. According to Building Commission data, the value of regional building approvals was almost $4 billion in 2006. Supported by relatively affordable housing, there are signs of solid regional property market activity and price growth.

The assessment of the likely drought impact on the economy remains largely unchanged since the *2006-07 Budget Update*. Historically, Victorian droughts are characterised by a sharp decline in winter crop production, followed by a strong recovery in the post-drought year. Dairy output declines because of lower milk yields per cow and reduced herds. Meat production initially increases in drought years as graziers reduce stock. On this basis, provided there is a return to normal seasonal conditions, winter crop production is likely to return to around pre-drought levels. Lower herd numbers result in dairy and meat production making a more gradual recovery.

Although conditions remain difficult, forward indicators suggest a return to more normal seasonal conditions. The Bureau of Meteorology has declared the end of El Niño conditions, with a continuation of neutral, or a switch to La Niña (wetter-than-normal) conditions, the more likely outcomes.

SHORT AND MEDIUM-TERM RISKS

The main short- to medium-term risks to the Victorian economic projections are from drought conditions, oil price volatility, wage and inflationary pressures, exchange rate movements, and global developments. These are also discussed in Chapter 6, *Statement of Risks*.

The prospects for the rural sector remain a risk to the broader Victorian economic outlook. As noted in the *2006-07 Budget Update*, the current drought is expected to detract between 0.5 and 1.0 percentage point from Victorian GSP growth. The current projections assume a return to normal seasonal conditions in 2007-08, so a continuation of dry conditions would place downward pressure on the growth outlook.

Although oil prices have eased from the peaks of August 2006, the risk of further volatility and rises remains, linked to geo-political tensions and potential supply disruptions. This would increase input prices and cause inflationary concerns.

The labour market remains tight, which may put upward pressure on wages and contribute to broader inflationary pressures. With underlying inflation at the upper end of the RBA's target band, this may result in further monetary policy tightening, which would put pressure on the growth forecasts.

Downward pressure on inflation may come from the exchange rate, which has appreciated since early March. However, any further appreciation of the Australian dollar would start placing additional pressures on Victoria's exports.

The global economy continues to surprise on the upside, but there are also a number of downside risks to global growth. The main downside risk stems from the correction in the US housing market, and the extent to which this weakness spills over into the rest of the US economy. There is also uncertainty regarding how the Chinese economy may respond to the government's tightening measures.

LONGER-TERM ECONOMIC GROWTH

Looking past the short- to medium-term risks to the Victorian economic projections, there are several longer-term challenges facing the economy.

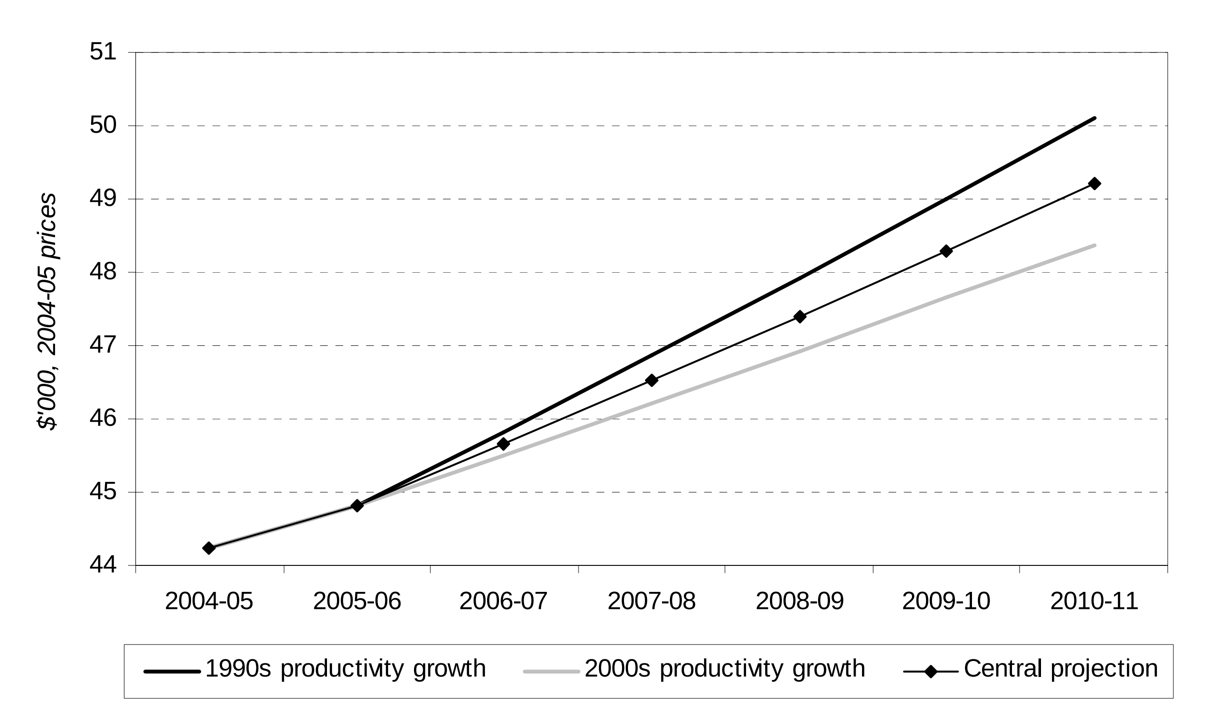
The long economic expansion has exhausted much of the economy's excess capacity, and Victoria's long-term economic prospects will be largely determined by developments in the labour supply and labour productivity.

The main challenge facing labour force participation comes from the projected ageing of the population. All things constant, growth of the labour force will slow because those at older ages generally participate much less in the labour force than younger people. This could lead to reduced economic growth and increased pressure on Government spending.

Victoria, and Australia more generally, enjoyed strong labour productivity growth in the 1990s. This performance owed in great part to a range of economic reforms implemented over the 1980s and 1990s, such as financial market deregulation, trade liberalisation and National Competition Policy. However, labour productivity growth has slowed noticeably in the current decade. While part of this slowing is cyclical, due to the economy hitting capacity constraints, it can also be attributed to the lessening emphasis on economic reform, as well as increased regulation in areas such as security and financial reporting.

Chart 2.6 demonstrates the impact of various labour productivity assumptions on real GSP per capita. The central projection assumes some improvement in labour productivity growth over the forecast period, which should be facilitated by the significant expansion in capital investment over recent years. However, matching the productivity performance of the 1990s would mean that Victorian GSP per capita would be $900 higher, in real terms, by 2010-11 relative to the central projection.

Chart 2.6: Victorian real GSP per capita



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

This analysis suggests that in order to achieve the productivity growth rates of the 1990s, and thereby contribute to better living standards for Victorians, reforms will be needed to boost labour market productivity and participation.

The Government is pursuing a third wave of economic reform to deliver improved productivity and participation. The Government is also a leader in pursing the National Reform Agenda, which seeks to create a more highly productive and participative workforce by investing in human capital, with a focus on improving the health and education of Australians. In addition, reinvigorating productivity growth will also depend on market-based reforms that promote more efficient use of resources, cutting red tape and investing in essential infrastructure.

One of the other major challenges facing the Victorian economy is climate change. It is increasingly accepted that there are risks to economic prosperity if there is no action on climate change. As well as climate change itself, policy responses will also have implications for economic growth. These issues are discussed in more detail in Chapter 7, *The Economic Reform Agenda*.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

- The Government is budgeting to achieve an operating surplus (net result from transactions) of $324 million in 2007-08. Over the three year forward estimates period, operating surpluses are projected to average $424 million each year.
- Expenses are projected to rise by 3.7 per cent in 2007-08 and by an average of 3.1 per cent over the budget and forward estimates. Income is projected to rise by 2.8 per cent in 2007-08 and by an average of 3.2 per cent over the same period.
- The net budget impact of output initiatives announced since the *2006-07 Budget Update* is $447 million in 2007-08, averaging $242 million a year over the forward estimates period.
- The 2007-08 Budget includes new asset investment funding with a total estimated investment of $2.9 billion. This is in addition to $397 million announced in the *2006-07 Budget Update*. Net infrastructure investment is expected to average $3.3 billion over the four years to 2010-11.
- Tax relief announced will benefit taxpayers by $167 million in 2007-08 and by a total of $835 million since the *Pre-Election Budget Update*.

BUDGET ESTIMATES AND OUTLOOK

The Government will continue to achieve its objective of an operating surplus of at least $100 million a year, while delivering the election commitments made in *Labor's Financial Statement 2006.*

As shown in Table 3.1, the Government is budgeting to achieve an operating surplus of $324 million in 2007-08. Over the three years to 2010-11, operating surpluses are projected to average $424 million. The rise in 2008-09 is mainly due to a one-off increase in non-cash income resulting from the transfer of assets free of charge to VicRoads upon the completion of EastLink. Total income from transactions of $34 269 million in 2007-08 is estimated to grow by an average 3.2 per cent over the budget and forward estimates. Total expenses from transactions of $33 945 million in 2007-08 is estimated to grow at an average of 3.1 per cent over the same period.

Further discussion of the operating statement can be found in Budget Paper No. 4, Appendix D, *Operating Statement Analysis*.

Table 3.1: Net result from transactions 2007-08 to 2010-11[(a)]

($ million)

	2007-08 Budget	2008-09 Estimate	2009-10 Estimate	2010-11 Estimate
Income from transactions				
Taxation	11 589.0	11 997.9	12 367.6	12 856.4
Dividends, TER and interest [(b)]	1 207.3	964.6	1 069.8	1 093.1
Grants	16 158.7	16 856.8	17 485.9	18 217.0
Sales of goods and services	2 643.8	2 702.4	2 711.7	2 737.3
Other income [(c)]	2 670.4	2 898.8	2 746.0	2 772.2
Total income from transactions	**34 269.2**	**35 420.5**	**36 381.0**	**37 676.0**
% change	2.8%	3.4%	2.7%	3.6%
Expenses from transactions				
Employee benefits	12 726.2	13 122.1	13 426.1	13 802.0
Superannuation	1 622.9	1 658.8	1 698.8	1 736.0
Depreciation and amortisation	1 470.1	1 537.2	1 623.7	1 773.9
Finance costs	486.3	586.7	705.2	769.3
Grants and transfer payments	6 520.3	6 279.3	6 222.5	6 323.8
Supplies and services	11 118.6	11 801.9	12 314.4	12 823.7
Other expenses	0.4	0.4	0.4	0.4
Total expenses from transactions	**33 944.9**	**34 986.3**	**35 991.1**	**37 229.2**
% change	3.7%	3.1%	2.9%	3.4%
Net result from transactions	**324.3**	**434.2**	**389.9**	**446.8**

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 remeasurements which, when added to the net result from transactions, yields the net result.*

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

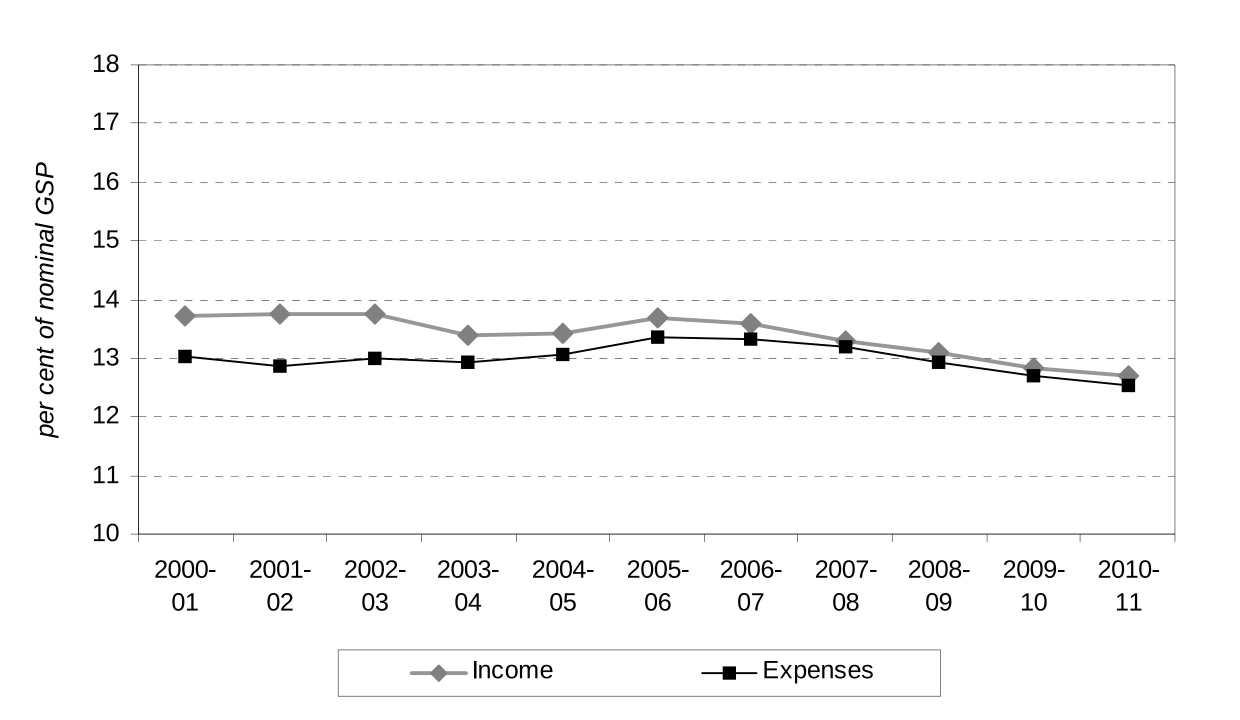
(c) *Comprises regulatory fees and fines, fair value of assets received free of charge, capital asset charge and other miscellaneous income.*

FISCAL OVERVIEW

As shown in Table 3.1, nominal income and expenses are closely aligned over the budget and forward estimates period, with income from transactions projected to grow by a modest 3.2 per cent on average over the budget and forward estimates, and expenses also anticipated to grow at an annual average of 3.1 per cent over the same period.

Chart 3.1 shows the ratio of operating expenses and income to nominal gross state product (GSP) from 2000-01 to 2010-11.

Chart 3.1: Income and expenses relative to nominal GSP



Source: Department of Treasury and Finance

Both expenses and income as a proportion of nominal GSP are projected to be lower in 2010-11 than in 2006-07. This is attributed to a number of factors including:

- the rate of growth in expenses being largely driven by inflation and Government policy decisions;
- the impact of tax cuts announced by the Government, including reductions to land tax, motor vehicle stamp duty, payroll tax and conveyancing duty;
- growth in property taxation revenue being lower than nominal GSP due to other factors such as the level of activity in the property market and significant cuts in land tax rates; and
- the impact of the extended smoking ban on gambling revenue.

Further discussion of the major factors that influence income and expenses, including policy decisions, economic conditions, Commonwealth-State financial relations, and demographic change, are discussed below. Further detail on the impact of these factors on the 2007-08 Budget and forward estimates is also provided in Budget Paper No. 4, Appendix D, *Operating Statement Analysis*.

Policy decisions

The actions of Government significantly affect Victoria's operating result through:

- decisions to improve the quantity and quality of service delivery to Victorians, resulting in increased Government expenditure; and
- changes to the tax system, which will affect revenue collections and the competitiveness of Victoria's tax system in comparison with other States.

The impact of 2007-08 Budget policy decisions on the operating surplus is discussed later in this chapter.

While the cuts to WorkCover insurance premiums do not directly impact the operating statement, they do reduce income tax equivalents receipts to the State. The 2007-08 Budget provides for the fourth consecutive 10 per cent reduction in the WorkCover insurance average premium rate. This brings Victoria's average premium rate to 1.46 per cent of wages, an historic low, and ensures the WorkCover scheme retains the second lowest average premium rate in Australia. The latest 10 per cent cut will save Victorian employers an additional $167 million in 2007-08. As a result of four successive cuts, Victorian employers will benefit from accumulated savings of $687 million in 2007-08.

Economic conditions

The 2007-08 Budget and forward estimates are prepared on the basis of economic projections outlined in Chapter 2, *Economic Conditions and Outlook*.

As shown in Chapter 6, *Statement of Risks*, the budget and forward estimates are sensitive to changes in economic projections. This is particularly true of revenue estimates. Recent history shows that revenue collections have significantly varied from estimates where unanticipated movements in economic projections occurred, for example, the property boom contributing to higher than anticipated tax collections. The revenue projections are based on the expected underlying developments in the economy, and abstract from large cyclical movements in various sectors.

Since forward estimates were published in the *2006-07 Budget Update*, changes in economic parameters, combined with demographic changes, have resulted in increases in annual income from transactions of $339 million on average for the period 2007-08 to 2009-10, primarily through their impact on taxation and investment income.

Commonwealth-State Financial Relations

Victoria will receive $16.2 billion in Commonwealth grants in 2007-08, rising to $18.2 billion in 2010-11.

Since the introduction of the GST on 1 July 2000 and the associated removal thereafter of a number of State taxes, total grants from the Commonwealth have grown from less than 40 per cent of Victoria's revenue to an estimated 47 per cent in 2007-08, thereby reducing Victoria's control over its revenue sources. The Victorian Government's financial capacity to meet the community's demand for services is therefore increasingly reliant on receiving a fair distribution of the Commonwealth Government's revenue pool.

Approximately one third of Commonwealth grants to Victoria (excluding those for on-passing) are in the form of specific purpose payments (SPPs). These are subject to conditions which potentially reduce the ability of the Victorian Government to provide responsive, efficient services, and are discussed further in Chapter 5, *Commonwealth-State Financial Relations.*

As shown in Budget Paper No. 4, Appendix D, *Operating Statement Analysis,* since the publication of the *2006-07 Budget Update*, variations in Commonwealth grants have resulted in increased annual income from transactions of $385 million on average between 2007-08 and 2009-10. The majority of this increase relates to GST revenue together with small movements in SPPs.

Demographic Change

Demographic factors such as an increasing number of Victorian residents and ageing of the population will place increasing pressure on Government expenditure over the forward estimates period. The economic implications of an ageing population also affect economic forecasts. This has been discussed in Chapter 2.

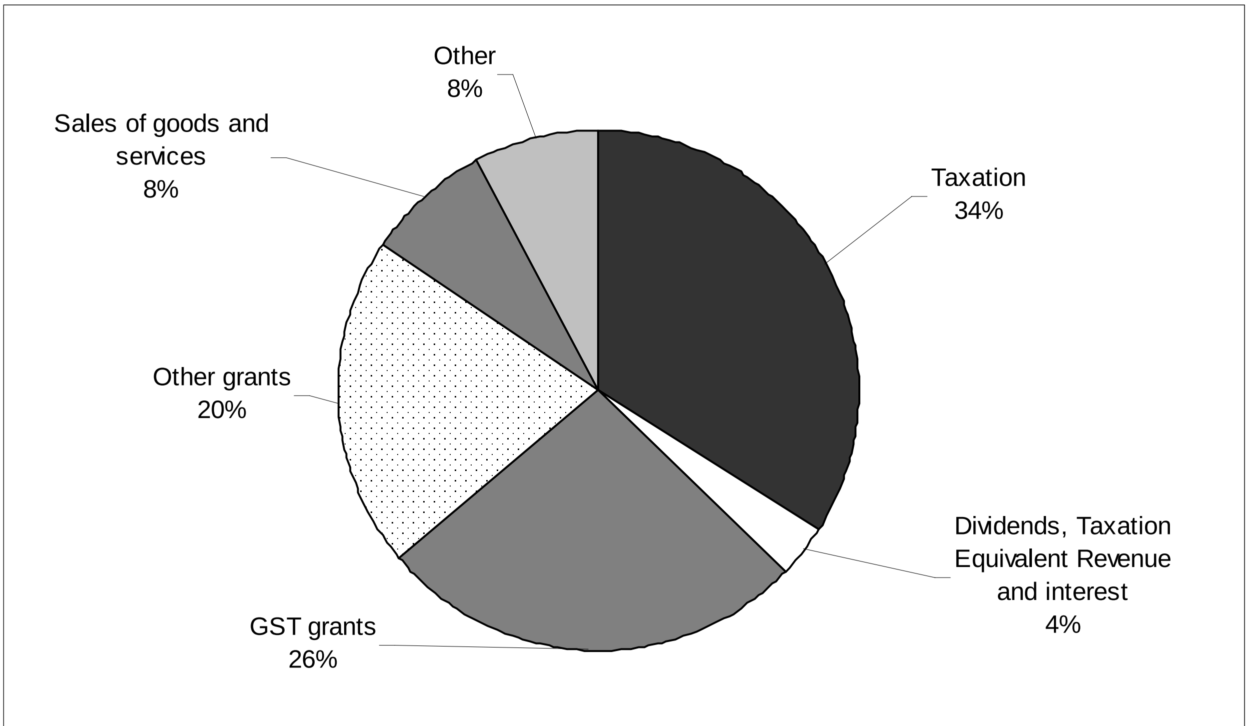
To ensure Victoria's future prosperity, the Government is proactively addressing the economic and fiscal pressures associated with the ageing of the population by leading national reform initiatives to improve workforce participation and productivity. This is discussed in more detail in Chapter 7, *The Economic Reform Agenda*.

SOURCES OF REVENUE

The Government relies on both State-sourced revenue and Commonwealth grants to deliver services to Victorians. As discussed above, policy decisions, economic conditions and Commonwealth-State financial relations can affect the relative size and proportion of government revenue sources that are available to support service delivery in Victoria.

Chart 3.2 shows the relative importance of various revenue sources for the Victorian general government sector.

Chart 3.2: Revenue 2007-08



Source: Department of Treasury and Finance

Total revenue from transactions is forecast to increase on average by 3.1 per cent over the period from 2007-08 to 2010-11.

The largest single source of revenue is grants from the Commonwealth, accounting for 47.2 per cent of income from transactions in 2007-08. Grants are expected to increase by 4.1 per cent on average from 2007-08 to 2010-11. This reflects several factors including:

- an increase in GST grants of 5.7 per cent on average over this period as a result of both an increase in the national GST pool and an anticipated increase in Victoria's share;
- growth in specific purpose operating and capital grants for on-passing of 3.7 per cent on average, largely for non-government schools; and
- growth in specific purpose operating and capital grants of 1.2 per cent on average over the forecast period.

Taxation provides around 34 per cent of income. Growth in taxation income is expected to average 3.5 per cent a year between 2007-08 and 2010-11. Over the budget and forward estimates period:

- payroll tax growth is projected to average 5.2 per cent a year, reflecting solid employment and wages growth;
- land transfer duty, with collections projected to increase by 0.5 per cent on average, due mainly to a modest projected increase in house prices;
- revenue from gambling taxes, which will increase broadly (average 4.8 per cent) in line with growth in household final consumption expenditure; and
- land tax with growth averaging 0.2 per cent reflecting growth in land values, offset by cuts in land tax rates announced in this budget.

Together, grants and taxation revenue account for approximately 80 per cent of Victoria's revenue. The remainder is made up of: sales of goods and services; dividends, income tax and rate equivalent revenue; interest; fines and regulatory fees and other income. These sources of income are estimated to increase by 0.4 per cent on average between 2007-08 and 2010-11.

Further information on Victoria's revenue sources can be found in Budget Paper No. 4, Chapter 3, *State Revenue*.

Tax Initiatives

Table 3.2 provides a summary of the tax initiatives included in the 2007-08 Budget. These initiatives will benefit taxpayers by $167 million in 2007–08 and by a total of $835 million since the *Pre-Election Budget Update*.

Table 3.2: 2007-08 Budget tax initiatives[(a)]

($ million)

	2006-07 Budget	*2007-08 Budget*	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
Tax Relief					
Land Tax cuts	0.0	-123.7	-129.2	-126.0	-122.6
Motor vehicle duty cuts	-6.2	-39.7	-41.6	-43.6	-45.7
Special land tax reform	0.0	-1.5	-1.5	-1.6	-1.6
Zone transition for congestion levy	-0.2	-0.2	0.0	0.0	0.0
Payroll tax [(b)]	-26.0	0.0	0.0	0.0	0.0
Land Transfer Duty [(b)]	-19.0	-47.0	-47.0	-95.0	-97.0
Total tax relief	**-51.4**	**-212.1**	**-219.3**	**-266.2**	**-266.9**
Other Revenue initiatives					
Wagering commission rate adjustment	0.0	3.9	4.0	4.2	4.3
Payroll tax harmonisation	0.0	2.0	2.0	2.1	2.2
Health Benefit Levy increase	0.0	39.0	39.0	39.0	39.0
Total Other Revenue initiatives	**0.0**	**44.9**	**45.0**	**45.3**	**45.5**
Total tax initiatives announced since *Pre-Election Budget Update*	**-51.4**	**-167.2**	**-174.3**	**-220.9**	**-221.4**

Source: Department of Treasury and Finance

Note:
(a) A negative figure indicates reduced revenue.
(b) Announced in the 2006-07 Budget Update.

Land tax

The 2007-08 Budget makes further cuts to land tax rates to strengthen the Government's recent land tax reforms.

Previous budgets have committed to significant reductions to the top land tax rate (from 5 per cent to 3 per cent), moderated the progressiveness of the land tax scale through the middle rates, and increased the tax free threshold to $200 000. The Government has also eliminated indexation factors and increased land valuation appeal rights.

The 2007-08 Budget increases the tax-free threshold further from $200 000 to $225 000. It also provides relief to those taxpayers who have faced the largest land tax increases in recent years by cutting the middle brackets of 1.2 per cent and 1.8 per cent to 0.8 per cent and 1.3 per cent respectively, and cutting the top rate from 3 per cent to 2.5 per cent. This is down 5 per cent from when the government was first elected.

The Government is also abolishing special land tax on primary production land that is wholly or partly in the metropolitan area, as well as on land that is compulsorily acquired.

These changes are worth $508 million over four years and benefit over 40 000 taxpayers. These changes also significantly improve Victoria's tax competitiveness, as Victorian businesses will now face the lowest levels of land tax in Australia for virtually all landholdings valued between $0.4 million and $4.5 million. Around 28 000 land taxpayers will be removed from the system as a result of the increase in thresholds.

Motor vehicle duty

The Government is helping to make new motor vehicles more affordable by reducing the effective duty rate to 2.5 per cent on passenger vehicles valued between $35 000 and $57 009. This is in line with the rate currently charged for new passenger vehicles valued up to $35 000. This initiative will provide $177 million worth of tax relief over five years on the purchase of new passenger cars, including those made in Australia. For example, the duty on a Holden Commodore Berlina will fall by 37.5 per cent, taking it from the second highest rate in Australia to the second lowest.

This measure, which takes effect from 1 May 2007, will be funded in large part by the removal of subsidies on petroleum, which will come into effect from 1 July 2007 and have provided negligible benefit to motorists. The petroleum subsidy has had no noticeable impact on fuel prices, with evidence indicating that it is more likely to have been absorbed into petroleum company profits than being passed on to motorists. In contrast, reducing the duty on motor vehicle sales will directly benefit motorists. By providing an incentive for motorists to switch to new, more fuel efficient, cars with additional safety features, this initiative is also expected to have positive environmental and road safety benefits at a cost of $13.1 million over the forward estimates period.

Payroll Tax Cut

The Government has brought forward to 1 January 2007 the reduction in the payroll tax rate from 5.15 per cent to 5.05 per cent by 1 July 2007, saving businesses $26 million in 2006-07.

Payroll tax harmonisation

From 1 July 2007, New South Wales and Victoria will have harmonised payroll tax legislation, including common definitions and exemptions, but excluding rates and thresholds. This will cut red tape by reducing payroll tax paperwork for around 8 000 businesses with operations on both sides of the Murray River.

Victoria and New South Wales are also examining the scope for introducing harmonised administrative arrangements, such as common payroll tax forms/systems, a one-stop shop for businesses paying payroll tax in Victoria and New South Wales, and common interpretations of the law by revenue offices.

Land Transfer Duty

The Government will provide land transfer duty relief for home buyers for contracts entered into from 1 January 2007 in respect of principal places of residence. For properties with dutiable values between $115 000 and $400 000 the current 6 per cent marginal rate will be reduced to 5 per cent. Over the subsequent $100 000 range from $400 000 to $500 000, a duty saving of $2 850 will apply.

Any first home buyer that qualifies for both the First Home Bonus and the land transfer duty concession is required to elect between the two.

Zone transition for Congestion Levy

There will be no increase in the Congestion Levy during 2007 and 2008 in those parts of Southbank and Port Melbourne to the west of Wurundjeri Way. This measure applies retrospectively from 1 January 2007, pending the outcome of the Government’s review of parking requirements in planning schemes, and will cost $0.2 million in 2006-07 and 2007-08.

Health Benefit Levy

From 2007-08, the Health Benefit Levy will increase from $3 033 to $4 333 on each electronic gaming machine operated in Victoria. This will raise an additional $39 million each year and, like all revenue raised by this levy, will be transferred directly into the Hospitals and Charities Fund.

Wagering commission rate adjustment

Under the *Gambling Regulation Act 2003* the wagering licensee (TABCORP) applies a maximum commission rate over the course of the year of 16 per cent of wagering turnover although various rates, up to 25 per cent, are deducted from different pools (e.g. Win/Place, quadrellas, trifectas). From 2007-08, the government will remove the annual 16 per cent commission rate and fix the rate deducted from each pool at its current level.

A projected increase in wagering activity on bet types currently paying commissions above 16 per cent including trifectas and quadrellas is expected to increase wagering tax revenue by $4 million annually. This reform will provide the wagering licensee with greater flexibility to merge betting pools internationally.

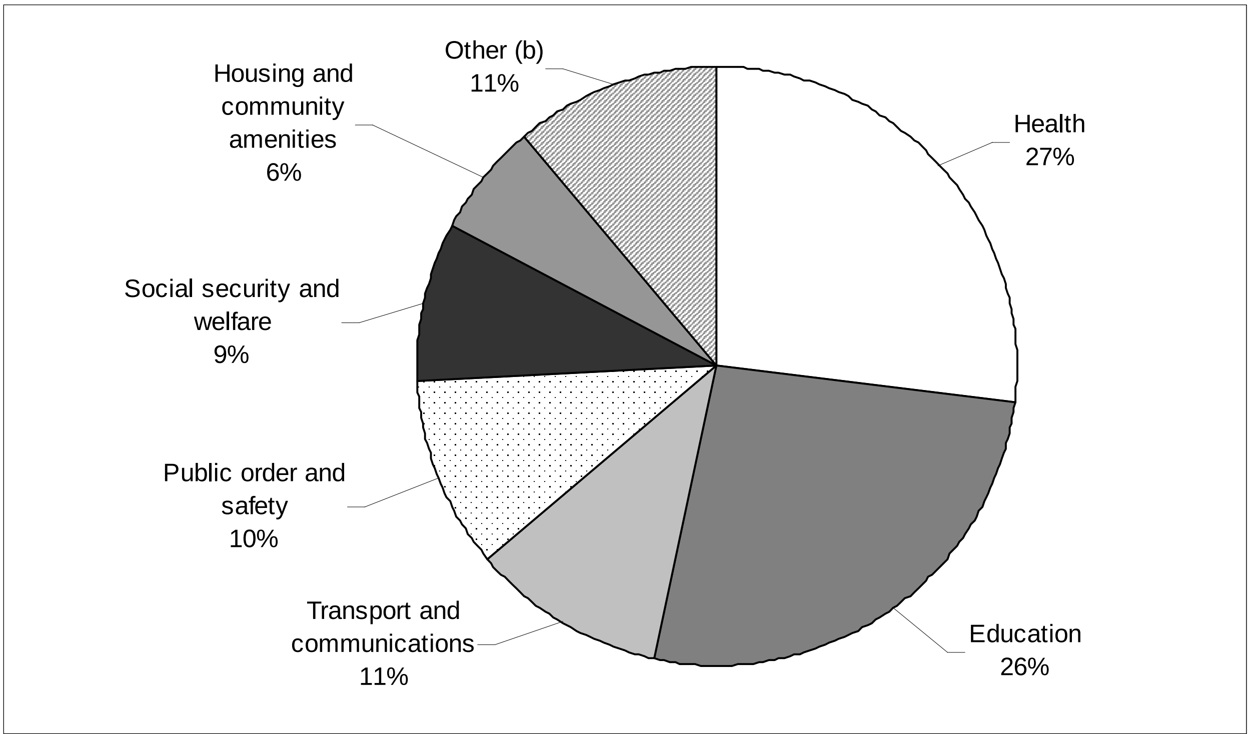
Detailed information on these initiatives can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives* and Budget Paper No. 4, Chapter 3, *State Revenue*.

SERVICE DELIVERY

The 2007-08 Budget builds on previous budgets to improve service delivery and to realise the Government's long-term vision set out in *Growing Victoria Together*.

Chart 3.3 provides an overview of the allocation of expenses in 2007-08, which is presented on a functional (rather than departmental) basis. The chart demonstrates the significant priority the Government places on delivering high quality health, education services, social security and welfare, with these categories accounting for more than 60 per cent of total expenses.

Chart 3.3: Expenses by function 2007-08[(a)]



Source: Department of Treasury and Finance

Notes:

(a) This chart is based on the Government Finance Statistics (GFS) expenses by function classification. With the introduction of the Australian equivalents to the International Financial Reporting Standards (A-IFRS), Victoria has adopted an operating statement format which is closely aligned to the GFS format, and the A-IFRS net result from transactions is equivalent to the GFS net operating balance.

(b) Other includes superannuation expenses and contingencies not allocated to departments.

The discussion below focuses on the contribution that Government decisions have made to the rate of growth in major categories of expenses, in order to pursue the Government's service delivery objectives.

Education

Education spending will represent 26 per cent of general government expenses in 2007-08 and is expected to rise by an average of 2.9 per cent each year over the forward estimates. This will continue the Government's commitment to the *Growing Victoria Together* objective of promoting high quality education and training for life long learning.

In the 2007-08 Budget, the Government will provide output funding of $349 million over five years for education initiatives. Funding has been provided to meet the Government's *Labor's Financial Statement* 2006 commitments, with initiatives including:

- $35 million for 300 Teacher Assistants;
- $80 million for 256 Primary Welfare Officers; and
- grants towards maths and science equipment ($11 million) and capital works in non-government schools ($30 million).

The Government has also provided funding for a range of other initiatives, including Excellence in Languages and continuing the Schools for Innovation and Excellence program. These output initiatives will ensure that Victoria continues to build on its high education standards.

The 2007-08 Budget invests $555 million TEI in our education facilities as part of the Government's record $1.9 billion TEI commitment for schools and TAFE announced in *Labor's Financial Statement* 2006. The 2007-08 Budget funding includes:

- $360 million TEI for the modernisation, regeneration and replacement of schools that will modernise 83 schools, replace four schools (including the next stage of the Monash Special Development School) as well as acquire land for new schools in Melbourne's growth areas;
- $50 million TEI for New Schools in Growth Areas; and
- $60 million TEI for the development of the *Ultranet*, an online teaching and learning system.

Health

Around one quarter of expenses are allocated to health spending, reflecting the high priority the Government places on ensuring that Victorians have access to high quality health services. Over the budget and forward estimates period, health expenses are projected to grow by an average of 3.5 per cent each year.

The 2007-08 Budget includes a number of significant initiatives that will help to meet the challenges of health including:

- $692 million over five years for hospital services to treat more patients sooner, ease pressure on emergency departments, meet growing demand in hospitals, expand suburban hospitals, and improve children's and women's health; and
- $22 million over four years and $18 million TEI for new and upgraded ambulance services across metropolitan Melbourne and rural Victoria.

This will be supported through additional investment of over $409 million TEI in hospital assets and infrastructure, including redevelopments at Frankston, Warrnambool, Western (Sunshine) and Western (Footscray) hospitals.

Transport and communications

While transport and communication-related expenses appear relatively small, accounting for 11 per cent of expenses in 2007-08, the majority of transport infrastructure projects are delivered as part of the Government's asset investment program and are accounted for in the balance sheet (rather than as operating expenses) in the State's accounts.

In the 2007-08 Budget, new operating funding of $194 million over five years has been approved for transport-related initiatives. This is additional to $946 million TEI. A significant proportion of this funding ($66 million operating funding and $501 million TEI) has been sourced directly from the *Meeting Our Transport Challenges* (MOTC) Asset Reserve. Key initiatives include:

- *A Fare Go* for Public Transport Users, abolishing Zone 3 on Melbourne's public transport and reducing V/Line fares by an average of 20 per cent;
- Metropolitan Train Services which address the overcrowding and reliability pressures on Melbourne's train network;
- the buyback of the regional rail network lease; and
- the Geelong Bypass Stage 4, providing an improved connection to the Princes Highway, by connecting the Geelong Ring Road to Anglesea Road.

Public order and safety

Around 10 per cent of expenses are allocated to public order and safety, in order to build safe communities consistent with the Government's *Growing Victoria Together* objectives. Expenses in this area will increase by 2.1 per cent each year from 2007-08 to 2010-11.

The 2007-08 Budget commits $318 million over five years and $167 million TEI to strengthen the Justice system. This provides funding for a number of initiatives including:

- expanding police numbers by an additional 350 police;
- supporting modern policing through an increased police vehicle fleet, state of the art equipment and replacements and upgrades to police stations;

- supporting police through 25 forensic officers and 25 crime specialists;
- fighting crimes of concern to the community, with a focus on family violence;
- reducing court delays through the addition of two new judges to each of the Supreme and County Courts, as well as more resources for the Office of Public Prosecutions;
- greater access to justice through increased resources to community legal centres and improved support for victims of crime; and
- making the State ready for any emergency by investing in equipment, training and facilities for all emergency services.

Social security and welfare

Social security and welfare will represent 9 per cent of total expenses in 2007-08. This includes spending of:

- $199 million over five years to improve support for people with a disability and their families, plus $15 million TEI for shared supported accommodation facilities;
- $166 million over four years to give children the best start in life and help working families by improving the accessibility and flexibility of child care, kindergarten and children's health services, plus $14 million TEI for placement and support facilities; and
- $103 million over four years to improve services for seniors, plus $62 million TEI for aged care facilities.

Housing and Community Amenities

Housing and Community Amenities will represent 6 per cent of total expenses in 2007-08. The 2007-08 Budget includes a number of significant initiatives directed towards housing including:

- $234 million over four years to extend the Government's $3 000 *First Home Bonus* until June 2009 and increase the bonus to $5 000 from 1 January 2007 for newly constructed homes;
- $200 million TEI over four years to provide an additional 800 public housing units across Victoria;
- $7.5 million over four years will be directed towards providing accommodation and day-to-day support for 16-19 year olds in housing crisis at four transitional accommodation sites to be built in Casey, Melton, Whittlesea and the Yarra Ranges; and
- $300 million in grants to housing Associations over four years to acquire an additional 350 properties for low income Victorians and improve the overall condition of accommodation through the replacement of 1 200 run down public housing units.

In addition, the Government will provide funding to protect the environment and our water resources for future generations through:

- $96 million over four years and $50 million TEI to protect our water resources (including irrigation channel improvements at Shepparton, water recycling projects and assistance to households and industry to reduce their water usage); and
- $45 million over four years and $5 million TEI to tackle climate change. These initiatives supplement the *Environmental Sustainability Action Statement* announced in July 2006, which included 150 initiatives worth more than $200 million, to help Victorian families, communities, business and Government respond to the environmental challenges of climate change, sustainable consumption (particularly in the reduction of water and energy consumption) and waste minimisation.

Other

Other expenses account for 11 per cent of total expenses in 2007-08. This includes:

- funding of $66 million over four years and $58.8 million TEI to enhance national parks and protect biodiversity;
- funding of $60 million is provided for both short-term and long-term measures to assist Victorian communities, businesses and the environment to recover from the impact of bushfires in Gippsland and North East Victoria. Initiatives include measures to support businesses and tourism operators. restoration of public visitor areas and roads, cultural values management and assessment, fire severity mapping, management of weeds, pests and threatened species on public land, assessment of timber supplies and bridges, rehabilitation of forest destroyed by fire, timber salvage and a range of catchment management services. Funding of $12 million TEI is provided for the replacement of bridges and fences in parks and forests and restoration of visitor facilities in affected parks to assist Victorian communities to recover from the impact of bushfires in Gippsland and North East Victoria;
- contributing $44 million over four years to the arts and cultural sectors to support growth and development as well as contributing $19 million TEI to the creation of Australia’s first centre for books and ideas, a new museum at Australian Centre for the Moving Image and planning and design of the Arts Centre Precinct. The Government will also contribute to the sport and recreation sector through an additional $57 million TEI for the rectangular sports stadium, $102 million over four years to build new sports infrastructure and support the sport and recreation organisations through a range of grants; and
- funding of $38 million over four years to improve Victorian companies’ export performance and attract investment, $54 million over four years to support tourism related initiatives, and initiatives totalling $18 million over four years to establish programs to support regional infrastructure development in targeted priority activities such as improving primary producers energy use through the *On Farm Energy Grants*.

New output and asset initiatives by Department

The 2007-08 Budget is the first stage of implementation of *Labor's Financial Statement 2006*. It includes the biggest school rebuilding program in Victoria's history and addressing increased demand for health services and prevention.

As shown in Table 3.3, in order to deliver the Government's policy objectives, the 2007-08 Budget provides net new funding to departments for output initiatives of $447 million in 2007-08, and an average of $242 million each year from 2008-09 to 2010-11. This is in addition to net funding provided in the *2006-07 Budget Update* of $173 million on average from 2007-08 to 2009-10.

Table 3.3: 2007-08 Budget new output initiatives funding by department[(a)]

($ million)

	2007-08 Budget	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
Education	81.8	90.9	80.2	74.3
Human Services	269.3	306.8	320.4	337.5
Infrastructure	68.0	36.0	40.2	47.4
Innovation, Industry and Regional Development	73.2	44.6	37.1	19.4
Justice	67.1	71.3	81.9	86.7
Premier and Cabinet	8.3	13.7	11.4	11.6
Primary Industries	32.4	13.1	11.7	11.5
Sustainability and Environment	44.3	45.5	33.9	29.7
Treasury and Finance	24.9	7.9	5.6	4.6
Victorian Communities	64.2	67.0	58.6	54.7
Parliament	7.0	6.3	5.7	5.8
Government wide	81.8	76.5	57.7	55.7
Total 2007-08 Budget output funding	**822.3**	**779.5**	**744.5**	**739.0**
Less funding from demand contingency and other efficiencies	375.6	415.8	541.4	580.2
Net impact of 2007-08 Budget output funding	**446.8**	**363.7**	**203.1**	**158.8**
Add: *2006-07 Budget Update* net output funding [(b)]	190.6	147.5	181.9	n.a
Net budget impact of output funding since 2006-07 Budget	**637.4**	**511.2**	**385.0**	**158.8**

Source: Department of Treasury and Finance

Notes:

(a) *These numbers 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) *2006-07 Budget Update net output funding is net of funding from demand contingency and other efficiencies.*

The 2007-08 Budget also provides funding for new asset investment projects with a total estimated investment (TEI) of $2.9 billion. This is in addition to $397 million provided for infrastructure investment in the *2006-07 Budget Update*. Over the four years to 2010-11, infrastructure investment is projected to average $3.3 billion each year. This will result in the average stock of public infrastructure for each Victorian growing from $11 059 in 2002 to $11 946 by 2011.

Total infrastructure investment as funded in the *2006-07 Budget Update* and 2007-08 Budget includes $1.5 billion TEI to deliver the Government's *Labor's Financial Statement 2006* election commitments, which are listed in Budget Paper No. 3, Chapter 4, *Election Commitments: Implementation Report Card*.

Table 3.4: 2007-08 Budget new asset funding by department

($ million)

	2007-08 Budget	*TEI [(a)]*
Education	218.6	505.1
Human Services	198.3	783.4
Infrastructure	180.0	918.9
Innovation, Industry and Regional Development	9.5	92.2
Justice	29.9	167.7
Premier and Cabinet	16.9	18.9
Primary Industries	11.0	181.5
Sustainability and Environment	20.7	91.7
Treasury and Finance	4.0	7.8
Victorian Communities [(b)]	-19.3	60.2
Parliament	0.9	0.9
Government wide	17.2	45.4
Total 2007-08 Budget asset funding	**687.6**	**2873.8**
Add: *2006-07 Budget Update* asset funding	119.5	396.5
Asset funding since the 2006-07 Budget	**807.1**	**3270.3**

Source: Department of Treasury and Finance

Notes:
(a) Total estimated investment. Includes projects which are to be delivered through the public non-financial corporations sector on behalf of the Government.
(b) 2007-08 is impacted by a recashflow of Rectangular Sports Stadium initiative - see Budget Paper No 3, Appendix A for details.

Further information on specific departmental policy initiatives is contained in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

USE OF CASH RESOURCES

The Government's capital program makes a significant contribution to the provision of services to the people of Victoria. The capital program is funded through the cash generated by operating activities and using the strength of the Government balance sheet.

Table 3.5 provides a summary of the cash generated through the operations of Victorian Government departments and other general government sector agencies and the use of cash to fund infrastructure investment.

Of the Government's average net infrastructure investment program of $3.3 billion over the four years to 2010-11, around 60 per cent will be funded by the cash surplus from operating activities. The remainder of the infrastructure program will be funded by a moderate increase in net debt.

Projected infrastructure spending from 2008-09 includes an unallocated capital provision that will be allocated to specific projects in future budgets. This allocation is in accordance with previous budget practice.

The Government has also allocated $10.5 billion to the *Meeting Our Transport Challenges* Statement, released in May 2006, to fund a range of transport infrastructure projects over ten years.

Over the budget and forward estimates period, general government net debt is projected to rise by $1.5 billion a year on average. As a percentage of gross state product, net debt will remain low at 2.9 per cent as at June 2011 and compared with 3.1 per cent in 1999.

Further information on the asset program, and the Government's balance sheet, is contained in Chapter 4, *Balance Sheet Management and Outlook.*

Table 3.5: Application of cash resources

($ million)

	2006-07 Revised	*2007-08 Budget*	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
Net result from transactions	**621.9**	**324.3**	**434.2**	**389.9**	**446.8**
Add back: Non-cash income and expenses (net) [(a)]	2 003.4	1 757.1	1 354.7	1 419.7	1 597.4
Net cash flow from operating activities	**2 625.3**	**2 081.4**	**1 789.0**	**1 809.6**	**2 044.2**
Less:					
Net investment in fixed assets					
Expenditure on approved projects	3 580.3	3 816.5	3 681.7	2 365.2	1 590.9
Unallocated provision for future allocation	0.0	..	263.0	532.3	815.9
Meeting Our Transport Challenges Reserve to be allocated in future [(b)]	..	7.5	56.5	212.9	460.9
Proceeds from asset sales	(163.5)	(202.3)	(117.8)	(117.8)	(115.4)
Total net investment in fixed assets	**3 416.8**	**3 621.7**	**3 883.5**	**2 992.5**	**2 752.3**
Finance leases	386.9	..	231.4	..	..
Other investment activities (net)	3.6	(2.8)	18.4	18.7	16.2
Decrease/(increase) in net debt	**(1 181.9)**	**(1 537.6)**	**(2 344.4)**	**(1 201.7)**	**(724.3)**

Source: Department of Treasury and Finance

Notes:

(a) Includes depreciation and non-cash movements in liabilities such as unfunded superannuation and employee benefits.

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

CHAPTER 4 – BALANCE SHEET MANAGEMENT AND OUTLOOK

- The general government sector will invest in excess of $13 billion over the next four years in the key areas of hospitals, transport, education and justice.
- Around 60 per cent of this capital expenditure program will be financed by cash operating surpluses. The remainder will be financed by borrowings utilising the Government's strong balance sheet position.
- Infrastructure investment by the public non-financial corporations is projected to be $2.5 billion in 2007-08 and $8.9 billion over the budget period. This will be predominantly funded from operating surpluses as well as debt and general government contributions.
- The net financial liabilities of the State will remain at low levels by historical and international standards and remain consistent with the prudent financial management that maintains the State's triple-A credit rating.
- The ratio of general government net financial liabilities to GSP is expected to increase modestly from 6.1 per cent in 2007 to 6.9 per cent in 2011. This remains well below the 10.6 per cent recorded in 1999, despite the impact of A-IFRS, which resulted in an increase in net financial liabilities to GSP of 2.2 percentage points in June 2005.
- The proportion of general government income directed towards servicing net financial liabilities, and therefore not available for service provision, is expected to remain below 7 per cent in the forward estimates.
- Net debt will continue to remain at low levels, increasing from $3.0 billion or 1.2 per cent of GSP at 30 June 2007 to $8.8 billion or 2.9 per cent of GSP at June 2011. This is below the ratio of 3.1 per cent of GSP in 1999 and well below the peak of 15.9 per cent in 1995.

GENERAL GOVERNMENT BALANCE SHEET

The State's balance sheet records the assets employed by the State offset by liabilities incurred by the State. The net asset position is an important indicator of the State's financial strength. A strong net asset position provides the capacity and the flexibility to absorb financial and economic shocks.

At 30 June 2006 the State had assets of $64.4 billion offset by liabilities of $26.9 billion leaving a net asset position of $37.5 billion. Net assets are projected to grow strongly to $55.5 billion by 30 June 2011, as rapid growth in assets outstrips more modest growth in liabilities.

It is the growth in physical assets – increasing by $24 billion from 30 June 2006 to 30 June 2011 – that is the main driver of the growth in net assets. The value of physical assets reflects both the construction of new infrastructure, as well as the revaluation of existing infrastructure. The growth in physical assets is partially offset by a projected growth in liabilities from 30 June 2006 to 30 June 2011 of $5.2 billion, reflecting the use of some borrowings to fund the infrastructure program over and above the use of cash surpluses from operations in each budget.

The other balance sheet items relate mainly to receivables and inventories on the asset side and payables and provisions on the liability side. These items are projected to grow slightly over the period to 30 June 2011. This is shown in Table 4.1.

Table 4.1: General government sector statement of financial position and key ratios as at 30 June

	1999 Actual AAS	*2006 Actual A-IFRS*	*2007 Revised A-IFRS*	*2008 Budget A-IFRS*	*2009 Estimate A-IFRS*	*2010 Estimate A-IFRS*	*2011 Estimate A-IFRS*
FINANCIAL POSITION				*($ billion)*			
Assets							
Physical assets [(a)]	32.2	56.1	60.0	63.8	68.6	76.3	80.1
Financial assets [(b)]	2.0	5.5	4.0	4.1	4.1	4.2	4.2
Other assets [(c)]	1.6	2.8	2.7	2.7	2.9	3.1	3.2
Total assets	**35.7**	**64.4**	**66.7**	**70.6**	**75.6**	**83.6**	**87.6**
Liabilities							
Superannuation	11.4	12.9	11.9	12.0	12.0	11.9	11.7
Borrowings	7.1	6.2	5.9	7.5	9.9	11.1	11.9
Other liabilities	3.6	7.8	7.8	8.0	8.2	8.4	8.5
Total liabilities	**22.2**	**26.9**	**25.6**	**27.5**	**30.1**	**31.3**	**32.1**
Net assets	**13.5**	**37.5**	**41.1**	**43.1**	**45.5**	**52.2**	**55.5**
KEY FINANCIAL RATIOS				*(per cent)*			
Growth in non-current physical assets	4.2	6.9	6.9	6.4	7.4	11.2	5.0
Growth in total assets	5.7	7.4	3.6	5.8	7.1	10.5	4.8
Total assets to GSP	23.3	27.6	27.2	27.4	27.9	29.5	29.5
Total liabilities to GSP	14.7	11.5	10.4	10.7	11.1	11.1	10.8
Net assets to GSP	8.8	16.1	16.8	16.7	16.8	18.4	18.7
Superannuation expenses and financing costs to total revenue [(d)]	9.7	7.5	6.5	6.2	6.3	6.6	6.6

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.

(c) Other assets include receivables, prepayments and inventories.

The remainder of this chapter examines firstly the general government balance sheet in detail, before reviewing the capital program of the public non-financial corporations and net financial liabilities of the non-financial public sector.

Capital stock

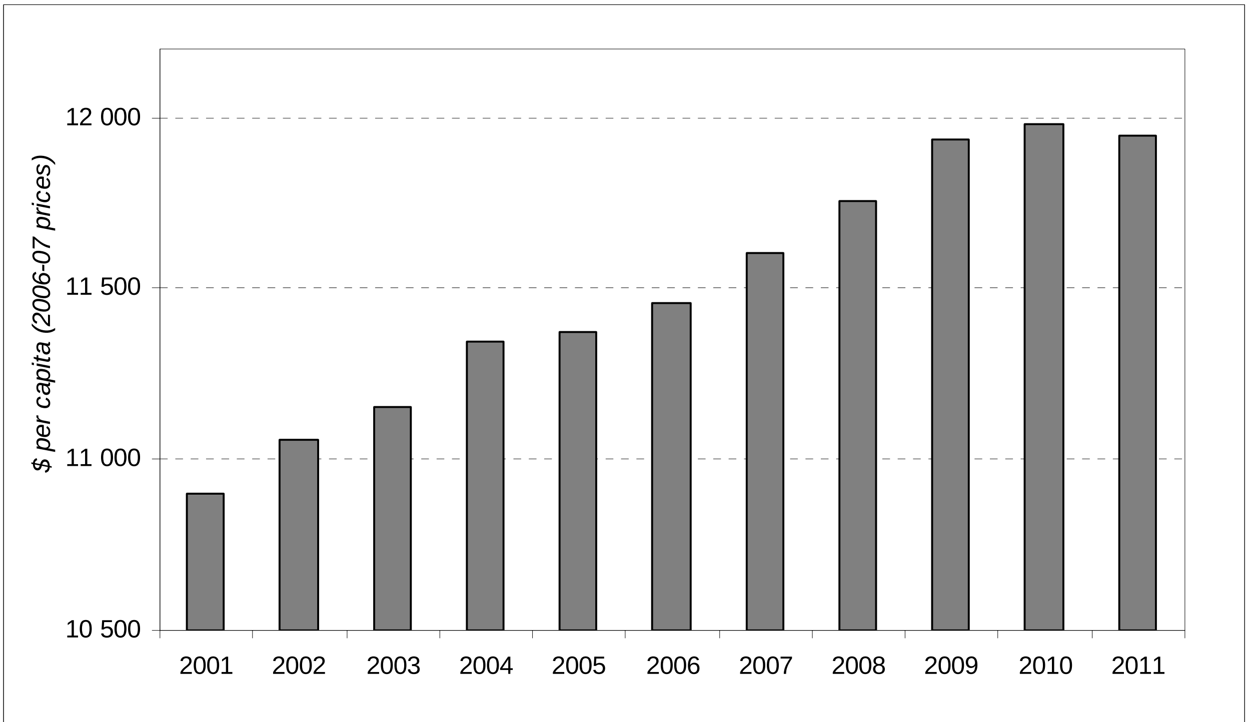
The largest category of assets for the general government sector is physical assets or the capital stock which is estimated to be $60 billion at 30 June 2007 and projected to grow to $80 billion by 20 June 2011.

The Government is committed to delivering world-class infrastructure to provide social, economic and environmental benefits across the State. Strategic investment in physical infrastructure directly supports State economic activity.

Past investment in infrastructure is reflected in the balance of the State's physical assets, or the capital stock. Continued investment in the capital stock is required to provide the infrastructure to enable enhanced government services to be delivered to the community and to provide important economic infrastructure for private sector growth.

Taking into account past and 2007-08 Budget decisions, infrastructure investment is expected to average $3.3 billion a year over the four years to 2010-11, exceeding depreciation by an average of $1.7 billion each year. Estimated growth in the real capital stock over the budget and forward estimates is 7.9 per cent – significantly more than population growth. This is reflected in strong growth in real capital stock per capita which is shown in Chart 4.1.

Chart 4.1: General government real capital stock per capita as at 30 June [(a)]



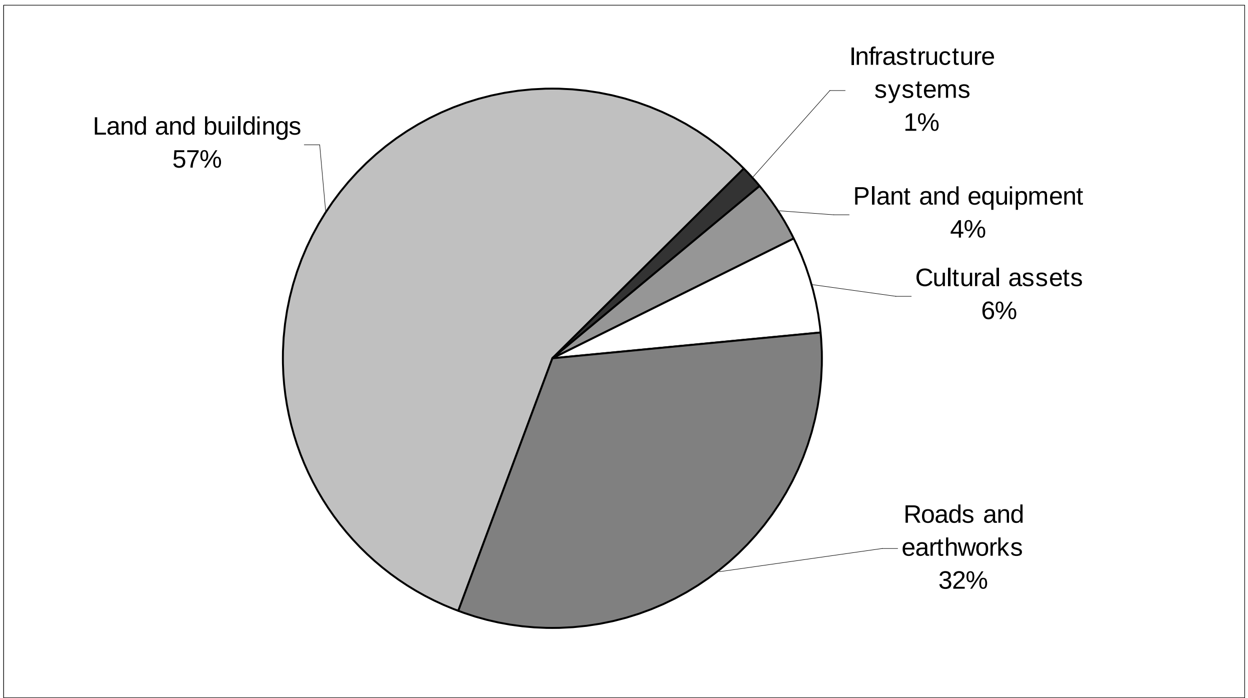
Source: Department of Treasury and Finance

Note:

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

Chart 4.2 shows the main component of the general government's $60 billion capital stock as at 30 June 2007. These are land and buildings (57 per cent of the total capital stock), roads and earthworks (32 per cent), cultural assets (6 per cent), plant and equipment (4 per cent) and infrastructure systems (1 per cent).

Chart 4.2: General government capital stock as at 30 June 2007



Source: Department of Treasury and Finance

2007-08 capital expenditure initiatives

Capital expenditure projects can be delivered in a number of different ways and the choice of delivery method will have implications for how it is presented in the State budget and balance sheet.

Traditionally, new infrastructure for the general government sector was funded through the Budget and owned directly by government. This is still true for the bulk of the Government's capital works program, much of which is provided to assist in the provision of publicly funded services (e.g. schools and public hospitals).

Capital expenditure by public non-financial corporations can be funded directly from their balance sheet through either borrowings, retained earnings or may be assisted by transfers from the general government sector.

Funding arrangements involving the private sector have increasingly been utilised by the State to fund infrastructure through arrangements known as public private partnerships (PPPs). This Government introduced its own PPP framework, *Partnerships Victoria* in 2000, to guide the development of PPPs in this state. *Partnerships Victoria* arrangements are 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 in a single project package. To date, 16 projects with a capital investment of over $4.5 billion have been contracted with private parties. Eleven of these projects are now operational.

Budget-Funded Projects

The 2007-08 Budget includes new asset projects with a TEI of $2.9 billion. The asset initiatives cover a range of areas including education, health and community services, community safety, the environment, and economic infrastructure such as road, rail and public transport linkages consistent with Labor's Financial Statement. Specific initiatives include:

- $555 million TEI to enhance and maintain Victoria's education system. This includes $360 million TEI for the modernisation, regeneration and replacement of schools as part of a 10-year plan to either rebuild or renew every Victorian school. Other initiatives include the construction of new schools in growth areas, a new specialist sports school as part of the redevelopment of Maribyrnong Secondary College and the development of a statewide online teaching and learning information system called Ultranet;
- $349 million TEI will upgrade and replace health, aged care facilities and community services facilities across Victoria, including the next stage of the Frankston Hospital Redevelopment, redevelopment works at the Western Hospital in Footscray and Sunshine, and expansion of the Northern Hospital;
- $234 million TEI for medical equipment including MRI machines and infrastructure works across Victoria;
- $200 million TEI over the next four years to fund the purchase for construction of 800 public housing units;
- $236 million TEI allocated to upgrade arterial roads, extend the Geelong Ring Road, and improve traffic flows and congestion; and
- $709m TEI to improve Victoria's rail network, including 10 new metropolitan trains, upgraded rail stations and associated infrastructure works.

Partnerships Victoria Projects

Three projects with a combined value of over $1 billion are currently under procurement or being prepared for procurement:

- The new Royal Children's Hospital –The private sector proponent will be contracted to design, construct, finance and maintain the facility over the contract period. Core clinical services shall be retained by the State (Royal Children's Hospital). Responses from the three shortlisted consortia to the state's project brief were received in March 2007 and are currently being evaluated. Operational commencement is expected to occur in 2011.
- The Melbourne Wholesale Fruit and Vegetable Market – The market is to be relocated to a new site in Cooper Street, Epping. The project will involve the design, construction, finance and maintenance of the new market by the private sector. The Melbourne Markets Authority will remain responsible for the management of the new market. The project is being prepared for procurement.

- The Barwon Water Biosolids Management Project – The successful private sector proponent will be contracted to design, construct, finance, operate and maintain a biosolids facility, located at Barwon Water's Black Rock site, over the contract period. Bids have been received and the contract is expected to be concluded in 2007.

Financial and other assets

The general government 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 $4 billion, as shown in Table 4.1.

Liabilities

General government liabilities are expected to be $25.6 billion at June 2007 and are projected to remain at prudent levels, rising to $32.1 billion by 30 June 2011. The major categories of liability are unfunded superannuation liabilities, gross debt and employee benefits.

Unfunded 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 that has arisen based on service to date. The unfunded superannuation liability is projected to fall by $1.0 billion in 2006-07 to $11.9 billion, largely due to strong investment returns on scheme assets. By 30 June 2008, the liability is projected to rise by $100 million to $12.0 billion. This slight increase is due to the fact that the level of scheme assets is significantly lower than the value of accrued liabilities and so does not generate a sufficient return to offset the growth in accrued liabilities.

It is important to note that changes in the Commonwealth government bond rate that underpins the discount rate used to value superannuation liabilities can also have a significant impact on the value of superannuation liabilities. However, these changes are driven by reporting requirements and do not effect the contributions actually required to finance superannuation liabilities.

State Superannuation Fund

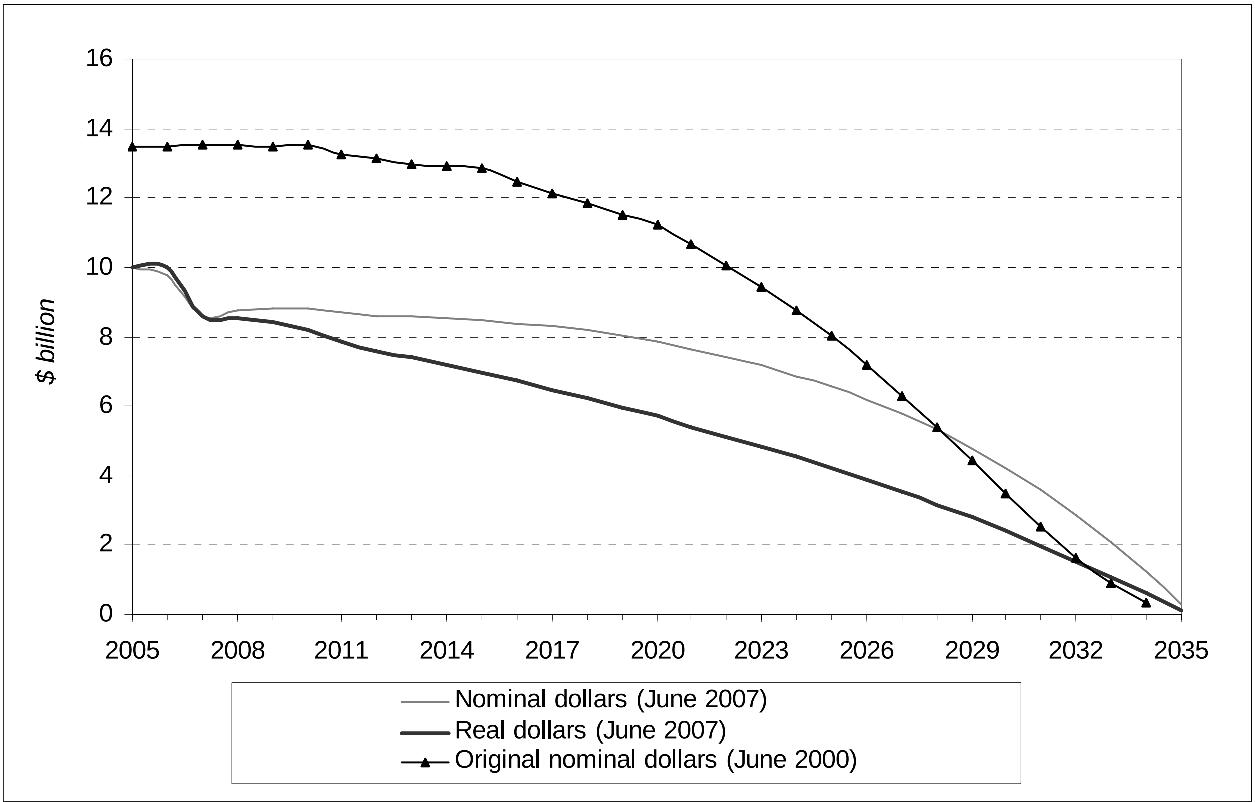
The State's unfunded superannuation liability primarily relates to the State Superannuation Fund (SSF) which is now part of the Emergency Services Superannuation Scheme (ESSS) following a merger of these schemes on 1 December 2005. While the former ESSS (excluding the SSF) is open to new members, the SSF has been closed to new members since 1993 and so its membership is both ageing and decreasing over time.

The State's unfunded superannuation liability in respect of the SSF largely accrued prior to 1995 when previous governments funded the SSF on a 'pay as you go' basis. In 2000, the Government adopted a framework aimed at fully funding these liabilities by 2035. The payments required under this framework are reviewed annually based on the advice of the scheme's actuary.

The 2035 full-funding date has been chosen to ensure that the cost of funding the liability is spread over a reasonable period and does not fall entirely on the current generation of taxpayers. While the A-IFRS accounting standards require the value of superannuation liabilities to be determined based on a Commonwealth government bond rate, funding requirements are determined based on the expected long-term earning rate of the scheme's assets. The expected long-term earning rate is considered appropriate for funding purposes as it provides a more realistic estimate of the likely return on the scheme's investments. This enables a more meaningful estimate to be made of the amount that the Government actually needs to contribute to the fund.

Chart 4.3 shows the expected profile of the unfunded liability of the SSF until 2035. The liability has been determined using the 'funding basis' (i.e. the scheme's assumed long-term earning rate is used as the discount rate). Therefore, these figures are lower than those shown in Table 4.1 which are prepared based on A-IFRS accounting standards.

Chart 4.3: 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 the superannuation liability by 2035. The chart above shows funding by this date but the actual progress of this may change depending on a range of factors including investment market conditions.

The Government has made payments to the SSF at higher levels than planned in the budget estimates. For example, between 2000-01 and 2005-06, the State made payments of $5 425 million to the SSF compared with an amount of $3 902 million that was expected to be paid under the original full-funding framework. Budgeted payments over the forward estimates period total $1 897 million. Based on current projections, the State expects to achieve full funding of the unfunded superannuation liability in the SSF by the target date of 2035.

The SSF's unfunded superannuation liability, as calculated on a 'funding basis', is expected to be $8.6 billion at 30 June 2007 and is now projected to peak, in nominal terms, at $8.8 billion in 2009, before declining steadily thereafter. The slight rise in the short-term is due to members' benefits accruing slightly more rapidly than the level of SSF's assets. The unfunded liability then declines as government contributions and investment earnings outweigh growth in the accrued liability. In real terms, the liability is expected to peak in 2007.

Managing the unfunded superannuation liability

The Government continuously monitors and reviews policy initiatives to ensure that the State's superannuation liabilities are managed efficiently. In particular, the Government conducted a detailed review of the Commonwealth's May 2006 Budget to assess the impact that legislative amendments may have on the State's superannuation liabilities. This review indicated that the Commonwealth's changes were not expected to have any adverse impact on the State's superannuation liabilities.

In particular, changes to the provisions governing the use of certain tax credits held by the State's superannuation schemes were announced as part of the Commonwealth Budget. Following consultation with the Commonwealth regarding the details of the changes, analysis indicates that they will not have an adverse financial impact on the State's superannuation schemes.

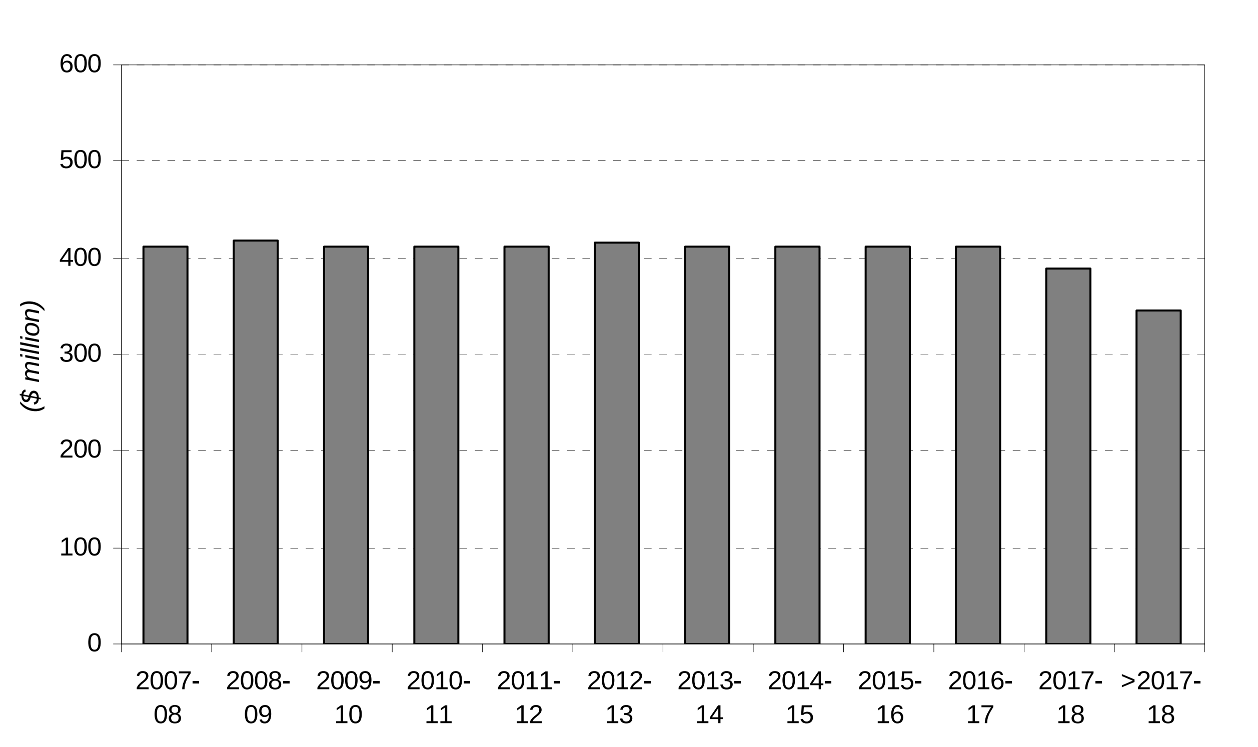
Borrowings

General government gross debt is expected to rise from $5.9 billion at June 2007 to $11.9 billion at June 2011 to assist in funding the $13 billion infrastructure program. Around 60 per cent of the infrastructure program will be funded by cash operating surpluses. The balance is funded, firstly by running down surplus financial assets, and then through increasing borrowings.

Management of the general government 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 of the general government sector treasury operations in a prudent manner.

The debt portfolio primarily comprises a fixed rate borrowing facility from the Treasury Corporation of Victoria, with an evenly spread maturity profile (see Chart 4.4). This ensures that a relatively small proportion of the debt portfolio is subject to repricing and uncertainty in any one period.

Chart 4.4: Maturity profile of the core debt borrowings of the general government sector as at 31 March 2007



Source: Department of Treasury and Finance

Employee liabilities

Employee liabilities represent the third largest liability after the unfunded superannuation liability and gross debt, and are projected to increase from $3.6 billion as at June 2007 to $4.1 billion by June 2011, an average growth rate of 3.6 per cent a year.

Employee liabilities are made up of accrued salaries and provision for annual leave and long service leave. The provision for long service leave is the present value of expected future payments to be made in respect of entitlements accrued by employees up to the reporting date. Wage growth (partially offset by staff turnover) is a key factor affecting the increase in long service leave liabilities over the forward estimates period.

Analysis of key financial indicators

In examining the liabilities of governments, ratings agencies focus on net financial liabilities. This consists of the unfunded superannuation liability and net debt, which represent the net obligations of the Government to investors and former employees respectively.

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.

Details of the key financial indicators are shown in Table 4.2.

Table 4.2: Net debt and net financial liabilities as at 30 June[(a)]

	1999 Actual	2006 Actual	2007 Revised	2008 Budget	2009 Estimate	2010 Estimate	2011 Estimate
General government							
Financial assets				*($ billion)*			
Cash and deposits	0.7	2.7	1.5	1.5	1.5	1.5	1.5
Advances paid	..	0.1	0.1	0.1	0.1	0.1	0.1
Investments, loans and placements	1.8	2.2	1.9	1.9	2.0	2.0	2.1
Total	**2.5**	**4.9**	**3.5**	**3.5**	**3.6**	**3.6**	**3.7**
Financial liabilities							
Deposits held	0.1	0.5	0.5	0.5	0.5	0.5	0.5
Advances received	..	..	..	..	..	..	..
Borrowings	7.1	6.2	5.9	7.5	9.9	11.1	11.9
Total	**7.3**	**6.7**	**6.4**	**8.0**	**10.4**	**11.6**	**12.4**
General government net debt	**4.8**	**1.8**	**3.0**	**4.5**	**6.8**	**8.0**	**8.8**
Public non-financial corporations net debt	1.3	3.0	3.4	4.3	5.0	5.9	6.5
Total non-financial public sector net debt	6.1	4.8	6.4	8.8	11.8	13.9	15.3
General government unfunded superannuation	11.4	12.9	11.9	12.0	12.0	11.9	11.7
General government net financial liabilities	16.2	14.7	14.9	16.5	18.8	19.9	20.4
Non-financial public sector net financial liabilities	17.5	16.7	18.3	20.7	23.8	25.9	27.2
Ratios to GSP				*(per cent)*			
General government net debt to GSP	3.1	0.8	1.2	1.7	2.5	2.8	2.9
General government net financial liabilities to GSP	10.6	6.3	6.1	6.4	6.9	7.0	6.9
Non-financial public sector net debt to GSP	4.0	2.0	2.6	3.4	4.4	4.9	5.1
Non-financial public sector net financial liabilities to GSP	11.4	7.2	7.5	8.1	8.8	9.1	9.2

Source: Department of Treasury and Finance

Note:

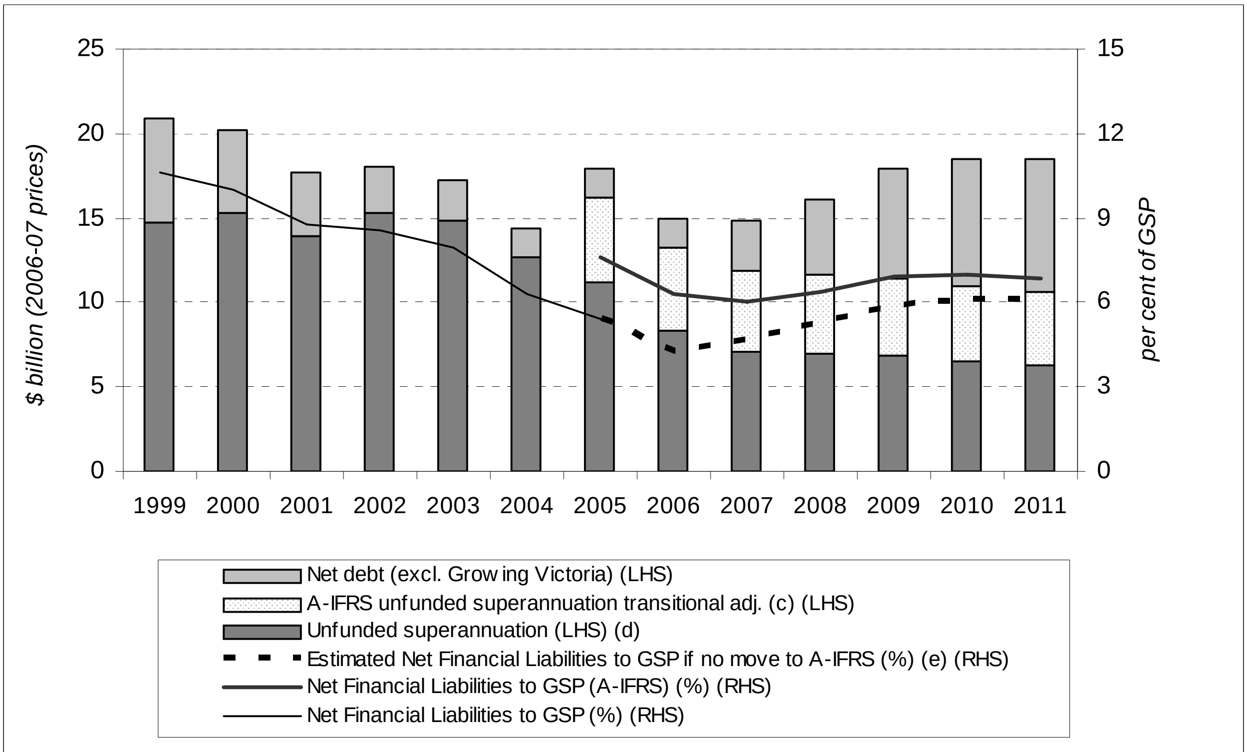
(a) Non-financial public sector net debt is the sum of general government net debt plus public non-financial corporations net debt, less inter-sector transactions. The data is based on Government Finance Statistics.

General government net financial liabilities and net debt

Table 4.2 shows that net financial liabilities of the general government sector are projected to increase from $14.9 billion at 30 June 2007 to $20.4 billion at 30 June 2011. As a proportion of GSP, net financial liabilities are projected to increase from 6.1 per cent to 6.9 per cent over the same period.

Since 1999, the Government has reduced net financial liabilities as a percentage of GSP by 4.6 percentage points, equivalent to a reduction in the liability of more than $11 billion in real terms.

Chart 4.5: General government real net financial liabilities as at 30 June[(a)(b)]



Source: Department of Treasury and Finance

Notes:

(a) *General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.*

(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) *For comparative purposes only, the transitional adjustment applied to unfunded superannuation liabilities in 2004-05 has also been separately identified in the period 2005 to 2011.*

(d) *Unfunded superannuation liabilities between 1999 and 2004 are calculated under the old Australian accounting standards, whereas between 2005 and 2011 the relevant A-IFRS standard has been applied.*

(e) *The net financial liabilities to GSP (as calculated applying the old Australian accounting standard) between 2005 and 2011 are estimates, and should be used for illustrative purposes only.*

General government net debt will increase from $3.0 billion at June 2007 to $8.8 billion at June 2011. As previously mentioned, this growth is driven by the government's infrastructure investment program. Chart 4.5 shows that general government net debt in real terms is projected to increase from $3.0 billion to $7.9 billion over the same period. As a proportion of GSP, net debt will continue to remain at low levels, increasing from 1.2 per cent of GSP at 30 June 2007 to 2.9 per cent of GSP at June 2011. This remains below the level of 3.1 per cent at June 1999. Similarly, as a proportion of revenue, net debt is projected to be 23.4 per cent as at June 2011 which is comparable to 23.7 per cent at June 1999.

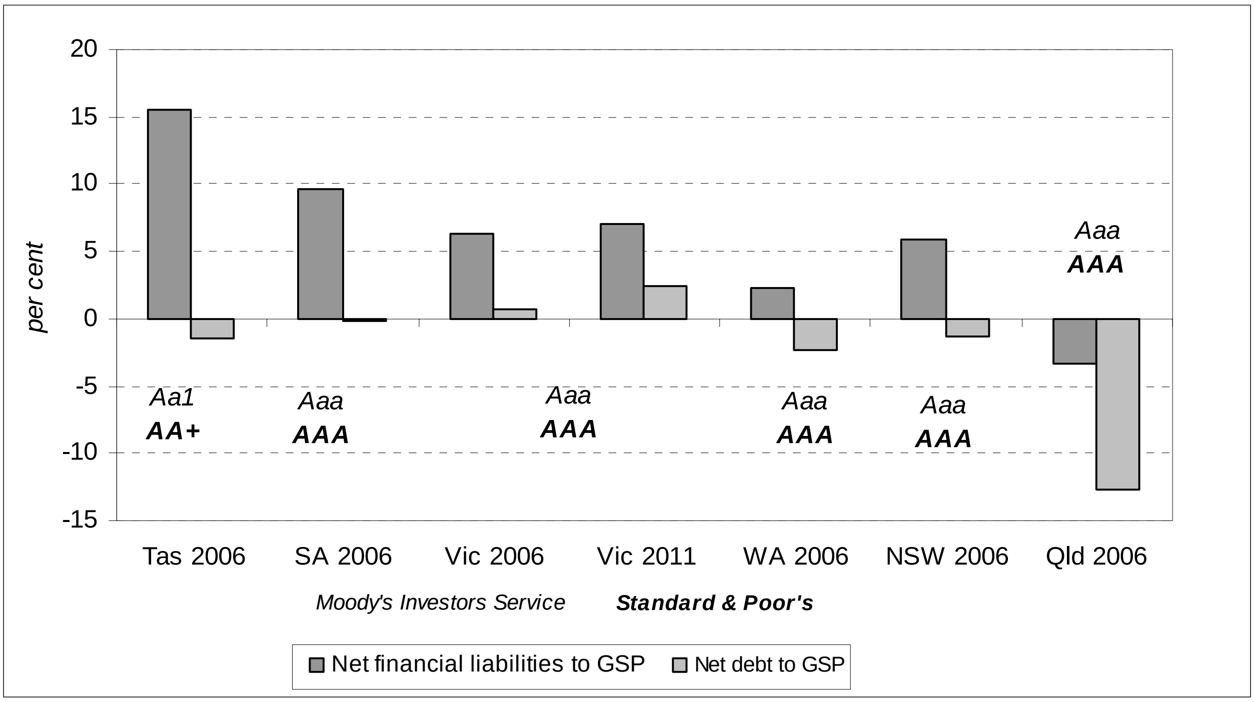
The proportion of general government income directed towards servicing net financial liabilities, and therefore not available for service provision, is expected to remain below 7 per cent in the forward estimates.

Compared to international standards, Victoria's level of net liabilities is low. Victoria is in a select group of regional and local governments that have a triple-A rating. Standard & Poor's noted in March 2006 that of the 190 regional governments outside the United States rated by Standard & Poor's, only 15 per cent have a triple-A rating.

Chart 4.6 shows that the ratio of Victoria's net financial liabilities to GSP (as reported by the Australian Bureau of Statistics) is in line with other non-resource rich triple-A rated states, such as New South Wales.

The chart shows that Queensland has negative net financial liabilities compared to the other States. This brings into sharp focus the shortcomings in the Commonwealth Grants Commission's assessment with Queensland, the financially strongest of the triple-A rated states, being a net recipient of GST grants, while NSW and Victoria are net subsidy providers. For further details, see Chapter 5, *Commonwealth-State Financial Relations*.

Chart 4.6: Comparison of general government net financial liabilities and net debt to GSP and Australian States' credit ratings



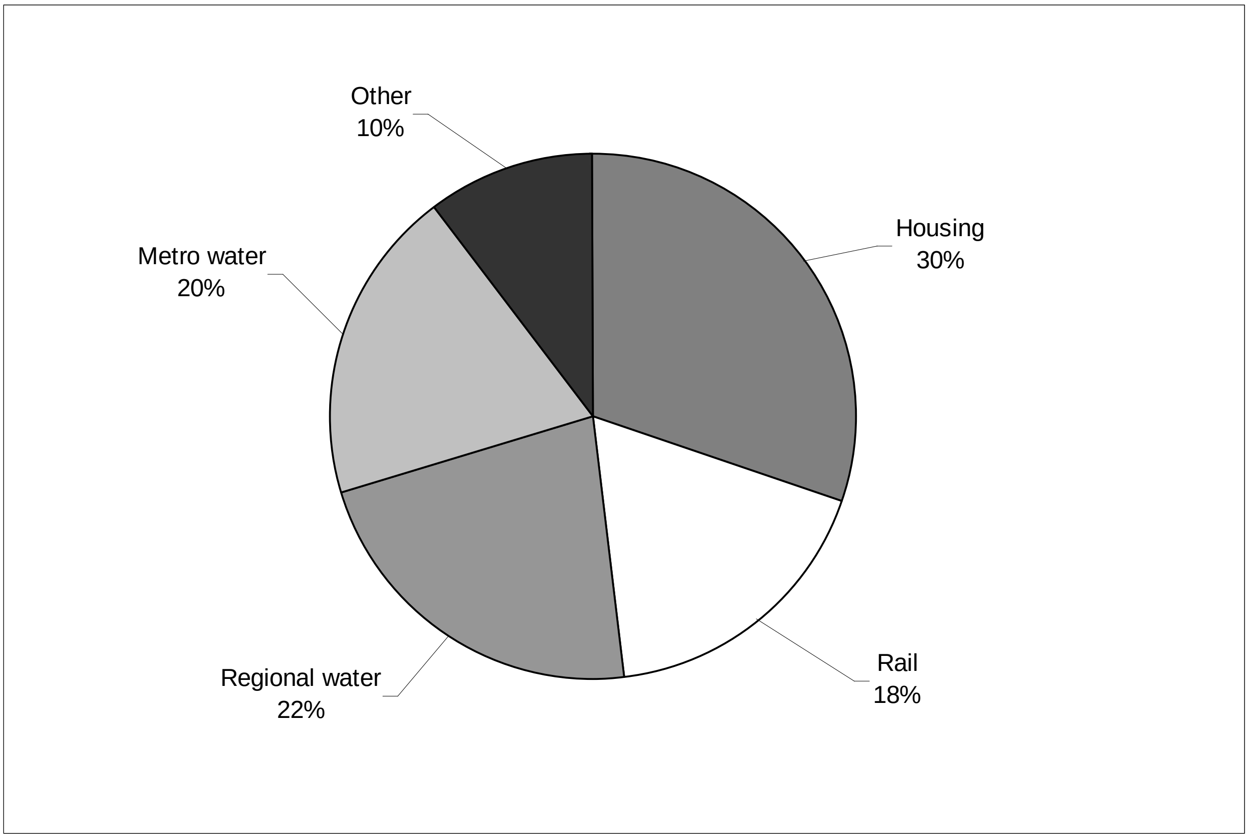
Source: Financial reports of Australian States.

PUBLIC NON-FINANCIAL CORPORATIONS

A significant component of the State's capital stock is held by the public non-financial corporations sector. Victorian public non-financial corporations operate in a range of sectors, including ports, metropolitan, regional and rural water, urban development, public housing, public transport, culture and recreation, and the primary industry sector (see Chart 4.7). The sector is projected to hold land and fixed assets of $40.7 billion at June 2007.

Since 2006-07, forward year GFS estimates of the public non-financial corporations sector have been included in the Budget papers.

Chart 4.7: Public non-financial corporations sector capital stock as at 30 June 2007



Source: Department of Treasury and Finance

While the sector is predominantly user funded, it also receives contributions from the general government sector where the Government sees broader public benefits above those accruing to the primary users of the sector's assets. Over the period 2007-08 to 2010-11, the general government sector will be making net contributions to other sectors of Government of $2.8 billion, primarily for capital purposes in the public non-financial corporations sector. In 2007-08, this includes:

- $330 million to Victorian Rail Track for the purchase of rail infrastructure assets, including station and track upgrades, passenger country rolling stock and mandatory capital improvements to the rail networks undertaken by the public transport operators on behalf of the Government;
- $100 million to the Public Transport Ticketing Authority for continued development, implementation and management of the new ticketing system for Victoria;
- $100 million to the Melbourne and Olympic Parks Trust for the construction of the new Rectangular Sports Stadium; and
- $40 million to Central Highlands Region Water Authority for construction of the Goldfields Superpipe. The pipeline will secure future sustainable water supplies for the major regional cities of Ballarat and Bendigo.

In addition, the public non-financial corporations sector can also finance asset investment through its own sources–through retained earnings and borrowings. In 2007-08, purchases of non-financial assets by the sector is projected to be $2.5 billion (GFS basis).

Regional water authorities are investing in a wide range of projects to increase and improve the delivery of sustainable water supplies and the use of recycled water throughout Victoria. Interconnecting water supply systems and diversifying away from rainfall-dependent sources of water will be particularly important in the context of the current drought and the longer-term pressures associated with climate change. The Goldfields Superpipe along with the Wimmera Mallee Pipeline Project, will assist in establishing a Victorian 'Water Grid' to enable water authorities to move water between regions as needed. The Gippsland Water Factory will provide recycled water, and assist in diversifying Victoria's sources of water supply.

In the metropolitan water sector, investment is driven by a variety of factors such as compliance with health and environmental policies, including reducing sewer spills in the transfer system, upgrading the sewage treatment capacity and recycling projects to diversify supply in response to the challenges of drought and climate change; examples include Northern Sewerage Project (Melbourne Water and Yarra Valley Water), Dandenong Treatment Plant (Melbourne Water) and Hallam Valley Main Sewer Extension Project (South East Water).

The key driver for investment spending in the transport sector is the implementation of *Meeting Our Transport Challenges* (released in May 2006). Major asset investments include new metropolitan trams and trains, regional rolling stock, station upgrades and rail capacity improvements. Additional investment in station upgrades, level crossings, pedestrian crossings and heritage assets is also being made. Continued development of Transit City initiatives include *Revitalising Central Dandenong* and *Footscray Transit City*.

Ongoing public housing improvements are a continued focus in the Housing portfolio, and investment to better match public housing stock to the needs of public housing tenants will continue.

NON-FINANCIAL PUBLIC SECTOR

The Government is committed to maintaining net debt and financial liabilities at prudent levels and maintaining the State's triple-A credit rating. The rating agencies focus on both net debt and net financial liabilities of the general government sector and the non-financial public sector as measures of overall indebtedness. By focusing on the non-financial public sector, the impact of the public non-financial corporations is included, enabling the agencies to assess the State's total call on the capital markets.

Moody's Investors Service and Standard & Poor's have both cited Victoria's low debt levels, high degree of financial flexibility, strong fiscal position and the Government's commitment to prudent financial management as the key drivers for Victoria's triple-A credit rating.

Net financial liabilities

The net financial liabilities of the non-financial public sector are projected to be $18.3 billion as at 30 June 2007 (7.5 per cent of GSP) and are forecast to increase to $27.2 billion (9.2 per cent of GSP) at 30 June 2011. This increase is attributable to increases in net debt in the general government and public non-financial corporations sectors.

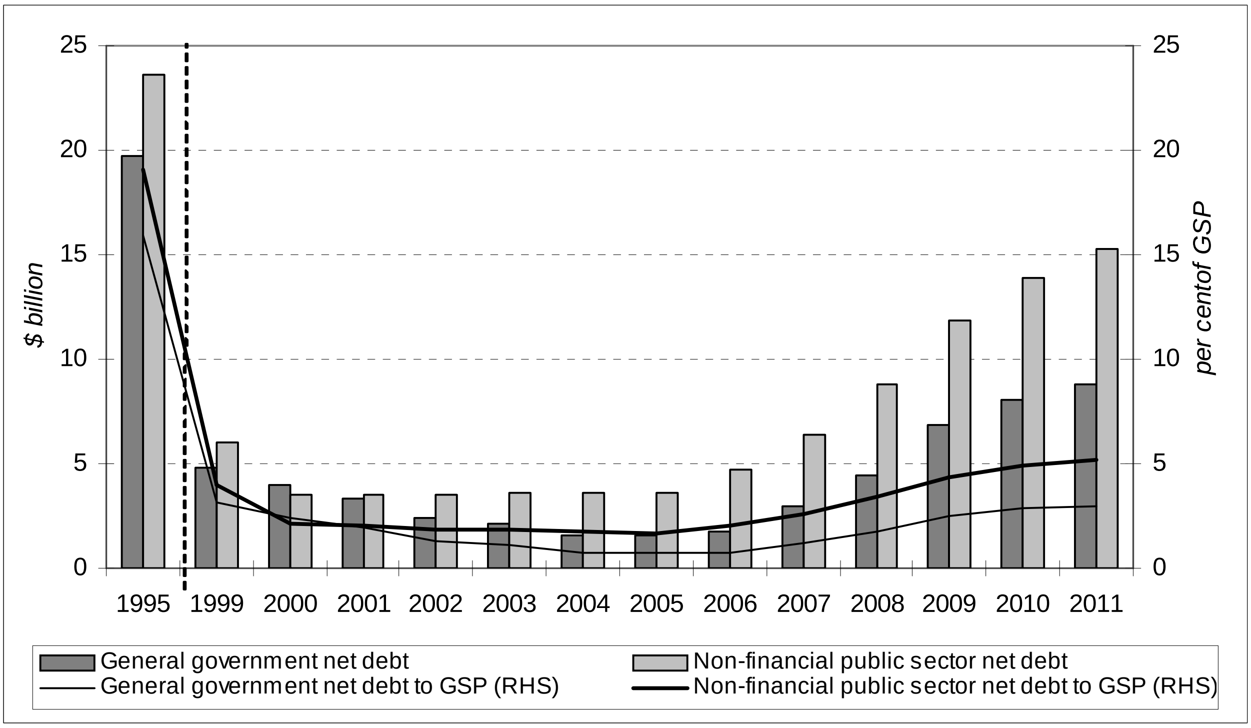
In the public non-financial corporation sector, superannuation is fully funded so the trend in the State's unfunded superannuation liability is driven by the general government sector which was discussed earlier.

Net debt

Non-financial public sector net debt comprises general government sector net debt and public non-financial corporations sector net debt. Table 4.2 shows that public non-financial corporations sector net debt is expected to increase from $3.4 billion in June 2007 to $6.5 billion in June 2011.

The increase in public non-financial corporations net debt is spread across a range of businesses, including $1.6 billion in the metropolitan water authorities, $900 million in the regional and rural water authorities, and $300 million in the Director of Housing. The increased debt of these authorities is mainly associated with their capital expenditure programs. In relation to metropolitan and regional water authorities, the Essential Services Commission will allow for the recovery of capital and debt servicing costs in their regulated water prices, providing a commercial return on the debt funded investment. As these projects generate long-term positive benefits to the community, the use of debt finance is appropriate.

Chart 4.8: General government and non-financial public sector net debt as at 30 June



Source: Department of Treasury and Finance

Table 4.2 and Chart 4.8 show that non-financial public sector net debt is projected to grow from $6.4 billion (2.6 per cent of GSP) at June 2007 to $15.3 billion (5.1 per cent of GSP) at June 2011. The increase of $8.9 billion is attributable to a $5.8 billion increase in general government net debt and a $3.1 billion increase in public non-financial corporations net debt. Overall, the level of State net debt will remain low and consistent with the maintenance of the triple-A ratings criteria which is a key financial objective of the Government.

CHAPTER 5 – COMMONWEALTH–STATE FINANCIAL RELATIONS

- Ongoing collaboration between the Commonwealth and the States is essential to improving service delivery in Australia.
- Victoria has abolished all states taxes agreed under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*.
- Victoria, New South Wales and, to a lesser extent, Western Australia continue to receive far less GST revenue than they collect by around $3.6 billion in 2007-08.
- Victoria is similarly disadvantaged with respect to specific purpose payment funding received.
- While there is a process underway to simplify the way GST distributions are calculated, Victoria considers that a new horizontal fiscal equalisation model in Australia is required to improve the incentives for reform and free up the States to continue to invest in economic growth.

THE NEED FOR COOPERATIVE FEDERALISM

The Australian federation is facing considerable challenges as a result of an increased tendency by the Commonwealth to act unilaterally and use legislative and financial power to intervene in areas of State responsibility. The value to the community of the diversity and familiarity with local circumstances that a federal system provides is lost when one level of government acts alone.

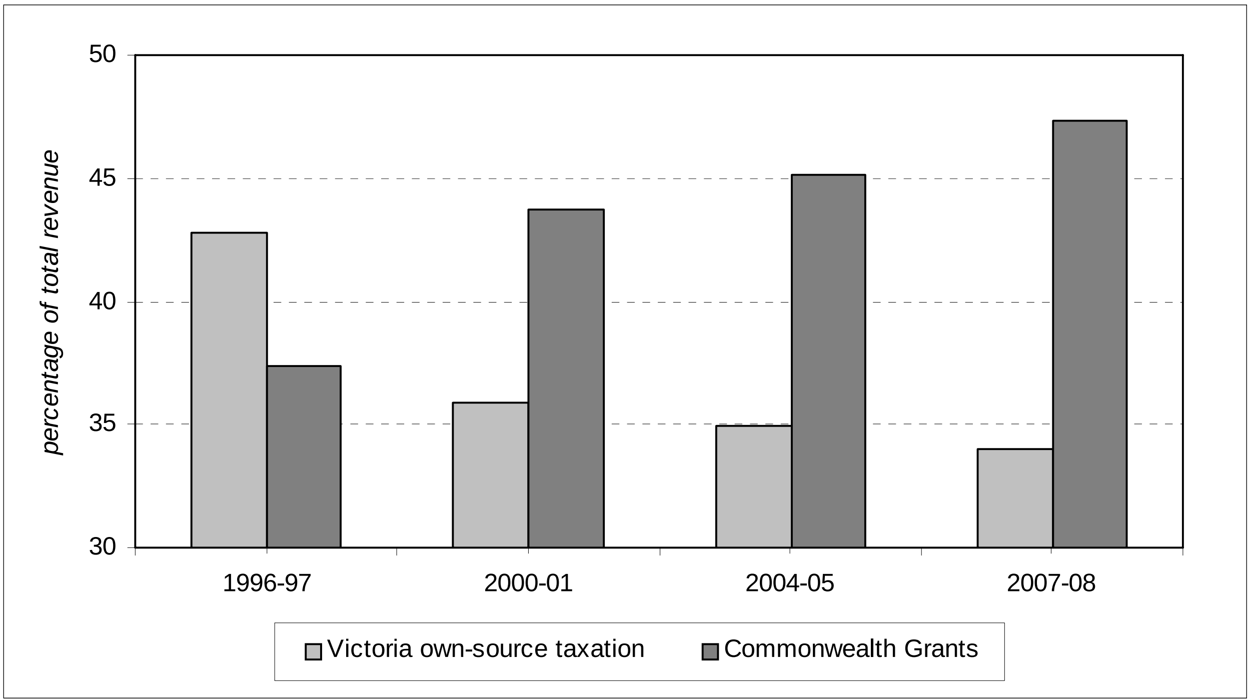
Continued improvements in service delivery can best be achieved with the cooperation of all levels of government across Australia. Proposals tend to be more measured, better scrutinised and bring together all areas of Australia when there is a mutually agreed reform.

Victoria believes in a cooperative approach and is seeking to continue working with the Commonwealth and other states and territories (the States) in the reinvigoration of the national reform agenda (the NRA). Collaboration between all levels of Government is crucial to achieving a successful outcome of the NRA. With many of the most beneficial reforms beyond the limited fiscal capacity of States alone, much of the potential gain of the NRA depends on the full commitment of the Commonwealth. The NRA, and Victoria's contribution to it, is discussed in more detail in Chapter 7, *The Economic Reform Agenda*.

Collaboration between jurisdictions is also required given the significant financial advantage the Commonwealth has over the States, particularly following the introduction of the Goods and Services Tax (GST) on 1 July 2000. As part of the introduction of the GST, a program to abolish specific transaction taxes levied by the States was finalised. Victoria was proactive in this area, and on 1 January 2007 was the first State to have fully abolished all agreed taxes.

As a result of the abolition of these State taxes, Victoria – like the other States – has become increasingly reliant on revenue from the Commonwealth. Since the striking down by the High Court of State petroleum, liquor, tobacco and alcohol franchise fees in 1997 (one-sixth of all state taxes), and the introduction of the GST, grants from the Commonwealth have grown from less than 40 per cent of Victoria's revenue in 1996-97 to approximately 47 per cent in 2007-08 (see Chart 5.1).

Chart 5.1: Victorian own-source taxation and Commonwealth grants as a percentage of total revenue



Source: Department of Treasury and Finance

The reduction in Victoria's control over its revenue sources is occurring at the same time as increased growth in demand for services such as health and education, driven in part by the impact of an ageing population.

In contrast, the Commonwealth's taxation revenues have been increasing at a faster rate than State tax revenues and more than surpass the Commonwealth's own expenditure needs, as demonstrated by its large budget surpluses over recent years.

COMMONWEALTH GRANTS

Grants received from the Commonwealth fall into three main categories: GST funding, specific purpose payments (SPPs) (both for State use and on-passing), and other purposes. The level of funding received from the Commonwealth is outlined in Table 5.1. GST grants and SPPs are discussed in more detail later in this chapter.

Table 5.1: Summary of Commonwealth grants

($ million)

	2006-07 Revised	*2007-08 Budget*	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
GST grants [(a)]	8 519.0	9 124.8	9 816.2	10 271.6	10 768.1
Specific purpose payments to the State	4 606.0	4 803.5	4 768.4	4 866.5	5 007.1
Specific purpose payments for on-passing	1 877.5	1 950.0	2 023.4	2 096.4	2 173.0
Other	275.8	280.4	248.7	251.4	268.7
Total grants	**15 278.4**	**16 158.7**	**16 856.8**	**17 485.9**	**18 217.0**

Source: Department of Treasury and Finance

Note:

(a) GST revenue in the out-years differs from that published in the Commonwealth budget papers. GST grants are based on the latest Commonwealth forecast of the national GST pool. Victoria's share of future GST grants is obtained using the Commonwealth's population projections and forecasting Victoria's assessed Commonwealth Grants Commission relativity out to 2010-11.

HOW GST FUNDS ARE DISTRIBUTED

Under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA), the States receive all GST revenue collected by the Commonwealth. This revenue is distributed between the States by the federal Treasurer on the recommendations of the Commonwealth Grants Commission (CGC). These recommendations are underpinned by the principle of horizontal fiscal equalisation (HFE). The system distributes over $40 billion in GST revenue which represents a significant share of States' revenue.

The CGC attempts to comprehensively equalise the financial capacities of all States by conducting detailed assessments of capacity and disability for 13 revenue and 39 expenditure categories. The CGC updates its relativities annually to reflect movements in state circumstances, while the methodologies underpinning the annual updates are subject to detailed review by the CGC every five years. The 2007 Update, released in February this year, was based on the application of the methodologies developed by the 2004 methodology review.

Outcomes from the 2007 CGC Update

Based on the new relativities recommended in the 2007 Update, which was calculated from data for the five years to 2005-06, Victoria's net GST grant share for 2007-08 will be an increase of around $64 million, or just 0.2 per cent of the total estimated GST pool, compared to the previous assessed relativity. According to the CGC, the improvement in Victoria's 2007-08 relativity mainly reflects the increased relative capacity of other states, in particular Western Australia and Queensland, to raise revenue from mining. Victoria has also been compensated for the abolition of some State taxes for which it had above-average raising revenue capacity. While Victoria experienced an increased net grant share, this amount would have been significantly greater had it not been for substantial revisions to data used to calculate GST distributions.

The 2007 Update has resulted in a compression of the relativities for the four larger states (New South Wales, Victoria, Queensland and Western Australia) and, for the first time since 2003-04, Western Australia has joined Victoria and New South Wales as a donor state. Western Australia's GST share was reduced dramatically, mainly attributable to its assessed increased fiscal capacity. The principal driver of Western Australia's higher fiscal capacity was a high level of activity in its property market, reflecting overall buoyancy of the State economy. Queensland also experienced a reduction in its share of the GST but continues to receive more GST than it collects despite its economy performing stronger than the rest of Australia. New South Wales and South Australia experienced an increase in its share of the GST and were the major beneficiaries of the 2007 Update.

The burden of the subsidy

The extent of the GST redistribution burden can be assessed by comparing the GST raised within each State with the GST distributed to each State. On this basis, the forecast shortfall for Victoria in 2007-08 is around $1.3 billion or $243 per capita, with Victoria receiving only 88 cents for every $1 of GST it raises.

Assessed at an aggregate level, Victoria, New South Wales, joined now to a lesser extent by Western Australia, continue to shoulder an enormous subsidy burden. In 2007-08, a forecast total of around $3.6 billion will be redistributed from these States to the rest of Australia.

HORIZONTAL FISCAL EQUALISATION REFORM IS REQUIRED

The Victorian Government considers that the current approach to GST distribution is fundamentally flawed. Extreme complexity, poor data quality, difficulty in determining genuine need, and the construct of an artificial 'standard' budget result in significant volatility in State budget positions. Importantly, the current approach also discourages states from undertaking reforms that will promote economic and social benefits.

The 2007 Update demonstrated the volatility of outcomes inherent in the current system and how the methodology acts against economic efficiency, substantially distributing away gains from economic growth. It also illustrated how the volatility of GST distributions makes it hard to plan spending on core services as it is difficult to predict future relativities and subsequently total revenue.

2010 review

The CGC is currently undertaking a review of the methodology used to distribute the GST (known as the 2010 review), to be implemented from 2010-11.

The 2010 review is examining key issues such as whether the present approach, which is based on a comprehensive assessment of virtually all revenue and expense items received or incurred by states, is appropriate and necessary, the size and trend of the redistributions, simplification, and data issues.

Victoria has been an active contributor to the review and is working collaboratively with the CGC and other states to achieve an improved and simplified GST distribution system. A number of Victoria's proposals for the review have been accepted, such as a top-down approach to simplification and materiality thresholds needing to be defined and rigorously implemented.

Work on the review commenced in 2005 and is progressing well. In 2006, Victoria provided input into determining the category structure (via a process of disaggregation) and to establishing the disability factor structure. The work program for 2007 centres on assessment frameworks for GST redistributions and the availability of data required to make the proposed assessments.

Greater reform is needed

While simplification is a positive move to reducing the problems in the current system, it is unlikely to eliminate them.

There will be remaining problems in the system following the planned simplification, including: cyclical factors being assessed leading to ongoing volatility, economic/fiscal capacity issues not being taken into account in a timely manner, and intensity of effort required for annual assessments.

These problems, coupled with the likely ongoing disincentives to reform mean that the CGC's approach to simplification will not be enough. A new model for GST distribution is required. Victoria believes that this new model should consider the following key policy criteria:

- Equity – States should be treated on a consistent basis;
- Efficiency – distortions in funding distribution to the states should be removed;
- Simplicity – GST shares should be relatively stable and predictable, which would lead to more effective fiscal planning and management; and
- Transparency – the model should be easily understood by all parties with no complicated or technical assessments.

In addition, such a model should also incorporate the four pillars previously advocated by Victoria for a new HFE model:

- protect the fiscal positions of the smaller States;
- deliver greater certainty of GST revenues for all states in the medium and longer term;
- reduce the distortions and deadweight costs imposed by the current system; and
- manage the transition to the new model.

In order to meet future economic challenges, there is a need to improve the incentives for reform and free up the States to continue to invest in economic growth. Victoria is willing to work with all States and the Commonwealth to develop a new model for GST distribution to achieve such outcomes.

REVIEW OF STATE TAXES UNDER THE INTERGOVERNMENTAL AGREEMENT

Victoria has been proactive in state tax reform and was the first State to fully meet its obligations to remove all the taxes specified to be abolished under the IGA.

Victoria, along with the other States, agreed to a timetable to abolish all but one of the IGA taxes that were listed only for review. Victoria has since completed the abolition of these taxes, ahead of all other States.

The exception was stamp duty on business conveyances, where the States proposed the abolition be confined to the goodwill component only (this component was not subject to duty in Victoria). The Commonwealth has subsequently argued for the complete abolition of business conveyancing duty, claiming that the States agreed to abolish this tax under the IGA. However, the terms of the IGA clearly demonstrate that there was no such agreement.

Victoria opposes the abolition of business conveyance duty on real property. The size of real property business conveyancing duty means that its abolition would have a significant financial impact on Victoria. Even by the Commonwealth's interpretation of affordability, it is simply not feasible to consider its removal in Victoria in the short or medium term.

Victoria has complied with the IGA and been a leader in removing all state taxes agreed to be abolished under the IGA.

SPECIFIC PURPOSE PAYMENTS

SPPs from the Commonwealth (including those for on-passing) account for around 40 per cent of Commonwealth funding to Victoria, and approximately 20 per cent of Victoria's total revenue. They form an important component of state funding for vital services such as health, education, housing, roads, rail and community welfare. Further details of major SPP payments are outlined in Budget Paper No. 4, Chapter 3, *State Revenue*.

SPPs are an important way in which Australian governments can jointly invest in the achievement of shared objectives, including fostering innovation and contributing to the success of reform. In order to maximise the outcomes achieved from available investment, SPPs need to be flexible, efficient, and focused on real outcomes. They should form the basis for genuine collaboration, sharing investment and risks fairly across governments and holding them accountable to the community, without diverting excessive resources to administration.

Increasing Commonwealth prescriptiveness regarding what and how States provide services constrains the ability of States to respond to the specific needs of their communities and hinders innovation and efficiency improvements. Burdensome arrangements for administering and reporting on programs, unilateral penalties and requirements – such as extensive Commonwealth 'badging' of investments – contribute little to the achievement of real outcomes.

With several major SPPs due to be renegotiated in 2007-08 and 2008-09, Australian governments have a real opportunity to make intergovernmental financial relations more constructive, collaborative, and focused on achieving the best outcomes for the community with the funding available.

Like the distribution of GST revenue, the distribution of SPP grants among the States unfairly disadvantages Victoria. In 2007-08, Victoria will receive approximately 22 per cent of total SPPs provided for States' own use. This is around $500 million less than the amount Victoria would receive if SPPs were distributed according to its population share.

CHAPTER 6 – STATEMENT OF RISKS

- The budget projections are sensitive to a number of upside and downside risks (both economic and fiscal) and contingent assets and liabilities.
- The main short to medium-term risks to the Victorian economic projections are from drought conditions, oil price volatility, wage and inflationary pressures, exchange rate movements and global developments.
- Contingency provisions in the budget estimates provide general protection against fiscal risks, including increased demand for government services.
- A number of contingent assets and liabilities have been identified, particularly relating to the public transport rail agreements.

This chapter provides a discussion of the risks to Victoria's budget position. These risks include economic risks, incorporating an analysis of the sensitivity of the budget operating surplus to macroeconomic shocks, and fiscal risks.

ECONOMIC RISKS

The main short to medium-term risks to the Victorian economic projections are from drought conditions, oil price volatility, wage and inflationary pressures, exchange rate movements and global developments.

The prospects for the rural sector remain a risk to the broader Victorian economic outlook. As noted in the *2006-07 Budget Update*, the current drought is expected to detract between 0.5 and 1.0 percentage point from Victorian economic growth. The current projections assume a return to normal seasonal conditions in 2007-08. In particular, good autumn and winter rains are critical for the next winter crop. If Victoria continues to experience severe rainfall deficiencies, the farm sector is likely to continue placing downward pressure on the growth outlook.

After peaking at almost US$80 a barrel in August 2006, oil prices have retreated, thus removing some of the pressure on headline inflation and reducing downside risks to global growth. However, oil prices remain volatile and at risk of further increases in the face of geo-political tensions and any potential supply disruptions. The oil price has been particularly sensitive to tensions over Iran, the world's fourth-largest oil exporter. Further increases in oil prices would increase input prices and inflationary pressures.

The labour market remains tight, with the national unemployment rate at a generational low and firms reporting increased difficulty in finding suitable labour. Measured wage growth, while firm, has not accelerated, with wage pressures largely concentrated in certain industries in the resource States. There is a risk, though, that the continuation of tight labour market conditions may eventually result in accelerating wage growth, which would put upward pressure on broader consumer price inflation. National headline inflation is expected to ease further in the near term before settling at a rate between 2.5 and 3.0 per cent by the second half of 2008. With underlying inflation at the upper end of the Reserve Bank of Australia's (RBA) target band, this may result in further monetary policy tightening.

Downward pressure on inflation may come from the exchange rate, which has appreciated since early March. However, any further appreciation of the Australian dollar would start placing additional pressures on Victoria's exports. The upward impetus of the Australian dollar has come mainly from interest rate differentials, with financial markets anticipating an increased likelihood of higher interest rates in Australia and cuts to official interest rates in the United States. The other key driver of the Australian dollar is the terms of trade, which are around their highest level since the 1950s, supported by high commodity prices. Once the supply of commodities begins to catch up to demand, there is likely to be some easing in prices and the terms of trade, and possibly less pressure on the exchange rate and Victoria's exporters.

The global economy continues to surprise on the upside, and growth is becoming more broadly based. Nonetheless, there are a number of downside risks to global growth. The main downside risk stems from the correction in the US housing market and the extent to which this weakness spills over into the rest of the US economy. Elsewhere, there is also some uncertainty regarding how the Chinese economy may respond to the government's intentions to slow and rebalance growth.

Sensitivity analysis

The sensitivity analysis quantifies the impact on revenue, expenses and the net result from transactions associated with variations to forecasts or projections of selected economic and financial variables. The major variables that affect Victoria's net result from transactions are economic growth, employment, prices, wages, interest rates, share prices, property prices and property transaction levels.

To assess sensitivity to change, the level of the economic variable in each case is permanently increased by one percentage point for one year, and then allowed to grow at the previously forecast rate. 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 one variable only, and does not attempt to capture the linkages with other variables in the economy.

In reality economic linkages would most likely mean that the variables would interact, which would alter the actual impact on the budget. For example, an increase in consumer prices may arise from several sources, such as a sharp decline in the exchange rate, a rise in energy prices or higher wage claims across the economy. In addition, higher prices would be expected to affect interest rates, the exchange rate, wage claims and other economic variables. As such, the impact on revenue, expenses and the net result from transactions is likely to be quite different from the sensitivity analysis if economic linkages were captured.

Table 6.1 Impact on the general government net result from transactions of a one percentage point increase in selected economic indicators in 2007-08[(a)(b)]

($ million)

	2007-08 Estimate	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
GSP				
Income from transactions	150	165	170	178
Expenses from transactions	-4	-10	-16	-23
Net result from transactions	**154**	**174**	**187**	**200**
Other economic flows	..	..	..	..
Net result	**154**	**174**	**187**	**200**
Employment				
Income from transactions	40	42	45	47
Expenses from transactions	-1	-4	-6	-8
Net result from transactions	**42**	**46**	**51**	**55**
Other economic flows	..	..	..	..
Net result	**42**	**46**	**51**	**55**
Consumer prices [(c)]				
Income from transactions	240	254	260	268
Expenses from transactions	85	87	82	78
Net result from transactions	**155**	**167**	**178**	**190**
Other economic flows	-119	..	..	..
Net result	**36**	**167**	**178**	**190**
Average weekly earnings				
Income from transactions	40	14	45	47
Expenses from transactions	-1	-3	-4	-7
Net result from transactions	**42**	**17**	**49**	**54**
Other economic flows	..	..	..	..
Net result	**42**	**17**	**49**	**54**
Enterprise bargaining agreements [(d)]				
Income from transactions	..	..	..	..
Expenses from transactions	131	166	177	190
Net result from transactions	**-131**	**-166**	**-177**	**-190**
Other economic flows	-169	..	..	..
Net result	**-300**	**-166**	**-177**	**-190**
Domestic share prices				
Income from transactions	..	9	..	..
Expenses from transactions	..	-5	-5	-5
Net result from transactions	**..**	**14**	**5**	**5**
Other economic flows	65	..	..	..
Net result	**65**	**14**	**5**	**5**
Overseas share prices				
Income from transactions	..	7	..	..
Expenses from transactions	..	-4	-4	-4
Net result from transactions	**..**	**11**	**4**	**4**
Other economic flows	48	..	..	..
Net result	**48**	**11**	**4**	**4**
Property prices				
Income from transactions	40	57	54	55
Expenses from transactions	-2	-6	-10	-13
Net result from transactions	**42**	**63**	**64**	**68**
Other economic flows	10	..	..	..
Net result	**52**	**63**	**64**	**68**

Table 6.1 Impact on the general government net result from transactions of a one percentage point increase in selected economic indicators in 2007-08[(a)(b)] (continued)

($ million)

	2007-08 Estimate	*2008-09 Estimate*	*2009-10 Estimate*	*2010-11 Estimate*
Property volumes				
Income from transactions	29	31	28	29
Expenses from transactions	-1	-3	-4	-6
Net result from transactions	**29**	**33**	**33**	**35**
Other economic flows	..	..	..	..
Net result	**29**	**33**	**33**	**35**
Interest rates [(e)]				
Income from transactions	36	116	34	34
Expenses from transactions	-1	12	22	36
Net result from transactions	**37**	**104**	**12**	**-2**
Other economic flows	3132	..	..	..
Net result	**3168**	**104**	**12**	**-2**

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 denotes an improvement. Numbers may not balance due to rounding.

(b) An equivalent one percentage point decrease in each indicator would have an opposite impact to that shown.

(c) Reflecting the departmental funding model, it is assumed that an increase in consumer prices within the Budget year does not impact on employee entitlements. This is a methodological change compared with what has been presented in previous budgets.

(d) Represents a one percentage point increase in all Government enterprise bargaining agreements.

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

The sensitivity analysis in Table 6.1 presents the sensitivity of both the net result from transactions and the net result to selected economic and financial indicators.

Sensitivity to economic growth

An increase in GSP would increase household consumption, leading to higher GST grant revenue and taxation revenue which would increase both the net result from transactions and the net result.

Sensitivity to employment

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

Sensitivity to prices

Increased consumer prices would 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 actuarial-based increase in superannuation liabilities adversely affecting the net result by way of an actuarial loss. In subsequent years, the now higher superannuation liabilities result in a slightly higher superannuation expense which reduces the net result from transactions.

Sensitivity to wages

A rise in the level of economy wide wages would result in higher payroll tax revenue although this is partially offset by a reduction in TAC dividends. This would result in 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 agreement

An across the board rise in the Government's enterprise bargaining agreements 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 superannuation fund lump-sum liabilities and result in a reduction in the net result for the budget year. The higher superannuation fund liabilities would flow through into 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. Increased domestic and international share prices thus raise the profits of the PFCs and reduce the valuation of the unfunded superannuation liability.

The net result from transactions responds positively to increases in share prices as PFC dividends rise with profits, with later year positive impacts reflecting the reduced cost associated with a lower unfunded superannuation liability.

Sensitivity to property prices

Increased property prices have an immediate impact on the net result from transactions through increased collections of conveyancing duty. At the same time, the valuation of the unfunded superannuation liability is reduced (due to the increased value of holdings of property in the investment portfolio of superannuation funds) which also increases the net result. In later years the increase in property prices continues to be reflected in higher conveyancing duty and land tax while the previous reduction in the unfunded superannuation liability reduces ongoing superannuation expenses.

Sensitivity to property transaction volumes

An increase in property transaction volumes would increase conveyancing duty 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. The higher income would be fully distributed as dividends and income tax equivalents in the second year. This is partly offset by lower water authority 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 valuation of superannuation fund liabilities and gives rise to an actuarial gain. In terms of ongoing superannuation expenses, the impact of a higher discount rate on service costs is slightly more than offset by an increase in the annual interest expense on the unfunded liability going forward, leading to an increase in annual superannuation expenses. The overall rise in both the net result from transactions and the net result is minimal by the end of the forward estimates.

FISCAL RISKS

Expenditure risks

With the introduction of the departmental funding model from 2004-05, departments need to plan for, and manage, all costs associated with delivering services. Under the model, variations to previous budget CPI forecast growth rates applied to output prices for the coming budget and forward estimates years are to be determined in the context of the next annual Budget. There are several general risks such as unforeseen changes in the size and structure of the Victorian population, which can affect the expenditure and revenue outlook. These risks can be classified into those affecting all government departments and those that are department specific.

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

The 2007-08 Budget and forward estimates include a contingency provision to allow for the likelihood that some of these department-specific and government-wide expenditure risks will be realised during the remainder of the budget year or over the course of the forward years.

The contingency provision includes a general allowance for:

- growth in Victoria's population, and consequent derived demand for government services;
- an allowance for depreciation expenditure that would be associated with new asset investments funded from the unallocated capital provision (subject to government approval); and
- other expenditure risks, including interest cost risks which were unforeseen or not able to be quantified, or were not formalised at the time of construction of the budget estimates.

In addition, the budget estimates include a contingency from 2008-09 that acknowledges funding for a number of existing decisions which will conclude in 2007-08 or the following years. A provision is made on the basis that Government may endorse a number of these decisions 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 the annual budget position to the extent that they cannot be accommodated within the contingency provision built into the budget estimates. The aggregate level of the operating contingency provisions contained in the budget estimates is shown in Note 10 of the Estimated Financial Statements (see Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*).

The budget estimates include an unallocated capital provision to provide capacity for future asset investment requirements. With a capital program the size of that funded by the Government, there are always likely to be variations in actual costs (compared to budget) for individual asset investment projects. However, the forward estimates assume that capital cost pressures are managed within the existing forward estimates. Management of capital cost pressures may occur in one of three ways:

- the reallocation of resourcing in departments' global capital budgets (reflecting the likelihood that cost over runs on some projects will be offset by cost under runs in other areas); and/or
- re-scoping a project to fit within funding parameters (subject to government approval); and/or
- funding from the unallocated capital funding set aside in the forward estimates (subject to government approval).

The aggregate level of the unallocated capital contingency provisions contained in the budget estimates, including purchases of property, plant and equipment and contributions to other sectors, is shown in Note 18 of the Estimated Financial Statements (see Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*).

Significant events that could represent a call on the operating contingency or unallocated capital funding and/or impact on total budget expenditure forecasts are detailed below.

Several significant enterprise bargaining agreements are due to expire in 2007. These include agreements covering police, teachers, nurses and a range of other health workers. Together these agreements account for more than 50 per cent of the State's $14 billion expenditure on employee benefits (including superannuation) and approximately 20 per cent of total Government expenditure.

Insurance exposures

The availability and affordability of commercial insurance has improved during the past year. The State no longer provides cover for tourism ventures or heritage and tourist railways, which have reverted to commercial insurance arrangements as such risks are readily underwritten by the commercial market at appropriate rates.

Pressures on private sector medical indemnity premiums have also eased, but there is still a risk that increasing medical costs and lack of availability of private doctors in some regions (notably obstetricians) may result in the State assuming larger numbers of high risk medical procedures. This risk, together with the impact of claims that arise from current levels of public medical services, means that there is a continuing need to closely monitor the State's medical indemnity liabilities and expenses.

As the insurer for the Victorian general government sector, the Victorian Managed Insurance Authority (VMIA) insures any additional risks assumed by the general government sector. It does so either explicitly through indemnities provided to non-government bodies, or implicitly through transfer of activities from private sector to general government sector service providers. However, the State continues to directly bear the risks of losses arising from events for which VMIA does not provide insurance, such as terrorist attacks.

Port Phillip Prison

In line with the existing contract, the Government is currently undertaking a review of the Prison Services Agreement for Port Phillip Prison. This review is expected to be finalised in 2007. The forward estimates reflect existing contractual arrangements.

Traffic Camera and Infringement Processing Contract

The current Traffic Camera and Infringement Processing Contract is due to expire in late 2007. Two RFTs were released by selective tender in January 2007 for traffic camera services and infringement management services. The forward estimates reflect existing contractual arrangements.

COAG National Reform Agenda

Currently the Commonwealth and State and Territory Governments are considering specific reform proposals to increase productivity and participation. The details of these proposals are still being developed. The funding required for these proposals will not be known until the proposals are fully developed and funding arrangements with the Commonwealth are agreed.

Changes to Exceptional Circumstances declared areas and eligibility criteria

The Government announced changes to the Exceptional Circumstances eligibility criteria including an extension of income and business support and interest rate subsidies. In addition, the Commonwealth Government announced on 9 March 2007 full Exceptional Circumstances declaration for South Western Victoria. Funding will be reviewed to meet Victoria's contribution to this scheme. Any further changes to eligibility criteria, extension of decleration, or an increase in the number of Exceptional Circumstance declared areas in Victoria would affect Victoria's position. No allowances have been made in the forward estimates for any further possible changes to Commonwealth Government Exceptional Circumstances declared areas.

Revenue risks

Commonwealth grants

Commonwealth grants are a major source of revenue for the Victorian Government, with an estimated grants income of approximately $16 billion in 2007-08. Commonwealth grants include general purpose grants (GST grants) and specific purpose payments (SPPs).

The level of SPPs is determined by the policies of the Commonwealth Government and is published on an annual basis in the Commonwealth budget papers. The level of GST grants is affected by the general level of activity in the Australian economy and the GST revenue sharing relativities as calculated by the Commonwealth Grants Commission (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.

The Commonwealth grants estimates in this 2007-08 Budget Update (GST grants and SPPs) are based on data published in the Commonwealth's 2006 Mid-Year Economic and Fiscal Outlook (MYEFO), released on 20 December 2006. The GST estimates are based on the Commonwealth's latest forecasts for Australia-wide economic activity, as published in the MYEFO. Any changes to economic conditions over the forward estimates period will have a direct impact on the amount of GST revenue to be distributed among the States.

Lotteries licence

The Government is currently undertaking a licensing process for the next public lotteries licence(s) to apply in Victoria and an announcement is expected to be made in 2007. While the budget estimates have been based on historical lotteries sales growth, no assumptions have been made concerning possible changes to future licensing structures.

CONTINGENT ASSETS AND LIABILITIES

Contingent assets

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

These can be classified into either quantifiable, where the potential economic benefit is known, or non-quantifiable.

Quantifiable contingent assets

Table 6.2: Quantifiable contingent assets as at 30 June

($ million)

	As at June 2006	*Estimate for June 2007* [(a)]
Guarantees, Indemnities	..	..
Potential early termination of contractual arrangements [(b)]	100.0	100.0
Legal proceedings and disputes	1.0	0.8
Other [(c)]	107.7	106.6
Total contingent assets	**208.7**	**207.4**

Source: Department of Treasury and Finance

Notes:

(a) There have been no material changes to quantifiable contingent assets since last reported in the 2005-06 Financial Report for the State of Victoria.

(b) Included under 'potential early termination of contractual arrangements' are any additional costs arising to the Director of Public Transport on early termination of the public transport partnership agreements. The operator must, to the extent of the performance bonds, indemnify the Director for any losses, damages or costs incurred by him as a result of early termination. If the operator does not do so, the Director has the right to draw on the operator's performance bonds for the amount of losses, damages or costs. The nominal value of these bonds is $100 million.

(c) 'Other' includes the EastLink project of $92 million. The remaining amounts in 'Other' relate to smaller individual contingencies.

EastLink

On 14 October 2004, the State entered into a concession deed with ConnectEast to design, construct, finance and operate EastLink. Various performance bonds provided under the concession deed can be drawn by the State in circumstances where the concessionaire (ConnectEast) or one of its contractors fails to meet its obligations. These bonds include a construction bond ($87 million) and an operation phase bond ($5 million). In the event of certain default events, there is potential for the $5 million to increase to $20 million.

Non-quantifiable contingent assets

Public transport partnership agreements

On 19 February 2004, the Director of Public Transport, on behalf of the Crown, entered into contractual arrangements with Connex and Yarra Trams to operate rail transport services in the State. The major contingent asset arising from those arrangements is profit sharing in which the Director is entitled to receive payment from Connex and Yarra Trams should franchisee profits exceed defined thresholds.

City Link compensable enhancement claims

The Melbourne City Link Concession Deed contains compensable enhancement provisions that enable the Victorian Government to claim 50 per cent of additional revenue derived by City Link Melbourne Limited as a result of certain events that particularly benefit City Link, including changes to the adjoining road network.

On 20 May 2005, the Victorian Government lodged a compensable enhancement claim relating to works to improve the traffic flow on the Westgate Freeway between Lorimer and Montague Streets.

Under the Monash-Westgate Freeways Improvement project, the Victorian Government's share of revenue uplifts will be calculated and paid three years after the completion of the project.

EastLink

As indicated above, on 14 October 2004, the State entered into a concession deed with ConnectEast to design, construct, finance and operate EastLink. In addition to the quantifiable contingent assets listed above, there is a non-quantifiable contingent asset relating to the Hand Over Bond through which ConnectEast has an obligation to the State, in certain limited circumstances, to the State to provide a bond to cover project rectification costs to the end of the concession period in 2043.

Contingent liabilities

A contingent liability is:

- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- a present obligation that arises from past events but is not recognised because:
  - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - the amount of the obligation cannot be measured with sufficient reliability.

As with contingent assets, contingent liabilities are also classified as either quantifiable or non-quantifiable.

Quantifiable contingent liabilities

Table 6.3: Quantifiable contingent liabilities as at 30 June

($ million)

	As at June 2006	*Estimates for June 2007*
Guarantees, indemnities	404.0	398.7
Potential early termination of contractual arrangements [(a)]	579.5	579.5
Legal proceedings and disputes	233.2	284.7
Other	43.9	43.8
Non-general government debt [(b)]	3 310.7	3 827.3
Total contingent liabilities	**4 571.3**	**5 133.9**

Source: Department of Treasury and Finance

Notes:

(a) Under 'potential early termination of contractual arrangements' is a contractual agreement of $579.5 million relating to the cost of correctional services beyond the current contract period. The State has the option to re-tender for the provision of correctional services every three years, after the initial five year period for each contract.

(b) Represents guarantees for loans made by the general government sector to agencies in the public non-financial corporations sector, primarily the water entities and other non-general government sector entities. The increase since June 2006 is mainly due to increased water industry capital works.

Non-quantifiable contingent liabilities

A number of potential obligations, which are non-quantifiable at this time, have been recognised by the Government arising from:

- indemnities provided in relation to transactions, including financial arrangements and consultancy services, as well as for directors and administrators;
- performance guarantees, warranties, letters of comfort, and the like;
- deeds in respect of certain obligations; and
- unclaimed moneys which may be subject to future claims by the general public against the State.

Asset sales

Potential exposures are associated with the sale of a number of assets and services where the purchaser was provided with various indemnities and warranties.

Royal Melbourne Showgrounds

A contingent liability exists relative to any claims which may be made against the Showgrounds Nominees Pty Ltd arising from joint venture dealings as outlined in the Development and Operations Agreement for the Royal Melbourne Showgrounds. An undertaking has been given by the joint venture parties to meet the indexed service fees payable to the Concessionaire (Developer) under the Development and Operations Agreement as and when they fall due, subject to the Concessionaire's achievement of defined service standards at the Showgrounds and relevant abatement if there are service failures.

Under the State Support Deed, Core Land, the State undertakes to ensure the performance of the payment obligations in favour of the Concessionaire and the performance of the joint venture financial obligations in favour of the security trustee.

Under the State Commitment to the Royal Agricultural Society (RAS), the State has agreed to support certain obligations of the RAS which may arise out of the Joint Venture Agreement. In accordance with the terms in the State Commitment to the RAS, the State will meet certain RAS obligations, in the form of a loan, if requested by RAS when RAS does not have financial capacity to pay and provided RAS has materially complied with all its material obligations under the Project Objectives Agreement, RAS Events Agreement and other Joint Venture project documents. If any outstanding loan amount remains unpaid at a date which is 25 years after the commencement of the operation term under the Development and Operation Agreement, the RAS will be obliged to satisfy and discharge each such outstanding loan amount. This may take the form of the transfer to the State of the whole of the RAS' participating interest in the joint venture.

The State has also entered into an agreement through the State Support Deed – Non-Core Land with Showgrounds Retail Developments Pty Ltd and the RAS whereby the State agrees to support certain payment obligations of the Royal Agricultural Society of Victoria Limited that may arise under the Non Core Development Agreement. In March 2007 Showgrounds Retail Developments Pty Ltd subsequently assigned all its rights and obligations under these agreements, via an Assignment Deed, to a third party.

Public transport rail partnership agreements

The Director of Public Transport, on behalf of the Crown, entered into new partnership contractual arrangements with franchisees to operate rail transport services in the State, operative from 18 April 2004. The following summarises the major contingent liabilities arising from those arrangements.

Contingent liabilities arising during the agreement period

There are a number of contingent liabilities arising from the Partnership Agreements between the Director of Public Transport and Connex and Yarra Trams, which were signed on 19 February 2004.

These potential liabilities refer to payments to be made by the Director of Public Transport to Connex and Yarra Trams should certain events occur:

Farebox risk sharing: the Director is obliged to make payments should farebox receipts fall below defined thresholds.

New ticketing revenue guarantee payment: franchisees have an option to elect to permanently move to a revenue guarantee payment regime should implementation matters or new ticket fare structures associated with the introduction of the new ticketing system cause a real reduction in the farebox. The revenue guarantee payment will be based on the prior period's farebox including an estimate for patronage growth and inflation. Under the arrangement, the Director is liable for the difference between actual farebox received and the guaranteed revenue amount.

New ticketing system: the State is obliged to pay any additional labour costs associated with training and deployment of staff in relation to the establishment of the new ticketing system.

Regional Fast Rail: the Director is required to meet the incremental costs incurred by Connex associated with the introduction of Regional Fast Rail.

Connex and Mainco indemnity

The Department has indemnified Connex and Mainco (including agents and contractors) against any loss caused by Regional Rail Link while undertaking Regional Fast Rail within the Connex network.

The Director indemnifies VicTrack and the Southern Cross Station Authority from any claim brought by the franchisees under the Infrastructure Lease.

Contingent liabilities on early termination or expiry of franchise agreement

Franchise assets: to maintain continuity of services, the Director at early termination or expiry of the franchise agreement will:

- for new rolling stock – either acquire the new rolling stock at predetermined values or have the lease payment obligations transferred to the Director or a successor franchise; and
- for franchise assets – either purchase the assets or have the assets transferred to the successor.

Unfunded superannuation: at the early termination or expiry of the contract, the Director will assume any unfunded superannuation amounts (apart from contributions the franchisee is required to pay over the contract term) to the extent that the State becomes the successor operator.

Contingent liabilities arising from potential changes to existing conditions

Change in Victorian law: franchisees may make a claim against the Director for any net losses incurred as a result of a change in Victorian law which directly relates to the franchise business.

Latent Defects: the Director is responsible for leased infrastructure defects above a threshold amount.

Pre-existing contamination: the Director is responsible for all costs associated with pre-existing contamination clean up. The Director also indemnifies the franchisee from and against all losses, damages, actions, suits, claims, demands, costs and expenses associated with pre-existing contamination.

Native Title: the Director is liable for payments of any valid compensation claim to Native Title holders made under any Native Title law in respect of the land defined in the infrastructure leases entered into with franchisees.

National Express receivership

In December 2002, the Government appointed receivers and managers to the National Express train and tram franchises, in order to protect Government interests, ensure continuation of services up to the commencement of new franchise agreements, and deal with any subsequent termination issues.

The Treasurer, under the Receivership Deed of Indemnity, has agreed to indemnify the receivers for debts properly incurred by them in the course of receivership. The Treasurer has also agreed to remunerate the receivers in accordance with the rates set out in the deed.

Melbourne City Link

An outstanding claim exists from Transurban City Link Limited, pursuant to the Melbourne City Link Concession Deed, relating to an alleged Material Adverse Effect in respect of the construction of Wurundjeri Way. Expert determination found in favour of the State. However, the claim has now been appealed to arbitration, which is currently proceeding. VicRoads is defending this claim and is unable to assess the likelihood of success at this time.

EastLink

On 14 October 2004, the State entered into a Concession Deed with ConnectEast to design, construct, finance and operate EastLink. The major non-quantifiable contingent liability arising from the concession deed relates to the Key Risk Management Regime. The Regime relates to the occurrence of certain circumstances that may have a detrimental impact on the concessionaire's ability to achieve its forecast returns. It identifies the areas that enable the concessionaire to claim redress from the State. These may include acts of prevention, failure to support a principal road interface, changes in state law, Native Title and the environmental effects statement.

Native Title

A number of claims have been filed with the Federal Court under the *Native Title Act 1993* that affect Victoria. While many such claims are being processed through the legal system, the Government has committed itself to resolving claims through mediation, where possible. It is not feasible at this time to quantify any future liability.

HIH Insurance

The State's quantifiable direct exposures arising from the collapse of the HIH Insurance Group are included in the liabilities shown in the financial statements of the agencies directly responsible for them – such as the Victorian WorkCover Authority and the VMIA – and are consolidated in the financial statements of the State.

The State's obligations in respect of its builders' warranty insurance rescue package are direct liabilities of the State itself. They do not form part of the liabilities of the VMIA which manages claims on behalf of the State, this responsibility having been transferred to VMIA from the Housing Guarantee Fund Limited, under the *House Contracts Guarantee (Amendment) Act 2005*.

The State also retains some unquantifiable contingent exposures arising from the collapse of the HIH Insurance Group. These contingent exposures arise primarily through the possibility that the State may be involved in litigation in which it would be entitled to recover damages from third parties. If these third parties were insured by HIH, recovery in full may not be possible.

Land remediation – environmental concerns

A number of Victorian government properties have been identified as potentially contaminated sites. The State does not admit any liability in respect of these sites. However, remedial expenditure may be incurred to restore the sites to an acceptable environmental standard in the event of future developments taking place.

Victorian Managed Insurance Authority – property and public liability

The VMIA was established in 1996 as a captive insurer for departments and participating bodies, predominantly in the general government sector. VMIA provides its client bodies with a range of insurance cover, including for property, public and products liability, professional indemnity and contract works. VMIA reinsures in the private market for losses above $50 million arising out of any one event, up to a maximum for each type of cover (e.g. $1 500 million for property and $750 million for public liability). The risk of losses above these reinsured levels and below $50 million is borne by the State.

Victorian Managed Insurance Authority – public healthcare insurances

VMIA insures the public healthcare system for a range of insurances, including medical indemnity risks. The Government has indemnified VMIA for losses on its public sector medical indemnity portfolio that exceed 120 per cent of claims estimates to be incurred in any one policy year.

Gambling licences

In 1994, the State sold a wagering licence and a gaming licence to TABCORP Holdings Limited (TABCORP) for $597 million. The *Gambling Regulation Act 2003* requires the State to provide a refund to TABCORP in 2012 of an amount equal to the licence value of the former licences or the premium payment paid by the new licensee, whichever is the lesser. While this creates an obligation on the State to refund the licence value to TABCORP, it will be offset by the premium payment from the issue of any new licences.

In 1992, a gaming operator's licence was issued to the Trustees of the Will and Estate of the late George Adams which transferred to Tattersall's Limited subsequent to a 2005 public listing, (the licensee). The *Gambling Regulation Act 2003* entitles the licensee to be paid, at the end of its current licence period in 2012, an amount equal to the value of its current licence or the premium payment paid by the new licensee, whichever is the lesser. This entitlement is contingent on the licensee not being granted a new licence.

The gambling licences are currently under review and a public submission and consultation process has been conducted for the review of the electronic gaming machine, Club Keno and wagering licences and funding arrangements for the racing industry post 2012. The Government anticipates an announcement on the post-2012 licence structures, funding arrangements and the timing and approach to the awarding of licences will be made later in 2007.

Builders' warranty

On 13 March 2002, Victoria and New South Wales jointly announced a series of reforms to Builders' warranty insurance arrangements. This announcement included a commitment to provide a catastrophe fund capable of supporting claims above $10 million. To meet this commitment, the two States offered reinsurance arrangements to all builders' warranty insurers covering claims in respect of any one builder in excess of $10 million, with each State reinsuring claims relating to properties in that State. South Australia has since also become involved in these arrangements. Since builders' warranty insurance commenced, there have been no losses by an insurer to any one builder that exceed this amount.

Victoria entered into a reinsurance agreement giving effect to these arrangements in December 2002 (effective from 1 January 2003) with one insurer. In late 2006, a subsequent agreement with a second insurer came into effect. Discussions have commenced regarding a similar agreement with a third insurer. These agreements require each insurer to pay reinsurance premiums to Victoria (and to any other State that is also a party to such an agreement) that are estimated to be sufficient for the State to at least break even on these arrangements. However, the State retains an unquantifiable contingent liability for additional claims.

CHAPTER 7 – THE ECONOMIC REFORM AGENDA

The Government's economic reform record has enabled Victoria to successfully weather regional and global challenges to the State economy and enjoy strong and solid growth.

However the need for further reform is strong, with Victoria, and Australia, facing significant longer term challenges to sustain economic growth.

These challenges need to be met by pursuing a new wave of economic reform designed to:

- *increase workforce participation and productivity* by increasing people's skill level and capacity to work;
- *improve business competitiveness* by cutting business costs, reducing red tape and fostering innovation; and
- *respond to climate change*, through ensuring a strong and resilient economy and adopting an adaptive and flexible policy approach in the face of uncertainty.

Some progress has been achieved over the past 12 months through discussions in COAG towards a National Reform Agenda. However, more needs to be done to safeguard the living standards of Australians.

THE MOMENTUM FOR ECONOMIC REFORM

Victoria has continued to successfully weather regional and global challenges to the State economy, and enjoy strong and steady economic growth. However, significant challenges loom ahead for Victoria, and Australia, which require consideration now if the prosperity of current and future generations is to be maintained.

Longer term challenges facing Victoria include the impact of an ageing population and slowing productivity growth, a changing global environment which brings both greater competition and trade opportunities, and emerging environmental challenges (particularly climate change).

To respond to these pressures, the Government is committed to pursuing a new wave of economic reform within Victoria, and in conjunction with other Australian governments, designed to:

- *increase workforce participation and productivity* by increasing people's skill level and capacity to work;

- *improve business competitiveness* by cutting business costs, reducing red tape and fostering innovation; and
- *respond to climate change*, through ensuring a strong and resilient economy and adopting an adaptive and flexible policy approach in the face of uncertainty.

This chapter outlines the challenges Victoria faces, progress to date in responding to these and future directions.

The Government's economic reform record

The Government's commitment to responsible financial management, significant investment in infrastructure and strong economic reform has ensured that Victoria's economic fundamentals have remained strong.

Since coming to office the Government has implemented a range of initiatives to strengthen incentives for business to grow and workforce participation to expand. This includes reform of the taxation system, a continuing drive for efficiency within government businesses, actions to reduce government red tape and encourage innovation, and major investment in skill development and new infrastructure projects.

Since 1999, the Government has announced significant tax reductions to stimulate business and investment in Victoria. Significant cuts to payroll tax and land tax, the abolition of numerous stamp duties as well as successive annual reductions in WorkCover premiums have helped support Victorian businesses to maintain their competitive edge. From 1 July 2007, New South Wales and Victoria will have harmonised payroll tax legislation, including common definitions and exemptions, but excluding rates and thresholds. This will cut red tape by reducing payroll tax paperwork for around 8 000 businesses with operations on both sides of the Murray River. Victoria and New South Wales are also working together to harmonise definitions, processes and administrative requirements relating to occupational health and safety and workers' compensation, to reduce unnecessary complications and burdens for businesses operating across both jurisdictions.

To help reduce barriers to competition and allow markets to work more efficiently, the Victorian Competition and Efficiency Commission (VCEC) has been established as the Government's foremost body advising on business regulation reform and identifying opportunities for improving Victoria's competitive position.

In order to position Victoria as a global leader in science and technology, the Government has invested in new and upgraded infrastructure and medical research facilities, in addition to $620 million in grants to support research and development in science, technology and innovation.

The Government has also helped create greater scope for improved productivity and capacity of Victoria's workforce through significant investments in social and economic infrastructure projects and health and education services. Over the last 18 months the Government has announced major policy commitments in the areas of education and training, health, transport and the environment through a number of statements, including:

- *Maintaining the Advantage: Skilled Victorians* – a $241 million statement to provide greater opportunities for people to participate in vocational education and training and extend their skills throughout their working life;
- *Healthy Futures* – a $230 million statement designed to ensure that Victoria's medical research base is well placed as a world leader in translating scientific research into practical benefits;
- *Meeting Our Transport Challenges* – a commitment of $10.5 billion over 10 years towards improving Victoria's transport network;
- *Our Environment Our Future* – over $200 million towards an environmental sustainability action plan; and
- *Moving Forward* – a $502 million package that provides support for provincial Victoria to meet new challenges and capture opportunities for growth.

However continued increases in the standard of living of Victorians will hinge on actively pursuing reform possibilities to increase workforce participation and productivity and improve business competitiveness, as well as developing policy responses to the challenge of climate change.

INCREASING WORKFORCE PARTICIPATION AND PRODUCTIVITY

The long economic expansion experienced by the State and at the national level has exhausted much of the economy's excess capacity, and Victoria's longer-run economic prospects will be largely determined by developments in the labour force and labour productivity.

The main challenge facing labour force participation comes from the projected ageing of the population. The proportion of the Victorian population aged 65 years and over is projected to rise from currently around 14 per cent to 20 per cent by June 2026. As baby boomers retire, labour force participation rates will decline. The Department of Treasury and Finance estimates that the impact of population ageing could reduce Victorian GSP by 4.6 per cent by 2020 and 8.6 per cent by 2030.

Victoria and Australia more generally enjoyed strong labour productivity growth in the 1990s. This performance owed much to a range of economic reforms enacted over the 1980s and 1990s, such as financial market deregulation, trade liberalisation and National Competition Policy. However, as outlined in Chapter 2, *Economic Conditions and Outlook* labour productivity growth has slowed noticeably in the current decade.

The National Reform Agenda

Within Victoria, and in conjunction with the Commonwealth and other States and Territories, the Government is pursuing a third wave of economic reform. The Council of Australian Governments (COAG) endorsed the need for a National Reform Agenda (NRA) in February 2006, focusing on reforms in human capital, better regulation and competition to raise living standards in Australia by lifting productivity and workforce participation over the next decade and beyond.

Modelling by the Productivity Commission (PC) released in February 2007 confirms previous estimates of the Department of Treasury and Finance of the large economic benefits that stand to be gained from a NRA. Combining the PC's estimates of the impact of competition and regulation reform, greater efficiency in health service delivery and improvements in our human capital, suggests that the NRA could boost GDP by up to 11 per cent after 25 years, which equates to approximately $100 billion a year in terms of today's economy.

Some progress has been made in discussions within COAG towards the NRA. Importantly, COAG agreed the institutional arrangements that will support the implementation of initiatives under the NRA. The COAG Reform Council (CRC) has been established to both monitor progress in implementing COAG agreed NRA reforms and assess the costs and benefits of reforms referred to it by COAG. Multiple reform areas in regulation and infrastructure have now been referred to the CRC.

However, much more needs to be done, especially in advancing initiatives in health, education and early childhood development if the initial promise of the COAG process is to be achieved. In the meantime, Victoria will continue to work within its own capacity to progress key reform options.

Maximising Victoria's Human Capital

The knowledge and skills of Victoria's workforce can be enhanced significantly by further improvements in vocational education and training, improving literacy and numeracy levels in schools, and the provision of targeted early childhood programs. At the same time, prevention and early detection of disease could improve the health of the population and contribute to greater workforce participation and productivity.

Vocational education and training

Higher skills are associated with higher levels of productivity, faster productivity growth and higher participation. Victoria's skilled workforce provides an economic advantage for the State in the face of competition from resource rich states for labour and capital.

An ageing population, increasing global economic integration, technological advances and changing work preferences are changing the pattern of demand for training. A significant change has been the shift in the demand for training from providing one-off, full-time, entry level training for school leavers to providing multiple episodes of part-time training to up-skill adult workers. The vocational education and training (VET) sector needs to be able to respond quickly and flexibly to these changes to help lift Australia's productivity growth and workforce participation.

Allowing public VET providers a high degree of autonomy from central controls is one way of allowing these providers to be responsive to changing demand for training. Victoria has the most decentralised public VET sector in Australia which enables Victorian TAFE institutes to operate on a more commercial basis than TAFE institutes in other States. According to the Commonwealth government, compared to other States, Victoria's TAFE institutes:

- are more flexible in delivering courses and training;
- can adjust to new course demands faster;
- are able to develop customised curriculum to suit individual and employer requirements;
- raise the largest amount of revenue; and
- have more overseas campuses and more students studying for a Diploma.[1]

Despite this success, further reform could improve the sector's responsiveness to address skill shortages. Some of this reform needs to occur at a national level in cooperation with State, Territory and Commonwealth governments. However, as State governments are primarily responsible for funding and regulating the VET sector, there is potential for change without waiting for national agreement.

Schools and early childhood

The State's vision for early childhood development aims to help children succeed in life and learning by delivering a system of integrated, high quality and accessible early childhood services. The Government's release in April 2007 of Victoria's Plan to Improve Outcomes in Early Childhood sets out a series of reforms to achieve this within a framework to improve antenatal care, strengthening the health, development and learning of zero to five year olds, enhancing the provision of early childhood education and care services and improving the early years workforce. In its Plan, Victoria proposes:

- a more professional early childhood education and care workforce;
- stronger universal early learning services for three and four-year olds and the eventual integration of child care and kindergarten; and
- better targeting of resources and services to disadvantaged children and their families.

In time, investment in early childhood development will accrue substantial benefits to the individual, families and the community. Benefits will take the form of better health outcomes, improved educational outcomes, higher rates of labour force participation, lower rates of dependence on the social security system and lower crime rates.

[1] Robb, A. (2007), *Training Our Workforce For Tomorrow,* Speech to the National Press Club, 14 March, Canberra

In April 2007 the Government also released a 10 year Plan to Improve Literacy and Numeracy Outcomes, directed toward making sure Victoria has quality teachers, fosters a culture of continuous improvement in schools and targets resources to where they are needed most. Through a proposed joint state and Commonwealth investment of approximately $924 million, various initiatives, such as increasing the use of literacy and numeracy specialist teachers and an additional 50 places in the current Victorian Career Change Program will drive educational improvement. Over a 10 year period, the plan aims to achieve:

- a 25 per cent reduction in the number of students that do not meet the national minimum benchmarks levels of achievement in literacy and numeracy testing for years 3, 5, 7 (and from 2008 year 9); and
- a 10-15 per cent improvement in the number of students reaching a medium benchmark level of achievement in literacy and numeracy testing for years 3, 5, 7 (and from 2008 year 9).

At the April 2007 meeting of COAG, First Ministers agreed to national standards for teachers and school leaders, quality assurance and regulation of child care and kindergarten, and a nationally enacted school entry assessment system. This is a step forward for national collaboration, but more needs to be done, in particular commitment to and funding for real reform as expressed in Victoria's State Action Plans.

A healthy workforce

An ageing population and rising community expectations mean that the demands on the health system will be significant. Reducing the load on the system in critical areas, through maintaining people's health for longer and dealing more effectively with chronic diseases will be critical to managing these growing demands. At the same time, ensuring a healthy workforce population to generate economic growth will be essential to support rising health care costs.

Preventable chronic diseases account for a large proportion of Australia's total health spending and have a high cost in terms of lost workforce participation and reduced productivity. Chronic diseases such as lung cancer, type 2 diabetes and cardiovascular disease are caused by a combination of risk factors, both avoidable and non-avoidable, as well as other determinants. Avoidable risk factors include smoking, excess weight and physical inactivity. Successfully tackling avoidable risk factors is important to increase the sustainability of Australia's health system.

Management of existing chronic disease can also be undertaken more effectively. It is increasingly recognised that quality care across the health care system can reduce the likelihood of hospitalisation. This inevitably requires cooperation across a range of service providers and levels of government.

COAG has identified the reduction of the incidence of chronic disease as an important way of improving Australia's future workforce participation and productivity. COAG discussions to date have focussed on the prevention, early detection and improved management of type 2 diabetes. With rising levels of obesity in the community, type 2 diabetes is expected to show the strongest growth in incidence of any chronic disease. Type 2 diabetes is largely preventable, provided people can lose weight, or avoid becoming overweight or obese. Further, without adequate management, individuals with type 2 diabetes are between two and five times more likely than the general population to have a heart attack or stroke. In April 2007, COAG announced a cost sharing package of $200 million involving the Commonwealth and the States and Territories to combat diabetes.

Victoria's own proposals for diabetes envisage a larger program over time. Key features of Victoria's proposal include initiatives related to:

- primary prevention to target modifiable lifestyle risk factors associated with type 2 diabetes;
- early detection and intervention of those at risk of type 2 diabetes or undiagnosed; and
- integrated health care for people with type 2 diabetes.

Other chronic diseases, such as mental illness, cancer and arthritis also have significant effects on quality of life and labour force participation. Options to prevent and better manage these diseases will need to be developed. The upcoming renegotiations with the Commonwealth Government for a new Australian Health Care Agreement provide an opportunity to encourage health system reform. The current agreement, which expires in 2008, is the major funding instrument for joint Commonwealth-State investment in the acute health system.

IMPROVING BUSINESS COMPETITIVENESS

Strong world growth, and the associated minerals commodity boom, has pushed up the Australian dollar and placed pressure on Victoria's exporters and import-competing businesses. Further pressure from global competition, especially from China, has forced Victoria's manufacturers to move toward high value-add and niche markets.

Continued reduction of business costs, including tax changes as detailed in Chapter 3, 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.

Regulatory Reform

In July 2006, the Government released the *Reducing the Regulatory Burden* initiative, Victoria's policy for reducing the cost of regulation for businesses and not-for-profit organisations. Victoria's strategy commits the Government to reducing both the administrative and compliance burdens of regulation. 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.

As part of its 2006 election policy, the Government also made a further commitment to reducing the complexity of regulation through reducing the number of pieces of primary legislation in Victoria by 10 per cent by the end of the current term.

The Government has been at the forefront of multijurisdictional action to reduce the burden of regulation. Victoria has taken a leading role in discussions within the Council of Australian Governments (COAG), the Council for the Australian Federation (CAF), 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. At its April 2007 meeting COAG made progress on several issues identified as regulatory hotspots. This included: implementing nationally consistent rail safety regulation; establishing a national system for trade measurement; and ensuring best practice regulation making and review processes applying to the Building Code of Australia. COAG also agreed to work on:

- harmonising occupational health and safety legislation;
- improving the efficiency of the environmental assessment and approval processes;
- developing a model to deliver a seamless, single online registration system for Australian Business Numbers; and
- an in principle agreement to establish a national system for the registration of personal property securities.

In addition CAF has agreed to prioritise reducing the complexity of State and Territory-based regulatory requirements for individuals who move from one jurisdiction to another, for example the processes for registering a motor vehicle in another State.

Infrastructure investment and reform

An efficient and productive infrastructure network is essential to support ongoing economic growth and development. Anticipated population growth will place increasing demands on the road and rail network and energy infrastructure. For example, Victoria's road freight and passenger movement tasks are expected to grow by 50 per cent and 25 per cent respectively by 2020. Public transport patronage is forecast to grow at an annual rate of between 3-4 per cent into the future. Victoria will also require new baseload electricity investment from as early as 2010-2015.

The Government has already signalled its commitment to the long term future of the State's road and rail network by assigning $10.5 billion in the *Meeting Our Transport Challenges* statement to upgrade and improve public transport services and road and rail infrastructure over ten years. In addition, the Government has identified a number of significant infrastructure investments essential to ensuring continued economic growth including expansion of the Port of Melbourne, and consideration of options for a new East-West transport link to alleviate congestion on the Monash-West Gate corridor.

While Victoria is a leading state in the area of infrastructure reform, additional productivity gains will accrue to the State from improved operation of national markets, and ongoing efforts to streamline and harmonise infrastructure regulation at the national level. COAG has agreed to a competition stream of reform under the NRA. This work program builds on and extends the national competition policy reforms of the 1990s.

A key national initiative – the Competition and Infrastructure Reform Agreement – provides for simpler, consistent, light handed approach across the nation to the economic regulation of significant infrastructure such as ports and rail. COAG has also endorsed a suite of long term heavy vehicle pricing reforms to ensure there is a clearer link between road use, demand, returns to asset owners and investment needs.

A number of initiatives designed to improve the function of the national energy market have also been endorsed by COAG. The key reforms in this area are the establishment of a National Energy Market Operator for both electricity and gas, which will encompass a new national electricity transmission planning function, and a national mandated roll-out of electricity smart meters to areas where the benefits outweigh the costs.

Innovation and research and development

Government's role in supporting innovation encompasses creation of a conducive regulatory environment, support for skill development, and encouragement of close collaboration and ties between government, industry and educational institutions.

In Victoria, the Government's active support for innovation is encapsulated in the Science, Technology and Innovation initiative, which builds Victoria's capabilities in scientific research and development and supports the development of new technologies and their adoption by industry.

The Victorian Government has called for all Australian governments to be engaged with the development of a National Innovation Agenda (NIA) with the following goals:

- increasing business innovation – since business and industry are the key players in converting knowledge and ideas into products and services for the local and global economy;
- providing the infrastructure to enable innovation – innovation enabling infrastructure is a component of economic infrastructure that supports the generation, dissemination and commercialisation of knowledge;
- developing skills for the innovation economy – skills in generating, integrating, adapting and applying new knowledge, technologies, processes and products are equally critical to driving innovation across the economy;
- creating a better regulatory environment for innovation – regulation can be a driver of innovation, particularly in areas such as health, safety and the environment, and may be required for the smooth introduction of new technologies; and
- forging better connections and collaborations – innovation generally occurs more rapidly and with greater intensity and effectiveness where there is a higher degree of collaboration.

The NIA will encourage the development of a program of collective actions by Australian governments to boost productivity and maximise the outcomes of innovation for the national economy. The NIA seeks to engage industry and innovation institutions in developing and implementing these actions.

RESPONDING TO CLIMATE CHANGE

In the past twelve months, there has been a fundamental shift in the climate change debate from a scientific focus to an emerging consensus that climate change presents a significant threat to long-term economic prosperity if no action is taken.

Internationally, the recent UK *Stern Review Report on the Economics of Climate Change* identified that the cost of doing nothing on climate change could lead to an average reduction in global per capita consumption of between 5 per cent and 20 per cent. While such figures are subject to uncertainty and should be treated with caution, it is clear that climate change presents a major long-term economic challenge for Victoria.

In Australia, some key areas at risk from climate change are water security, primary production, infrastructure assets, tourism, coastal settlements and the energy sector. These impacts will not be uniform because Australia is made up of many different climates, and regions characterised by different energy, water and environmental assets, land uses and industry structures.

Climate change has the potential to place significant additional claims on government finances – for example, to protect public assets, provide disaster relief and response, mitigate new health risks and protect against new bio-security risks.

Furthermore, in a future carbon and water constrained world, the competitive strength afforded by Australia's abundant natural resource endowments has the potential to be eroded. This highlights the need for a strong, resilient and flexible economy that will foster innovation and productivity in order to offset any erosion of Victoria's competitive strengths and broader economic impacts of climate change.

The role of government in responding to climate change

Climate change is an issue that will affect the whole community and, therefore, responsibility for responding to climate change should be shared by all levels of government, business and the wider community.

Long-term policy responses are needed that are adaptable and regularly reviewed in light of changing scientific and economic developments. Overall policy responses should be as efficient as possible. For example, where new regulations are required to respond to climate change, it is important that the compliance burden is minimised and appropriate regulatory offsets are sought. Further, where practicable, the use of market-based incentives and instruments, such as pricing and trading, should be encouraged.

Governments have a number of key roles in responding to climate change, including:

- providing information to enable the community and business to prepare for the possibility of more frequent adverse climatic events;

- ensuring continuity of essential services, such as water supply and electricity, that could be adversely affected by reduced rainfall or extreme weather events;
- providing interim emergency and welfare assistance in response to disasters and droughts;
- providing a certain policy environment that promotes least-cost carbon abatement measures such as emissions trading and, as far as possible, avoiding policies that favour particular technologies or industries;
- building capacity in industry to take advantage of the opportunities presented by climate change – for example, by supporting research and development and creating a conducive policy environment for long-term investment decisions;
- enhancing water trading, and adopting a flexible and adaptive approach to management of Victoria's water supply systems;
- ensuring the appropriate allocation of climate-related risk between government and the private sector, and facilitating the effective operation of insurance markets to manage climate change risk;
- facilitating structural adjustment in the Victorian economy; and
- protecting the community against biosecurity and health risks associated with climate change.

Water supply

Below-average rainfalls over the past decade suggest our climate may already be changing, creating uncertainty as to what future rainfall patterns will look like. In the past, Victoria's strategy for securing its water supplies was to build large storage facilities such as reservoirs and dams. However, with impending climate change bringing greater uncertainty about future rainfall patterns, Victoria will need diverse and flexible strategies to manage the State's water supply and ensure security of supply at least cost to society.

The Government has announced or has underway a number of initiatives to augment supplies for various regions and both consumptive and environmental purposes. These include:

- the Wimmera Mallee Pipeline, a major strategic water supply augmentation involving the replacement of over 16 000km of open channels with some 8 800km of reticulated pipe line;
- the Goldfields Superpipe, which will provide for additional supplies to Bendigo and Ballarat;
- the reconnection of Tarago Reservoir to supply an additional 15 000ML by 2009; and
- an upgrade of Melbourne's Eastern Treatment Plant to treat wastewater to Class-A standard and maximise future recycling opportunities.

In future, Victoria will need to diversify its sources of water supply and consider options that are not rainfall dependent. The Government has announced feasibility studies and the development of business cases for:

- the harvesting of groundwater as a new source of water for Geelong;
- the construction of a channel to bypass the Barmah Choke and deliver more water into the Goulburn irrigation system; and
- several alternative large-scale water supply augmentation options to meet Melbourne's future water demand – including the Eastern Water Recycling Project proposal, a desalination plant and stormwater reuse. The Government is also examining the newly proposed north-south pipeline.

The Government will also consider a broad range of demand-side options, including water efficiency measures and scarcity-based pricing. The current drought has highlighted the potential of water trading, which has been of significant assistance to irrigators by giving them the opportunity to more effectively adapt their business operations to the circumstances. Buyers and sellers can trade either permanent entitlements or temporary allocations depending upon their individual needs and preferences, allowing them to purchase water to assist crop and livestock enterprises to survive or to provide an alternative source of income for irrigators who choose to sell water.

There remains significant scope to expand water markets by building interconnecting infrastructure. Interconnecting our water supply systems will maximise flexibility for water sharing across regions and between uses, making the best use of the available capacity within the system. It could also create much wider opportunities for large water users to engage in water trade. In designing systems, it remains important to maintain incentives for private businesses and individuals to plan ahead for changing climate conditions.

Greenhouse gas emissions

In response to the challenge of managing greenhouse gas emissions, the Government has set a target of reducing Victoria's greenhouse gas emissions by 60 per cent by 2050, and has a range of other policies in place that are transitioning the economy towards achieving this target. These include:

- support for a National Emissions Trading Scheme, that would provide flexibility for emitters to find the least cost method to reduce their emissions;
- support for the development and deployment of low emissions technology – for example, through the Energy Technology Innovation Strategy, Victorian Renewable Energy Target scheme and the Clean Coal Authority; and
- demand-side policies focused on improving Victoria's energy efficiency – for example, through the Victorian Energy Efficiency Target scheme, and rebates to assist households purchase energy efficient products.

Strategies to mitigate the risk of further climate change will require deployment of the lowest economic cost greenhouse gas abatement policy tools available. Given the relative energy intensity of Victoria’s economy, this will be critical to Victoria’s future competitiveness.

FUTURE DIRECTIONS

The challenges discussed above are substantial and should be addressed in a collaborative way by all levels of Australian government. Some progress has been made, and important first steps have been taken. However, there is more to be done before this process achieves the potential gains to economic growth of the NRA confirmed by the Productivity Commission, and the challenges posed by climate change are addressed.

The success of the NRA will depend on genuine reform, governance and funding. While an appropriate governance framework is being developed, existing intergovernmental arrangements (such as Specific Purpose Payments) should not set a precedent for funding arrangements. As discussed in Chapter 5, *Commonwealth-State Financial Relations*, intergovernmental arrangements should reflect a spirit of co-operation between governments, defining broad principles, outcomes and measures of progress. Like the approach taken to the NRA, Victoria is proposing to work with all States and the Commonwealth to develop new models for funding distribution to achieve better outcomes for everyone.

In the face of long term challenges to economic growth and prosperity, the Government will continue to work actively with all levels of government to progress the goals of the NRA, in conjunction with developing and implementing specific economic reforms for Victoria, so as to achieve better outcomes for all Victorians.

ABBREVIATIONS AND ACRONYMS

13FISH	Fisheries Offence Reporting Line
4WD	Four Wheel Drive
AAS	Australian Accounting Standard
A-IFRS	Australian - International Financial Reporting Standards
ABS	Australian Bureau of Statistics
ACAS	Aged Care Assessment Services
ACE	Adult and Community Education
ACMI	Australian Centre for the Moving Image
ATO	Australian Tax Office
BIA	Business Impact Assessment
CALD	Culturally and Linguistically Diverse
CAV	Consumer Affairs Victoria
CBD	Central Business District
CCS	Carbon Dioxide Capture and Geological Storage
CCTV	Closed Circuit TV
CERT	Community Emergency Response Teams
CFA	Country Fire Authority
CGF	Commonwealth Games Federation
CGC	Commonwealth Grants Commission
CMA	Catchment Management Authority
CMYI	Centre for Multicultural Youth Issues
CO_2	carbon dioxide
COAG	Council of Australian Governments
CRC	Cooperative Research Centre
CSF	Community Support Fund
DDA	*Disability Discrimination Act*
DHS	Department of Human Services
DIIRD	Department of Innovation, Industry and Regional Development
DOE	Department of Education
DOI	Department of Infrastructure
DOJ	Department of Justice
DPC	Department of Premier and Cabinet
DPI	Department of Primary Industries
DSE	Department of Sustainability and Environment
DTF	Department of Treasury and Finance
DVC	Department for Victorian Communities
ECIS	Early Childhood Intervention Services

EES	Environment Effects Statements
EOC	Equal Opportunity Commission
EPA	Environment Protection Authority
ESSS	Emergency Services Superannuation Scheme
ETIS	Energy Technology Innovation Strategy
FFG	*Flora Fauna Guarantee Act 1988*
FINA	International Swimming Federation (Fédération Internationale de Natation)
FMA	*Financial Management Act 1994*
FreeZA	Drug and Alcohol Free Zone
FTE	Full-time Equivalent
GBE	Government Business Enterprise
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GLM	Government Land Monitor
GP	General Practitioner
GSP	Gross State Product
GST	Goods and Services Tax
GVT	*Growing Victoria Together*
HACC	Home and Community Care
HFE	Horizontal Fiscal Equalisation
HIH	Health International Holdings
ICN	Industry Capability Network
ICT	Information and Communications Technology
ICU	Intensive Care Unit
IGA	Intergovernmental Agreement
IMF	International Monetary Fund
IRI	International Roughness Index
IT	Information Technology
ITIL	Information Technology Infrastructure Library
LFS 2006	*Labor's Financial Statement 2006*
LHS	Left Hand Side
M2030	Melbourne 2030
M&CH	Maternal and Child Health
MAV	Municipal Association of Victoria
MCEETYA	Ministerial Council on Education, Employment, Training and Youth Affairs
MFESB	Metropolitan Fire and Emergency Services Board
MIP	Managed Individual Pathway
MSAC	Melbourne Sports and Aquatic Centre
MYEFO	Mid–Year Economic and Fiscal Outlook
NA	Not available or Not applicable
NIA	National Innovation Agenda

NILS	No Interest Loans Scheme
NRA	National Reform Agenda
OCI	Office of the Chief Investigator
OCIO	Office of the Chief Information Officer
OHS	Occupational Health and Safety
PARCS	Prevention and Recovery Care Services
PC	Productivity Commission
PDRSS	Psychiatric Disability Rehabilitation and Support Services
PFC	Public Financial Corporation
PNFC	Public Non-Financial Corporations
PROV	Public Record Office of Victoria
RAS	Royal Agricultural Society
RBA	Reserve Bank of Australia
RCH	Royal Children's Hospital
RDV	Regional Development Victoria
RFR	Regional Fast Rail
RFT	Request for tender
RHS	Right Hand Side
RIDF	Regional Infrastructure Development Fund
RIS	Regulatory Impact Statement
RSPCA	Royal Society for Prevention of Cruelty to Animals
SAAP	Supported Accommodation Assistance Program
SEES	Supplementary Environment Effects Statement
SEITA	Southern and Eastern Integrated Transport Authority
SES	State Emergency Service
SEV	Standard Equivalent Value
SPP	Specific Purpose Payment
SRS	Supported Residential Services
SSA	Shared Supported Accommodation
SSF	State Superannuation Fund
STDF	Small Towns Development Fund
STI	Science, Technology and Innovation
TAC	Transport Accident Commission
TAFE	Technical and Further Education
TEI	Total Estimated Investment
TER	Total Estimated Return
U3A	University of the Third Age
UNESCO	United Nations Educational, Scientific, and Cultural Organization

VAGO	Victorian Auditor-General's Office
VCAL	Victorian Certificate of Applied Learning
VCE	Victoria Certificate of Education
VCEC	Victorian Competition and Efficiency Commission
VEC	Victorian Electoral Commission
VECCI	Victorian Employers' Chamber of Commerce and Industry
VEOHRC	Victorian Equal Opportunity and Human Rights Commission
VERS	Victorian Electronic Records Strategy
VET	Vocational Education and Training
VGBO	Victorian Government Business Offices
VGSO	Victorian Government Solicitor's Office
VICERS	Vigilance Control and Event Recording System
VICNISS	Victorian Hospital Acquired Infection Surveillance System
VICSES	Victoria State Emergency Service
VIMP	Victorian Initiatives for Minerals and Petroleum
VIS	Victorian Institute of Sport
VLRC	Victorian Law Reform Commission
VMIA	Victorian Managed Insurance Authority
VPHS	Victorian Population Health Survey
VPS	Victorian Public Service
VRHS	Victorian River Health Strategy
VSLGA	Victorian State-Local Government Agreement
VWA	Victorian WorkCover Authority
WIES	Weighted Inlier Equivalent Separations
WPP	Workforce Participation Partnerships
YACVic	Youth Affairs Council Victoria

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.

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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2007-08 Strategy and Outlook

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State Government Victoria

Department of Treasury and Finance