

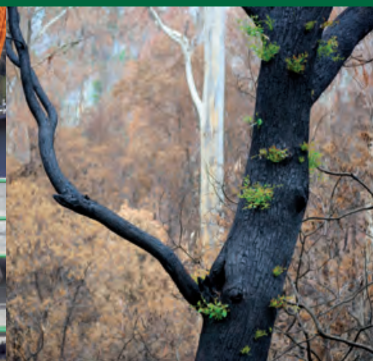


VICTORIAN BUDGET

2009-10 Strategy and Outlook

Budget Paper No. 2

Presented by John Lenders MP
Treasurer of the State of Victoria

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Strategy and Outlook

2009-10

Presented by

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Treasurer of the State of Victoria

for the information of Honourable Members

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INTRODUCTION

Budget Paper No. 2, *Strategy and Outlook*, describes the State's economic and financial position and performance while also outlining its fiscal strategy. This budget paper analyses the effects of the current global economic downturn on the Victorian economy. It demonstrates the State's commitment to responsible fiscal management in these challenging times, using operating surpluses to underwrite increased investment in productive infrastructure to support key services.

This budget paper takes into account the financial impacts of all policy decisions taken by the Victorian Government, as well as Commonwealth Government funding revisions and other information that affects the projected general government (GG) sector financial statements as at 29 April 2009 unless otherwise stated. Financial impacts of decisions taken after that date, including the April meeting of the Council of Australian Governments will be reflected in the *2009-10 Budget Update*.

Budget Paper No. 2 is the primary source for information on the State's financial performance and forward projections, and consists of the following chapters and appendices.

Chapter 1 – Economic and Fiscal Strategies and Objectives

Chapter 1 focuses on the Victorian Government's economic and fiscal strategies in the context of the *2009-10 Budget*, including the impact of the global and domestic economic downturn. It details Victoria's five financial policy objectives, which embody the principles of sound financial management, and discusses how the *2009-10 Budget* will contribute to the achievement of these goals.

Chapter 2 – Economic Conditions and Outlook

Chapter 2 provides an overview of the current economic conditions in Victoria in the context of the global financial climate. It provides a detailed discussion of the projected trends in the key measures of economic growth; gross state product, employment, unemployment, inflation, wages and population. The chapter also details the key risks and challenges facing the Victorian economy.

Chapter 3 – Budget Position and Outlook

Chapter 3 outlines the GG budget position as well as the forward years estimates. It shows how the Government's economic and fiscal strategy, outlined in Chapter 1, will impact on the GG sector's financial performance and position in the context of the economic environment, as discussed in Chapter 2.

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

Chapter 4 – Financial Sustainability of Victorian Government

Chapter 4 presents an overview of the activities of the broader public sector by adding the State's public non-financial corporations (PNFCs) to the GG sector's financial information, as presented in Chapter 3.

This chapter explains how the fiscal aggregates contribute to the Government's objective of maintaining net financial liabilities at prudent levels, including the maintenance of a triple-A credit rating.

Chapter 5 – Economic Reform Agenda

Chapter 5 discusses Victoria's economic reform agenda. The current economic downturn has reinforced the need for Victoria to pursue its vigorous program of reform to ensure that the State is well placed for the economic upturn, and to address medium and long-term challenges.

The chapter provides an overview of reforms underway to address the challenges posed by slowing economic growth, an ageing population and climate change. It identifies opportunities for further or accelerated reform as a result of the current downturn. The chapter also includes analysis of developments at the national level, including an overview of new Commonwealth-State financial arrangements.

Appendix A – Operating Statement Reconciliation

Appendix A reconciles the movement in the State's forward estimates between those in the *2008-09 Budget Update* and those in the *2009-10 Budget*. As part of this reconciliation, explanations are provided on the key elements driving the movements in estimates.

Appendix B – Sensitivity Analysis Table

Appendix B details the economic indicators and assumptions underpinning the forward estimates from 2009-10 and illustrates the impact that changes to these assumptions will have on the State's budget position.

CHAPTER 1 – ECONOMIC AND FISCAL STRATEGIES AND OBJECTIVES

- The *2009-10 Budget* confirms Victoria's strong fiscal position, despite the substantial adverse impact of the Global Financial Crisis. The Government is forecasting an operating surplus of $165 million in 2009-10, and an average of $349 million over the forward estimates period.
- Victoria's economy faces a much more challenging economic environment than it has for many years, and there are risks that the outlook could be worse than forecast.
- The Government has reassessed its short-term operating surplus target to ensure it remains relevant, and has revised the target from at least 1 per cent of revenue to at least $100 million to allow for the delivery of vital services and the provision of key infrastructure, while maintaining a sound fiscal position.
- The budget includes measures designed to support economic activity and secure jobs, and to assist recovery from the February 2009 bushfires. It also positions the State for long-term growth in production and employment as global conditions recover.
- Net infrastructure investment is projected to be $7 billion in 2009-10 and an average of $4.4 billion a year from 2010-11 to 2012-13. This investment will help to cushion Victoria from the worst effects of the Global Financial Crisis by securing 35 000 jobs and build capacity for future strong growth.
- Strong, sustainable state finances remain essential to the long-term health of the Victorian economy. They underpin the State's triple-A credit rating, low borrowing costs and a stable economic environment, which together maintain business and consumer confidence and drive investment and jobs growth.
- Reflecting the Government's substantial infrastructure program, general government net debt will increase to 5.1 per cent of gross state product (GSP) in 2012-13. The Government is committed to maintaining debt at prudent levels and will achieve this by constraining expenditure growth, maintaining operating surpluses and reducing borrowings in the medium term.

THE ECONOMY AND THE BUDGET

The Government is forecasting an operating surplus (net result from transactions) of $165 million in 2009-10, with an average of $349 million over the forward estimates period.

The budget has been framed against a deteriorating global and local economic environment and reflects the impact of slower growth on government finances. In particular, GST revenue and state taxation revenue forecasts have been revised down significantly since the *2008-09 Budget*, although revenue overall has been revised up primarily because of larger grants from the Commonwealth for specific purposes, including under the *Nation Building – Economic Stimulus Plan*. The budget includes measures designed to support economic activity and protect jobs through the downturn, and to assist recovery from the Victorian 2009 bushfires.

The budget also positions the State for long-term growth in production and employment as global conditions recover, maintaining a strong, sustainable fiscal position and building Victoria's infrastructure, skills and human capital in line with the Government's longer-term economic and fiscal strategies. The Government remains committed to delivery of key services in health, education and community safety.

Strong, sustainable state finances remain essential to the long-term health of the Victorian economy. They underpin the State's triple-A credit rating, low borrowing costs and a stable economic environment, which maintain business and consumer confidence and drive investment and jobs growth. The *2009-10 Budget* represents a strong response to short-term adverse economic circumstances, while also demonstrating the Government's commitment to prudent fiscal management and reform that will position the State to take advantage of improvements in economic conditions.

CURRENT ECONOMIC CONDITIONS AND OUTLOOK

The economic outlook for Victoria has deteriorated in the face of the Global Financial Crisis. Large falls in financial asset prices nationally and internationally have reduced household wealth and consumer confidence, leading to weakness in consumer spending. A decrease in business confidence and tightening credit conditions are likely to lead to large declines in private business investment. In line with national trends, the Victorian labour market has also softened. The unemployment rate increased sharply over the year to 5.7 per cent in March compared with just above 4 per cent a year earlier.

Victoria faces a much more challenging economic environment than it has for many years and risks remain on the downside. Further detail on the economy and the economic outlook is in Chapter 2, *Economic Conditions and Outlook*.

RESPONDING TO CURRENT CHALLENGES

Global Financial Crisis

The global nature and extent of the current downturn present major challenges for governments and monetary authorities.

In Australia, the Reserve Bank has reduced the cash rate by 4.25 percentage points since September 2008, bringing the official interest rate to 3 per cent, its lowest level in almost 50 years. Reductions in mortgage interest rates have improved housing affordability and, together with the stimulatory effect of the *First Home Owner Boost*, have resulted in a tentative recovery in dwelling approvals in Victoria. Despite the easing in monetary policy, conditions in the business sector are still affected by constrained access to credit and high borrowing costs.

The Commonwealth Government has introduced substantial measures to support economic activity, including over $50 billion in spending on major stimulus packages since October 2008.

Victoria is working actively with the Commonwealth Government to implement projects funded through the *Nation Building – Economic Stimulus Plan*, as well as through a series of National Partnerships designed to improve services in education, health and housing. Victoria will also leverage Commonwealth labour market programs and target increased education, training and retraining opportunities to help school leavers and retrenched workers position themselves for recovery.

The Victorian Government will deliver a record infrastructure program, with a focus on projects that can start quickly and secure jobs. Net infrastructure investment is projected to be a record high of $7 billion in 2009-10 and will average $4.4 billion a year over the forward estimates period. This builds on the already large infrastructure program of recent years, of around $4 billion annually. The Government has provided funding for the delivery of the first stage of the *Victorian Transport Plan* and is also investing in essential infrastructure in the areas of housing, health and education.

These investments, funded by the Victorian Government and through the Commonwealth fiscal stimulus package, represent a large and targeted economic stimulus that will help to cushion the Victorian economy from the worst of the Global Financial Crisis, as well as prepare the State to take advantage quickly of the economic upturn by reducing infrastructure bottlenecks. Combined with significant projects being delivered through public-private partnerships and the public non-financial corporations sector, this investment program will secure up to 35 000 jobs in 2009-10.

The Government is also taking immediate action to fast-track major private sector development projects to support activity and employment. Since April 2009, the Government announced that it would fast-track ten significant projects, and more enduring planning and regulatory reforms are being developed. The Government is also committed to supporting residential construction activity through releasing land in a timely way and continuing to assist home buyers.

Victorian 2009 bushfires

The Government is investing in the recovery of bushfire affected towns and regions in response to the Victorian 2009 bushfires, one of the worst natural disasters in Australian history. The Government has established, in partnership with the Commonwealth, the Victorian Bushfire Reconstruction and Recovery Authority to oversee and coordinate the rebuilding of communities.

The Government is also working in partnership with the Red Cross and the Commonwealth Government to manage the unprecedented volume of donations generously provided by Victorians, Australians and the international community. A Royal Commission has been established to investigate the causes and response to the fires and to make recommendations to mitigate similar events occurring in the future.

Further detail on specific policy measures in this budget is provided in Budget Paper No. 3 Appendix A, *Output, Asset Investment and Revenue Initiatives*.

ENSURING LONG-TERM STRONG SUSTAINABLE GROWTH

The Global Financial Crisis and the resulting impact on the Victorian economy mean that the focus of the *2009-10 Budget* is on supporting economic activity and employment. In the current environment, the Government needs to support economic activity in ways that meet the needs of the community and build capacity for the future. This budget is a strong response to these difficult economic times.

However, the health of the Victorian economy over the medium term, especially its ability to support investment and generate jobs, also requires government to give high priority to ensuring that the conditions are in place to underpin strong growth as economic conditions improve.

The lessons of the past decade are instructive. Victoria's strong economic record has been supported by a combination of sound financial management, investment in the State's productive capacity and an ambitious reform agenda. These three building blocks for growth in production and jobs remain a priority for Victoria.

This budget demonstrates the Government's commitment to protecting the State's triple-A rating, ensuring a sustainable operating balance and helping to return the economy to a strong growth path.

At the same time, the Government is investing heavily in Victoria's infrastructure, skills and human capital, which will support strong growth in output and jobs in the future.

Victoria also remains committed to a vigorous reform program to improve competitiveness and take full advantage of the economic upturn when it comes, including through skills reform, infrastructure initiatives, and reducing the burden of state regulation on businesses. The economic downturn presents opportunities to accelerate reforms in areas such as education and training, which will strengthen the capability of the workforce for the future. The current environment also means that the public sector must continue to identify efficiencies in its own operations to protect jobs and maintain key services for a growing and ageing population.

Further detail on the Government's fiscal strategy and investment program is in the following section. Further detail on the Government's reform agenda is provided in Chapter 5, *Economic Reform Agenda*.

SUSTAINABLE FISCAL STRATEGY

The Victorian Government's fiscal strategy is underpinned by a set of key short-term and long-term financial policy objectives. These objectives are built on the following principles of sound fiscal management set out in the *Financial Management Act 1994* (the Act):

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

The Government's short-term and long-term financial objectives and targets are summarised in Table 1.1 below. Further detail on the objectives and a discussion of how the *2009-10 Budget* will continue to support their achievement is in following sections, and in Chapter 3, *Budget Position and Outlook.*

Table 1.1: 2009-10 Financial objectives and strategies

Objective	*Short-term target*	*Long-term target*
Operating surplus	Operating surplus of at least $100 million in each year	Maintain a substantial budget operating surplus that allows for the delivery of the Government's infrastructure objectives
Infrastructure	Implement strategic infrastructure projects	Deliver world-class infrastructure to maximise economic, social and environmental benefits
Service delivery	Implement the 2006 election commitments	Provide improved service delivery to all Victorians
Taxation	Implement reforms	Provide a fair and efficient tax system that is competitive with other states
Net financial liabilities	Maintain a triple-A credit rating	Maintain state government net financial liabilities at prudent levels

Source: Department of Treasury and Finance

Operating surplus

Despite the economic downturn, Victoria's fiscal position remains strong, and the prudent approach taken by the Government will ensure sustainable fiscal outcomes through the forward estimates period.

The Government remains committed to achieving its short and long-term operating surplus targets.

The Government has reassessed its short-term operating surplus target to ensure it remains relevant in the current fiscal and economic environment. The target has been revised from an operating surplus of at least 1 per cent of revenue (in the *2008-09 Budget*) to at least $100 million to allow for the delivery of vital services and the provision of key infrastructure, while also maintaining a sound fiscal position.

In the future, the Government is committed to returning to a budgeted operating surplus of at least 1 per cent of revenue. Budgeting for operating surpluses allows the Government to deliver on its infrastructure program to secure Victorian jobs, while maintaining net debt at prudent levels.

The Government is forecasting an operating surplus (net result from transactions) of $165 million in 2009-10, with an average of $349 million over the forward estimates period (see Chart 1.1).

In the short term, the operating surplus has been affected by a number of factors, including:

- lower state taxation and GST revenue as a result of the current economic downturn and Global Financial Crisis;

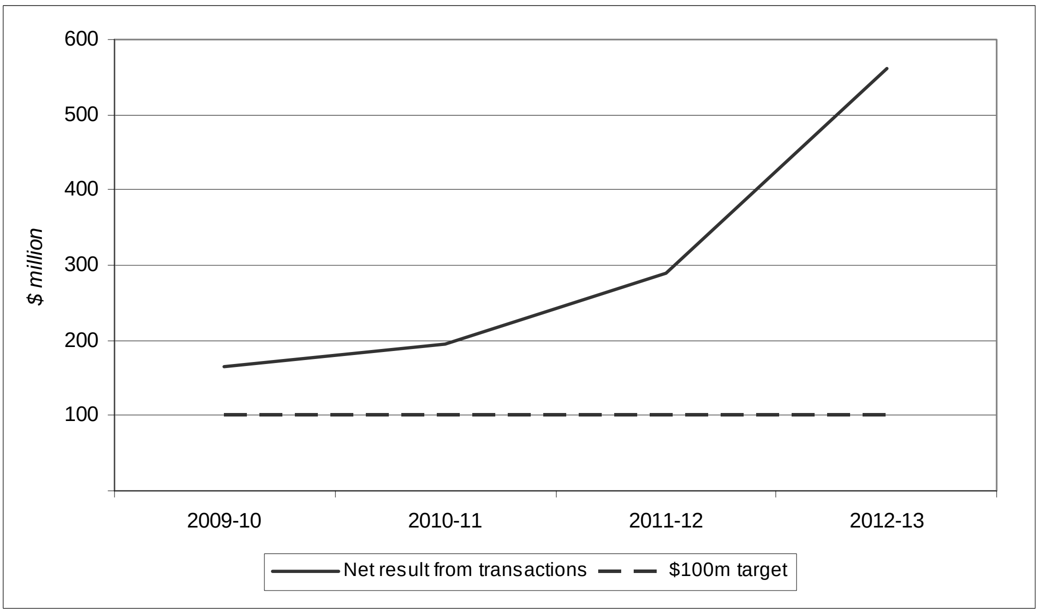
- policy measures taken by the Government to support activity and meet short-term needs, including for recovery from the Victorian 2009 bushfires; and
- the one-off Commonwealth Government fiscal stimulus package, which funds a mix of services and infrastructure; the associated expenditure is therefore recorded partially on the operating statement and partially on the balance sheet as part of the Government's infrastructure investment program.

Compared with the estimates published in the *2008-09 Budget Update*, the operating surplus is expected to be $247 million lower in 2009-10, and an annual average of $246 million lower from 2010-11 to 2011-12. Although economic growth is expected to be significantly lower and economic conditions have worsened, total revenue has been revised upwards since the *2008-09 Budget Update*. This primarily reflects payments from the Commonwealth for specific purposes, including under the fiscal stimulus package, partly offset by substantial reductions in State taxation and GST revenue.

Revenue and expenses are projected to grow by 1.6 per cent a year and 1.3 per cent a year on average, respectively, between 2009-10 and 2012-13.

Growth in revenue and expenses is similar in 2009-10 and 2010-11, but expenditure grows more slowly than revenue during the later forward estimates years. This widening gap between revenue and expenditure growth from 2011-12 reflects a rebuilding of the taxation base as economic conditions improve, and the Government's commitment to prudent management of operating expenditure.

Chart 1.1: General government sector net result from transactions



Source: Department of Treasury and Finance

Infrastructure

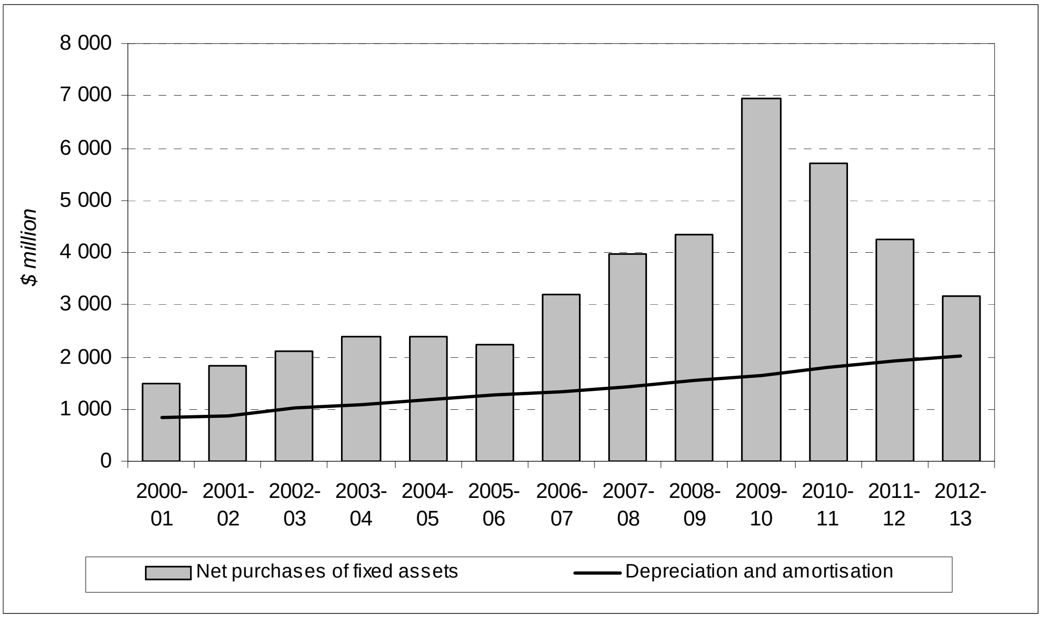
The Government continues to invest in strategic infrastructure projects to generate jobs in the short term and deliver world class infrastructure assets that generate economic, social and environmental benefits for current and future generations. These projects will help to ensure that Victoria is well positioned to take advantage of opportunities from the economic recovery.

Net infrastructure investment by the general government sector is projected to be a record $7 billion in 2009-10 and an average of $4.4 billion a year from 2010-11 to 2012-13 (see Chart 1.2).

The substantial investment in 2009-10 and 2010-11 reflects a temporary boost from the projects being funded by the Commonwealth fiscal stimulus package, as well as the exceptionally high levels of Victorian Government infrastructure investment. In 2011-12 and 2012-13, general government net infrastructure investment remains at historically high levels, even though the Commonwealth stimulus investment and substantial state initiatives will be almost concluded. Returning the state capital program to long-term sustainable levels is an important element of the Government's budget management strategy, and critical to ensuring that the State's budget remains on a prudent path within and beyond the forward estimates period.

Infrastructure investment is expected to exceed estimated depreciation between 2009-10 and 2012-13 (see Chart 1.2), resulting in growth of 9 per cent in the general government real capital stock over this period. The general government real capital stock is the accumulation of past acquisitions of land, buildings, infrastructure, equipment and intangible assets by the general government sector, less amounts used up in depreciation. It represents an important part of the State's capacity to grow, to deliver quality services, and to support private sector economic activity.

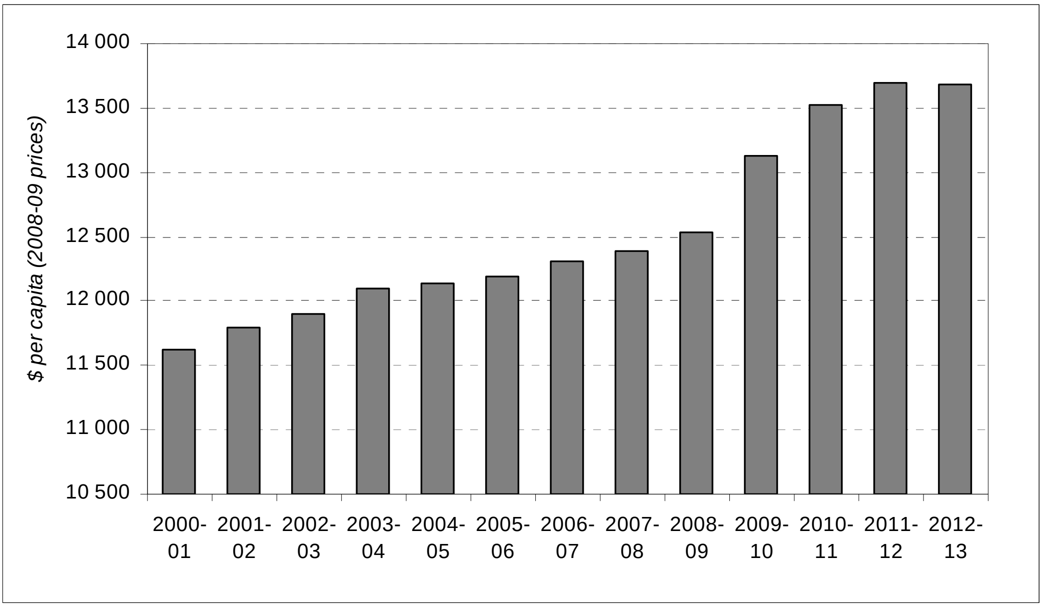
Chart 1.2: General government sector net infrastructure investment



Source: Department of Treasury and Finance

Growth in the general government real capital stock is expected to outstrip population growth, resulting in a significant rise in the average stock of public infrastructure for each Victorian (see Chart 1.3).

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



Source: Department of Treasury and Finance

Note:
(a) Real capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets in 2008-09 prices.

The *2009-10 Budget* delivers substantial funding commitments for the first tranche of initiatives under the *Victorian Transport Plan*, with $4.9 billion provided in partnership with the Commonwealth Government to deliver new services and infrastructure to transform Victoria's transport system.

Victoria is working actively with the Commonwealth Government to cushion the economy from the worst of the Global Financial Crisis and to ensure Victoria is well positioned to benefit from the expected economic recovery. In partnership with the Commonwealth, Victoria will deliver a $1.7 billion boost to social housing which will provide over 5 000 new dwellings and stimulate jobs in the construction sector.

Victorian government schools will receive a significant boost of $2.9 billion in infrastructure funding in this budget. This includes $402 million total estimated investment from the State Government to continue the rebuilding and modernising of all government schools under the *Victorian Schools Plan*, and $2.4 billion for Victorian education infrastructure under the Commonwealth Government's *Building the Education Revolution* initiative.

Outside the general government sector, significant investment will be delivered, including the construction of the Wonthaggi desalination plant and other projects from the Victorian Water Plan.

It is estimated that delivery of this overall program of infrastructure investment, coupled with Victoria's expected share (based on population) of the Commonwealth's three infrastructure funds, will secure up to 35 000 jobs in 2009-10. This includes an estimated 25 000 people working on these projects in construction and related services, plus up to 10 000 in other parts of the economy supplying materials, components and services for those projects.

Service delivery

The *2009-10 Budget* provides $6.5 billion over five years in funding for output initiatives. It also demonstrates the benefits of a cooperative relationship with the Commonwealth Government, with funding to implement a number of major initiatives agreed by the Council of Australian Governments in the areas of health, education, housing, skills and Indigenous services.

The budget provides $1.1 billion over the next five years for health and hospital services, including funding to meet Victoria's National Partnership commitments. Highlights include $781 million over five years for an expansion of hospital services to address increasing demand pressures, a $72 million investment in the health workforce and a $45 million boost for an elective surgery blitz.

In addition, there is also funding for *Mental Health Reform Strategy* initiatives and disabilities reform, with $84 million and $68 million respectively provided to enable people with mental health issues and disabilities to lead fulfilling lives and participate in the community.

Bushfire response and recovery measures have been allocated funding of $908 million over five years. This includes funding for fire suppression and emergency management of the Victorian 2009 bushfires, initiatives to support individuals, businesses and communities affected by the bushfires, and initiatives to increase preparedness for future bushfires.

The *2009-10 Budget* also commits $330 million over four years in additional funding to strengthen the justice system, provide for enhanced policing and expand corrections services. To build on skills reform, $141 million over five years in skills initiatives has been committed to ensure that all Victorians are given the opportunity to access the training they require to find employment.

The Government is continuing to build services in health, education and community safety by implementing its *Labor's Financial Statement 2006* election commitments. Through the *2008-09 Budget*, the Government completed funding for the delivery of all its election output commitments totalling $2.7 billion. Continuing through this budget, the Government makes significant progress towards funding its election asset commitments with a total estimated investment of $549 million, building on the $2.5 billion of initiatives previously funded. The remaining $429 million of election asset commitments will be delivered in next year's budget.

Taxation

The Victorian Government remains committed to providing a fair and efficient tax system that is competitive with other states.

The Government has announced and implemented substantial tax reform over the past 10 years. These reforms aim to improve economic outcomes by increasing the efficiency and equity of the Victorian tax system, and include:

- over $5.3 billion worth of announced tax cuts;
- abolishing eight state taxes as agreed with the Commonwealth Government under the *Intergovernmental Agreement on Federal Financial Relations*, faster than any other state;
- a flattening out of the land tax scale and significant reductions in payroll and land tax rates;
- significant reform of land tax to moderate the impact of the property market boom; and
- measures to reduce the capacity for tax evasion so that taxpayers who are doing the right thing are not unduly burdened. Examples include strengthening anti-avoidance provisions in the conveyancing duty base and reducing the incentive for landowners to minimise their land tax liabilities through the use of trusts.

In addition, the Government has been a leader in reducing compliance costs for businesses dealing with state taxes across borders by harmonising payroll tax administration with the other states from 2007. More recently, the Victorian Government has reduced compliance costs on business by establishing an online tax e-business system, which is now used by 96 per cent of businesses to lodge their payroll tax and is available to all businesses to manage their land tax affairs. This has saved businesses up to $10 million in administrative costs.

The Government has implemented a number of reforms aimed at making home ownership easier for Victorians. These include the introduction of the *First Home Bonus* from June 2004 and implementing the 2006 election policy to introduce a Principal Place of Residence concession on stamp duty on land transfers. The *2008-09 Budget* also extended the Principal Place of Residence conveyancing duty concession to those eligible for the *First Home Owner Grant* and *First Home Bonus*, and introduced the *Regional First Home Bonus.*

The Commonwealth Government's review of Australia's tax and transfer system (the Henry Review) – including state taxes and transfers – represents an opportunity to identify other potential tax reforms. To make changes, the Commonwealth and state governments have to work together to improve the effectiveness of a tax system that is out of step with the responsibilities of different levels of government. The states operate in an environment of vertical fiscal imbalance, where they raise insufficient revenue to fund their expenditure responsibilities, and so depend on Commonwealth grants. This imbalance stands in the way of significant reform to state taxation; any reforms made must not be to the further detriment of state financial independence.

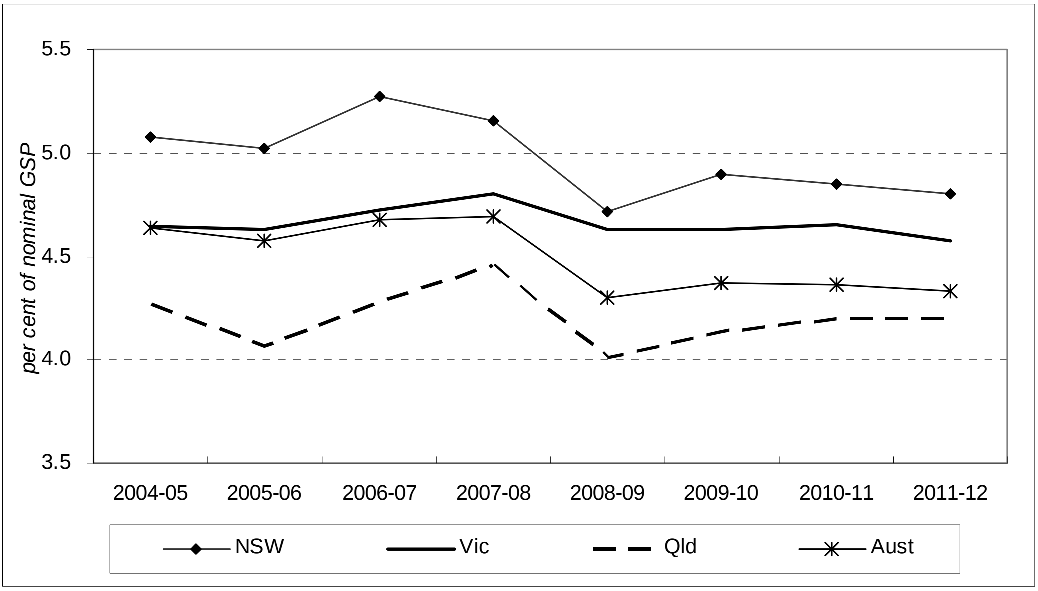
Under the *Intergovernmental Agreement on Federal Financial Relations*, all states and territories agreed to abolish a range of taxes by 1 July 2013. Victoria was the first state to abolish all the agreed taxes, doing so by 1 January 2007, and Tasmania is the only other state to have also complied. Given the expected economic benefits to business and the broader community, the Victorian Government remains committed to taxation reforms, even though taking the lead in this important area of reform has arguably disadvantaged Victoria from a budgetary point of view. Had Victoria delayed tax reform by following the New South Wales (NSW) timetable, it is estimated that Victoria would have received around $1.4 billion extra revenue over the last nine years and $400 million over the next three years.

Since the *2008-09 Budget Update*, several states including NSW, Queensland and South Australia have announced that they were deferring abolition of some taxes that were to be abolished under the *Intergovernmental Agreement on Federal Financial Relations*.

Chart 1.4 provides a comparison of Victoria's taxation competitiveness with NSW, Queensland and the Australian average, based on estimates published at a similar time in the *2008-09 Budget Update* (or equivalent publication) of these jurisdictions. Over the period 2004-05 to 2011-12, Victoria maintains a lower tax to GSP ratio than NSW and is expected to narrow the gap with Queensland and move closer to the Australian average over the forward estimates period.

States have recently announced revenue raising measures to address deteriorating budget positions as a result of the Global Financial Crisis. For example, NSW and Queensland increased their land tax rates and have deferred abolition of taxes. As a result, Victorian businesses and investors with landholdings valued over $400 000 will now pay less land tax than those in NSW. Meanwhile, compared with Queensland, Victorian businesses now pay lower land tax than their counterparts for all properties valued between $350 000 and $5.7 million, increasing to $7 million in 2010.

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



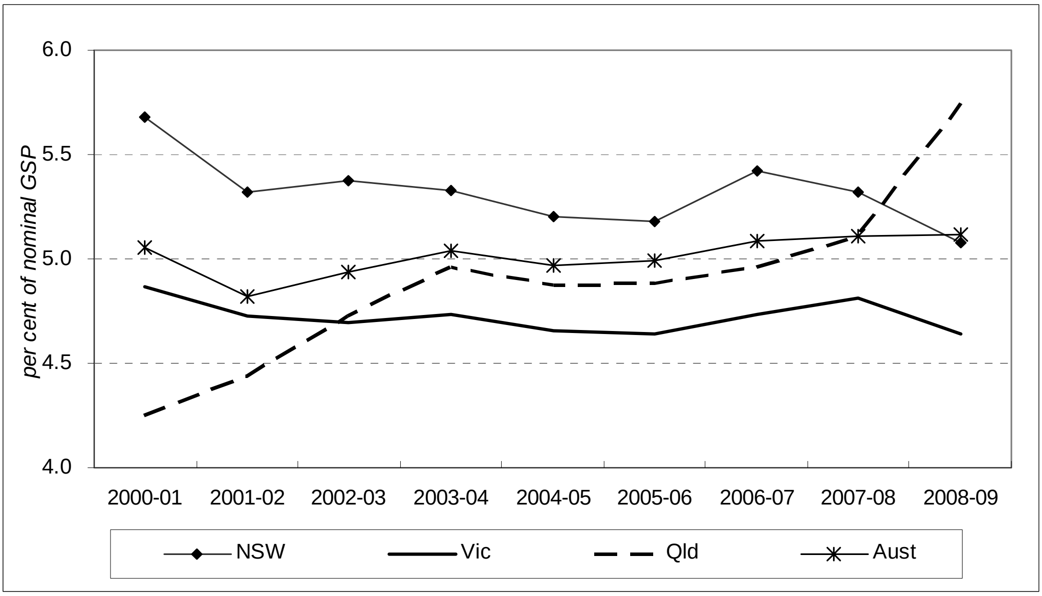
Sources: Australian Bureau of Statistics, Department of Treasury and Finance and various state publications

Note:

(a) Historical taxation data to 2007-08. Thereafter, taxation data are 2008-09 Budget Update *(or equivalent publication) estimates, being the latest forward estimates available on a consistent basis across all jurisdictions.*

Making interstate comparisons of tax competitiveness is difficult and Victoria's position also needs to be considered in the broader context. For example, unlike some other states, Victoria has only limited access to royalty revenue. In 2007-08, Western Australia, Queensland and NSW each collected in excess of $500 million in royalty revenue compared with around $40 million for Victoria. Chart 1.5 shows that Victoria's ratio of taxes plus royalties to GSP is below that of the Australian average over the decade since 2000-01, with the gap widening in 2008-09.

Chart 1.5: Taxation and royalty revenue as a percentage of GSP[(a)]



Sources: Australian Bureau of Statistics, Commonwealth Grants Commission, Department of Treasury and Finance and various state publications

Note:

(a) Historical taxation and royalty data to 2007-08. Taxation and royalty data for 2008-09 are 2008-09 Budget Update *(or equivalent publication) estimates. In addition, NSW and Tasmania royalty data for 2008-09 are estimated from data in their respective 2008-09 budgets.*

Net financial liabilities

The Government's balance sheet remains solid. This has been achieved through a commitment to the sound financial management of the Victorian Government's net financial liabilities. Victoria's triple-A credit rating was reaffirmed by Standard & Poor's in November 2008, and by Moody's in January 2009. Over the forward estimates period, it is expected that 51 per cent of the general government sector infrastructure program will be financed by cash operating surpluses, with the balance to be funded by increases in borrowings. This is consistent with the Government's strategy to continue to invest in essential infrastructure to support economic activity and protect jobs during the current downturn, enhancing Victoria's competitiveness once recovery occurs.

The resulting increase in borrowings over the forward estimates period will remain within sustainable and fiscally prudent levels, as constrained growth in operating expenditure allows cash operating surpluses to contribute substantially to the financing of infrastructure spending.

General government borrowings (reflected in the measure of net debt to GSP) are projected to rise between 2009-10 and 2011-12, before falling in 2012-13 to 5.1 per cent of GSP. These borrowings are being applied to implement the Government's substantial, and historically high, capital investment program.

The Government recognises the importance of balancing the need to support the Victorian economy during the current economic downturn with ensuring that the State's budget remains on a sustainable path over the forward estimates period and beyond, and maintaining the State's triple-A credit rating.

In April 2009, the Government announced it would be securing and preserving jobs in the public sector through a new wages policy. In response to lower inflation forecasts, the Government announced that the 3.25 per cent a year guideline rate a year for Enterprise Bargaining Agreements would drop to 2.5 per cent, with the opportunity for further increases in line with productivity increases.

In line with the lower inflation expectations, the Government will also revise the existing departmental funding and price review models used to inform the appropriate level of funding for non-wage costs from 2010-11 onwards. Together the changes to how wage and non wage costs are funded will allow the Government to manage underlying expenditure growth while supporting the government's commitment to maintaining real wages and its pledge to protect public sector jobs.

To this end, the Government is committed to reducing its borrowings over the medium term by returning the infrastructure program to historical levels as a per cent of GSP towards the end of the forward estimates period, thus reducing the call on cash to fund new infrastructure, and allowing the projected increased operating surpluses to repay existing debt.

In combination, these measures will ensure that general government borrowings remain at sustainable levels and that the State is well placed to take advantage of opportunities presented in the economic recovery.

The ratio of net financial liabilities to GSP is set to rise over the forward estimates period, from 7.6 per cent in June 2008 to 15.5 per cent by June 2013. This increase reflects higher levels of borrowings along with an $11.5 billion increase in the reported superannuation liability during 2008-09, with $7.4 billion of this increase attributable to a reduction in the Commonwealth bond rate. The bond rate forms the basis of the discount rate required to be used to value the superannuation liability. The Government has no control over the discount rate and does not seek to forecast its future movements.

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- The global economic environment has continued to deteriorate. Global economic activity is forecast to decline in 2009, which would be the weakest outcome in the post-war period.
- In the face of the Global Financial Crisis, the economic outlook for Victoria has been revised down. Victoria’s gross state product is expected to grow by 0.5 per cent in 2008-09 and 0.25 per cent in 2009-10, followed by a gradual recovery to trend rates of growth by the end of the estimates period.
- In 2009-10, the key area of weakness in Victoria will be private business investment, where the pipeline of work has diminished due to low confidence and tighter credit conditions. This will be partly offset by public investment, as the Victorian and Commonwealth Governments boost infrastructure investment.
- Consumption is expected to be subdued. Although household disposable incomes have been boosted by lower interest rates and petrol prices, households are increasing saving in response to reduced household wealth. Dwelling investment is forecast to grow, in part due to significant stimulus measures by government.
- Labour market conditions have also eased. Employment growth has stalled, and the unemployment rate has steadily risen from its previously historical lows. Victorian employment is forecast to decline by 1.0 per cent, and the unemployment rate is expected to average 7.0 per cent in 2009-10.
- Wage growth and underlying consumer price inflation are forecast to ease, in response to lower commodity prices and easing demand pressures.
- Population growth has been revised up, reflecting the recent unexpected strength in both births and net overseas migration.
- The economic outlook is sensitive to a number of risks. The key downside risks include a further deterioration in the global outlook, ongoing financial market volatility, entrenched low confidence, and higher-than-envisaged unemployment. The key upside risk to growth relates to the impact of stimulus on the economy.
- While the near-term economic outlook is weak and there are still a number of downside risks to growth, the longer-term prospects for the Australian and Victorian economies remain positive.

VICTORIAN ECONOMIC PROJECTIONS

The economic outlook has deteriorated further since the *2008-09 Budget Update*. Driven by a severe financial crisis and a wide-spread loss of confidence, the world economy is experiencing a synchronised recession. The Australian and Victorian economies are not immune to these developments. Economic activity has slowed in response to lower external demand, falling asset prices, tighter credit conditions and lower business and consumer confidence.

The Victorian economic projections have been revised to reflect this weaker economic environment. Victorian gross state product (GSP) is expected to grow by 0.5 per cent in 2008-09 and by 0.25 per cent in 2009-10. The weakest growth is expected to occur in the first half of 2009. Growth is then forecast to recover gradually, rising to 2.25 per cent in 2010-11, and returning towards trend rates of growth by the end of the forward estimates period. The recovery is forecast to be relatively gradual, as households, firms, governments and financial institutions recover from large declines in asset prices. The slower GSP growth is accompanied by lower forecasts for employment growth, and a higher projected unemployment rate. Reflecting the weaker economic activity, wage growth and inflation are expected to moderate faster than previously envisaged. Near-term population projections have been revised up, due to the recent unexpected strength of population growth, from both births and net overseas migration.

The main contributor to Victoria's weaker economic growth in 2009-10 will be private business investment, where the impacts of low confidence and credit constraints are most pervasive, and where the private sector pipeline of activity is diminishing quickly. This will be partly offset by a stronger contribution from public investment, as the Victorian and Commonwealth Governments boost infrastructure investment in response to the downturn. Household consumption is expected to be subdued, as households increase their saving in response to reduced household wealth. On the other hand, dwelling investment is forecast to post solid growth, driven by low interest rates, the *First Home Owner Boost* and pent-up demand.

The overall outlook is marked by considerable uncertainty, and the Victorian economic projections are sensitive to a number of risks. The key downside risks include a further deterioration in the global outlook, ongoing global financial market volatility, entrenched low confidence, and higher-than-envisaged unemployment. The key upside risk to growth relates to the impact of stimulus – fiscal and monetary – on the economy.

The economic projections used in the *2009-10 Budget* are set out in Table 2.1. These 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)]

	2007-08 Actual	2008-09 Forecast	2009-10 Forecast	2010-11 Forecast	2011-12 Forecast	2012-13 Forecast
Real gross state product	3.2	0.50	0.25	2.25	3.00	3.00
Employment	2.7	0.25	-1.00	0.50	1.50	1.50
Unemployment rate [(b)]	4.5	5.00	7.00	7.75	7.75	7.75
Consumer price index	3.6	3.25	2.00	2.25	2.50	2.50
Wage price index [(c)]	3.8	4.25	3.75	3.25	3.50	3.50
Population [(d)]	1.8	1.80	1.60	1.50	1.40	1.40

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

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

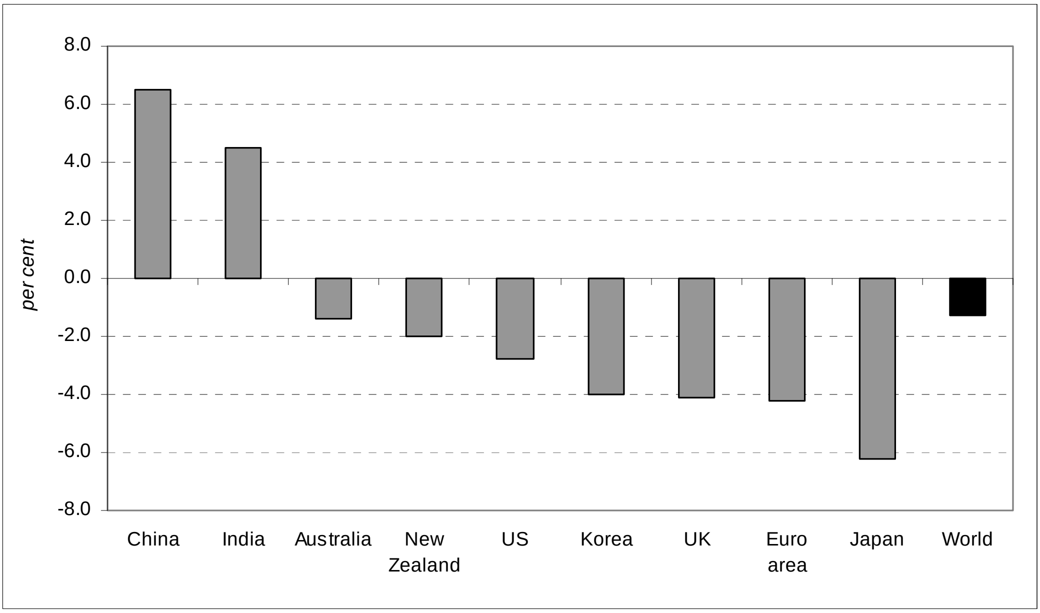
ECONOMIC OVERVIEW

International economic conditions and outlook

The weakening of international economic conditions has been considerably worse than expected at the time of the *2008-09 Budget Update*. Global production and trade contracted very sharply in the last quarter of 2008, and there have been large downward revisions to forecast world economic growth. The International Monetary Fund’s (IMF) April *World Economic Outlook* has forecast that the world economy will contract by 1.3 per cent in 2009 (Chart 2.1). This would be the weakest outcome in over sixty years. The advanced economies are expected to contract by 3.8 per cent in 2009. Emerging and developing economies are also being significantly impacted, and are expected to expand by 1.6 per cent in 2009. The decline in global economic activity is reflected in the outlook for world trade volumes, which are forecast by the IMF to decline by 11.0 per cent in 2009. The IMF projects a gradual recovery over the course of 2010, with growth of 1.9 per cent.

The global financial system remains under significant stress. There is a high level of investor uncertainty about bank solvency, lending standards have been tightened, credit spreads remain elevated and markets for securitised assets mostly remain frozen in the absence of government support. The problems in the financial sector persist despite extensive public sector support, including liquidity provisions, capital injections, asset purchases, bank deposit insurance and wholesale funding guarantees. Difficulties in the financial sector are having a negative impact on the real economy, which in turn is worsening the problems in the financial sector. A sustained recovery in the global economy will depend on the stabilisation of financial conditions.

Chart 2.1: Economic growth forecasts for major trading partners in 2009[(a)]



Source: International Monetary Fund

Note:
(a) Real GDP, annual per cent change. World GDP calculated using purchasing power parity weights.

In the United States, the problems in the financial sector and weakness in the housing market continue to weigh on the economy. The drop in asset prices has significantly reduced household wealth, leading to sharp reductions in consumer spending. Business investment has been reduced and is being impacted by the adverse financial conditions. Exports are no longer a driver of economic growth as the economies of major trading partners weaken. As a result, the labour market is deteriorating rapidly with the loss of around five million jobs since December 2007, and the unemployment rate rising to 8.5 per cent in March. However, there are signs that the pace of decline in economic activity is beginning to slow, and significant monetary and fiscal stimulus should support economic growth in the months ahead. Following a forecast fall of 2.8 per cent in 2009, US gross domestic product (GDP) is forecast to be flat in 2010.

The major European economies are also experiencing a severe downturn. This reflects a sharp decline in export demand, which has led to low business confidence and investment. Adverse financial conditions are also weighing on a number of European economies, with the United Kingdom particularly affected by the strains in its large financial sector. In some European countries, such as Spain, Ireland and the United Kingdom, the economies have been severely impacted by housing market corrections. The Eurozone economy is expected to experience a more severe slowdown than the United States due to its larger export sector, and the more moderate response of monetary and fiscal policy. GDP is forecast to decline by 4.2 per cent in the Eurozone and by 4.1 per cent in the United Kingdom in 2009.

The Japanese economy has been one of the hardest hit by the global downturn. A decline in export demand, partly due to the marked appreciation of the yen, has had flow-on effects to business investment and consumer spending, and has led to a slump in the Japanese economy. Industrial production has declined by over 30 per cent in the past six months, to be at its lowest level since the early 1980s. The outlook for the Japanese economy is very weak, with poor prospects for a near-term pick-up in export growth, which has been a significant driver of economic growth in Japan in recent years. Japanese GDP is expected to decline by 6.2 per cent in 2009 and then rise by 0.5 per cent in 2010.

China's economic growth is decelerating but is holding up better than in most other countries. Economic growth has slowed due to a decline in exports, as well as weakening export-related investment and real estate investment. Consumer spending growth is decelerating but remains at a relatively high level. China's financial sector has not been significantly affected by the broader financial crisis, and the Chinese economy is not significantly reliant on external financing. In addition, the Chinese Government's 4 trillion yuan fiscal stimulus is expected to provide significant support to economic growth in the coming months, and there are early indications that the package is already having a positive effect, especially in terms of infrastructure investment. The IMF forecasts the Chinese economy to grow by 6.5 per cent in 2009, which is a sharp fall from its 13 per cent growth in 2007, and slightly below the government's target of 8 per cent growth.

Elsewhere in Asia, the newly industrialised Asian economies – Hong Kong, South Korea, Singapore and Taiwan – have been hit hard by the Global Financial Crisis, with trade and production contracting. For these economies, GDP is expected to decline by 5.6 per cent in 2009. The New Zealand economy is also slowing, with weakness evident in household consumption, business investment and exports, and the economy weighed down by a weak housing market. The IMF forecasts New Zealand's economy to contract by 2.0 per cent in 2009.

The Global Financial Crisis has resulted in commodity prices declining significantly across all commodity sectors, marking the end of the commodity price boom that began in 2003. Weakening demand has seen crude oil prices falling by around 65 per cent from the peak in July 2008, to be around US$50 per barrel. Lower commodity prices and increasing spare capacity are placing significant downward pressure on consumer price inflation in many countries. The IMF considers deflation to be a significant risk to the outlook, particularly for advanced economies including the United States and Japan.

The outlook for the global economy is highly uncertain. The projection of a modest recovery in 2010 is conditional on effective policy responses to stabilise financial conditions and improve confidence. Global equity markets have shown signs of recovery since early March suggesting that investors have become less bearish about the outlook.

Australian economic conditions and outlook

The Australian economy has been significantly affected by the global financial and economic turmoil. This has led to tighter credit conditions, large declines in Australian equity prices, lower global commodity prices, weaker economic growth of major trading partners, and negative impacts on the confidence of Australian households, businesses, and investors. These adverse effects are now being seen in the Australian real economy. Australia's GDP contracted by 0.5 per cent in the December quarter, the first such quarterly decline since December 2000. Over the course of 2008, GDP expanded by only 0.3 per cent, with all states experiencing a slowing in growth.

While Australia's financial system has felt the effects of the Global Financial Crisis, it is better placed to withstand these effects than the financial systems of many other countries. Australia's banks remain profitable and are soundly capitalised, supported by a strong regulatory and prudential system, and with low exposure to the high-risk securities that have led to large losses for many overseas financial institutions. The Commonwealth Government has also taken steps to support the Australian financial system by providing guarantees of deposits and wholesale funding of authorised deposit taking institutions in Australia.

One of the key drivers of Australia's growth in the recent past has been the terms of trade boom, which was the outcome of strong global demand for commodity resources. This boom significantly boosted domestic incomes and activity in resource-rich states. The outlook for Australia's key exports and the terms of trade has changed significantly with the onset of the Global Financial Crisis. Contract prices of thermal and coking coal have fallen by around 44 per cent and 59 per cent respectively, and iron ore contract prices are likely to fall by around 30 to 40 per cent. Such falls in the terms of trade will reduce gross domestic income, and possibly lead to a narrowing of some of the growth differentials that had emerged between the resource and non-resource states. It has also weakened the Australian dollar, which depreciated significantly over the second half of 2008, although it has appreciated in more recent weeks.

The national labour market performed strongly throughout the first half of 2008, and the unemployment rate reached a generational low of 3.9 per cent in February 2008. However, the labour market has weakened since mid 2008. Employment has been broadly unchanged, as a fall in full-time employment has been offset by higher part-time employment. The participation rate remains near record highs, but the national unemployment rate has increased sharply, to 5.7 per cent in March. Despite the easing in labour market conditions, national wage growth remains robust, at 4.3 per cent over the year to December.

Headline consumer price inflation was high throughout 2008, with pressure stemming from high petrol prices, rents, food and finance and insurance costs. Falling petrol prices and lower finance and insurance costs eased the pressure on inflation in the December and March quarters. Despite this, underlying price pressures remain high, with national underlying inflation at 4.2 per cent over the year to March.

While inflationary pressures led to a more restrictive monetary policy setting throughout 2007-08, the speed and severity of the global economic slowdown in 2008-09 led to the Reserve Bank of Australia (RBA) embarking on an aggressive easing of monetary policy. The official cash rate has been reduced by 4.25 percentage points since September 2008, to 3 per cent.

The Commonwealth Government has also acted to support economic growth by announcing two discretionary fiscal stimulus packages. The $10.4 billion *Economic Security Strategy*, announced in October 2008, consisted of $8.7 billion in payments to pensioners, carers, and low and middle income families, $1.5 billion to help first home buyers purchase a home, as well as $0.2 billion for new training places. The $42 billion *Nation Building – Economic Stimulus Plan*, announced in February 2009, includes $28.8 billion in direct public investment in schools, housing, energy efficiency, community infrastructure, roads and support to small businesses, mainly delivered in 2009-10 and 2010-11. It is also delivering $12.2 billion in payments to low and middle income Australians, mainly in late 2008-09.

Overall, the Australian economy is relatively well placed, given strong population growth, greater policy flexibility, a strong regulatory and prudential system, and a sound banking system. The IMF expects Australia to fare better than most other advanced economies in the current global downturn. The IMF forecasts Australian GDP to contract by 1.4 per cent in 2009 and to rise by 0.6 per cent in 2010. The IMF forecasts are at the lower end of the range of Consensus forecasts for Australia.

Victorian economic conditions and outlook

Like Australia, the Victorian economy faces a much more challenging economic environment than it has for many years, and economic conditions in Victoria are likely to mirror national trends. While there have been a number of stimulatory policy measures aimed at tempering the impacts of the Global Financial Crisis, the economic outlook has deteriorated and the economic projections have been revised down significantly since the *2008-09 Budget Update*.

Victoria’s GSP is expected to grow by 0.5 per cent in 2008-09 and 0.25 per cent in 2009-10, reflecting significant falls in business investment and weak household consumption, offset by growth in dwelling investment and public investment. Growth is forecast to recover gradually, rising to 2.25 per cent in 2010-11 and to trend rates of growth by the end of the forecast period, as improving global economic conditions drive a recovery in business investment and consumption.

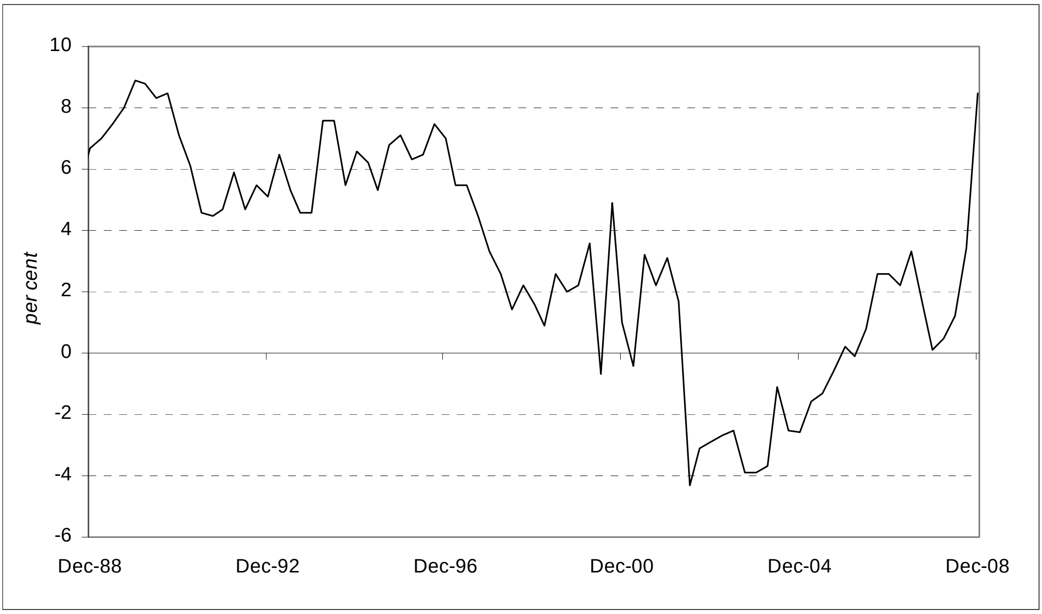
While the near-term economic outlook is weak, the longer-term prospects for the Victorian economy remain positive. Victoria has a diversified economy with sound fundamentals and a competitive business environment. It is benefiting from strong population growth and the Government’s investment in infrastructure and human capital.

Consumer spending

Household consumption has weakened significantly, to be 0.5 per cent lower over the year to the December quarter 2008. Household wealth has fallen, reflecting a decline of around 50 per cent in the Australian sharemarket since its peak in late 2007 and a softening in Melbourne house prices over the past year. As a consequence, households have increased their saving to rebuild assets and reduce household debt (see Chart 2.2). More recent spending indicators, such as retail turnover, suggest that consumption continued to decline in the early part of 2009.

The slowing in consumption has come despite significant boosts to household disposable incomes from significantly lower interest rates, fiscal stimulus measures and lower petrol prices. The anticipated deterioration in the labour market is expected to further constrain consumer spending, due to the adverse effect on real income growth from weaker employment and wage growth. Consumer confidence is also at low levels, although it appears to have stabilised.

Chart 2.2: Australian household saving ratio

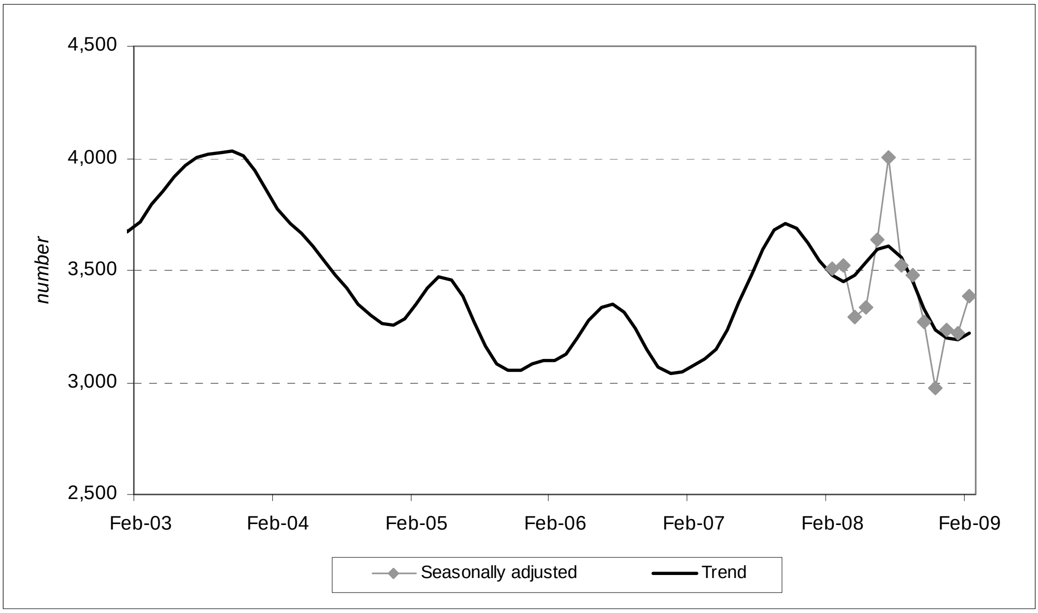


Source: Australian Bureau of Statistics

Dwelling investment

Victorian dwelling investment has exhibited solid growth in recent quarters, outpacing national growth. The near-term outlook for dwelling investment is weaker, reflecting the fall in dwelling approvals and housing finance in the second half of 2008 (Chart 2.3). However, a recovery is expected to occur by the second half of 2009 as a result of the effects of interest rate cuts and the stimulatory effect of the *First Home Owner Boost*. There are early signs of a rebound in the number of housing finance commitments and in first home buyer demand. Dwelling finance obtained by first home buyers as a percentage of total dwelling finance (excluding re-financing) increased to a record of almost 40 per cent in January. Dwelling approvals have also increased, to be up 13.8 per cent over the three months to February. Victoria has accounted for more than 30 per cent of national dwelling approvals in recent months and there is anecdotal evidence of cautious optimism in the Victorian housing industry.

Chart 2.3: Victorian dwelling approvals



Source: Australian Bureau of Statistics

Business investment

Private business investment in Victoria is easing, following particularly strong growth in recent years. Business conditions have been severely affected by the deterioration in the world economy. Similar to national trends, business confidence in Victoria has fallen to near 20 year lows, while a lack of available credit as well as more stringent lending criteria has led to several project delays and cancellations. The pass-through of recent cuts in official interest rates to business lending has also been much less than for household mortgages. In the face of low confidence and tighter credit conditions, the private sector pipeline of work yet to be done has diminished, with the value of Victorian non-residential building approvals declining by around 30 per cent over the past six months. These factors point to significantly lower capital expenditure over the next 12 months, across both machinery and equipment investment and non-residential construction.

International trade

Victorian services exports performed strongly in 2007-08, rising by over 11 per cent in volume terms, the second fastest growth of any state. The value of Victoria’s education-related services exports has grown particularly strongly, more than doubling over the past five years. Victoria’s services imports also grew strongly in 2007-08, supported by a strong Australian dollar and the strength of domestic demand.

Victorian merchandise exports increased moderately in 2008, largely driven by non-farm exports. Exports have been hampered by weaker trading partner growth, while agricultural exports continue to be held back by poor seasonal conditions. Victorian merchandise imports have declined recently as a result of weakening domestic demand.

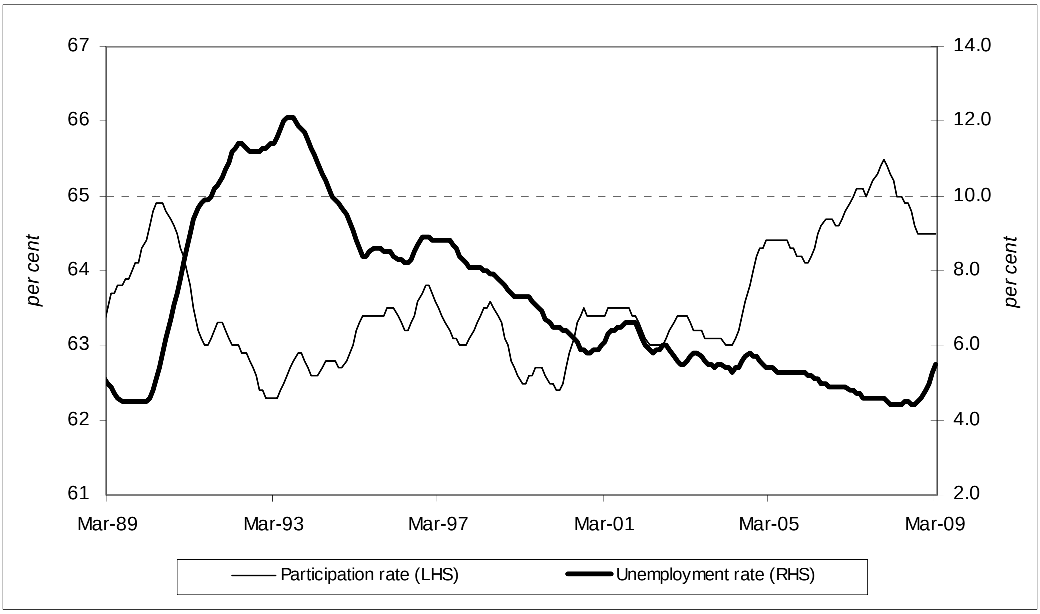
Looking ahead, near-term export growth in Victoria is expected to be adversely affected by the rapid slowdown in the economies of key trading partners such as Japan and Korea. It is expected that significantly weaker global demand will more than offset gains in the competitiveness of Victorian exporters from the lower Australian dollar. Victorian imports are likely to continue to moderate as a result of weakened business confidence and weakness in the manufacturing sector which has been the main driver of the imports of machinery and equipment. Overall, net trade is expected to make a small but positive contribution to Victoria’s GSP growth in 2008-09 and 2009-10.

Labour market

The Victorian labour market has softened over the past year. Employment is broadly unchanged over the year to March. This reflects a fall in full-time employment offset by a rise in part-time employment. The participation rate has declined over the past year but remains at a relatively high level. Victoria's unemployment rate has increased by 1.5 percentage points to 5.7 per cent, to be in line with the Australian average (see Chart 2.4).

Employment growth is expected to deteriorate further in the year ahead. Employment conditions reported in recent business surveys suggest a further rise in the unemployment rate as businesses respond to weaker economic activity. Other leading indicators are similarly weak; the ANZ measure of job advertisements has fallen by more than 50 per cent in the past year. Looking ahead, employment is forecast to decline by 1.0 per cent and the unemployment rate is forecast to average 7.0 per cent in 2009-10, rising to 7.75 per cent in 2010-11.

Chart 2.4: Victorian participation and unemployment rates[(a)]



Source: Australian Bureau of Statistics

Note:
(a) Trend data.

Wages

Victorian wage growth in recent years has been relatively robust. The latest data from the December quarter show the Victorian wage price index recorded growth of 4.3 per cent over the year, above the average rate over the 11-year history of the series. Wage growth has been high across both the public and private sectors. The ongoing strength over the past few years reflected the tightness of the labour market, characterised by a historically low unemployment rate, higher inflationary expectations and skill shortages.

However, consistent with slowing economic activity, wage growth is set to ease, to 3.75 per cent in 2009-10 and 3.25 per cent in 2010-11. While this is yet to show in official statistics, current business surveys signal an initial easing in expected labour costs and less difficulty in finding labour. Consultation with business suggests this trend will continue into 2009. There is also evidence of employers and workers adopting wage moderation, in order to limit job losses arising from the downturn. This is consistent with the Victorian Government's new wages policy.

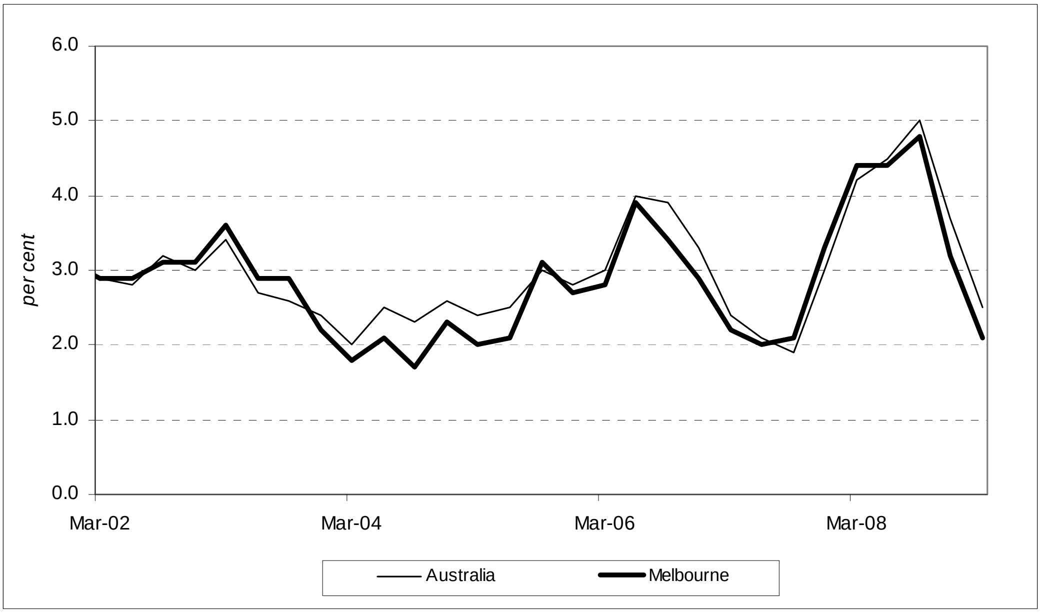
Inflation

Headline inflationary pressures have moderated significantly since the *2008-09 Budget Update*. Annual inflation was 2.5 per cent nationally and 2.1 per cent in Melbourne over the year to March (see Chart 2.5). Inflation has eased mainly due to sharply lower fuel costs as well as lower costs of financial and insurance services. However, underlying inflation is still relatively high.

Price rises were relatively broad-based during 2008, with particularly strong increases in the costs of food, housing, financial and insurance services, and transportation. More broadly, this occurred during a period of rising world commodity prices, strong domestic demand and high rates of capacity utilisation. These forces have now reversed, and it is expected that this will result in weaker price growth. The weakness in domestic demand is expected to reduce the pricing power of producers and retailers, and also lead to more moderate increases in labour costs. This may be partially offset by upward pressure from housing and non-market prices.

Melbourne consumer price inflation is expected to ease from a relatively high rate of 3.25 per cent in 2008-09, to 2.0 per cent in 2009-10, before returning to trend at 2.50 per cent from 2011-12. Indicators of inflation expectations have eased significantly.

Chart 2.5: Consumer price inflation[(a)]



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

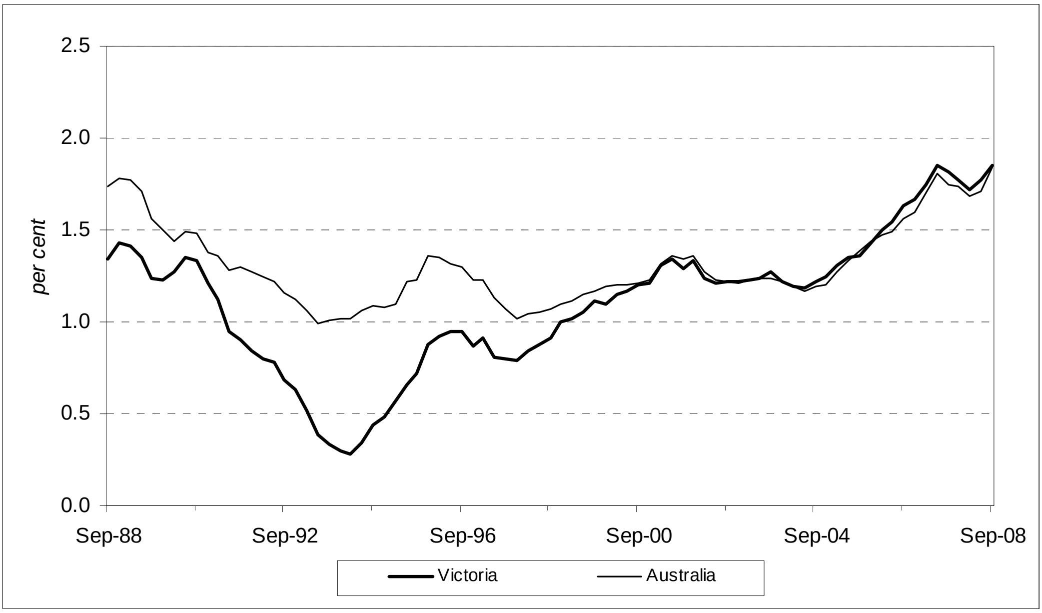
Note:
(a) Four-quarter ended percentage change.

Population

Victoria's population has grown by a very strong 1.8 per cent over the past year (see Chart 2.6). The increase has continued to be driven by net overseas migration, which is at a record high and accounted for more than 60 per cent of growth in the year to September 2008. Notably, several upwards revisions to net overseas migration numbers were applied following finalisation of migration statistics using matched passenger cards. The revisions amounted to 15 330 persons in 2006-07, an upward movement of over 30 per cent. There has also been an increase in the birth rate.

Near-term population growth has been revised up, and population growth is then forecast to ease gradually over the forecast period. This is based largely on expected declines in net overseas migration, which could moderate in response to less favourable labour market conditions and decreases in the Commonwealth Government's migration targets.

Chart 2.6: Growth of estimated resident population



Source: Australian Bureau of Statistics

Regional Victoria

The economy of regional Victoria is dealing with the challenges posed by the Global Financial Crisis, prolonged drought conditions and the recent devastating bushfires. While activity may be weak in the near-term, the medium and longer term prospects are positive.

In response to the weaker economic environment, employment in regional Victoria has eased, to be 1.9 per cent lower over the year to the March quarter. The unemployment rate in regional Victoria has risen to 6.0 per cent. According to Building Commission data, the value of regional building approvals remained at a high level of around $4.1 billion in 2008. This level of activity has been underpinned by strong population growth in regional Victoria of 1.3 per cent in 2007-08 and a revised 1.4 per cent in 2006-07, the highest growth rate since 1990.

Poor weather conditions have resulted in the output of the Victorian agricultural sector being subdued in 2008-09. The latest Australian Bureau of Agricultural and Resource Economics estimate for Victorian winter crop production is 3.1 million tonnes in 2008-09, down 21 per cent on 2007-08, and below the five-year average. In the dairy sector, milk production has shown a modest increase of 1.8 per cent in the first eight months of 2008-09. Assuming a return to more normal seasonal conditions, an increase in the output of the agricultural sector is expected in 2009-10. A potential recovery may be constrained, however, by reduced irrigation water allocations. While rural commodity prices have declined in recent months, farmers remain cautiously optimistic about the medium-term outlook for agricultural demand and prices, especially from the growing Asian region.

In February 2009, Victoria experienced its most devastating bushfires on record. There was significant loss of life and extensive loss of private property, including the partial or almost complete destruction of townships like Marysville. These bushfires have caused disruptions to economic activity in these regions, particularly primary production, forestry and tourism. However, economic activity is expected to recover. This will be supported by construction activity to rebuild and repair public infrastructure, buildings and dwellings, and additional tourism promotional activity.

RISKS TO THE OUTLOOK

The economic landscape has been very volatile in the past six-to-nine months, and as a result the economic projections are marked by a greater-than-usual degree of uncertainty. The key downside risks include continued deterioration in the global outlook, ongoing financial market volatility, entrenched low confidence, and higher-than-envisaged unemployment. The key upside risk to growth relates to the impact of stimulus, fiscal and monetary, on the economy.

The global economic outlook has deteriorated markedly in a very short space of time. The IMF’s forecast of 2009 world GDP growth has been revised down from 3.0 per cent to -1.3 per cent in the past seven months. While there are some signs of stabilisation in the United States and China, most economic indicators remain weak. Hence there is the risk that there will be further downward revisions to forecast global growth, which would have negative implications for Victoria’s growth outlook.

A key feature of the global economy has been weakness and volatility in financial markets. Equity markets fell by around 50 per cent from their late 2007 peaks, and credit spreads increased to historically high levels. These movements adversely affected wealth and confidence. Over the forecast period, the projections assume an improvement in credit conditions and gradual recovery in equity prices. While there have been some encouraging signs, there is a risk that financial markets remain very volatile, which could temper any economic recovery.

It could also prolong the weakness in consumer and business confidence, which has been at significantly below-average levels. An improvement in confidence is important to facilitate the economic recovery, whereas continued weakness in confidence could lead to further reductions in spending, investment and employment.

To date, the Australian household sector’s financial position has been in relatively good shape. Disposable incomes have increased significantly due to lower interest rates and petrol prices, and stimulus payments from the Commonwealth Government, and a large part of this income gain has been devoted to households reducing their debt levels. However, with unemployment now rising, it is possible that there will be an increased prevalence of household financial stress. If the unemployment rate rises significantly more than expected, this would have negative implications for household spending, asset prices and the economic outlook generally.

There is a risk that the recovery in economic activity, domestically and abroad, could be much faster than expected. The cut-backs in global production towards the end of 2008 were severe, and there are few signs of excess inventory stocks. There are signs that some countries have started to rebuild inventories in some key commodities. There is also the risk that monetary and fiscal policy, which has been loosened significantly, could stimulate demand and activity by more than is anticipated.

While the near-term economic outlook is weak and there are still a number of downside risks to growth, the longer term prospects for the Australian and Victorian economies remain positive. Policy flexibility and a stable banking sector will mitigate the negative consequences of the Global Financial Crisis. Population growth is at an historically high level, which will continue to underpin spending and investment in the Victorian economy. The Victorian Government is investing heavily in infrastructure and human capital to meet the demands of a growing population and to support the productive capacity of the economy. This will leave the Victorian economy in a good position to take advantage of the eventual upturn in economic prospects.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

- The *2009-10 Budget* confirms Victoria's strong fiscal position, despite the substantial adverse impact of the economic downturn.
- The Government is meeting its revised budget objective of an operating surplus (net result from transactions-operating balance) of at least $100 million over the forward estimates. The operating surplus is expected to be $165 million in 2009-10 and an average of $349 million a year over the forward estimates period.
- The Victorian budget has been able to meet the challenges of the Global Financial Crisis, significant reductions in taxation and GST revenue, and the financial impact of helping communities affected by the 2009 Victorian bushfires. Since the *2008-09 Budget*, GST and taxation revenue has been revised downwards by almost $8 billion over the four years to 2011-12.
- The Government is responding to the current economic downturn by investing for the future and securing jobs. Net infrastructure investment to provide quality transport, education, health and housing services, and to improve long-term economic potential, is projected to be a record $7 billion in 2009-10 and projected to average $4.4 billion a year over the forward estimates.
- The Commonwealth Government has also responded with their $42 billion *Nation Building – Economic Stimulus Plan*, of which Victoria will share in around $5 billion, which aims to stimulate the economy and contribute towards Victoria making a good recovery from the economic downturn.
- Reflecting this substantial infrastructure program, general government net debt is projected to be 1.9 per cent of gross state product (GSP) by 30 June 2009 and to increase to 5.1 per cent of GSP by 30 June 2013. The Government is committed to maintaining the State's triple-A credit rating by constraining expenditure growth, maintaining an operating surplus and maintaining debt at prudent levels.

BUDGET ESTIMATES AND OUTLOOK

This chapter provides an overview of the budget position for the period 2009-10 to 2012-13 for the general government (GG) sector.

The budget and forward estimates are based on the economic projections outlined in Chapter 2, *Economic Conditions and Outlook*, and reflect the accounting policies and assumptions documented in Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*.

Unless otherwise stated, the estimates take into account the financial impacts of all policy decisions taken by the Victorian Government, as well as Commonwealth funding revisions and other information that affects the projected general government sector financial statements as at 29 April 2009. Specific policy decisions that have been made since the *2008-09 Budget* and which affect the budget position have been summarised in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

The *2009-10 Budget* and forward estimates years, 2010-11 to 2012-13, represent planning projections based on unchanged policy and other assumptions throughout the forecast period. Outcomes will differ from these projections for many reasons, including any materialisation of risks, such as the impact of changed economic conditions as described in Chapter 2, *Economic Conditions and Outlook* and the sensitivity of the budget to these risks as noted in Appendix B, *Sensitivity Analysis Table*.

FISCAL OVERVIEW

The Government has maintained a strong fiscal position despite significant economic and fiscal challenges that have arisen during 2008-09. The strong operating statement and balance sheet, coupled with the State's existing triple-A credit rating, have positioned the Government to expand investment in key infrastructure, to provide quality transport, education, health and housing services, and to improve productivity in the economy.

As shown in Table 3.1, the Government is budgeting to achieve an operating surplus of $165 million in 2009-10. Over the three years to 2012-13, operating surpluses are projected to average $349 million a year. This outcome is consistent with the Government's broader strategy to position the Victorian economy to withstand current and future risks associated with the Global Financial Crisis. This outcome also delivers on the Government's short-term objective of a budget operating surplus of $100 million or more per year. In the long term, the Government is committed to maintaining a budgeted operating surplus to provide the framework to deliver its infrastructure program and maintain high quality services, while retaining the triple-A credit rating.

Compared with the estimates published in the *2008-09 Budget Update*, the operating surplus is expected to be $247 million lower in 2009-10 and $246 million a year lower on average from 2010-11 to 2011-12. Although economic growth is expected to be significantly lower and economic conditions have worsened, revenue has been revised upwards since the *2008-09 Budget Update*. This primarily reflects payments from the Commonwealth for specific purposes associated with the *Nation Building – Economic Stimulus Plan*, partly offset by substantial reductions in GST revenue and State taxation revenue.

As shown in Table 3.1 and Chart 3.1, growth in revenue and expenses is similar in 2009-10 and 2010-11, but expenditure grows more slowly than revenue during the last two forward estimates years. This reflects the Government's prudent management of operating expenditure in a slower revenue growth environment. Revenue and expenses are both projected to grow by 8.3 per cent in 2009-10, largely due to the effect of fiscal stimulus payments from the Commonwealth, new policy announcements in this Budget, and general wages growth in line with the Government's wages policy. Total revenue is estimated to increase by 1.6 per cent a year on average over the forward estimates period, compared with growth of 1.3 per cent a year on average in total expenses.

Table 3.1: Net result from transactions 2009-10 to 2012-13[(a)]

($ million)

	2009-10 Budget	*2010-11 Estimate*	*2011-12 Estimate*	*2012-13 Estimate*
Revenue				
Taxation	13 273.7	13 987.7	14 439.4	14 951.0
Dividends, TER and interest [(b)]	813.5	962.7	1 249.3	1 076.2
Sales of goods and services	5 044.1	5 294.3	5 487.4	5 599.6
Grants	21 554.1	20 733.9	20 559.2	21 238.7
Other current revenue	1 702.9	1 623.4	1 534.1	1 524.5
Total revenue	**42 388.3**	**42 602.1**	**43 269.3**	**44 390.0**
% change	8.3%	0.5%	1.6%	2.6%
Expenses				
Employee expenses	15 276.5	15 925.5	16 629.4	17 247.1
Superannuation [(c)]	2 258.4	2 339.1	2 389.4	2 491.9
Depreciation	1 646.4	1 785.8	1 931.1	2 014.3
Interest expense	713.8	959.9	1 106.9	1 136.2
Other operating expenses	13 885.7	13 779.4	13 775.6	13 855.4
Grants and other transfers	8 442.3	7 617.0	7 146.6	7 083.0
Total expenses	**42 223.2**	**42 406.8**	**42 979.1**	**43 827.9**
% change	8.3%	0.4%	1.3%	2.0%
Net result from transactions	**165.1**	**195.3**	**290.3**	**562.1**
Total other economic flows included in net result	**77.6**	**102.3**	**109.6**	**103.0**
Net result	**242.8**	**297.5**	**399.9**	**665.1**

Source: Department of Treasury and Finance

Notes:

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

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

(c) *Comprises superannuation interest expense and other superannuation expenses.*

Alternative measures of operating performance

In addition to the operating surplus, the Government uses other financial results to measure its performance. Table 3.2 below presents these alternative measures.

Table 3.2: Summary of alternative measures of financial performance

($ million)

	2009-10 Budget	*2010-11 Estimate*	*2011-12 Estimate*	*2012-13 Estimate*
Net result from transactions (net operating balance) [(a)]	165.1	195.3	290.3	562.1
Net lending/(borrowing) [(b)]	(3 325.3)	(2 604.8)	(2 198.9)	(298.0)
Net result	242.8	297.5	399.9	665.1
Cash surplus/(deficit) [(c)]	(2 694.4)	(2 051.4)	(893.9)	4.1

Source: Department of Treasury and Finance

Notes:
(a) Net result from transactions or net operating balance is a key fiscal aggregate and is revenue from transactions minus expenses from transactions. It excludes gains and losses resulting from changes in price levels and other changes in the volume of assets.
(b) The financing requirement of government, calculated as the net operating balance less the net acquisition of non-financial assets. A positive result reflects a net lending position and a negative result reflects a net borrowing position.
(c) Cash surplus/(deficit) equals the net cash flows from operating activities less investments in non-financial assets.

In summary, these measures of operating performance show that Victoria's financial performance remains strong over the forward estimates period, despite the impact of the economic downturn.

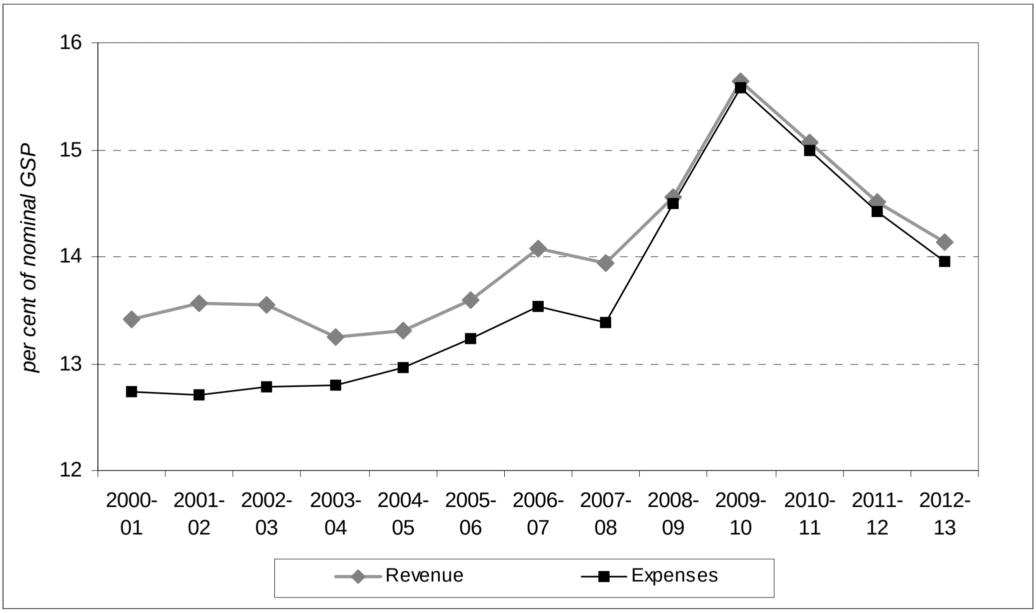
In particular, the net operating balance (equivalent to the net result from transactions) which is now the basis for measuring the budget estimates on an accrual basis in all Australian states and the Commonwealth, providing comparability with these jurisdictions, remains in surplus throughout the period.

The Government is borrowing $3.3 billion in 2009-10 and an average $1.7 billion a year over the forward estimates period, in order to support the implementation of the Government's infrastructure program.

The net result for the *2009-10 Budget* is $243 million and an average of $454 million per year over the forward estimate period. The net result is obtained by adding various revaluation gains and losses on assets and liabilities, such as those arising from movements in market prices, or the disposal of physical assets, to the net result from transactions.

The Government will be in a net cash deficit position between 2009-10 and 2011-12, reflecting the phasing of the Government's significant infrastructure program. A return to cash surplus is expected in 2012-13 as the infrastructure program returns to lower levels and as the net result from transactions improves.

Chart 3.1: Revenue and expenses relative to nominal GSP



Source: Department of Treasury and Finance

OPERATING STATEMENT ANALYSIS

Revenue

Total revenue is forecast to increase by $1.3 billion, or 3.2 per cent, a year on average over the budget and forward estimates period. Compared with the estimates published in the *2008-09 Budget Update,* total revenue is forecast to be $2.9 billion higher in 2009-10, and $1.1 billion a year higher on average over the period 2010-11 to 2011-12.

The revenue forecasts are affected by higher Commonwealth grants for specific purposes, including the Commonwealth's *Nation Building – Economic Stimulus Plan*, which has significantly boosted revenues over the forward estimates period, partly offset by significant reductions to the GST grants received from the Commonwealth and State taxation revenue. Since the *2008-09 Budget*, GST and taxation revenue has been revised downwards by almost $8 billion over the four years to 2011-12.

Grants

Grants revenue received by the State has been affected by significant changes in the framework for Commonwealth State financial relations, which came into effect on 1 January 2009. The new framework, agreed by the Council of Australian Governments (COAG), is designed to improve the quality and effectiveness of government services by reducing Commonwealth prescriptions on service delivery by the States, and providing increased flexibility in the way services are delivered.

In particular, there has been a major rationalisation in the number of specific purpose payments (SPPs) to the States from the Commonwealth, with the creation of five new broad SPPs: health, education, skills, affordable housing and disabilities. Another new form of funding, National Partnerships (NP) payments, has also been created. These will fund specific projects and have been established to facilitate and/or reward states that deliver nationally significant reforms. Victoria will continue to work cooperatively with the Commonwealth Government on projects funded through its fiscal stimulus package and through the COAG process.

Grants, mainly from the Commonwealth, represent the largest source of revenue, accounting for $21.6 billion (or 51 per cent) of total revenue in 2009-10. Grants are expected to increase by 14.7 per cent between 2008-09 and 2009-10, and then stabilise over the next three years. This primarily reflects:

- an average annual increase over the forward estimates period in GST grant revenue of 6.5 per cent. Since the *2008-09 Budget* there has been a downward revision to GST grants averaging $1.6 billion a year between 2009-10 and 2011-12. Victoria's share of the GST pool is expected to increase based on a projection of Victoria's assessed relativities and population share;
- additional funding of approximately $1.7 billion over five years to 2012-13 for the five new broadbanded Specific Purpose Payments in the areas of healthcare, schools, skills, affordable housing and disabilities;
- new funding associated with the creation of a new payment stream for National Partnerships (NP) to drive national economic and social reforms; and
- approximately $5 billion from 2009-10 to 2011-12 for the *Nation Building – Economic Stimulus Plan* for timely economic stimulus aimed at improved nation building and supporting economic growth and jobs.

Taxation Revenue

Taxation is forecast to be $13.3 billion (or around 31 per cent) of general government revenue in 2009-10.

Growth in taxation revenue is expected to be adversely affected by the slowdown in economic growth and inflation in 2009-10. In particular, payroll tax revenue is expected to grow by 1.5 per cent, as wages growth is partially offset by lower employment. Gambling revenue is expected to grow by only 1.0 per cent reflecting subdued household consumption. However, revenue will be supported by an expected rebound in stamp duty on land transfer revenue through the course of 2009-10 in response to historically low mortgage interest rates. The introduction of the Growth Areas Infrastructure Contribution, increased motor vehicle registration fees in line with population growth and CPI, as well as other factors such as the impact of rising insurance premiums on insurance taxation revenue will also contribute to taxation revenue growth in 2009-10.

Taxation revenue is expected to grow, on average, by 4.0 per cent a year over the forward estimates period, reflecting the following factors:

- payroll tax revenue is projected to grow by 5.0 per cent a year on average, reflecting a recovery in employment beginning in 2010-11 and continuing wages growth;
- stamp duty on land transfer revenue is projected to increase by 5.5 per cent a year. The strongest growth in land transfer duty will occur in 2010-11 as the full impact of current low interest rates work their way through the property market and as the economy recovers. The prospective recovery in economic growth will support land transfer duty from 2011-12, although this is expected to be moderated by a return to more normal levels of interest rates;
- growth (on average) in land tax revenue of 0.9 per cent a year, reflecting expectations of only modest growth in land valuations over the forward estimates period, offset by the ongoing disaggregation of land holdings which reduces the land tax base;
- revenue from gambling taxes is projected to increase by an average of 2.3 per cent a year, principally reflecting expected growth in consumer spending, partially offset by the impact of changes to racing tax arrangements which are to apply post 2012; and
- motor vehicle and insurance tax revenue are expected to increase by an average of 4.9 per cent and 4.6 per cent respectively, consistent with expected inflation and economic activity.

Dividends, income tax and rate equivalent, and interest revenue

This category of revenue comprises dividends, income tax and rate equivalent revenue received by the state from government business enterprises, and interest revenue. Dividend, income tax and rate equivalent and interest revenue is projected to be $814 million in 2009-10 and is expected to increase to $1.2 billion in 2011-12 and declining slightly in 2012-13.

Income tax and rate equivalent (ITE) revenue is expected to show a rising trend over the forward estimates period, underpinned by an expected improvement in the profitability of the water sector. ITEs from the Public Financial Corporation (PFC) sector have been significantly reduced due to the impact of the Global Financial Crises on expected profitability.

Dividend income is projected to increase to $645 million by 2011-12, before falling to $430 million by 2012-13. The increase to 2011-12 reflects growth in both the Public Non-Financial Corporation (PNFC) and PFC sector. Dividends from the PNFC and PFC sectors over the forward estimates period are expected to increase in line with the expected recovery from the current economic downturn.

In calculating income tax equivalents and dividends for PFCs that hold financial assets, an assumption is made that investment earnings from 2009-10 will revert to the long-term average. This assumption affects the profile of expected revenue over the forward estimates period. However, declines in financial markets have resulted in carry forward losses for the Transport Accident Commission (TAC) and Victorian WorkCover Authority (VWA) and no income tax equivalent revenue is expected to be payable during the forward estimates period from these agencies.

Other revenue

Together, grants, taxation revenue, dividends, income tax equivalent and interest are estimated to account for approximately 84 per cent of Victoria's revenue in 2009-10. The remainder is made up of sales of goods and services and other income including fines and regulatory fees. Combined, revenue from sales of goods and services and other current revenue are estimated to increase by 1.3 per cent a year on average between 2009-10 and 2012-13.

Further information on Victoria's revenue sources can be found in Budget Paper No. 4, Chapter 4, *State Revenue*, with detailed analysis and explanations of the differences between the forecast for 2009-10 to 2011-12 at the time of the *2008-09 Budget Update* and the revised forecast provided in Appendix A, Operating *Statement Analysis*.

Expenses

The *2009-10 Budget* builds on previous budgets by improving core service delivery in transport, education and health, by acting to secure jobs, by fostering innovation in science and technology, and assisting Victorians affected by the 2009 Victorian bushfires. However, the Government will also continue to focus on managing underlying expenditure growth during this period of slower revenue growth, through implementation of the new wages policy and constraining non-wage operating costs.

Total expenses from transactions are forecast to be \$42.2 billion in 2009-10. Compared with the estimates published in the *2008-09 Budget Update*, total expenses are forecast to be \$3.2 billion higher in 2009-10, and \$1.4 billion a year higher on average over the period 2010-11 to 2011-12.

Employee expenses

Employee expenses (including superannuation) are forecast to be \$17.5 billion in 2009-10. Growth in employee expenses over the forward estimates period is expected to average \$735 million, or 4 per cent, a year which is consistent with historical growth, and lower than the growth in employee expenses expected at *2008-09 Budget Update* (6.1 per cent a year on average).

In April 2009, the Government announced it would be securing and preserving jobs in the public sector through a new wages policy. In response to lower inflation forecasts, the Government announced that the 3.25 per cent a year guideline rate a year for Enterprise Bargaining Agreements would drop to 2.5 per cent, with the opportunity for further increases in line with productivity increases. This revised guideline rate for wage increases is reflected in the forward estimates as lower costs of employee expenses compared to those in the *2008-09 Budget Update*.

The year on year growth primarily reflects the outcome of appropriately remunerating front line staff, as well as output policy initiatives, including *2009-10 Budget* initiatives. The increased Commonwealth specific purpose payments discussed previously also have corresponding expenditure that contributes to the growth in services. These additional services will be delivered by additional staff and will contribute to growth in employee expenses over the forward estimates period.

Expenditure associated with own source revenue by general government (GG) entities such as schools, TAFEs and hospitals is expected to increase in line with the associated increase in revenue.

Other operating expenses

Other operating expenses, which include purchases of supplies and services, maintenance expenses, and operating lease payments, are forecast to be \$13.9 billion in 2009-10, representing 33 per cent of total expenditure.

These expenses are projected to decrease by an average of \$10 million (or less than 1 per cent) a year across the forward estimates. This change mainly reflects the Government's policy initiatives including those announced in the *2008-09 Budget Update* and *2009-10 Budget*, and increases relating to flow-on expense impacts of increased Commonwealth specific purpose payments and expenditure associated with own source revenue by entities such as schools, TAFEs and hospitals.

In line with lower inflation expectations, the Government will also revise the existing departmental funding and price review models used to inform the appropriate level of funding for non-wage costs from 2010-11 onwards. Together the changes to how wage and non wage costs are funded will allow the Government to manage underlying expenditure growth while supporting the government's commitment to maintaining real wages and its pledge to protect public sector jobs.

Grants and other transfers

Grants and other transfers, which represent 20 per cent of total expenses, are forecast to increase by 17 per cent between 2008-09 and 2009-10 to $8.4 billion. The level of grants and other transfers is expected to decrease back to 2008-09 levels by 2012-13.

This trend primarily reflects the pattern of fiscal stimulus payments received from the Commonwealth for on passing as grants to schools and for housing to be delivered by the PNFC sector.

Depreciation expense

Depreciation expense is projected to be $1.6 billion in 2009-10 and to grow by 7 per cent a year on average over the forward estimates period. This reflects the Government’s investment in infrastructure and forecast revaluations of existing assets.

Interest expense

Interest expense is estimated to grow in line with the anticipated increase in borrowings that is being used to fund the Government’s infrastructure program. The growth of the interest expense is expected to moderate in line with the completion of the infrastructure program.

New output initiatives by department

Table 3.3 shows the budget impact of the new output initiatives which will be implemented in order to deliver the Government’s policy objectives for the *2009-10 Budget*. These new initiatives have a net impact of $689 million in 2009-10 and an average of $220 million a year from 2010-11 to 2012-13. This is in addition to the net impact of $46 million a year on average from 2009-10 to 2011-12 from *2008-09 Budget Update* output initiatives.

Table 3.3: Net impact of *2009-10 Budget* new output initiatives[(a)]

($ million)

	2009-10 Budget	*2010-11 Estimate*	*2011-12 Estimate*	*2012-13 Estimate*
Education and Early Childhood Development [(b)]	382.4	377.6	408.5	429.2
Human Services [(c)]	575.8	508.7	528.4	545.8
Innovation, Industry and Regional Development	88.5	54.9	37.9	15.5
Justice	118.9	96.4	84.4	78.7
Planning and Community Development	60.0	44.6	31.9	24.7
Premier and Cabinet	13.1	21.2	18.6	19.1
Primary Industries	5.4	4.3	4.1	4.4
Sustainability and Environment	4.1	12.2	15.5	16.3
Transport	98.4	87.4	130.1	152.1
Treasury and Finance	141.8	47.1	14.1	10.6
Parliament	1.3	..	..	..
Government-wide	203.5	91.9	86.1	57.2
Total *2009-10 Budget* output funding	**1693.2**	**1346.2**	**1359.6**	**1353.5**
Less funding from demand contingency and other efficiencies	1004.2	1121.3	1219.7	1059.4
Net impact of *2009-10* Budget output funding	**689.1**	**224.9**	**139.9**	**294.2**
Add: *2008-09 Budget Update* net output funding [(d)]	64.4	56.2	17.8	na
Net budget impact of output funding since *2008-09 Budget*	**753.4**	**281.0**	**157.7**	**294.2**

Source: Department of Treasury and Finance

Notes:

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

(b) Variance is attributable to three main factors:

(i) the impact of an output price review;

(ii) initiatives funded from within the 2009-10 Budget;

(iii) additional supplementation funded by the Commonwealth and price escalation for anticipated cost increase in 2009-10.

(c) Output price increases arise from initiatives funded within the 2009-10 Budget, additional supplementation provided by the Commonwealth, an output price review and price escalation for anticipated cost increases in 2009-10.

(d) Net impact of 2008-09 Budget Update output initiatives is net of funding from demand contingency and other efficiencies.

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

Other economic flows

Differences between the net result from transactions and the net result are due to other economic flows. This includes actuarial adjustments arising from movements in market prices, gains and losses on the disposal of physical assets and provisions for doubtful debts.

Total other economic flows included in the net result from 2009-10 to 2012-13 primarily relate to the sale of non-financial assets such as land and property, plant and equipment, in particular the estimated revenue in the forward estimates from the sale of surplus government land including crown land.

FISCAL RISKS

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

Revenue risks

Commonwealth grants

Commonwealth grants are a major source of revenue for the Victorian Government with estimated grants income of approximately $21.4 billion in 2009-10. Commonwealth grants include general purpose grants (GST grants), specific purpose payments (SPPs) and National Partnership agreement payments (NPs).

A new framework for Commonwealth grants, agreed by COAG, came into effect on 1 January 2009, and is designed to improve the quality and effectiveness of government services by reducing Commonwealth prescriptions on service delivery by the states, and providing increased flexibility in the way services are delivered. The number of SPPs to the states from the Commonwealth was rationalised from over 90 to five. These five new, broad-based SPPs are in the areas of health, education, skills, affordable housing and disability services. Another new form of funding, called National Partnerships (NP) payments, have also been phased in to fund specific projects and to facilitate and/or reward states that deliver nationally significant reforms.

The level of GST grants is affected by the general level of activity in the Australian economy and the GST revenue sharing relativities calculated by the 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. Any changes to economic conditions will have a direct impact on the amount of GST revenue to be distributed among the states.

Commonwealth grants revenue estimates represent the latest information available to the Victorian Government at the time of finalisation of the *2009-10 Budget*.

Taxation revenue

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

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

Expenditure risks

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

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

The *2009-10 Budget* estimates include a contingency provision to allow for the likelihood that some expenditure risks will eventuate during the budget year or during the forward estimates period. The contingency includes a provision for:

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

In addition, the *2009-10 Budget* estimates include a contingency from 2010-11 that acknowledges funding for a number of existing programs that will conclude in 2009-10 or the following years. A provision is made on the basis that Government may endorse a number of these programs to continue or be replaced to meet service delivery priorities.

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

Sensitivity analysis

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

USE OF CASH RESOURCES

The Government continues to invest in strategic infrastructure projects in order to secure jobs in the short-term and deliver world class infrastructure assets that increase the economic, social and environmental benefits for current and future generations.

These infrastructure projects offer longer-term returns to the Victorian economy, by maximising the State’s economic potential and supporting sustainable long-term growth. The Government has used the *2009-10 Budget* to reiterate its commitment to infrastructure investment and ensure that Victoria is well positioned for the projected economic recovery.

Table 3.4 provides a summary of cash generated through the operations of Victorian Government departments and other general government sector agencies, and how that cash is applied to infrastructure investment, and the associated impact on net debt. Projected infrastructure spending also includes an approved capital provision that will be allocated to specific projects in future budgets.

Table 3.4: Application of cash resources

($ million)	2008-09 Revised	2009-10 Budget	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Net result from transactions	**163.0**	**165.1**	**195.3**	**290.3**	**562.1**
Add back: Non-cash income and expenses (net) (a)	1 769.8	2 146.2	2 168.3	2 396.0	2 316.2
Net cash flow from operating activities	**1 932.8**	**2 311.3**	**2 363.6**	**2 686.2**	**2 878.2**
Less:					
Net investment in fixed assets					
Expenditure on approved projects	4 543.1	7 183.4	5 668.2	3 965.7	2 582.1
Capital provision approved but not yet allocated	..	..	262.8	555.0	845.0
Proceeds from asset sales	(190.5)	(222.8)	(228.3)	(261.5)	(252.4)
Total net investment in fixed assets	**4 352.6**	**6 960.6**	**5 702.7**	**4 259.2**	**3 174.7**
Finance leases (b)	..	74.7	121.0	840.1	..
Other investment activities (net)	664.6	(39.7)	(27.1)	(27.7)	(28.0)
Decrease/(increase) in net debt	**(3 084.4)**	**(4 684.2)**	**(3 433.1)**	**(2 385.5)**	**(268.5)**

Source: Department of Treasury and Finance

Notes:

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

(b) The finance leases in 2009-10 and 2010-11 is in relation to the Partnerships Victoria in Schools project and the finance lease recognised in 2011-12 is in relation to the redevelopment of the Royal Children's Hospital.

Table 3.5 provides reconciliation between the measure of infrastructure used by the Victorian Government and that used by the Australian Bureau of Statistics (ABS).

The Victorian Government measure of net investment in fixed assets is equal to the investment by the general government sector for fixed assets, including investment by PNFC's which is funded by the general government sector, less asset sales.

In contrast, the ABS measure of gross fixed capital formation excludes transfers to and from the PNFC sector, purchases and sales of non-produced assets, acquisitions under finance lease and assets given and received free of charge.

Table 3.5: Reconciliation between net infrastructure investment and gross fixed capital formation

($ million)	2008-09 Revised	2009-10 Budget	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Net Investment in fixed assets	**4 352.6**	**6 960.6**	**5 702.7**	**4 259.2**	**3 174.7**
Add:					
Assets received free of charge	214.8	56.7	51.0	0.7	0.8
	4 567.4	7 017.4	5 753.7	4 260.0	3 175.5
Less:					
Net (purchase)/disposal of investments for policy purposes	1 295.0	1 954.8	1 287.8	679.1	300.5
Acquisitions under finance leases and similar arrangements	231.4	74.7	121.0	840.1	..
Non-produced assets	171.7	145.4	23.3	58.4	19.6
Assets given free of charge	60.7	..	..	..	..
	1 758.8	2 174.9	1 432.1	1 577.6	320.2
Gross fixed capital formation	**2 808.7**	**4 842.4**	**4 321.6**	**2 682.4**	**2 855.3**

Source: Department of Treasury and Finance

Since coming to office in 1999, the Government has completed or committed to unprecedented infrastructure renewal and expansion in the areas of health, education, public safety, social housing, and transport. The Government's net infrastructure investment program (which includes total purchases of property, plant and equipment, capital contributions to other sectors of government and net proceeds from sale of assets) is projected to be $7 billion in 2009-10 and to average $4.4 billion over the forward estimates period.

Around 50 per cent of the $20 billion infrastructure program over the four years to 2012-13 will be funded from the cash surpluses from operating activities. The remainder of the infrastructure program will be funded by borrowings.

Total net investment in infrastructure includes expenditure on new projects approved in the *2009-10 Budget*. Table 3.6 shows the new asset funding by department in 2009-10. The *2009-10 Budget* commits substantial funding for the first tranche of initiatives under the *Victorian Transport Plan*, with $4.9 billion being provided to deliver new services and infrastructure to begin the transformation of Victoria's transport system. Additional projects funded in the *2009-10 Budget* include upgrades to hospitals in Bendigo, Dandenong and Geelong, targeted urban renewal projects in Broadmeadows, and upgrades to emergency services infrastructure. In addition, the *2009-10 Budget* delivers a boost to social housing which is expected to deliver over 5 000 new houses.

Victoria is also working actively with the Commonwealth Government to cushion the economy while the global financial system remains under stress and to build Victoria's future economic potential. The Commonwealth's *Building the Education Revolution* funding and the State's *Victorian Schools Plan* investment in the *2009-10 Budget* provides funding of $2.9 billion for Victorian schools.

Table 3.6: *2009-10 Budget* new asset funding

($ million)

	2009-10 Budget	*TEI* [(a)]
Education and Early Childhood Development	1446.5	2677.1
Human Services	556.9	1074.9
Innovation, Industry and Regional Development	31.6	92.7
Justice	38.7	80.2
Planning and Community Development	13.1	118.5
Premier and Cabinet	9.5	31.8
Primary Industries	..	..
Sustainability and Environment	14.0	24.5
Transport	911.2	4450.3
Treasury and Finance	22.7	39.2
Parliament	..	..
Government wide	41.4	78.3
Total 2009-10 Budget asset funding	**3085.6**	**8667.6**
Add: 2008-09 Budget *Update* asset funding	223.1	780.8
Asset funding since the 2008-09 Budget	**3308.7**	**9448.4**

Source: Department of Treasury and Finance

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

Budget Paper No.3, Appendix A, *Output, Asset Investment and Revenue Initiatives* includes a detailed list and description of all asset initiatives announced in the *2009-10 Budget*.

FINANCIAL POSITION

Table 3.7 presents the general government sector balance sheet which comprises assets and liabilities of all government departments and other bodies that provide services free of charge or at prices significantly below their cost of production.

The general government net asset position, measured by subtracting liabilities from assets, is an important indicator of the sector's financial strength. A strong net asset position allows the government to expand the infrastructure investment program while maintaining prudent borrowing levels.

Table 3.7: General government sector statement of financial position as at 30 June

($ billion)

	1999 Actual AAS	2008 Actual GFS-GAAP	2009 Revised GFS-GAAP	2010 Budget GFS-GAAP	2011 Estimate GFS-GAAP	2012 Estimate GFS-GAAP	2013 Estimate GFS-GAAP
FINANCIAL POSITION							
Assets							
Non-financial assets	32.4	66.0	68.6	75.3	81.5	88.7	92.4
Financial assets	3.3	8.7	8.8	8.7	8.9	9.4	9.9
Investments in other sector entities							
PNFC [a]	21.9	41.1	41.9	43.5	44.8	44.8	44.8
PFC [a]	1.2	3.8	0.3	0.8	1.6	2.3	2.8
Total assets	**58.8**	**119.5**	**119.6**	**128.4**	**136.9**	**145.2**	**149.9**
Liabilities							
Superannuation	11.4	12.9	24.4	24.7	25.0	25.4	25.6
Borrowings [b]	7.1	8.2	11.4	15.9	19.5	22.3	23.1
Other liabilities	3.6	8.0	9.1	9.4	9.6	9.8	10.0
Total liabilities	**22.2**	**29.1**	**44.9**	**50.0**	**54.1**	**57.5**	**58.6**
Net assets	**36.7**	**90.4**	**74.8**	**78.4**	**82.7**	**87.7**	**91.3**

Source: Department of Treasury and Finance

Notes:
(a) PNFC: Public non-financial corporations, PFC: Public financial corporations.
(b) Borrowings include deposits held and advances received.

Assets

General government sector assets are forecast to be $120 billion by 30 June 2009 and to rise by a further $30 billion by 30 June 2013, at an average rate of 5.8 per cent a year.

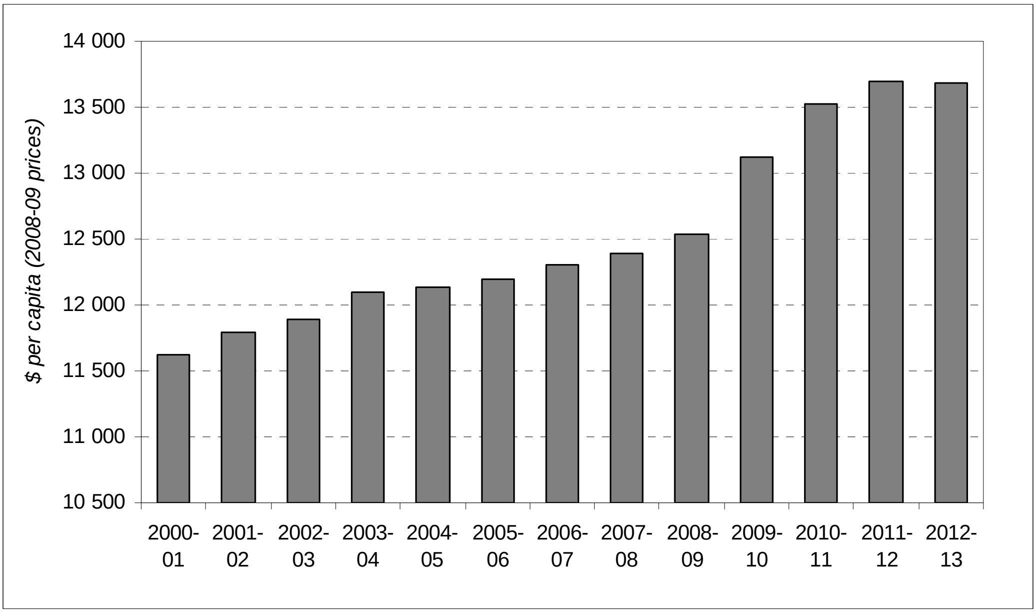
Non-financial assets

Non-financial assets are projected to be $69 billion at 30 June 2009 and projected to grow to $92 billion by 20 June 2013.

This growth is driven by the government's infrastructure program, which is forecast to average $5 billion a year over the four years to 2012-13, exceeding depreciation by an average of $3.2 billion.

Chart 3.2 shows that there has been strong growth in the real capital stock per capita in recent years, and that this growth is projected to continue over the forward estimates period.

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



Source: Department of Treasury and Finance

Note:

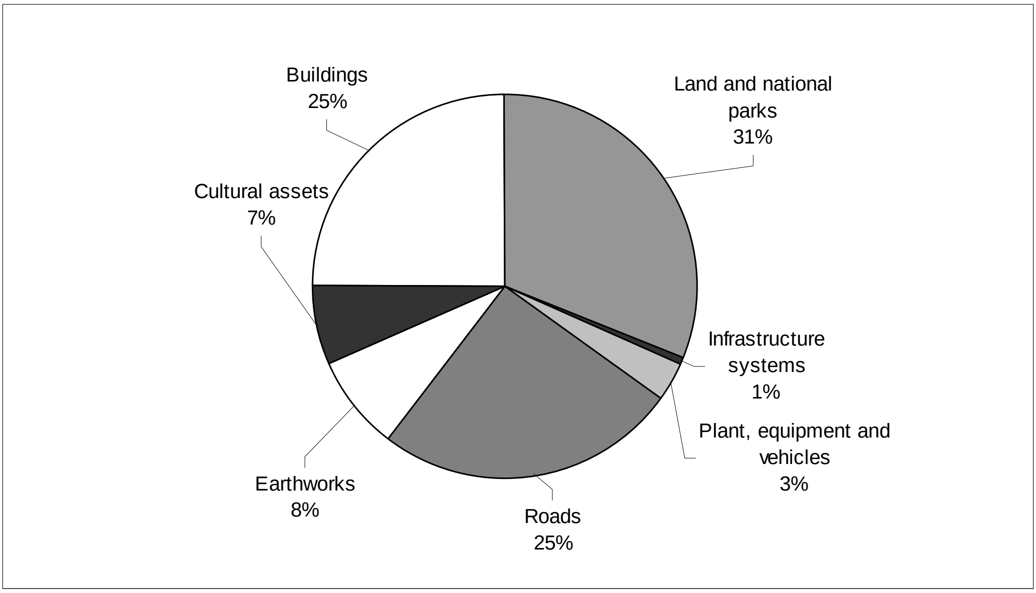
(a) *Real capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets in 2008-09 prices.*

The growth in the real capital stock per capita is expected to stabilise by 2012-13, reflecting the Government's strategy of scaling back the historically high infrastructure program in order to reduce the future call on borrowings as the economy recovers from the current economic downturn.

This projected growth will nevertheless be sufficient to maintain the Government's asset base to support service delivery and economic growth. The real capital stock is expected to continue to grow at least in line with population growth.

Chart 3.3 shows the general government sector's capital stock as at 30 June 2009 by asset class. The four largest classifications are land and national parks (31 per cent of the total capital stock), buildings (25 per cent), roads (25 per cent) and earthworks (8 per cent). This composition of the capital stock is consistent with previous years.

Chart 3.3: General government sector capital stock as at 30 June 2009[(a)(b)]



Source: Department of Treasury and Finance

Notes:
(a) Due to a change in methodology by including the revaluation of capital stock, effective from the 2007-08 Budget, this chart is not directly comparable to similar charts shown in previous years.
(b) Capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets.

Investments in other sector entities

Investments in other sector entities consist of the net assets of the State's PFCs and PNFCs. Investments in PNFCs and PFCs are expected to increase from $42.8 billion in June 2009 to $50.2 billion by June 2013. This increase is driven by equity injections from the general government sector, combined with revaluation gains on the value of investments. The revaluation increments largely reflect the impact of an expected return to trend growth in financial markets on the PFC sector.

Financial and other assets

The general government sector also holds other financial assets including cash and deposits, receivables and investments, loans and placements. Cash and deposits are expected to increase by around $700 million by June 2013, as cash balances are restored for liquidity management purposes following the impact of the Global Financial Crisis.

Liabilities

General government liabilities are projected to be $45 billion as at 30 June 2009 and are projected to grow to $59 billion by 30 June 2013.

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.

While the State's reported superannuation liability is projected to increase by $11.5 billion in 2008-09, $7.4 billion of this increase is attributable to a reduction in the discount rate that is required to be used to value the superannuation liability. The discount rate, which is based upon long term Commonwealth Government bond rates, has fallen from 6.54 per cent a year as at 30 June 2008 to 4.66 per cent a year as at 31 March 2009. It is important to note that the increase in the reported superannuation liability arising from the reduction in discount rate has no impact on the amount of cash required to fund the State's superannuation liability over time. Funding requirements continue to be calculated using a long term investment return, currently 8 per cent a year before tax.

The ongoing Global Financial Crisis has also continued to impact significantly on investment markets and the return on superannuation scheme assets has been far lower than expected. However, given the long-term nature of superannuation it is appropriate to maintain a strategy with a long-term focus rather than attempting to predict, and react to, short-term volatility.

Beyond 2008-09, the State's reported superannuation liability is projected to increase from $24.4 billion in 2008-09 to $25.6 billion in 2012-13. This projected increase is primarily attributable to the use of a lower discount rate, as discussed above, along with the fact that some of the schemes are only partially funded and so the return on assets is not sufficient to offset the growth in accrued liabilities. However, given the sensitivity of the State's reported superannuation liability to movements in the discount rate the reported liability may continue to exhibit considerable volatility.

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

Borrowings

Total borrowings (including deposits held) for the general government sector are expected to increase from $11.4 billion in June 2009 to $23.1 billion by June 2013. Moderate growth in borrowings is expected from 2011, reflecting the completion of substantial components of the Government's existing infrastructure program by the end of the forward estimates period.

KEY FINANCIAL INDICATORS

Table 3.8: General Government sector net debt, net financial liabilities and key ratios as at 30 June

	1999 Actual AAS	*2008 Actual GFS-GAAP*	*2009 Revised GFS-GAAP*	*2010 Budget GFS-GAAP*	*2011 Estimate GFS-GAAP*	*2012 Estimate GFS-GAAP*	*2013 Estimate GFS-GAAP*
				($ million)			
Net Debt [(a)]	4.8	2.2	5.2	9.9	13.4	15.7	16.0
Net Financial Liabilities	18.8	20.4	36.0	41.3	45.2	48.1	48.7
				(per cent)			
Net Debt to GSP [(b)]	3.1	0.8	1.9	3.7	4.7	5.3	5.1
Net interest to total revenue [(c)]	2.1	..	0.4	0.7	1.2	1.5	1.6
Net Financial Liabilities to GSP [(b)]	11.9	7.6	13.4	15.2	16.0	16.1	15.5
Net interest + superannuation interest expense to total revenue	4.6	0.8	2.0	2.2	2.8	3.2	3.2

Source: Department of Treasury and Finance

Notes:

(a) Net debt is the sum of deposits held, advances received and borrowings less the sum of cash deposits, advances paid, and investments, loans and placements.

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

(c) Net interest equals interest expense less interest revenue.

Net debt

The Government balance sheet remains solid. Victoria's triple-A credit rating was re-affirmed by Standard & Poor's in November 2008 and Moody's Investor Services in January 2009. The Government's continued sound management of its balance sheet underpins this rating.

A key measure of balance sheet strength is net debt, which is calculated by subtracting liquid financial assets from gross debt. General government net debt is expected to increase from $5 billion in June 2009 to $16 billion by June 2013. This is above recent levels, and reflects the increase in borrowings required to fund the Government's infrastructure program over the forward estimates period.

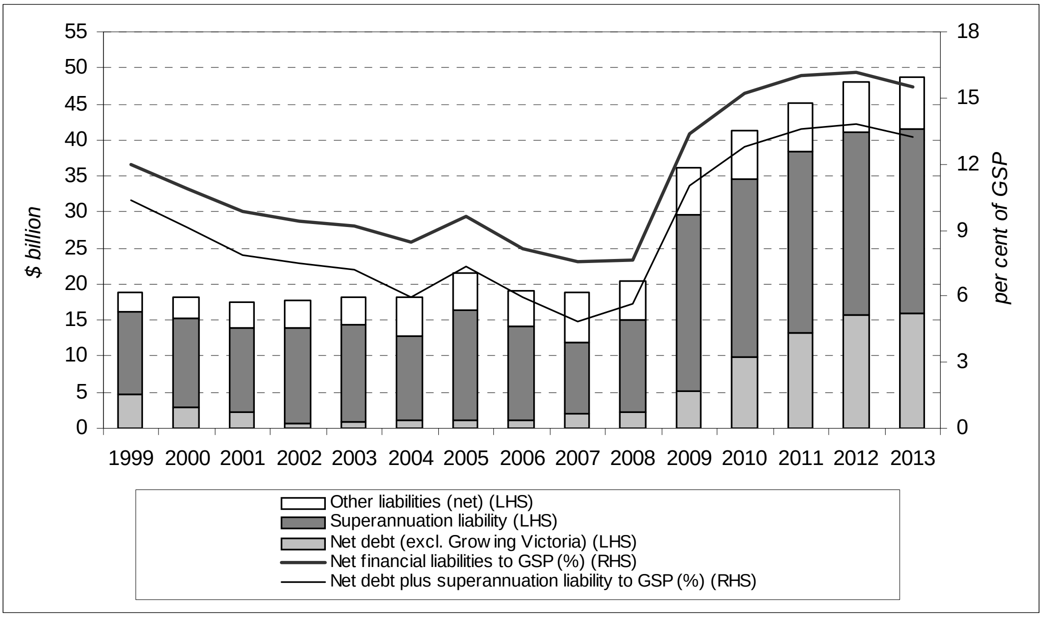
Over the budget and forward estimates period, as a percentage of GSP, net debt will rise from 1.9 per cent as at June 2009, to 5.3 per cent as at June 2012, before declining to 5.1 per cent as at June 2013. The reduction of the net debt to GSP ratio in 2012-13 reflects the government's commitment to repay borrowings, and limit new borrowings by reducing the infrastructure program to lower, historical levels, without comprising the quality of service delivery.

A significant proportion of infrastructure spending will be financed by cash operating surpluses, thereby limiting the reliance upon additional borrowings.

Net financial liabilities

In examining the liabilities of governments, the financial community focuses on net financial liabilities as a measure of indebtedness. Table 3.8 shows that net financial liabilities of the general government sector are expected to increase from $36 billion in June 2009 to $49 billion by June 2013.

Chart 3.4: General government sector net financial liabilities as at 30 June



Source: Department of Treasury and Finance

As depicted in Chart 3.4, the ratio of net financial liabilities to GSP will increase in comparison to recent historical levels. This movement largely reflects the growth in the superannuation liability and in general government borrowings during the period, consistent with the State's strategy of using its strong financial position to respond to the economic downturn by investing in infrastructure with a focus on projects that can start quickly and generate new jobs.

There will be a significant increase in net debt and net financial liabilities in the medium term. By 2011-12, the increase in debt is expected to moderate, with cash operating surpluses expected to meet in excess of 60 per cent of net infrastructure investment. The Government is committed to maintaining fiscal discipline, and has undertaken a number of initiatives (including a more conservative wages policy for public service employees) to maintain debt at prudent and sustainable levels over the longer term.

CHAPTER 4 – FINANCIAL SUSTAINABILITY OF VICTORIAN GOVERNMENT

- This chapter builds on the information presented in Chapter 3, by incorporating the broader public sector, through the addition of the State's public non-financial corporations (PNFCs) to the general government sector, thereby producing the non-financial public sector (NFPS).
- The PNFC sector is forecasting a net surplus from transactions of $31 million in 2009-10. The net result from transactions is expected to improve over the remainder of the forward estimates period, largely due to strong growth in income from sales of goods and services by the water sector.
- NFPS capital spending on new infrastructure for the four years to 2012-13 will total $32.1 billion. This represents a major increase compared to the four years to 2008-09, and reflects significant investment in water, transport and other essential infrastructure.
- NFPS net debt is expected to increase from 4.2 per cent of gross state product (GSP) in June 2009 to an estimated 10.0 per cent by June 2013. This reflects the State's strategy of using its strong financial position to respond to the economic downturn by investing in infrastructure that will stimulate economic growth and jobs in the short term, whilst increasing Victoria's future productive capacity in the longer term.
- NFPS net financial liabilities are expected to increase to 20.2 per cent of GSP by 2012-13, reflecting increases in borrowings and superannuation liabilities. Despite the increase, total net financial liabilities will remain at prudent and sustainable levels and are not expected to affect the State's triple-A credit rating.

INTRODUCTION

This chapter provides an overview of the activities of the broader public sector, by adding the State's PNFCs to the general government sector, to form the State's NFPS. The fiscal aggregates reported in this chapter are not targeted by the government's budget strategy, although they do contribute to the Government's objective to maintain net financial liabilities at prudent levels, including the maintenance of a triple-A rating.

FINANCIAL PERFORMANCE OF THE PUBLIC NON-FINANCIAL CORPORATIONS SECTOR

The PNFC sector comprises a wide range of entities that provide goods and services (of a non-financial nature) to the public while meeting commercial principles through cost recovery via user charges and fees. The most significant of the Victorian PNFCs are those providing water, housing, transport and port services.

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

($ million)

	2009-10 Budget	*2010-11 Estimate*	*2011-12 Estimate*	*2012-13 Estimate*
Revenue				
Interest	55.5	47.2	47.5	48.6
Dividends income tax equivalent and rate equivalent revenue	35.9	41.9	47.9	51.0
Sales of goods and services	4 148.6	4 514.2	4 980.3	5 351.6
Grants	2 851.7	2 516.4	2 376.2	2 385.5
Other current revenue	467.8	492.4	478.1	487.5
Total revenue	**7 559.6**	**7 612.2**	**7 930.1**	**8 324.2**
Expenses				
Employee expenses	803.4	831.2	854.9	875.5
Other superannuation	69.4	71.6	73.1	74.7
Depreciation	1 055.4	1 110.1	1 175.0	1 215.1
Interest expense	700.7	883.1	1 025.3	1 095.3
Other operating expenses	3 865.9	3 911.5	4 057.5	4 221.9
Grants and other transfers	943.7	558.2	283.8	245.6
Other property expenses	90.3	116.4	134.2	173.1
Total expenses	**7 528.7**	**7 482.0**	**7 604.0**	**7 901.1**
Net result from transactions – Net operating balance	**30.8**	**130.2**	**326.1**	**423.1**

Source: Department of Treasury and Finance

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

Revenue

Total revenue is forecast to increase an average of 5.3 per cent per annum over the four years to 2012-13. Sales of goods and services, which account for an estimated 54.9 per cent of total PNFC revenue, are expected to increase by an average of 7.3 per cent per annum over the period. This is largely driven by strong growth in the water sector, which is expected to achieve average annual growth in sales of goods and services of 14.4 per cent over the four years to 2012-13. The revenue growth is largely underpinned by anticipated increases in the price of regulated water, as determined by the Essential Services Commission. The price rises allow the water sector to recoup the cost of the major infrastructure upgrades that will drought proof the State.

The other major source of revenue for the PNFC sector is grants income, which accounts for an estimated 37.7 per cent of total revenue in 2009-10. After increasing to $2 852 million in 2009-10, grants income is projected to decline to $2 376 million by 2011-12 before a slight increase in 2012-13. The increase in 2009-10 and decline in 2010-11 is largely due to changes in the Commonwealth funding agreement with Housing and Community Building (formerly Director of Housing).

Other sources of revenue are projected to remain relatively steady over the period.

Expenses

The average expected rate of growth in expenses over the four years to 2012-13 is 3.6 per cent. Other operating expenses largely consist of operating supplies and consumables in the water and transport sectors, and account for an estimated 51.3 per cent of total expenses in 2009-10. Other operating expenses are projected to increase across the forward estimates period to $4 222 million by June 2013. The increase can be largely attributed to the Metropolitan Water sector, reflecting higher operational costs associated with new infrastructure. In addition, the item also includes a significant increase in the capital assets charge incurred by Victorian Rail Track, for which there is an offsetting revenue item within grants income.

Interest expense is forecast to increase to $1 095 million by 2012-13. This represents an average annual growth rate of 19.8 per cent, and is underpinned by the expected increase in borrowings from $8 303 million in June 2009 to $16 800 million by June 2013.

Other property expenses consist of State Income Tax Equivalent expenses, and are expected to increase to $173 million by 2012-13. This largely relates to the Metropolitan Water sector, and reflects improved trading results over the forward estimates period.

Net result from transactions

The PNFC sector is forecasting a net surplus from transactions of $31 million in 2009-10. The sector has budgeted for improved operating surpluses for the remainder of the forward estimates period, largely attributed to increased revenues from the water sector, combined with low growth rates in major cost categories such as employee expenses and other operating expenses.

FINANCIAL PERFORMANCE OF THE NON-FINANCIAL PUBLIC SECTOR

The Non-Financial Public Sector (NFPS) comprises the general government sector and public non-financial corporation sectors (i.e. it excludes the public financial corporations sector). Table 4.2 below shows the summary operating statement for the NFPS sector, which combines and consolidates the results for the general government and PNFC sectors. Transactions between the general government and PNFC sectors are eliminated, including dividends payable by PNFCs.

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

($ million)

	2009-10 Budget	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Revenue				
Taxation revenue	13 070.6	13 766.9	14 204.9	14 777.5
Interest	455.2	445.5	453.3	456.3
Dividends and income tax equivalents and rate equivalents	117.7	272.6	324.2	314.3
Sales of goods and services	7 957.5	8 496.8	9 025.8	9 451.0
Grants	21 475.8	20 647.5	20 482.7	21 152.3
Other current revenue	2 120.2	2 065.3	1 961.7	1 961.6
Total revenue	**45 197.1**	**45 694.6**	**46 452.7**	**48 113.0**
Expenses				
Employee expenses	16 042.9	16 721.0	17 447.6	18 085.0
Superannuation interest expense	659.2	677.8	699.9	722.9
Other superannuation	1 668.7	1 733.0	1 762.6	1 843.8
Depreciation	2 701.8	2 895.9	3 106.2	3 229.4
Interest expense	1 379.7	1 808.0	2 099.3	2 198.7
Other operating expenses	16 342.0	16 195.1	16 212.8	16 460.5
Grants and other transfers	6 386.9	5 501.9	4 895.4	4 774.3
Other property expenses	0.0	(0.0)	0.0	0.0
Total expenses	**45 181.2**	**45 532.6**	**46 223.9**	**47 314.3**
Net result from transactions – Net operating balance	**15.9**	**162.1**	**228.8**	**798.6**
less Net acquisition of non-financial assets from transactions	8 138.6	6 869.9	4 960.1	1 786.5
Net Lending/(borrowing)	**(8 122.7)**	**(6 707.8)**	**(4 731.3)**	**(987.8)**

Source: Department of Treasury and Finance

Note:

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

The net result from transactions is expected to show an operating surplus of $16 million in 2009-10, before increasing over the remainder of the forward estimates period to an expected surplus of $799 million by 2012-13.

Growth in revenue is expected to average 3.5 per cent over the four years to 2012-13. Both taxation and grants revenue, which accounts for an estimated 76.4 per cent of revenue in 2009-10 have been discussed in the previous chapter. Sales of goods and services are expected to grow by an average of 4.3 per cent over the period, and includes the impact of strong growth in sales by the water sector.

Growth in total expenses is expected to average 2.9 per cent over the next four years, reflecting effective expenditure management over the period. This is slightly below the expected rate of revenue growth, resulting in a steady improvement in the expected net result from transactions across the forward estimates period.

USE OF CASH RESOURCES BY THE NON-FINANCIAL PUBLIC SECTOR

Table 4.3 below provides a summary of cash generated through the operations of the NFPS, how that cash is applied to infrastructure investment, and the associated impact on net debt.

Table 4.3: Application of cash resources for the non-financial public sector

($ million)

	2009-10 Budget	*2010-11 Estimate*	*2011-12 Estimate*	*2012-13 Estimate*
Net result from transactions	**15.9**	**162.1**	**228.8**	**798.6**
Add back: Non-cash income and expenses (net) [(a)]	2 839.9	3 042.3	3 352.1	3 194.6
Net cash flow from operating activities	**2 855.8**	**3 204.3**	**3 580.9**	**3 993.2**
Less:				
Net investment in fixed assets				
Expenditure on approved projects	10 918.5	9 894.3	7 453.6	5 274.5
Proceeds from asset sales	(376.5)	(381.1)	(331.8)	(316.1)
Total net investment in fixed assets	**10 542.0**	**9 513.3**	**7 121.9**	**4 958.5**
Finance leases [(b)]	75.4	121.0	840.1	..
Other investment activities (net)	96.6	139.8	138.0	131.5
Decrease/(increase) in net debt	**(7 858.3)**	**(6 569.8)**	**(4 519.0)**	**(1 096.7)**

Source: Department of Treasury and Finance

Notes:

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

(b) The finance lease recognised in 2009-10 and 2010-11 is in relation to the Victorian Schools Public Private Partnership project. The finance lease recognised in 2011-12 is in relation to the redevelopment of the Royal Children's Hospital.

Investment in non-financial assets

Total net investment in infrastructure includes expenditure on new projects approved in the *2009-10 Budget*, including the first funding announcements under the *Victorian Transport Plan*. It also includes projects such as the Royal Children's Hospital, the Wonthaggi water desalination plant and rural water infrastructure improvements in the Goulburn Murray Irrigation District.

Net investment in fixed assets is expected to be $10.5 billion in 2009-10, and is estimated to total $32.1 billion over the four years to 2012-13. This represents a significant increase when compared to $20.4 billion for the four years to 2008-09, and reflects the Government's strategy of continuing to invest in essential infrastructure during a period of declining economic growth.

It is expected that 42.4 per cent of the new infrastructure will be funded by cash operating surpluses. The remainder will be funded by borrowings.

It should be noted however, over $4.0 billion of expenditure currently shown in Table 4.3 for purchases of non-financial assets is likely to be undertaken as Partnerships Victoria projects and accordingly the cash flow forecasts will be revised when the projects are awarded, to take account of the different cash flow profile.

The Government has already announced significant infrastructure investments for the PNFC sector, including:

- the $1 billion Northern Victoria Infrastructure Renewal Project (NVIRP) is implementing water distribution and delivery efficiency improvements by 2012-13, to deliver water savings of an average of 225GL per year to be shared equally by irrigators, environment and Melbourne. The Government is contributing $600 million, Melbourne Water Corporation $300 million and the Irrigators $100 million;;
- the $750 million Sugarloaf Interconnector which will link the Goulburn River to the Melbourne system and transfer a share of the water savings obtained through NVIRP to Melbourne from 2010. Melbourne Water Corporation will finance the delivery of this Project;
- $610 million for the purchase of another twenty metropolitan trains and associated stabling and maintenance facilities; and
- $754 million for the delivery of works to address congestion on the metropolitan train network, including electrification to Sunbury and rail extension to South Morang.

Procuring New Infrastructure

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

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

There are currently 18 *Partnerships Victoria* projects in existence with a capital investment of approximately $5.8 billion. Fifteen of these projects have reached commissioning and are now operational, and a further two projects are expected to reach commissioning in 2009-10.

A significant recent step for PPP policy was the formation of nationally harmonised guidance for the use of PPPs throughout Australia. The National PPP Policy and Guidelines were endorsed by the Council of Australian Governments in November 2008. The National Guidelines are broadly consistent with current Victorian practice, with additional Victorian-specific guidance provided in the *Partnerships Victoria* Requirements.

In PPP projects, the provision of private finance provides the necessary incentives to enable the effective transfer of appropriate risks to the private sector. A current issue arising out of the Global Financial Crisis which is affecting PPPs nationally (and indeed globally) is the shortage of liquidity in financial markets for larger commercial transactions (including PPPs).

Victoria is considering the potential implications of the liquidity shortage on PPP projects and is currently discussing this issue with other jurisdictions, together with Infrastructure Australia, through various PPP related forums.

Future Partnerships Victoria Projects

Four *Partnerships Victoria* projects with a combined capital value of over $4 billion are currently under procurement. In each case, the project will only proceed as a PPP if this provides best value compared with what the same project could achieve under a more traditional procurement method. These projects are:

- Wonthaggi Desalination Project – The successful private sector proponent will be responsible for the design, construction, financing, operations and maintenance of the facility. Construction is scheduled to commence in 2009 with the first water due to be supplied by the end of 2011;
- BioSciences Research Centre – The State, through the Department of Primary Industries, in joint venture with La Trobe University (La Trobe), is investing in the development of the Biosciences Research Centre (BRC) located at La Trobe’s Bundoora campus. In the 2007-08 Budget, the State committed $180 million to fund capital costs and specialised equipment for the project. La Trobe has committed $50 million and the site on which the BRC will be constructed. A private sector consortium will be responsible for the financing, design, construction, commissioning and maintenance of the new BRC. Contract execution is expected by the end of the current financial year. The BRC is expected to be completed by the fourth quarter of 2011 and fully operational by the end of the first quarter of 2012;
- Ararat Prison – In July 2008, it was announced that the new 350-bed medium-security Ararat Prison would be procured as a PPP, adjacent to the existing Ararat prison. The prison is a key part of the progressive upgrade of Victoria’s correctional system and will provide upgraded correctional services to meet future projected prisoner growth. The private sector partner will design, construct, finance and maintain the facilities over the contract period, while core custodial services will be delivered by the State. Contract execution is expected to take place in the first quarter of 2010, with the prison expected to be completed in 2012; and

- Peninsula Link Project – Peninsula Link involves the delivery of approximately 25 kilometres of freeway standard road between the Frankston Freeway-EastLink Interchange at Carrum Downs and the Mornington Peninsula Freeway at Mount Martha. The successful private sector proponent will be responsible for the design, construction, financing, operations and maintenance of the freeway, for which it will receive regular Service Payments from the State subject to the ongoing achievement of specific service standards. Construction is scheduled to commence in December 2009 with the road opening to traffic in early 2013. A contribution to this project is being sought from the Commonwealth Government.

FINANCIAL POSITION OF THE NON-FINANCIAL PUBLIC SECTOR

Table 4.4 shows the summary balance sheet of the NFPS sector. Net assets are expected to increase to $94.5 billion by 30 June 2013. The projected increase is underpinned by prudent balance sheet management, including the fact that a substantial proportion of infrastructure spending will be financed by operating cash flow surpluses.

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

($ billion)

	1999 Actual AAS	*2008 Actual GFS*	*2009 Revised GFS-GAAP*	*2010 Budget GFS-GAAP*	*2011 Estimate GFS-GAAP*	*2012 Estimate GFS-GAAP*	*2013 Estimate GFS-GAAP*
Assets							
Non-financial assets [(a)]	57.0	112.2	119.6	130.8	140.9	150.6	155.0
Financial assets [(b)]	7.2	14.2	11.9	11.6	11.8	12.0	12.6
Investments in other sector entities [(c)]	1.2	3.0	0.2	0.8	1.6	2.3	2.8
Total assets	**65.4**	**129.4**	**131.7**	**143.2**	**154.4**	**164.8**	**170.5**
Liabilities							
Superannuation	11.4	13.0	24.5	24.8	25.1	25.4	25.6
Borrowings [(d)]	9.9	13.9	19.2	26.7	33.2	37.8	39.2
Other liabilities	6.2	10.6	11.2	11.3	11.2	11.1	11.1
Total liabilities	**27.5**	**37.5**	**54.9**	**62.7**	**69.5**	**74.3**	**76.0**
Net assets	**37.9**	**91.9**	**76.8**	**80.5**	**84.9**	**90.5**	**94.5**

Source: Department of Treasury and Finance

Notes:

(a) Non-financial assets include land and buildings, plant and equipment, roads and earthworks, cultural collections and other non-current assets.

(b) Financial assets include cash assets, advances paid, investments, loans and placements, receivables, and investments accounted for using the equity method.

(c) Consists of investment in public financial corporations.

(d) Borrowings include deposits held and advances received.

Non-financial assets account for the bulk of total assets, and consist of land and buildings, plant and equipment, and other fixed assets. Non-financial assets are expected to increase to $155.0 billion by June 2013, due to the substantial infrastructure investment over the period.

Other assets comprise financial assets, as well as investments in other sector entities. Investments in other sector entities consists of the net assets of the State's public financial corporations, which are expected to fall to $0.2 billion by June 2009 as a result of the continuing impact of the Global Financial Crisis.

Borrowings (including advances received and deposits held) are expected to rise by $20.1 billion, to $39.2 billion over the four years to 2012-13. The increase assists the funding of the $32.1 billion infrastructure program for the NFPS.

FINANCIAL SUSTAINABILITY

The growth in borrowings over the forward estimates period will result in a corresponding increase to both net debt and net financial liabilities. As shown in Table 4.5, net financial liabilities are expected to increase to $63.3 billion, or 20.2 per cent of GSP by June 2013. This increase is largely driven by an increase in borrowings over the forward estimates period, as well as an estimated $11.5 billion increase in the net superannuation liability during 2008-09. As discussed in Chapter 3, the superannuation changes largely relate to movements in the discount rate used to value the liability, as well as the continuing impact of the Global Financial Crisis on investment returns.

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

	1999 Actual AAS	2008 Actual GFS	2009 Revised GFS-GAAP	2010 Budget GFS-GAAP	2011 Estimate GFS-GAAP	2012 Estimate GFS-GAAP	2013 Estimate GFS-GAAP
	($ million)						
Net debt [a]	6 058.3	3 890.3	11 220.1	19 078.4	25 648.1	30 167.1	31 263.9
Net Financial Liabilities	20 833.8	23 500.1	42 979.6	51 072.0	57 706.3	62 369.4	63 344.8
	(per cent)						
Net debt to GSP [b]	3.9	1.5	4.2	7.0	9.1	10.1	10.0
Net interest to total revenue [c]	2.3	0.6	1.4	2.0	3.0	3.5	3.6
Net financial liabilities to GSP [b]	13.3	8.8	16.0	18.8	20.4	20.9	20.2
Net interest + superannuation interest expense to total revenue	4.6	1.4	2.9	3.5	4.5	5.1	5.1

Source: Department of Treasury and Finance

Notes:

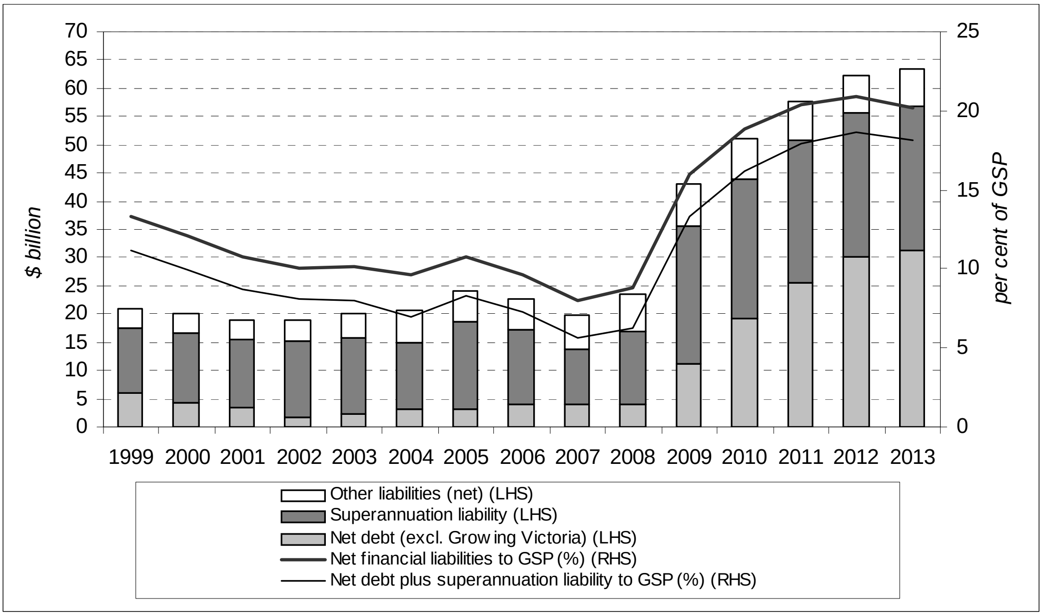
(a) Net debt is the sum of deposits held, advances received and borrowings less the sum of cash deposits, advances paid, and investments, loans and placements.

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

(c) Net interest equals interest expense less interest revenue.

As shown in Chart 4.1, after significant increases in net debt and net financial liabilities in the short term, the increase in debt is expected to moderate from 2011-12. In 2012-13, cash operating surpluses are expected to meet over three quarters of net infrastructure investment. The Government is committed to maintaining fiscal discipline, and has undertaken a number of initiatives (including a more conservative wages policy for public service employees) to bring expenditure growth below revenue growth, thus boosting the operating surplus over time. It is through this strategy that the Government will maintain debt at prudent and sustainable levels over the longer term.

Chart 4.1: Non-financial public sector net financial liabilities



Source: Department of Treasury and Finance

Commonwealth Guarantee of State Borrowings

Victoria's commitment to its triple-A credit rating saw Victoria's cost of borrowing fall to the lowest of any Australian state over the past year. However, as a result of the Global Financial Crisis, it was becoming increasingly difficult for all Australian jurisdictions to raise long term funds, especially those that had either suffered a downgrade in their credit rating or were under the threat of one.

Consequently, the Commonwealth Government announced it was prepared to provide a guarantee over all debt issued by State and Territory Governments up to a maturity term consistent with its own debt profile, and with similar terms and conditions as those applying to the guarantee of bank borrowings. The practicalities of how the guarantee will work are still being considered, with legislation expected to be introduced to the Federal Parliament in May 2009. While Victoria is participating in these discussions, it remains committed to ensuring that any measures are temporary and can be sensibly unwound once a full return to open market operations is possible.

STATE FINANCIAL INDICATORS AND CREDIT RATINGS

Victoria receives credit ratings from two ratings agencies: Standard and Poor’s (S&Ps) and Moody’s Investor Services (Moody’s). Both agencies examine a wide range of financial and non-financial indicators when assessing the credit worthiness of jurisdictions. The agencies have recently been releasing more information to markets on their methodologies, as well as updates on the credit ratings of all Australian jurisdictions.

In particular, S&Ps has described its assessment of key indicators that could trigger a change in a state’s credit rating. S&Ps provided details of their approach in its March 2009 report *How stable is the credit quality of the Australian States*. The report endorsed Victoria’s broad strategy of prudent fiscal management.

One of S&Ps key indicators is net debt (excluding advances paid) and the superannuation liability of the non-financial public sector as a proportion of operating revenue. In Victoria’s case, S&Ps have indicated that the trigger point for a ratings downgrade from triple-A would be if this ratio were to exceed 130 per cent. It is important to note that this trigger point varies across Australian jurisdictions, with all other states having a lower trigger point than Victoria. Victoria’s high trigger point is a reflection of the breadth of its economic base combined with its strong fiscal position and generally high quality infrastructure. In 2013, Victoria’s ratio is forecast to reach 118.5 per cent, well short of the published S&Ps trigger point.

Moody’s have provided similar endorsements of Victoria’s financial management in reaffirming the State’s triple-A credit rating in January 2009.

Victoria monitors the ratings agency indicators closely when developing its budgetary strategy to ensure its triple-A credit rating is maintained.

CHAPTER 5 – ECONOMIC REFORM AGENDA

- The current economic downturn has reinforced the need for Victoria to vigorously pursue its economic reform agenda to ensure that the State is well placed for the upturn, and to address medium- and long-term challenges.
- To prepare for the upturn, and to address the longer term challenges presented by the ageing population, the Government continues to encourage productivity growth through skills reform, infrastructure initiatives, and reducing the burden of state regulation on businesses.
- The current fiscally-constrained environment also makes it imperative for the public sector to improve even further the efficiency of its own operations in order to protect jobs and maintain key government services for a growing and ageing population.

Victoria has been a national leader in economic reform. In addition to its own program of state-based reforms, the Victorian Government is working collaboratively with the Commonwealth and other Australian governments to pursue national reforms in a number of key areas, including health and ageing, education, skills, training, climate change and water, infrastructure, business regulation and competition, housing and indigenous reform, and Commonwealth-State financial relations. A strong record of reform, coupled with sound economic and financial management, has positioned Victoria well to weather the challenges presented by the current Global Financial Crisis and economic downturn.

Even so, the Global Financial Crisis is expected to have a significant impact both on the Victorian economy and on the State's finances. This is reflected in the sharp downward revisions in the economic forecasts that underpin this year's budget and makes the task of maintaining a sound financial position and of maintaining a focus on Victoria's underlying economic competitiveness all the more challenging. Yet these challenges must be met if Victoria is to position itself to respond quickly to recovery when it comes.

Thus, in responding to the economic downturn, the emphasis of the Government's strategy is stimulating jobs and enhancing Victoria's competitiveness. These objectives are being pursued through reforms designed to:

- skill the workforce for transition and recovery;
- improve business competitiveness;

- deliver more efficient infrastructure and facilitate investment;
- improve the efficiency of the Government's own operations;
- ease the adjustment to a carbon-constrained economy; and
- implement more outcomes-focused Commonwealth-State financial arrangements.

The additional challenge of responding to the Global Financial Crisis makes it even more imperative to pursue lasting reforms that will position Victoria to take full advantage of economic recovery, and help to address the longer term challenges posed by slowing productivity, the ageing population and climate change.

SKILLING THE WORKFORCE FOR TRANSITION AND RECOVERY

Boosting investment in training in times of economic downturn enables people to develop skills that can be utilised when the economy recovers.

Maintaining training effort in areas that will flourish again when demand picks up will be essential to ensure that skill bottlenecks do not represent a constraint to growth in the recovery. Similarly, dynamic shifts in skill requirements through the downturn and into the recovery phase and the emergence of new industries post recovery, underscore the need for a highly flexible, responsive and demand-driven training system.

The greatest demand and need for training will come from those who are about to enter the labour force – particularly young school leavers and those just completing their post-school education and training – and those most likely to be displaced during a downturn: young people, those with little work experience, and those with low levels of education. In past economic downturns, youth unemployment has increased more quickly and to a greater degree than adult unemployment rates.

In Victoria, the vocational education and training sector is being transformed into a flexible and responsive system through the reforms and increased funding the Government announced in August 2008: *Securing Jobs for your Future – Skills for Victoria*. There is a two-stage implementation, with eligible Victorians able to access the Victorian Training Guarantee to undertake training at the Diploma and Advanced Diploma level at a wider range of training providers from 1 July 2009. The second stage of this initiative will apply to all qualification levels from 1 January 2011.

These reforms mean the training system will be even better equipped to cater for the needs of youth and displaced workers. For example:

- all people aged up to 20 years, and those 20 and over who do not have a qualification at Diploma or Advanced Diploma level or higher, can access a government-subsidised place in these higher level courses from 1 July 2009;
- from 1 January 2011, Victorians will be guaranteed a government subsidy to undertake training towards qualifications higher than the qualifications they hold, and those aged up to 20 will be able to access subsidised training at any qualification level; and
- a limited number of exemptions to eligibility criteria are available on a case-by-case basis, such as retrenched workers whose qualifications are redundant and who need to retrain to improve their future employment prospects.

These reforms will boost the system's capacity to deliver what individuals and businesses need. The Victorian Training Guarantee is a ground-breaking initiative that brings government subsidised training within the reach of thousands more people.

In addition to state-based reforms, Victoria continues to work closely with the Commonwealth and other states and territories to improve the delivery of education and training services. This includes the Council of Australian Governments (COAG) National Partnership agreement for the delivery of training under the Productivity Places Program, which commenced in January 2009. The Commonwealth Government has also announced funding to encourage employers to keep apprentices on.

IMPROVING BUSINESS COMPETITIVENESS

A key priority for Victoria in improving the business environment has been to keep the taxes and charges on business low and competitive. Victoria has also long been a national leader in regulatory reforms to reduce the burden of 'red tape' on businesses.

Reforms in these areas improve the national and international competitiveness of all Victorian businesses and foster economic growth.

Reducing the burden of regulation

Key elements of Victoria's best practice regulation making and review frameworks include:

- an independent gatekeeper, the Victorian Competition and Efficiency Commission (VCEC) to assess the adequacy of the assessments of regulatory proposals;
- targeted reductions in the administrative burden of regulation ('red tape') through the *Reducing the Regulatory Burden* initiative;
- the *Victorian Guide to Regulation*, which sets out the principles and characteristics of good regulation for all Victorian regulators;

- leadership in harmonisation of regulation through collaboration with other jurisdictions; and
- comprehensive public inquiries into regulatory matters conducted by the VCEC, the Essential Services Commission, and the State Services Authority.

Through the *Reducing the Regulatory Burden* initiative, the Government has committed to cutting red tape by 15 per cent over three years and 25 per cent over five years. The targets amount to $154 million and $256 million per annum, respectively, in red tape savings. The Department of Treasury and Finance has estimated that the productivity boost from reducing red tape has the potential to expand Victoria's economy by up to $747 million a year (in 2005-06 prices) by 2016.

Victoria is progressing well against the three-year 30 June 2009 target. The Treasurer reported in November 2008 that departments have accelerated their regulatory review activities and, as a result, net reductions based on current initiatives are now estimated to be in the order of $162 million a year. The Treasurer will provide a further update later in 2009.

The VCEC is expected to deliver its final report on environmental regulation in mid-2009. As part of this inquiry, VCEC will identify opportunities for Victoria to maintain its leadership in this area and will consider ways in which the regulations can be improved to meet the future challenges of environmental sustainability and a carbon-constrained economy. It is a very timely inquiry as acting on its recommendations will help streamline Victoria's environmental regulatory and approval processes. Together with ongoing reforms to planning regulations, this will be vital to the efficient delivery of the large infrastructure program needed to meet the challenge of climate change.

The Government has also made significant progress on its commitment to reduce the number of principal Acts of Parliament by 20 per cent by 2010. A total of 153 Acts have been repealed to date, and the Victorian Parliament will consider repealing up to another 100 Acts during 2009.

Victoria continues to be at the forefront of national action to reduce the burden of regulation for Victorian businesses operating across state borders. Victoria and New South Wales were the first states to adopt harmonised payroll tax arrangements and Victoria has continued to push strongly for national regulatory reform. In late 2008, COAG signed a National Partnership Agreement to deliver a seamless national economy in 36 areas, which will reduce costs incurred by business and individuals in complying with unnecessary and inconsistent regulation across jurisdictions.

The seamless national economy agenda includes a historic agreement to harmonise occupational health and safety laws by 2011. Businesses have consistently identified overlapping health and safety laws as a major source of unnecessary red tape. Other reforms that will enhance business competitiveness include:

- a national trade licensing system to facilitate a more mobile workforce;
- streamlined environmental assessment and approval processes, with development proposals assessed only once, through a combined assessment process covering both Commonwealth and State responsibilities;
- increasing uptake of electronic development assessments to speed up approvals; and
- reforms to infrastructure regulation, which will improve access and reduce bottlenecks for essential economic infrastructure.

With the introduction of the Commonwealth's Carbon Pollution Reduction Scheme (CPRS) as the key driver of reductions in greenhouse gas emissions across the Australian economy, streamlining existing greenhouse gas-reducing policies across all jurisdictions will be critical to ensure cost-effective change. A rigorous reform process will aim to reduce duplication and ensure a competitive business environment conducive to adjusting to a low-carbon economy.

There will also be a need to address regulatory overlap and 'green tape' once the CPRS is in place.

Business tax competitiveness

The Government remains committed to providing a fair and efficient tax system that is competitive with other states. Victorian businesses have benefited from substantial tax reform over the past decade. These reforms have been designed to improve economic outcomes by increasing the efficiency and equity of the Victorian tax system. The reforms implemented include:

- over $5.3 billion worth of announced tax cuts;
- abolishing eight state taxes as agreed with the Commonwealth Government under the *Intergovernmental Agreement on Federal Financial Relations,* faster than any other state;
- a flattening out of the land tax scale and significant reductions in payroll and land tax rates;
- significant reform of land tax to moderate the impact of the property market boom; and
- measures to reduce the capacity for tax evasion so that taxpayers who are doing the right thing are not unduly burdened. Examples include strengthening anti-avoidance provisions in the conveyancing duty base and reducing the incentive for landowners to minimise their land tax liabilities through the use of trusts.

Victorian businesses now face the second lowest rate of payroll tax in Australia at 4.95 per cent, with Queensland's at 4.75 per cent. However, due to the way that payroll tax is calculated in Queensland, Victorian businesses effectively pay the lowest payroll tax for payrolls valued between $4.9 million and $13.6 million.

A further examination of Victoria's tax competitiveness with other Australian jurisdictions is provided in Chapter 1.

WorkCover premiums

While tax competitiveness is an important part of business decision-making, low WorkCover insurance premiums are another factor that improves the competitiveness of Victoria as a business location. Successive reductions in the WorkCover insurance average premium rates in recent years ensure that Victoria's WorkCover scheme continues to have one of the lowest average premium rates in Australia.

DELIVERING MORE EFFICIENT INFRASTRUCTURE AND FACILITATING INVESTMENT

Victoria has been investing heavily in economic and social infrastructure and is continuing to do so in the *2009-10 Budget*. The delivery of efficient infrastructure is a fundamental foundation for enhancing business competitiveness and fostering economic growth. A strong focus on investment in infrastructure is also playing a pivotal role in the Government's response to the current economic downturn.

The Government is accelerating its own infrastructure program, as well as working alongside the Commonwealth Government to deliver investments as part of the *Nation Building – Economic Stimulus Plan*, and projects funded by the Building Australia Fund. The implementation of new infrastructure projects generates activity and jobs in the short term, while also boosting the medium- and long-term productive capacity of the State and improving the underlying competitiveness of the Victorian economy.

Meanwhile, the Victorian Government is improving the efficiency of its infrastructure networks through pricing and regulatory reforms.

The private sector is a major provider of infrastructure, both in its own right, and in partnership with the Government in the delivery of major projects. The Government can facilitate such investment through streamlining planning rules and approval processes.

Economic regulation of infrastructure

More efficient investment in, and usage of, key infrastructure facilities can sometimes be achieved through greater reliance on market mechanisms, including price signals, to create appropriate incentives for both owners and users. Because much infrastructure exhibits natural monopoly characteristics, there is a lack of competition to impose market discipline. Nevertheless, efficient outcomes can be achieved through the use of well-designed economic regulation.

Victoria has strong credentials in the effective economic regulation of infrastructure services. Recently, the focus of economic regulation in Victoria has shifted to areas such as water and freight networks, and a number of reforms are occurring in these sectors.

Prolonged periods of drought and the consequent restrictions on water usage have emphasised the importance of the efficient provision of water and sewerage services, and the development of innovative solutions for balancing supply and demand. The major water supply augmentation announced in the *Our Water Our Future – The Next Stage of the Government's Plan* will result in new and diversified sources of bulk water, and optimal management of future water supplies will require supporting institutional reforms.

Accordingly, the Government announced in July 2008 that it would develop an access regime for water and sewerage infrastructure services to enable effective competition in markets upstream and downstream from the natural monopoly segments of the market. In November 2008, it directed the Essential Services Commission to undertake an inquiry into developing a state-based access regime to achieve the Government's objectives.

The Essential Services Commission is expected to report its findings to the Minister for Finance by the end of September 2009.

Freight networks are another important area of ongoing reform. The *Victorian Transport Plan*, announced in December 2008, includes measures to improve the efficient operation and productivity of the transport network. It included a strategy to develop an efficient and sustainable freight network. *Freight Futures: Victorian Freight Network Strategy* establishes the Government's vision to modify the physical structure of the Victorian freight network and to provide access to more productive vehicles that should enable industry to operate more efficiently and addressing growing public concerns about local congestion and environmental impacts.

At a national level, progress continues to be made on the COAG-endorsed reform of the national pricing system for heavy vehicles. A key feature of the 2008 Heavy Vehicle Charges Determination was the removal of cross-subsidies between vehicle classes so that individual trucks now face a greater cost of their wear and tear on the national road network.

Facilitating private sector investment

With investment by the private sector a key component of aggregate demand, reforms to stimulate activity in this area will help to sustain employment and boost economic growth.

The Government is already taking action to help facilitate approval to unblock major private sector projects. Since April 2009, the Government has announced decisions to fast-track ten significant projects – including housing, retail and office space developments – which will help to boost economic activity and maintain jobs.

At the same time, the Government is progressing permanent improvements in planning and investment approval processes to reduce avoidable time delays and facilitate household and private business investment. These reforms will ensure that there are no unnecessary barriers to the State positioning itself for recovery. As part of the Government's *Reducing the Regulatory Burden* initiative, reforms to the planning system will provide substantial cost savings to Victorian businesses while improving housing affordability, including:

- the review of the *Planning and Environment Act 1987*, which will streamline current laws, remove redundant provisions, and strengthen timeliness in the planning process, including an examination of the planning permit and amendment processes;
- cutting red tape in Melbourne's growth areas by replacing complex planning processes with new Precinct Structure Plans, with a stronger role for the Growth Areas Authority, in consultation with local government; and
- the Planning Applications Online initiative which will put paper-based planning applications online, substantially reducing the time and complexity of the planning permit process.

The impact of current environmental approval processes on the delivery of projects is also being examined by the VCEC in the context of its inquiry into environmental regulation. The VCEC's draft report, released in March 2009, outlined ways to streamline the environmental assessment process (for example, by applying time limits to all stages of the process), which could reduce delays, without compromising Victoria's environmental objectives.

IMPROVING THE EFFICIENCY OF GOVERNMENT'S OWN OPERATIONS

Just as the economic downturn is forcing the private sector to examine ways to improve its productivity, so too has the current fiscally-constrained environment reinforced the need for the Government to look at its own operations with a view to improving efficiency and maximising the value of Victorian taxpayers' money.

Better asset utilisation is being achieved through the Government's Shared Facility Partnerships guide to good governance for schools and the community, which focuses on facilities that can be shared by schools and the broader community, including libraries and resource centres, halls and meeting spaces, recreational/sporting facilities, information technology centres, and performing arts spaces. To examine the potential for increased sharing of government and community facilities in Victoria, both in relation to existing and new facilities, the Government has asked the VCEC to undertake an inquiry in this area. A draft report for consultation purposes is expected to be released by the VCEC in June 2009.

The Government is also keeping its corporate services cost efficient through a series of *Efficient Government* initiatives, including establishing a new shared library service for government departments and agencies, consolidating Victorian Government car pools, establishing a shared facilities management service for Victorian Government accommodation, and development work towards one information technology service for government by standardising core information and communication technology services across government.

Harnessing the power of the marketplace to provide efficient solutions to achieving policy outcomes and the delivery of government services is another area of increasing focus and reform. Victoria is already well-advanced in the use of innovative market-based instruments in natural resource management and in the more efficient and effective delivery of environmental outcomes. For instance, the BushTender program, which uses auctioned conservation contracts to conserve native vegetation is one example of how market-based instruments are being applied in Victoria.

ADJUSTING TO A CARBON CONSTRAINED ECONOMY

While there is a strong focus on responding to the effects of the Global Financial Crisis, work is nevertheless continuing on addressing the longer term challenges posed by climate change.

Fundamental to the Commonwealth Government’s proposed climate change strategy is the introduction of a Carbon Pollution Reduction Scheme (CPRS). This would place a cap on the amount of carbon pollution industry can emit and, by requiring affected businesses to buy a permit for each tonne of carbon they contribute to the atmosphere, would effectively introduce an explicit price for carbon. Determined by the market, this carbon price will be the driving factor behind structural adjustments to the carbon-constrained economy.

The development of an effective national response to climate change is an established priority for COAG. Over the past year, COAG’s Working Group on Climate Change and Water has been working toward the achievement of three key objectives:

- a single national emissions trading scheme (ETS) incorporating state schemes;
- a nationally consistent set of climate change measures to support the ETS; and
- a national cooperative approach to long-term adaptation to climate change.

Some notable progress has been made towards these goals but, while these achievements are significant, they do not address the breadth of issues that Australia must tackle in the decades ahead. Further national reform aimed at assisting the Australian community to adjust effectively to the CPRS and climate change is required.

Aspects of the design and operation of the proposed CPRS have the potential to impact directly on state finances. These include scheme coverage (particularly how the scheme will treat areas of state policy responsibility such as agriculture and forestry), the scale and nature of assistance for adversely affected groups and additional state spending requirements imposed by the CPRS. To avoid adverse consequences for the States and Territories, the Commonwealth Government will need to consult and work with state and territory governments on all aspects of CPRS design that affect them. This includes consultation in the lead-up to legislation being passed, and over time as the impacts of the scheme emerge.

REFORMING COMMONWEALTH-STATE FINANCIAL RELATIONS

The nature of financial relations between the Commonwealth and state governments will be a key determinant of the success of future nation-building reforms.

On 1 January 2009, a new framework for federal financial relations, agreed by COAG came into effect. The framework is designed to improve the quality and effectiveness of government services and provide the States with increased flexibility in the way they deliver jointly-funded services.

There has been a major rationalisation in the number of specific purpose payments (SPPs) to the States from the Commonwealth, with the creation of five new broad SPPs covering health, schools, skills and workforce development, affordable housing and disabilities. Each SPP is associated with a National Agreement that contains objectives, outcomes, outputs and performance indicators, and clarifies the roles and responsibilities that will guide the Commonwealth and the States in the delivery of services across the relevant sectors.

Another new form of funding, National Partnership (NP) payments, has been created. These will fund specific projects and facilitate and/or reward states that deliver nationally significant reforms.

The new federal financial framework provides a clearer specification of roles and responsibilities of each level of government and an improved focus on public accountability for better outcomes and better service delivery. The accountability of governments to the public will be enhanced through simpler, standardised and more transparent public performance reporting for all jurisdictions. The independent COAG Reform Council (CRC) will provide annual reports to COAG containing the performance data to assist the public in assessing governments' progress against agreed objectives outcomes and outputs. The CRC will also report its own comparative analysis of the performance of governments in meeting the objectives of the National Agreements. The new performance reporting framework is to be further developed and overseen by the Ministerial Council for Federal Financial Relations, in consultation with relevant COAG Working Groups and other Ministerial Councils, with the aim of consolidating the current range of reporting requirements to make them more efficient.

The COAG reforms to federal financial relations are a positive step in establishing genuinely collaborative approaches to delivering core services. The challenge now facing governments is to use these reforms to ensure that more simple and flexible agreements are developed so that resources are more focused on the achievement of improved outcomes for the community.

Commonwealth review of Australia's tax and transfer system

In May 2008, the Commonwealth Government announced a comprehensive review ('the Henry Review') into all aspects of Australia's tax and transfer system (including state taxes and transfers). The Victorian Government welcomes the Henry Review as it represents an opportunity to identify major taxation and transfer payment reforms that will drive economic growth and make the Australian tax system simpler, fairer and more transparent.

Significant improvements to our tax and transfer system can help prepare Australia for a strong recovery and a prosperous future, by ensuring the most productive use of our resources.

To make these changes, the Commonwealth and state governments will need to work together. Improvements to Commonwealth taxation are needed, as well as improvements to state taxation. Most importantly, this review is the first time in 50 years that Commonwealth and state taxation have been seriously examined together.

Over decades, our tax and transfer system has changed incrementally, often without a clear plan or direction, and sometimes with unintended consequences.

In its submission to the review, the Victorian Government has highlighted the need for reform in the following areas:

- **Improving workforce participation and productivity.** The existing interaction between personal income tax and the welfare system can create high effective marginal tax rates, which discourages people from entering the workforce or working more. Workforce participation and productivity are key elements in promoting Australia's long-term economic growth, particularly as the population ages, and the relative size of the workforce declines.
- **Reducing the complexity of the tax and transfer system.** The Australian tax system is complex, which costs businesses, individuals and governments time and resources to understand and comply with its requirements. There is a wide range of options that could be considered to reduce the burden of complying with taxation laws and make the system simpler and more transparent. For example, the Commonwealth could consider reducing the number of tax expenditures, simplifying the welfare system and its administration, and standardising taxation of capital. For its part, the Victorian Government has already acted to make tax administration simpler, including by taking a national leadership role with New South Wales in harmonising the administration of payroll tax.

- **State governments need better access to secure taxation revenue to fund services.** Much of the tax paid in Australia is not spent by the level of government that collects it. The Commonwealth collects over 85 per cent of taxes and has access to some of the largest, broadest and fastest-growing taxes. However, the Commonwealth is only responsible for around half of expenditure on government services, with state governments having primary responsibility for school education, hospitals, infrastructure, police and emergency services, and a range of other areas.

  This imbalance, often referred to as vertical fiscal imbalance, has grown in recent years, with net Commonwealth payments to the States (as a proportion of gross domestic product) at historically low levels.

  This imbalance results in confused accountability, blame shifting, and inefficient churn of tax revenues between levels of government. It also reduces the flexibility for states to respond to community needs, plan future investment and respond to shocks and crises. Future cost pressures, including an ageing population and climate change, will put states in an increasingly difficult position.

The Commonwealth and the States have recently agreed to a new federal financial relations framework, which aims to address some of these issues. However, this imbalance still stands in the way of significant reform to state taxation, which will require deeper, structural reforms and greater cooperation between the different levels of government. For example, a move by the States away from a reliance on stamp duties could only be realistically achieved if this revenue stream was replaced with revenue collected by the Commonwealth Government. This could be achieved in the following two broad ways (or a combination of both): increasing existing Commonwealth Government grants to the States and/or the States sharing revenue from Commonwealth tax bases. Such a reform would need to be implemented carefully to ensure the States have increased fiscal autonomy to deliver services.

The review of Australia’s tax system provides an opportunity to agree to major reforms that could accelerate Australia’s future economic recovery. The right reforms can help ensure our economy is dynamic and position governments to be able to provide the best schools, hospitals, police infrastructure and environmental management to prepare us for the future.

THE STRENGTHENED CASE FOR REFORM

Victoria’s strong track record of ambitious economic reform has helped sustain strong rates of economic growth in the past and is now helping the State weather the effects of the global economic downturn.

A key lesson from past economic downturns is that the economy does not simply revert to its former state when recovery occurs. While some sectors can be expected to rebound once credit restrictions ease and confidence and consumer demand picks up, in other sectors of the economy the downturn will accelerate a process of longer term structural decline. Firms that survive will emerge leaner and more efficient. Some jobs will disappear for good; but new jobs in other emerging industries will take their place.

Keeping business costs low and competitive, investing in productivity enhancing infrastructure, minimising red tape, ensuring that planning and project approval processes do not unduly delay recovery in private investment, and ensuring that Victoria's education and training institutions and models of service delivery are flexible and responsive to changing needs, will all be crucial to ensuring that Victoria is positioned to respond quickly when recovery comes.

These imperatives strengthen the case for further reform. Accordingly, the Government's strategy includes reforms in skills, education and retraining that will strengthen the human capital of the workforce for the future. It will continue to pursue reductions in the regulatory burden to help boost business competitiveness, while working with the Commonwealth and other Australian governments to improve the Australian taxation system. There are reforms to encourage the efficient provision and usage of key infrastructure networks, while measures are underway to facilitate increased private sector investment. The Government is also examining its own operations, and introducing efficiency-enhancing reforms in order to protect jobs and maintain key government services.

Meanwhile, the Government continues to work with the Commonwealth and other Australian governments in shaping an effective response to the challenges of climate change, and in the development of a new framework for Commonwealth-State financial relations that provide incentives for reform, while maintaining a focus on the achievement of improved outcomes for the community.

APPENDIX A – OPERATING STATEMENT RECONCILIATION

INTRODUCTION

This appendix supports the commentary provided in Chapter 3, *Budget Position and Outlook*, by providing a reconciliation and explanations of the key movements in the 2009-10 to 2011-12 net result from transactions since these estimates were published in the *2008-09 Budget Update*.

Table A.1: Reconciliation of *2008-09 Budget Update* to *2009-10 Budget* estimates[(a)]

($ million)

	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
Net result from transactions: 2008-09 Budget Update	**412.4**	**429.7**	**547.7**
Plus: Variations in income from transactions since 2008-09 Budget Update			
Policy decision variations	**17.0**	**17.4**	**17.9**
Economic/demographic variations			
Taxation	(365.0)	(410.4)	(485.1)
Investment income [(b)]	(210.1)	(1.9)	9.0
Total economic/demographic variations	**(575.1)**	**(412.3)**	**(476.2)**
Commonwealth grant variations			
General purpose grants	(1 137.9)	(1 179.9)	(1 080.6)
Specific purpose payment grants	4 229.8	2 701.6	1 500.4
Total Commonwealth grant variations	**3 091.9**	**1 521.7**	**419.8**
Increase in own-source revenue	**171.7**	**129.8**	**104.8**
Administrative variations	**242.1**	**375.6**	**515.5**
Total variation in income from transactions since 2008-09 Budget Update	**2 947.6**	**1 632.1**	**581.7**
Less: Variations in expenses from transactions since 2008-09 Budget Update			
Policy decision variations [(c) (d)]	**689.1**	**224.9**	**139.9**
Commonwealth variations	**1 462.4**	**744.3**	**199.0**
Variations due to changes in own-source revenue	**83.5**	**90.6**	**88.8**
Administrative variations			
Superannuation variations	130.0	136.7	118.1
Other administrative variations	830.0	670.0	293.4
Total administrative variations	**959.9**	**806.7**	**411.5**
Total variation in expenses from transactions since 2008-09 Budget Update	**3 194.8**	**1 866.5**	**839.2**
Revised net result from transactions	**165.1**	**195.3**	**290.3**

Source: Department of Treasury and Finance

Notes:

(a) *Totals may not add due to rounding.*
(b) *Investment income includes dividends, income tax and rate equivalent revenue and interest.*
(c) *Policy decisions are net of funding from contingencies and other efficiencies.*
(d) *Policy decisions include some expenditure associated with Commonwealth funding for the delivery of the Commonwealth* Nation Building – Economic Stimulus Plan *and the COAG outcomes of November 2008.*

Variations to income from transactions

When compared to the estimates published in the *2008-09 Budget Update*, total income from transactions is estimated to be $2 948 million higher in 2009-10, $1 632 million higher in 2010-11 and $582 million higher in 2011-12.

New revenue policy decisions made by government are expected to result in increased revenue of $17 million in 2009-10 and an average of $18 million a year in 2010-11 and 2011-12. This reflects increased taxpayer compliance as a result of the *State Revenue Office – Compliance and e-Sys* initiative announced in this budget.

The impact of the Global Financial Crisis on the Victorian economy and other economic and demographic variables have resulted in downward revisions in taxation revenue of $365 million in 2009-10 and an average of $448 million a year in 2010-11 and 2011-12.

Material changes to taxation revenue estimates due to economic and demographic changes include:

- a downwards revision to land transfer duty revenue (down by $174 million in 2009-10 and on average by $152 million a year in the following two years) reflecting the current weakness in the property market and the deterioration in the economic outlook;
- a downwards revision to payroll tax revenue (down by $150 million in 2009-10 and by an average of $225 million a year in the following two years) primarily due to the deterioration in the employment outlook;
- a downwards revision to gambling taxes and duty on motor vehicle registrations and transfer (down by $119 million combined in 2009-10 and by an average $158 million a year in the following two years);
- an upwards revision to land tax revenue (up $48 million in 2009-10 and by an average $44 million a year in the following two years) due to higher than expected site revaluations as at 1 January 2008; and
- an upwards revision to insurance tax revenue (up $17 million in 2009-10 and by an average $23 million a year in the following two years) reflecting expected increases in insurance premiums.

Investment income has been revised downwards by $210 million in 2009-10, with minor revisions in 2010-11 and 2011-12.

The fall in investment income in 2009-10 mainly reflects a deferral of State Electricity Commission of Victoria (SECV) dividends and a reduction in dividends from the Transport Accident Commission (TAC) as a result of reduced profitability during 2008-09 due to challenging financial conditions. It also reflects a downward revision in investment revenue of $35 million from both the Victorian Property Fund and the Residential Tenancy Fund due to a decrease in interest rates affecting fund earnings.

Further deterioration in financial markets since the *2008-09 Budget Update* has resulted in a reduction of expected income tax equivalent revenue from the TAC and the Victorian WorkCover Authority (VWA) of $154 million in 2011-12 as a result of carry-forward tax losses. No ITEs are forecast to be received from these agencies over the period 2009-10 to 2011-12.

Total Commonwealth grants have been revised upwards by $3 092 million in 2009-10, $1 522 million in 2010-11 and $420 million in 2011-12.

General purpose grants in the form of GST have been revised downwards by $1 138 million in 2009-10 and by an average of $1 130 million a year in 2010-11 and 2011-12. This reduction is primarily related to a decline in the GST pool reflecting the deterioration in the outlook for the Australian economy.

Specific purpose payment (SPP) grants from the Commonwealth have been revised upwards by $4 230 million in 2009-10, $2 702 million in 2010-11 and $1 500 million in 2011-12. The profile of the expected total additional Commonwealth SPP grants revenue since the *2008-09 Budget Update* primarily reflects the timing of the *Nation Building – Economic Stimulus Plan* in 2009-10 and 2010-11. This upwards revision primarily reflects:

- additional funding secured through the new *Intergovernmental Agreement on Federal Financial Relations* announced by the Council of Australian Governments (COAG) in November 2008. This is expected to average $785 million a year from 2009-10 to 2011-12 and provides a significant funding injection by the Commonwealth into the areas of health, education, skills and workforce development and housing;
- increased grants for the delivery of the Commonwealth *Nation Building – Economic Stimulus Plan*. This includes funding for the expansion of the Government's infrastructure investment program in schools, housing, community infrastructure and roads. Funding is also included for repairs to existing public housing dwellings and grants for on-passing to non-government schools for further infrastructure investment in this sector; and
- funding expected under the Nation Building Program (AusLink II) agreement with the Commonwealth has been revised upwards by an average of $272 million a year over the three-year period based on updated estimates of project cashflows. This will be invested in the Government's infrastructure investment program.

Own-source revenue has been revised upwards by $172 million in 2009-10 and an average of $117 million a year in 2010-11 and 2011-12 primarily reflecting contributions from water authorities to the infrastructure investment associated with the *Northern Victoria Irrigation Renewal Project* (NVIRP) ($78 million a year on average over the period). The upwards revision also reflects additional revenue for the health sector ($31 million a year on average over the period) from TAC, VWA and other sources for additional services.

Administrative variations have been revised upwards by $242 million in 2009-10, $376 million in 2010-11 and by $515 million in 2011-12. This primarily reflects:

- the receipt of higher capital assets charge (CAC) revenue from VicTrack ($106 million in 2010-11 and $215 million in 2011-12) reflecting the Government's significant investment in new rail-related infrastructure as part of the *2009-10 Budget*;
- contributions associated with the establishment and operation of a new cross-border health service, *Albury Wodonga Health*, ($55 million in 2009-10 rising to $58 million in 2011-12) which is associated with offsetting expenditure; and
- additional revenue of $31 million in 2009-10 and an average of $31 million a year in the following two years due to a change in accounting treatment which progressively recognises gross (rather than net) City Link concession fee revenue in accordance with accounting conventions.

Variations to expenses from transactions

Compared to the *2008-09 Budget Update*, total expenses from transactions are estimated to be $3 195 million higher in 2009-10, $1 867 million higher in 2010-11 and $839 million in 2011-12.

New output policy decisions (net of funding from contingencies and other efficiencies) made by the Government since the *2008-09 Budget Update* account for $689 million in 2009-10, $225 million in 2010-11 and $140 million in 2011-12 of these additional expenses. This reflects the Government's commitment to secure Victorian jobs during the current economic downturn, and to continue to invest in high-quality service delivery.

Policy decisions made by Government include expenditure associated with the *Nation Building – Economic Stimulus Plan* such as maintenance funding for existing social housing dwellings. They also include expenditure associated with the new *Intergovernmental Agreement on Federal Financial Relations* announced by COAG in November 2008 as mentioned above.

Expenditure revisions associated with Commonwealth grant variations account for additional expenditure of $1 462 million in 2009-10, $744 million in 2010-11 and $199 million in 2011-12. This mainly reflects the on-passing of grants to non-government schools, and non-government organisations to build social housing as part of the *Nation Building – Economic Stimulus Plan*. The expense profile of Commonwealth variations therefore reflects the timing of the *Nation Building – Economic Stimulus Plan* in 2009-10 and 2010-11.

Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*, provides more detailed information on the Government's service delivery commitments, while Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, provides a detailed list and description of all service delivery initiatives announced in the *2009-10 Budget*.

Expenditure associated with variations in own-source revenue has been revised upwards by $83 million in 2009-10 and an average of $90 million a year in 2010-11 to 2011-12. This primarily reflects the expenditure associated with the additional revenue generated by the health sector mentioned above as well as contributions from water authorities to the operating costs of NVIRP.

Total administrative variations are expected to increase by $960 million in 2009-10, $807 million in 2010-11 and $412 million in 2011-12.

Superannuation related expenses have been revised upwards by $130 million in 2009-10 and by an average of $127 million a year in 2010-11 and 2011-12. The increase is primarily due to a lower value of superannuation assets being available to generate the planned return on assets and thus offset the accruing cost of superannuation entitlements. The lower than expected value of superannuation assets is primarily attributable to the ongoing Global Financial Crisis which has adversely impacted on asset values through financial market volatility and reduced corporate profitability. Despite this, the State's superannuation assets continue to be invested in accordance with a long term investment strategy that is appropriately aligned to the term and nature of the liabilities.

Other administrative variations include:

- an increase in the contingency provision of $246 million in 2009-10 and an average of $424 million in 2010-11 and 2011-12 that is not allocated to departments. This provides for the future funding of programs to meet the Government's service delivery priorities and takes into account anticipated future growth in the demand for government services and other unquantified expenditure risks such as those that may still be realised from the 2009 bushfires. It also reflects decisions made by Government that have not yet been announced;
- a revision to the existing departmental funding and price review models used to inform the appropriate level of funding for non-wage costs from 2010-11 onwards, in line with lower inflation expectations. Together with the new wages policy, this will allow the Government to manage underlying expenditure growth while supporting the government's commitment to maintaining real wages and its pledge to protect public sector jobs;
- an increase in interest expense reflecting the Government's commitment to maintain and expand its infrastructure program against the backdrop of a challenging economic environment ($49 million in 2009-10 and an average of $208 million in the following two years);
- increased expenditure associated with the establishment of *Albury Wodonga Health* of $55 million in 2009-10 and an average of $57 million a year in the following two years as mentioned above;

- additional expenditure of $31 million in 2009-10 and an average of $31 million a year in 2010-11 and 2011-12 associated with the change in accounting treatment for City Link concession fees as mentioned above; and
- an increase in CAC provided to VicTrack ($44 million in 2009-10 and an average of $129 million in 2010-11 and 2011-12 as mentioned above).

APPENDIX B – SENSITIVITY ANALYSIS TABLE

INTRODUCTION

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

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

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

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

Table B.1: Impact on the general government fiscal results of selected economic indicators being one per cent higher than expected in 2009-10[(a) (b) (c)]

($ million)

	2009-10 Estimate	*2010-11 Estimate*	*2011-12 Estimate*	*2012-13 Estimate*
Gross state product				
Income from transactions	130	138	146	153
Expenses from transactions	5	-2	-9	-16
Net result from transactions	**124**	**139**	**155**	**169**
Other economic flows	..	..	..	..
Net result	**124**	**139**	**155**	**169**
Employment				
Income from transactions	46	48	50	53
Expenses from transactions	-1	-4	-7	-9
Net result from transactions	**47**	**52**	**57**	**62**
Other economic flows	..	..	..	..
Net result	**47**	**52**	**57**	**62**
Consumer prices [(d)]				
Income from transactions	250	253	261	270
Expenses from transactions	98	93	86	80
Net result from transactions	**152**	**160**	**175**	**190**
Other economic flows	-161	..	..	..
Net result	**-8**	**161**	**176**	**191**
Average weekly earnings				
Income from transactions	51	53	56	59
Expenses from transactions	5	2	..	-3
Net result from transactions	**46**	**51**	**56**	**61**
Other economic flows	..	..	..	..
Net result	**46**	**51**	**56**	**61**
Enterprise bargaining agreements [(e)]				
Income from transactions	22	22	23	23
Expenses from transactions	163	204	221	237
Net result from transactions	**-141**	**-182**	**-198**	**-214**
Other economic flows	-242	..	..	..
Net result	**-383**	**-182**	**-198**	**-214**
Domestic share prices				
Income from transactions	..	..	..	..
Expenses from transactions	..	-3	-3	-3
Net result from transactions	**..**	**3**	**3**	**3**
Other economic flows	35	..	..	..
Net result	**35**	**3**	**3**	**3**
Overseas share prices				
Income from transactions	..	..	..	..
Expenses from transactions	..	-3	-3	-3
Net result from transactions	**..**	**3**	**3**	**3**
Other economic flows	34	..	..	..
Net result	**34**	**3**	**3**	**3**

Table B.1: Impact on the general government fiscal results of selected economic indicators being one per cent higher than expected in 2009-10 (continued)[(a) (b) (c)]

($ million)

	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Property prices				
Income from transactions	42	65	66	67
Expenses from transactions	-1	-6	-9	-13
Net result from transactions	**43**	**71**	**75**	**80**
Other economic flows	16	..	..	..
Net result	**60**	**72**	**77**	**81**
Property volumes				
Income from transactions	33	37	37	38
Expenses from transactions	-1	-3	-5	-7
Net result from transactions	**34**	**40**	**42**	**45**
Other economic flows	..	..	..	..
Net result	**34**	**40**	**42**	**45**
Interest rates [(f)]				
Income from transactions	21	37	35	35
Expenses from transactions	23	159	194	228
Net result from transactions	**-2**	**-122**	**-159**	**-192**
Other economic flows	4293	..	..	..
Net result	**4291**	**-122**	**-159**	**-192**

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 a higher surplus or lower deficit. Numbers may not balance due to rounding.

(b) The sensitivity from a 1 per cent lower-than-expected outcome of an economic variable would, in most instances, simply be the opposite of the impact shown in the table. However, for some results, the impacts of changes are not symmetrical and therefore care should be exercised when using the table to estimate the impact of lower-than-expected economic variables.

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

(d) Reflecting the Government's departmental funding arrangements, it is assumed that an increase in consumer prices within the budget year does not impact on employee entitlements.

(e) Represents a 1 per cent increase in all government enterprise bargaining agreements.

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

Sensitivity to economic growth

Higher-than-expected gross state product leads to higher revenue, principally from goods and services tax (GST) grant revenue and taxation revenue from related consumption taxes. This also leads to increased sales of goods and services leading to an increase in expenses. However, over time, a decrease in interest costs results in a decline in expenses. This increases both the net result from transaction and the net result.

Sensitivity to employment

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

Sensitivity to consumer prices

Higher consumer prices are assumed to lead to higher Commonwealth-sourced revenue and revenue from sales of goods and services (reflecting indexation and changes in other charges), 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 Government's departmental funding arrangements, the 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.

The increase in consumer prices would also result in an immediate increase in the superannuation liability which would adversely affect the net result by way of an actuarial loss. In subsequent years the now higher superannuation liability also increases the superannuation expense slightly. Overall, there is a positive impact on the net result from transactions.

Sensitivity to average weekly earnings

A rise in the level of economy-wide wages would result in higher payroll tax revenue, contributing to an increase in the net result from transactions and net result. As with the sensitivity to consumer prices, where there is an increase in Commonwealth-sourced revenue (due to indexation arrangements), there is a proportional increase in expenses. The Government's enterprise bargaining agreements are assumed to be unchanged over the projection period.

Sensitivity to enterprise bargaining agreements

Enterprise bargaining agreements have the potential to pose a substantial risk to Victoria's budget position. The Government's public sector wages funding policy seeks to maintain the real value of wages and seeks productivity offsets for higher wage outcomes to minimise the risk to the budget. An across-the-board rise in the Government's enterprise bargaining agreements in excess of the level set out in its wages policy would result in an increase in employee entitlements and a corresponding decline in the net result from transactions. This is only partially offset by increased revenue from indexation arrangements and user charges (which are based on the cost of providing services).

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

Sensitivity to domestic and overseas share prices

The State's public financial corporations (PFCs) and superannuation funds have holdings of domestic and international shares as part of their respective investment portfolios. In relation to the PFCs, higher domestic and international share prices therefore raise the profits (or reduce losses) and so the associated income tax equivalents (ITEs) from PFCs generally rise. However, in the current environment, where there have been substantial decreases in share and other asset prices, accumulated carry forward tax losses mean there will be little or no impact.

Higher share prices also reduce the value of the superannuation liability due to the increase in superannuation fund assets. Furthermore, the higher than expected level of superannuation fund assets also reduces the superannuation expense beyond the budget year, thereby improving the net result from transactions in forward years.

Sensitivity to property prices

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

Sensitivity to property volumes

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

Sensitivity to interest rates

A one percentage point increase in interest rates is assumed to occur equally across the entire term structure. The increase in interest rates reduces the valuation of long-term liabilities of the PFCs and, where this raises measured profits of these entities for distribution to the general government sector through ITEs, there will be an increase in revenue. This is partly offset by lower public non-financial corporation dividends and ITEs due to higher borrowing costs, as well as an increase in the borrowing costs of the general government sector.

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

STYLE CONVENTIONS

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

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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