Strategy and Outlook

2004-05

Presented by

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Treasurer of the State of Victoria

for the information of Honourable Members

Budget Paper No. 2

TABLE OF CONTENTS

CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

- The Government is committed to maintaining a general government operating surplus of at least $100 million in each year. The budget projections show that this target will be achieved, with a surplus of $545 million budgeted for 2004-05, and an average surplus of $571 million in the 2005-06 to 2007-08 period.
- The Government is committed to delivering world-class infrastructure to enhance social, economic and environmental outcomes across the State. In line with this goal, this budget provides new asset funding with a total estimated investment of $2.0 billion and the general government capital stock is projected to grow by 7.4 per cent in real terms over the four years to June 2008, well in excess of Victoria's projected population growth of 4.2 per cent.
- The Government will continue to improve quality, access and equity in service delivery to all Victorians through the continuing implementation of its 2002 election commitments and improved targeting of social services. The Government has now funded 100 per cent of its 138 election output commitments, and has approved around 80 per cent of funding for asset commitments for commencement in 2004-05. Contingency and other provisions are sufficient to fund the remaining election commitments in future budgets. The Government is undertaking major reform to ensure that benefits and services attached to concession cards are targeted to those Victorians most in need, especially low-income earners and children.
- The Government is committed to providing a fair and efficient tax system that is competitive with other States. In line with this, the Government has implemented further reform to a key business tax – land tax – and providing substantial relief for first home buyers. After allowing for known future tax policy changes in all States, Victoria's taxes are set to remain below the Australian average and below New South Wales.
- The Government will maintain state government net financial liabilities and net debt at prudent levels and retain Victoria's triple-A credit rating.

This chapter sets out the Government's financial policy objectives and strategies as required by the *Financial Management (Financial Responsibility) Act 2000*. The Act includes a set of sound financial management principles. These are to:

- manage financial risks faced by the State prudently, having regard to economic circumstances;
- pursue spending and taxation policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden;
- maintain the integrity of the Victorian tax system;
- ensure that government policy decisions have regard to their 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.

These financial management principles underpin the Government's financial policy objectives and strategies.

The Government's financial strategy, objectives and priorities were set out in its 2002 election policy statement *Delivering Financial Responsibility*. The broad strategic priority is to provide a sound and stable financial basis from which growth can be promoted across the whole State. The Government will deliver world-class infrastructure to drive economic growth, and to improve quality, access and equity in key services to all Victorians, while maintaining a sound financial position.

This strategy is also consistent with managing longer-term fiscal issues, since the capacity of governments and the wider community to manage risks and capitalise on opportunities in the future will depend critically on the strength of the economy and government finances. Several long-term fiscal pressures exist for Victoria, including:

- reduced growth in the workforce and therefore in payroll and other taxes as the Victorian population ages;
- rising health costs resulting from new health technologies and ageing of the population;
- Commonwealth grants (on current policy settings) not keeping pace with economic growth;
- environmental change;
- changing infrastructure needs;
- strong growth in demand for concession card related benefits; and
- rising community expectations of government services.

Whatever challenges the future presents, strong and sustained economic growth, consistent with social equity and environmental sustainability, will produce positive outcomes – for individuals, businesses and governments. For example, a sustained

0.25 per cent a year increase in productivity growth could halve the projected fiscal gap arising from the above-mentioned long-term pressures on the budget (for further details see the Department of Treasury and Finance discussion paper launched in April 2003, *Shaping a Prosperous Future*).

For this reason, the Bracks Government has a strategic focus on building a more competitive, innovative and productive economy, through programs included in *Victoria: Leading the Way*, investing in communities to link the whole State, and enhancing education and lifelong learning opportunities.

The Government's Economic Statement, *Victoria: Leading the Way,* released on 20 April 2004 represents an action plan targeted at the Government's top priorities for the whole State, including:

- cutting the cost of doing business and reducing red tape;
- driving new investment and infrastructure;
- creating new export opportunities and innovative industries; and
- boosting Victoria's services sector.

The Government's financial responsibility legislation requires a statement of its short and long-term financial objectives in each budget. It is a key element supporting the financial management principle of providing full, accurate and timely disclosure of financial information relating to the activities of the Government and its agencies.

The Government's short and long-term financial objectives, as shown in Table 1.1, are consistent with *Growing Victoria Together*, which outlines the Government's vision for balancing economic, social and environmental priorities in Victoria over the next decade. Progress against each of the five objectives is discussed in the following sections of this chapter.

Table 1.1: 2004-05 Financial objectives

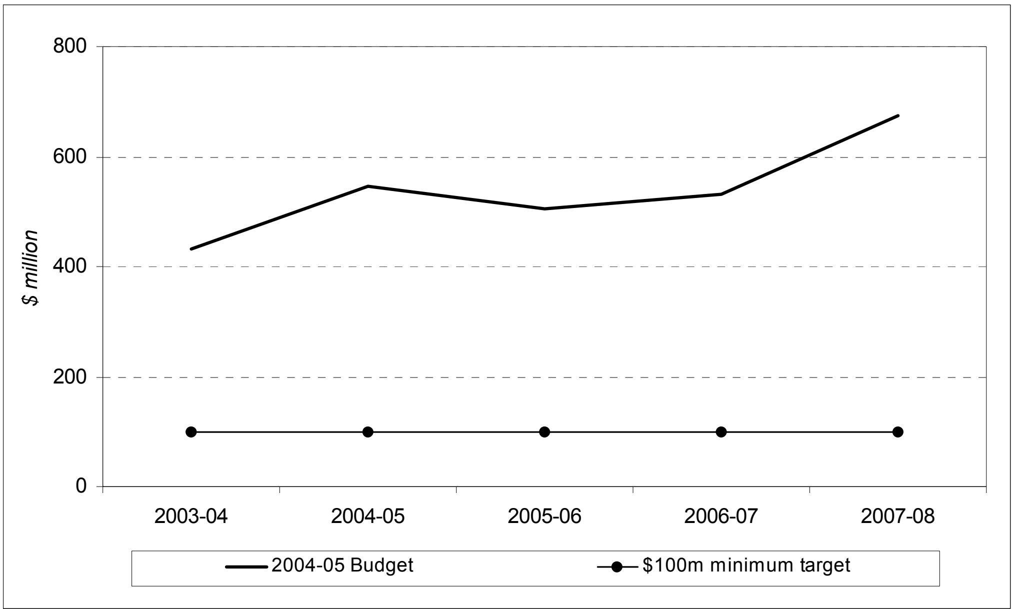
Long-term	*Short-term*
Maintain a substantial budget operating surplus	Operating surplus of at least $100 million in each year
Deliver world-class infrastructure to maximise economic, social and environmental benefits	Implement strategic infrastructure projects, including those funded from the Growing Victoria infrastructure reserve
Provide improved service delivery to all Victorians	Implement 2002 election commitments
Provide a fair and efficient tax system that is competitive with other States	Implement reforms to Victoria's business taxation system
Maintain state government net financial liabilities at prudent levels	Maintain a triple-A credit rating

OBJECTIVE ONE: OPERATING SURPLUS

The Government's long-term objective remains to deliver a substantial budget operating surplus. In the short term, its objective is to maintain an operating surplus of at least $100 million in each year. This is the key financial measure for the Government.

As shown in Chart 1.1, the outlook for the general government operating surplus is consistent with the Government's short-term objective. Following an estimated surplus of $432 million in 2003-04, the operating surplus is forecast to be $545 million in 2004-05 and to average $571 million in the following three years.

Chart 1.1: General government operating surplus[a]



Source: Department of Treasury and Finance

Note:
(a) The general government sector operating surplus is equivalent to the 'net result' in the statement of financial performance in Budget Paper No. 4, Chapter 1, Estimated Financial Statements.

The Government's fiscal strategy enables it to maintain a buffer above the $100 million minimum operating surplus target to allow for unforeseen circumstances and budget flexibility.

The operating surplus objective and buffer accord with the financial management principle of pursuing expenditure and taxation policies that allow reasonable stability and predictability in tax burden levels. Thus, Victorians can have confidence that overall tax rates and the level of service delivery will not need to be adjusted markedly and unexpectedly at some future date to protect the State's financial position.

Application of the surplus

Table 1.2 shows that the operating surplus is an important funding source for the Government's substantial capital investment program. In 2004-05, net investment in fixed assets of $2 872 million is funded from depreciation and other non-cash expenses ($1 996 million), the operating surplus ($545 million), an increase in net debt ($143 million), and a drawdown in the Growing Victoria infrastructure reserve of $186 million.

The capital investment program is being funded while maintaining net debt at modest levels, with only moderate increases forecast in the forward estimates period.

Table 1.2: Application of cash resources

($ million)

	2003-04 Revised	2004-05 Budget	2005-06 Estimate	2006-07 Estimate	2007-08 Estimate
Operating surplus	432.5	545.0	505.4	530.5	675.7
Plus: Non-cash expenses (net) [a]	1 385.9	1 995.6	2 185.6	1 457.6	1 311.7
Net cash flow from operating activities	**1 818.3**	**2 540.6**	**2 690.9**	**1 988.1**	**1 987.4**
Plus: Net drawdown of Growing Victoria infrastructure reserve	622.8	185.6	4.5	..	..
Total cash available for asset investment	**2 441.1**	**2 726.2**	**2 695.4**	**1 988.1**	**1 987.4**
Less:					
Net investment in fixed assets [b]	2 113.3	2 871.6	2 465.4	2 281.8	2 153.9
Other investment activities (net) [c]	18.1	(2.0)	432.2	2.5	4.4
Decrease in net debt (excluding Growing Victoria) [d]	**309.7**	**(143.4)**	**(202.2)**	**(296.2)**	**(170.9)**

Source: Department of Treasury and Finance

Notes:
(a) Includes depreciation and movements in unfunded superannuation liability and liability for employee benefits.
(b) Includes net contributions to other sectors of government.
(c) The increase in 2005-06 reflects the Statement of Financial Position impact flowing from the completion and handover to the State of the Spencer Street Station redevelopment project.
(d) Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.

Alternative measures of operating performance

The Government currently headlines the operating surplus derived from the Australian Accounting Standard (AAS 31). This and alternative measures of operating performance are shown in Table 1.3.

An alternative measure of operating performance developed by the Victorian Department of Treasury and Finance is the *standardised operating surplus*. This measure has been developed to increase understanding of the significant impact the volatility of financial asset prices can have on the operating surplus. Changes in asset values have a direct impact on the general government sector superannuation liability, and increases to the liability are recorded as an expense in the statement of financial performance.

The standardised operating surplus is equal to the operating surplus less the difference between the actual rate of return and the long-term actuarial expected rate of return on superannuation funds and other financial assets. This removes the impact and volatility in asset markets on the operating result and allows for a more complete analysis of the State's underlying financial performance. The standardised operating surplus in 2003-04 also removes a one-off item on the operating statement relating to balance sheet adjustments associated with the discontinuation of the Smelter Reduction Amount (SRA). The SRA is excluded to enable the methodological basis of the standardised operating surplus to remain consistent and allows a comparison with prior year results.

Over the budget and forward estimates period, the standardised operating result is identical to the AAS 31 operating result, since it is assumed the expected return on financial assets will be realised and there are no unusual items akin to the discontinuation of the SRA.

Another operating result and other measures of financial performance are published under the Government Finance Statistics (GFS) framework used by the Australian Bureau of Statistics (see Budget Paper No. 4, Chapter 6, *Uniform Presentation of Government Finance Statistics*).

The *GFS operating balance*, as a measure of financial performance, is broadly similar in concept to the headline AAS 31 operating result, as both match revenue (including taxes and grants) earned in the year, to expenses incurred. Like the standardised operating result, the GFS operating balance does not include changes in superannuation liability. The GFS operating balance is forecast to be in surplus over the outlook period.

Net lending is equal to the GFS net operating balance less net capital formation. As net lending treats asset expenditure as an immediate expense, rather than over time (through depreciation), it is lower than the GFS net operating balance over the forward estimates due to the size of the infrastructure program.

The *GFS cash surplus* is equal to net cash flows from operating activities less net investment in non-financial assets. Equivalently, the cash surplus is equal to net lending excluding revenue accruals and non-cash expenses principally relating to superannuation and employee entitlements. As a result, the cash surplus is generally higher than net lending but lower than the GFS net operating balance.

Table 1.3: AAS 31 and GFS budget measures

($ million)

	2003-04 Revised	2004-05 Budget	2005-06 Estimate	2006-07 Estimate	2007-08 Estimate
Operating surplus (AAS 31)	432	545	505	531	676
Standardised operating surplus (a)	1 036	545	505	531	676
Net operating balance (GFS)	719	529	493	467	574
GFS net lending (b)	851	- 472	- 847	- 186	- 43
GFS cash surplus (b)	695	338	105	35	3

Source: Department Treasury and Finance

Notes:

(a) Operating surplus (AAS 31) less the difference between the actual rate of return on superannuation fund and other financial assets and the expected long-term rate of return at the beginning of the financial period. Includes an adjustment for the one-off item amounting to $1 250 million relating to the discontinuation of the Smelter Reduction Amount in 2003-04.

(b) These measures exclude the impact of Growing Victoria investments, which are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and therefore are not available to redeem gross debt.

International financial reporting standards

Australia, along with a number of other countries, is currently considering changes to accounting standards designed to enhance comparability across jurisdictions. The private sector is likely to be affected by any changes to retrospective reporting requirements affecting reporting periods commencing after 1 January 2005, and involving the harmonisation of Australian and international accounting standards. The public sector is likely to be affected by this change from 2005-06 onwards, together with a second proposed harmonisation of the new accounting standards to a revised framework of GFS. There is currently no timetable for this second element of changes affecting the public sector.

The Victorian Government is actively monitoring the proposed changes to the accounting framework, and the timetable for harmonisation of accounting frameworks with GFS. Both sets of possible changes are likely to affect the presentation of financial information across government, at the aggregate level as well as at entity level. The Government's preference is for any changes to be made in a way that preserves transparency while avoiding confusion and possible inconsistencies in treatment.

Until the final form and content of the possible changes are known, the Government will continue to publish its financial information on the basis of the existing accounting and GFS frameworks.

OBJECTIVE TWO: INFRASTRUCTURE

The Government is committed to delivering world-class infrastructure to enhance social, economic and environmental benefits across the State. In *Growing Victoria Together,* the Government identified the following priority infrastructure actions:

- building fast, reliable and efficient transport and communication infrastructure;
- better linking of Melbourne and regional ports to industry and agricultural centres across Victoria;
- connecting more Victorians to the internet and other new technologies; and
- rebuilding and modernising the State's social infrastructure including schools, hospitals, prisons, police stations, community services and recreational and cultural resources – the foundations for a prosperous and equitable society.

In its recent economic statement, *Victoria: Leading the Way*, the Government also announced a range of infrastructure initiatives and plans to ensure an ongoing sustainable and competitive business environment. The statement showcases the next steps in the Government's economic program including investing in world's best infrastructure to move goods to markets cheaper and faster. Major initiatives include;

- a $367 million *Partnerships Victoria* project to redevelop the Melbourne Convention Centre to provide Victoria a world-class integrated exhibition and convention centre able to compete in the national and international business events market;
- $15 million total estimated investment (TEI) for the completion and acceleration of detailed feasibility studies and design plans for the channel deepening project development proposal, with a total project value of between $350 million and $450 million;
- $4.7 million over two years towards final site analysis and site design for the relocation and redevelopment of the Melbourne Wholesale Markets; and
  - $2.1 million TEI to develop fully detailed designs for the grade separation of Footscray Rd and the realignment of the rail track into and within the Port of Melbourne, with a total project value of over $120 million.

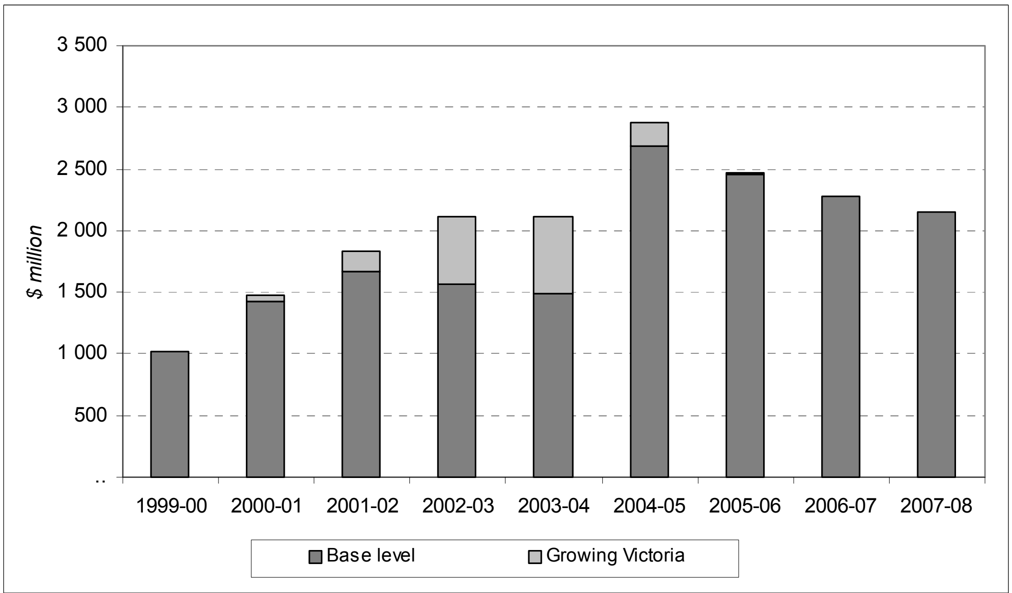
Building on the substantial infrastructure spending commitments made by the Government in the past four budgets, the 2004-05 Budget provides funding for the commencement of new infrastructure investment projects with a TEI of $2.0 billion, in addition to the $364 million announced in the *2003-04 Budget Update* and major asset investments outlined in *Victoria: Leading the Way*. Other significant components of the 2004-05 Budget program include:

- $20 million TEI as part of the *Caring for Children* package to boost children's health services and protect and care for vulnerable children;
- a $50 million boost to the supply of affordable housing across Victoria;

- $174 million TEI providing new and replacement schools and TAFEs across the State, modernising existing facilities and rebuilding schools damaged by fire;
- $30 million TEI for new community facilities to be shared by schools, clubs and community groups;
- $317 million TEI for new and upgraded health and community care facilities;
- $16 million TEI toward enhancing counter-terrorism measures;
- $164 million TEI for an outer-metropolitan arterial road program, upgrading roads in outer suburbs; and
- $73 million TEI toward a rural roads package to improve key regional roads.

The Government's commitment to delivering world-class infrastructure is reflected in Chart 1.2, which shows past actual expenditure on net infrastructure investment by the general government sector, together with forward projections, and indicates the significant increase in infrastructure spending since 1999-2000. The Growing Victoria infrastructure reserve is expected to be extinguished with the allocation of the final $4.5 million in 2005-06.

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

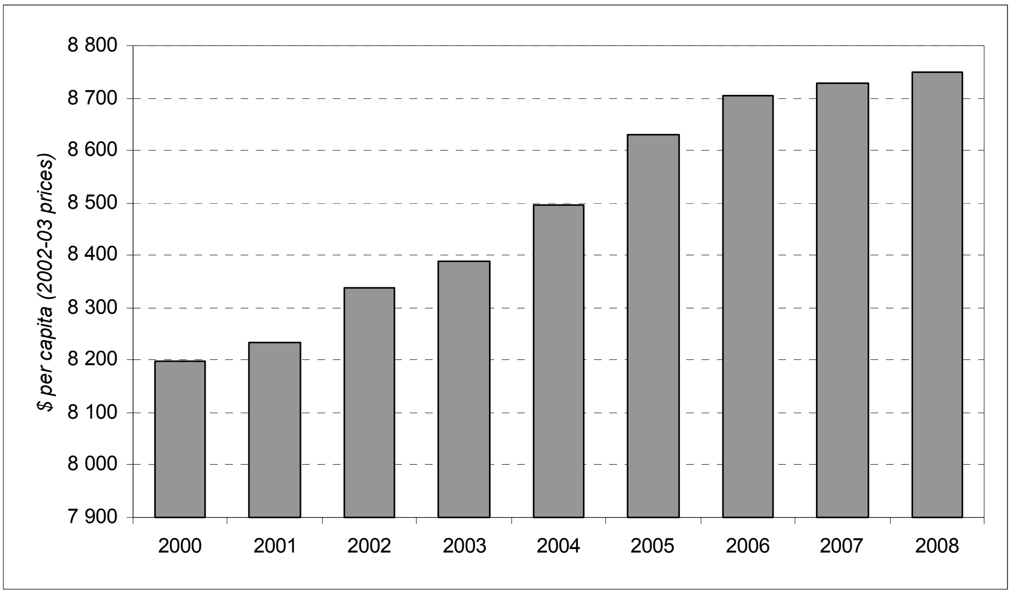


Source: Department of Treasury and Finance

Note:
(a) Includes purchases of property, plant and equipment and net contributions to other sectors of government less proceeds from sale of property, plant and equipment.

Over the period 2004-05 to 2007-08, general government net infrastructure investment will average $2.4 billion a year, with $2.9 billion in 2004-05. This level of expenditure well exceeds estimated depreciation of around $1.2 billion a year, and results in growth of the real capital stock over the four years to June 2008 of 7.4 per cent, well above the projected population growth of 4.2 per cent over the same period. Chart 1.3 shows that by 2008 each Victorian will be supported, on average, by nearly $8 800 (in real terms) of public sector infrastructure, up from $8 200 (in real terms) in 2000.

Chart 1.3: Real capital stock per capita as at 30 June



Source: Department of Treasury and Finance

The significant boost to Victoria's infrastructure has been made possible by Victoria's strong financial position. The past and forecast operating surpluses, together with the Growing Victoria infrastructure reserve, have enabled the Government to pursue its program of significantly upgrading and modernising infrastructure. Further details of how the 2004-05 Budget asset investment program impacts on the State's balance sheet can be found in Budget Paper No. 2, Chapter 4, *Balance Sheet Management and Outlook.*

OBJECTIVE THREE: SERVICE DELIVERY

The Government is continuing to improve quality, access and equity in service delivery to all Victorians through the implementation of the Government's 2002 election commitments. A substantial part of these commitments, as outlined in *Labor's Financial Statement 2002*, were funded in the 2003-04 Budget. In this budget, the Government approved the remaining 18 of the 138 output initiatives that required funding in 2004-05.

Table 1.4: *Labor's Financial Statement 2002* summary of asset and output funding to date

	Labor's Financial Statement costings	*Funded in 2003-04 Budget*	*Funded in 2004-05 Budget*	*Total funding to date*	*To be considered in future budgets*	*Per cent funded to date*
Output						
LFS output costing *($ million)*	2 520.0	1 940.8	765.9	2 706.7	..	107%
Number of initiatives *(number)*	138 [(a)]	120	18 [(b)]	138	..	100%
Asset						
LFS asset TEI *($ million)*	1 915.8	539.6	939.7	1 479.3	499.4	77%
Number of initiatives *(number)*	52 [(c)]	27	14	41	11	79%

Source: Department of Treasury and Finance

Notes:

(a) Represents the 133 output initiatives published in the Labor's Financial Statement 2002, as well as six asset initiatives that were subsequently funded as outputs and the combination of the Koori Maternity Services and the Improved Maternity Services for Rural Hospitals output initiatives. These two output initiatives were combined to emphasise the development of new models of care for maternity services in rural hospitals and Aboriginal Health Cooperatives.

(b) Excludes the National Ice Sports Centre and Hospital Demand Management Strategy output initiatives that are detailed in Table 2.1 of Budget Paper No. 3, Chapter 2, as funding was also committed in the 2003-04 Budget.

(c) Represents the 59 asset initiatives published in the Labor's Financial Statement 2002, less six asset initiatives that were subsequently funded as outputs and the combination of the New Schools and School Replacement Program asset initiatives into the Building Better Schools – New and Replacement Schools asset initiative.

The Government will continue to improve quality, access and equity in service delivery to all Victorians through the continuing implementation of its 2002 election commitments and improved targeting of social services. The Government has now funded 100 per cent of its 138 election output commitments, and has approved around 80 per cent of funding for asset commitments for commencement in 2004-05. Contingency and other provisions are sufficient to fund the remaining election commitments in future budgets.

Growing Victoria Together provides the framework that balances the Government's economic, social and environmental goals and objectives for all Victorians. The 2004-05 Budget builds on these foundations, focusing on jobs, families, communities, health, education and innovation.

Since coming to office, the Government has increased Victoria's spending to produce better outcomes in the areas of education, health and community safety. For example:

- class sizes in prep to year 2 have fallen from an average of 24.3 students in 1999 to 21.0 students in 2004;

- since its introduction in 2001-02, the Hospital Demand Management Strategy has improved the quality and effectiveness of Victoria's public health system enabling hospitals to treat an average of 35 000 extra patients a year, halving of hospital bypass incidents and reduced elective surgery waiting lists; and
- Victoria is the safest State in Australia, with the rate of crimes against the person the lowest of all the States (measured per 100 000 persons).

The 2004-05 Budget provides additional output funding of $1 078 million in 2004-05 and an average of $839 million over the following three years. After accounting for funding from existing forward estimates contingencies, the net budget impact of 2004-05 output initiatives is $688 million in 2004-05. This is in addition to the output initiatives announced in the *2003-04 Budget Update* of $70 million in 2004-05.

The 2004-05 Budget continues the major improvements that have been made to Victoria's health care system since the Bracks Government came to office with initiatives of $1.9 billion over four years, as well as asset investment of $355 million TEI, to ensure the provision of high quality, accessible health and community services.

In education, the 2004-05 Budget commits $296 million over four years, as well as asset investment of $324 million TEI, to value and invest in lifelong education.

The Victorian Government will provide first home buyers with a $5 000 *First Home Bonus* until 30 June 2005. All Victorian first home buyers who qualify for the Government's $7 000 First Home Owner Grant (FHOG) can apply for the additional *First Home Bonus* for homes purchased on or after 1 May 2004 and valued up to $500 000.

The total Victorian Government grant of $12 000 will fully offset stamp duty for property purchases of $272 000 and below and for lower priced housing will also provide significant funds to meet other costs of setting up a first home. In total the new grant is expected to benefit about 26 000 Victorian first home buyers. During the period that the more generous Victorian Government's $5 000 grant is available, the conveyance duty exemptions for first home buyers with families will be suspended.

New departmental funding model

In the 2003-04 Budget, the Government announced that it was undertaking fundamental reform of departmental funding arrangements to better drive productivity growth and achieve improved policy outcomes. Since then, significant work has been undertaken by the Government to develop a new departmental funding model, which will apply from 2004-05.

The funding model will help achieve the Government's desired policy outcomes and drive productivity by ensuring departments are accountable for managing costs while providing departments with certainty about future funding levels. The primary feature of the model is a clearer focus on service delivery, simplicity in setting estimates and allocating responsibility for productivity and risk where they are best managed.

Under the model, the Government will determine the level of service and the total price for these services. Departments will be responsible for ensuring delivery of agreed services within the Government's desired parameters and managing the associated costs. The price will be increased over time by an approved escalation factor to maintain alignment with movements in the rate of inflation. The combination of these elements replaces the 1.5 per cent productivity dividend previously applied to departments' forward estimates.

This means that for the first time since the 1984-85 Budget, an explicit productivity dividend (set at 1.5 per cent in 2003-04) will not be extracted from departmental forward estimates. Improvements in productivity are still required, but the model adopts a more sophisticated approach by allowing departments to take account of individual circumstances in realising productivity. Overall, the model enables greater funding certainty for departments over a four-year period and provides incentives for better risk and productivity management across government.

OBJECTIVE FOUR: TAXATION

The Government has a long-term commitment to a fair and efficient tax system that is competitive with other States.

The Bracks Government announced business tax cuts worth more than $1 billion during its first term in office through its packages, *Better Business Taxes* released in April 2001 and *Building Tomorrow's Businesses Today* released in April 2002. This budget sees further tax reform focused on: reducing the tax burden for Victorian home buyers, investors and self-funded retirees, and businesses; enhancing the security of Victoria's taxation base; and maintaining the Government's capacity to protect the environment.

As part of the budget the Victorian Government is seeking to enhance housing affordability. Concession cardholders purchasing a home will benefit from increasing the threshold for a full conveyance duty exemption from $150 000 to $250 000, and the threshold for a partial exemption from $200 000 to $350 000, for properties purchased on or after 1 May 2004. The conveyance duty exemptions cannot be received in conjunction with the Victorian Government's one-off $5 000 *First Home Bonus*, which is available to first home buyers for homes purchased until 30 June 2005 and valued up to $500 000.

As announced in *Victoria: Leading the Way,* land tax is being substantially reformed in 2004-05. The tax-free threshold is being increased by $25 000 to $175 000, making it the highest tax-free threshold for companies and trustees in Australia and removing 24 000 land tax payers from the base. The top marginal tax rate will be reduced from 5 per cent to 4 per cent in 2004-05, and will be progressively reduced to 3 per cent by 2008-09, benefiting 1 800 land tax payers and improving Victoria's tax competitiveness. The middle land tax brackets will also be increased over a two-year period to provide relief to about 21 000 land tax payers with property worth between $675 000 and $1 080 000. This will benefit Victorian business, investors and self-funded retirees.

Victoria's payroll tax provisions for employment agencies will be aligned with other Australian jurisdictions. This will make it easier for businesses to comply with the legislation and operate efficiently where they provide services in several states.

As previously announced in the *Better Business Taxes* package, stamp duty on mortgages will be abolished from 1 July 2004. Victoria is the first State to remove this tax, which is estimated to save over 400 000 businesses and households around $200 million a year.

Debits tax will also be abolished from 1 July 2005, as agreed at the 26 March 2004 meeting of the Ministerial Council for Commonwealth-State Financial Relations. This initiative removes a tax that costs Victorians approximately $250 million a year.

The integrity of Victoria's taxation base will be improved by amendments to provisions in the *Duties Act 2000* to make them comparable with typical provisions in other States. These enhancements will ensure that an appropriate and fair amount of revenue is collected from high value property transactions involving land. These measures will be complemented by expanding the ability of the Commissioner of State Revenue to obtain an accurate valuation of dutiable property when a dutiable transaction involving the simultaneous sale of a business occurs.

The Victorian Government's capacity to maintain the quality of Victoria's regional parks, gardens, trails, waterways, bays and recreational assets within the greater metropolitan area will be secured by ensuring that the real value of the metropolitan parks charge is maintained. This will be achieved through increases in the minimum charge and variable charge, and ongoing indexation of these charges. Combined, these revenue measures are forecast to generate additional revenue of $5.2 million in 2004-05, rising to $11.4 million in 2007-08, which will be directly used to enhance the metropolitan parks system.

Concessions and tax expenditures

The Government's long-term commitment to ensure a fair and efficient tax system is also demonstrated by its commitment to well-targeted reform of its concession programs.

The Government has put in place reform of concessions by instigating a range of improvements to address these issues. The package as detailed in Budget Paper No. 4, Chapter 4, *Tax Expenditures and Concessions*, is designed to:

- provide a substantial benefit to the most disadvantaged, while increasing the overall budget commitment to support for low-income earners;

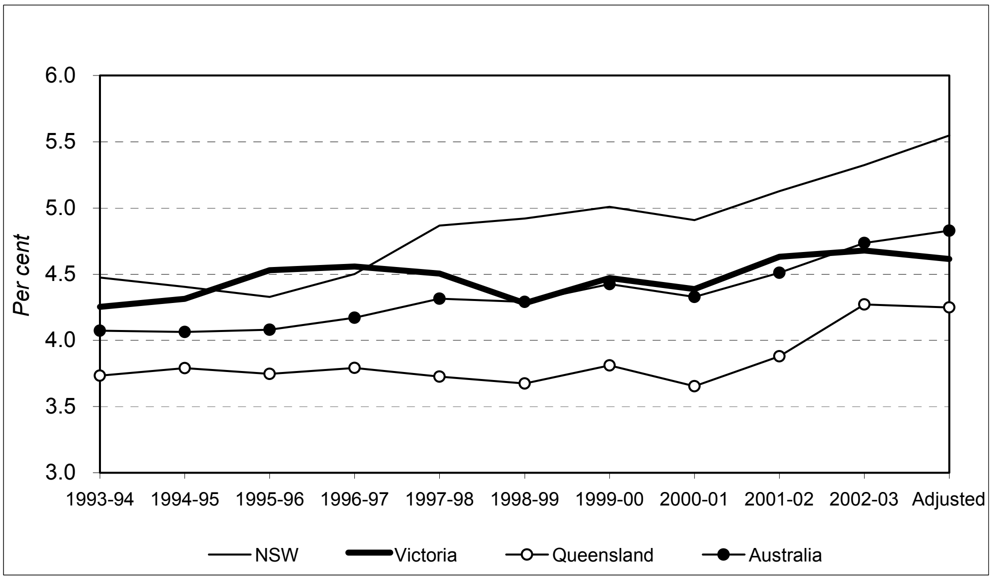
- redistribute funding to improve education and health outcomes, and help households afford essential bills; and
- improve transparency, reporting and administration of concessions so that they are delivered in the most efficient way.

Tax competitiveness

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

Victoria's preferred measure of tax competitiveness is state taxation expressed as a share of nominal gross state product (GSP). This measure relates the level of taxation revenue to economic capacity. Taxation revenue as a share of nominal GSP for Victoria, New South Wales, Queensland and the Australian average is shown in Chart 1.4.

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



Source: Australian Bureau of Statistics, Department of Treasury and Finance, 2002-03 Financial Reports of all jurisdictions.

Note:
(a) Taxation data have been recast to reflect only those taxes that remain after 1 July 2006. 2002-03 data have been further adjusted for Victorian tax changes announced in this budget, but assuming no further tax changes by other States in their 2004-05 budgets. It also includes changes announced by New South Wales in its Mini Budget released on 6 April 2004.

The increase in taxation as a share of GSP in 2001-02 and 2002-03 in Victoria, New South Wales, Queensland and Australia on average reflects the buoyant economic activity in those years, particularly in the property market.

Using 2002-03 actual taxation data for all jurisdictions, and adjusting for all known future tax changes previously announced by all States (including estimated costings of the announcements in the New South Wales Mini Budget) as well as Victoria's tax changes announced in this budget, Victoria's taxation as a share of nominal GSP is set to be 0.2 percentage points of nominal GSP below the Australian average, and 0.9 percentage points of GSP below New South Wales.

While tax competitiveness is an important part of business decision-making, WorkCover premiums also impact on the attractiveness of Victoria as a business location. In the Government's Economic Statement, *Victoria: Leading the Way*, the Government announced a reduction of the average WorkCover premium rate by 10 per cent in 2004-05, consolidating Victoria as having the second lowest average premium rate compared to all States, and 25 per cent lower than New South Wales. This further enhances the competitive position of Victoria and entrenches it as a low-cost place to do business.

OBJECTIVE FIVE: NET FINANCIAL LIABILITIES

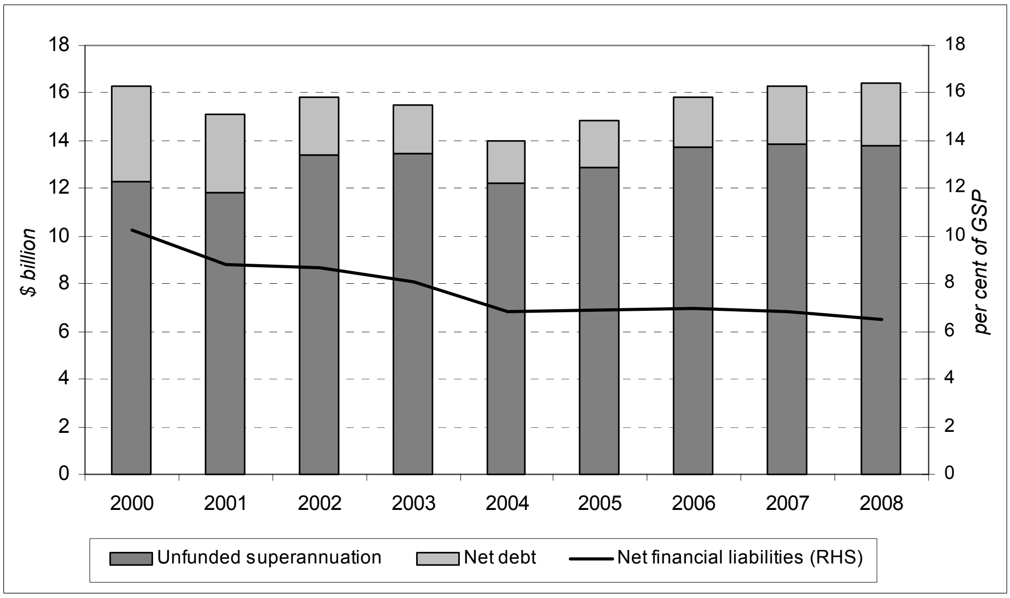
The Government is committed to maintaining the State's net financial liabilities at prudent levels in order to achieve its short-term objective of maintaining Victoria's triple-A credit rating. General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities, as shown in Chart 1.5.

Both Standard & Poor's and Moody's Investors Service affirmed Victoria's triple-A long-term local currency debt rating in December 2003. Both rating agencies cited Victoria's low debt levels, strong fiscal position and strong financial performance in recent years as key reasons behind their affirmations.

The 2004-05 Budget outlook reinforces these positive factors since:

- operating surpluses are projected for 2004-05 ($545 million) and for the remainder of the forward estimates period ($571 million a year on average);
- general government net debt (excluding Growing Victoria) is forecast to increase from $1.8 billion in June 2004 to $2.6 billion in June 2008. At around 1 per cent of GSP from June 2004 to June 2008, net debt remains modest compared to 3 per cent in 1999 and 16 per cent in 1995; and
- as a share of GSP, general government net financial liabilities (excluding the Growing Victoria infrastructure reserve) are projected to fall from 6.8 per cent at June 2004 to 6.5 per cent at June 2008. Strong investment returns and the impact of the triennial actuarial review of the State Superannuation Fund in 2003-04 have lowered the level of general government net financial liabilities (excluding the Growing Victoria infrastructure reserve) to $14.0 billion at June 2004, which is expected to rise to $16.4 billion by June 2008 (see Chart 1.5).

Chart 1.5: General government net financial liabilities excluding Growing Victoria as at 30 June [(a) (b)]



Source: Department of Treasury and Finance

Notes:

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

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

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- The Victorian economy has performed consistently, with average annual growth exceeding the national average over the five years to 2002-03.
- Business investment has been strong in Victoria and is expected to remain above the national average.
- The Victorian economy is now emerging from the effects of the drought, with growth expected to pick up to 3.25 per cent in both 2003-04 and 2004-05.
- As housing construction returns to more sustainable levels, economic growth is expected to be boosted by a recovery in exports.
- Global economic conditions, especially in the United States and East Asia, are expected to be supportive of Victorian economic growth.
- Employment in Victoria is expected to grow by 1.25 per cent in 2003-04, and by 1.5 per cent in 2004-05.
- With domestic price and cost pressures largely contained, and a sustained post-drought recovery under way, the Victorian unemployment rate is expected to average 5.5 per cent in 2003-04 and 2004-05.

VICTORIAN ECONOMIC PROJECTIONS

The economic projections used in the 2004-05 Budget are set out in Table 2.1.

This chapter contains an overview of the international, national and Victorian economic environment and a discussion of key issues and risks to the Victorian economic outlook. The discussion covers the key components of economic growth (domestic demand, consumer spending, housing construction, business investment and net exports) as well as population, the labour force and financial market developments.

An assessment of the major risks to the economic projections is included in Chapter 6, *Statement of Risks*.

Table 2.1: Victorian economic projections[(a)]

	2002-03 Actual	2003-04 Forecast	2004-05 Forecast
Real gross state product	2.6	3.25	3.25
Employment	2.2	1.25	1.50
Unemployment rate [(b)]	5.8	5.50	5.50
Consumer price index	3.3	2.25	2.00
Wage cost index [(c)]	3.6	3.50	3.50
Population [(d)]	1.2	1.10	1.10

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

Notes:

(a) Year-average per cent change on previous year unless otherwise indicated. All projections apart from population are rounded to the nearest 0.25 percentage points. Projections of population are rounded to the nearest 0.1 percentage points.

(b) Year-average level, per cent.

(c) Total hourly rate excluding bonuses.

(d) June quarter, per cent change on previous June quarter.

ECONOMIC OVERVIEW

World and Australian economic conditions and outlook

The global economy improved in the second half of 2003 as the effects of the conflict in Iraq and the severe acute respiratory syndrome (SARS) outbreak in Asia subsided. The United States and Asia were the main engines of growth, and expectations improved steadily over the year. The world economic growth outlook is likely to be supportive of Victorian economic growth over the forecast period.

There had been some doubts as to whether the recovery in the United States would be sustained, due to slower than expected growth in employment. However, rebounding business investment, accompanied by continued robust consumer spending, contributed to two quarters of strong growth in the second half of 2003, and growth of 4.3 per cent through the year.

The Japanese economy grew by 3.6 per cent over 2003, underpinned by increased export demand in Asia. China has grown strongly in recent years, and growth at near double-digit rates is expected to continue. The second half of 2003 saw renewed confidence in the Asian economies in general following the apparent containment of the SARS outbreak.

Growth in the European Union has been slow for several years, and there are concerns about the sustainability of the recoveries in Germany, France and Italy, although the United Kingdom is experiencing consistent growth.

The Consensus Economics survey of April 2004 forecasts that the world economy will expand by 3.7 per cent in 2004, easing to 3.2 per cent in 2005. The forecasts for Victoria's major trading partners suggest that there are good growth prospects for key markets in 2004, moderating only slightly in 2005. In its December 2003 *Economic*

Outlook, the Organisation for Economic Co-operation and Development (OECD) was also positive, forecasting GDP growth in the OECD region to increase from 2.0 per cent in 2003 to around 3 per cent in both 2004 and 2005.

The Australian economy grew by 4.0 per cent over 2003. Business investment was a major contributor to this performance, increasing by 10.0 per cent over the year to December 2003. Household consumption and housing investment were also strong, rising by 5.5 per cent and 6.4 per cent, respectively, over the year. Australia's net exports declined over 2003, with imports increasing by 10.2 per cent and exports falling by 0.5 per cent.

The Commonwealth Treasury, in its *Mid-Year Economic and Fiscal Outlook* (December 2003), forecast growth of 3.75 per cent in 2003-04 and 3.5 per cent in 2004-05. This is consistent with private sector forecasts of national growth.

Victorian economic conditions and outlook

The Victorian economy has experienced consistent growth, averaging 3.9 per cent a year, over the five years to 2002-03. This compares favourably to the national average of 3.6 per cent for the same period, and is the second strongest growth rate of all the States. Victoria has also outperformed the national economy in growth in productivity and business investment over the past five years. There will be a need to maintain a strong productivity performance in the longer term because of pressures such as population ageing, rising health costs and an increasingly competitive global economy.

Recovery from the drought

The Victorian economy is now emerging from the effects of the recent severe drought. As expected, Victorian economic growth slowed to 2.6 per cent in 2002-03, after declining agricultural production shaved as much as 1.25 percentage points from the aggregate growth figure, and contributed to the largest fall in merchandise export volumes since at least the late 1980s.

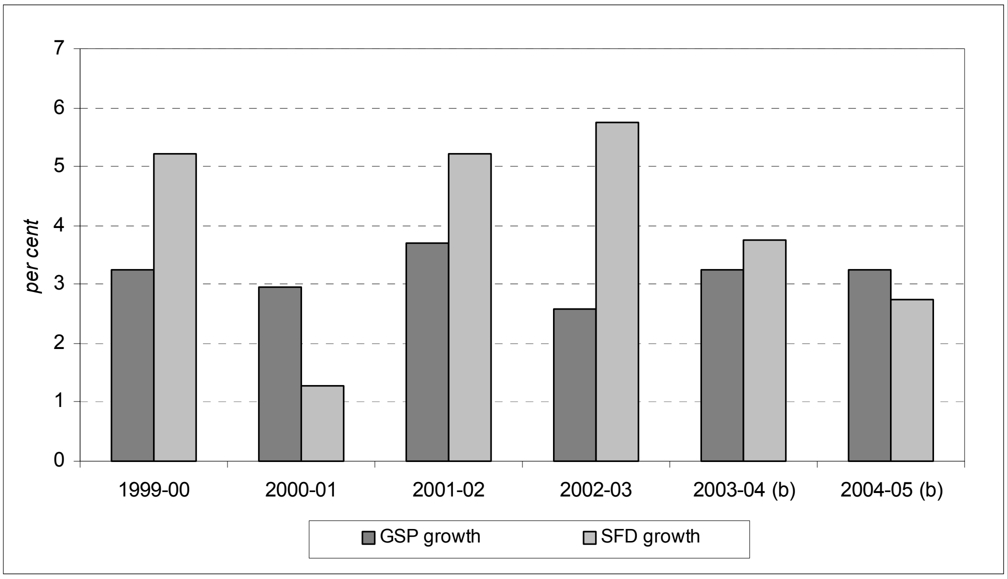
Whilst seasonal conditions remain adverse in some parts of the State, the worst effects of the drought have now passed, with the Australian Bureau of Agricultural and Resource Economics (ABARE) estimating that Victorian winter crop production rebounded to a record level in 2003-04. This has not yet been reflected in export volumes, although exports are expected to strengthen during 2004 as cereal inventories accumulated from the winter crop are run down.

Recovery from the drought is also evident in investment in (breeding) livestock, up 29 per cent on the drought year (2002-03), and from estimates of crop production. The need to rebuild livestock numbers is expected to constrain beef production in the short term, as it may take several years for cattle numbers to recover. ABARE also expects some rebuilding of sheep numbers in the medium term, against the trend of the past decade, as a response to relatively attractive prices for wool and sheep meat.

GSP and state final demand

Although consumer spending growth recovered strongly in late 2003, dwelling construction and business investment were already at very high levels. As such, the scope for further strong growth in domestic demand is limited. However, the global economy is strengthening at the same time as the drought-related constraints on many supplies of exports are being eased. Overall then, domestic growth sources (especially dwelling investment) are likely to be increasingly replaced by net exports in the year ahead, bringing growth in state final demand (which does not include net exports) into closer alignment with growth in GSP than has been the case in recent years (see Chart 2.1). This 'rebalancing' of growth is discussed in more detail later in this chapter.

Chart 2.1: Growth of real gross state product [(a)] and state final demand[(a)]



Source: Australian Bureau of Statistics, Department of Treasury and Finance
Notes:
(a) Chain volume measure.
(b) DTF forecast.

Consumer spending

Following a slowdown in early 2003, there has been a recovery in the growth of Victorian consumer spending. The strong Australian dollar and tourism fuelled by the 2003 Rugby World Cup are likely causes of this upturn.

To the extent that the recent strength of consumer spending has been supported by large increases in housing prices and household equity, there are risks from any moderation in the housing market. Higher interest rates would also adversely affect households that have incurred high levels of debt during the recent surge in asset prices.

However, recent partial indicators of household consumption show a positive near-term outlook, with retail trade growing strongly in early 2004, and consumer sentiment at high levels.

Dwelling construction

The persistence of high levels of dwelling construction has been surprising, but forward indicators now suggest a return to more sustainable levels. Victorian private dwelling approvals are trending down moderately, and housing finance approvals have also fallen in recent months.

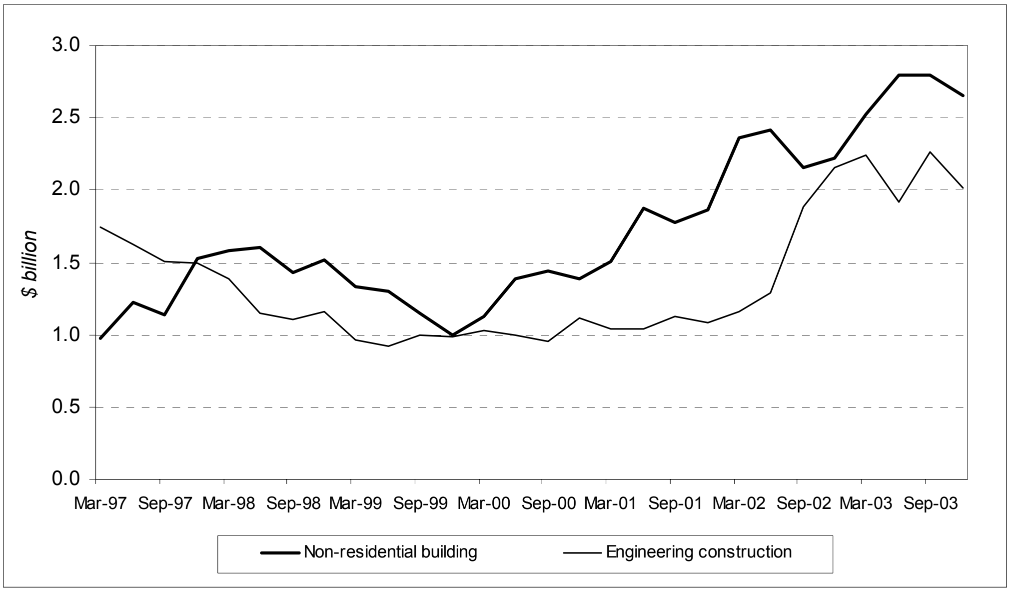
There are indications that the rapid growth in Melbourne house prices of recent years may be slowing. The Australian Bureau of Statistics (ABS) price index for established houses for Melbourne increased by 12.5 per cent in the year to December 2003, compared with 18.9 per cent nationally over the same period.

Business investment

Forward indicators suggest that Victorian business investment will remain above the national average and the second highest of the states, in per capita terms, behind Western Australia. There is a strong pipeline of work under way in non-residential construction and engineering construction, including the fast rail links to regional Victoria, the redevelopment of Spencer Street station, the Austin and Repatriation Medical Centre redevelopment, the Southern Cross twin office tower development and the redevelopment of the Queen Victoria Hospital site. Other projects under way include developments at Docklands, the Urban Workshop office building, further development of Bass Strait gas fields and additional automotive industry capacity (see Chart 2.2, which does not include major projects not yet commenced, such as the Mitcham-Frankston Freeway).

Much of the recent growth in the investment pipeline originates from the private sector. In the medium term, this will be supplemented by major infrastructure projects signalled in the economic statement, *Victoria: Leading the Way*, such as redeveloping and relocation of the Melbourne wholesale markets and redevelopment of the Melbourne Convention Centre.

Chart 2.2: Forthcoming construction work [(a)]



Source: Australian Bureau of Statistics

Note:
(a) Work yet to be done, quarterly data, current prices.

Net exports

Victorian agricultural exports were affected by the drought and bushfires in late 2002 and early 2003, while other exports suffered from soft global conditions. More recently, the competitiveness of Victoria's exporters and manufacturers deteriorated because of the strength of the Australian dollar.

The volume of exports in the December quarter of 2003 was 9.5 per cent lower than a year earlier, and the value of exports declined even faster (down 17.8 per cent). There are, however, signs of a recovery in agricultural exports. Exports of dairy products, meat, wool and cereals grew significantly in the December quarter of 2003. Although no data are available for export volumes by region, changes in values and exchange rates would suggest a rise in export volumes to the United States and East Asia, and volume declines to Japan, Europe and New Zealand during 2003.

International merchandise import volumes into Victoria have grown strongly in the past two years, partly in response to the growth in business investment. Growth in volumes appears to have moderated in late 2003, after abstracting from civil airliner imports, which are recorded by the ABS as imports in the State of arrival (although the corresponding investment is allocated across all States).

Labour market

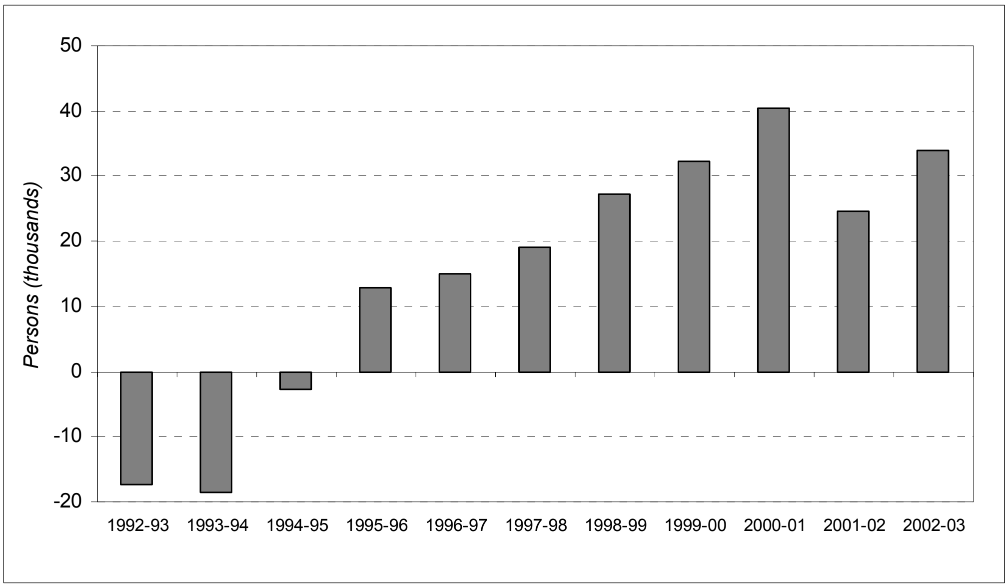
The Victorian unemployment rate averaged 5.7 per cent over 2003, and remained around this level in early 2004. The Victorian unemployment rate has been consistently below the national rate for almost four years, and is expected to average 5.5 per cent in 2003-04 and 2004-05.

There has been some compositional change in Victorian employment. Over the past two years, there has been a net gain of about 24 000 jobs in construction, but some decline in agricultural jobs due to the drought. These trends may begin to unwind as more moderate growth in construction sector employment is expected to coincide with a recovery in agricultural employment. Employment in the food industry has also tended to follow agricultural employment with a lag, and is expected to recover accordingly.

Population

The composition of population growth is changing in Victoria. Interstate migration gains are being replaced by a larger share of overseas migration into Australia. In the year to the September quarter of 2003, Victoria had a net gain of just 39 people from interstate, compared to a peak of 5 756 people in the year to the September quarter of 2000, but net overseas migration gains increased from 28 182 to 36 251 over the same period. Net migration into Victoria over the past decade is shown in Chart 2.3.

Chart 2.3: Net migration into Victoria from interstate and overseas [(a)]



Source: Australian Bureau of Statistics

Note:
(a) Financial year data.

Victoria's population grew by 1.33 per cent in the year to September 2003, marginally higher than the national growth rate. However, Victorian and national population growth is likely to drift down as the population ages, and is expected to fall below 1 per cent a year by the end of the decade.

Victoria is currently gaining a greater share of overseas migrants than its share of national population. The population forecasts assume no net interstate migration into or out of Victoria over the projection period.

Financial markets

The strong appreciation of the Australian dollar during 2003 (up 31 per cent relative to the US dollar and 21 per cent in trade weighted terms) has placed Victorian industries under competitive pressure in export markets and from imports. Rises in official interest rates in late 2003 can also be expected to contribute to a slowing in domestic demand.

The economic impact of the 0.5 percentage point overall increase in interest rates in late 2003 will take some time to appear. Economic modelling suggests that this policy tightening may shave as much as 0.5 percentage points from national GDP growth in 2004-05, with adverse impacts on employment growth for up to two years.

Higher interest rates are likely to restrain housing and business investment as well as consumer demand for durable goods. Industry competitiveness may also be affected by a less accommodative monetary policy if it contributes to further upward pressure on the exchange rate.

Economic outlook

Economic growth in Victoria is expected to be 3.25 per cent in 2003-04, which is unchanged from the *2003-04 Budget Update*. The slowdown in housing that was expected in 2003-04 appears to have been delayed. However, stronger than expected housing investment in 2003-04 has not necessitated an upward revision to the economic growth forecast, as it has been offset by weaker than expected net exports. As the slowdown in housing is now expected to occur in 2004-05, the forecast for Victorian economic growth in 2004-05 is now 3.25 per cent, down from the *2003-04 Budget Update* forecast of 3.5 per cent.

Employment is now expected to grow by 1.25 per cent in 2003-04 (up from 1.0 per cent in the *2003-04 Budget Update*), largely reflecting stronger growth in late 2003. Consumer inflation is expected to be 2.25 per cent in 2003-04, easing slightly to 2.0 per cent in 2004-05. The lower inflation outlook in 2004-05 largely reflects the impact of the unexpected strength of the Australian dollar on the price of imported consumer goods.

The forecasts assume that the impact on economic growth of the prospective slowing in dwelling construction will be largely offset by a recovery in net international merchandise exports. A larger or more rapid than expected decline in dwelling investment, or a weaker or delayed recovery in net exports, would have adverse consequences for the economic growth outlook. The re-emergence of drought conditions or a deterioration in the international economic outlook would also increase this risk.

The forecasts of Victorian GSP growth outlined above are slightly higher than that expected by the private sector. On average, the private sector is expecting Victorian GSP growth of between 2.75 to 3.00 per cent in 2003-04 and 2004-05. The differences primarily reflect private sector forecasters' expectations of somewhat weaker growth in consumer spending and housing in Victoria. The fundamentals for consumer spending remain sound, with low unemployment and moderate growth in income to support reasonable growth in spending in 2004-05, albeit at a slower pace than in 2003-04. The business investment outlook is positive, given the volume of work in the construction pipeline and, in the longer term, the major infrastructure projects signalled in *Victoria: Leading the Way*. A more detailed description of prospects for the housing sector is provided below.

The forecasts of Victorian GSP growth in 2003-04 and 2004-05 are slightly below the Commonwealth's forecasts for national GDP growth for both years, of 3.75 per cent and 3.50 per cent, respectively.

REBALANCING GROWTH

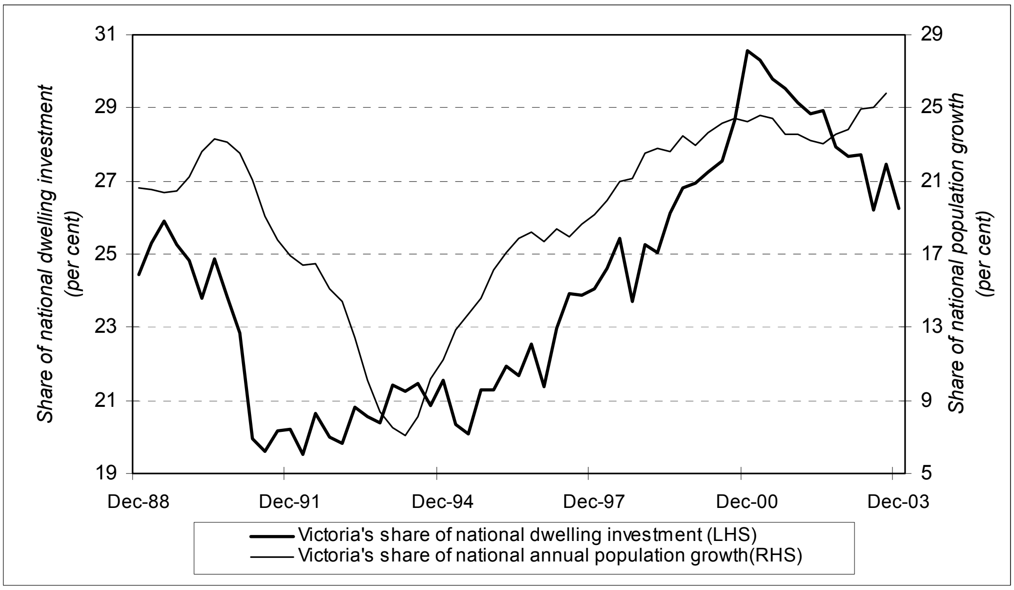
The extent to which the prospective export recovery will offset the impact of the expected easing in the housing cycle will have an important bearing on the growth outlook for the Victorian economy.

The housing cycle

The strong growth in housing investment has been a significant contributor to growth, in Victoria and Australia more generally, over the past five years. However, investment in housing appears to be returning to more sustainable levels, following the rapid growth in construction activity and prices of recent years. Forward indicators support the expectation of a moderate decrease in housing investment over the remainder of 2004 and early 2005. While approvals have declined, they remain above the long-term average, which suggests an orderly slowing.

Victorian dwelling investment has been driven strongly by population growth. Chart 2.4 shows that Victoria's share of national dwelling investment and the State's share of national annual population growth have been highly correlated. The close association between these series reflects the need to add to the housing stock when population grows more rapidly. Victoria's share of national investment has declined in recent quarters, yet it remains above the State's share of the national economy. Victoria's share of national population growth has risen over the past five quarters, suggesting that growth fundamentals remain positive for Victorian dwelling construction.

Chart 2.4: Victoria's shares of housing investment[(a)] and population growth[(b)]

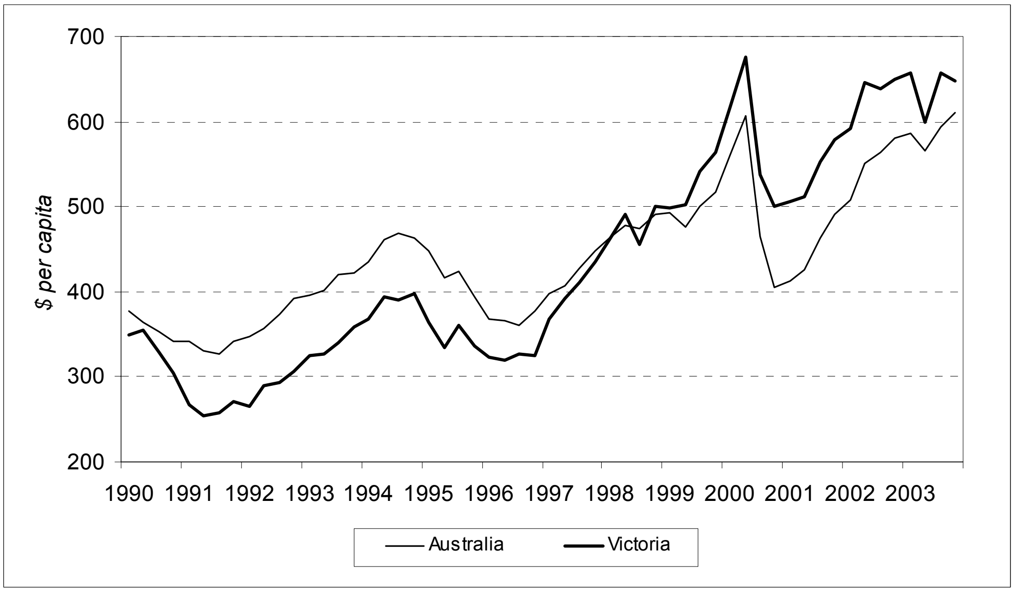


Source: Australian Bureau of Statistics

Note:
(a) Quarterly, seasonally adjusted, chain volume measure.
(b) Increase in population from four quarters earlier.

The strong growth in Victorian housing investment of recent years reflects in part a catch-up effect following a lengthy period of under-investment (by national standards) throughout most of the 1990s. Chart 2.5 shows that Victorian per capita dwelling investment has exceeded national levels since the late 1990s. This is unlikely to have resulted in over-investment and an oversupply of housing.

Chart 2.5: Dwelling investment per capita[(a)]

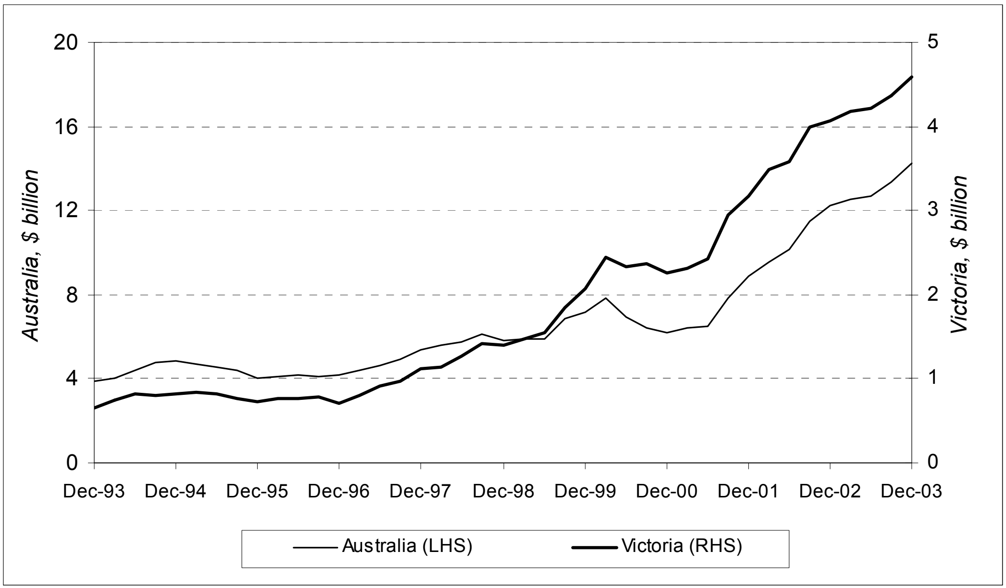


Source: Australian Bureau of Statistics

Note:
(a) Per capita, quarterly, seasonally adjusted, chain volume measure.

Another measure of housing investment is the value of residential work still to be completed. For the December quarter of 2003 this was valued at more than $4.5 billion, greater than Victoria's share of the national economy, implying that there is still considerable work in the residential construction pipeline (see Chart 2.6).

Chart 2.6: Forthcoming housing construction[(a)]



Source: Australian Bureau of Statistics

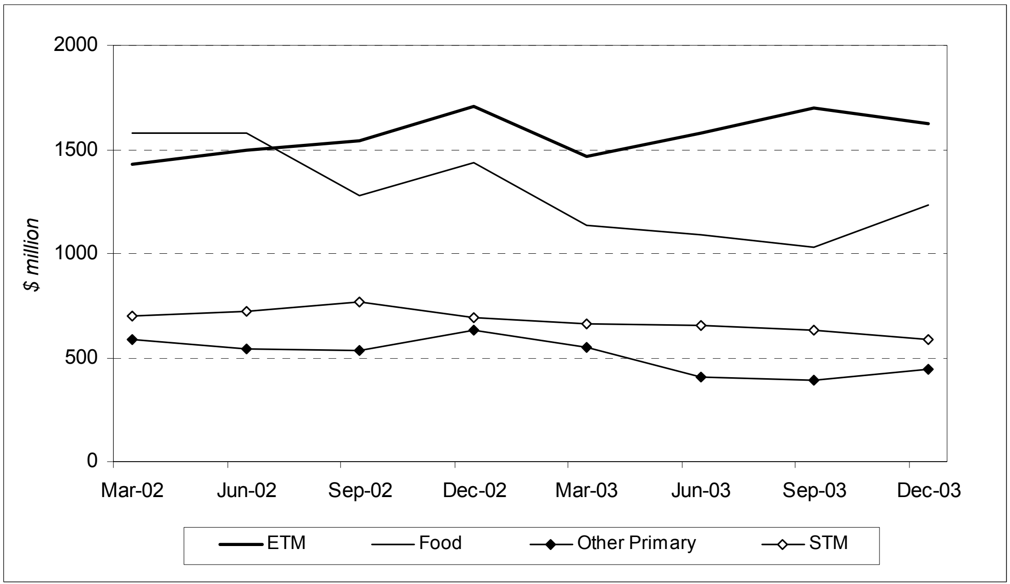
Note:
(a) Work yet to be done, quarterly data, current prices.

Exports

Victorian exports have recently been affected by international events, and by the severe impact of the drought on the agricultural sector. An expected rebound in net exports in 2004-05 would be the first positive contribution to growth from net exports in four years. Chart 2.7 shows the value of exports in selected categories over the past two years.

The severe drought of 2002-03 reduced agricultural sector exports and resulted in the culling of livestock cattle and sheep. The value of Victorian exports of food and other primary commodities declined noticeably during the drought (see Chart 2.7). ABARE expects short-term returns from grains (primarily wheat) exports after a record crop in 2003-04, the bulk of which will be exported in 2004-05. Although an upturn in agricultural exports was experienced in the December quarter of 2003, a stronger rebound is due, especially for food and live animals which were most strongly affected by the drought.

Chart 2.7: Value of exports by category[(a)]



Source: Australian Bureau of Statistics, unpublished data

Note:
(a) Elaborately transformed manufactures (ETM), simply transformed manufactures (STM), food and other primary exports, current prices.

With a global recovery underway a resurgence of demand is expected. Victoria is well placed to take advantage of increased global demand, as its four major export destinations (New Zealand, the United States, Japan and China) are forecast by Consensus Economics to grow strongly in 2004.

The combination of agricultural recovery and stronger world economic growth was evident in late 2003 with several commodity groupings in both agriculture and manufacturing experiencing growth. While manufacturing growth was more general, livestock, cereals and dairy all performed well for the agricultural sector.

Risks to the timing and strength of the recovery remain. Though the worst of the drought appears to have passed, the March quarter of 2004 has been one of the driest on record. However, the Bureau of Meteorology's current rainfall outlook is for a 50 per cent chance of above average rainfall in the June quarter of 2004.

Nevertheless, the rebound in the winter crop, optimism about the global outlook and tentative signs of a recovery in food exports all point to a positive outlook for the export sector.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

- An operating surplus of $545 million is budgeted for the general government sector in 2004-05.
  - Total operating expenses are expected to increase by 4.2 per cent in 2004-05, reflecting the net budget impact of output funding initiatives, with growth averaging 3.0 per cent a year over the forward estimates period.
  - Total operating revenue is budgeted to increase by 4.5 per cent in 2004-05, reflecting increased taxation revenue, investment income and Commonwealth grants, with a projected growth in revenue on average of 3.1 per cent a year over the forward estimates period.
- Over the remainder of the forward estimates period, the operating surplus is projected to average $571 million.
- The net budget impact of output initiatives is $688 million in 2004-05, averaging $412 million over the following three years.
- The budget includes new asset funding with a total estimated investment of $2 374 million.

This chapter provides details of the projected budget position for the period 2004-05 to 2007-08. The discussion of the budget and forward estimates focuses on trends in the aggregate budget position, as well as a reconciliation of major variations in key budget aggregates since the 2003-04 Budget released in May 2003 and the *2003-04 Budget Update* published in December 2003.

The forward estimates outlined in this chapter are based on the economic projections outlined in Chapter 2, *Economic Conditions and Outlook* and reflect the detailed accounting policies and assumptions documented in Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*. The estimates take into account all announced policy commitments of the Victorian Government. They also represent planning projections for future budgets based on an unchanged policy assumption.

2004-05 BUDGET INITIATIVES

The 2004-05 Budget includes new initiatives that will deliver improved services and promote growth across the whole State. The 2004-05 Budget continues the delivery of the Government's election commitments as set out in *Labor's Financial*

Statement 2002 and detailed in Budget Paper No. 3*,* Chapter 2*, Election Commitments – Implementation Report Card.* All of the output and asset initiatives identified to start in 2004-05 have been funded.

Initiatives affecting operating expenses

Table 3.1 shows that the 2004-05 Budget provides additional funding for new output initiatives, including the cost of implementing the Government's 2002 election commitments, of $1 078 million in 2004-05, averaging $839 million over the remaining three years.

After allowing for funding from existing forward estimates demand and other contingencies put aside for service delivery and demand growth, the net budget impact of 2004-05 output funding is $688 million in the budget year, averaging $412 million over the following three years. As indicated in Table 3.1, this is in addition to $70 million in new 2004-05 output funding previously approved and announced in the *2003-04 Budget Update*.

Table 3.1: New output funding since 2003-04 Budget

($ million)

	2004-05 Budget	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
2004-05 Budget new output funding	1 078.3	897.4	860.0	760.0
Less:				
Demand and other contingencies	390.7	410.2	440.9	431.5
Net budget impact of new 2004-05 Budget output funding	**687.6**	**487.2**	**419.2**	**328.4**
Add: *2003-04 Budget Update* output funding	70.0	95.2	116.6	..
Net budget impact of output funding since 2003-04 Budget	**757.6**	**582.5**	**535.7**	**328.4**

Source: Department of Treasury and Finance

Table 3.2 shows the total value of new output funding by department in the 2004-05 Budget. The funding decisions are targeted towards the key service areas of:

- valuing and investing in lifelong education;
- providing high quality, accessible health and community services;
- ensuring Victoria's children have the best possible start in life;
- keeping our streets, homes and workplaces safe;
- creating more jobs and building competitive and thriving innovative industries across Victoria;
- growing and linking all of Victoria by delivering efficient, reliable and modern road, rail and public transport linkages;
- promoting environmental sustainability and protecting Victoria's natural resources for future generations;

- building cohesive communities, reducing inequalities and delivering a new era in support for low-income Victorians; and
- promoting rights and respecting diversity.

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

Table 3.2: 2004-05 Budget new output initiatives funding by department

($ million)

	2004-05 Budget	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Education and Training [(a)]	89.9	66.0	75.9	73.8
Human Services [(a)]	349.6	319.6	281.7	222.4
Infrastructure	301.6	299.5	302.1	298.2
Innovation, Industry and Regional Development	33.2	24.6	28.5	3.6
Justice	78.9	94.2	80.9	77.1
Premier and Cabinet	12.9	15.0	11.7	9.7
Primary Industries	10.7	6.8	4.6	1.5
Sustainability and Environment	18.0	15.0	17.4	15.9
Treasury and Finance	133.3	3.9	3.9	4.0
Victorian Communities	10.7	11.9	8.8	5.3
Parliament	2.1	1.9	2.0	2.0
Government-wide	37.5	39.0	42.5	46.5
Less: Funding from demand and other contingencies	390.7	410.2	440.9	431.5
Net budget impact of new 2004-05 Budget output funding [(b)]	**687.6**	**487.2**	**419.2**	**328.4**

Source: Department of Treasury and Finance

Notes:

(a) Includes funding provided as part of the Government's taxation concessions.

(b) Excludes initiatives funded through internal reprioritisation or other existing fund sources and 2003-04 Budget Update output initiatives.

Asset investment initiatives

The 2004-05 Budget provides funding for the commencement of new infrastructure investment projects with a total estimated investment (TEI) of $2 374 million (including $364 million announced in the *2003-04 Budget Update*). This includes funding for the Government's *Labor's Financial Statement 2002* election commitments with a TEI of $940 million.

The scale of the 2004-05 infrastructure program and the scope and nature of projects approved demonstrate the Government's commitment to promoting economic, social and environmental development across the whole State. Over the next four years, 2004-05 to 2007-08, expenditure on infrastructure investment is expected to average $2.4 billion a year.

Table 3.3 provides a summary of new infrastructure asset investment funding by department. Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives* and Appendix B, Growing Victoria infrastructure reserve of the same Budget Paper provide more detailed information on the Government's 2004-05 infrastructure investment initiatives.

Table 3.3: 2004-05 Budget new asset funding by department

($ million)

	2004-05 Budget	*TEI* [(a)]
Education and Training	142.7	323.7
Human Services	180.9	384.6
Infrastructure	155.9	662.6
Innovation, Industry and Regional Development	23.8	366.9
Justice	37.7	52.8
Premier and Cabinet	17.9	28.4
Sustainability and Environment	2.0	82.7
Treasury and Finance	21.4	31.0
Victorian Communities	5.4	14.5
Parliament	4.0	8.5
Government-wide	17.0	54.5
Total 2004-05 Budget asset funding	**608.5**	**2 010.1**
Add: 2003-04 Budget Update asset funding	71.2	364.3
Asset funding since the 2003-04 Budget	**679.7**	**2 374.4**

Source: Department of Treasury and Finance

Note:
(a) Total estimated investment.

Revenue initiatives

Table 3.4 provides a summary of the revenue measures the Government has introduced in the 2004-05 Budget, to assist land tax payers and home buyers and enhance the overall taxation system, as well as other initiatives taken since the 2003-04 Budget and initiatives announced in previous budgets that are yet to be implemented.

The 2004-05 Budget revenue initiatives include the land tax reforms, announced in *Victoria: Leading the Way*. Through these reforms the tax-free threshold for land tax will be increased by $25 000 to $175 000 from 2004-05, removing approximately 24 000 land taxpayers from the land tax base, and the top land tax rate will be reduced from 5 per cent to 3 per cent by 2008-09. The net impact of the total 2004-05 Budget initiatives is a reduction in taxation of $59 million in 2004-05, rising to an average $132 million a year over the remaining forward estimates period.

Revenue initiatives announced since the 2003-04 Budget included the introduction, from 1 July 2004, of a land tax on electricity transmission easements held by electricity transmission companies. The 2004 land tax rates will apply to the annual land tax on electricity easements. This initiative will raise an estimated $80 million a year. The net impact of this and other pre-budget initiatives is a reduction in taxation revenue of $30 million in 2003-04 and then an increase of $80 million in 2004-05 and across the forward estimates years.

A number of revenue initiatives announced in previous budgets will also be implemented and include:

- abolishing mortgage duty from 1 July 2004, as previously announced in the *Better Business Taxes* package in April 2001. Mortgage duty is currently levied at the rate of 0.4 per cent on all business and private mortgages, which are secured against real property. Its removal will benefit business and individual tax payers by around $200 million in a full year; and
- abolishing debits tax from 1 July 2005, as foreshadowed in the 1999 Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations and confirmed at the Ministerial Council meeting for Commonwealth-State Financial Relations on 26 March 2004.

Overall total revenue initiatives to be implemented in 2004-05 and subsequent years will benefit taxpayers by $137 million in 2004-05, rising to an average of $529 million a year over the remaining forward estimates period.

Additional information on these measures is also provided in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives* and Budget Paper No. 4.

Table 3.4: Revenue initiatives

($ million)

	2003-04 Revised	*2004-05 Budget*	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Budget initiatives					
Conveyance duty: tax base protection	..	50.0	60.0	60.0	60.0
Land tax reform	..	-124.0	-197.0	-222.0	-244.0
Metropolitan Parks Charge: increase in the levy in 2004-05 and indexation	..	5.2	6.8	9.0	11.4
Payroll tax: standardisation of employment agency provisions	..	10.0	20.0	20.0	20.0
Total budget initiatives (a)	**..**	**-58.8**	**-110.2**	**-133.0**	**-152.6**
Initiatives announced since 2003-04 Budget					
Housing revenue	-40.0	..	..	..	..
Duty on mortgage - backed debentures	10.0	..	..	..	..
Land tax: electricity transmission easements	..	80.0	80.0	80.0	80.0
Total initiatives announced since 2003-04 Budget (a)	**-30.0**	**80.0**	**80.0**	**80.0**	**80.0**
Initiatives announced in previous budgets that are yet to be implemented					
Mortgage duty	..	-158.0	-197.2	-200.4	-205.9
Debits tax	..	..	-257.8	-283.9	-286.7
Total revenue initiatives to be implemented in 2004-05 and subsequent years (a)	**-30.0**	**-136.8**	**-485.2**	**-537.3**	**-565.2**

Source: Department of Treasury and Finance
Note:
(a) A negative figure indicates reduced revenue.

Taxation expenditures

In addition to the revenue initiatives identified above, the 2004-05 Budget includes a concessions package that contains the expansion of the current conveyance duty exemption for concession cardholders for properties purchased on or after 1 May 2004, offset by the reduction in the motor vehicle registration concession. As shown in Table 3.5, the concessions package is projected to raise on average $49 million a year across the forward estimates period, which is redirected to other concession programs for low income earners.

Additional information on these expenditures is also provided in Budget Paper No. 3, Appendix A *Output, Asset Investment and Revenue Initiatives* and Budget Paper No. 4, Chapter 3 *State Revenue*.

Table 3.5: Taxation expenditures

($ million)

	2003-04 Revised	*2004-05 Budget*	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Concessions package:					
Increased conveyancing duty exemption for concession cardholders	-3.7	-22	-20	-20	-21
Motor vehicle registration concession	..	64.3	67.8	71.4	75.1
Total concessions package [(a)]	**-3.7**	**42.3**	**47.8**	**51.4**	**54.1**

Source: Department of Treasury and Finance

Note:

(a) The whole of this amount has been redirected to other concessions such as an increase in the education maintenance allowance; expanded conveyance duty exemptions for concession cardholders; and indexation of key State Government concessions and other initiatives as outlined Budget Paper No. 4, Chapter 4, Tax Expenditures and Concessions.

2004-05 BUDGET ESTIMATES AND OUTLOOK

Table 3.6 provides a summary of the statement of financial performance for the period 2003-04 to 2007-08.

For a detailed discussion of the revised 2003-04 Budget outcome, including an explanation of the variation from the published 2003-04 Budget estimates, see Budget Paper No. 4, Appendix B, *Revised 2003-04 Budget Outcome*. In addition, Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes* provides a more detailed statement of financial performance for the forward estimates outlook period. The forward estimate projections take into account all announced policy initiatives.

Table 3.6: Summary statement of financial performance 2003-04 to 2007-08

($ million)

	2003-04 Revised	*2004-05 Budget*	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Taxation	10 240.1	10 384.2	10 385.6	10 709.8	11 097.4
Investment income	1 034.0	1 225.4	1 307.7	1 265.6	1 347.6
Grants	12 345.7	13 080.5	13 716.2	14 207.6	14 852.4
Sales of goods and services	2 165.0	2 231.3	2 272.8	2 309.1	2 327.7
Other revenue (a)	1 946.4	2 063.4	2 072.6	2 103.4	2 099.6
Total revenue	**27 731.2**	**28 984.9**	**29 755.0**	**30 595.6**	**31 724.6**
per cent change		4.5%	2.7%	2.8%	3.7%
Superannuation	774.7	1 789.2	1 843.4	1 890.3	1 883.9
Depreciation	1 057.1	1 142.7	1 206.7	1 267.3	1 337.5
Borrowing costs	483.4	476.2	482.1	468.2	456.0
Employee benefits	9 837.3	10 480.5	10 854.5	11 221.3	11 486.0
Supplies and services	8 970.4	9 311.0	9 780.0	10 083.2	10 695.8
Other expenses (b)	6 175.8	5 240.1	5 082.9	5 134.6	5 189.8
Total expenses	**27 298.7**	**28 439.9**	**29 249.6**	**30 065.0**	**31 048.9**
per cent change		4.2%	2.8%	2.8%	3.3%
Operating surplus	**432.5**	**545.0**	**505.4**	**530.5**	**675.7**

Source: Department of Treasury and Finance

Notes:

(a) Comprises regulatory fees and fines, fair value of assets received free of charge, gains/losses on disposal of physical assets, capital asset charge revenues and other miscellaneous revenue.

(b) Includes grants and transfer payments and amortisation expense.

As set out in Table 3.6, the operating surplus is budgeted to increase from $432 million in 2003-04 to $545 million in 2004-05, an increase of approximately $113 million. The operating surplus is then expected to average $571 million over the remainder of the forward estimates period.

Operating expenses

2004-05 Budget estimates

Total operating expenses are budgeted at $28 440 million in 2004-05, representing an increase of $1 141 million or 4.2 per cent on the revised estimate for 2003-04.

The increase in 2004-05 operating expenses is largely the result of:

- net new policy funding of $688 million, which contributes to the budgeted increases in employee benefits of $643 million and supplies and services $341 million – the latter includes the net budget impact of the new train and tram agreements with Connex and Yarra Trams, recently announced by the Government.

Funding of $1.1 billion has been provided for the costs of the new rail partnerships over the forward estimates (including 2003-04). This includes payments to the new operators, funding requirements of Metlink as well as termination payments associated with the end of the original franchise contract; and

- wages cost funding provided in the forward estimates consistent with government wages policy. This is sufficient to fund the Victorian Public Service Enterprise Bargaining Agreement (EBA) recently agreed to by the Government and the Community and Public Sector Union (CPSU), but subject to voting by CPSU members in mid 2004. Similar allowances have been made for teacher and nurse EBAs.

In addition, two one-off impacts on operating expenses have largely offset each other:

- the reduction in superannuation expense in 2003-04 as a result of better than anticipated performance in superannuation investment returns and the results of the 2003 triennial review of the State Superannuation Fund (SSF). In the budget and forward years, investment returns to state superannuation funds (including the SSF) are assumed to return to long-run actuarial rates, leading to a more normal level of estimated superannuation expense and contributing to a budgeted increase of around $1 015 million in 2004-05; and
- the reduction in other expenses in 2004-05 from the one-off Smelter Reduction Amount write-off in 2003-04 of $1 250 million (see Budget Paper No. 4, Appendix B, *Revised 2003-04 Budget Outcome* for further details).

Forward estimates outlook

Beyond 2004-05, total expenses are expected to increase by 3.0 per cent a year on average.

Modest growth in superannuation expense (averaging 1.7 per cent a year) is partly offset by a decline in borrowing costs of 1.4 per cent a year on average. Depreciation expense is expected to increase by an average 5.4 per cent a year, reflecting growth in the capital stock as a result of the Government's continuing substantial infrastructure investment program and revaluations of physical assets.

Other expenses (largely comprising employee benefits, supplies and services and grants) are expected, in aggregate, to increase on average by 3.0 per cent a year. This is broadly in line with expected price inflation and Victorian population growth.

Operating revenue

2004-05 Budget estimates

Total operating revenue is projected to be $28 985 million in 2004-05, representing a $1 254 million or 4.5 per cent increase on the 2003-04 revised estimate. Driving this revenue growth is modest taxation increases, strengthening investment income and increased Commonwealth grants.

Taxation revenue is projected to increase by approximately $144 million or 1.4 per cent in 2004-05 relative to the revised estimate for 2003-04. The modest increase reflects the net impact of several factors, such as:

- increased payroll tax of $175 million (6.5 per cent), reflecting continued wages and employment growth as well as the net impact of policy changes and the full year effect of the cessation of the payroll tax exemption for apprenticeships and trainee wages;
- excluding the impact of the collection of land tax on electricity transmission easements in 2005 ($80 million), a land tax increase of $69 million (8.9 per cent);
- increased motor vehicle taxation revenue of $129 million (10.5 per cent) reflecting annual indexation of registration fees, an increase in the number of vehicles registered and a reduction in the registration concession;
- a budgeted reduction of $278 million (11.1 per cent) in duty on land transfers reflecting an expected slowdown in the growth of house prices and reduction in the volume of sales; and
- the removal of duty on mortgages from 1 July 2004, as announced in the Government's *Better Business Taxes* package, worth around $200 million a year.

The increase in investment income of $192 million or 18.5 per cent compared to 2003-04 is largely the result of additional dividend revenue from the re-commencement of dividend payments by the Transport Accident Commission (TAC), due to a stronger than expected profit for the December 2003 half-year, which has resulted in an improved funding position for TAC.

Grants revenue is expected to increase by $735 million (6.0 per cent) in 2004-05 compared to 2003-04. This increase is largely the result of:

- Commonwealth general purpose grants increasing by $271 million (3.9 per cent), which is lower than the estimated increase (5.1 per cent) in the overall GST pool;
- Commonwealth specific purpose payments grants increasing by $257 million (7.0 per cent) largely reflecting an increase in road grants, while grants for on-passing are forecast to increase $134 million (8.6 per cent) largely reflecting increases in Commonwealth assistance to non-government schools; and
- an additional $65 million in 2004-05 as part of TAC funding ($130 million across two years) to improve Victoria's road infrastructure in both rural and metropolitan areas.

Sales of goods and services revenue in 2004-05 is budgeted to increase by 3.1 per cent in 2004-05 compared to 2003-04. The impact of this increase is offset by a similar increase in operating expenses related to the cost of goods and services sold.

Land transfers

In recent years budget estimates have been based on a moderation in property market activity. However, this moderation has not yet occurred. The resilience of the Victorian property market over several years has reflected various factors, including low interest rates, continuing overseas migration to Victoria and strong population growth, a robust Victorian economy and labour market and the effect of the First Home Owner Grant. In addition, equity market instability may have further added to the relative attractiveness of property as an investment.

Indeed, house price growth in Melbourne has been exceptionally strong, with the result that the ratio of house price to income has reached record levels. However, the rate of growth in Melbourne median house prices has declined in each of the past three quarters, with the December 2003 quarter growth of 0.8 per cent, the lowest in the past seven quarters. Transactions and volumes may moderate in response to recent interest rate increases. With housing affordability at low levels, this moderation in the property market is expected to continue into 2004-05. The Victorian Government is providing an additional one-off $5 000 *First Home Bonus*, from 1 May 2004 until 30 June 2005, for properties up to $500 000.

In 2004-05 land transfer duty revenue is expected to be $2 236 million, a decline of $278 million (11.1 per cent) from the previous year. By 2005-06 conveyance duty is expected to be 17.4 per cent below the level recorded in 2003-04. As a share of GSP, conveyance duty is projected to decline over the forward estimates period.

Gambling taxation

On 1 September 2002 the Government introduced smoking bans in gaming venues. Since the introduction of the bans there has been a substantial decline in gambling activity, particularly in electronic gaming machine (EGM) venues and, to a lesser extent, the casino. In 2003-04 it is estimated that the loss of revenue due to the impact of the smoking ban is around $213 million. The 2004-05 Budget estimates assume that gambling behaviour has now adjusted to the impact of the smoking ban, with gambling revenue remaining permanently lower as a result.

Forward estimates outlook

Beyond 2004-05 total revenue is expected to increase on average by 3.1 per cent a year. This reflects projected growth in taxation revenue, investment income and Commonwealth grants.

Taxation revenue is projected to grow on average by 2.2 per cent a year over the forward estimates period. The forward estimates growth follows a similar pattern to that in 2004-05 with increased revenue from payroll, land and motor vehicle taxes, offset by further reductions in duty on land transfers and bank accounts debits tax removal on 1 July 2005

Commonwealth grants are projected to grow at an annual average rate of 4.3 per cent between 2004-05 and 2007-08. This growth reflects higher general purpose payments, largely GST receipts, and specific purpose payments, in particular funding being provided to non-government schools.

Investment income is projected to return to more normal growth patterns, with a projected annual average increase of 3.2 per cent from 2004-05 to 2007-08, largely as a result of additional dividend revenue from the re-commencement of dividend payments by the Transport Accident Commission and continuing growth in interest revenue.

RECONCILIATION OF FORWARD ESTIMATES TO PREVIOUSLY PUBLISHED ESTIMATES

Table 3.7 compares the revised outlook for the operating surplus for the period 2004-05 to 2006-07 to the estimates published in the 2003-04 Budget.

The projected 2004-05 Budget operating surplus is $545 million, an increase of $224 million from the result estimated at the time of the 2003-04 Budget.

Table 3.7: Reconciliation of 2004-05 Budget estimates to 2003-04 Budget

($ million)

	2004-05 Budget	*2005-06 Estimate*	*2006-07 Estimate*
Operating surplus - 2003-04 Budget	**321.0**	**304.4**	**547.3**
Plus: Revenue variations in 2003-04 Budget Update	472.7	669.5	502.3
Less: Expense variations in 2003-04 Budget Update	320.9	409.8	512.9
Operating surplus - 2003-04 Budget Update	**472.9**	**564.1**	**536.7**
Plus: Revenue variations since 2003-04 Budget Update			
Economic/demographic effects			
Taxation revenue	357.4	218.3	185.1
Investment income	160.1	81.2	20.1
Total economic/demographic variations	**517.5**	**299.5**	**205.2**
Policy variations			
Budget initiatives	- 58.8	- 110.2	- 133.0
Land tax: electricity transmission easement	80.0	80.0	80.0
Total policy variations	**21.2**	**- 30.2**	**- 53.0**
Taxation expenditures (concessions)	**42.3**	**47.8**	**51.4**
Commonwealth funding revisions			
General purpose grants	11.4	- 120.8	40.4
Specific purpose payments	180.8	187.9	242.2
Total Commonwealth funding variations	**192.2**	**67.1**	**282.6**
Administrative variations			
Interest revenue - budget financing	79.5	101.9	120.0
Forecast revision - fees & fines	44.4	46.1	49.6
Sales of goods and services and own source revenue	98.3	59.6	64.6
Other miscellaneous variations	136.2	74.2	- 11.7
Total administrative variations	**358.4**	**281.8**	**222.4**
Total variation in operating revenue since 2003-04 Budget Update	**1 131.7**	**666.1**	**708.6**
Less: Operating expenses variations since 2003-04 Budget Update			
Policy decisions			
New output funding	1 078.3	897.4	860.0
Less: Contingency provision	- 390.7	- 410.2	- 440.9
Total policy variations	**687.6**	**487.2**	**419.2**
Commonwealth funding revisions	**137.9**	**159.2**	**184.5**
Administrative variations			
Depreciation	45.1	58.5	57.9
Superannuation	- 89.4	- 118.3	- 129.0
Own sourced revenue expenditure	80.1	59.6	56.7
Other administrative variations	198.2	78.6	125.7
Total administrative variations	**234.0**	**78.4**	**111.2**
Total variation in operating expenses since 2003-04 Budget Update	**1 059.5**	**724.9**	**714.9**
Operating surplus – 2004-05 Budget	**545.0**	**505.4**	**530.5**

Source: Department of Treasury and Finance

Variations to total operating revenue

Operating revenue is projected to be $836 million higher on average over the period 2004-05 to 2006-07 than the estimates projected at the time of the *2003-04 Budget Update*.

Economic and demographic effects, impacting on taxation and investment income, is projected to be on average $341 million higher than estimated in the *2003-04 Budget Update* estimates. Taxation is the largest driver of this revision, increasing on average by $254 million over the three years. This increase largely reflects higher land values feeding into land tax and land transfers duty, as well as projected growth in payroll tax due to expected continued strength in wages and employment growth.

Policy variations made up of budget initiatives and land tax on electricity transmission easements are projected to reduce operating revenue on average by $21 million a year. The budget initiatives are projected to reduce total operating revenue by an average $101 million a year, while the land tax on electricity transmission easements held by electricity transmission companies will raise an additional $80 million a year. Details of these changes are set out above under 'Revenue initiatives' and in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, and Budget Paper No. 4.

Commonwealth funding revenue has been revised up by an average $181 million a year. Specific purpose payments have increased on average by $204 million a year, with additional funding for road programs and to non-government schools. This has been offset by reductions in general purpose grants. The reduction in general purpose grants has resulted largely from a decline in the guaranteed minimum amount (GMA) due to lower inflation, lower population share and reduced forgone gambling revenue. The level of general purpose grants is now based on GST revenue because it exceeds the GMA from 2004-05, but it is still below the previously projected GMA level.

A range of administrative and forecast variations account for the balance of the variation in projected revenue since the *2003-04 Budget Update*. These include:

- an increase in interest revenue of $80 million in 2004-05, rising to $120 million in 2006-07 reflecting higher cash surpluses and interest rates than projected at the time of the *2003-04 Budget Update*;
- upward revisions to projected fees and fines on average of $47 million a year, mainly reflecting increased Board registration fees in a range of general government sector agencies; and
- an increase on average of $74 million a year in sales of goods and services and own-source revenue, mainly as a result of revised third party revenue to hospitals from activities such as private patient fees and charges for hospital facilities.

Variations to total operating expenses

Projected operating expenses for 2004-05 have been revised up by $1 060 million since the *2003-04 Budget Update*, with the increase in projected expenses falling to $715 million in 2006-07.

New output policy initiatives are the main driver of the increase in operating expenses, with estimates projected to increase on average by $945 million a year from 2004-05 to 2006-07. After deducting the contingency provision set aside in previous budgets for additional demand and other cost pressures, the net addition to total operating expenses as a result of policy decisions is $688 million in 2004-05, falling to $419 million in 2006-07. Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives* provides more detailed information on the Government's service delivery and strategy while Appendix A, *Output, Asset Investment and Revenue Initiatives*, of the same Budget Paper provides a detailed list and description of all service delivery initiatives implemented in this budget.

Commonwealth funding revisions contribute on average $161 million a year in operating expenses. Consistent with the revenue increases discussed above, the increased expenditure mainly relates to non-government schools and road maintenance funding.

Since the *2003-04 Budget Update* there are a range of other administrative variances that contribute to a net increase in operating expenses. These include:

- an increase in depreciation expenses on average of $54 million a year mainly as a result of revaluation of roads;
- the impact of the 2003 triennial actuarial review of the State Superannuation Fund (SSF) in reducing the SSF's accrued liabilities. The triennial actuarial review found that the SSF's accrued liabilities were $345 million lower than previously estimated. This adjustment and the better than anticipated performance in superannuation investment returns in 2003-04, lead to a reduced superannuation expense over the forward estimates period; and
- the increase on average of $66 million a year in own source revenue expenditure which is financed by increased sales of goods and services, mainly in the hospital sector.

The balance of the administrative variations is mainly due to updated economic forecast adjustments, including changes in vehicle lease arrangements, and a partial replenishment of the contingency to take account of various risks facing the budget.

USE OF CASH RESOURCES

Table 3.8 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 financing activities. The table also provides a reconciliation of the projected budget operating surplus to the projected change in general government net debt over the forward estimates period.

Table 3.8 shows that the expected budget operating surplus for 2004-05 is $545 million. However, the operating result is affected by a number of expense and revenue items that do not require or provide cash resources during the year. These include depreciation, growth in unfunded superannuation liabilities and employee benefit liabilities. Adjusting for these non-cash items yields projected net cash inflow from operating activities for 2004-05 of $2 541 million, compared to a revised estimate of $1 818 million for 2003-04.

Net expenditure on the purchase of infrastructure and other fixed assets is expected to increase to $2 872 million in 2004-05, compared to $2 113 million in 2003-04. The $2 541 million cash surplus from operating activities will be the main source of funding for the 2004-05 infrastructure program, with the balance sourced from a drawdown of Growing Victoria financial assets and, to a lesser extent, increased debt. The Growing Victoria infrastructure reserve funds were explicitly put aside over the last five years to provide a boost to future infrastructure spending (for further details on the Growing Victoria infrastructure program see Budget Paper No. 3, Appendix B, *Growing Victoria Infrastructure Reserve*). In 2004-05 general government net debt is projected to increase by approximately $143 million.

Table 3.8: Application of cash resources

($ million)

	2003-04 Revised	*2004-05 Budget*	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Operating surplus	**432.5**	**545.0**	**505.4**	**530.5**	**675.7**
Plus: Non-cash expenses (net)(a)	1 385.9	1 995.6	2 185.6	1 457.6	1 311.7
Net cash flow from operating activities	**1 818.3**	**2 540.6**	**2 690.9**	**1 988.1**	**1 987.4**
Plus: Net drawdown of Growing Victoria infrastructure reserve	622.8	185.6	4.5	..	..
Total cash available for asset investment	**2 441.1**	**2 726.2**	**2 695.4**	**1 988.1**	**1 987.4**
Less:					
Net investment in fixed assets (b)					
Expenditure on approved projects	2 182.9	2 952.5	2 208.6	1 615.5	1 055.8
Unallocated provision for future allocation			348.1	728.9	1 224.2
Proceeds from asset sales	- 69.6	- 80.9	- 91.3	- 62.6	- 126.2
Total net investment in fixed assets	**2 113.3**	**2 871.6**	**2 465.4**	**2 281.8**	**2 153.9**
Other investment activities (net)	18.1	- 2.0	432.2	2.5	4.4
Decrease in net debt (excluding Growing Victoria)	**309.7**	**- 143.4**	**- 202.2**	**- 296.2**	**- 170.9**

Source: Department of Treasury and Finance

Notes:

(a) *Includes depreciation and increase in unfunded superannuation liability and increase in liability for employee benefits.*

(b) *Includes net contribution to other sectors of government.*

With the Growing Victoria infrastructure reserve largely utilised by the end of 2004-05, infrastructure investments of $2 300 million a year averaged over the 2005-06 to 2007-08 period are largely financed by cash flow from operating activities averaging $2 222 million over this period. The balance is financed by additional debt of $223 million a year on average. The $432 million other investment activities increase reflects the equivalent increase in assets and liabilities flowing from the completion and handover to the State of the *Partnerships Victoria* Spencer Street Station redevelopment project.

Table 3.8 also sets out the provision for future capital investment projects through unallocated capital. This provision rises from $348 million in 2005-06 through to $1 224 million in 2007-08.

CHAPTER 4 – BALANCE SHEET MANAGEMENT AND OUTLOOK

- The general government's balance sheet is in a strong financial position to withstand financial and economic shocks.
- Moody's Investors Service and Standard & Poor's have both cited Victoria's low debt levels, high degree of financial flexibility, strong fiscal position and the Government's commitment to responsible financial management as the key drivers for Victoria's triple-A credit rating.
- General government sector total assets are expected to grow at an average 4.6 per cent a year between June 2004 and June 2008, driven by strong growth in infrastructure investment. Real capital stock is expected to grow by 7.4 per cent, more than the projected rate of population growth of 4.2 per cent, supporting service delivery and facilitating business sector expansion. Total gross asset investment over the four years from 2004-05 is in excess of $10 billion.
- General government net financial liabilities (excluding the Growing Victoria infrastructure reserve) are expected to increase from $14.0 billion at June 2004 to $16.4 billion at June 2008. As a share of GSP, these liabilities are projected to fall from 6.8 per cent to 6.5 per cent, signifying that the modest liability increase can be serviced by the growing Victorian economy.
- Unfunded superannuation liabilities, at an estimated $12.2 billion at June 2004, represent the State's largest liability. The State has adopted a funding framework with the aim of achieving 100 per cent funding by 2035.
- General government net debt (excluding the Growing Victoria infrastructure reserve) is forecast to increase from $1.8 billion in June 2004 to $2.6 billion by June 2008. At around 1 per cent of GSP, net debt remains modest, compared to 3 per cent of GSP in 1999 and 16 per cent in 1995.

INTRODUCTION

The Government is committed to the financial objective of maintaining net financial liabilities at levels which are both prudent and consistent with maintaining the State's triple-A credit rating. Net financial liabilities are the sum of unfunded superannuation liabilities and gross debt less financial assets.

This chapter reviews the key components of assets and liabilities on the general government balance sheet and the drivers underpinning their trends.

A robust and growing balance sheet provides stability, flexibility and capacity to absorb financial and economic shocks, as well as a growing asset base to improve quality, access and equity in key services to all Victorians. As such, the physical capital stock and prospective additions are examined in this chapter with a particular focus on the risk management approaches to the delivery of large projects.

As net financial liabilities are a key indicator of financial strength, this chapter also discusses the strategy for managing the unfunded superannuation liability and net debt.

Finally, the key indicators of financial strength are assessed to demonstrate the robustness of Victoria's financial position.

SUMMARY BALANCE SHEET

The general government sector's assets and liabilities, which make up the 'balance sheet', are set out in Table 4.1.

Net assets are projected to increase by \$6.4 billion from \$24.7 billion at June 2004 to \$31.1 billion at June 2008. The growth in net assets over this period reflects the cumulative general government operating surpluses of \$2.3 billion over this period as well as normal asset revaluations. With net assets rising, the balance sheet is supporting the Government's commitment to financial responsibility by providing a strong and stable financial basis for the State.

Largely reflecting investment in infrastructure by the Government as well as normal revaluations of the capital stock, total assets are projected to grow from \$50.3 billion at June 2004 to \$59.6 billion at June 2008.

In contrast, total liabilities are projected to show a lesser rise, from \$25.6 billion at June 2004 to \$28.5 billion at June 2008, which reflects increases in the unfunded superannuation liabilities, and small increases in borrowings and other liabilities.

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

($ billion)

	1999 Actual	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Revised	2005 Budget	2006 Estimate	2007 Estimate	2008 Estimate
Assets										
Physical assets [(a)]	32.2	34.1	35.4	39.2	41.7	43.5	46.0	48.7	50.7	52.7
Financial assets [(b)]	2.0	3.3	4.2	4.1	4.3	4.7	4.7	5.0	4.7	4.6
Receivables, etc [(c)]	1.6	1.5	1.6	1.8	1.9	2.0	2.1	2.2	2.2	2.4
Growing Victoria [(d)]	0.0	1.0	1.1	1.4	0.8	0.2	0.0	0.0	0.0	0.0
Total assets	**35.7**	**40.0**	**42.4**	**46.5**	**48.7**	**50.3**	**52.8**	**55.8**	**57.7**	**59.6**
Liabilities										
Superannuation	11.4	12.3	11.8	13.4	13.4	12.2	12.9	13.7	13.9	13.8
Borrowings	7.1	6.4	6.4	6.4	6.3	6.2	6.4	6.9	6.9	6.9
Other liabilities	3.6	3.8	4.4	4.9	5.4	7.2	7.4	7.6	7.7	7.9
Total liabilities	**22.2**	**22.5**	**22.6**	**24.7**	**25.1**	**25.6**	**26.7**	**28.2**	**28.5**	**28.5**
Net assets	**13.5**	**17.5**	**19.7**	**21.8**	**23.6**	**24.7**	**26.0**	**27.6**	**29.2**	**31.1**

Source: Department of Treasury and Finance

Notes:

(a) *Physical assets include land and buildings, plant and equipment, and roads and earthworks, cultural and other assets.*

(b) *Financial assets include cash assets, and investments, loans and placements. It does not include the Growing Victoria infrastructure reserve.*

(c) *Receivables include receivables, prepayments and inventories.*

(d) *Even though the Growing Victoria infrastructure reserve invests in financial assets, it is earmarked for physical asset investment and therefore treated as non-financial.*

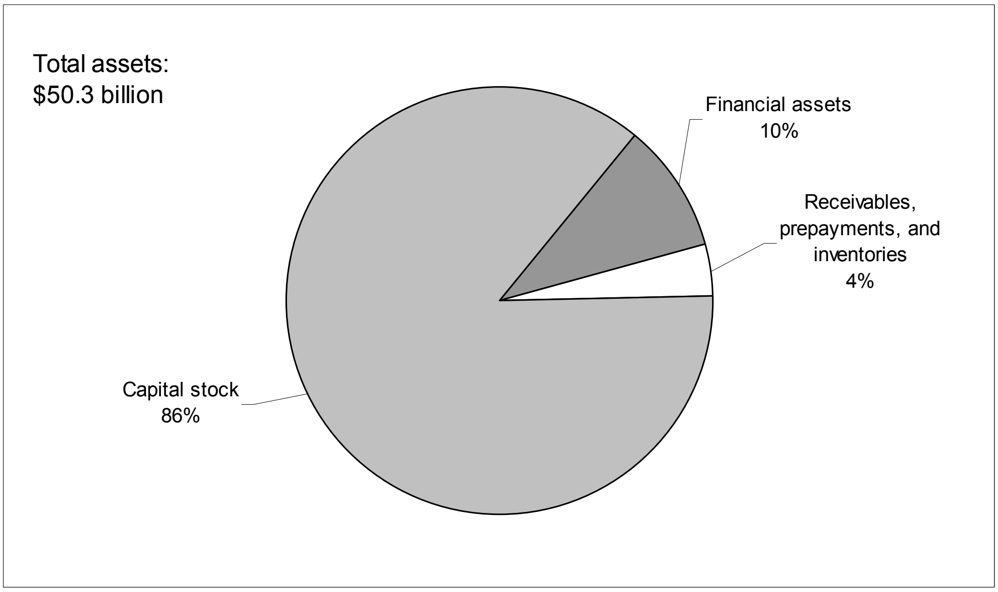
Total assets

Growth in total assets is expected to average 4.6 per cent a year between June 2004 and June 2008, due mainly to the Government's investment in the capital stock and the effect of normal asset revaluations.

Chart 4.1 shows the most important component is physical assets, or the capital stock, which enables government services to be delivered to the community and provides important economic infrastructure for the private sector. The general government sector also holds financial assets and other assets, including receivables, prepayments and inventories.

Financial assets are expected to remain relatively stable over the forward estimates period. Receivables are expected to increase by $0.4 billion over the next four years.

Chart 4.1: Projected general government assets by category as at 30 June 2004



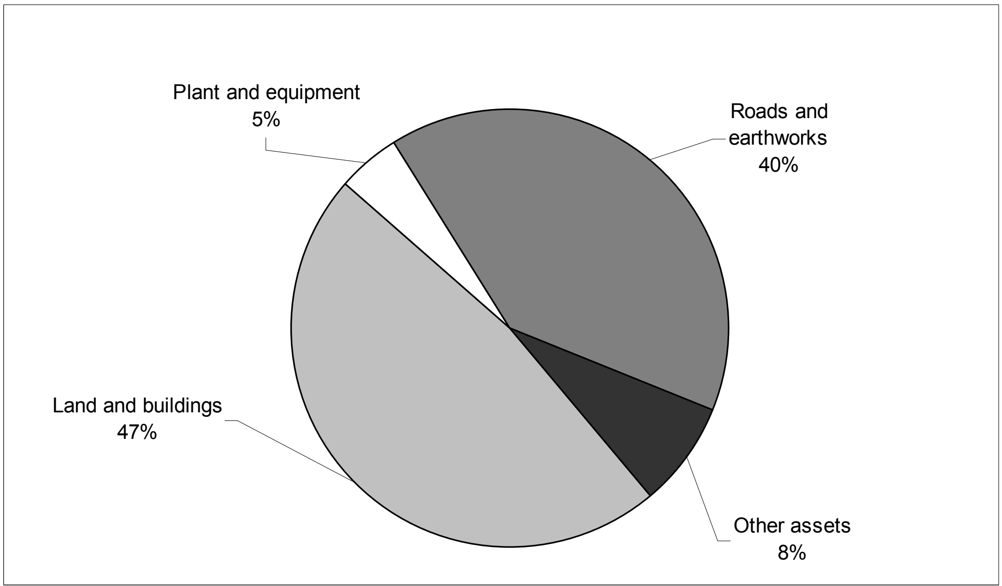
Source: Department of Treasury and Finance

Capital stock

Chart 4.2 shows the main components, by asset category, of the capital stock as at 30 June 2004. Land and buildings account for the largest proportion at 47 per cent ($20.6 billion), followed by roads and earthworks at 40 per cent ($17.3 billion), plant and equipment at 5 per cent ($2.2 billion) and other assets at 8 per cent ($3.4 billion).

More broadly, the capital stock includes investments in social (e.g. hospital and schools) and economic (e.g. transport) infrastructure. As such, the composition of the capital stock is a reflection of past decisions by government as to the extent of social and economic infrastructure needed to support government service delivery and to ensure support for businesses to compete and grow.

Chart 4.2: Capital stock as at 30 June 2004



Source: Department of Treasury and Finance

Asset investment strategy – growing the capital stock

Looking forward, the Government is committed to sustaining and adapting a portfolio of physical assets that enable public services to be appropriately, effectively and efficiently delivered to the community. The Government has committed to total gross asset investment over the next four years in excess of $10 billion.

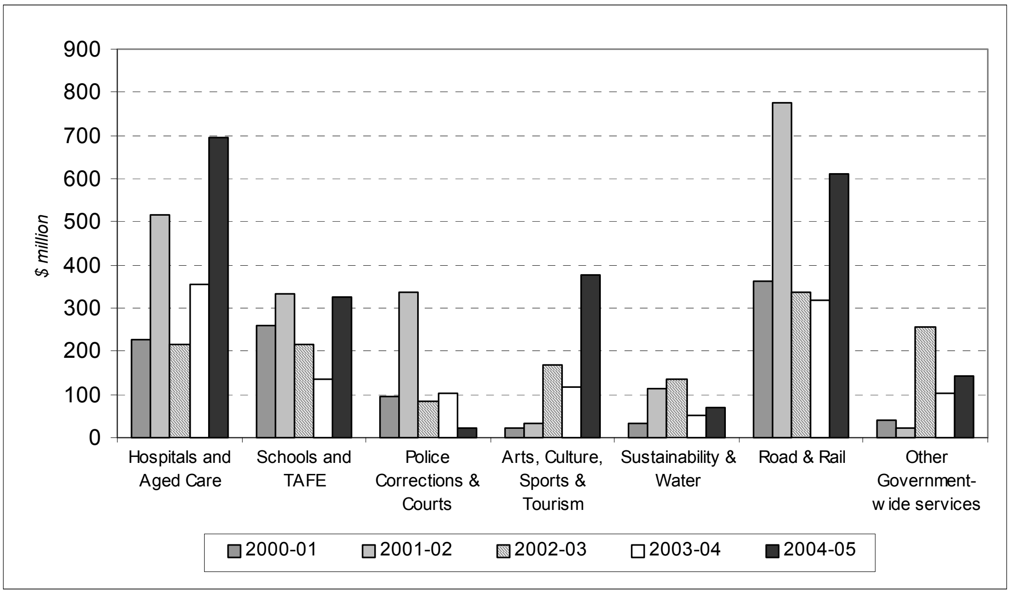
The *2003-04 Budget Update* and the 2004-05 Budget announced new asset projects with a total estimated investment of $2.4 billion. The asset initiatives cover a range of areas including education, health and community services, community safety and the environment, together with economic infrastructure such as road, rail and public transport linkages. Further details of the 2004-05 Budget asset investment program can be found in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives* and Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives.*

Social and economic infrastructure can be improved either through building new assets or through the renewal or replacement of existing assets. Of the asset investment announced in the 2004-05 Budget, around 60 per cent is for renewal or replacement initiatives and the remainder is for initiatives for new and enhanced infrastructure.

Chart 4.3 shows the level of investments by asset class announced in each budget over the period 2000-01 to 2004-05. The actual expenditure and delivery of assets will occur over a period of years. Investment by government is the product of long-range service planning and often takes many years to deliver. As a consequence, announced investments in an asset class can vary significantly from year to year. The asset investments announced in recent budgets (as shown in Chart 4.3) include:

- significant investment in restoring health facilities to maximise service delivery potential, as well as the upgrade of aged care facilities to meet Commonwealth accreditation requirements;
- funding for new and replacement schools as well as school equipment and facilities and the modernisation of TAFE facilities and equipment;
- commencing in 2001-02, a significant investment in police facilities to renew the stock to better meet the challenges of a modern and increasing police force. Replacement of about two-thirds of the police station stock is underway, mostly replacing facilities that pre-date 1974;
- Commonwealth Games related infrastructure and funding for the redevelopment of the Melbourne Convention Centre; and
- significant investment in transport infrastructure including in road and rail links, and public transport upgrades.

Chart 4.3: Budget announcements of TEI by key infrastructure class

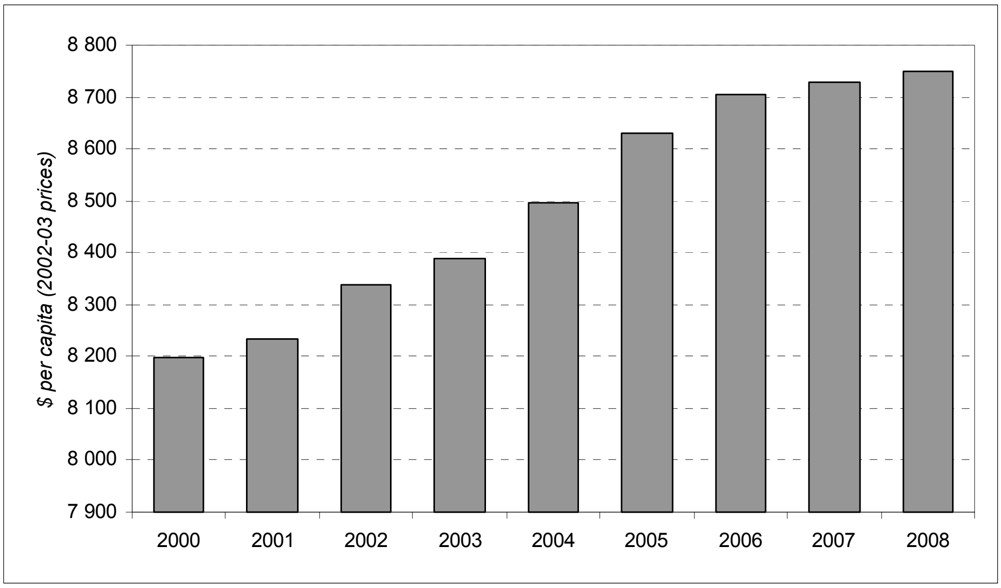


Source: Department of Treasury and Finance

Taking into account past and 2004-05 Budget decisions, infrastructure investment is expected to average $2.4 billion a year between 2004-05 and 2007-08, well in excess of depreciation of around $1.2 billion a year.

As a result, estimated growth in the real capital stock of 7.4 per cent is more than the projected 4.2 per cent rate of growth in the population over the four years to June 2008 (see Chart 4.4).

Chart 4.4: Real capital stock per capita as at 30 June



Source: Department of Treasury and Finance

Asset investment strategy – better infrastructure delivery processes

While the amount of asset investment is important, it is essential that the asset investments be delivered as efficiently as possible.

The Victorian Government has adopted risk management approaches to manage large infrastructure investments. Both the Gateway Initiative and *Partnerships Victoria* framework are designed to ensure projects are delivered to achieve value for money, on time and within scope and budget.

Gateway Initiative

The Victorian Government introduced the Gateway Initiative to reduce the risk of project cost and time overruns, to ensure alignment of projects with strategic objectives, and to better coordinate initiatives across all areas of government.

Gateway is an integral part of the Government's commitment to responsible financial and resource management and applies to asset investments undertaken within the general government sector.

The four elements of the Gateway Initiative are:

- multi-year strategy: to improve decision-making about departmental asset investment initiatives and their alignment to strategic plans;
- business case development: to assist departments and agencies develop better business cases, allowing the right investments to be selected and project risks and delivery terms to be identified and addressed;
- Gateway review process: to independently review key projects from initiation to completion to ensure achievement of milestones. The Gateway review process incorporates best practice techniques that have been refined in both the public and private sectors, and is aimed at enhancing the State's risk management capacity; and
- enhanced asset investment reporting: to give improved exception-based asset monitoring as an integral part of an overall risk management framework.

Partnerships Victoria

The Government is committed to maximising the value of infrastructure spending through the responsible use of resources of both the public and private sectors. *Partnerships Victoria*, launched in June 2000, provides the policy for a whole-of-government approach to the provision of public infrastructure and related ancillary services through public-private partnerships. The policy focuses on whole-of-life costing and full consideration of the benefits of risk transfer to private parties.

Where there is the potential to offer enhanced value for money compared to conventional procurement approaches, the *Partnerships Victoria* framework allows the Government to provide improved services at a lower cost. The potential for this is likely to occur in larger projects where there is scope for some or all of the following attributes:

- integration of design, construction, operation and maintenance over the life of an asset, within a single project package;
- innovation and significant transfer of risk to a private party; and
- appropriate third-party usage of facilities, either concurrently or 'out-of-hours', thereby reducing net cost to government.

Under *Partnerships Victoria*, the Government retains direct control over those core services where it is in the public interest to do so (such as custodial services in prisons, teaching in government schools and judiciary functions).

Value for money, rather than capital scarcity or balance sheet treatment, is the driver for the adoption of a *Partnerships Victoria* approach. Full budget funding is set aside for non self-funding projects before market interest is formally sought, allowing a project to proceed in public ownership should private bidders not offer value for money.

The Government confirmed its support for the *Partnerships Victoria* policy following an independent review conducted during 2003-04. The 'Review of *Partnerships Victoria* Provided Infrastructure' examined the eight projects for which contracts had been executed and the processes involved in their evaluation. The Review found that these first eight projects provided tangible evidence of the benefits that flow from harnessing private sector skills and innovation in infrastructure.

In releasing the report in March 2004, the Government indicated its agreement with many of the Review recommendations and noted that a number of the issues raised were already being taken into account as part of ongoing improvement of the policy.

In the time since the *Partnerships Victoria* framework has been in place, ten contracts have been signed with private parties with a total capital value of around $1 billion. Contracts for four *Partnerships Victoria* projects with a total capital value exceeding $350 million have been executed in the last twelve months - Mobile Data Network, Enviro Altona, Metropolitan Mobile Radio and Correctional Facilities. The other projects are: Echuca/Rochester Wastewater Treatment Plant, Casey (Berwick) Community Hospital, Film and Television Studios, Spencer Street Station Redevelopment, Wodonga Wastewater Treatment Plant, and the County Court, the first to be delivered under this framework.

The 2004-05 Budget provides funding for new infrastructure investment projects totalling about $2.5 billion, of which 14 per cent is expected to be delivered under *Partnerships Victoria.* The following projects are currently in the market:

- Mitcham-Frankston Freeway: The project will be built by the private sector and funded by direct tolls. The 40km freeway will join the Eastern Freeway at Mitcham to the Frankston Project at Seaford;
- Central Highlands Water—North Ballarat Wastewater Plant and Reuse Project: The project involves upgrading the Ballarat North Treatment Plant to a tertiary treatment level to cater for full reuse of effluent, with the need to comply with stricter EPA wastewater discharge standards;
- Emergency Alerting Systems: The project is a multi-agency initiative to equip career and volunteer emergency services personnel throughout Victoria with alerting devices. The systems will enable the Country Fire Authority, the Victorian Statewide Emergency Services and Rural Ambulance Victoria to contact their career and volunteer staff and alert them to emergency situations;

- Royal Melbourne Showgrounds Redevelopment: The principal aim of the redevelopment of the site is to transform the Showgrounds land portion of the site into a high quality multipurpose venue for the staging of the annual Royal Melbourne Show and other events; and
- Royal Women's Hospital Redevelopment: The Royal Women's Hospital (RWH) Redevelopment Project involves the co-location of a new RWH adjacent to the Royal Melbourne Hospital site in Parkville. The new RWH will be a joint undertaking between the State, the Women's and Children's Health Service and Melbourne Health.

In the 2004-05 Budget, the Government has committed funding for a new Melbourne Convention Centre, which will be considered under *Partnerships Victoria*. The new Melbourne Convention Centre, including a 5 000 seat Plenary Hall, will be built on land adjacent to the Melbourne Exhibition Centre site.

A number of projects are currently under consideration to be delivered under the *Partnerships Victoria* guidelines. These projects span a range of sectors: health and human services, education, water and economic infrastructure, which include:

- relocatable classrooms;
- Melbourne wholesale fruit, vegetable, flower and fish markets redevelopment;
- affordable housing;
- aged care facilities/sub acute facilities;
- Werribee Plains vision;
- Eastern treatment plant;
- Barwon Water: biosolids Black Rock treatment plant; and
- metropolitan health food services project.

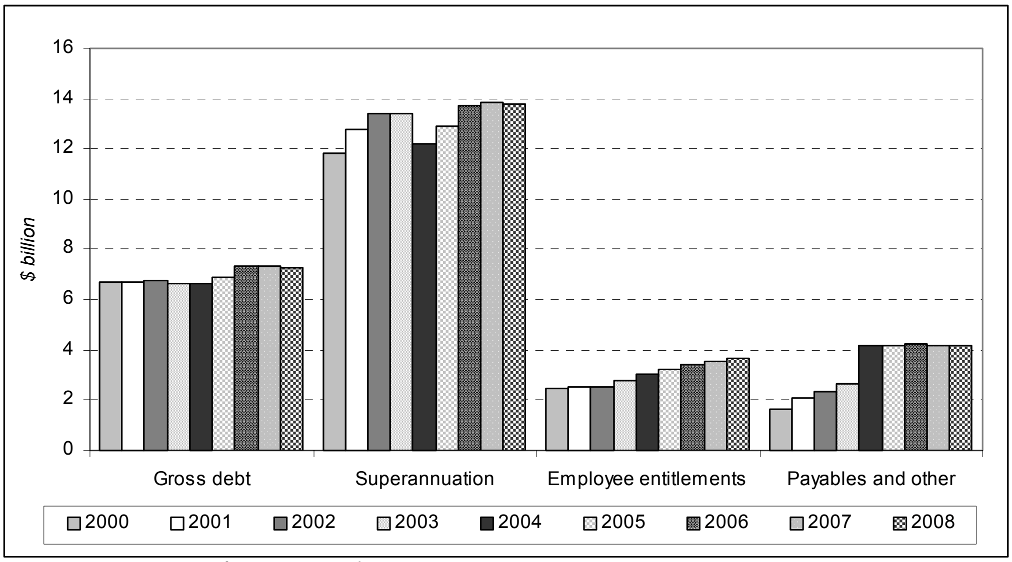
Financial assets

As shown in Table 4.1, general government financial assets are expected to decline marginally from $4.7 billion in June 2004 to $4.6 billion in June 2008. About 50 per cent of these assets are held in the Budget Sector Investment Fund. This fund was initially established in June 2000 for the Growing Victoria infrastructure reserve. Over the last few years, the fund has increased due to strong cash surpluses. The fund invests in highly-rated domestic fixed-interest securities, with an average credit rating of AA+ and a minimum rating of A-. As the Growing Victoria program is expected to be substantially utilised in 2004-05, the need to maintain an investment fund is under consideration.

Total liabilities

While the total assets on the general government balance sheet are projected to grow by \$9.3 billion over the period from June 2004 to June 2008, the total liabilities are projected to grow at a much lower \$2.9 billion (see Table 4.1). The main liabilities are unfunded superannuation liabilities, gross debt and other liabilities (employee benefits). General government liabilities at June 2004 are projected to be \$25.6 billion and are expected to grow at an average 2.8 per cent a year thereafter. Chart 4.5 shows the trends in the various liability categories.

Chart 4.5: General government sector liabilities by category as at 30 June



Source: Department of Treasury and Finance

Unfunded superannuation liabilities

Unfunded superannuation liabilities are the most significant liability on the State's balance sheet. The unfunded liabilities of the State's superannuation schemes represents the present value of future benefits that members have already accrued that are not covered by fund assets. The prior service costs are being funded by an annual payment determined on the basis of actuarial advice that is consistent with the Government's aim of 100 per cent funding of the State's unfunded superannuation liabilities by 2035.

At 30 June 2004, the State's unfunded superannuation liability is projected to be \$12.2 billion, a decrease of \$1.2 billion from June 2003. The decrease is largely attributable to:

- better than expected returns on superannuation fund assets during 2003-04, resulting from strong global equity market performance;

- a reduction in the State Superannuation Fund's (SSF) unfunded liability following the actuary's triennial review of the fund. As part of that review, the actuary revised a number of economic and demographic assumptions (see below). The net result of these changes was a reduction of $345 million in the SSF's 30 June 2003 unfunded superannuation liability; and
- a $966 million payment into the SSF from the Consolidated Fund, $491 million more than originally budgeted. This figure excludes the regular contributions made by departments and agencies to cover the cost of benefits that members accrued during the 2003-04 financial year.

Triennial actuarial review

In previous budgets, an earnings rate of 7 per cent a year had been assumed for all fund assets. In the recent triennial actuarial review, the SSF's actuary refined the earning rate assumptions for fund assets to recognise that investment returns on assets which back current pension liabilities are not subject to tax, while investment returns on assets which back non-pension liabilities are taxed at 15 per cent. Assets which back current pension liabilities are therefore assumed to earn 7.5 per cent a year, while assets which back non pension liabilities are assumed to earn 6.6 per cent a year.

As the SSF's pension liabilities exceed its assets, and will do so for the foreseeable future, the actuary has adopted a 7.5 per cent a year investment earnings assumption to reflect the tax-free status of earnings.

The actuary made several other assumption changes, including a reduction in the assumed long-term CPI growth rate from 3 per cent to 2.5 per cent a year and a lightening of the pensioner mortality assumption.

Payments from the Consolidated Fund

The $966 million payment in 2003-04 is part of the Government's strategy of making additional payments to the SSF to eliminate its unfunded liability, which largely accrued prior to 1995 when the fund was funded on a 'pay as you go' basis.

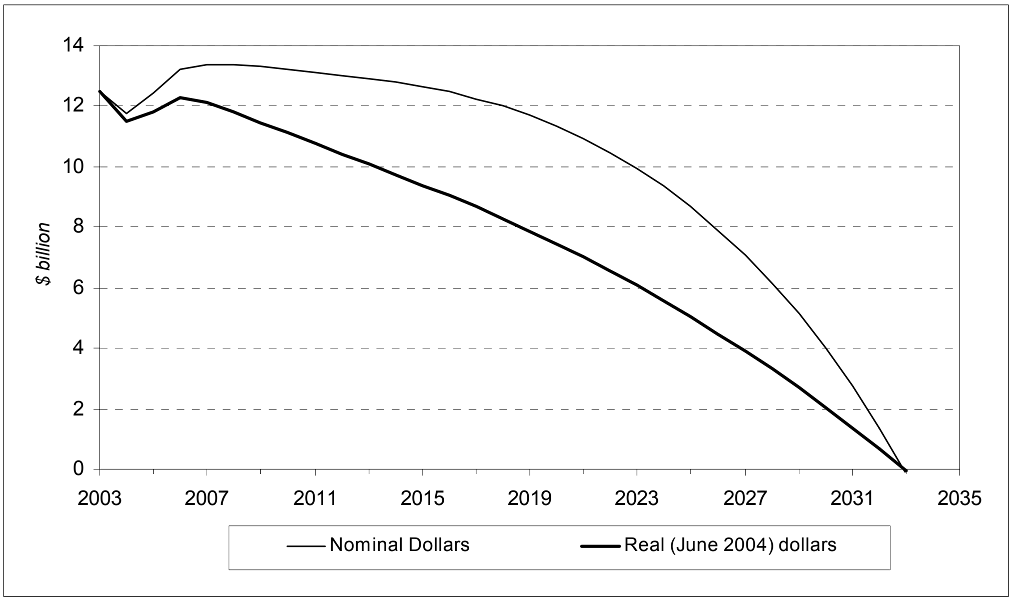
The Government's sound financial management over the past five years has allowed it to make payments to the SSF over and above the schedule originally set out by the actuary to fully fund the scheme by 2035. By 30 June 2004, the Government will be around $1.8 billion ahead of the original payment schedule. Based on current projections, the State will comfortably achieve the full funding target of 2035.

Projected unfunded liabilities

The SSF's unfunded liability is now expected to peak at $13.4 billion in 2007, before declining slowly to $12.1 billion by 2018, and then declining rapidly thereafter (see Chart 4.6). In real terms, the peak is reached in 2005-06.

The unfunded liability is projected to rise in the short term due to member benefits accruing more rapidly than the SSF's assets. After 2007, the unfunded liability declines as government contributions and investment earnings outweigh accrued liability growth.

Chart 4.6: General government sector unfunded superannuation liabilities of the State Superannuation Fund – long-term projections [(a)]



Source: Department of Treasury and Finance

Note:

(a) The Government is committed to fully funding superannuation liabilities by 2035. The chart above shows funding earlier than 2035. This situation may change depending on a range of factors including investment market conditions.

Unfunded liabilities and superannuation expenses

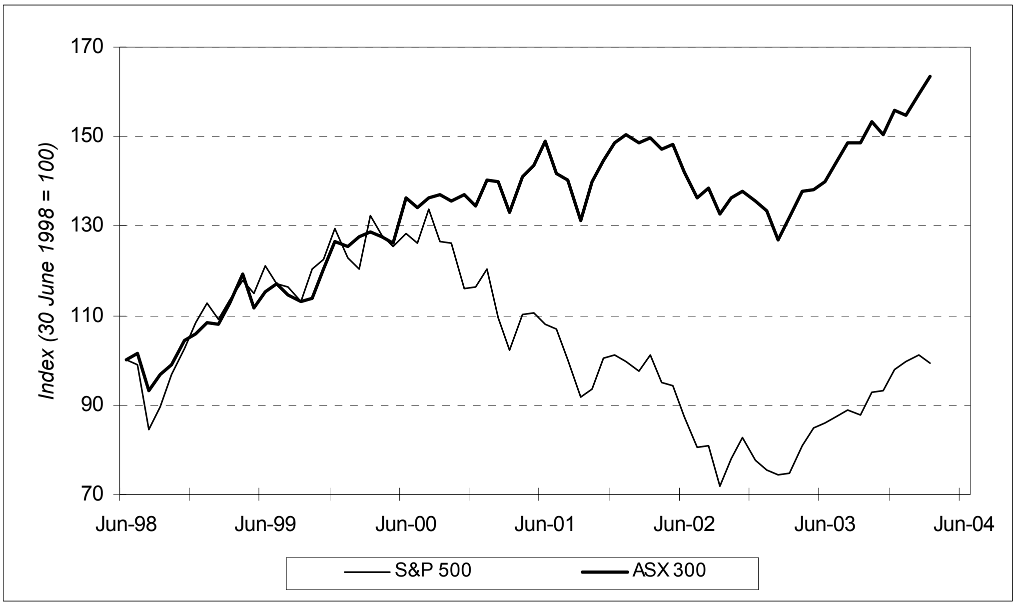
Movements in unfunded superannuation liabilities directly impact on superannuation expenses recorded in the statement of financial performance. Over the past three years, this has meant considerable volatility in superannuation expenses and the operating surplus.

During 2001-02 and 2002-03, it is estimated that superannuation expenses were around $1.7 billion higher than budgeted for this period due to poor global investment returns. For the first nine months of 2003-04, better than expected investment returns have reduced superannuation expenses by around $645 million.

The long-term nature of the State's unfunded superannuation liabilities means that the assets backing those liabilities need to be invested in long-term growth investments such as shares. Chart 4.7 shows the Standard & Poor's 500 (S&P 500) and the ASX 300 indices since 30 June 1998. The volatility in share markets accounts for a large part of the volatility in superannuation expenses over the past three years.

Although the S&P 500 has gained 15.6 per cent so far in 2003-04, it is still below its 30 June 1998 close. Exacerbating the poor returns from US shares during the past two years has been the appreciation of the Australian dollar, which rose 10.2 per cent against the US dollar in 2001-02 and 19.5 per cent in 2002-03. The investment portfolios of Victoria's public sector superannuation funds are only partly hedged against currency market fluctuations. The trustees of the superannuation funds are responsible for decisions on hedging currency exposures.

Chart 4.7: Movement of benchmark indices since 30 June 1998[(a)]



Source: IRESS Market Technology Limited

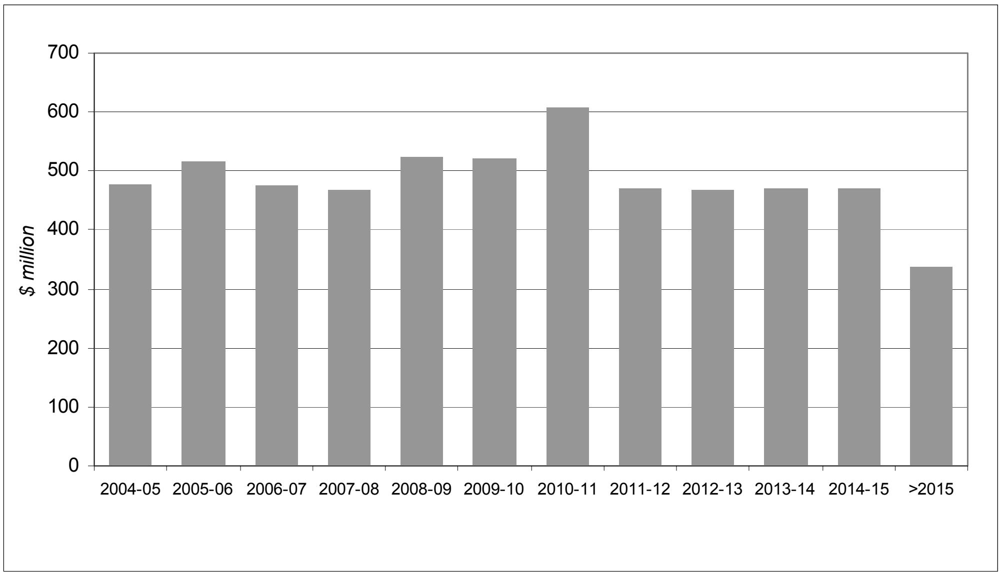
Note:
(a) The S&P 500 index is in US dollar terms.

Gross debt

General government gross debt is expected to stabilise at $6.9 billion in the forward estimates period, compared with $6.2 billion at June 2004 and $7.1 billion at June 1999. Management of the general government debt portfolio continues to be based on the key objectives of achieving relative certainty of interest costs, while minimising borrowing costs and refinancing risk, and managing the financial and operational risks of the general government sector treasury operations in a prudent manner.

The debt portfolio is primarily comprised of a fixed rate borrowing facility from Treasury Corporation of Victoria, with an evenly spread maturity profile (see Chart 4.8). This ensures that a relatively small proportion of the debt portfolio is subject to repricing and hence uncertainty in any one period.

Chart 4.8: Maturity profile of the core debt borrowings of the State as at 31 March 2004



Source: Department of Treasury and Finance

Other liabilities

Other liabilities consist mainly of employee liabilities and payables and grow from $7.2 billion at June 2004 to $7.9 billion at June 2008, an increase of $0.7 billion.

Employee liabilities represent the third largest liability after unfunded superannuation liabilities and gross debt, and are projected to increase from $3.0 billon as at June 2004 to $3.7 billion by June 2008, an average growth rate of 5.5 per cent a year.

Employee liabilities are made up of accrued salaries, annual leave and a provision for long service leave. The provision for long service leave is the present value of expected future payments to be made in respect of services provided by employees up to the reporting date. Wage growth and staff turnover are the key factors impacting on the increase in long service leave liabilities over the forward estimates period.

Payables are expected to increase significantly in 2003-04 and then stabilise in the forward estimates period. The increase in 2003-04 is mainly due to the Government's decision to discontinue collections of the Smelter Reduction Amount from 30 June 2004, and instead provide the State Electricity Commission of Victoria with a $1.25 billion indemnity in respect of the Electricity Supply Agreements with the aluminium smelters at Point Henry and Portland. These agreements expire in 2014 and 2016, respectively. The smelter obligations will be met after 30 June 2004 from the Consolidated Revenue. To minimise the impact on the budget, a land tax on electricity transmission easements will apply from 1 July 2004. This initiative will raise an estimated $80 million a year.

FINANCIAL ANALYSIS

For the purposes of analysing financial strength, the following measures are the most important: net debt and net financial liabilities.

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

The rating agencies focus on both net debt and net financial liabilities of the general government sector and the non-financial public sector as measures of overall indebtedness. Net financial liabilities are the sum of unfunded superannuation liabilities and net debt (gross debt less financial assets). The State's liability management strategy is therefore focused on managing the unfunded superannuation liabilities and net debt. In this section, three measures are discussed: general government net debt, state net debt (the sum of general government net debt and the debt of the non-financial public corporations) and general government net financial liabilities.

General government net debt

The standard measure used to assess general government indebtedness is net debt, as defined and reported in Budget Paper No. 4, Chapter 6, *Uniform Presentation of Government Finance Statistics*. Under this framework, net debt is determined by deducting liquid financial assets from gross debt. The rationale for deducting liquid financial assets is that, in a period of financial difficulty, liquid assets would be readily available to redeem debt. Consistent with this philosophy, the financial assets in the Growing Victoria infrastructure reserve are not deducted from net debt because these financial assets are committed to fund the Growing Victoria infrastructure projects.

In Table 4.2, the increase in general government net debt from $1.8 billion (0.9 per cent of GSP) at June 2004 to $2.6 billion (1.0 per cent of GSP) at June 2008 is due to an increase of $0.4 billion relating to the Spencer Street Station Redevelopment, $0.1 billion for the motor vehicle lease facility, and $0.3 billion due to purchases of non-financial assets and contribution to other sectors for capital purposes.

General government net debt remains very modest over the forward estimates period (see Chart 4.9) in comparison to $4.9 billion (3.3 per cent of GSP) at June 1999 and $19.7 billion (16.3 per cent of GSP) at June 1995.

State net debt

The rating agencies also focus on the broader public sector represented by the non-financial public sector (the State). To fully appreciate the State's call on the capital markets, the level of state debt is therefore of relevance.

Table 4.2 and Chart 4.9 show that non-financial public sector net debt (excluding the Growing Victoria infrastructure reserve) is projected to grow from $3.8 billion (1.9 per cent of GSP) at June 2004 to $5.4 billion (2.1 per cent of GSP) at June 2008. The increase of $1.6 billion is mainly attributable to the increase of $0.8 billion in general government net debt (discussed above) and $0.8 billion in public non-financial corporations net debt.

The increase in the public non-financial corporations' net debt is due to an increase of $0.5 billion in the metropolitan water authorities, $0.1 billion in the Port of Melbourne Corporation and $0.2 billion across a range of authorities.

The forecast increase in water authorities net debt is mainly associated with capital expenditure programs targeted towards works associated with network growth, infrastructure upgrade and renewal, environmental and recycling projects. The capital works programs are mainly driven by growth in housing development activity and population, and compliance with Environment Protection Authority licence requirements and the government's recycling and water policies.

The increase in net debt in the Port of Melbourne Corporation is due to capital expenditure program consistent with the current strategic direction of the business, including strategic land acquisitions and upgrade/refurbishment of berth facilities.

Overall, the level of state net debt remains low and positions the State comfortably within the triple-A ratings criteria.

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

	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Revised	2005 Budget	2006 Estimate	2007 Estimate	2008 Estimate
					($ billion)				
Financial assets (excluding Growing Victoria)									
Cash and deposits	0.9	0.9	1.7	1.1	1.0	1.1	1.1	1.1	1.2
Advances paid	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Investments, loans and placements	1.4	2.2	2.4	3.2	3.7	3.7	3.9	3.6	3.4
	2.8	3.4	4.4	4.5	4.9	4.9	5.2	4.9	4.7
Financial liabilities									
Deposits held	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Advances received	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Borrowings	6.4	6.4	6.4	6.2	6.2	6.4	6.8	6.8	6.8
	6.7	6.7	6.8	6.7	6.7	6.9	7.3	7.3	7.3
General government net debt	**3.9**	**3.3**	**2.4**	**2.1**	**1.8**	**1.9**	**2.1**	**2.4**	**2.6**
Unfunded superannuation	12.3	11.8	13.4	13.4	12.2	12.9	13.7	13.9	13.8
General government net financial liabilities	**16.2**	**15.1**	**15.8**	**15.6**	**14.0**	**14.8**	**15.8**	**16.3**	**16.4**
Non-financial public sector net debt [(b)]	5.2	4.6	3.5	3.6	3.8	4.5	4.8	5.2	5.4
					(per cent)				
General government net debt to GSP	2.5	1.9	1.3	1.1	0.9	0.9	0.9	1.0	1.0
General government net financial liabilities to GSP	10.2	8.8	8.7	8.1	6.8	6.9	7.0	6.8	6.5
Non-financial public sector net debt to GSP [(b)]	3.2	2.7	1.9	1.9	1.9	2.1	2.1	2.2	2.1

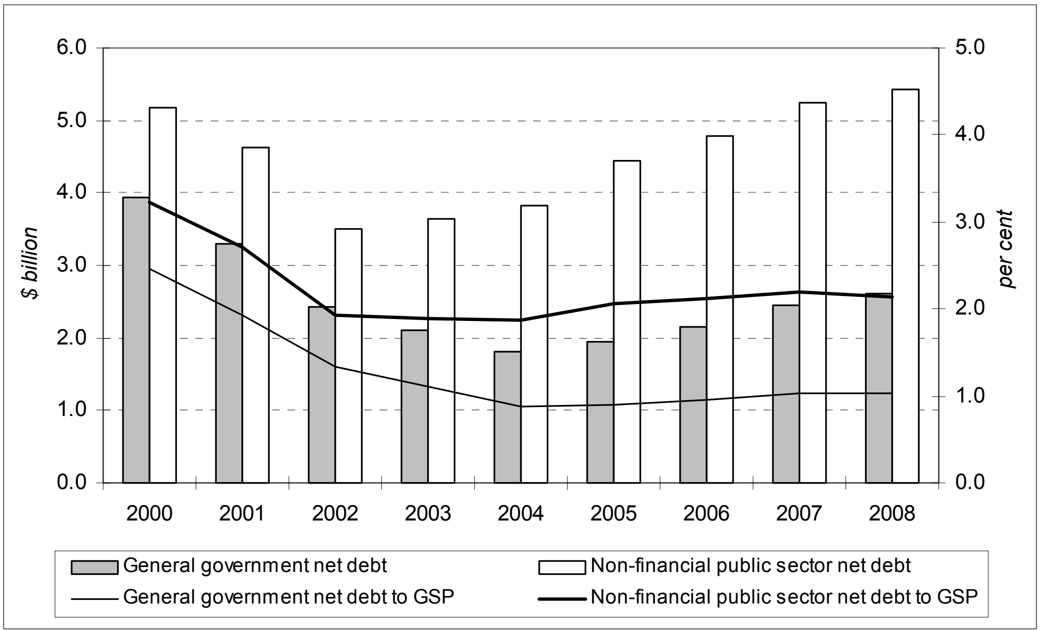
Source: Department of Treasury and Finance

Notes:

(a) The Growing Victoria infrastructure reserve is excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.

(b) Non-financial public sector net debt is the sum of general government net debt plus public non-financial corporations net debt, less inter-sector transactions. The forward estimates for this sector's net debt includes estimates provided by major entities such as the metropolitan water authorities, Port of Melbourne Corporation and VicUrban. Net debt for all the other authorities is assumed to be constant.

Chart 4.9: General government and non-financial public sector net debt (excluding Growing Victoria) as at 30 June



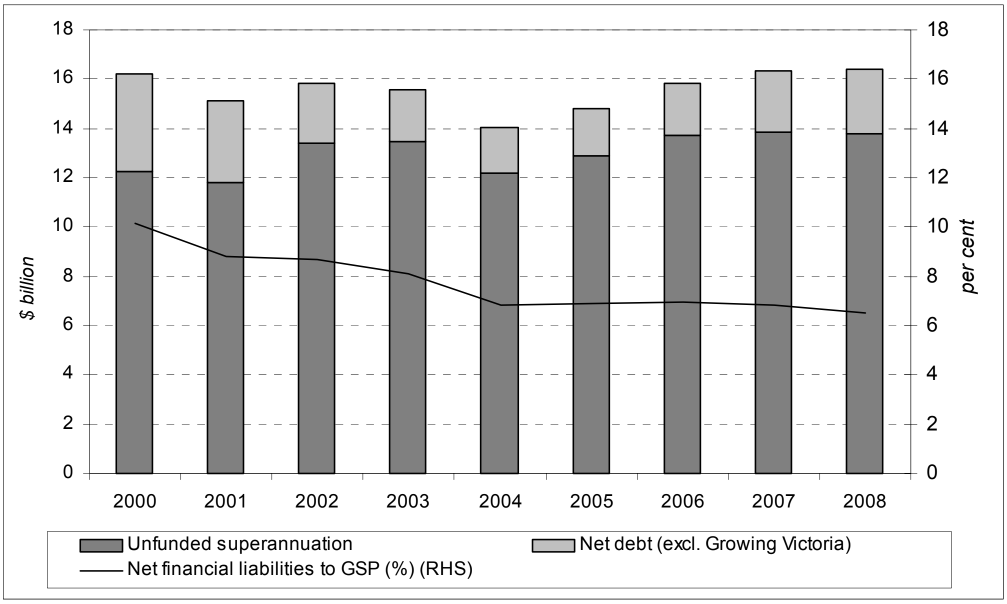
Source: Department of Treasury and Finance

Net financial liabilities

Net financial liabilities are the sum of unfunded superannuation liabilities and general government net debt. Movements in the unfunded superannuation liabilities and net debt were discussed earlier in this chapter.

Table 4.2 shows that, as a share of GSP, general government net financial liabilities (excluding the Growing Victoria infrastructure reserve) are projected to fall from 6.8 per cent at June 2004 to 6.5 per cent at June 2008. Strong investment returns and the impact of the triennial actuarial review of the State Superannuation Fund in 2003-04, have lowered the level of general government net financial liabilities (excluding the Growing Victoria infrastructure reserve) to $14.0 billion at June 2004, which is expected to rise to $16.4 billion by June 2008 (see Chart 4.10).

Chart 4.10: General government net financial liabilities as at 30 June excluding Growing Victoria as at 30 June[(a)(b)]



Source: Department of Treasury and Finance

Notes:

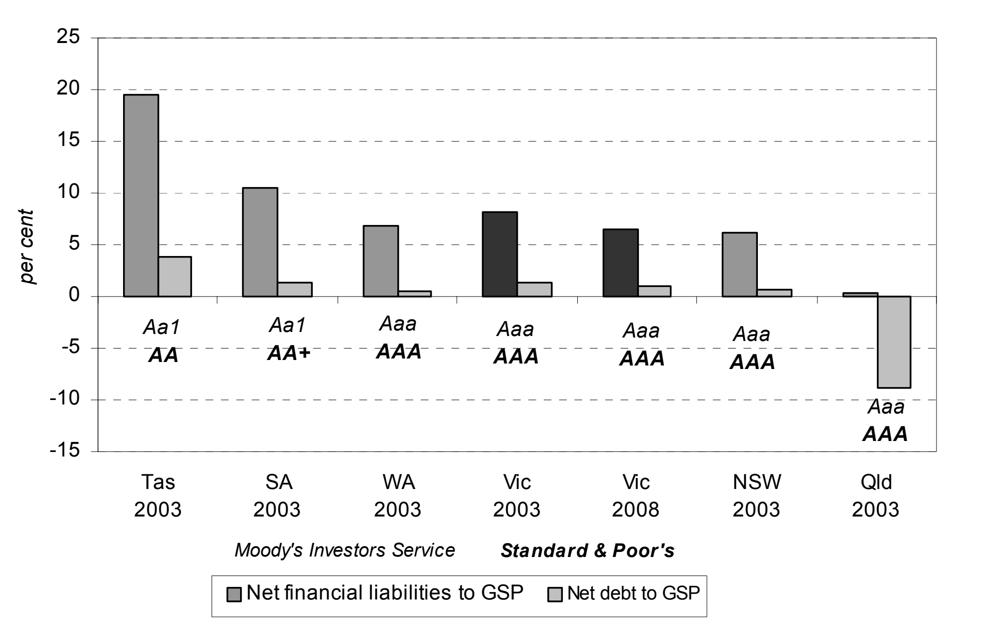
(a) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.

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

Chart 4.11 shows the ratio of Victoria's net financial liabilities to GSP (as reported by the Australian Bureau of Statistics) is in line with other triple-A rated States, such as New South Wales and Western Australia.

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

Chart 4.11: Comparison of general government net financial liabilities and net debt to GSP as at 30 June and Australian States' credit ratings



Source: Department of Treasury and Finance

Indicators of financial strength

The indicators of financial strength displayed in Table 4.3 provide three further perspectives on the general government balance sheet – growth, financial sustainability and financial flexibility.

Growth

These ratios reflect the additions to and deletions from the asset base to meet long term service delivery objectives. In 2004-05 and 2005-06, there is a significant growth in infrastructure assets. The continued growth in the ratio of asset investment to non-current physical assets shows that the Government is maintaining its strong commitment to infrastructure investment over the forward estimates period.

Financial sustainability

Table 4.3 shows that total borrowings as a percentage of total assets is projected to increase marginally in 2005-06 due to the completion of the Spencer Street Station Redevelopment. This will result in a $437 million increase in general government net debt. While the asset is also recognised on the general government balance sheet, total assets are not projected to increase to the extent of maintaining a constant or lower ratio of borrowings to total assets. Consequently, total borrowings to total assets shows a marginal increase to 12.3 per cent before continuing the longer-term downward trend.

Unfunded superannuation liabilities to total assets improved substantially in 2003-04 mainly due to the decrease in the unfunded superannuation liabilities (as discussed earlier). This ratio is projected to stabilise at around 24 per cent to 2005-06, before resuming the long term downward trend due to the growth in total assets.

Total borrowings and unfunded superannuation liabilities expressed as a ratio to GSP both show steady long-term decline from 2000-01 to 2007-08.

Financial flexibility

These ratios indicate the State's ability to respond to unexpected events or opportunities.

Reflecting the reduction in the liabilities burden, the servicing of debt and superannuation expenses have also declined accordingly.

Conclusion

The analysis in this chapter confirms that the State's balance sheet is robust and has the flexibility and capacity to absorb financial and economic shocks. It also demonstrates that the Government's commitment to responsible and prudent financial management is leading to a favourable outcome through lower financial burdens on future generations while building a substantial physical capital stock to support service delivery and facilitate business sector expansion.

Table 4.3: Indicators of financial condition – general government

(per cent)

	2000-01 Actual	*2001-02 Actual*	*2002-03 Actual*	*2003-04 Revised*	*2004-05 Budget*	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Growth								
Growth in non-current physical assets	3.8	7.3	6.4	4.1	6.0	6.2	4.3	4.1
Asset investment to non-current physical assets	4.5	5.2	5.0	5.3	5.8	4.8	5.0	4.8
Financial sustainability								
Long-term borrowings to total assets	15.1	13.4	12.1	12.1	12.0	12.1	11.7	11.3
Total borrowings to total assets	15.4	13.7	12.8	12.4	12.2	12.3	11.9	11.5
Unfunded superannuation liabilities to total assets	28.7	28.8	27.6	24.3	24.4	24.5	24.0	23.2
Total liabilities to total assets	54.9	53.0	51.6	50.9	50.6	50.5	49.4	47.9
Long-term borrowings to GSP	3.6	3.4	3.0	3.0	2.9	3.0	2.8	2.7
Total borrowings to GSP	3.7	3.5	3.2	3.0	3.0	3.0	2.9	2.7
Unfunded superannuation to GSP	6.9	7.3	7.0	5.9	6.0	6.0	5.8	5.5
Total liabilities to GSP	13.2	13.5	13.1	12.5	12.4	12.4	11.9	11.3
Financial flexibility								
Borrowing costs to total revenue	2.5	1.9	2.0	1.8	1.7	1.7	1.6	1.6
Superannuation expenses to total revenue	6.0	10.2	6.8	7.3	6.9	7.0	7.0	7.0
Superannuation expenses and borrowing costs to total revenue	8.6	12.1	8.7	9.2	8.7	8.7	8.6	8.6

Source: Department of Treasury and Finance

CHAPTER 5 – COMMONWEALTH-STATE FINANCIAL RELATIONS

- The Federal and State Treasurers have agreed to a Victorian sponsored motion for a review of the Commonwealth Grants Commission's methodology for horizontal fiscal equalisation. While the review will not be as broad as Victoria, New South Wales and the Commission itself intended, it is a first step in addressing significant weaknesses in the current approach to equalisation.
- Victoria supports the principle of equalisation and redistribution to those States with a narrow economic base. However, States with a substantial financial capacity, such as Queensland, should at a minimum be able to stand on their own, and as well help support those States in need of assistance.
- The current Commonwealth Grants Commission system is damaging Australia's economic prospects by imposing unnecessary economic costs on the nation. The costs and inefficiencies are a result of duplication, cost shifting, burdensome administrative requirements and a lack of strategic coordination.
- The Commission's 2004 Report has resulted in Victoria and New South Wales providing an increased subsidy to the other States. Surprisingly, the economically smaller States and Territories, such as Tasmania, South Australia and Northern Territory have also lost revenue shares to Queensland and Western Australia. As a result, the GST grant to Queensland in 2004-05 will exceed that of Victoria, even though Queensland has less than three quarters of Victoria's population.
- Compared to an equal per capita distribution, Victoria's redistribution to other States will increase to around $1.4 billion in 2004-05, or $275 per person, the highest per capita fiscal subsidy of any State. Based on the difference between the GST raised and the GST distributed to each State, Victoria's redistribution is over $1.7 billion, with the State receiving only 80 cents of each $1 of GST it raises.

HOW GST FUNDS ARE BEING DISTRIBUTED

Under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA), signed by the Commonwealth and the States/Territories (the States) in June 1999, the States receive all goods and services tax (GST) revenue collected by the Commonwealth. The GST revenue is shared between States on a basis determined by the Commonwealth Grants Commission (the Commission), based on the principle of horizontal fiscal equalisation (HFE). The system distributes over $34 billion in GST revenue and represents a significant share of States' revenue. For Victoria, GST grants represents about 25 per cent of total revenue.

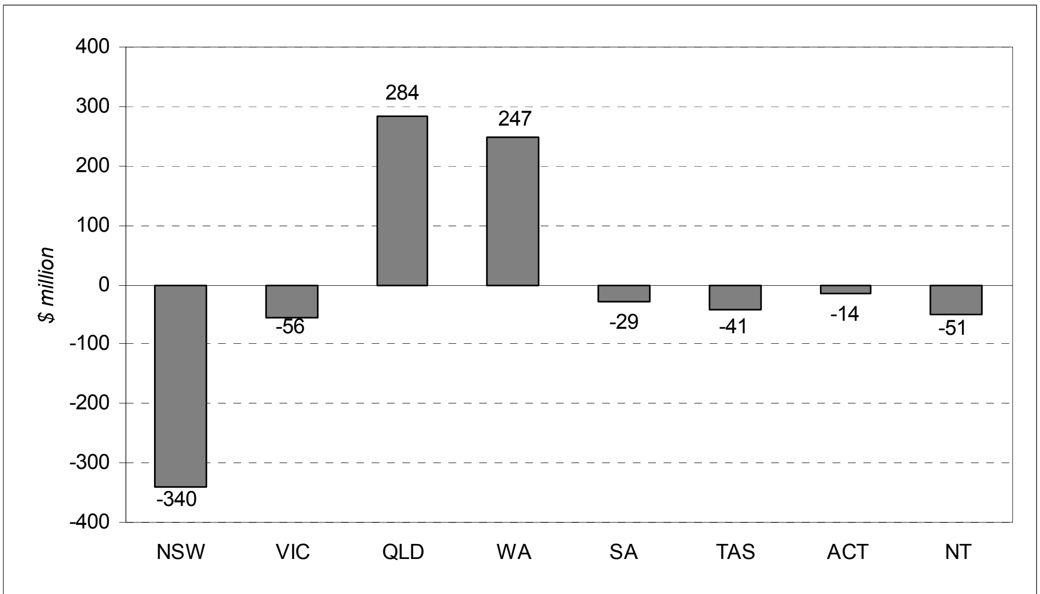
The Commission attempts to comprehensively equalise the financial capacities of all of the States based on estimates of their revenue-raising capacities and the cost of providing the full range of state services. The Commission reviews its methodology every five years, and the latest review, the *Report on State Revenue Sharing Relativities 2004 Review* (2004 Report), has just been completed. The results of the 2004 Report will be used for the first time to distribute grant funds in 2004-05.

OUTCOMES FROM THE COMMISSION'S 2004 REPORT

Based on the new relativities recommended in the 2004 Report, Victoria's GST grant share for 2004-05 will decrease by $56 million (see Chart 5.1).

Queensland and Western Australia will gain $284 million and $247 million in GST revenue, respectively, while New South Wales will lose $340 million. The economically smaller States of South Australia, Tasmania and the Northern Territory will also receive smaller GST revenue.

Chart 5.1: Impact of revised GST revenue relativities on GST grants for all States and Territories



Source: Department of Treasury and Finance

The outcome of the 2004 Report is, in Victoria's view, inconsistent with the general expectations of the outcome of HFE. The revised relativities have resulted in the economically smaller States, which have historically been considered as having greater needs, losing share to States that are economically stronger, such as Queensland and Western Australia. In addition, rather than reducing complexity and improving accountability, the 2004 Report has continued to add to the perception that the Commission's system is a 'black box', which produces incomprehensible outcomes.

Victoria's negative outcome from the Commission's 2004 Report is a result of the Commission's use of judgement when assessing submissions put forward by each of the States. In general, claims presented by other States for disabilities associated with small-scale, rural and remote services and indigenous populations appear to have been accepted to a greater extent by the Commission than evidence provided by Victoria. For example, the Commission did not accept or heavily discounted the evidence provided by Victoria in relation to:

- the higher cost of providing services to communities from non-English speaking backgrounds and with low English fluency; and
- the extra costs incurred by large cities in maintaining urban arterial roads and providing public housing.

The Commission's comments on the review process

In addition to its conclusions in relation to the distribution of grants, in its 2004 Report, the Commission took the unusual step of commenting on the review process itself. The Commission cited (and accepted) many of the concerns Victoria has persistently raised regarding the current equalisation arrangements and indicated that it was 'supportive of a far-reaching review of equalisation, including its underlying purposes and objectives'.

In particular, the Commission indicated that it has 'serious concerns' about the comparability and reliability of the data provided by the States and believes that it 'may be pushing some data too far'. Furthermore, the Commission found that the extent of changes in States' needs (which reflect the specific characteristics of each State) could not be readily explained by changes in the underlying circumstances of those States.

The Commission also noted that it was 'not obvious that the increased detail actually produces a better equalisation outcome', which is one of the fundamental objectives of the current grants system.

Based on the above concerns, the Commission proposed a 'work program that enables the widest possible consideration of the issues of concern to the States'. In its view, such a work program should focus on the need for a comprehensive approach to equalisation, the trends in redistributions, simplifying the process, and data concerns.

The burden of the subsidy

One of Victoria's major concerns with the current arrangements for HFE is that the subsidy, which now only falls on Victoria and New South Wales, is growing at an unsustainable rate.

Compared to equal per capita shares, Victoria's redistribution to the other States for 2004-05 is estimated at around $1.4 billion or $275 per capita, the highest per capita redistribution of any State (see Table 5.1). It is particularly noteworthy that Queensland's share of GST revenue will exceed that of Victoria in 2004-05, even though it only has about three-quarters of Victoria's population.

Table 5.1: Fiscal subsidy for 2004-05 based on equal per capita distribution

	GST revenue CGC distribution [(a)] *($ million)*	*Equal per capita distribution* [(b)] *($ million)*	*Redistribution compared with equal per capita* *($ million)*	*($ per capita)*
NSW	9 549.5	11 383.7	-1 834.2	- 271
Vic	7 078.6	8 455.0	-1 376.4	- 275
Qld	7 098.9	6 647.9	451.0	115
WA	3 494.4	3 365.7	128.7	64
SA	3 181.5	2 533.2	648.3	421
Tas	1 395.0	836.0	559.0	1 152
ACT	657.6	570.8	86.8	267
NT	1 664.4	327.6	1 336.8	6 714
Total	**34 120.0**	**34 120.0**		

Source: Department of Treasury and Finance

Notes:
(a) Relativities as recommended by the CGC Report on State Revenue Sharing Relativities 2004 Report.
(b) Based on Commonwealth Treasury Supplementary Estimates Advice, 11 March 2004.

An alternative way to assess the fairness of the grant shares is to compare the GST raised with the GST distributed to each State. On this basis, the difference for Victoria in 2004-05 is over $1.7 billion, with the State receiving only 80 cents of each $1 of GST it raises (see Table 5.2).

Table 5.2: Fiscal subsidy for 2004-05 based on GST raised

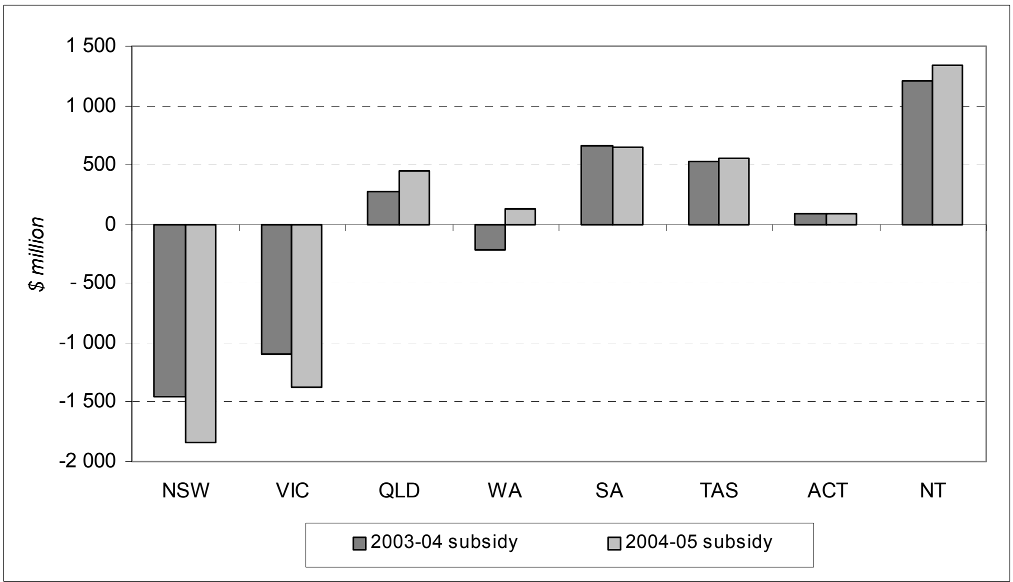
	GST revenue CGC distribution [(a)] ($ million)	*GST raised [(b)] ($ million)*	*Redistribution compared with GST raised ($ million)*	*($ per capita)*
NSW	9 549.5	11 885.6	-2 336.1	- 343.0
Vic	7 078.6	8 811.8	-1 733.2	- 346.0
Qld	7 098.9	6 250.2	848.7	215.1
WA	3 494.4	3 108.0	386.4	193.4
SA	3 181.5	2 459.1	722.4	477.6
Tas	1 395.0	683.1	711.9	1 454.0
ACT	657.6	648.9	8.7	18.3
NT	1 664.4	273.2	1 391.2	6 919.9
Total	**34 120.0**	**34 120.0**		

Source: Department of Treasury and Finance

Notes:
(a) Relativities as recommended by the CGC Report on State Revenue Sharing Relativities 2004 Report.
(b) Australian Bureau of Statistics Catalogue No. 5206.0.

In previous years, the funding of the redistribution has been shared between Victoria, New South Wales and Western Australia. However, Western Australia has gained financially from the 2004 Report, so now only Victoria and New South Wales are carrying the subsidy. This has resulted in the redistribution from Victoria, based on an equal per capita basis, increasing by $287 million between 2003-04 and 2004-05 (see Chart 5.2).

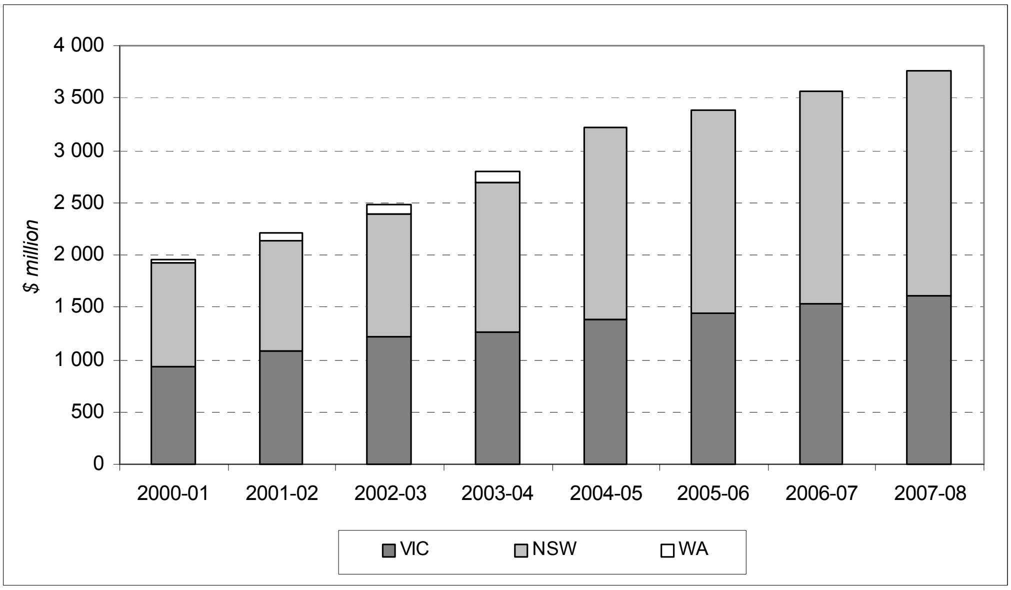
Chart 5.2: Change in GST subsidy from 2003-04 to 2004-05 based on an equal per capita distribution



Source: Department of Treasury and Finance

Over the longer term, the trend points to a significantly increased redistribution. Between 2000-01 and 2004-05, Victoria's per capita subsidy to other States increased by 37 per cent (to $1.4 billion in aggregate), compared with expected nominal Victorian GSP per capita growth of 21 per cent over the same period. It is projected that Victoria's subsidy will continue to grow, hitting about $1.6 billion by 2007-08 (see Chart 5.3).

Chart 5.3: Cross-subsidisation by Victoria, New South Wales and Western Australia



Source: Department of Treasury and Finance

AN EVALUATION OF THE CURRENT GRANTS SYSTEM

In addition to concerns about the sustainability of the subsidy, Victoria has always held the view that the current system is too complex, relies heavily on dubious data and creates perverse incentives and efficiency effects.

These concerns compelled Victoria, New South Wales and Western Australia to commission an independent assessment of the methods for allocating Commonwealth grants, undertaken by Professor Ross Garnaut and Dr Vince FitzGerald in 2002.

Garnaut and FitzGerald found the current system to be an incomprehensible 'black box' that obscures accountability. In particular, the review concluded that the current system of Commonwealth-State funding arrangements:

- has deficiencies on all equalisation criteria: efficiency, equity, simplicity and transparency;

- has a negligible, or even adverse, effect on equity at the levels of individuals and households; and
- is complex, difficult to understand, and diminishes the accountability of the Commonwealth.

The authors also concluded that the current system does not increase equity for individual Australians, despite this being a fundamental objective of the current arrangements. Instead, the authors argue, it imposes economic costs of up to $280 million each year, and is severely damaging Australia's economic prospects. The unnecessary costs and inefficiencies are a result of duplication, cost shifting, lack of efficiency drivers and a lack of coordination.

A REVIEW OF COMMONWEALTH-STATE FINANCIAL RELATIONS

Victoria has continually put forward evidence that the current grants system has major flaws that are constraining growth of the Australian economy and place an unfair subsidy burden on Victoria and New South Wales, whilst distorting public policy. It is on that basis that Victoria has repeatedly pushed for a comprehensive review of the outdated grants distribution system.

At the recent meeting of the Federal and State Treasurers, Victoria took the lead in proposing a review of the current approach to equalisation, which was ultimately accepted by the Federal Treasurer.

The review will be overseen by Heads of Treasuries, using resources and expertise both from within and external to the Commission. The review will consider:

- whether the present approach, which is based on a comprehensive assessment of virtually all receipts and expenses in the operating statements of States, is appropriate and necessary;
- the size and trend of the redistributions;
- simplification; and
- data issues.

In Victoria's view, the Terms of Reference for the review, which are generally based on the suggestions put forward by the Commission in its 2004 Report, are too narrow given the fundamental flaws in the present system. This is a view shared by New South Wales, and to a point, the Commission itself.

Nevertheless, Victoria sees this review as the first positive step in reforming the arcane Commonwealth-State financial relations system. Victoria believes that this review will confirm that the current system is overly complex, open to manipulation and produces perverse outcomes, thereby exposing the need for more comprehensive reform.

NET IMPACT OF GRANTS ON VICTORIA'S FINANCIAL POSITION

GST grants

Under the IGA, there is a guarantee that no State or Territory will be worse off as a result of the new national tax arrangements. To ensure this, the Commonwealth provides GST transitional grants where required. Further, under the IGA, the Commonwealth was no longer required to pay financial assistance grants and revenue replacement payments to the States from 1 July 2000.

The IGA also requires that the States:

- adjust gambling taxes to take into account the GST;
- abolish financial institutions duty and stamp duty on quoted marketable securities from 1 July 2001;
- fund the First Home Owner Grant scheme; and
- pay the Australian Taxation Office costs associated with administering the GST.

The calculation of the need for future GST transitional grants also incorporates the decision at the March 2004 meeting of Ministerial Council on Commonwealth-State Financial Relations to abolish debits tax from 1 July 2005. The revenue loss for Victoria as a result of the abolition of debits tax has been estimated at about $258 million in 2005-06.

With stronger growth in GST revenue than previously forecast, Victoria is not expected to require GST transitional grants from 2004-05 (see Table 5.3). However, in 2005-06, following the removal of debits tax Victoria's GST revenue share is only marginally above the level where GST transitional grants would be required. As a result, any minor adverse change in GST revenue, in revenues forgone, or in other costs incurred as a result of the new national tax arrangements (which are taken in to account when assessing whether a State is worse off) will lead to GST transitional grants again being required.

Specific purpose payments

Specific purpose payments (SPPs) comprise approximately 37 per cent of Commonwealth grants to the States and represent 20 per cent of Victoria's total revenue. They form an important component of state funding for vital services such as health, education, housing, roads and community welfare. Further details of SPP payments are outlined in Budget Paper No. 4, Chapter 3, *State Revenue*.

The Commonwealth Government distributes SPPs with specific policy intentions.

SPP arrangements are very complex. There are about 100 different SPPs, covering programs that vary considerably in size. SPPs impose considerable administrative costs on both the Commonwealth and the States. They also blur accountability between levels of government, and Commonwealth input controls can reduce the flexibility of the States in meeting the needs of their populations and hinder efficiency improvements.

In 2004-05, the Commonwealth estimates Victoria will receive $4.1 billion in SPPs, which is over $300 million less than the State would receive if SPPs were distributed on an equal per capita basis. As a result, Victoria receives the lowest SPPs per capita of any State or Territory. For example, Victorian roads carry 27 per cent of the roads traffic, but Victoria receives just 15 per cent of all federal road funding. In addition, in Victoria more students are completing VCE than at any time in the last ten years, yet the Commonwealth Government has cut 6 000 places from Victorian universities.

Table 5.3: Impact of the GST on the Victorian budget

($ million)

	2003-04 Revised	*2004-05 Budget*	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
Change in revenue					
GST revenue	6 792.2	7 078.6	7 473.6	7 893.6	8 313.3
Growth dividend [(a)]	64.0	79.3	96.2	112.3	132.9
Financial institutions duty [(a)]	- 398.3	- 410.2	- 422.6	- 435.4	- 448.5
Debits tax [(a)]			- 257.8	- 283.9	- 286.7
Marketable securities [(a)]	- 247.7	- 263.1	- 280.3	- 294.2	- 306.5
Gambling taxes	- 389.4	- 406.0	- 428.7	- 452.6	- 477.7
Safety net revenues	-1 683.9	-1 730.6	-1 774.3	-1 824.5	-1 876.7
Off-road diesel rebate	58.4	59.2	59.7	60.4	61.1
Financial assistance grants forgone	-4 003.7	-4 085.3	-4 214.6	-4 356.3	-4 496.1
Total change in revenue	**191.6**	**321.8**	**251.1**	**419.5**	**615.1**
Change in expenditure					
First Home Owner Grant	206.7	226.4	243.9	245.7	247.5
Reimbursement of ATO administration costs	141.2	143.9	146.8	149.8	152.8
Total change in expenditure	**347.9**	**370.3**	**390.7**	**395.5**	**400.3**
Net budget impact prior to adjustments	**-156.3**	**-48.5**	**-139.6**	**24.0**	**214.8**
End of year adjustments	-6.4				
Add: Embedded tax savings [(a)]	122.9	131.5	140.5	154.2	164.5
Net budget impact prior to Commonwealth transitional guarantee	**-39.9**	**83.1**	**1.1**	**178.0**	**379.4**
Net Commonwealth guarantee payments	**39.9**	**0.0**	**0.0**	**0.0**	**0.0**

Source: Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations; Department of Treasury and Finance

Notes:

(a) These estimates were agreed in 1999 and will not be subject to further negotiation with the Commonwealth.

REVIEW OF STATE TAXES

Under the IGA, the Commonwealth-State Ministerial Council on Financial Relations agreed to undertake a review of the need to retain a range of stamp duties by July 2005. The Ministerial Council has now agreed to the Terms of Reference for this review, with a report to be considered in March 2005.

The objectives of the review include:

- the achievement of a new national tax system, including the elimination of a number of existing inefficient taxes which are impeding economic activity;
- the provision to State and Territory Governments of revenue from a more robust tax base that can be expected to grow over time; and
- an improvement in the financial position of all State and Territory Governments once the transitional changes have been completed, relative to that which would have existed had the current arrangements continued.

The range of stamp duties to be covered by the review is listed in the IGA. It includes several stamp duties that have either already been abolished or have never been applicable in Victoria, as well as a number of current stamp duties.

Those stamp duties that have been abolished or have never been applicable in Victoria include duty on:

- non-quotable marketable securities;
- leases;
- rent payable under tenancy agreements;
- mortgages, bonds, debentures and other loan securities (being abolished from 1 July 2004);
- the value of a secured loan property;
- credit arrangements, instalment purchase arrangements and rental arrangements;
- the value of the loan under credit arrangements;
- credit business in respect of loans made, discount transactions and credit arrangements; and
- cheques, bills of exchange and promissory notes.

Those stamp duties that currently apply in Victoria and are listed for review include duty on:

- non-residential conveyances: stamp duty levied on the value of conveyances other than residential property conveyances;
- the price of goods purchased under instalment purchase arrangements; and
- rent paid in respect of the hire of goods, including consumer and producer goods.

Any removal of taxes will affect budget capacity and flexibility in the forward years. Victoria considers that any review must consider the affordability for each State and Territory of abolishing any current taxes, taking into account its grants share, fiscal pressures and financial objectives.

CHAPTER 6 – STATEMENT OF RISKS

- The budget projections are sensitive to a number of upside and downside risks (both economic and fiscal) and contingent assets and liabilities.
- The major economic risk is that a larger than projected housing market decline, not offset by a stronger recovery in net exports, lowers the general government operating surplus both directly through lower property taxes and indirectly via reduced economic growth.
- Contingency provisions within the budget provide general protection against fiscal risks, including increased demand for government services.
- A number of contingent assets and liabilities have been identified.

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

ECONOMIC RISKS

Victoria's major economic risk is that the forecast recovery in net exports does not sufficiently offset a decline in the housing market. The worst case scenario of this is a larger than expected decline in residential building, combined with a continued sluggish performance of net exports.

While a softening in the housing market is expected, a more severe decline will impact on taxation revenue by lowering stamp duty further than the 17.4 per cent currently accounted for in the forward estimates. As a significant revenue stream, changes to residential dwelling related stamp duty will impact directly on the budget operating surplus.

Recent subdued results from exports can be attributed to the drought severely curtailing the agricultural sector's capacity to supply export goods, and a succession of global market disruptions due to terrorism and the SARS epidemic. While the drought appears to have passed, with rain in late 2003 producing a record grain crop, the March quarter of 2004 has been one of the driest on record according to the Bureau of Meteorology. A return to drought conditions across the State would reimpose many of these export supply constraints.

On the other hand, the international economic situation has strengthened, and will lead to greater demand for Victorian exports. Export data for late 2003 indicates a rebound in Victoria's two major export categories of food and elaborately transformed manufactures. Global policy settings are currently highly accommodative, with the United States engaged in high levels of military spending while cutting taxes, and interest rates at generation-low levels in many of the major economies. There is a risk that growth among Victoria's major trading partners may be greater than expected, contributing to stronger than anticipated outcomes for exports.

Weaker than expected population growth is a risk to Victoria's economic outlook. Victoria currently gains a greater share of overseas migrants compared with its share of national population, so a significant, sustained outflow of population to other States would dampen the outlook for Victorian economic growth. The population forecasts used for the 2004-05 Budget assume no net interstate migration into or out of Victoria over the forward estimates period.

Sensitivity analysis

The 2004-05 sensitivity analysis indicates the risk associated with forecasts or projections of selected economic and financial variables by estimating the impact on revenue, expenses and the operating surplus. The major variables that affect Victoria's operating surplus are economic growth, employment, prices, wages, interest rates and volatility in asset markets.

To assess sensitivity to change, the level of the economic indicator, in each case, is permanently increased by one percentage point in the first year above the forecast growth rate (detailed in Chapter 2, *Economic Conditions and Outlook*) and then allowed to grow at the forecast rate. It is assumed during the analysis of each indicator that all others follow their forecast growth rates.

Table 6.1: Impact on the general government operating surplus of a one percentage point increase in selected economic indicators in 2004-05[a][b]

($ million)

	2004-05 Estimate	*2005-06 Estimate*	*2006-07 Estimate*	*2007-08 Estimate*
GSP				
Taxes, regulatory fees and fines	36	36	38	39
Other revenue [c]	89	101	111	122
Superannuation expenses	..	..	..	..
Other expenses	..	..	1	2
Operating surplus	**125**	**137**	**148**	**159**
Employment				
Taxes, regulatory fees and fines	29	30	32	33
Other revenue [c]	1	3	4	6
Superannuation expenses	..	..	..	..
Other expenses	..	..	..	..
Operating surplus	**30**	**33**	**36**	**39**
Consumer prices				
Taxes, regulatory fees and fines	44	44	46	48
Other revenue [c]	150	161	165	171
Superannuation expenses	120	..	..	..
Other expenses [d]	40	173	177	182
Operating surplus	**33**	**32**	**34**	**36**
Average weekly earnings [e]				
Taxes, regulatory fees and fines	29	30	32	33
Other revenue [c]	-14	-13	1	3
Superannuation expenses	109	9	10	9
Other expenses [d]	..	..	..	..
Operating surplus	**-94**	**8**	**24**	**27**
Domestic share prices				
Taxes, regulatory fees and fines	..	..	..	..
Other revenue [c]	5	5	..	..
Superannuation expenses	-46	-3	-4	-4
Other expenses	..	..	..	..
Operating surplus	**50**	**8**	**4**	**4**
Overseas share prices				
Taxes, regulatory fees and fines	..	..	..	..
Other revenue [c]	4	4	..	..
Superannuation expenses	-32	-2	-3	-3
Other expenses	..	..	..	..
Operating surplus	**35**	**6**	**3**	**3**
Property prices				
Taxes, regulatory fees and fines	32	29	49	49
Other revenue [c]	2	4	5	8
Superannuation expenses	-10	-1	-1	-1
Other expenses	..	..	..	..
Operating surplus	**44**	**34**	**55**	**58**

Table 6.1: Impact on the general government operating surplus of a one percentage point increase in selected economic indicators in 2004-05[a][b] (continued)

($ million)

	2004-05 Estimate	2005-06 Estimate	2006-07 Estimate	2007-08 Estimate
Property volumes				
Taxes, regulatory fees and fines	23	21	21	22
Other revenue [c]	2	3	3	4
Superannuation expenses	..	..	..	..
Other expenses	..	..	..	..
Operating surplus	**25**	**24**	**25**	**26**
Interest rates [f]				
Taxes, regulatory fees and fines	..	..	..	..
Other revenue [c]	77	80	41	42
Superannuation expenses	98	7	7	7
Other expenses	3	7	12	17
Operating surplus	**-24**	**65**	**21**	**17**

Source: Department of Treasury and Finance

Notes:

(a) *A positive number for taxes, regulatory fees and fines, and other revenue denotes an increase in revenue. A positive number for superannuation expenses and other expenses denotes an increase in expenses (and hence a reduction in the operating surplus). A positive number for the operating surplus denotes an improvement in the operating surplus. Numbers may not balance due to rounding.*

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

(c) *Other revenue includes changes in dividends and income tax equivalent payments from public authorities. These revenues are based on an estimated dividend payout ratio. However, dividends paid by government business enterprises are determined by the Treasurer having regard to relevant commercial considerations including reported profit/loss, operating cash flow, gearing and interest cover, capital requirements and the views of the Board and the portfolio Minister. Therefore, the actual impact on this revenue source is dependent on the current circumstances of the relevant public authority.*

(d) *Following the implementation of the departmental funding model, employee entitlements, included as part of other expenses, are now sensitive to changes in prices, whereas in previous years these impacts would have been identified under Average Weekly Earnings.*

(e) *Assumes wages of Victorian Government employees also increase by one per cent above government wages policy without productivity offsets or additional departmental funding.*

(f) *Assumes a one percentage point increase in interest rates over the entire period.*

Sensitivity to economic growth

A one per cent increase in gross state product (GSP) is estimated to boost the operating surplus by $125 million in 2004-05, rising to $159 million in 2007-08. This is a larger sensitivity than previously published and owes to a change in the sensitivity of Commonwealth grants (show in the ‘other revenue’ component).

In 2004-05, Victoria will cease to be paid a GST transitional grant as its GST grant revenue is estimated to exceed the minimum amount guaranteed under the Intergovernmental Agreement. As a result, Victoria's grant revenue will be largely determined by national economic growth, rather than the more stable factors which underpinned the calculation of the guaranteed minimum amount in the Intergovernmental Agreement.

Sensitivity to employment

An increase of one per cent in forecast employment will contribute $30 million to the operating surplus in 2004-05, rising to $39 million in 2007-08, primarily as a result of increased payroll taxes.

Sensitivity of prices

A one per cent rise in the Consumer Price Index (CPI) is estimated to increase the operating result by $33 million in 2004-05. Increased income from taxes and other revenue more than offsets the impact of CPI on unfunded superannuation liabilities, which only applies in the first year.

In accordance with the departmental funding model, increased funding provided to departments for expenditure on operating costs of wages, supplies and services, offsets revenue gains in the forward years resulting in an average increase of $34 million a year. There is no impact in the budget year on employee entitlements, as the departmental funding model requires departments to manage costs within their departmental budgets.

Sensitivity to wages

An increase in economy-wide wages has a significant current year impact, lowering the operating surplus by $94 million after a one per cent rise. If these increases flowed through to higher than anticipated public service wages, there would be a consequential one-off rise in the level of unfunded superannuation liabilities, as future benefits are calculated from members' salaries. In the forward years, the superannuation expenses ease considerably, and the remaining forward estimates period shows small rises, up to $27 million in 2007-08.

Sensitivity to domestic and overseas share prices

Movements in equity prices have a significant current year impact on superannuation expenses, but a more moderate general impact on the forward years. A one per cent rise in domestic share prices will increase the operating surplus by $50 million in 2004-05, with a corresponding rise in overseas share prices raising the operating surplus by $35 million in the same year. Looking further ahead increases in the operating surplus average $5 million a year as a result of a domestic share price rise, and an average $4 million a year from overseas share market changes.

Sensitivity to property prices

Increasing property prices by one per cent in 2004-05 will result in a $44 million increase in the operating surplus. A lag in the valuation determinations of property for land tax assessments results in delayed land tax receipts, further boosting revenue from 2006-07 onwards.

Sensitivity to property transaction volumes

An increase of one per cent in property transaction volumes, holding prices steady, is estimated to increase the operating surplus by $25 million in 2004-05, rising only slowly in the forward years. The operating surplus is less sensitive to a change in property volumes than prices due to a combination of volumes having no impact on superannuation expenses or land tax receipts.

Sensitivity to interest rates

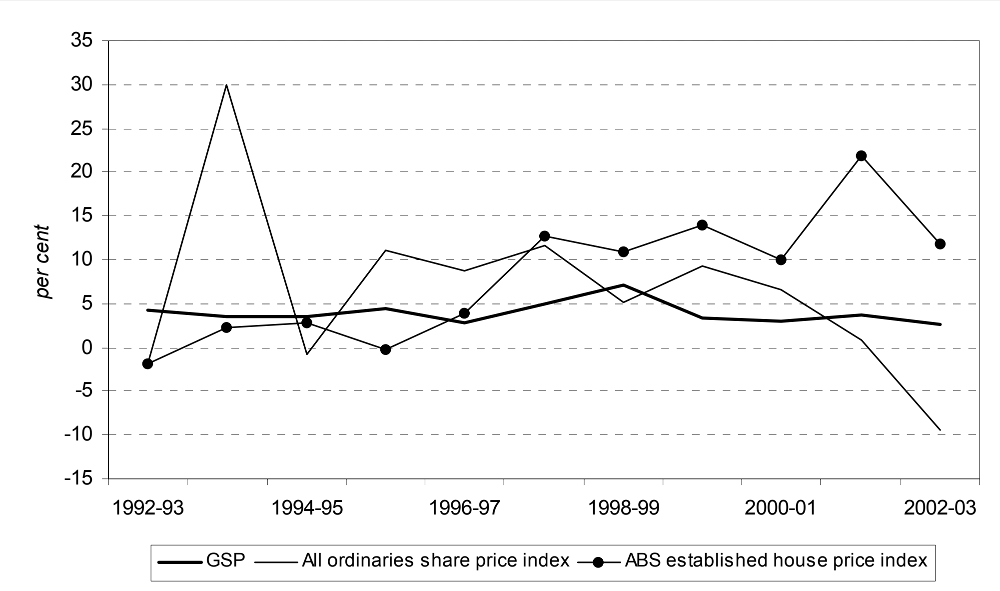
An assumed one per cent increase in the forecast interest rate is estimated to decrease the operating surplus by $24 million in 2004-05, becoming positive in 2005-06 when it rises to $65 million.

The current year decline mainly reflects unrealised losses on bonds held by the State Superannuation Fund as a result of a once-off increase in interest rates.

Variability of economic indicators

In interpreting the estimates in Table 6.1, it is worth noting that, historically, some of the economic indicators listed have been more volatile than others. In particular, although variations in GSP and employment growth, wage and consumer price inflation, and interest rates have been broadly similar since the mid-1980s, property and share markets have been considerably more volatile (see Chart 6.1).

Chart 6.1: Comparison of volatility of economic parameters[(a)]



Source: Department of Treasury and Finance

Note:
(a) Annual percentage growth on preceding year.

In combination with the outcomes of the sensitivity analysis, these results suggest that:

- share prices are volatile in the short term and are likely to be a major source of variation in the budget operating position in the year in which fluctuations occur;
- property prices, like share prices, are relatively volatile and have grown strongly in recent years. Property prices have a substantial ongoing impact on the budget operating position, while the initial impact is smaller than that of share prices;
- fluctuations in economic activity (GSP and employment) can also be an important source of variation in the budget operating position, over the entire forward estimates period, not just in the first year;
- variations in general wage and inflation rates are not volatile and have only moderate impact on the operating surplus; and
- interest rates are less variable and have a smaller ongoing impact on the operating position than other parameters.

FISCAL RISKS

Expenditure risks

With the introduction of the departmental funding model from 2004-05, departments will need to plan for, and manage, all costs associated with delivering services. This includes wage increases within government wages policy, which was a risk previously held and managed centrally through a contingency provision. Total departmental funding provided by government is now subject to an approved indexation factor, which maintains alignment with movements in the rate of inflation. This, combined with productivity improvements, provides sufficient allowance in the current departmental estimates to meet award wage increases consistent with government policy.

There are also several general risks, such as unforeseen changes in the size and structure of the Victorian population, which can impact on the expenditure and revenue outlook. These risks can be classified into those that affect all government departments and those that are department specific.

The main risks to specific departmental expenditures relate to growth in demand for key services, the modernisation of assets, and government responses to unforeseen events. Examples of these types of impacts could include pressures related to the maintenance of assets, such as government schools and TAFE institutes, and funding required in relation to natural disaster relief.

The 2004-05 Budget and forward estimates include a contingency provision to allow for the likelihood that some of these department-specific and government-wide expenditure risks will be realised during the budget year or over the course of the forward years. The contingency provision includes a general allowance for:

- growth in Victoria's population, and from it, derived demand for government services; and
- other expenditure risks which are unforeseen or not able to be quantified at the time of construction of the budget estimates.

In addition, the budget estimates now include a contingency from 2007-08 that acknowledges that a number of initiatives with only four-year funding will conclude in 2006-07. A provision is provided on the basis that the Government may endorse a number of these initiatives 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 impact on total expenditure and the annual budget position to the extent that they cannot be accommodated within the contingency provision built into the budget estimates.

In addition to the operating contingency, the budget estimates include an unallocated capital provision to provide capacity for future asset investment funding requirements. With a capital program the size of that funded by the Government, there are always likely to be variations in actual costs for individual asset investment projects against budget. However, the forward estimates assume that capital cost pressures are managed within the existing forward estimates with no budget impact. Management of capital cost pressures may occur in one of three ways:

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

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

Roads

Roads of National Importance are funded on a 50:50 basis between State and Commonwealth governments. Depending on the size and timing of announcements made by the Commonwealth, the Victorian Government may be required to provide matching funding for road construction and operating expenditure.

AusLink

The Commonwealth Government has announced its intention to introduce, from July 2004, a new funding model for Australia's land infrastructure called *AusLink*. The Commonwealth is proposing to fund rail, in addition to road, projects on a declared national network. The Commonwealth has announced a preference to introduce reciprocal funding arrangements with state and territory governments, including for the currently declared National Highway System, which is presently funded 100 per cent by the Commonwealth for maintenance as well as construction.

Insurance exposures

Over the past year, governments in Australia have been subject to sustained pressure to compensate for the absence of private sector insurance in areas as diverse as medical indemnity, professional indemnity cover for medical research, and public liability for religious institutions, adventure tourism, historic railways and public transport operations. To date, last resort insurance arrangements in Victoria have been entered into under strict conditions with known, limited potential exposure.

Furthermore, pressures on private medical indemnity premiums may result in the State assuming larger numbers of high risk medical procedures. Any such movement, together with the impact of claims that arise from the current levels of public medical services, means that there is a continuing need to monitor closely the State's medical indemnity liabilities and expenses.

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

Wimmera-Mallee Pipeline

In the 2002-03 Budget, the Government committed funding of $77 million nominal total estimated investment (TEI) for Victoria's contribution to the Wimmera-Mallee pipeline project, over the next decade. Victoria's share was based on the $301 million preliminary business case for the project. This initiative will replace the existing 17 500 kilometres of open channels with a new pipelines system in the Wimmera-Mallee region. This funding was subject to Commonwealth matching funding and confirmation of feasibility. The Commonwealth has yet to fully commit to this project. The Commonwealth Government confirmed in January 2003 that, through this year's National Heritage Trust allocation, it would provide $7.5 million for the detailed design process, in effect matching Victoria's 2003-04 contribution.

In November 2003, an interim business case revised the total from $301 million to $501 million TEI. The Government is currently reviewing the interim business case.

Revenue risks

Permanent Trustee Australia Pty Ltd v Commissioner of State Revenue

In 2001, Permanent Trustee Australia Pty Ltd (Permanent Trustee) objected to an assessment of stamp duty made by State Revenue Office (SRO) relating to an agreement to develop a hotel at Melbourne Airport. Permanent Trustee's claim that the *Commonwealth Places (Mirror Taxes) Act 1998* (Commonwealth), which provides revenue to the States in relation to Commonwealth places, is contrary to section 55 of the Constitution of the Commonwealth of Australia because it is a law dealing with subject matter other than the imposition of taxation, and it deals with more than one subject of taxation.

The matter was heard by the full bench of the High Court of Australia on 4 March 2004, and the Court has reserved its decision.

CONTINGENT ASSETS AND LIABILITIES

Contingent assets

Contingent assets are either:

- possible assets that arise from past events where the probability of existence of an asset is considered higher than remote, but which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- assets that fail either or both of the criteria for recognition as assets. These are:
  - assets for which it is not probable that the future economic benefits embodied in them will eventuate; and/or
  - assets that do not possess a cost or other value that can be measured reliably.

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

Quantifiable contingent assets

Table 6.2: Quantifiable contingent assets

($ million)

	As at June 2003	*Estimate for June 2004*
Guarantees, indemnities	0.8	0.8
Potential early termination of contractual arrangements	80.0	100.0
Legal proceedings and disputes	1.2	1.2
Other	70.7	70.7
Total contingent assets	**152.7**	**172.7**

Source: Department of Treasury and Finance

Included in Table 6.2 under 'potential early termination of contractual arrangements' are any additional costs arising to the Director of Public Transport on early termination. The operator must, to the extent of the performance bonds, indemnify the Director for any losses, damages or costs incurred by him as a result of early termination. If the operator does not do so, the Director has the right to draw on the operator's performance bonds for the amount of losses, damages or costs. The expected value of these bonds as at 30 June 2004 is $100 million ($80 million for 2003).

Included in Table 6.2 under 'other' are Transurban Concession Fees relating to Melbourne City Link. A dispute exists between Transurban and the Australian Tax Office (ATO) on the treatment of deductibility of concession fees for tax purposes. Transurban has announced that it will appeal a decision. In the event the appeal succeeds, the net present value of the concession fees payable to the State would increase by an estimated $65 million.

Non-quantifiable contingent assets

Public transport partnership agreements

On 19 February 2004 the Director of Public Transport (the Director), on behalf of the Crown, entered into contractual arrangements with Connex and Yarra Trams to operate rail and tram transport services in the State. The following section summarises the major contingent assets arising from those arrangements.

Operational performance regime (OPR): the OPR entitles the Director to receive penalty payments from operators failing to meet set punctuality and reliability performance targets.

Contingent liabilities

Contingent liabilities are either:

- possible liabilities that arise from past events where the probability of existence of a liability is considered higher than remote, but which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- provisions that fail either or both of the criteria for recognition as liabilities. These are:
  - provisions for which it is not probable that the future sacrifice of economic benefits will be required; and/or
  - provisions, the amount of which cannot be measured reliably.

Similarly to contingent assets, contingent liabilities are also classified as either quantifiable or non-quantifiable.

Quantifiable contingent liabilities

Table 6.3: Quantifiable contingent liabilities

($ million)

	As at June 2003	*Estimate for June 2004*
Guarantees, indemnities	189.8	208.5
Potential early termination of contractual arrangements	712.5	599.0
Legal proceedings and disputes	271.3	271.3
Other	60.1	15.8
Non-general government debt	3 160.2	3 465.2
Total contingent liabilities	**4 393.9**	**4 559.8**

Source: Department of Treasury and Finance

Included in Table 6.3 under 'potential early termination of contractual arrangements' is a contractual agreement of $599 million ($713 million for 2003) relating to the cost of correctional services beyond the current contract period. The State has the option to re-tender for the provision of correctional services every three years, after the initial five-year period for each contract. The commercial arrangement for the provision of prison facilities for the remaining 14 years and correctional services for the remainder of the current three-year term, which expires on 9 September 2005, are included as commitments above.

In Table 6.3, the non-general government debt projections are based on the assumption that there is no net change in the level of debt for public financial corporations during 2003-04.

Non-quantifiable contingent liabilities

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

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

Asset sales

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

Melbourne Cricket Ground redevelopment

On 15 August 2002, the State entered into agreements to support the redevelopment of the Melbourne Cricket Ground (MCG) for the 2006 Commonwealth Games. This is in addition to a commitment to provide grants of $77 million towards the capital cost of the redevelopment and a guarantee of up to $360 million in respect of a Treasury Corporation of Victoria Loan Facility to the Melbourne Cricket Club (MCC). These agreements include:

- indemnities to the MCG Trust and the MCC in the event that there should be insufficient trading surpluses to meet scheduled debt servicing and repayments, or if the total project construction cost exceeds $450 million;

- agreement for compensation to the Australian Football League (AFL) as a result of the holding of the Commonwealth Games in 2006. The amount of compensation will be finalised following the completion of the 2006 AFL draw. All compensation claims will be calculated in accordance with an agreed compensation formula;
- compensation for lost seating capacity for the Grand Finals in 2003, 2004 and 2005. All compensation claims will be calculated in accordance with an agreed compensation formula. The base compensation has been agreed at $5.7 million and will be paid in equal instalments on 30 November 2003 and 2004. If capacity targets are unable to be met, agreement has been reached to provide additional compensation as a pro-rata amount in accordance with the compensation formula; and
- previously provided indemnities to the MCC and MCG Trust in the context of the 1990 Great Southern Stand development, which have been re-incorporated into the contractual arrangements of the Northern Stand redevelopment, under greater accountability and responsibility of the MCC to the MCG Trust.

Former Public Transport Corporation lease arrangements

Under various transport lease arrangements made by the former Public Transport Corporation, the State of Victoria indemnified the lessors against adverse tax rulings and third-party personal injury claims, where the third party is injured by the operation of the equipment during the period of the lease. The last of these lease arrangements was terminated by June 1998. The normal statute of limitations is five years for tax claims and six years for personal injury claims.

Public transport rail partnership agreements

On 19 February 2004, the Director of Public Transport (the Director), on behalf of the Crown, entered into new partnership contractual arrangements with Connex. and Yarra to operate rail transport services in the State. The following summarises the major contingent liabilities arising from those arrangements.

The new Arrangements are operative from 18 April 2004 and the Interim Operating Agreement (IOA) obligations are proposed to be settled before 30 June 2004.

Contingent liabilities arising from National Express receivership

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

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

Contingent liabilities arising during the new Agreement period

There are a number of contingent liabilities arising from the New Partnership Agreements between the Director and Connex and Yarra Trams which were signed on 19 February 2004. Possible material liabilities below refer to payments to be made by the Director to Connex and Yarra Trams should certain events occur:

Operational performance regime (OPR): the OPR obligates the Director to make incentive payments for operators exceeding set punctuality and reliability performance targets.

Commonwealth Games revenue guarantee payments: the Director is obligated to make a top-up payment should, as a result of the Commonwealth Games, farebox receipts fall below a projected amount based on the prior period's farebox and patronage growth.

Commonwealth Games kilometre payment: the Director is obligated to make payment for additional service kilometres operated above the master timetable requirements in respect of the Commonwealth Games.

New ticketing revenue guarantee payment: operators have an option to elect to permanently move to a revenue guarantee payment regime should implementation matters or new ticket fare structures associated with the introduction of the new ticketing system cause a real reduction in the farebox.

The revenue guarantee payment will be based on the prior period's farebox including an estimate for patronage growth and inflation. Under the arrangement, the Director is liable for the difference between actual farebox received and the guaranteed revenue amount.

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

Access charge adjustment

Should the access charge regime for train rail access be reset, then the Director is obligated to make payment to the operator in respect of any increased cost as a result of the reset.

The Director is also required to reimburse the operator's reasonable costs incurred in renegotiating the access charges.

Regional Fast Rail

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

VicTrack and Spencer Street Station Authority Indemnity

The Director indemnifies VicTrack and the Spencer Street Station Authority from any claim brought by the operators under the Infrastructure Lease.

Capital projects

In respect of any contract variation orders relating to the commissioning of the new Nexus trains, the Director is obligated to meet half the cost of any variation issued by Connex until the earlier of 300 000 kilometres or 31 August 2004. In addition, the Director will meet one quarter of the cost of any variation order issued by Connex until the earlier of 400 000 kilometres or 31 October 2004.

Contingent liabilities on early termination or expiry

Operator assets: to maintain continuity of services, the Director at early termination or expiry of the Arrangements has:

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

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

Contingent liabilities arising from potential changes to existing conditions

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

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

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

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

Melbourne City Link

The key arrangements for Melbourne City Link are set out in the Concession Deed, which has effect from 20 October 1995.

Under the arrangements as set out in the Concession Deed and the legislation, the State was responsible for acquiring and paying for the land necessary for the project to proceed, paying for certain state works and general project costs. It is also subject to certain compensation claims in the event that it can be shown that Transurban's revenue has been adversely affected by State actions. For State actions to change roads, laws or policies to the benefit of the operating company's revenue, the State may share that benefit.

While all land has been acquired, the final compensation payable is subject to resolution in some instances.

There is currently an outstanding claim from Transurban relating to an alleged 'Appendix Event' and leading to a Material Adverse Effect claim from Transurban in relation to the construction of Wurundjeri Way and widening of the Westgate Freeway. This claim is currently being handled by the documented dispute resolution processes, and the Department of Infrastructure is managing the claim on behalf of the State. In the first phase of this process, an independent expert has found in favour of the State. However, Transurban has invoked the appeal process, leading to the documented arbitration procedures.

Native title

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

Gas supply incident

The State, and a number of its instrumentalities, have been named as parties in a class action before the Supreme Court arising from the explosion and fire in September 1998 at Esso's gas processing plant at Longford. The State and its instrumentalities have denied liability and are vigorously defending their rights.

HIH Insurance

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

The State's obligations in respect of its builders' warranty insurance rescue package are direct liabilities of the State itself. They do not form part of the liabilities of Housing Guarantee Fund Limited, which manages claims on behalf of the State.

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

Smelter Reduction Amount

The State Electricity Commission of Victoria (SECV) is the first defendant in a matter before the High Court of Australia, commenced by summons dated 5 June 2003, in which Australian Steel Company (Operations) Pty Ltd is the plaintiff. The plaintiff has claimed that Schedule 9A2 of the National Electricity Code, among other legislation imposing a charge known as the Smelter Reduction Amount, is invalid. The plaintiff seeks reimbursement of Smelter Reduction Amounts previously paid, together with interests and costs. The claim is still at an early stage in terms of legal processes, and the timing and outcome of any conclusion are uncertain. It is not practicable to quantify the liability in the event of a successful claim by the plaintiff.

Under an agreement between the SECV and the State of Victoria in relation to this matter, the interests of the SECV are being managed by the State, and the SECV has been granted a full indemnity by the State for all legal costs and any other monies payable by the SECV in the matter.

2006 Commonwealth Games

In winning the bid to host the 2006 Commonwealth Games in Melbourne, the State entered into two contracts:

- the Endorsement Contract with the Australian Commonwealth Games Association; and
- the Host City Contract with the Commonwealth Games Federation.

Subsequent to winning the rights to host the Games, the Government established the Melbourne 2006 Commonwealth Games Pty Ltd as the Organising Committee for the Games, with the Premier as the sole shareholder. The responsibilities of Melbourne 2006 Commonwealth Games Pty Ltd were transferred to a newly established statutory authority in October 2003, known as the Melbourne 2006 Commonwealth Games Corporation (M2006). An agreement between the State and M2006 provides the basis for funding M2006 to 2007.

Under the Endorsement Contract, the State is obliged to underwrite any shortfall between revenue and expenditure of M2006 for the organisation of the Games. Also under this contract, any remaining surplus resulting from the Games, after the Organising Committee has discharged all financial commitments and other obligations, is to be transferred to the Association. This surplus is, in turn, required to be paid to the State to be used for the benefit of sport in Victoria.

The Host City Contract specifies the rights and obligations of the Organising Committee in relation to organising the Games. The contract includes the commitment the State gave in its bid document to offer travel grants to competitors and team officials attending the Games.

M2006 has an agreement with the Nine Network Australia Pty Ltd in relation to broadcast rights to the Games for Australia and Papua New Guinea. The agreement includes certain force majeure and major change provisions, which may be invoked in certain circumstances. M2006 has obtained insurance against the risk of these circumstances arising and resulting in payments becoming refundable to the Nine Network.

Land remediation — environmental concerns

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

Victorian Managed Insurance Authority

The Victorian Managed Insurance Authority (VMIA) was established in 1996 as a captive insurer for departments and participating bodies (predominantly in the general government sector). VMIA provides its client bodies with a range of insurance cover, including for property, public and products liability, professional indemnity and contract works. VMIA re-insures in the private market for losses above $50 million arising out of any one event, up to a maximum for each type of cover (e.g. $1 250 million for property and $750 million for public liability). The risk of losses above these re-insured levels is borne by the State.

Gambling/gaming licences

In 1994, the State sold a wagering and gambling licence to TABCORP Holdings Limited (TABCORP) for $597 million. The *Gaming and Betting Act 1994* requires the State to provide in 2012 a refund to TABCORP of an amount equal to the licence value of the former licences or the premium payment paid by the new licensee, whichever is the lesser. While this creates an obligation on the State to refund the licence value to TABCORP, it will be offset by the premium payment from the issue of any new licences. In 1992, a gaming operator's licence was issued to the Trustees of the Will and Estate of the late George Adams (the licensee). The *Gaming Machine Control Act 1991* entitles the licensee to be paid, at the end of its current licence period in 2012, an amount equal to the value of its current licence or the premium payment paid by the new licensee, whichever is the lesser. This entitlement is contingent on the licensee not being granted a new licence.

Builders' warranty

The builders' warranty insurance market, like other insurance markets, was affected by the 11 September 2001 terrorist attacks in the United States and adverse claims experience. In mid-April 2002, the State agreed to provide temporary (to 30 June 2002) re-insurance support to builders' warranty insurance provider Dexta

Corporation, following the withdrawal of some of its commercial re-insurance support. This support was subsequently extended to 30 September 2002. The Government determined that there would be no further extension.

The State received re-insurance premiums for this participation and is required to contribute to payment of re-insured claims, as well as paying management fees. The precise timing and value of claims-related payments is uncertain, as claims may be made by home owners for up to 6½ years after the arrangement ceased.

Based on Dexta's previous levels of activity, the central estimate of the State's gross exposure (i.e. before premium receipts) is not more than $6 million. While the State expects, along with the commercial re-insurers who are party to the agreement, to at least break even on these arrangements, the State retains an unquantifiable contingent liability that claims may exceed the central estimate.

On 13 March 2002, Victoria and New South Wales jointly announced a series of reforms to builders' warranty insurance arrangements. This announcement included a commitment to provide a catastrophe fund capable of supporting claims above $10 million. Since builders' warranty insurance commenced, there have been no losses exceeding this amount by an insurer to any one builder. To meet this commitment, the two States offered reinsurance arrangements to all builders' warranty insurers covering claims in respect of any one builder exceeding $10 million, with each of the two States reinsuring claims relating to properties in that State. A reinsurance agreement giving effect to these arrangements was concluded in December 2002 (effective from 1 January 2003) with one insurer. This agreement requires the insurer to pay the two States reinsurance premiums that are estimated to be sufficient for the States to at least break even on these arrangements. However, the State retains an unquantifiable contingent liability for additional claims.

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

INDEX