



2006-07



STRATEGY AND OUTLOOK

2006-07 STRATEGY AND OUTLOOK Budget Paper No. 2

Budget Paper No. 2
Presented by the Honourable John Brumby MP
Treasurer of the State of Victoria
on the occasion of the Budget 2006-07



Strategy and Outlook

2006-07



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for the information of Honourable Members

Budget Paper No. 2

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CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

- The Government will meet its \$100 million budget surplus target, ensuring that businesses and families in Victoria have a stable financial environment in which to invest and plan for their future. The target will be achieved with a surplus of \$317 million in 2006-07 and averaging \$316 million over the forward estimates period.
- The Government is helping create greater capacity for economic growth through significant investments in infrastructure projects. This budget provides new asset investment funding with total estimated investment of \$3.6 billion. In addition to the \$1.3 billion announced in the *2005-06 Budget Update*, this brings total 2006–07 TEI to \$4.9 billion. Over the next four years, general government real capital stock will grow by 11.0 per cent; more than double the expected rate of population growth.
- The Government continues to make significant progress against its key social objectives, including rebuilding schools, hospitals, police stations, aged care facilities and community centres. All of the Government’s election output and asset commitments have now been funded, with the remaining \$112 million of funding provided in this Budget.
- This budget finances a number of major policy statements:
 - *Moving Forward: Making Provincial Victoria the Best Place to Live, Work and Invest*;
 - *Maintaining the Advantage: Skilled Victorians* – investing in our training system;
 - *Healthy Futures* – delivering better health, research and jobs for Victorians; and
 - *Meeting Our Transport Challenges* – connecting Victorian communities.
- Victoria has continued to reform payroll tax, land tax and WorkCover premiums. All of these have been further reduced in this budget. As a result of these cuts, Victoria’s overall tax level is around the Australian average and significantly below that of New South Wales.

- Victoria is maintaining modest and sustainable levels of net financial liabilities, consistent with its triple-A rating. The Government is using its strong balance sheet and budget position to fund key investment projects that generate long-term benefits.

FINANCIAL STRATEGY, OBJECTIVES AND PRIORITIES

This chapter sets out the Government's financial policy objectives and strategies as required by the *Financial Management (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, taking into consideration economic circumstances;
- pursue spending and taxation policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden;
- maintain the integrity of the Victorian tax system;
- ensure that government policy decisions have regard to their effects on future generations; and
- provide full, accurate and timely disclosure of financial information relating to the activities of the Government and its agencies.

In its 2002 election policy statement, *Delivering Financial Responsibility*, the Government announced its financial strategy, objectives and priorities. A sound financial position provides a stable financial basis from which growth can be promoted across the whole State through delivering world-class infrastructure to drive economic growth and improving the quality, access and equity in key services to all Victorians.

In the edition of *Growing Victoria Together* released on 29 March 2005, the Government considered Victoria's changing environment and identified some crucial challenges ahead, including:

- creating more quality jobs and innovative industries, and growing and linking all of Victoria;
- providing high quality and accessible health and community services, education and training services;
- protecting the environment and reducing the level of greenhouse gas emissions and solid waste;
- building safe and friendly communities that respect diversity and reduce the disadvantages in health, education and housing; and
- promoting sound financial management and an accountable government that encourages the participation of all Victorians in public affairs.

The Government's short and long-term financial objectives are summarised in Table 1.1. The rationale for, and progress against, each of the five objectives is discussed in the following sections of this chapter.

Table 1.1: 2006-07 Financial objectives

<i>Long-term</i>	<i>Short-term</i>
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
Provide improved service delivery to all Victorians	Complete the implementation of the 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

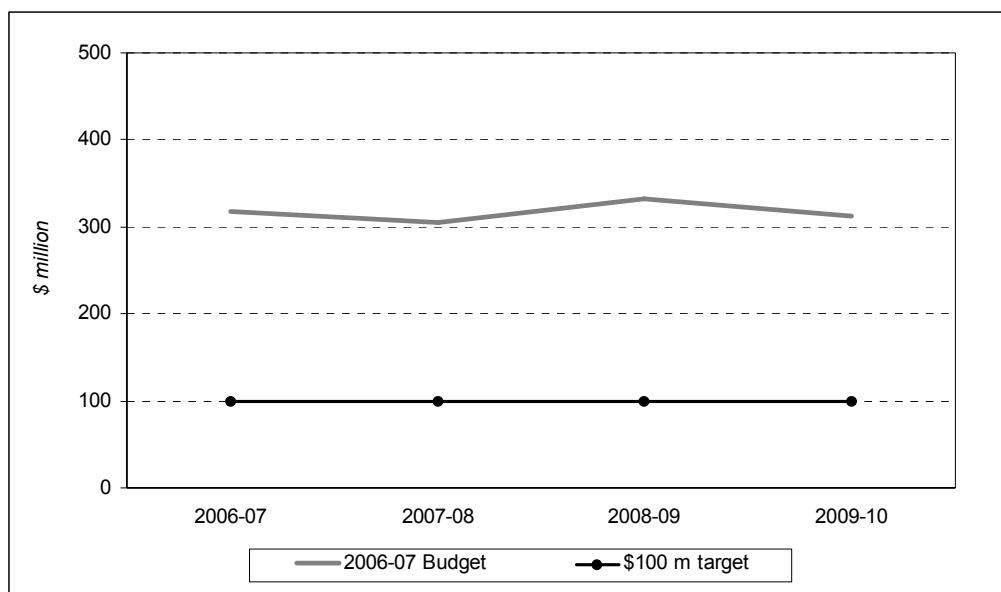
OBJECTIVE ONE: OPERATING SURPLUS

The Government continues to meet its target of maintaining an operating surplus of at least \$100 million. While achieving this objective, the Government has also reduced taxes, increased investment and kept net financial liabilities at prudent levels. This strong operating performance has increased the State's net worth and contributed to economic stability and business growth in Victoria.

As part of the implementation of the Australian equivalents to International Financial Reporting Standards (A-IFRS), the Government reviewed the financial measure against which the \$100 million operating surplus is to be achieved, and determined that the A-IFRS net result from transactions is the most robust measure of the Government's financial management under the new standards. Further information about the A-IFRS operating statement and financial measure is available in Budget Paper No. 4.

The A-IFRS net result from transactions is expected to be \$317 million in 2006-07 and to average \$316 million over the forward estimates (see Chart 1.1). The Government's fiscal strategy is to maintain a buffer above the \$100 million minimum operating surplus to allow for unforeseen circumstances and provide budget flexibility.

Chart 1.1: General government sector net result from transactions



Source: Department of Treasury and Finance

Alternative measures of operating performance

As shown in Table 1.2, the GFS net operating balance, used by the Australian Bureau of Statistics (see Budget Paper No. 4, Chapter 6, *Uniform Presentation of Government Finance Statistics*), is the same as the A-IFRS net result from transactions. Both measures exclude the effects of revaluation (holding gains or losses) arising from changes in market prices and other changes in the volume of assets.

Table 1.2: A-IFRS and GFS budget measures

	(\$ million)			
	2006-07	2007-08	2008-09	2009-10
	Budget	Estimate	Estimate	Estimate
A-IFRS net result from transactions	317	305	331	312
A-IFRS net result	276	271	302	283
GFS net operating balance	317	305	331	312
GFS net lending/(borrowing)	(582)	(896)	(1 183)	(796)
GFS cash surplus/(deficit) ^(a)	157	(818)	(925)	(706)

Source: Department of Treasury and Finance

Note:

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

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

A GFS measure of operating performance is net lending. This measure is equal to the *GFS net operating balance* less net capital formation. Reflecting the Government's substantial infrastructure investment, GFS net lending in 2006-07 shows a deficit of \$582 million. In the forward estimates period, the GFS net lending deficit averages \$958 million a year.

The GFS cash surplus is equal to net cash flows from operating activities less net acquisition of non-financial assets and acquisition under finance leases. As a flow measure of operating performance, the cash surplus excludes non-cash expenses such as superannuation and employee entitlements. The GFS cash position is expected to be in surplus by \$157 million in 2006-07 and in deficit by an average of \$816 million over the forward years.

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

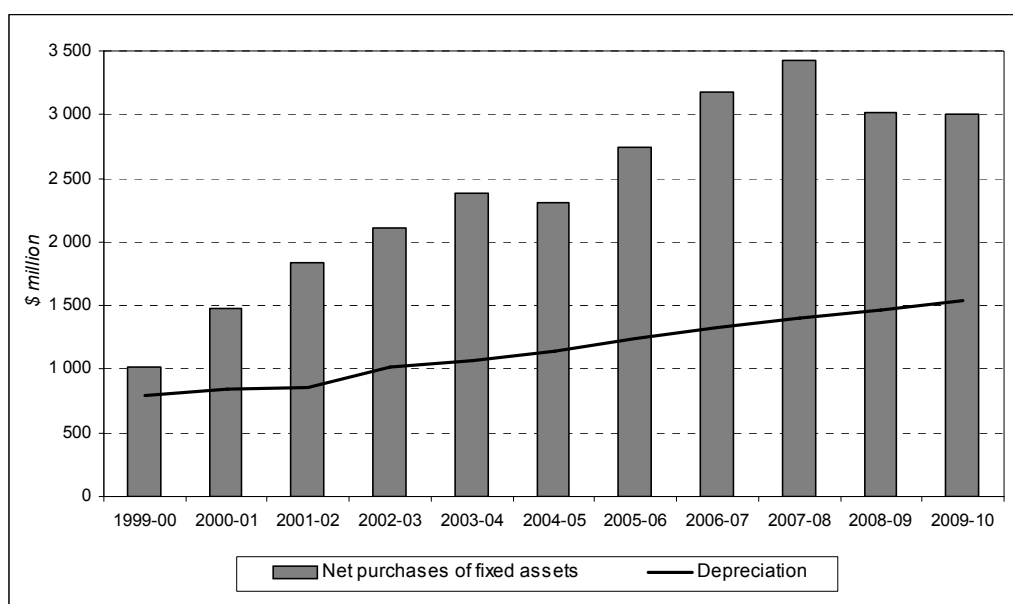
OBJECTIVE TWO: INFRASTRUCTURE

The Government is committed to delivering world-class infrastructure.

Since 2000-01, the Government has invested around \$13 billion in infrastructure, averaging over \$2 billion a year. This is around double the annual average investment in the five years prior to 2000-01.

Chart 1.2 shows the general government net infrastructure investment since the beginning of the decade, together with projections for the forward estimates period. The level of investment is expected to average \$3.2 billion a year over the next four years.

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



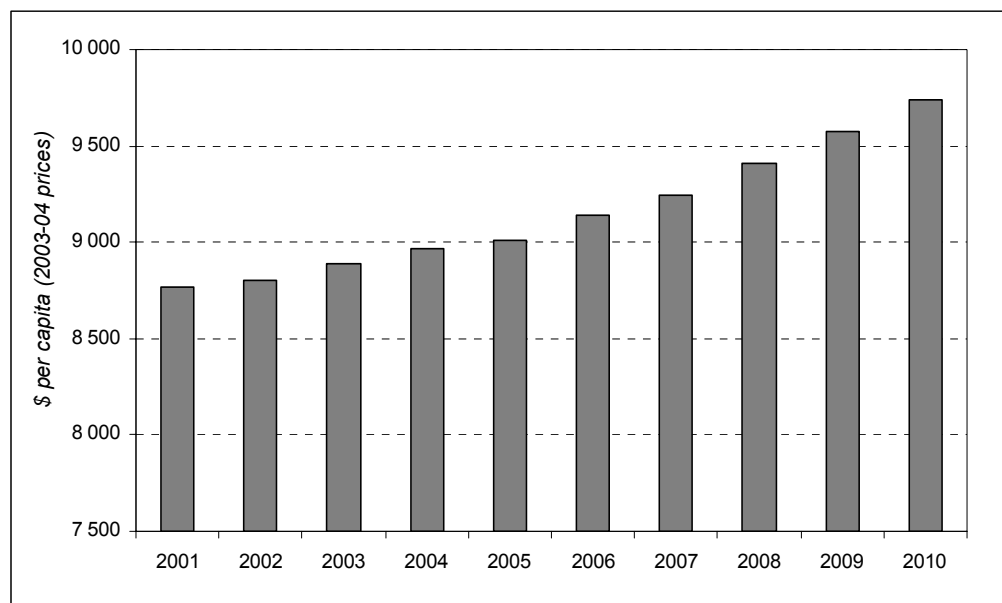
Source: Department of Treasury and Finance

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 2006-07 to 2009-10, general government net infrastructure investment will exceed estimated depreciation by around \$1.7 billion a year, resulting in an 11.0 per cent growth in the real capital stock over the four years to June 2010. This is more than double the 4.2 per cent projected population growth over the same period. Chart 1.3 shows that in real per capita terms, the average stock of public infrastructure for each Victorian will grow from \$8 764 in 2001 to \$9 740 by 2010.

Chart 1.3: General government sector real capital stock per capita as at 30 June



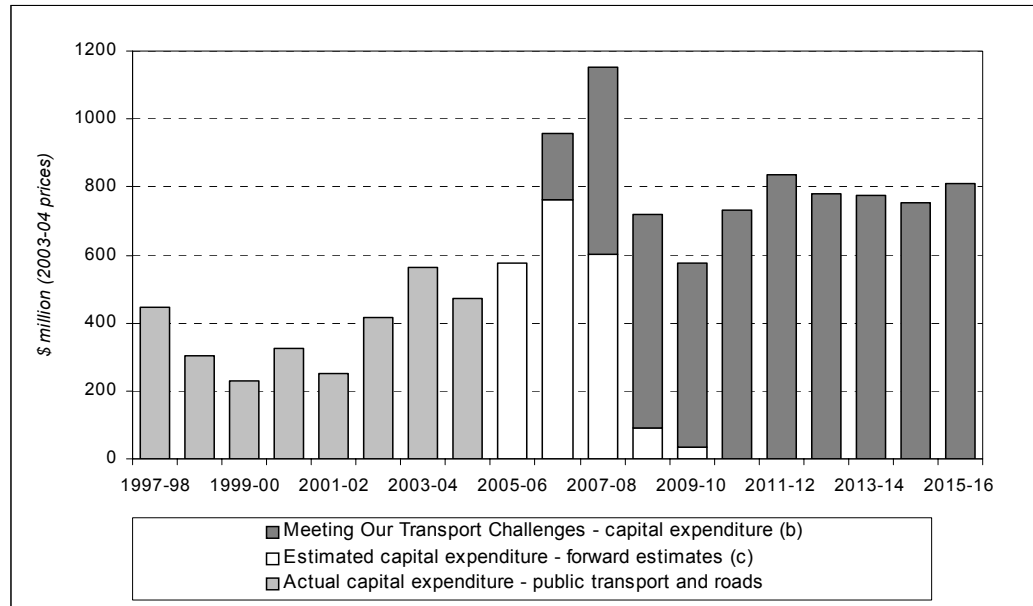
Source: Department of Treasury and Finance

Record capital spending is announced as part of the 2006-07 Budget with new asset funding expected to reach \$3.6 billion total estimated investment (TEI). This is in addition to the 2005-06 Budget Update capital investment worth \$1.3 billion TEI.

The 2006-07 Budget provides record levels of investment in transport and education. The Government's *Meeting our Transport Challenges* statement committed to inject \$10.5 billion into the transport network over the next ten years, of which \$1.7 billion is for recurrent expenditure and \$8.8 billion is for new transport projects. This major new investment in the State's transport network will connect our growing communities, cut congestion, and deliver a modern and safe system for all Victorians.

Chart 1.4 provides an indication of the increasing level of investment this Government has made in transport infrastructure since 1999. The average annual increase in the real level of investment in transport infrastructure from 1999-2000 to 2015-16 is expected to be over 8 per cent.

Chart 1.4 Department of Infrastructure – State funded transport real capital expenditure^(a)



Sources: Department of Infrastructure and portfolio agencies, Annual Reports, 1997-98 to 2004-05 and Department of Treasury and Finance

Notes:

- (a) Includes State-funded investment in fixed assets and capital contributions to VicTrack, Transport Ticketing Authority, V/Line and SEITA. Excludes projects funded through Private Public Partnership arrangements, public transport franchise arrangements and estimated Commonwealth funded investment expenditure.
- (b) Includes transport commitments to be delivered by Department of Infrastructure only.
- (c) Forward estimates include impact of previous project commitments.

Meeting Our Transport Challenges establishes a forward plan of transport projects over the next 10 years, including:

- a \$400 million investment to create a cross-town transport network for Melbourne;
- the provision of \$2 billion to deliver a substantial boost in the capacity of Melbourne's rail network;
- investment of \$1.6 billion to deliver major improvements to Melbourne's train and tram services, including new trains and trams;
- an additional \$400 million to help deliver first class public transport for provincial Victoria;
- an additional \$2 billion to upgrade Victoria's arterial road network, including construction of the Western Highway-Deer Park Bypass;
- a \$737 million package of improvements to boost capacity and reduce congestion on the Monash-West Gate corridor, making east-west travel across the city faster and more reliable; and
- new investment of \$1.0 billion in transport safety to make Victoria's rail services safer and more secure, and continue to reduce the road toll.

The Government will establish the *Meeting Our Transport Challenges* reserve to ensure that sufficient funds are set aside to fund projects. The cash flow of projects funded from the reserve is set out in Budget Paper No. 4, Appendix B, *Meeting Our Transport Challenges Reserve Report*.

Details of the specific projects in *Meeting Our Transport Challenges* that are funded in the 2006-07 Budget are outlined in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

This budget also provides a record high of \$448 million TEI for schools and TAFEs, including the first tranche of projects to be funded from the *Building Tomorrow's Schools Today* fund. Over the next few years a total of \$600 million will be committed to school infrastructure projects through the *Building Tomorrow's Schools Today* fund. This investment is in addition to the normal program of investment in our schools.

Hospital infrastructure is also a significant focus of the 2006-07 Budget, with \$391 million TEI being provided to fund significant capital works across hospitals, health, aged care and community services facilities. This is in addition to the \$868 million TEI announced as part of the *2005-06 Budget Update* for the Royal Children's Hospital and the Alfred Hospital Intensive Care Unit.

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

OBJECTIVE THREE: SERVICE DELIVERY

Over the past few months the Government has announced major policy commitments through a number of statements:

- *Moving Forward: Making Provincial Victoria the Best Place to Live, Work and Invest*;
- *Maintaining the Advantage: Skilled Victorians* – investing in our training system;
- *Healthy Futures* – delivering better health, research and jobs for Victorians; and
- *Meeting Our Transport Challenges* – connecting Victorian communities.

These commitments cover the key service delivery areas of education and training, health and transport across the whole State. The funding provided through the 2006-07 Budget to meet these commitments is aimed at ensuring that significant progress is made towards achieving the goals in *Growing Victoria Together*. These investments will also build on the successes to date:

- the Government's investment in creating pathways for young people has raised the proportion of young Victorians completing year 12 or equivalent from 82.9 per cent in 1999 to 85 per cent in 2005, higher than any other state;
- since 1999, the Government has increased its investment in the education sector, reducing the average class size for prep to year 2 to an all-time low of less than 21; and
- the investment in health, aged care and community facilities has grown. This has supported the treatment of more patients, reduced waiting times, doubled the support package for people with disabilities and boosted assistance for families with young children. Since 1999, the number of patients treated in Victoria's hospitals has increased by 22 per cent.

These achievements support the election commitments outlined in *Labor's Financial Statement 2002*, which included a combination of new and improved services and better access to government services for all Victorians. All of the Government's 138 output election commitments were funded for implementation following the 2004-05 Budget (see Table 1.3). Details on funding for all individual output election commitments can be found in the 2003-04 and 2004-05 Budget Papers.

Following the 2005-06 Budget there were five remaining partially funded asset initiatives. In this Budget, those five initiatives have been fully funded with a total of \$112 million TEI provided. Details on the election commitments can be found in Budget Paper No. 3, Chapter 3, *Election Commitments: Implementation Report Card*.

Table 1.3: 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	Funded in 2005-06 Budget	Funded in 2006-07 Budget	Total funding	Projects funded (per cent)
Output							
LFS output costing (\$ million)	2 520.0	1 940.8	765.9	..	..	2 706.7	..
Number of initiatives	138 ^(a)	120	18	..	..	138	100%
Asset							
LFS asset TEI (\$ million)	1 915.8	539.6	939.7	392.6	111.7	1 983.6	..
Number of initiatives	52 ^(b)	27	14	11 ^(c)	^(d)	52	100%

Source: Department of Treasury and Finance

Notes:

- (a) Represents the 133 output initiatives published in 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 Hospital 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) 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 Schools Replacement program asset initiatives into the Building Better Schools: New and Replacement Schools asset initiative.
- (c) Includes the Bendigo Physiotherapy refurbishment that was funded within existing resources of the Department of Human Services.
- (d) Full implementation of five initiatives which have received partial funding to date.

The 2006-07 Budget provides a net funding impact of output initiatives of \$423 million in 2006-07, and an average of \$495 million each year from 2007-08 to 2009-10. This is an addition to net funding provided in the 2005-06 Budget Update of \$168 million on average from 2006-07 to 2008-09. Details on the costing of these output and asset initiatives can be found in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*.

The Budget also allocates significant funding for *Maintaining the Advantage: Skilled Victorians*, a skills strategy designed to complement the national reform agenda by setting out Victoria's action plan to:

- increase young Victorians' involvement in education and training;
- provide more opportunities for Victorians of all ages to upgrade skills;
- introduce more flexibility and choice for students;
- match training priorities to business needs; and
- help people of all ages participate in the workforce.

The 2006-07 Budget also provides new initiatives to build schools, increase the capital funding for schools, invest in teaching and learning facilities, support programs for students with disabilities and improve facilities in TAFE institutes. This will improve the quality and condition of our learning environment and support parents of children at the key transition stages of prep and year 7.

Building on last year's *A Fairer Victoria*, the 2006-07 Budget provides a second tranche of initiatives to reduce disadvantage. In particular, the Budget includes funding of \$818 million for a range of programs, including disability services, children's services, affordable housing and aged care. This is to ensure that everyone has a fair chance to participate and contribute to the social and economic life of Victoria. To continue to work to address disadvantage, a variety of programs will focus on giving children the best start in life, keeping young people on track, building partnerships with Indigenous Victorians, supporting people with a disability and their families, ensuring fairer access to services and assisting older Victorians to remain independent.

The 2006-07 Budget continues the Government's investment to expand hospital services and reduce elective surgery waiting lists, ensure that Victoria's emergency care services meet growing demand and implement a new approach to mental health services with a focus on early intervention and community-based services. Funds from this budget will strengthen the home and community care program and improve access to services for disadvantaged Victorians aged 60 years and over.

In particular, the 2006-07 Budget commits an additional \$508 million over four years to *Hospital Futures* – a strategy to deal with continuing increases in demand for hospital care. The funding will go towards increasing the number of patients treated in our hospitals, boosting emergency and maternity services, and to hospital diversion and substitution programs.

This Budget also invests \$502 million through *Moving Forward* to enable provincial Victoria to respond to challenges such as global competition, an ageing population, skills shortages and the ongoing need to rebuild infrastructure. At the heart of *Moving Forward* are a \$200 million renewal of the Regional Infrastructure Development Fund and a new \$100 million Provincial Victoria Growth Fund.

Other key initiatives in the 2006-07 Budget include fighting organised crime and counter terrorism, building major sporting infrastructure, protecting and managing Victoria's environment and maintaining an efficient and sustainable use of natural resources.

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

OBJECTIVE FOUR: TAXATION

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

The reform of Victoria's taxation system is part of a wider reform agenda led by the Victorian Government which aims to lift productivity and workforce participation through the implementation of reform embracing human capital, competition and best practice regulation. The Government has implemented a number of initiatives including reform of the taxation system, a continuing drive for efficiency within government businesses, actions to reduce government red tape and a major new investment in skill development. Details of improvements to the taxation system are highlighted below; a description of the Government's wider reform agenda can be found in Chapter 7, *Productivity, Participation and Reform Agenda*.

Since 1999, the Government has announced significant tax reductions. These have been included in *Better Business Taxes* (April 2001), *Building Tomorrow's Business Today* (April 2002), and the Government's Economic Statement, *Victoria: Leading the Way* (April 2004). Primarily, these initiatives reduced the tax burden of Victorian homebuyers, investors, self-funded retirees, and businesses; and enhanced the security of Victoria's tax base. These tax reductions have also supported business and investment in Victoria.

The 2006-07 Budget assists Victorian businesses grow and keep competitive by providing further relief through:

- reducing the payroll tax rate to 5 per cent over three years; and
- announcing a land tax reform package worth \$167 million over four years.

This is in addition to the abolition of rental business duty from 1 January 2007 announced in the 2005-06 Budget.

The taxation reform measures announced in the 2006-07 Budget will provide net tax relief to Victorian taxpayers of \$734 million over four years. Detailed information on these initiatives can be found in Chapter 3, *Budget Position and Outlook*; Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*; and Budget Paper No. 4, Chapter 3, *State Revenue*.

Tax competitiveness

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

Victoria's preferred measure of tax competitiveness is state taxation expressed as a share of nominal gross state product (GSP). This measure relates the level of taxation revenue to economic capacity. Taxation revenue as a share of nominal GSP for Victoria, New South Wales, Queensland and the Australian average is shown in Chart 1.5.

The general increase in taxation as a share of GSP between 2001-02 and 2003-04 reflects the buoyant economic activity in these years, particularly in the property market, which yielded increases in conveyancing revenue. The increase was most notable for Queensland, which benefited most from the property boom.

In 2006-07, Victoria's tax ratio is budgeted to have fallen to 4.50 per cent, an estimated 0.40 percentage points (\$980 million) below New South Wales and around the Australian average. Over the forward estimates period, Victoria's taxation as a share of nominal GSP is forecast to decline further to 4.25 percentage points of nominal GSP by 2009-10.

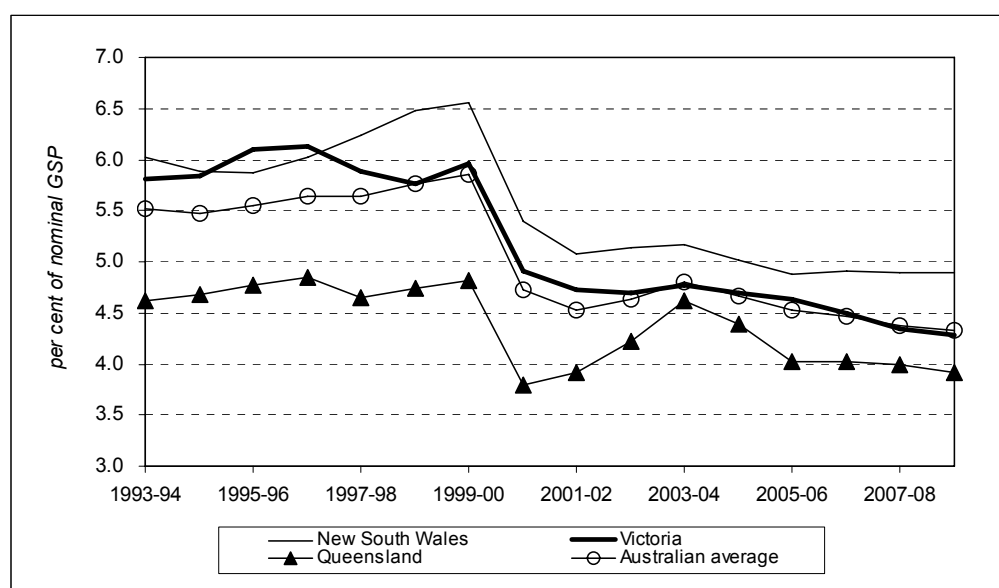
While tax competitiveness is an important part of business decision making, WorkCover premiums are another business cost that also affects the attractiveness of Victoria as a business location. In this budget, sound financial management has enabled the Government to cut the average WorkCover premium rate by a further 10 per cent, bringing Victoria's premium rate to 1.62 per cent of wages, an historic low, and the second lowest among the States, 25 per cent lower than New South Wales and 46 per cent lower than South Australia. This rate cut lowers business costs by a further \$170 million in 2006-07. The cumulative savings to Victorian businesses of three successive 10 per cent premium cuts is \$520 million in 2006-07.

Workplace safety and its regulation have gone through remarkable change in the last five years. There have been significant and sustained decreases in the rate of workplace deaths and injuries during that period, with 2005 being the safest year in a generation. Last year, Victoria recorded the lowest number of workplace fatalities since records began, as well as the largest reduction in the number of injury claims since 1997-98.

In November 2005, the Government announced a \$155 million package of initiatives to benefit injured Victorian workers and their families. The package includes support for injured workers for up to an additional 6 months of benefits beyond the current 104 weeks, 18 per cent increase in death benefits to affected families and improved counselling services.

The reduced WorkCover premiums, workplace safety reforms and tax measures have enabled Victorian business to maintain their competitive edge.

Chart 1.5: Taxation revenue as percentage of GSP^(a)



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

Note:

(a) Historical taxation data from 1993-94 onwards, revised estimates for 2005-06 and forecasts for the forward estimates period. Victorian data represent 2006-07 Budget estimates. WA data (included in the Australian average) are consistent with the recently released 2006-07 Budget. Data for all other jurisdictions represent their 2005-06 Budget Update estimates. There has been no adjustment to reflect any subsequent policy changes by other jurisdiction.

OBJECTIVE FIVE: NET FINANCIAL LIABILITIES

Victoria's balance sheet is very strong. This is evident from its triple-A credit rating, which was affirmed by international credit rating agencies, Moody's Investors Service and Standard & Poor's in October 2005. Both agencies cited Victoria's strong fiscal position, low debt levels and prudent financial management as the key factors behind its triple-A credit rating.

About 60 per cent of the general government infrastructure program will be financed by the net cash inflow from operations – which is equivalent to the operating surplus less depreciation and other non-cash provisions. For the remainder, the Government will use the strength of its balance sheet and strong budget position to fund key public investment projects that provide long-term economic and social benefits to Victoria.

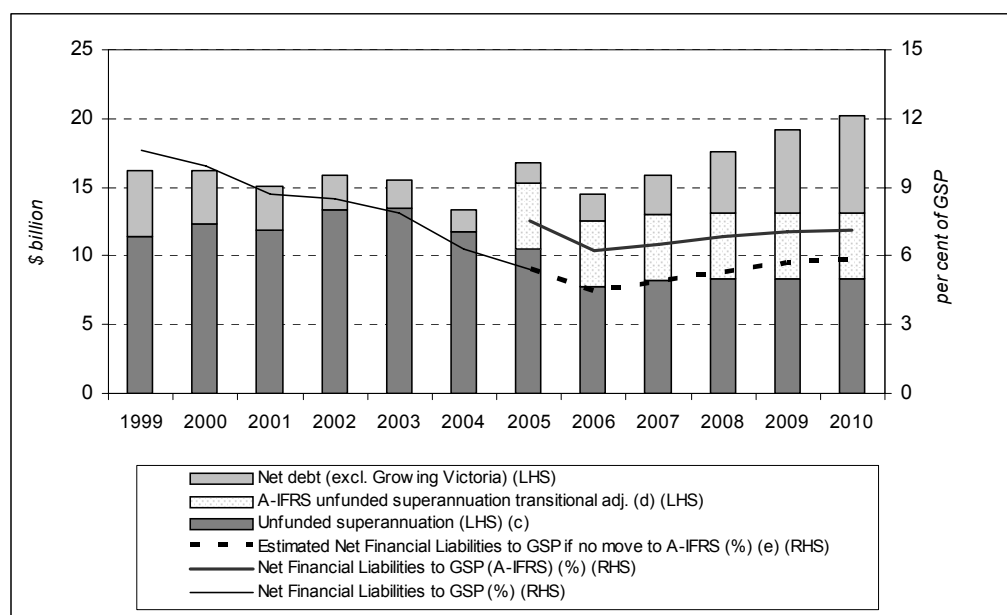
Accordingly, Chart 1.6 shows that general government net debt is projected to increase from \$2.0 billion at June 2006 to \$7.1 billion at June 2010. These remain low debt levels by historical and international standards. For example, the projected general government net debt of \$7.1 billion in 2010 is equivalent to 2.5 per cent of GSP, compared to 3.1 per cent in 1999 and 15.9 per cent in 1995.

In addition, the servicing burden of the State's largest liability, its unfunded superannuation, will ease over the forward estimates period. As a proportion of GSP, unfunded superannuation liabilities are forecast to decline from 5.4 per cent in June 2006 to 4.6 per cent in June 2010. This offsets the servicing burden of rising net debt.

The ratio of net financial liabilities (the sum of net debt and unfunded superannuation liabilities) to GSP is expected to increase modestly from 6.2 per cent in June 2006 to 7.1 per cent in June 2010, but remain well below the 10.6 per cent level recorded in June 1999. Most importantly, the proportion of budget revenue absorbed by superannuation and interest expense is projected to remain fairly steady at just below 7 per cent over the next four years.

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

Chart 1.6: General government net financial liabilities, as at 30 June^{(a)(b)}



Source: Department of Treasury and Finance

Notes:

- (a) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.
- (b) Net debt is calculated as gross debt less liquid financial assets. In the years applicable, Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.
- (c) Unfunded superannuation liabilities between 1999 and 2004 are calculated under the old Australian accounting standards, whereas between 2005 and 2010 the relevant A-IFRS standard has been applied.
- (d) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liabilities in 2004-05 has also been separately identified in the period 2005 to 2010.
- (e) The net financial liabilities to GSP (as calculated applying the old Australian accounting standard) between 2005 and 2010 are estimates, and should be used for illustrative purposes only.

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- Economic growth in Victoria is expected to strengthen from 2.50 per cent in 2005-06 to 3.25 per cent in 2006-07, with a pick-up in consumer spending and some recovery in net exports, and further to 3.50 per cent in 2007-08.
- In 2005-06 the Victorian economy exhibited a strong economic performance, particularly when compared to the other non-resource States.
- This growth reflects the strength of business investment, strong population growth and solid employment growth.
- The main short- to medium-term risks to the Victorian economic projections include potential movements in domestic and foreign interest rates, the crude oil price and the Australian dollar.

VICTORIAN ECONOMIC PROJECTIONS

The Victorian economy in 2005-06 is expected to have grown by 2.50 per cent, in line with the forecast Australian average. Over the past four years, the Victorian economy has grown by an average of 3.6 per cent, above the national average growth rate of 3.3 per cent. Growth in 2005-06 largely reflects strong machinery and equipment investment and infrastructure construction, both of which are important for the continuing productive capacity of the State. It represents a strong economic performance, particularly when compared to the other non-resource States.

The minerals commodity price boom has been an important source of income growth nationally, but has also contributed to a high exchange rate and reallocation of capital and labour to mineral-rich regions. This has placed increased pressure on non-mineral exporters and import-competing businesses in States such as Victoria. Despite this, Victoria's economic fundamentals remain strong. Gross state product (GSP) is expected to improve in 2006-07, as a result of a pick-up in the growth of consumer spending, and some recovery in net exports (while the outlook for exports is mixed, more moderate growth in imports is expected). The international economic environment is expected to remain supportive.

The economic projections used in the 2006-07 Budget are set out in Table 2.1. The remainder of the 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.

Table 2.1 Victorian economic projections^(a)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>
Real gross state product	2.3	2.50	3.25	3.50	3.25	3.25
Employment	3.3	1.50	1.25	1.50	1.25	1.25
Unemployment rate ^(b)	5.7	5.50	5.50	5.25	5.25	5.25
Consumer price index	2.0	3.00	2.50	2.50	2.50	2.50
Wage price index ^(c)	3.9	3.75	3.50	3.50	3.50	3.50
Population ^(d)	1.2	1.10	1.00	1.00	1.00	1.00

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 growth are rounded to the nearest 0.1 percentage point.
- (b) Year-average level, per cent.
- (c) Total hourly rate excluding bonuses.
- (d) June quarter, per cent change on previous June quarter.

ECONOMIC OVERVIEW

The world economy

Significant features of the world economy in 2005 included continued strong economic growth in the United States, China's near double-digit growth and Japan's improving economic performance. Although growth in Europe remained modest, the global outlook remains supportive. The International Monetary Fund (IMF), in its forecasts released in mid-April, expects world growth rates to remain strong at 4.9 per cent in 2006 and 4.7 per cent in 2007. Significantly, the IMF believes that growth is becoming more broadly based across regions and revised up its world growth forecasts which, if realised, would represent five consecutive years of GDP growth at 4 per cent or more. Private sector forecasters surveyed by Consensus Economics in May 2006 also expect strong world growth. Likewise, the Organisation for Economic Co-operation and Development (OECD), in its May 2006 Economic Outlook, expects continued stable economic growth for its member countries. The strong global economy should underpin continued demand for Victorian and Australian exports.

US interest rates and higher oil prices both represent risks for the world economy. Concerns about the size of the US budget and current account deficits, which are mirrored by surpluses in Asia and oil-producing nations, may lead to US dollar-denominated assets losing their attractiveness. Any resulting upward pressure on US interest rates could have a negative impact on world growth.

China's strong economic growth continued in 2005, driven by investment and, to a lesser extent, consumption and export growth. The IMF forecasts growth in 2006 and 2007 of 9.5 and 9.0 per cent respectively. However, the strength of China's fixed asset investment growth has led to concerns of overcapacity, in an environment in which the potential for manufacturers to reduce costs is limited because of high prices for raw materials.

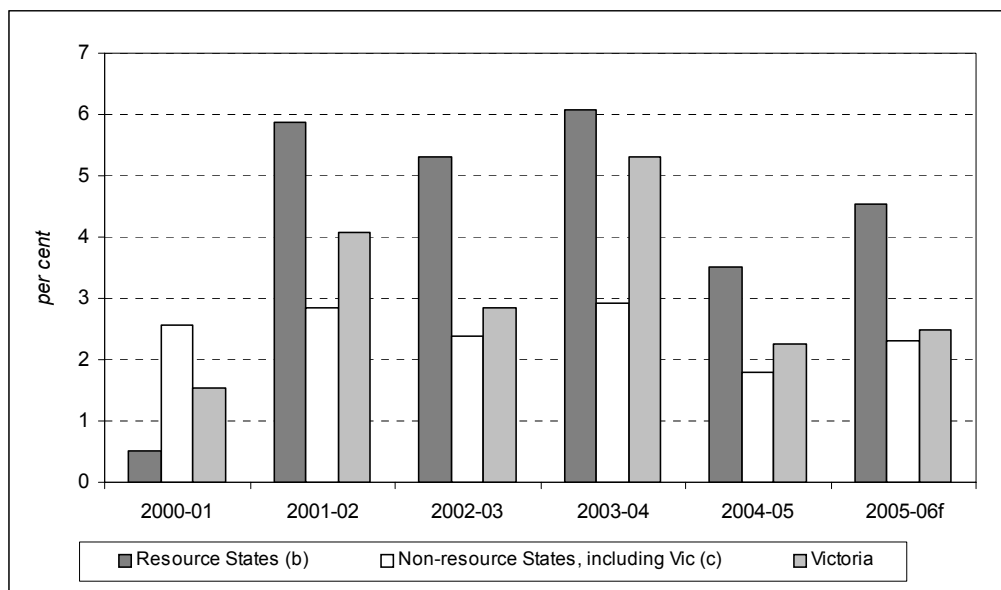
The IMF is projecting strong growth in Asia including India. Specifically the outlook for non-China East Asia has strengthened with the global information and communication technology recovery, which has led to a pick-up in industrial production. The United Kingdom and Euro area outlook appears to be improving, but growth is forecast to remain modest.

Australian economic conditions and outlook

National economic growth eased during 2005 with consumer spending moderating as households responded to high debt levels and slower house price growth in the major markets. There was also a mild decline in dwelling construction. At the same time, there has been a broad-based expansion in business investment encouraged by, but by no means confined to, the resources sector and associated infrastructure development. The Commonwealth Budget forecast is for national growth to rise from 2.50 per cent in 2005–06 to 3.25 per cent in 2006–07, partly in response to an improving outlook for net exports.

While the minerals commodity price boom has been an important source of income growth nationally, it has also contributed to the emergence of a sharp division between regions in terms of the pace of economic growth (see Chart 2.1).

Chart 2.1 Victorian economic growth in context^(a)



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

Notes:

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

The regional impact is illustrated by the change in Western Australia's rate of net interstate migration. Two years ago Western Australia lost around 1 600 people annually, whereas in the year to September 2005 Western Australia gained around 2 000 people. Also, private business investment in new machinery and equipment in Western Australia has doubled over the three years to December 2005.

National employment growth slowed in the second half of 2005, in response to more moderate economic growth, but the Reserve Bank believes that the labour market remains tight. The Commonwealth Budget forecast is for year-average national employment growth to slow from 2 per cent in 2005-06 to 1 per cent in 2006-07, largely reflecting the lagged effect of slower GDP growth. Anecdotal evidence indicates that skills shortages are a continuing problem for Victorian businesses. Nationally, annual wages growth has been firm, but not as high as might have been expected and evidence of wage pressures has been mixed. There have been significant wage rises in some States and industries: for example, wages in the construction industry in Western Australia grew 8.7 per cent through 2005. In Victoria annual wage growth has been moderating over the past year and is currently 3.7 per cent.

During 2005 Australia's average CPI inflation remained relatively moderate at 2.7 per cent, despite steady wages growth, an increase in the terms of trade, and an increase in world oil prices. This in part reflected the earlier appreciation of the Australian dollar, which resulted in tradables inflation (inflation for those items whose prices are largely determined on the world market) of 2.0 per cent nationally through 2005, compared with non-tradables at 3.5 per cent.

In recent quarters, inflation – both producer and consumer – has started to edge up. Citing the impact of strong global conditions, tight capacity and solid demand growth on inflationary pressures, the Reserve Bank increased interest rates in May 2006 by 25 basis points, the first rise in 14 months. The Reserve Bank has left its forecast of underlying inflation broadly unchanged at 2.75 per cent, but expects a temporary rise in headline CPI inflation above 3 per cent in the near term. The Commonwealth Treasury expects national CPI inflation to average 2.75 per cent in 2006-07. The impact on consumer spending of higher petrol prices and tighter monetary policy is expected to be at least partly offset by income tax cuts announced in the Commonwealth Budget in May.

The Consensus Economics panel of private forecasters expects Australian economic growth to pick up from 2.7 per cent in 2005-06 to 3.5 per cent in 2006-07.

Victorian economic conditions and outlook

The Victorian economy has slowed in line with national trends, although it appears to have been growing more rapidly than the rest of the non-resource States (see Chart 2.1). To some extent this reflects a softer landing for the housing market, including house prices in Victoria than, for example, in NSW. Nevertheless, economic modelling by the Victorian Department of Treasury and Finance suggests that the minerals commodity price boom may have reduced the State's annual growth rate by up to half a percentage point on average over the past two years.

The Victorian economy is forecast to grow at 2.50 per cent in 2005-06 supported by strong business investment and population growth, solid employment growth and moderate growth in consumer spending. This is in spite of pressure on net exports and softer dwelling construction. High levels of household debt and more restrained growth in house prices are contributing to some household balance sheet rebuilding. Growth in 2006-07 is forecast at 3.25 per cent as growth in consumer spending recovers along with an emerging improvement in net exports.

In Melbourne consumer price inflation is expected to decline from 3.00 per cent in 2005-06 to 2.50 per cent from 2006-07 to 2009-10. This is lower than the Commonwealth Treasury 2006-07 expectation of national inflation, and reflects lower demand and wage pressures outside the resource States. For example, CPI inflation in Perth has diverged from the other major capitals and is now running about 1 percentage point higher than the national average in annual terms, because of very strong growth in the price of new housing in Perth.

Wage pressures in Victoria appear to have started moderating with the wage growth forecast at 3.75 per cent in 2005-06 and, for the forward estimates period, 3.50 per cent. Victorian employment growth has improved following a slowdown in late 2005. The improvement is a lagged response to the recovery in activity that began in the March quarter 2005. The longer term employment projections reflect the emergence of the economic implications from the ageing of the population.

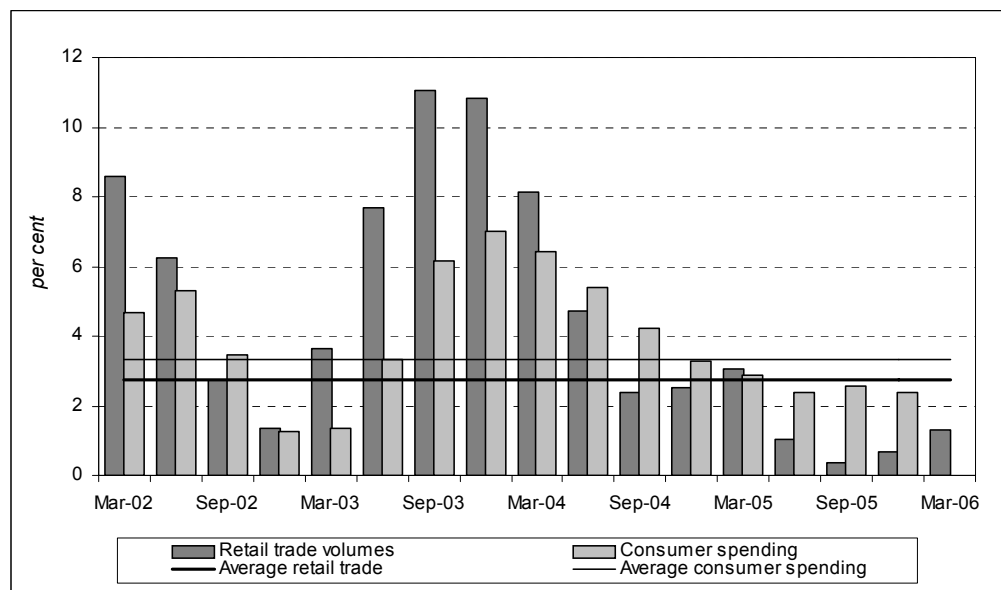
Beyond 2006-07 annual Victorian GSP growth is expected to converge to between 3.25 and 3.50 per cent. Towards the end of the decade the declining growth rate of the working age population combined with population ageing may begin to contribute to more moderate long-term GSP growth.

Consumer spending

Since December 2004 Victorian consumer spending has been growing at below-average rates (as measured over a 20 year period), reflecting a combination of higher petrol prices, more modest employment growth and households rebuilding their balance sheets as house prices stabilise.

Although consumer sentiment has been volatile because of influences such as higher petrol prices and an interest rate rise, there are signs of improving confidence among Victorian consumers. In addition, the growth rate in retail trade volumes has increased for two successive quarters (see Chart 2.2).

Chart 2.2: Victorian consumer spending and retail trade^{(a)(b)}



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

Notes:

(a) Chain volume measures, annualised per cent change in quarterly trend.

(b) Averages calculated over 20 year period.

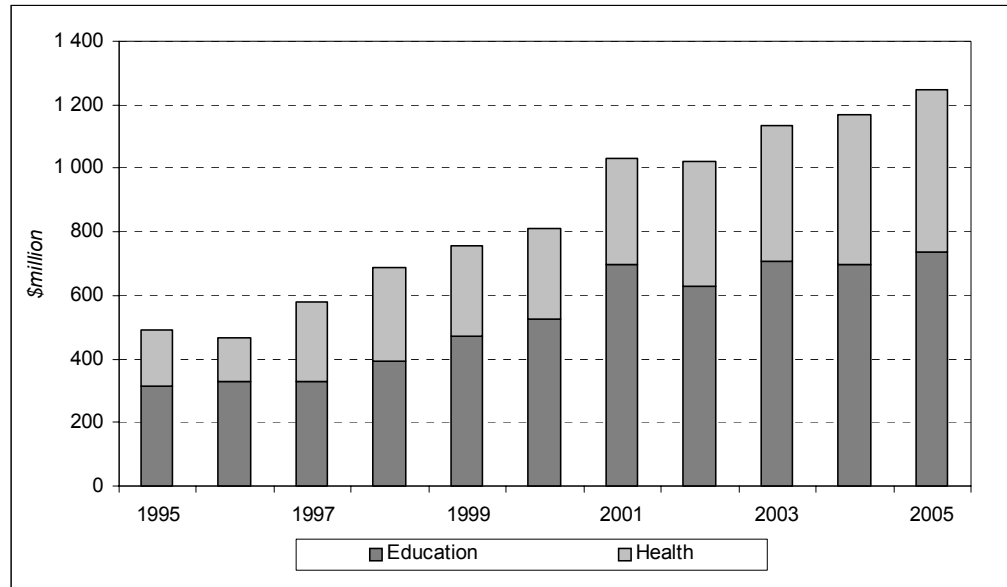
Consumer spending is expected to recover during 2006, consistent with ongoing strong income growth. Consumers are likely, however, to remain cautious in view of the potential for further increases in oil prices and continuing high levels of household debt.

Business investment and infrastructure

Private business investment is expected to continue driving much of Victoria's growth in 2006. In 2005 new private business investment grew 13.3 per cent, driven by growth in new machinery and equipment investment and new engineering construction. Victoria's real per capita trend business investment has been higher than the national average for the past six years and the second highest of all States for almost the past five years.

Much of this investment has been in infrastructure. More recently this has included the \$2.5 billion construction of EastLink and \$1.3 billion gas field developments in the Otway Basin. It also includes commercial property construction such as the \$430 million Southern Cross office tower and the \$250 million AXA Asia Pacific office building at the Docklands. In addition, investment in social infrastructure, such as health and education, has now been over \$1 billion a year for the past five years (see Chart 2.3). The current health and education construction pipeline of work yet to be done is also strong, at \$800 million, which is higher than the average for the past five years.

Chart 2.3: Victorian construction work done on education and health^(a)



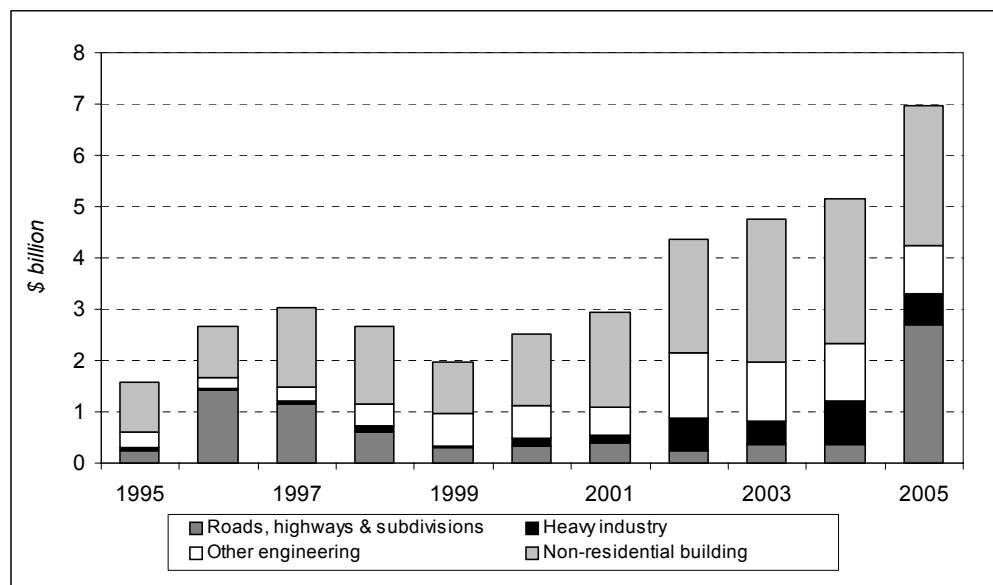
Source: Australian Bureau of Statistics

Note:

(a) Public and private investment.

The outlook for non-residential construction (engineering construction and non-residential building) remains strong, with the current pipeline around record levels. The non-residential building pipeline is \$2.7 billion and the engineering construction pipeline is \$4.2 billion, most of which is in roads, highways and subdivisions (\$2.7 billion) and heavy industry (\$0.6 billion) (see Chart 2.4). This represents a substantial future work program involving both the private and public sectors. Business investment can be expected to consolidate at an historically high level over the forecast period.

Chart 2.4 Victorian non-residential construction pipeline^(a)



Source: Australian Bureau of Statistics

Note:

(a) Year end.

Dwelling investment

Forward indicators for dwelling investment are mixed, with the number of private dwelling units approved pointing to continuing soft conditions, but housing affordability in the near term is improving and rental vacancy rates are low. On balance, this should contribute to a gradual recovery in residential construction activity over the forecast period. In Victoria more than 40 000 first home buyers entered the market in 2005, more than any other State. Housing affordability indicators published by the Real Estate Institute of Australia also suggest Victoria is the most affordable State on the eastern seaboard.

International trade

Victoria's import-competing businesses and exporters have operated in a highly competitive business environment over recent years. Anecdotal evidence suggests that the influence of China on Victoria's manufacturing industry is pervasive, with Victorian manufacturers continuing to focus on maintaining their low cost base and targeting more niche or value-adding markets.

Despite these external factors, many of Victoria's businesses achieved strong export growth in 2005. Solid gains were seen in exports of meat, beverages, road vehicles and power generating equipment. Imports were also strong, particularly in (elaborately transformed) manufacturing, which partly reflects the high level of business investment.

There should be some improvement in net exports in 2006-07, although the outlook for exports is mixed. A forecast jump in crop production is expected to boost cereal exports, although this is likely to be offset by an easing of meat exports (reflecting the expected re-entry of the United States into the Japanese beef market) and by continued softness in dairy exports (reflecting lingering effects of the drought and the diversion of exports to high-value domestic sales).

If strong world demand for Australian mining exports continues to put upward pressure on the exchange rate, import competition will remain intense and conditions for Victorian and Australian non-mining exporters will be difficult. Offsetting this, the strength of the global economic outlook may benefit businesses with niche or high value-adding capabilities that can respond quickly to new opportunities.

Labour market

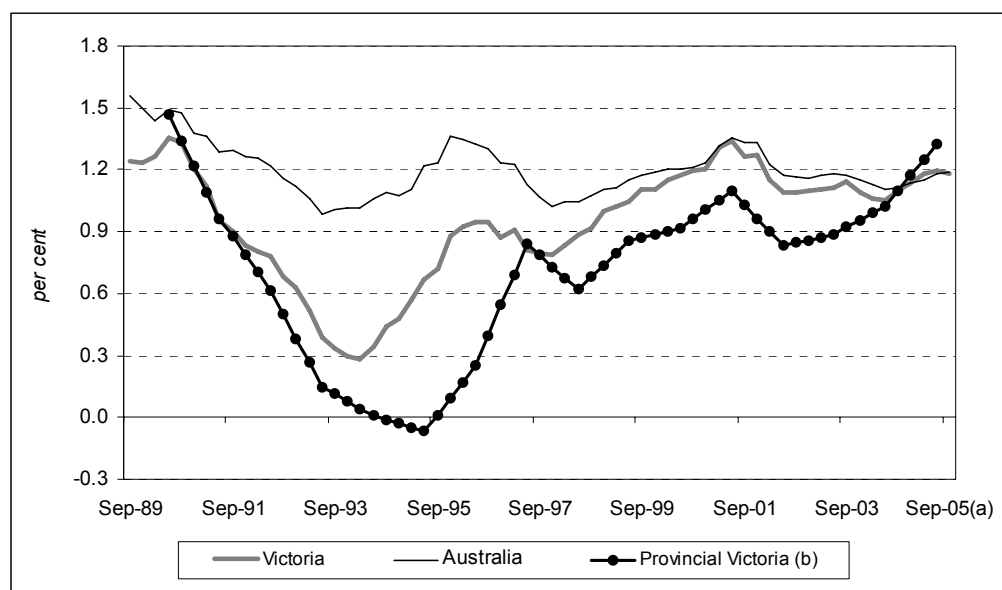
Following exceptional strength in 2004-05, employment growth is expected to remain solid in 2005-06 at 1.50 per cent, in line with the long-run average. The longer term employment projections reflect the emergence of the economic implications from the ageing of the population.

Victorian participation rates remain high and the unemployment rate low, currently at 5.3 per cent. The average unemployment rate for 2005 was 1.6 percentage points below that for 1999. Employment growth in Victoria has been particularly strong in property and business services, health and community services and construction, reflecting the strength of building and infrastructure activity. Over the past three years, manufacturing employment has declined in Victoria and elsewhere, partly reflecting the high Australian dollar and import competition from China. Despite this, manufacturing remains Victoria's second-largest employer and some manufacturing sub-sectors are performing strongly; for example, in the year to February 2006 average annual employment in machinery and equipment increased by over 9 000 persons in Victoria.

Population

Annual population growth in Victoria was 1.2 per cent in 2004-05 (see Chart 2.5) and exceeded the national average for the first time since 1963-64, driven by unusually high rates of net overseas migration to Victoria. A relatively high proportion (29 per cent or around 32 000 persons in net terms) of overseas migrants to Australia arrived in Victoria during the year to September 2005 compared with Victoria's share of national population (25 per cent). Assuming annual net migration stabilises over the forecast period at levels consistent with recent historical experience, Victorian population growth is expected to slow to 1.10 per cent in 2005-06 and around 1.00 per cent in 2006-07 and later years.

Chart 2.5 Victorian and Australian annual population growth



Sources: Australian Bureau of Statistics; Department of Sustainability and Environment

Notes:

(a) Preliminary data.

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

Provincial Victoria

Employment growth in provincial Victoria resumed in late 2004 and employment increased in 2005 by 3.0 per cent on average. Similarly, population growth has been strong, with the latest Australian Bureau of Statistics estimate of annual resident population growth, for 2004-05, at 1.3 per cent, the highest since 1989-90 (see Chart 2.5). It is also the first time in 15 years that every region has experienced population growth.

In 2005-06 total winter crop production in Victoria was forecast by the Australian Bureau of Agricultural and Resource Economics (ABARE) to be 5.6 million tonnes, up 42 per cent on the previous year. The Bureau of Meteorology has presented a neutral to moderately below-average outlook for rainfall during the August quarter 2006 across Victoria.

Bushfires around Stawell, Yea, Moondarra, the Grampians, Kinglake and Anakie in January 2006 claimed four lives, burnt around 160 000 hectares, resulted in stock losses of more than 64 000, and destroyed over 2 500 commercial beehives and more than 2 500 km of boundary and internal fencing. The bushfires also adversely affected the tourist industry and local businesses. Financial assistance should aid primary producers and local businesses in the recovery process.

Risks to the outlook

The main short- to medium-term risks to the Victorian economic projections stem from potential movements in domestic and foreign interest rates, the crude oil price and the Australian dollar, as well as the risks from possible wage pressures, any disruption to strong world economic growth and specific events such as avian influenza. The Reserve Bank recently responded to inflationary pressures by lifting interest rates by 25 basis points to 5.75 per cent in May 2006, the first rise in 14 months.

Oil prices have been increasing on the back of strong world demand and recent concerns about supply from Iran and Nigeria. Further oil price rises carry an inflationary risk. Similarly, the currently tight labour market could result in increased wage pressures which may precipitate a tightening of monetary policy. While the Australian dollar may continue to be supported by high commodity prices, any significant depreciation could have inflationary impacts. However, a weakening in the Australian dollar would provide some support to the State's exporters.

World growth has been strong over the past few years and is starting to become less dependent on the United States, as Japan and, to a lesser extent, Europe, begin to show some improvement. However, possible risks to world growth are concerns about the size of the US budget and current account deficits, with any resulting upward pressure on US interest rates being negative for world growth. The emergence of overcapacity in China's manufacturing sector, could lead to a slowdown in its industrial production growth and also adversely affect world growth.

The economic reform challenge

Victoria faces several challenges to sustained economic growth. In the short-term these include the dual effect of high petrol prices and the impact of the recent interest rate rise. In the medium-term, there are challenges from the effects of the minerals commodity price boom on non-mineral exporters and import-competing businesses, and increasing international competitive pressures. In the long-term, challenges include the impact of population ageing and a slow-down in productivity growth. Victoria shares these challenges with Australia as a whole, although the effect of the minerals commodity price boom has meant that the Australian dollar has been higher than otherwise, and this has increased pressure on non-mineral and import-competing businesses in Victoria.

The key to meeting these challenges is to boost productivity and labour force participation. To do this the Victorian Government has developed a blueprint for reform with the following key areas:

- further improving the business environment, through cutting business costs and reducing the burden of regulation;
- infrastructure investments;
- human capital reform to enhance the workforce including education, training, and health; and
- innovation, and research and development.

As well as promoting this agenda in Victoria, in August 2005, the Victorian Government took the lead in promoting a new *National Reform Agenda* (NRA). The Victorian proposals were outlined by the Premier in *The Third Wave of National Reform* and sought national agreement for reforms in human capital, better regulation, and competition. In February 2006 the Council of Australian Governments (COAG) endorsed the NRA, and over the course of 2006 the details of this agenda, including the funding arrangements, are to be negotiated. Chapter 7, *Productivity, Participation and the Reform Agenda*, discusses these issues in more detail.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

- The Government is budgeting to achieve an operating surplus (net result from transactions) of \$317 million in 2006-07.
- Over the three year forward estimates period, operating surpluses are projected to average \$316 million each year.
- Overall expenses are projected to rise by 4.5 per cent in 2006-07 and by an average of 3.2 per cent in the outyears ending 2009-10. Overall income will rise by 4.0 per cent in 2006-07 and by an average of 3.1 per cent over the forward estimates.
- The net budget impact of output initiatives announced since the *2005-06 Budget Update* is \$423 million in 2006-07, averaging \$495 million a year over the forward estimates period.
- The budget includes new asset investment funding with a total estimated investment of \$3.6 billion. This is in addition to \$1.3 billion announced in the *2005-06 Budget Update*, bringing the total to \$4.9 billion TEI. Net infrastructure investment is expected to average \$3.2 billion over the four years to 2009-10.
- Tax initiatives announced will benefit taxpayers by \$133 million in 2006-07 and a total of \$734 million over the budget and forward estimates. This includes payroll tax relief of \$533 million over four years.

BUDGET ESTIMATES AND OUTLOOK

The Government will continue to achieve its objective of an operating surplus of at least \$100 million a year.

As shown in Table 3.1, the Government is budgeting to achieve an operating surplus from transactions of \$317 million in 2006-07. Over the three years to 2009-10, operating surpluses are projected to average \$316 million.

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

Table 3.1: Net result from transactions 2006-07 to 2009-10^(a)

	(\$ million)			
	2006-07 Budget	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
Income from transactions				
Taxation	10 971.0	11 167.3	11 573.4	12 110.6
Dividends, TER and interest ^(b)	1 251.2	1 097.8	1 074.5	1 079.9
Grants	15 077.9	15 925.5	16 456.1	17 003.3
Sales of goods and services	2 552.4	2 589.9	2 653.2	2 658.1
Other income ^(c)	2 589.7	2 682.4	2 837.5	2 648.0
Total income from transactions	32 442.1	33 462.9	34 594.7	35 499.8
% change	3.98%	3.15%	3.38%	2.62%
Expenses from transactions				
Employee benefits	12 019.5	12 297.0	12 648.5	12 902.6
Superannuation	1 710.4	1 760.7	1 784.2	1 816.7
Depreciation and amortisation	1 322.1	1 403.1	1 464.0	1 543.5
Finance costs	428.0	454.1	550.0	617.6
Grants and transfer payments	6 207.2	6 071.5	5 944.3	5 946.4
Supplies and services	10 437.7	11 170.6	11 871.9	12 360.8
Other expenses	0.5	0.5	0.5	0.5
Total expenses from transactions	32 125.3	33 157.5	34 263.4	35 188.0
% change	4.47%	3.21%	3.34%	2.70%
Net result from transactions	316.8	305.4	331.3	311.9

Source: Department of Treasury and Finance

Notes:

- (a) This is an abbreviated operating statement. The full statement is shown in Budget Paper No. 4, Chapter 1, Estimated Financial Statements and Notes, and provides additional information on economic flow remeasurements which, when added to the net result from transactions, yields the net result.
- (b) Comprises dividends, income tax and rate equivalent revenue and interest.
- (c) Comprises regulatory fees and fines, fair value of assets received free of charge, capital asset charge and other miscellaneous income.

The 2006-07 Budget builds on previous budgets to deliver improved service delivery to all Victorians and to realise the Government's long-term vision as set out in *Growing Victoria Together*. This includes funding for a number of major policy statements including:

- *Moving Forward: Making Provincial Victoria the Best Place to Live, Work and Invest;*
- *Maintaining the Advantage: Skilled Victorians;*
- *Healthy Futures: Delivering better health, research and jobs for Victorians;* and
- *Meeting Our Transport Challenges.*

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

As shown in Table 3.2, in order to deliver the Government's policy objectives, the 2006-07 Budget provides funding to departments for new output initiatives of \$810 million in 2006-07, and an average of \$809 million each year from 2007-08 to 2009-10. This is an addition to net funding provided in the *2005-06 Budget Update* of \$168 million on average from 2006-07 to 2008-09.

Taking into account funding utilised from existing forward estimates contingencies and other efficiencies, the net budget impact of output initiatives included in the 2006-07 Budget is \$423 million in 2006-07, averaging \$495 million over the forward estimates period. In accordance with normal budgeting practice, contingencies are included in the forward estimates to ensure that there is sufficient capacity to fund increased service delivery demand resulting from population growth, and for specific projects, such as the *New Ticketing Solution*, where funding has not previously been announced for commercial-in-confidence reasons.

Table 3.2: 2006-07 Budget new output initiatives funding by department^(a)

	(\$ million)			
	2006-07 Budget	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
Education and Training	113.7	122.7	111.9	113.8
Human Services	244.1	258.8	256.1	259.9
Infrastructure	161.6	148.1	124.9	131.3
Innovation, Industry and Regional Development	36.8	62.4	57.4	46.7
Justice	72.7	59.2	52.8	45.4
Premier and Cabinet	23.4	28.8	16.6	14.9
Primary Industries	4.8	3.1	2.8	2.2
Sustainability and Environment	38.7	49.5	46.5	45.2
Treasury and Finance	9.0	12.6	12.6	12.7
Victorian Communities	23.0	33.3	24.4	18.5
Parliament	4.2	0.1	0.1	0.1
Government wide	77.6	90.7	85.4	76.8
Total 2006-07 Budget output funding	809.6	869.3	791.5	767.3
Less funding from demand contingency and other efficiencies	387.0	347.3	298.2	298.6
Net impact of 2006-07 Budget output funding	422.6	522.0	493.3	468.7
Add: 2005-06 Budget Update net output funding ^(b)	161.9	170.0	171.7	n.a.
Net budget impact of output funding since 2005-06 Budget	584.4	692.0	665.0	468.7

Source: Department of Treasury and Finance

Notes:

- (a) These numbers differ from Budget Paper No. 3, Appendix A, as amounts funded from internal reprioritisation or other existing sources have been deducted in the figures above.
- (b) 2005-06 Budget Update net output funding is net of funding from demand contingency and other efficiencies.

The 2006-07 Budget also provides funding for new asset investment projects with a total estimated investment (TEI) of \$3.6 billion. This is in addition to \$1.3 billion provided for infrastructure investment in the *2005-06 Budget Update*. Over the four years to 2009-10, infrastructure investment is projected to average \$3.2 billion each year. This historically high level of investment will result in the average stock of public infrastructure for each Victorian growing from \$8 764 in 2001 to \$9 740 by 2010.

This funding includes \$112 million TEI to deliver the Government's remaining *Labor's Financial Statement 2002* election commitments, which are listed in Budget Paper No. 3, Chapter 3, *Election Commitments: Implementation Report Card*.

Table 3.3: 2006-07 Budget new asset funding by department

	(\$ million)	
	2006-07 Budget	TEI ^(a)
Education and Training	217.3	448.0
Human Services	124.0	394.5
Infrastructure	219.3	2181.8
Innovation, Industry and Regional Development	5.0	35.0
Justice	42.2	102.3
Premier and Cabinet	1.0	5.5
Primary Industries	0.6	3.2
Sustainability and Environment	12.2	79.7
Treasury and Finance	19.2	8.3
Victorian Communities	54.6	147.9
Parliament	3.7	3.7
Government wide	22.0	162.8
Total 2006-07 Budget asset funding	721.0	3572.6
Add: 2005-06 Budget Update asset funding	219.3	1281.3
Asset funding since the 2005-06 Budget	940.3	4854.0

Source: Department of Treasury and Finance

Note:

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

Tax Initiatives

Table 3.4 provides a summary of tax relief initiatives included in the 2006-07 Budget. Reforms to payroll tax, land tax and conveyancing duty will reduce tax revenue by \$133 million in 2006-07, rising to \$227 million in 2009-10. This is in addition to tax relief announced in the *2005-06 Budget Update*.

Table 3.4: 2006-07 Budget tax initiatives^(a)

	(\$ million)			
	2006-07	2007-08	2008-09	2009-10
	Budget	Estimate	Estimate	Estimate
Conveyancing duty: pensioner concessions	-8.7	-8.2	-8.1	-8.5
Land tax package	-63.0	-41.0	-21.0	-42.0
Payroll tax cuts	-61.0	-128.0	-168.0	-176.0
Budget tax relief initiatives	-132.7	-177.2	-197.1	-226.5
Add: <i>2005-06 Budget Update</i> tax initiatives	-18.0	-15.8	-13.5	-12.2
Total tax relief initiatives	-150.7	-193.0	-210.6	-238.7

Source: Department of Treasury and Finance

Note:

(a) A negative figure indicates reduced revenue.

The 2006-07 Budget assists Victorian businesses to grow and keep competitive by further reducing the payroll tax rate from 5.25 per cent currently, to 5 per cent over three years. This brings total payroll tax cuts by the Government to 13 per cent and benefits over 20 000 businesses by \$533 million over the budget and forward estimates period.

The 2006-07 Budget marks a third stage in the reform of the Victorian land tax system. Previous budgets committed to significant reductions to the top land tax rate (from 5 per cent to 3 per cent), moderated the extreme progressiveness of the land tax scale through the middle rates, and increased the land tax tax-free threshold to \$200 000. This budget further reforms the land tax system by:

- reducing the 1 per cent, 1.5 per cent and 2.25 per cent rates to 0.8 per cent, 1.2 per cent and 1.8 per cent respectively;
- bringing forward the cut to the top rate to 3 per cent from 2008 to 2007;
- again capping land tax increases at 50 per cent in 2007 with respect to the same landholdings;
- eliminating the use of indexation factors, which are currently used to adjust land valuations across entire municipalities in non-valuation years; and
- enabling taxpayers to appeal their land valuation upon receipt of their land tax assessment in all years by bringing forward the use of land valuations.

Together these last two measures mean that land tax liabilities will generally remain unchanged every second year with respect to the same landholdings. In addition, land tax will now always be levied on the actual valuation of individual properties, improving the accuracy and credibility of land valuations and more accurately reflecting the current state of the property market.

Currently the use of valuations for the purposes of calculating land tax is lagged by two years. To enable taxpayers to appeal their land tax valuation upon receipt of their land tax assessment, it is necessary to bring forward the use of valuations by a year. Whilst this has the effect of drawing forward a small amount of revenue, this has been more than offset by the new land tax relief measures that have been announced.

Other taxation relief measures include increasing the thresholds for the pensioner and concession cardholder stamp duty concession and restoring the 'first homebuyer with families' stamp duty concession.

From 30 May 2006, a full stamp duty concession will be available to eligible pensioners or concession cardholders purchasing property valued up to \$300 000, with a partial concession available up to \$400 000. The 'first homebuyers with families' concession provides a full stamp duty concession in lieu of the First Home Bonus on property valued up to \$150 000, with a partial concession up to \$200 000.

This is in addition to the abolition of rental business duty from 1 January 2007 (at a cost of around \$65 million per year) announced in the 2005-06 Budget.

The taxation reform measures announced in the 2006-07 Budget will provide net tax relief to Victorian taxpayers of \$734 million over four years. Detailed information on these initiatives can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives* and Budget Paper No. 4, Chapter 3, *State Revenue*.

FISCAL OVERVIEW

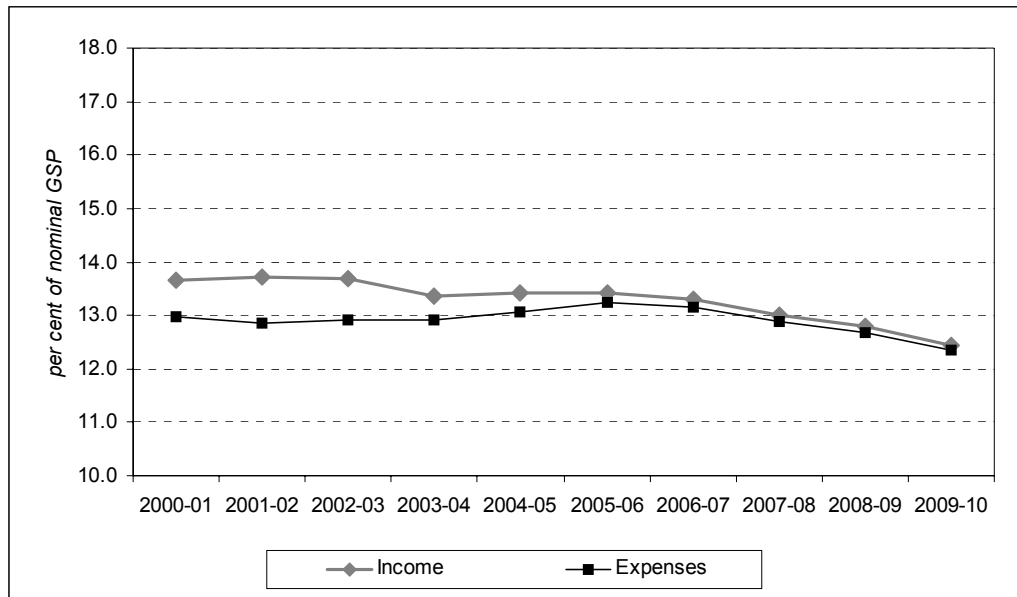
Chart 3.1 shows the ratio of operating expenses and income to nominal gross state product (GSP) from 2000-2001 to 2009-10.

As shown above in Table 3.1, nominal income and expenses are closely aligned over the budget and forward estimates period, with income from transactions projected to grow by a modest 3.4 per cent on average over the budget and forward estimates, and expenses anticipated to grow at an annual average of 3.6 per cent over the same period.

From 2006-07 to 2009-10, both expenses and income are projected to decline as a proportion of nominal GSP, thereby reducing the overall call of Government on the economy. This can be attributed to a number of factors including:

- the impact of tax cuts announced by the Government, including reductions to payroll tax rates and land tax;
- growth in payroll tax, property taxation revenue and gambling taxation revenue being lower than nominal GSP due to other factors such as the composition of wages across firm sizes, the level of activity in the housing market, and the effect of extended smoking bans;
- modest growth in non-GST grants income from the Commonwealth; and
- the rate of growth in expenses being largely driven by inflation and Government policy decisions, rather than broader economic activity.

Chart 3.1: Income and expenses relative to nominal GSP



Source: Department of Treasury and Finance

The following section contains further discussion of the major factors that influence income and expenses, including policy decisions, economic conditions, Commonwealth-State relations, and demographic change.

Further analysis of the impact of these factors on the 2006-07 Budget and forward estimates is also provided in Budget Paper No. 4, Appendix D, *Operating Statement Analysis*.

Policy decisions

The actions of Government significantly impact on Victoria's operating position through:

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

The impact of 2006-07 Budget policy decisions on the operating surplus has been outlined in Tables 3.2, 3.3 and 3.4.

Economic conditions

The 2006-07 Budget and forward estimates are prepared on the basis of economic projections outlined in Chapter 2, *Economic Conditions and Outlook*.

As shown in Chapter 6, *Statement of Risks*, the budget and forward estimates are sensitive to changes in economic projections. This is particularly true of revenue estimates. Recent history shows that revenue collections have significantly varied from estimates where unanticipated movements in economic projections occurred, for example, the housing boom contributing to higher than anticipated tax collections.

Since forward estimates were published in the *2005-06 Budget Update*, changes in economic parameters, combined with demographic changes, have resulted in increases in annual income from transactions of \$336 million on average for the period 2006-07 to 2008-09, primarily through their impact on taxation and investment income.

Operating expenses are influenced by movements in inflation, as under the departmental funding model, indexation funding is provided to departments to provide for wages growth and inflation in non-wage costs such as the purchases of supplies and services. From 2006-07 to 2009-10, departmental output funding has been indexed by 2.5 per cent in each year in line with projected increases in the consumer price index.

Commonwealth-State Financial Relations

Victoria will receive \$15.1 billion in Commonwealth grants in 2006-07, rising to \$17.0 billion in 2009-10. As this accounts for approximately 46 per cent of Victoria's income from transactions, grants from the Commonwealth Government have a significant impact on Victoria's budget position.

Since the introduction of the GST on 1 July 2000 and the associated removal thereafter of a number of State taxes, total grants from the Commonwealth have grown from less than 40 per cent of Victoria's revenue to an estimated 46 per cent in 2006-07, thereby reducing Victoria's control over its revenue sources. The Victorian Government's financial capacity to meet the community's demand for services is therefore increasingly reliant on receiving a fair distribution of the Commonwealth Government's revenue pool.

Approximately one third of Commonwealth grants to Victoria (excluding those for on passing) are in the form of specific purpose payments (SPPs) which are subject to various conditions. The Government believes that SPP agreements should be developed through negotiation with relevant States, as the State Government is in the best position to make policy decisions affecting its interests. Where SPP funding is determined unilaterally by the Commonwealth and subject to restrictive conditions, this reduces the ability of the Victorian Government to provide a flexible and appropriate policy response to the community's needs.

As shown in Budget Paper No. 4, Appendix D, *Operating Statement Analysis*, since the publication of the *2005-06 Budget Update*, variations in Commonwealth grants have resulted in increased annual income from transactions of \$326 million on average between 2006-07 and 2008-09, and increased expenses from transactions of \$36 million on average over the same period. The reason that the increase in expenses is less than the revenue increase is because some Commonwealth grants are provided for capital, rather than operating purposes, and the associated expenditure by Victoria is therefore recorded in the cash flow statement and balance sheet but not the operating statement.

Demographic Change

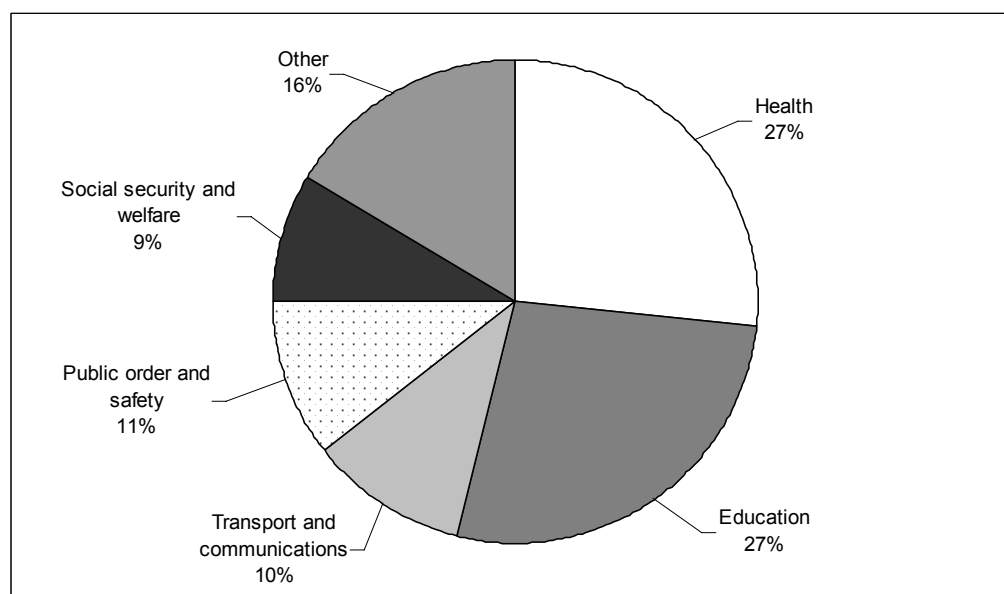
Demographic factors such as an increasing number of Victorian residents and ageing of the population will place increasing pressure on Government expenditure. The economic implications of an ageing population also impact on the economic forecasts.

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

SERVICE DELIVERY

Chart 3.2 provides an overview of the allocation of expenses in 2006-07, which is presented on a functional (rather than departmental) basis. The chart demonstrates the significant priority the Government places on delivering high quality health, social security and welfare, and education services for the Victorian community, with these categories accounting for more than 60 per cent of total expenses.

Chart 3.2: Expenses by function 2006-07^(a)



Source: Department of Treasury and Finance

Note:

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

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

Education

Education remains the Government's number one priority, and accounts for more than a quarter of general government expenses in 2006-07. Education spending is projected to increase by an average of 2.8 per cent each year over the budget and forward estimates period. This will support progress toward the *Growing Victoria Together* objective of promoting high quality education and training for lifelong learning.

In addition to the \$161 million output funding over four years and \$80 million capital funding announced in March 2006 as part of *Maintaining the Advantage: Skilled Victorians*, the Government will provide output funding of \$620 million over the five years for education and training initiatives. These include the Program for Students with Special Needs, *School Start Bonus*, *Literacy Improvement Teams*, building leadership capacity in the education workforce, continuation of the Victorian Certificate of Applied Learning, and the Schools for Innovation and Excellence Program and a range of other output measures.

The 2006-07 Budget also provides \$368 million TEI for education and training infrastructure, including the construction of seven new schools and six replacement schools, 56 school modernisation projects, the *School Land Purchasing Program*, and a number of other initiatives to ensure that Victoria has world-class education and training infrastructure.

Health

Around one quarter of expenses are allocated to health spending, reflecting the high priority the Government places on ensuring that Victorians have access to high quality health services. Over the budget and forward estimates period, health expenses are projected to grow by 3.6 per cent each year.

The 2006-07 Budget has contributed to increased spending in this area by providing funding for a number of significant initiatives including Victoria's contribution of \$124 million over five years to a major Council of Australian Government (COAG) health reform package; \$508 million over four years for *Hospital Futures*; and \$116 million over four years for initiatives related to improving mental health services.

This will be supported by additional asset investment including \$1.1 billion for new and upgraded health care facilities; \$81 million for aged care facilities; and \$74 million for the purchase of new and replacement medical equipment.

Transport and communications

While transport and communication-related expenses appear relatively small, accounting for 10 per cent of expenses in 2006-07, it should be noted that the majority of transport infrastructure projects are delivered as part of the Government's asset investment program and hence are accounted for in the balance sheet (rather than as operating expenses) in the State's accounts.

In May 2006, the Government released *Meeting Our Transport Challenges* which injects \$10.5 billion over 10 years into the transport network. This includes \$477 million in output funding to be provided over the next four years, which accounts for part of the increase in transport and communications spending of 4.6 per cent on average over the budget and forward estimates period.

The Government's significant commitments in this area will foster a thriving economy by growing and linking all of Victoria.

Public order and safety

Around 11 per cent of expenses are allocated to public order and safety, in order to build safe communities consistent with the Government's *Growing Victoria Together* objectives. Expenses in this area will increase by 2.7 per cent each year from 2006-07 to 2009-10.

To further progress against this objective, the 2006-07 Budget commits a further \$389 million over four years and \$128 million TEI to strengthen the justice system. This provides funding for a number of initiatives including fighting counter-terrorism and organised crime; supporting the police and emergency services; and programs for offenders.

This funding also includes measures to further enhance road safety for Victorians. In addition, \$471 million capital funding and \$55 million over four years will be provided by the Transport Accident Commission to extend the Safer Roads Infrastructure Program, as part of *Meeting Our Transport Challenges*.

Social security and welfare

In the 2006-07 Budget, the Government has confirmed its commitment to addressing disadvantage by committing a further \$818 million to achieve its goals under *A Fairer Victoria*.

The increase in spending on social security and welfare of 3.5 per cent on average from 2006-07 to 2009-10 is partly attributable to a number of initiatives announced in the 2006-07 Budget via *A Fairer Victoria*. This includes: \$268 million over five years to improve the health and wellbeing of Victorian children and their families; \$53 million over four years to improve services for seniors; \$29 million over five years to address the issues of homelessness; \$42 million over four years to provide assessment planning and support for people with a disability and their families; and \$4.6 million over two years to assist energy consumers experiencing difficulties paying their energy bills.

Other

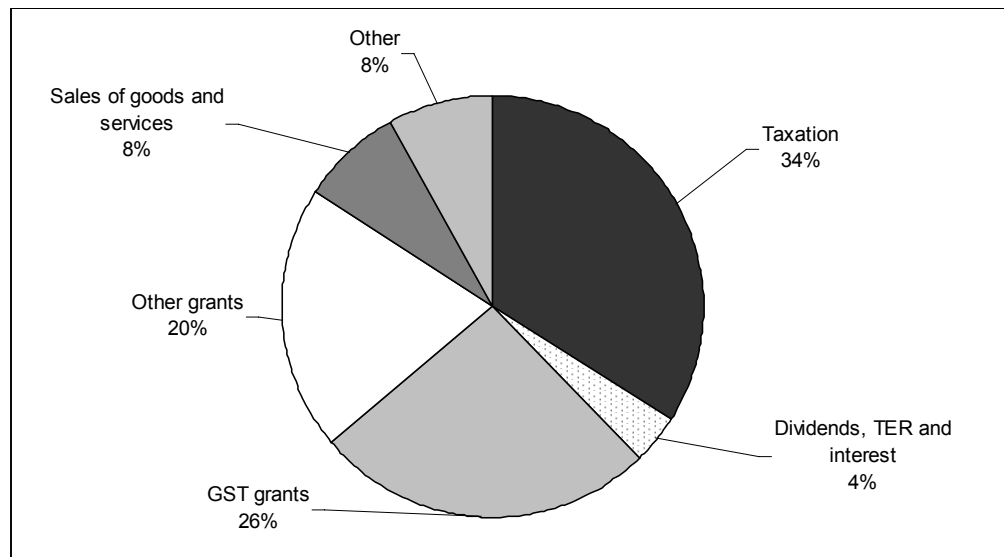
Other expenses account for 16 per cent of total expenses in 2006-07. This includes spending on:

- protecting the environment for future generations and supporting the efficient use of natural resources. The Government will provide additional funding for a number of initiatives including establishing three new metropolitan parks and new visitor facilities at a fourth metropolitan park (\$13 million TEI); fire prevention, management and recovery (\$37 million over five years); and preserving our water resources (\$110 million TEI and \$50 million output funding over five years). This is in addition to funding announced in *Moving Forward*, part of which focused on environmental and land management practices;
- encouraging participation in community, cultural and recreational organisations. The Government will provide \$75 million over five years to the arts and cultural sectors for initiatives including the transformation of the State Library of Victoria's service model; modernising the Arts Centre; grants to the small arts sector, grants to arts, cultural and community festivals and celebrations; and funding for the television and digital media industries. The Government will also contribute \$143 million for the construction of a new rectangular sports stadium; \$22 million over three years for grass roots sporting development; and \$19 million over two years for the racing industry;
- building a strong and innovative economy. The Government will provide funding in this area for a number of initiatives including \$24 million over four years for a package of small business programs; \$73 million over four years for initiatives to promote tourism, major events and business conference attraction; \$22 million over five years to facilitate investment and exports; and \$42 million over four years to further cut red tape and reduce the burden of regulation on business and non-government organisations.

SOURCES OF REVENUE

Chart 3.3 shows the relative importance of various revenue sources for the Victorian general government sector.

Chart 3.3: Revenue 2006-07



Source: Department of Treasury and Finance

The largest single source of revenue is grants from the Commonwealth, accounting for 46 per cent of income from transactions in 2006-07. It is anticipated that grants will increase by 4.6 per cent on average from 2006-07 to 2009-10. This reflects a combination of factors including:

- an increase in GST grants of 6.7 per cent over this period as a result of both an increase in the national GST pool and an anticipated increase in Victoria's share;
- growth in specific purpose grants for on-passing of 2.8 per cent on average, largely for non-government schools and local government;
- growth in specific purpose operating and capital grants of 2.7 per cent on average over the budget and forward estimates, with increased grants for education, health and roads being partially offset by the loss of non-recurring grants for the *Melbourne 2006 Commonwealth Games*, borrowing cost compensation and drought relief; and
- the abolition of National Competition Policy grants from 2006-07 onwards, at an annual cost to Victoria of \$200 million.

Taxation provides around 34 per cent of income. Growth in taxation income is expected to average 3.1 per cent over the budget and forward estimates period.

Victoria's taxation income is largely drawn from the following sources:

- Payroll tax, with growth averaging 3.2 per cent over the budget and forward estimates, reflecting solid employment and wages growth over this period. This growth has been offset by the reduction in the payroll tax rate announced in the 2006-07 Budget.
- Land transfer duty, with collections projected to increase by 2.6 per cent on average over the next four years, largely as a result of forecast growth in house prices, and an increase in transaction volumes.
- Revenue from gambling taxes, which will increase broadly in line with growth in household final consumption expenditure, with revenue growth in 2007-08 and 2008-09 adversely affected by the introduction of the complete smoking ban within enclosed licensed premises from 1 July 2007.
- Land tax. Taking into account continuing reform to the land tax system announced as part of the 2006-07 Budget, land tax collections will decline by 3.1 per cent from 2005-06 to 2006-07, and then increase by 1.2 per cent on average over the remainder of the forward estimates period.

Together, grants and taxation income account for 80 per cent of Victoria's revenue. The remainder is made up of sales of goods and services; dividends, income tax and rate equivalent revenue; interest; and other income. These sources of income are not anticipated to significantly increase between 2006-07 and 2009-10.

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

USE OF CASH RESOURCES

The operating surplus is an important funding source for the Government's substantial capital investment program. Table 3.5 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.

Around 60 per cent of the Government's net infrastructure investment program of \$3.2 billion on average over the four years to 2009-10 will be funded by the cash surplus from operating activities. The remainder of the infrastructure program will be funded by a moderate increase in net debt.

Projected infrastructure spending from 2007-08 includes an unallocated capital provision that will be allocated to specific projects in future budgets. This allocation is in accordance with previous budget practice to ensure realistic forward projections of asset investment consistent with the Government's desire to ensure that an appropriate asset base exists to support ongoing service delivery.

The Government has also allocated \$5.9 billion to the *Meeting Our Transport Challenges Reserve* to fund a range of transport infrastructure projects over the next ten years as part of the Government's recent *Meeting Our Transport Challenges Statement*.

Over the budget and forward estimates period, general government net debt is projected to rise by \$1.3 billion a year on average. As a percentage of gross state product, net debt will remain low at 2.5 per cent as at June 2010, compared with 3.3 per cent in 1999 and 16.3 per cent in 1995.

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

Table 3.5: Application of cash resources^(a)

	(\$ million)				
	2005-06 Revised	2006-07 Budget	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
Net result from transactions	449.5	316.8	305.4	331.3	311.9
Add back: Non-cash income and expenses (net) ^(b)	1 894.6	2 059.1	1 479.6	1 338.5	1 631.7
Net cash flow from operating activities	2 344.1	2 375.9	1 785.0	1 669.8	1 943.5
Less:					
Net investment in fixed assets					
Expenditure on approved projects	2 892.6	3 292.6	3 305.0	2 401.8	1 572.0
Unallocated provision for future allocation	..	0.0	263.0	615.0	1 332.0
<i>Meeting Our Transport Challenges Reserve</i> to be allocated in future ^(c)	..	20.0	65.6	114.8	199.7
Proceeds from asset sales	(148.4)	(130.8)	(205.8)	(116.2)	(96.6)
Total net investment in fixed assets	2 744.2	3 181.8	3 427.8	3 015.4	3 007.1
Finance leases	615.1	..	..	222.0	..
Other investment activities (net)	(520.9)	15.4	(2.8)	17.6	17.9
Decrease/(increase) in net debt	(494.2)	(821.3)	(1 640.0)	(1 585.1)	(1 081.5)

Source: Department of Treasury and Finance

Notes:

- (a) Proceeds from the sale of Victoria's share in Snowy Hydro Limited are not included in the above table.
- (b) Includes depreciation and non-cash movements in liabilities such as unfunded superannuation and employee benefits.
- (c) Further information on the *Meeting Our Transport Challenges Reserve* can be found in Budget Paper No. 4, Appendix B.

CHAPTER 4 – BALANCE SHEET MANAGEMENT AND OUTLOOK

- The Government is using its strong balance sheet to finance a larger infrastructure program than anticipated in May 2005, with modest and sustainable levels of net financial liabilities.
- With infrastructure investment over the four years from 2006-07 now set to be in excess of \$12 billion, the real capital stock is expected to grow by 11.0 per cent, more than double the expected rate of population growth.
- Over 60 per cent of this investment program will be financed by cash operating surpluses. For the remainder, the Government will use the strength of its balance sheet to finance public investment projects which have a long-term pay off. Accordingly, general government net debt is projected to increase from \$2.0 billion at June 2006 to \$7.1 billion at June 2010.
- Net debt will remain at low levels by historical and international standards, and is consistent with prudent financial management that maintains the State's triple-A credit rating. Projected general government net debt of \$7.1 billion or 2.5 per cent of GSP at June 2010 is still low compared to 3.1 per cent of GSP in 1999 and 15.9 per cent in 1995.
- The burden of servicing the State's largest liability, unfunded superannuation, will ease over the next four years and thereby offset the rise in the debt servicing burden.
- The ratio of net financial liabilities to GSP is expected to increase modestly from 6.2 per cent in 2006 to 7.1 per cent in 2010. This ratio will remain below the 8.5 per cent projected for 2009 in last year's budget and well below the 10.6 per cent recorded in 1999 despite the impact of A-IFRS which resulted in an increase in net financial liabilities to GSP of 2.2 percentage points. Importantly, the proportion of budget revenue absorbed by superannuation and interest expense is projected to remain fairly steady at just below 7 per cent over the next four years.

- With a projected \$2.2 billion of net infrastructure spending in 2006-07, the water, port, rail and other public non-financial corporations are also investing to upgrade and provide additional infrastructure to ensure public services are maintained at an appropriate standard. Infrastructure investments in the public non-financial corporation sector is funded from a range of sources including operating revenue, debt and general government contributions.
- The Government continues to improve governance frameworks and investment processes to ensure accountability for managing the State's assets and liabilities and to achieve value for money in the delivery of services to all Victorians.

BALANCE SHEET

A strong balance sheet provides the basis for the State to continue to support the infrastructure investment needed for Victoria to grow and prosper. The Government has been able to achieve a sound balance sheet and continue to deliver record asset investment, due to past and projected operating surpluses.

The Government is committed to delivering world-class infrastructure to provide social, economic and environmental benefits across the State. Strategic investment in physical infrastructure directly supports state economic activity, laying the foundation for more quality jobs and innovative industries across Victoria. Investment in social infrastructure such as health and education promotes more productive human resources and assists in addressing social disadvantage.

Reflecting the Government's commitment, the State's capital stock has grown strongly in recent years. This is expected to continue, with real per capita growth in the capital stock projected over the forward estimates period.

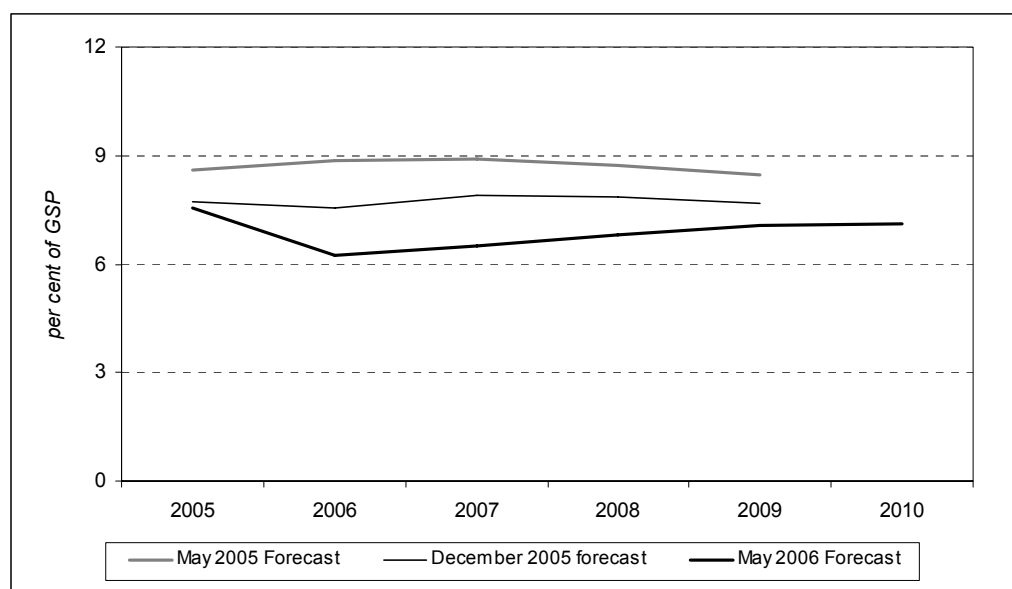
The Government has maintained net financial liabilities at prudent levels, which is confirmed by the State's triple-A credit rating. Given the low level of financial liabilities both historically and by international standards, there is capacity to use the strength of the balance sheet to finance key public investment projects which will have long-term benefits for all Victorians. Reflecting this, net debt is projected to increase over the forward estimates period. However, as a proportion of gross state product (GSP), net debt is still projected to remain at historically low levels, as are total liabilities and net financial liabilities.

As shown in Table 4.1, general government total liabilities as a proportion of GSP declined between June 1999 (AAS) and June 2006 (A-IFRS), and are expected to remain stable in the forward estimates period. Due to the low level of financial liabilities, the proportion of general government revenue directed towards servicing liabilities, and therefore not available for service provision, are significantly below 1999 levels and are expected to remain below across the forward estimates period.

Since the last budget in May 2005 the balance sheet position has improved considerably. Net financial liabilities as at 30 June 2006 are now projected to be \$14.5 billion (6.2 per cent of GSP), compared with a May 2005 forecast of \$20.3 billion (8.8 per cent of GSP). This \$5.8 billion improvement reflects: increased earnings on superannuation fund assets reflecting strong investment markets; an increase in the longest dated Commonwealth bond rate used to discount the State's superannuation liabilities and additional payments to the State Superannuation Fund over and above the payments required under the funding framework to achieve full funding by 2035; and a return of surplus capital from TAC.

As a consequence, a stronger infrastructure program than anticipated in May 2005 has been able to be financed with lower net financial liabilities than projected in the 2005-06 Budget. This is depicted in chart 4.1 which shows net financial liabilities of 7.1 per cent of GSP at the end of the forward estimates in 2010, down on the 8.5 per cent forecast in the 2005-06 Budget for 2009, largely reflecting the strong investment market performance.

Chart 4.1: General government net financial liabilities



Source: Department of Treasury and Finance

The remainder of this chapter further examines the general government balance sheet, as well as the contribution of public non-financial corporations in enhancing the State's balance sheet.

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

	1999 Actual AAS	2005 Actual A-IFRS	2006 Revised A-IFRS	2007 Budget A-IFRS	2008 Estimate A-IFRS	2009 Estimate A-IFRS	2010 Estimate A-IFRS
FINANCIAL POSITION							
			(\$ billion)				
Assets							
Physical assets ^(a)	32.2	52.5	56.5	60.2	64.6	69.6	74.6
Financial assets ^(b)	2.0	4.4	4.5	4.0	3.9	3.6	3.4
Receivables, etc ^(c)	1.6	3.0	3.1	3.0	3.1	3.2	3.2
Total assets	35.7	59.9	64.2	67.2	71.5	76.4	81.2
Liabilities							
Superannuation	11.4	15.3	12.5	13.1	13.1	13.1	13.1
Borrowings	7.1	5.6	6.1	6.4	7.9	9.3	10.1
Other liabilities	3.6	7.9	7.6	7.7	7.9	8.0	8.1
Total liabilities	22.2	28.8	26.2	27.2	28.9	30.4	31.4
Net assets	13.5	31.2	37.9	40.0	42.6	46.0	49.8
KEY RATIOS ACCOUNTING							
			(per cent)				
Growth in non-current physical assets	4.2	19.0	7.7	6.6	7.2	7.7	7.2
Total liabilities to GSP	14.7	13.0	11.3	11.1	11.2	11.2	11.0
Superannuation expenses and financing costs to total revenue ^(d)	9.7	6.8	7.1	6.6	6.6	6.7	6.9
KEY RATIOS - GFS							
			(per cent)				
Net debt to GSP	3.1	0.7	0.9	1.1	1.7	2.2	2.5
Net financial liabilities to GSP	10.6	7.6	6.2	6.5	6.8	7.1	7.1

Source: Department of Treasury and Finance

Notes:

- (a) Physical assets include land and buildings, plant and equipment, roads and earthworks, cultural collections and other non-current assets.
- (b) Financial assets include cash assets, investments, loans and placements.
- (c) Receivables etc. include receivables, prepayments and inventories.
- (d) For data on an A-IFRS basis, only expenses from transactions are included.

TOTAL ASSETS

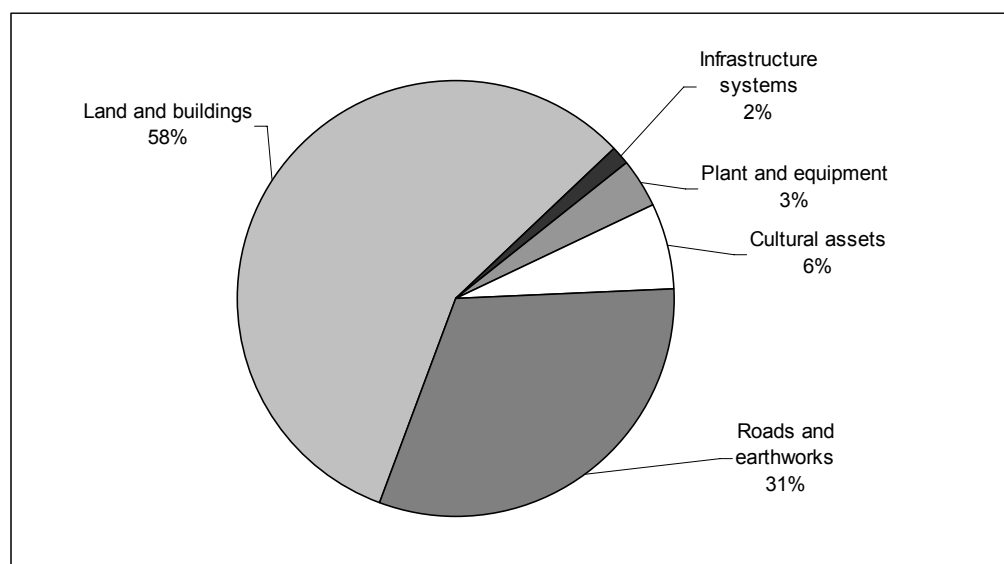
Growth in general government total assets is expected to average 6.1 per cent a year between June 2006 and June 2010, due to the Government's strong commitment to infrastructure and the impact of normal asset revaluations.

General government capital stock

The most significant component of the general government sector's assets is physical assets, or the capital stock. Continued investment in the capital stock is required to provide the infrastructure to enable government services to be delivered to the community and to provide important economic infrastructure for private sector growth.

Chart 4.2 shows the main components of the general government's \$56.5 billion capital stock as at 30 June 2006. These are land and buildings (58 per cent of the total capital stock), roads and earthworks (31 per cent), cultural assets (6 per cent), plant and equipment (3 per cent) and infrastructure systems (2 per cent).

Chart 4.2: General government capital stock as at 30 June 2006

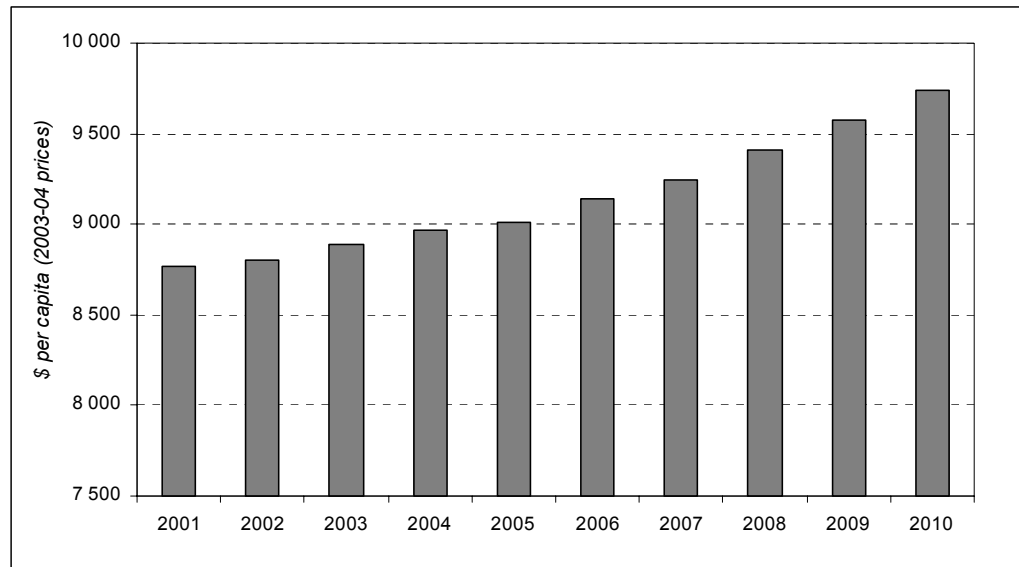


Source: Department of Treasury and Finance

Taking into account past and 2006-07 budget decisions, infrastructure investment is expected to average \$3.2 billion over the four years to 2009-10, well in excess of depreciation of around \$1.4 billion a year.

As a result, estimated growth in the real capital stock of 11.0 per cent – more than double the population growth. This is reflected in strong growth in real capital stock per capita (see Chart 4.3).

Chart 4.3: General government real capital stock per capita as at 30 June



Source: Department of Treasury and Finance

2006-07 Asset initiatives

The 2006-07 Budget includes new asset projects with a TEI of \$3.2 billion. The asset initiatives cover a range of areas including education, health and community services, community safety, the environment, and economic infrastructure such as road, rail and public transport linkages. Commitments to asset investment in social and environmental infrastructure include:

- \$448 million TEI to build better schools and TAFE colleges, and to enhance student outcomes. Other initiatives include the provision of computers in schools and the establishment of the Victorian Student Register, which will issue the Academic Number across accredited school education and training providers for all Victorians up to the age of 24 years;
- \$1.3 billion TEI to upgrade and replace health, aged care facilities and community services facilities across Victoria, including the rebuilding of the Royal Children's Hospital and a major upgrade of the Royal Melbourne Hospital emergency department; and
- \$147 million TEI to maintain Victoria's reputation as the sporting hub of Australia, including a \$143 million contribution to a new rectangular sports stadium.

The 2006-07 Budget also commits to investment in economic infrastructure that will grow the Victorian economy, including \$2.2 billion for Transport Infrastructure projects announced in the *Meeting our Transport Challenges* statement, ensuring Melbourne remains one of the most liveable cities in the world, and provincial Victoria continues to be a prosperous and attractive place to work and live. The Statement acknowledges the importance of the environment and puts in place plans for a sustainable transport system that provides Victorians with better access to their homes, work, and community.

Better asset management and delivery

In 2005, the Government approved the implementation of the Victorian Government Asset Management Framework for the general government sector. The framework will, over time, enhance strategic control by government of the State's asset base. It will provide a greater level of assurance that the State's physical assets are able to appropriately support government and community services.

This will be achieved by ensuring that:

- government is presented with departmental strategies and investment proposals that will support current service delivery priorities; and
- departmental systems identify, plan for and better deliver asset investment projects and adequately recognise the needs of the existing asset base.

A key objective of the Asset Management Framework is to ensure that vital government assets are appropriately managed over their useful life.

Gateway Initiative

The Victorian Government introduced the Gateway Initiative in August 2003 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.

The four elements of the Gateway Initiative are:

- assessment of departmental multi-year strategies: to improve decision making about departmental asset investment initiatives and their alignment to strategic plans;
- project life-cycle guidance material: assists departments and agencies to deliver projects. Guidance is provided to assist with the development of better business cases, allowing the right investments to be selected and project risks and delivery terms to be identified and addressed. Further guidance material is currently being completed to cover the remaining life cycle stages of project development from procurement strategy to the benefits evaluation stage;

- Gateway Review Process: independently reviews key projects at critical stages from initiation to completion to ensure achievement of milestones and the delivery of benefits; and
- Asset Investment Reporting: to give exception-based asset monitoring as an integral part of an overall risk management framework.

Partnerships Victoria

The *Partnerships Victoria* policy provides the framework for provision of public infrastructure and related ancillary services through public-private partnerships. The policy focuses on whole-of-life costing, full consideration of project risks and optimal risk allocation between the public and private sectors. Under *Partnerships Victoria*, the Government retains direct control over the core services (such as custodial services in prisons and judiciary functions) associated with the infrastructure.

Partnerships Victoria is most useful in major and complex capital projects with opportunities for innovation, risk transfer, appropriate third-party usage of facilities and the integration of design, construction, and maintenance over the life of an asset, within a single project package.

To date, 16 projects with a capital investment value of over \$4.5 billion have been contracted with private parties. Seven of these projects have reached commissioning and are now operational, and a further four projects are expected to reach commissioning in 2006. The following two projects with a combined capital investment value of over \$1.0 billion have been approved for delivery under *Partnerships Victoria*.

The new Royal Children's Hospital

The private sector proponent will be contracted to design, construct, finance and maintain the facility over the contract period. Core clinical services shall be retained by the State (Royal Children's Hospital). The *Partnerships Victoria* approach will encourage a focus on achieving the hospital's modern day service expectations and model of care in a purpose built facility to provide enhanced specialist paediatric health care services to the children of Victoria.

The Melbourne Wholesale Fruit and Vegetable Market

The market is to be relocated to a new site in Cooper Street, Epping in Melbourne's north. The project will involve the design, construction, finance and maintenance of the new market by the private sector. Given the large scale of the project, the commercial development possibilities and the opportunity for risk transfer to the private sector it is considered that *Partnerships Victoria* delivery will provide the State and the Melbourne Markets Authority (MMA) with the best value for money outcome. The MMA will remain responsible for the management of the new market.

Financial and other assets

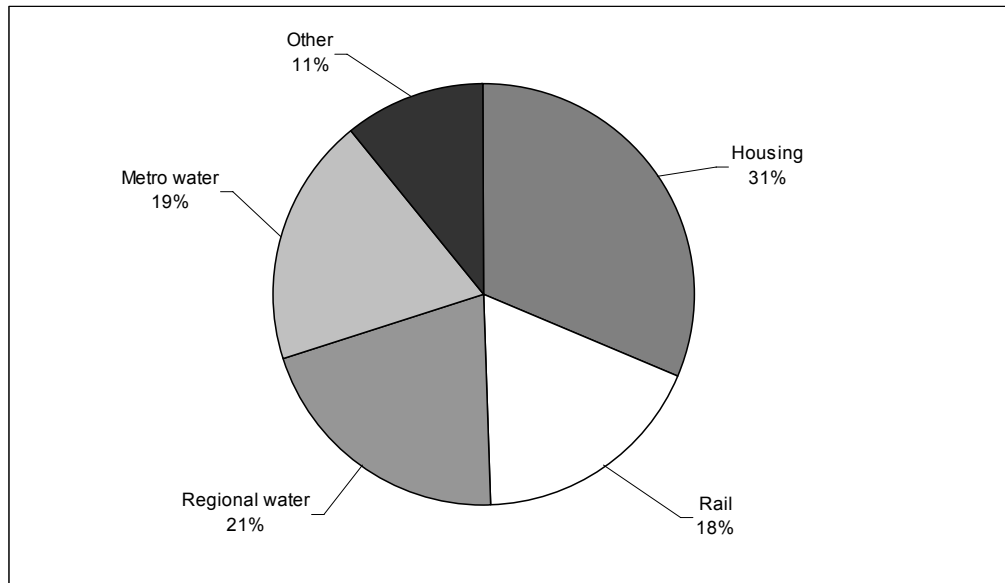
The general government sector also holds financial assets and other assets, including receivables, prepayments and inventories. Financial assets are expected to decline over the forward estimates period, as they are used to fund the Government's infrastructure program. As shown in Table 4.1, general government financial assets are expected to decline from \$4.6 billion in June 2006 to \$3.5 billion in June 2010.

Public non-financial corporations

A significant component of the State's capital stock is held by the public non-financial corporations sector. Victorian public non-financial corporations operate in a range of sectors, including ports, metropolitan, regional and rural water, urban development, public housing, public transport, culture and recreation, and the primary industry sector (see Chart 4.4). The sector is projected to hold land and fixed assets of \$39 billion at June 2006.

The 2006-07 Budget for the first time publishes forward year estimates of the public non-financial corporations sector. Previously estimates for the sector were not provided for the periods beyond the current Budget year. Publishing forward estimates of this sector (on a Government Finance Statistics basis) improves fiscal transparency, assists in making interstate data comparisons, creates consistency with the general government sector and enhances the quality of data for the non-financial public sector (comprising the general government and public non-financial corporations sectors).

Chart 4.4: Public non-financial corporations sector capital stock as at 30 June 2006 ^(a)



Source: Department of Treasury and Finance

Note:

(a) Property, plant and equipment, and roads and earthworks.

While the sector is predominantly user funded, it also receives contributions from the general government sector where the Government sees broader public benefits above those accruing to the primary users of the sector's assets. Over the period 2006-07 to 2009-10, the general government sector will be making net contributions to other sectors of Government of \$2.6 billion, primarily for capital purposes in the public non financial corporations sector. In 2006-07, this includes:

- \$115 million to the Transport Ticketing Authority for procurement and management of the new ticketing solution for Victoria;
- \$297 million to Victorian Rail Track for the purchase of rail infrastructure assets, including Regional Fast Rail assets, upgrades to country train tracks and mandatory capital improvements to the rail networks undertaken by the public transport operators on behalf of the Government. Note that this excludes any *Meeting Our Transport Challenges* funding; and
- \$52 million to the Melbourne and Olympic Parks Trust for the construction of the new Rectangular Sports Stadium.

In addition, the public non-financial corporations sector can also finance asset investment through its own sources – through retained earnings and borrowings. In 2006-07, net purchases of non-financial assets by the sector are projected to be \$2.2 billion (GFS basis).

Infrastructure investment underway in the public non-financial corporations sector is quite diverse. The development of the Port's land side capacity and channel infrastructure are a key focus for the Port of Melbourne, and are in line with the long-term vision for the growth and development of the Port.

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

Rail infrastructure assets are continuing to grow with the purchase of new country passenger trains (V'Locity trains), new suburban passenger trains, the extension and development of telecommunications network assets, various asset management works associated with level crossings, pedestrian crossings and heritage assets. *Meeting our Transport Challenges* builds on this with funding for rail capacity improvements, new trams and trains, tram platform upgrades and a new high-tech train control centre. In support of *Melbourne 2030*, VicUrban is leading the delivery of *Revitalising Central Dandenong* (a Transit City initiative), which involves infrastructure development works over the next 15 to 20 years.

In the water sector, investment is being driven by a variety of factors including network growth, EPA regulation compliance, infrastructure renewal/upgrades, and by initiatives contained within the Government's White Paper on water reform *Our Water Our Future*. Works include the investment in recycled water technologies (water conservation), sewerage treatment plant upgrades, and irrigation supply system upgrades underpinning a prosperous irrigation industry.

Regional urban water authorities are also involved in a range of projects to improve service quality for customers in provincial Victoria. An example of a major project in the water sector is the Wimmera Mallee Pipeline Project (WMPP) which will supply stock and domestic water to a region that covers 10 per cent of the total land area of Victoria, from the Grampians to the Murray River. The WMPP is being jointly funded by the Victorian Government, the Commonwealth Government and the Grampians Wimmera Mallee Water Authority.

Other projects currently underway in the water sector include the remediation and redevelopment of the Dandenong Treatment Plant (Melbourne Water) and the Hallam Valley Main Sewer Extension Project (South East Water).

TOTAL LIABILITIES

The liabilities of the general government sector are projected to remain at prudent levels. The main liabilities are unfunded superannuation liabilities, gross debt and employee benefits. General government liabilities at June 2007 are projected to be \$27.2 billion.

Unfunded superannuation liability

Unfunded superannuation liability is the most significant liability on the State's balance sheet.

The State recognises a liability in respect of its defined benefit schemes based on the difference between the assets of these schemes and the present value of the underlying obligation to members. After falling by \$2.8 billion in 2005-06, largely due to strong equity returns on investments, the State's unfunded superannuation liability is projected to be \$13.1 billion as at 30 June 2007 up \$0.6 billion from 30 June 2006. This increase is due to the fact that over this period accrued liabilities are projected to grow faster than assets.

The decrease of \$2.8 billion in unfunded superannuation liabilities between 30 June 2005 and 30 June 2006 is primarily due to a favourable investment performance, an increase in the discount rate used in measuring the liability, and an additional contribution by the Government of \$400 million.

State Superannuation Fund

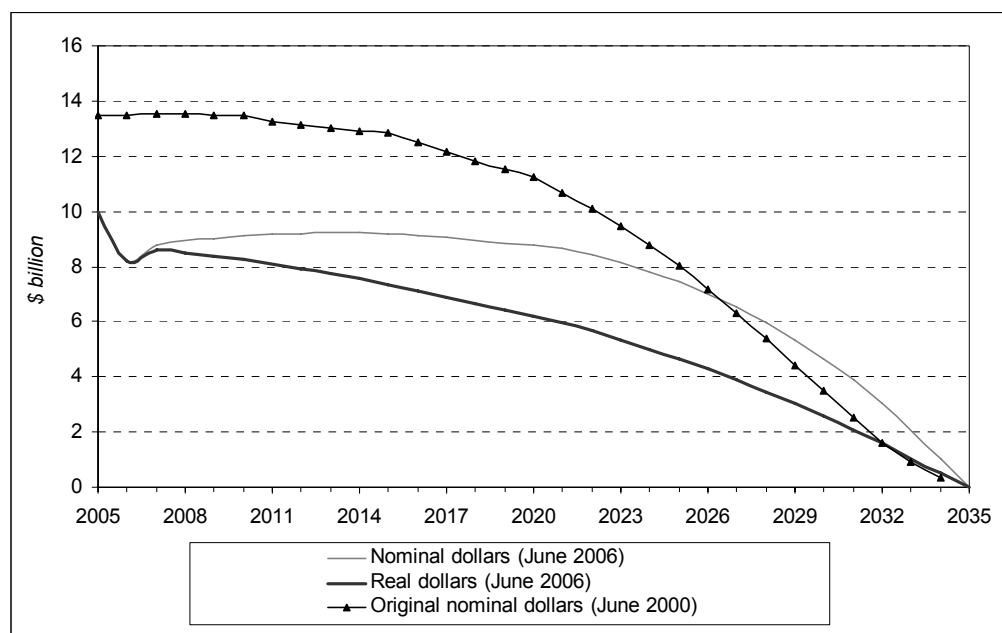
The State's unfunded superannuation liability was largely accrued prior to 1995 when previous governments funded the State Superannuation Fund (SSF) on a 'pay as you go' basis. In 2000, the Government adopted a funding framework aimed at fully funding these liabilities by 2035. This funding framework is based on actuarial advice and is reviewed annually.

The 2035 full-funding date ensures that the cost of funding the liability is spread over a reasonable period and does not fall entirely on the current generation of taxpayers. The elimination of the unfunded liability will result in increased budget flexibility in future years.

Under this framework, funding requirements are determined based on the expected long-term earning rate of the scheme's assets. The expected long-term earning rate typically differs from the discount rate that is required to be used to value the liability under the A-IFRS accounting standards (i.e. the longest-dated Commonwealth Government bond rate). However, the earning rate is considered appropriate for funding purposes as it reflects the best estimate of the earnings of the scheme over the long term. This enables the determination of a more meaningful estimate of the amount that Government actually needs to contribute to fully fund the superannuation liability.

Chart 4.5 below shows the expected profile of the unfunded liability of the SSF until 2035. For the purpose of preparing this chart, the liability has been determined using the ‘funding basis’ (i.e. the scheme’s assumed long-term earning rate is used as the discount rate). These figures cannot therefore be compared with the unfunded superannuation liability figures contained in the estimated financial statements which are prepared on an A-IFRS basis.

Chart 4.5: General government sector unfunded superannuation liability of the Emergency Services Superannuation Scheme (State Superannuation Fund section) – long-term projections ^(a)



Source: Department of Treasury and Finance

Note:

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

Under the 2035 full-funding framework, provision is made in the budget for payments to the SSF from the Consolidated Fund which are in addition to the regular payments made by departments and agencies to meet the accruing cost of benefits.

The Government's sound financial management over the past five years has allowed it to make payments to the SSF faster than originally planned in the budget provision which is based on the schedule originally set out by the actuary to fully fund the State's liability in that scheme by 2035. Between 2000-01 and 2004-05, the State made payments of \$4 675 million compared to \$3 185 million required under the original full-funding framework. At 30 June 2006, the Government will be around \$1 167 million ahead of the original payment schedule. Budgeted payments over the forward estimates period total \$1 637 million. Based on current projections, the State is on track to achieve full funding of the superannuation liability by the target date of 2035.

The SSF's unfunded superannuation liability is calculated on a 'funding basis' is now expected to peak, in nominal terms, at \$10.9 billion in 2013, before declining slowly to \$10.6 billion by 2018 and declining rapidly thereafter. The unfunded liability is expected to rise slowly in the short-term due to members' benefits accruing a little more rapidly than the SSF's assets. The unfunded liability then declines as government contributions and investment earnings outweigh accrued liability growth. In real terms, the peak is reached in 2007.

Managing the unfunded superannuation liability

The Government continues to actively manage its superannuation liability and to explore opportunities to reduce this liability. An example of this is the integration of the Emergency Services Superannuation Scheme with the State Superannuation Fund from 1 December 2005. This change is expected to reduce total fund administration costs and deliver taxation and investment management efficiencies.

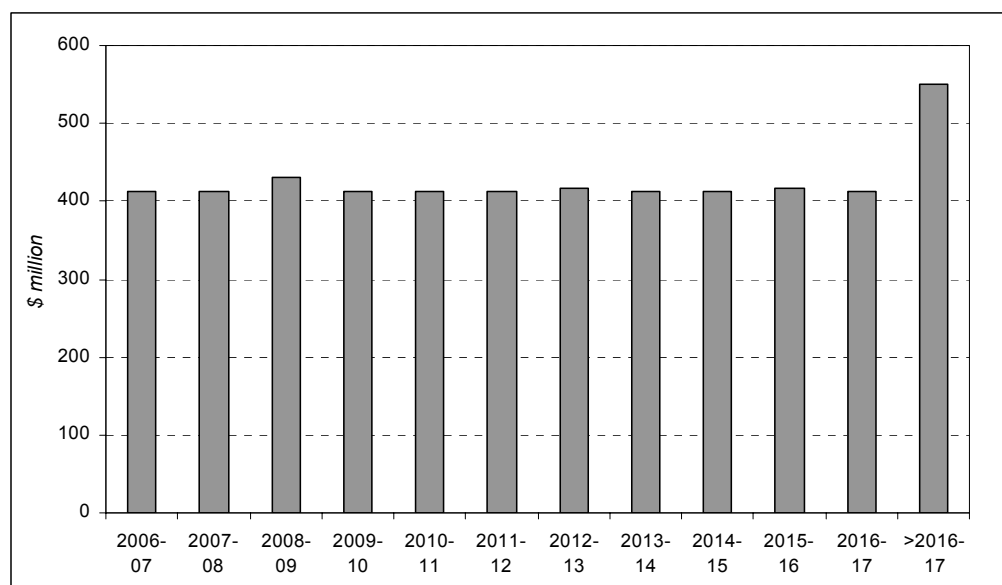
Gross debt

General government gross debt is expected to increase over the forward estimates period, from \$6.6 billion at June 2006 to \$10.6 billion at June 2010. The Government will be utilising the strength of the balance sheet and budget position to support the Government's strong infrastructure program. It is worth noting that the bulk (over 60 per cent) of the infrastructure program is being funded by cash operating surpluses. The balance is funded from firstly running down surplus financial assets and then through increasing borrowings.

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

The debt portfolio primarily comprises a fixed rate borrowing facility from the Treasury Corporation of Victoria, with an evenly spread maturity profile (see Chart 4.6). This ensures that a relatively small proportion of the debt portfolio is subject to repricing and hence uncertainty in any one period.

Chart 4.6: Maturity profile of the core debt borrowings of the general government sector as at 31 March 2006



Source: Department of Treasury and Finance

Employee liabilities

Employee liabilities represent the third largest liability after the unfunded superannuation liability and gross debt, and are projected to increase from \$3.5 billion as at June 2006 to \$4.0 billion by June 2010, an average growth rate of 3.7 per cent a year.

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

FINANCIAL ANALYSIS

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

The rating agencies focus on both net debt and net financial liabilities of the general government sector and the non-financial public sector (NFPS) as measures of overall indebtedness. These measures are discussed in turn in the following sectors.

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.

Net debt is projected to be 0.9 per cent of GSP at June 2006, which is very low by historical and international standards. As noted previously, the Government is prudently making use of its strong financial capacity to fund key public investments. As a result, general government net debt will increase from \$2.0 billion at June 2006 to \$7.1 billion at June 2010.

Importantly, as a proportion of GSP, net debt will still remain at low levels, consistent with maintaining the State's triple-A rating. Projected net debt of 2.5 per cent of GSP at June 2010 remains low in comparison to 3.1 per cent at June 1999 and 15.9 per cent at June 1995. Similarly, as a proportion of revenue, net debt of 20.0 per cent at June 2010 is lower than 23.7 per cent at June 1999, and significantly lower than 121.3 per cent at June 1995.

On an international comparison basis, this level of debt is low. Victoria is in a select group of regional and local governments that have a triple-A rating. Standard & Poor's noted in March 2006 that of the 190 regional governments outside the United States rated by Standard & Poor's, only 15 per cent have a triple-A rating.

Net debt will increase by \$821 million in 2006-07, funding approximately a quarter of the Government's key infrastructure investment programs over the year. Of the increase in net debt, \$552 million relates to a run-down of financial assets accumulated from prior years' strong operating surpluses. The balance of \$269 million will be funded by additional borrowings.

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 also relevant.

Non-financial public sector net debt comprises general government sector net debt and public non-financial corporations sector net debt. Public non-financial corporations sector net debt is expected to increase from \$3.2 billion in June 2006 to \$5.1 billion in June 2010.

The increase in public non-financial corporations net debt is due to increased net debt across a range of entities, including \$1 billion in the metropolitan water authorities, \$0.5 billion in the regional and rural water authorities, and \$0.1 billion in the Director of Housing. The increased debt of these authorities is mainly associated with their capital expenditure programs that were discussed earlier in this chapter. In relation to metropolitan and regional water authorities, the Essential Services Commission will allow for the recovery of capital and debt servicing costs in their regulated price paths.

As these projects generate long-term positive benefits to the community, the use of debt finance is appropriate. Moreover, the State's low debt ratios can easily accommodate a modest increase in debt.

Table 4.2 and Chart 4.7 show that non-financial public sector net debt is projected to grow from \$5.2 billion (2.2 per cent of GSP) at June 2006 to \$12.2 billion (4.3 per cent of GSP) at June 2010. The increase of \$7.0 billion is attributable to the increase of \$5.1 billion in general government net debt (discussed above) and an estimated \$1.9 billion in public non-financial corporations net debt. The estimated ratio of non-financial public sector net debt to GSP at 4.3 per cent in 2010, compares to 4.0 per cent in 1999 and 19.0 per cent in 1995. Overall, the level of State net debt will remain low and the State is positioned very comfortably within the triple-A ratings criteria.

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

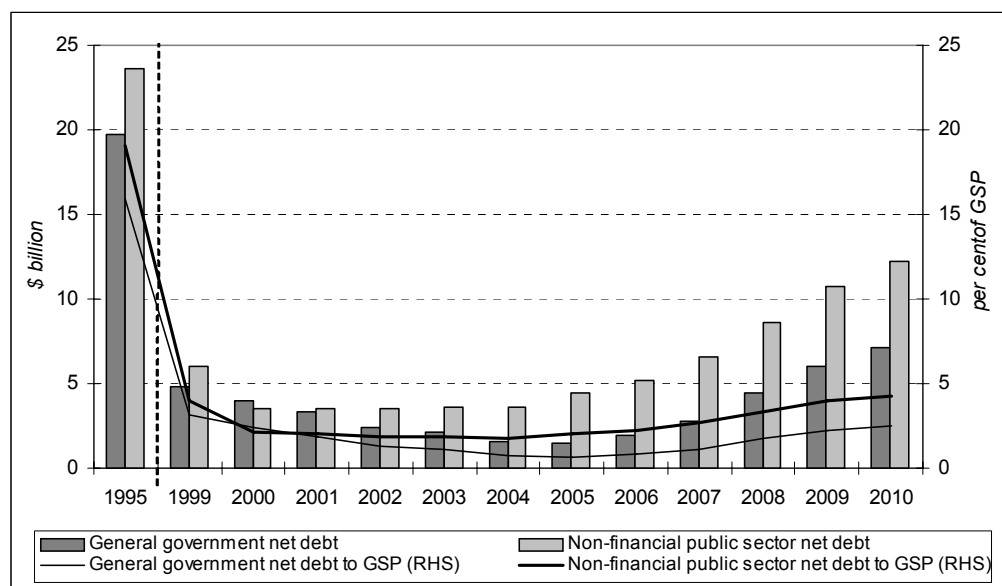
	1999 Actual AAS	2005 Actual A-IFRS	2006 Revised A-IFRS	2007 Budget A-IFRS	2008 Estimate A-IFRS	2009 Estimate A-IFRS	2010 Estimate A-IFRS
Financial assets				(\$billion)			
Cash and deposits	0.7	1.8	1.8	1.6	1.6	1.6	1.6
Advances paid	0.5	0.1	0.1	0.1	0.1	0.1	0.1
Investments, loans and placements	1.3	2.6	2.7	2.3	2.2	2.0	1.8
Total	2.5	4.5	4.6	4.0	4.0	3.7	3.5
Financial liabilities							
Deposits held	0.2	0.4	0.5	0.5	0.5	0.5	0.5
Advances received	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Borrowings	7.1	5.6	6.1	6.4	7.9	9.3	10.1
Total	7.4	6.0	6.6	6.9	8.4	9.8	10.6
General government net debt	4.8	1.5	2.0	2.8	4.4	6.0	7.1
Public non-financial corporations net debt	1.3	2.5	3.2	3.7	4.1	4.7	5.1
Total non-financial public sector net debt	6.1	4.0	5.2	6.6	8.6	10.7	12.2
General government unfunded superannuation	11.4	15.3	12.5	13.1	13.1	13.1	13.1
General government net financial liabilities	16.2	16.8	14.5	15.9	17.6	19.1	20.3
				(per cent)			
General government net debt to GSP	3.1	0.7	0.9	1.1	1.7	2.2	2.5
General government net financial liabilities to GSP	10.6	7.6	6.2	6.5	6.8	7.1	7.1
Non-financial public sector net debt to GSP	4.0	2.0	2.2	2.7	3.3	4.0	4.3

Source: Department of Treasury and Finance

Note:

(a) Non-financial public sector net debt is the sum of general government net debt plus public non-financial corporations net debt, less inter-sector transactions.

Chart 4.7: General government and non-financial public sector net debt as at 30 June



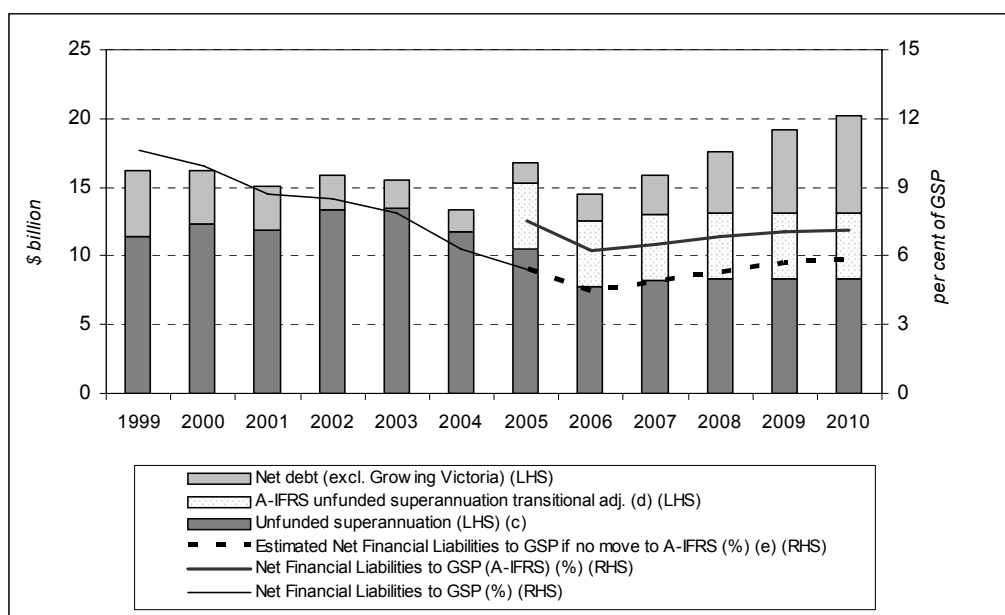
Source: Department of Treasury and Finance

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.

Chart 4.8 shows that, as a share of GSP, general government net financial liabilities is expected to increase modestly from 6.2 per cent in 2006 to 7.1 per cent in 2010, but remain below the 8.5 per cent projected for 2009 in last years budget and the 10.6 per cent recorded in 1999.

Chart 4.8: General government net financial liabilities as at 30 June^{(a)(b)}



Source: Department of Treasury and Finance

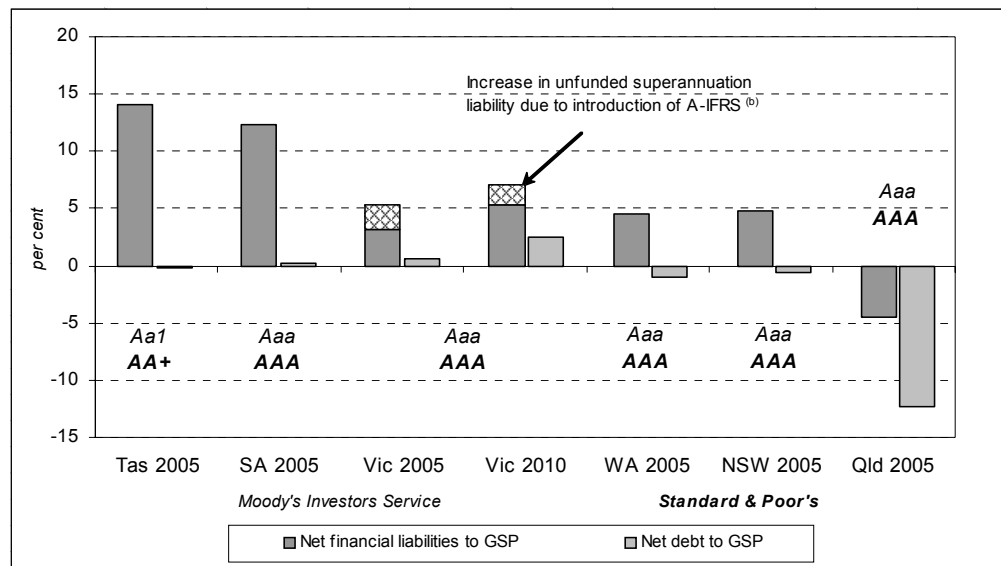
Notes:

- (a) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.
- (b) Net debt is calculated as gross debt less liquid financial assets. In the years applicable, Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.
- (c) Unfunded superannuation liabilities between 1999 and 2004 are calculated under the old Australian accounting standards, whereas between 2005 and 2010 the relevant A-IFRS standard has been applied.
- (d) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liabilities in 2004-05 has also been separately identified in the period 2005 to 2010.
- (e) The net financial liabilities to GSP (as calculated applying the old Australian accounting standard) between 2005 and 2010 are estimates, and should be used for illustrative purposes only.

Chart 4.9 shows that the ratio of Victoria's net financial liabilities to GSP (as reported by the Australian Bureau of Statistics) is in line with other triple-A rated states, such as New South Wales and Western Australia, once the impact of the introduction of A-IFRS is taken into account (as data on an A-IFRS basis is not available for other jurisdictions).

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 Relations*.

Chart 4.9: Comparison of general government net financial liabilities and net debt to GSP and Australian States' credit ratings^(a)



Source: *Financial reports of Australian States*

Notes:

- (a) Data for 2005 is based on AAS data.
- (b) As other jurisdictions have not reported on an A-IFRS basis, data on a comparable accounting basis between jurisdictions for both 2005 and 2010 is not available. To allow for meaningful comparison between the 2005 AAS and 2010 A-IFRS data for Victoria, the A-IFRS transitional adjustment applied to unfunded superannuation liabilities in 2004-05 and 2009-10 have been separately identified.

CHAPTER 5 – COMMONWEALTH-STATE FINANCIAL RELATIONS

- The Victorian Government is working to promote a constructive and cooperative dialogue between Commonwealth and State jurisdictions.
- Collaboration is clearly working. It has allowed the State and Commonwealth Governments to come together to initiate the development of the next wave of national economic reform.
- However, there are still some areas where major reform is lagging – the way GST revenue is distributed between the States and Territories being a case in point.
- Victoria and New South Wales collectively continue to shoulder an enormous subsidy burden. In 2006-07 a total of \$3.6 billion will be redistributed away from Victoria and New South Wales towards the rest of Australia.
- There is a growing view among business, opinion leaders and the general community that there needs to be fundamental reform of the national approach to the way GST revenue is shared. The aim should be to simplify, reduce uncertainty and remove the disincentives for States to pursue pro-growth policies, while still achieving the objectives of horizontal fiscal equalisation.

POTENTIAL GAINS FROM COOPERATIVE FEDERALISM

The federal system of government has major strengths when functioning effectively. It decentralises power, enables local decisions to be made at the local level and provides strong incentives for States and Territories (the States) to be innovative, efficient and competitive – much stronger incentives than would apply under a centralised, or unitary, system.

Australia's citizens quite rightly expect access to a wide range of high quality government services which serve the diverse needs of a dispersed population. The value to the community of the diversity and familiarity with local circumstances that a federal system provides is lost when one level of government acts alone. Continued improvements in these service delivery areas can best be achieved with the cooperation of all levels of government across Australia.

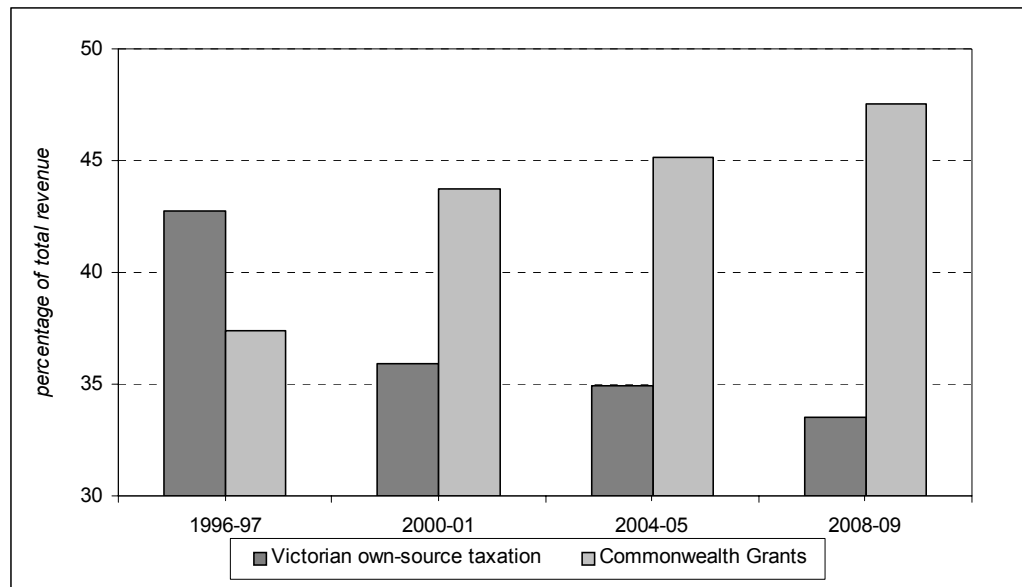
One area where working together has proved an important and necessary part of advancing national well-being is the reinvigoration of the national microeconomic reform agenda. While there is still much left to do to achieve outcomes in this area, State and Commonwealth Governments have come together and made substantial progress over the past 12 months. This reform agenda, and Victoria's contribution to it, is returned to in more detail later in this Chapter and in Chapter 7, *Productivity, Participation and the Reform Agenda*.

Another area where Victoria considers the cooperative model can drive sustainable and meaningful economic reform is the way GST revenues are distributed between the States.

While Victoria has led the States in achieving incremental reform in this area, fundamental change is required if the nation is to achieve a simpler, more certain and fairer outcome for all States that will benefit the nation as a whole.

The importance of such reform is reinforced by the fact that Victoria – like the other States – is increasingly reliant on the GST and other revenue from the Commonwealth. Since the striking down by the High Court of one-sixth of all state taxes in 1997, and the introduction of the GST on 1 July 2000, grants from the Commonwealth have grown from less than 40 per cent of Victoria's revenue to approximately 45 per cent in 2004-05 (see Chart 5.1). At the same time, Victoria is experiencing growth in demand for services such as health and education, much of it driven by an ageing population.

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



Source: Department of Treasury and Finance

HOW GST FUNDS ARE DISTRIBUTED

The States receive all GST revenue collected by the Commonwealth, with the distribution decided by the Commonwealth Treasurer each year based on advice from the Commonwealth Grants Commission (CGC).

Outcomes from the CGC's 2006 Update

The CGC attempts to comprehensively equalise the financial capacities of all States based on estimates of their revenue raising capacities and their costs of providing the full range of state services, expressed in terms of State relativities. The CGC updates its relativities annually to reflect movements in data, with a comprehensive methodology review every five years (most recently in 2004).

Based on the 2006-07 relativities, Victoria's GST grant share will increase by around \$220 million a year. Revisions by the Australian Bureau of Statistics to the data series on compensation for employees was the main driver of Victoria's increased GST grant share. Victoria gained \$146 million as a result of this correction. The overall GST gain is roughly offset by the loss of National Competition Policy (NCP) payments – worth about \$188 million in 2005-06 (see Table 5.1). The other major beneficiaries of the changes in relativities are New South Wales and the Northern Territory.

It is noteworthy that despite the recent development of a 'dual economy' in Australia, whereby the resource-rich States (Western Australia and Queensland) are growing much more strongly than the rest of the nation and benefit greatly from booming mining royalties (and are expected to continue to do so), these States have only suffered a minor deterioration in their GST grant shares. In fact, only a combined additional amount of \$52 million has been transferred away from these two States in 2006-07 as a result of the impact of rising commodity based revenues on CGC relativities.

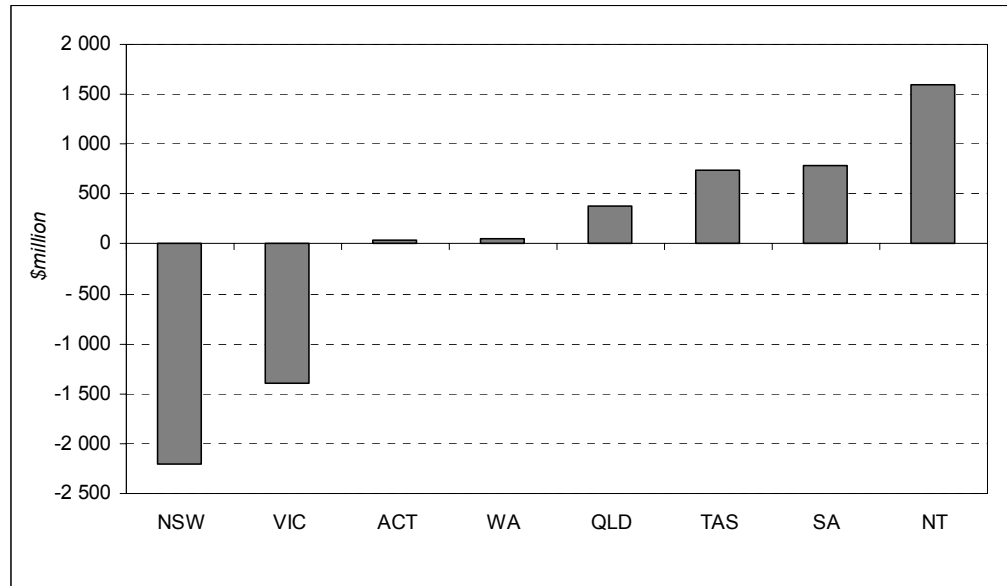
Given the widely held view that the strength of the Western Australia and Queensland economies is likely to be sustained in the medium term, the long delay in the flow through of this strength to GST relativities means that Western Australia and Queensland will continue to avoid bearing their fair share of the GST redistribution burden.

Lastly, the CGC had resolved in its 2004 Review to improve the quality of the data used in its land revenue assessment. However, it has now indicated that it will not be proceeding with this improvement in this or subsequent updates because it believes there are data comparability issues that can not be overcome. The inability to implement this decision will cost Victoria approximately \$60 million in 2006-07.

The burden of the subsidy

The extent of the GST redistribution burden can be assessed by comparing the GST raised within each State with the GST distributed to each State. On this basis, the shortfall for Victoria in 2006-07 is around \$1.4 billion (see Chart 5.2) or \$270 per capita, with Victoria receiving only 86 cents for every \$1 of GST it raises.

Chart 5.2: Fiscal subsidy for 2006-07 based on GST raised^(a)



Source: Department of Treasury and Finance

Note:

(a) Estimates are based on data from the Commonwealth Government 2006-07 Budget Paper 3 and the Australian Bureau of Statistics Catalogue No. 5206.0.

Victoria and New South Wales collectively continue to shoulder an enormous redistribution burden. In 2006-07 a total of \$3.6 billion will be redistributed away from Victoria and New South Wales towards the rest of Australia.

REFORM OF HOW GST REVENUE IS SHARED BETWEEN THE STATES

Victoria has long held the view that the current system of sharing GST revenue between the States is too complex, relies heavily on dubious data and methodologies that incorporate extensive CGC judgement, and creates a disincentive to broad national economic reform. Victoria has consistently taken the lead and will continue to do so in terms of pushing for significant reform of the way GST revenue is distributed between the States.

In 2002, Victoria helped commission an independent assessment of Commonwealth-State funding arrangements, undertaken by Professor Ross Garnaut and Dr Vince FitzGerald. The review concluded that the current system has deficiencies on key equalisation criteria (efficiency, equity, simplicity and transparency).

Following the conclusions by the CGC in its 2004 Review that it had 'serious concerns' about the data it used, that it was not clear that the level of detail used actually produced a better equalisation outcome, and that there were incentives towards increased complexity, Victoria gained support for a Treasuries' review of the current approach. While the terms of reference were very narrow (for example, they excluded the examination of the underlying principles of equalisation), they went some way towards reviewing key aspects of the system.

The review findings, considered at the meeting of Commonwealth and State Treasurers in March 2005, reinforced Victoria's views regarding shortcomings of the data used in the current system, the system's lack of transparency and the need to improve the robustness of CGC decisions. It concluded that the CGC's present approach could benefit from a program of simplification and it was agreed that the terms of reference of the next methodology review by the CGC (the 2010 Review) would explicitly examine various means of achieving simplification.

The CGC's 2010 Review

As part of its 2010 Review, the CGC is looking at various means by which the grants allocation methodology can be simplified and made more robust, including:

- aggregating existing assessment categories, components and factors, in whole or in part;
- eliminating category assessments found unreliable because of unsatisfactory data or methodology; and
- applying a materiality threshold to current and future assessments.

The CGC has also been directed to address issues relating to the quality and fitness for purpose of data, undertake a programme of continuous improvement of assessments, and review the scope for use of more general indicators of revenue capacity and expenditure need.

The CGC released a Progress Report in February 2006 which recognised many of the arguments put forward in Victoria's first submission to the 2010 Review. These include: that a top down approach to simplification is the most effective reform strategy; that simplification is not inconsistent with equalisation, and can in fact enhance the equalisation outcome; and that materiality thresholds need to be strictly defined and rigorously implemented.

The Progress Report is a welcome first step towards an improvement in the methodology. However, as evidenced by developments in the 2006 Update, further progress needs to occur in addressing issues relating to quality and fitness for purpose of the data used by the CGC. Such improvements can be made by implementing robust methodologies that utilise high level, quality data (as opposed to having a large number of very complex methodologies that push the limits of the available data) and by ensuring that data is from independent sources or subject to independent verification. Victoria will continue to actively participate in the collaborative approach that has been adopted for this CGC review.

Work in 2006 will centre on issues of aggregation in relation to categories, components and factors, with the CGC reporting to the 2007 Treasurers' Conference.

More substantial reform

There is a growing view among business, opinion leaders, and the general community that there needs to be fundamental reform of the national approach to horizontal fiscal equalisation.

The Victorian Government supports this view and believes the GST distribution can be done in a much simpler and much more stable way, without diluting incentives for reforms which grow the national economy.

The current system penalises States that undertake public policy reforms that promote a strong business climate and grow their revenue base and economies. This is because when a particular State's economy strengthens, that State is assessed as having increased revenue capacity and so needs less GST revenue. This is clearly a disincentive to pro-growth reform.

The Victorian Government supports the principle of equalisation and redistribution to those States with small economies, however, resource-rich States with substantial financial capacity, such as Queensland and Western Australia, should at a minimum be able to stand on their own, and potentially help those States in clear need of assistance.

Any reform model should be a simple and implementable approach that addresses the significant deficiencies of the current system, while retaining the core concept of horizontal fiscal equalisation based on the smaller States and Territories continuing to get the support they need from the larger and stronger States.

To achieve this, Victoria proposes that more substantial horizontal fiscal equalisation reform should be built around four pillars:

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

Victoria is keen to open a dialogue, with the Commonwealth as an active partner, to find a better and simpler way to distribute GST revenues in order to provide greater funding certainty and remove the disincentive for States to pursue economic reform.

REVIEW OF STATE TAXES UNDER THE INTERGOVERNMENTAL AGREEMENT

The IGA that introduced the GST specified that the States would abolish a number of state taxes and review the need for retaining a range of other state taxes by 2005.

The state taxes that were listed for review under the IGA by 2005 comprised duty on:

- non-quotable marketable securities;
- leases;
- mortgages, bonds, debentures and other loan securities;
- 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.

Victoria has been proactive in state tax reform as part of the IGA, having either removed or announced the removal of all but one of the taxes scheduled for review by 2005. Victoria has, as a consequence, secured the State's GST position going forward.

In 2005 the States and Territories, except for New South Wales and Western Australia, put forward timetables for abolishing their remaining IGA taxes subject to review. Subsequently, Western Australia and New South Wales put forward their own timetables for abolishing these taxes. The Commonwealth Government has accepted the proposed timetables for abolishing all but one of the IGA taxes subject to review. The exception is stamp duty on business conveyances where the States have proposed the abolition be confined to the goodwill component only. In response the Commonwealth has indicated a preference for the abolition of all business conveyancing duty (i.e. duty on both a business's goodwill and real property).

Victoria opposes the abolition of business conveyance duty on real property on both public policy and administrative grounds. The different stamp duty treatment of residential and business property raises serious equity questions as to why homebuyers should pay stamp duty when big business would not. It also creates significant administrative issues associated with the difficulty in classifying various property transactions and dealing with anti-avoidance activities.

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

Impact of grants on Victoria's financial position

GST grants

Untied grants (general purpose grants) under the IGA in 2006-07 and over the forward estimate years comprise GST grants only.

In previous years, untied grants also included NCP payments but these payments have been discontinued by the Commonwealth from 2006-07 (see the following section).

The IGA also provides for Budget Balancing Assistance to ensure that no State or Territory will be worse off as a result of the changed national taxation and grant arrangements which commenced in 2000-01. Victoria received such assistance up until 2003-04.

The removal of a range of state taxes following the introduction of the GST means there is now a greater reliance on grants revenue to meet Victoria's expenditure needs. The increasing reliance on GST revenue, whilst favourable in terms of longer-term revenue buoyancy, introduces a new source of volatility into Victoria's annual budget estimates.

Table 5.1: Summary of Commonwealth grants to Victoria

	(\$million)				
	2005-06	2006-07	2007-08	2008-09	2009-10
	Revised	Budget	Estimate	Estimate	Estimate
GST grants ^(a)	7 850.5	8 469.2	9 006.4	9 544.1	9 961.0
National Competition Payments	187.7	0.0	0.0	0.0	0.0
Specific purpose payments to the State (own-use)	4 332.3	4 501.4	4 699.7	4 685.3	4 800.8
Specific purpose payments for on-passing	1 796.1	1 876.6	1 935.4	1 996.6	1 996.6
Other	215.9	230.7	284.0	230.2	244.9
Total grants	14 382.5	15 077.9	15 925.5	16 456.1	17 003.3

Source: Department of Treasury and Finance

Note:

(a) GST revenue in the out-years differs from that published in the Commonwealth budget papers. GST grants are based on the Commonwealth budget forecast of the national GST pool. Victoria's share of future GST grants is obtained using the Commonwealth's population projections and forecasting the assessed relativities out to 2009-10 using a straight line projection of annual per capita relativities to its current five year average. In addition, an adjustment is made to the share to reflect anticipated movements in the assessed relativities as a result of the phased abolition of certain state duties over the forward estimates period.

Specific purpose payments

Specific purpose payments (SPPs) from the Commonwealth (including those for on-passing) comprise approximately 20 per cent of the Victorian Government's total revenue. SPPs form an important component of state funding for vital services such as health, education, housing, roads and community welfare. There are about 100 different SPPs, covering programs that vary considerably in size. Further information on the major SPPs is provided in Budget Paper No. 4, Chapter 3, *State Revenue*.

The States believe that there are opportunities in relation to SPPs for Commonwealth funding conditions to be made more flexible in order to provide greater scope for States to improve the efficiency and effectiveness of services and achieve better community outcomes. The States believe that SPP agreements should be designed to help ensure they achieve the best outcomes for the community with the funding available.

At its meeting in February 2006, the Council of Australian Governments (COAG) agreed that SPPs that significantly affect the health system should be reviewed prior to their renegotiation with the intention of identifying any elements that, if changed, could contribute to better health outcomes. The Australian Health Care Agreements (AHCAs), as the next major health SPP due for renegotiation, will be the focus of the first COAG review. The review will specifically seek to identify any elements in the AHCAs that may:

- inhibit the capacity of States and Territories to pursue policies that, within the given funding level, can contribute to better health outcomes; and/or
- inhibit States and Territories from refocussing expenditure from acute inpatient care to the promotion of wellness and management of diseases outside of hospitals.

COAG has also agreed that in light of the experiences gained as a result of reviews of health SPPs, consideration be given as to whether the design of major SPPs in other areas would benefit from a similar process before their renegotiation.

In 2006-07 it is estimated that own-use SPPs to Victoria will be about \$4.5 billion. Victoria's share of total SPPs from the Commonwealth to all of the States is about \$476 million less than the amount Victoria would receive if SPPs were distributed on an equal per capita basis. The Victorian Government does not believe that this is a fair distribution by the Commonwealth, and is in addition to the unfair distribution of GST revenue away from Victoria. Further, it is projected that own-use SPPs to Victoria will grow by an average of only 2.7 per cent a year over the forward estimates period.

National Competition Policy payments

The Victorian Government is a strong supporter of the NCP model, which offers the States a reward mechanism for their investment in economic reform, thereby producing national economic benefits. In recent years, NCP payments to Victoria have averaged around \$200 million a year and have played a critical role in encouraging the NCP reform program.

In 2005-06 Victoria will receive an estimated \$187.7 million in NCP payments. Victoria's NCP payment share was reduced by \$9.9 million as a result of an adverse recommendation from the National Water Commission (NWC) in relation to progress on water trading between New South Wales, South Australia and Victoria. The Victorian Government does not agree with this reduction.

While there has been some recent progress towards an agreement on the way forward in relation to water trading arrangements, the NWC has indicated that it is awaiting implementation of an agreement before considering amending its recommendation.

Despite the obvious value in linking NCP payments to reform progress to create incentives to continue economic reforms, the Commonwealth Government has made a unilateral decision to end the current NCP arrangements from 2006-07.

The Victorian Government is committed to an ongoing process of microeconomic reform, and considers that this can best be achieved in cooperation with the other States and the Commonwealth in a similar way to what occurred with the NCP arrangements. The Victorian Government has been actively pushing for a new wave of national economic reform, releasing a proposal document in August 2005 titled *A Third Wave of National Reform: A New National Reform Initiative for COAG*.

The *National Reform Initiative* culminated in the *National Reform Agenda*, agreed by all jurisdictions at COAG in February, with the emphasis on human capital, competition and regulatory reform. COAG agreed that the Commonwealth will provide funding to the States on a case by case basis once specific implementation plans have been developed. What has yet to be agreed, however, is the funding framework that will provide both the resources and incentives to deliver substantial, lasting, reform.

Because of the nature of our federal system, while States will derive some fiscal benefit, most of the benefits of reform accrue to the Commonwealth Government in the form of increased tax revenue or reduced expenditure. This, coupled with the fact that it is the States that will be required to bear most of the up-front investment costs, underpins the Victorian-led call, by the States, for a funding framework which has as its core principle, a fair sharing of the costs and benefits of reform. The *National Reform Agenda* and Victoria's contribution to it is returned to in more detail in Chapter 7, *Productivity, Participation and the Reform Agenda*.

CHAPTER 6 – STATEMENT OF RISKS

- The budget projections are sensitive to a number of upside and downside risks (both economic and fiscal) and contingent assets and liabilities.
- The main short- to medium-term risks to the Victorian economic projections, include potential movements in domestic and foreign interest rates, the crude oil price and the Australian dollar.
- 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, particularly relating to the public transport rail agreements.

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

ECONOMIC RISKS

The main short- to medium-term risks to the Victorian economic projections stem from potential movements in domestic and foreign interest rates, the crude oil price and the Australian dollar, as well as the risks from possible wage pressures, and disruption to strong world economic growth and specific events such as avian influenza.

The Reserve Bank recently responded to inflationary pressures by lifting interest rates by 25 basis points to 5.75 per cent in May 2006, the first rise in 14 months. The Bank has left its forecast for underlying inflation broadly unchanged at 2.75 per cent, but expects a temporary increase in headline CPI inflation above 3 per cent in the near term, before gradually declining to between 2.5 and 3 per cent. The Bank has already demonstrated it will respond if demand or inflation pressures prove stronger than expected. Possible upside risks to inflation include higher-than-expected oil prices, stronger labour demand (resulting in wage pressures) and any substantial depreciation in the Australian dollar. Financial markets expect a further modest increase in interest rates. Any larger adjustment would place pressure on the medium-term growth forecasts.

Oil prices have been increasing on the back of strong world demand and recent concerns about supply from Iran and Nigeria. Australian and global economic growth outcomes have been marked by their resilience to recent increases in oil prices. Compared with previous episodes of sharply rising oil prices, the advanced economies are now less oil dependent, and inflation expectations are better anchored under prevailing monetary regimes.

One of the possible reasons for moderate core inflation in Australia, has been the relative strength of the Australian dollar, which has resulted in lower import and oil prices (in Australian dollar terms). While the Australian dollar may continue to be supported by higher commodity prices, any significant depreciation could have inflationary impacts. However, a weakening in the Australian dollar would provide some support to the State's exporters.

Employment growth has slowed from 2004-05 to be more in line with output, but the Reserve Bank believes that the labour market remains tight. Anecdotal evidence suggests some Victorian businesses continue to suffer skills shortages. However, evidence of wage pressures is mixed. There have been significant wage rises in some States and industries: for example, wages in construction in Western Australia grew 8.7 per cent through 2005. Overall wage growth in Australia is currently around 4 per cent. Nevertheless there is a risk that the currently tight labour market could result in increased wage pressures which may precipitate a tightening of monetary policy.

A possible risk to world demand is concern about the size of the US budget and current account deficits, mirrored by significant surpluses in Asia and oil-producing countries. If US dollar-denominated assets become less attractive to investors, any resulting upward pressure on US interest rates could have negative implications for world growth. Similarly, if overcapacity in China's manufacturing sector leads to a slowdown in its industrial production, this could also adversely affect world demand.

Finally, there are risks from specific events of uncertain likelihood, including a possible avian influenza pandemic, which have the potential to cause considerable economic disruption globally and in Australia.

Sensitivity analysis

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

To assess sensitivity to change, the level of the economic variable in each case is permanently increased by one percentage point for one year, and then allowed to grow at the previously forecast rate. It is assumed during the analysis of each variable, that all other variables follow their forecast growth. As such, the analysis only captures the effect on the net result from transactions of changing one variable only, and does not attempt to capture the linkages with other variables in the economy.

Table 6.1: Impact on the general government net result from transactions of a one percentage point increase in selected economic indicators in 2006-07^{(a)(b)}

	(\$ million)			
	2006-07	2007-08	2008-09	2009-10
	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>
GSP				
Taxes, regulatory fees and fines	36	37	39	41
Other income ^(c)	106	119	132	142
Superannuation expenses	..	..	..	..
Other expenses	..	..	1	2
Net result from transactions	142	156	170	181
Superannuation - actuarial gains (losses)	..	..	..	..
Net result	142	156	170	181
Employment				
Taxes, regulatory fees and fines	34	35	36	38
Other income ^(c)	1	3	5	7
Superannuation expenses	..	..	..	..
Other expenses	..	..	..	..
Net result from transactions	35	38	41	45
Superannuation - actuarial gains (losses)	..	..	..	..
Net result	35	38	41	45
Consumer prices				
Taxes, regulatory fees and fines	46	47	49	51
Other income ^(c)	173	186	191	195
Superannuation expenses	..	6	7	7
Other expenses	41	195	199	204
Net result from transactions	178	32	34	35
Superannuation - actuarial gains (losses)	-118	..	..	..
Net result	60	32	34	35
Average weekly earnings ^(d)				
Taxes, regulatory fees and fines	34	35	36	38
Other income ^(c)	-13	-12	3	5
Superannuation expenses	..	14	14	15
Other expenses	..	..	..	..
Net result from transactions	21	9	25	28
Superannuation - actuarial gains (losses)	-163	..	..	..
Net result	-142	9	25	28

Table 6.1: Impact on the general government net result from transactions of a one percentage point increase in selected economic indicators in 2006-07^{(a)(b)} (continued)

	(\$ million)			
	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
Domestic share prices				
Taxes, regulatory fees and fines	..	..	..	..
Other income ^(c)	5	5	..	..
Superannuation expenses	..	-3	-4	-5
Other expenses	..	..	..	..
Net result from transactions	5	8	4	5
Superannuation - actuarial gains (losses)	59	..	..	..
Net result	64	8	4	5
Overseas share prices ^(f)				
Taxes, regulatory fees and fines	..	..	..	..
Other income ^(c)	4	4	..	..
Superannuation expenses	..	-3	-3	-4
Other expenses	..	..	..	..
Net result from transactions	4	7	3	4
Superannuation - actuarial gains (losses)	46	..	..	..
Net result	50	7	3	4
Property prices				
Taxes, regulatory fees and fines	34	34	51	52
Other income ^(c)	2	4	5	8
Superannuation expenses	..	-1	-1	-1
Other expenses	..	..	..	..
Net result from transactions	36	39	57	61
Superannuation - actuarial gains (losses)	11	..	..	..
Net result	47	39	57	61
Property transaction volumes				
Taxes, regulatory fees and fines	24	25	25	27
Other income ^(c)	2	3	4	5
Superannuation expenses	..	..	..	..
Other expenses	..	..	..	..
Net result from transactions	26	28	29	32
Superannuation - actuarial gains (losses)	..	..	..	..
Net result	26	28	29	32
Interest rates ^(e)				
Taxes, regulatory fees and fines	..	..	..	..
Other income ^(c)	77	80	41	42
Superannuation expenses	-6	5	16	28
Other expenses	1	5	9	13
Net result from transactions	82	70	16	1
Superannuation - actuarial gains (losses)	3178	..	..	..
Net result	3260	70	16	1

Source: Department of Treasury and Finance

Notes:

(a) A positive number for taxes, regulatory fees and fines, and other income 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 net result from transactions and net result). A positive

number for the net result from transactions and net result denotes an improvement. Numbers may not balance due to rounding.

- (b) An equivalent one percentage point decrease in each indicator would have an opposite impact to that shown.
- (c) Other income includes general and specific purpose grants, including grants for on-passing, as well as changes in dividends and income tax equivalent payments from public authorities. Dividends and income tax equivalent payments 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 a one percentage point increase across the entire term structure, i.e. short and long rates, over the entire forward estimates period.
- (f) The increase in the estimated impact of movements in overseas share prices on the net result and the net result from transactions, relative to that published in the 2005-06 Budget, reflects the correction of a spreadsheet error which had resulted in an underestimation of the value of overseas shares held by the state superannuation funds.

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

Sensitivity to economic growth

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

Sensitivity to employment

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

Sensitivity to prices

Increased consumer prices would lead to higher Commonwealth sourced revenue (due to indexation), as well as higher GST and taxation revenue as the value of tax bases rise in nominal terms. However, the higher revenue is partly offset by a higher cost of supplies and services, and some increases in outlays on grants and transfers. In accordance with the departmental funding model, while higher prices would have no impact in the budget year, they would flow through into increased output funding for departmental expenses in the forward years, and overall, there is a positive impact on the net result from transactions.

The increase in consumer prices would also result in an immediate actuarial-based increase in superannuation liabilities negatively impacting the net result. In subsequent years, the now higher superannuation liabilities result in a slightly higher superannuation expense which reduces the net result from transactions.

Sensitivity to wages

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

The increased wages would increase the value of superannuation fund lump-sum liabilities and result in a reduction in the net result for the budget year. The higher superannuation fund liabilities would flow through into an increase in the superannuation expense in the remaining out years. The overall impact would be to increase the net result from transactions and net result from 2007-08 onwards.

Sensitivity to domestic and overseas share prices

The State's public financial corporations (PFCs) and superannuation funds have holdings of domestic and international shares as part of their respective investment portfolios. Increased domestic and international share prices thus raise the profits of the PFCs and reduce the valuation of the unfunded superannuation liability.

The net result from transactions responds positively to increases in share prices as PFC dividends rise with profits, with later year positive impacts reflecting the impact of reduced valuation of unfunded superannuation liabilities on future superannuation expenses.

Sensitivity to property prices

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

Sensitivity to interest rates

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

The increase in interest rates reduces the valuation of long term liabilities of the PFCs and raises measured profits of these entities for distribution to the general government (GG) sector. The higher income would be fully distributed as dividends and income tax equivalents in the first two years. This is partly offset by lower water authority dividends due to higher borrowing costs, as well as an increase in the borrowing costs of the GG sector.

At the same time, the increase in interest rates reduces the valuation of superannuation fund liabilities. In terms of ongoing superannuation expenses, the impact of a reduction in the unfunded liability is slightly more than offset by an increase in the annual interest expense on the unfunded liability going forward – leading to an increase in annual superannuation expenses. Hence the rise in both the net result from transactions and the net result is minimal by the end of the forward estimates.

Sensitivity to property transaction volumes

An increase in property transaction volumes would increase conveyancing duty revenue leading to a rise in the net result from transactions and net result.

FISCAL RISKS

Expenditure risks

Following the introduction of the departmental funding model from 2004-05, departments now need to plan for, and manage, all costs associated with delivering services. There are, however, several general risks such as unforeseen changes in the size and structure of the Victorian population, which can affect the expenditure and revenue outlook. These risks can be classified into those affecting all government departments and those that are department specific.

The main risks to specific departmental expenditures relate to growth in demand for key services, and government responses to unforeseen events.

The 2006-07 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 consequent derived demand for government services;
- an allowance for depreciation expenditure that would be associated with new asset investments funded from the unallocated capital provision (subject to government approval); and
- other expenditure risks, including interest cost risks, which are unforeseen or not able to be quantified, or have not yet been formalised at the time of construction of the budget estimates.

In addition, the budget estimates include a contingency from 2007-08 that acknowledges funding for a number of existing initiatives which will conclude in 2006-07 or the following years. 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. The aggregate level of the operating contingency provisions contained within the budget estimates is shown in Note 10 of the Estimated Financial Statements (see Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*).

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. 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/or
- funding from the unallocated capital funding set aside in the forward estimates (subject to government approval).

The aggregate level of the unallocated capital contingency provisions contained within the budget estimates is shown in Note 18 of the Estimated Financial Statements (see Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*).

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

Insurance exposures

The availability and affordability of commercial insurance has improved during the past year, although difficulties remain for particular clients and risks, particularly professional indemnity insurance for some highly specialised professions. The State no longer provides cover for tourism ventures or heritage and tourist railways, which have reverted to commercial insurance.

Pressures on private sector medical indemnity premiums have also eased, but there is still a risk that increasing medical costs and lack of availability of private doctors in some regions may result in the State assuming larger numbers of high risk medical procedures. The possibility of such movement, together with the impact of claims that arise from 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. It does so either explicitly through indemnities provided to non-government bodies, or implicitly through transfer of activities from private sector to general government sector service providers. However, the State continues to bear directly the risks of losses arising from events for which VMIA does not provide insurance, such as terrorist attacks.

Revenue risks

Commonwealth grants

Commonwealth grants are a major source of revenue for the Victorian Government, with an estimated grants income of approximately \$15 billion in 2006-07. Commonwealth grants include general purpose grants (GST grants) and specific purpose payments (SPPs). Prior to 2006-07, general purpose grants also included National Competition Policy (NCP) payments. However, the Commonwealth Government will cease making NCP payments to the States and Territories from 2006-07 following its unilateral decision to end the NCP arrangements. NCP payments to Victoria had averaged around \$200 million a year.

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

The CGC provides updates of its GST revenue sharing relativities in February each year. These are then subject to the approval of the Commonwealth Treasurer at the annual Ministerial Council for Commonwealth-State Financial Relations.

The Commonwealth grants estimates in this budget (GST grants and SPPs) are based on data published in the Commonwealth's 2006-07 Budget, released on 9 May 2006. The GST estimates are based on the Commonwealth's latest forecasts for Australia-wide economic activity. Any changes to economic conditions over the forward estimates period will therefore have a direct impact on the amount of GST to be distributed among the States.

Lotteries licence

The Government is currently undertaking a licensing process for the next public lotteries licence(s) to apply from 2007 to 2017. An announcement in relation to the next public lotteries licence or licences will be made in mid-2006. While the budget estimates have been based on historical lotteries sales growth, no assumptions have been made concerning possible changes to future licensing structures.

Potential proceeds from asset sales

On 13 February 2006, the Government announced that Victoria would participate in the sale of Snowy Hydro Limited, along with NSW and the Commonwealth, in exchange for strengthened rights and protections of environmental flows for rivers and water for irrigation. Victoria currently holds a 29 per cent interest in Snowy Hydro Limited. The sale will be led by NSW (as the largest shareholder) in consultation with Victoria and the Commonwealth.

This asset is currently held by the State Electricity Commission of Victoria. Consistent with established budget practice regarding previous business asset sales, the published forward estimates of both the non financial corporations sector (Budget Paper No. 4, Chapter 6) and the general government sector (Budget Paper No. 4 Chapter 1), do not include an allowance for, nor intended use of, any proceeds that may result from this sale.

The Victorian and NSW Governments have committed a combined \$60 million of sale proceeds directly into environmental programs – \$50 million to help increase Snowy River flows above 21 per cent (post 2012) and \$10 million to accelerate programs to get the best use of existing flows.

Of the expected sale proceeds received by Victoria a total of \$600 million will be invested in a once in a generation school building fund – *Building Tomorrow's Schools Today* – to accelerate and transform Victoria's school infrastructure. The Fund will provide a unique opportunity to transform school infrastructure to meet the needs of the 21st century.

The Fund will be targeted towards modernising schools, particularly those in disadvantaged areas that were built in the 1950's and 1960's that are reaching the end of their useful life. The Fund will also invest in excellence through quality facilities across the State particularly in science, sport and higher academic achievement. This Budget allocates an initial \$100 million, so that work can get underway promptly. In addition, an advance allocation of \$50 million will be provided to schools in 2005-06 to meet immediate maintenance needs.

Once the sale of Snowy Hydro Limited is finalised, the published forward estimates will be adjusted to reflect the proceeds, together with the remaining allocation towards the school building fund – *Building Tomorrow's Schools Today* – and the environmental programs.

CONTINGENT ASSETS AND LIABILITIES

Contingent assets

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

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

Quantifiable contingent assets

Table 6.2: Quantifiable contingent assets

	(\$ million)	
	As at June 2005	Estimate for June 2006 ^(a)
Guarantees, Indemnities	1.4	1.4
Potential early termination of contractual arrangements	100.0	100.0
Legal proceedings and disputes	1.4	1.4
Other	134.2	138.0
Total contingent assets	237.0	240.8

Source: Department of Treasury and Finance

Note:

(a) There have been no material changes to quantifiable contingent assets since last reported in the 2004-05 Financial Report for the State of Victoria.

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 of the public transport partnership agreements. The operator must, to the extent of the performance bonds, indemnify the Director for any losses, damages or costs incurred by him as a result of early termination. If the operator does not do so, the Director has the right to draw on the operator's performance bonds for the amount of losses, damages or costs. The expected value of these bonds is \$100 million.

'Other', under Table 6.2, relates to a dispute existing between Transurban City Link Limited and the Australian Tax Office in respect of the taxation treatment of concession fees payable by Transurban to the Victorian Government of \$43 million. Other also includes EastLink bonds of \$92 million.

Transurban City Link

A dispute exists between Transurban City Link Limited and the Australian Taxation Office (ATO) in respect of the deductibility for taxation purposes of concession fees payable by Transurban to the Victorian Government. The Federal Court had previously found against Transurban in this matter, however, an appeal by Transurban to the full bench of the Federal Court was determined in its favour in October 2004. The ATO has appealed the matter to the High Court, who heard the case on 1 February 2006 and are expected to hand down a judgement soon.

The State and Transurban signed a Letter of Intent on 17 May 2006 under which Transurban will purchase existing Concession Notes held by the State and all future Concession Notes for a total of \$614 million in nominal payments over the next four years. Formal documents implementing the transaction are expected to be signed by 30 June 2006. If the tax case goes against Transurban, the consideration to be paid to the State will be reduced by around \$43 million.

EastLink

On 14 October 2004, the State entered into a concession deed with ConnectEast to design, construct, finance and operate EastLink (formerly known as the Mitcham Frankston Project). Various performance bonds provided under the concession deed can be drawn by the State in circumstances where the concessionaire (ConnectEast) or one of its contractors fails to meet its obligations. These bonds include a construction bond (\$87 million) and an operation phase bond (\$5 million).

Non-quantifiable contingent assets

Public transport partnership agreements

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

Profit sharing: The Director is entitled to receive payment from Connex and Yarra Trams should Franchisee profits exceed defined thresholds.

Operational performance regime: The operational performance regime entitles the Director to receive penalty payments if Connex and Yarra Trams fail to meet set punctuality and reliability performance targets.

Special event payments: The Director is entitled to receive payments at a set rate for special event kilometres short of a defined contractual limit.

Newport Depot: The annual 'Franchise Sum' payable to Connex is to be reduced by the value of the Newport lease rental at the expiry or early surrender of the lease.

OneLink Service Contract: The Director will be paid all compensation payments under the OneLink Service Contract for failure to meet required performance standards.

Employee entitlements: Connex and Yarra Trams are required to manage employee entitlements to agreed forecast amounts.

The Director is entitled to receive payments where the provision for employee entitlements (excluding long service leave) is greater than an agreed forecast amount, and actual long service leave payments are less than an agreed forecast amount.

Adjustment event: The Director is obliged to decrease the fixed monthly 'Franchise Sum' payable as a result of a defined adjustment event occurring, which has a fundamental impact.

Compensable enhancement claim for improving the flow on the Westgate Freeway

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

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

EastLink

As indicated above, on 14 October 2004, the State entered into a concession deed with ConnectEast to design, construct, finance and operate EastLink. The following paragraphs summarise the major non-quantifiable contingent assets arising from the concession deed.

Additional lease rental

The concession deed sets out circumstances where the State is entitled to receive, by way of increased lease rentals, a share of revenue that the concessionaire receives over an agreed base sum. The concessionaire's ability to make these payments also depends on other cash flow criteria at the time.

Compensable enhancements

The concession deed sets out circumstances where the State may receive compensation for providing a measurable benefit to the concessionaire by the taking of certain actions. Primarily, these are enhancements to the road network that generate incremental traffic for the concessionaire over and above those road network enhancements which have already been identified in the concession deed and which have been factored in to the current tolling structure. Any compensation receivable would be net of any negative impacts caused by the State by the taking of certain actions (e.g. negative impact on traffic levels).

Refinance benefits

In the event that the concessionaire is able to achieve future incremental refinancing benefits, over and above the refinancing assumptions included in the final bid, over the course of the concession, the State would share in any gain subject to certain conditions.

Contingent liabilities

A contingent liability is:

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

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

Quantifiable contingent liabilities

Table 6.3: Quantifiable contingent liabilities

	<i>As at</i>	<i>Estimate</i>
	<i>June 2005</i>	<i>for June</i>
		<i>2006</i>
		<i>(\$ million)</i>
Guarantees, Indemnities	400.6	400.6
Potential early termination of contractual arrangements	633.7	633.7
Legal proceedings and disputes	281.7	292.3
Other	28.6	30.3
Non-general government debt	3115.2	3407.7
Total contingent liabilities	4459.8	4764.6

Source: Department of Treasury and Finance

Table 6.3 includes ‘guarantees, indemnities’ totalling \$400.6 million, comprising Cooperative Housing Societies guarantees and indemnities of \$39.5 million, Melbourne Cricket Club guarantees of \$332.1 million (for the redevelopment of the Melbourne Cricket Ground) and various other guarantees of \$29 million.

Under ‘potential early termination of contractual arrangements’ is a contractual agreement of \$633.7 million relating to the cost of correctional services beyond the current contract period. The State has the option to re tender for the provision of correctional services every three years, after the initial five year period for each contract.

‘Legal proceedings and disputes’ refers to litigation matters managed by the respective general government departments.

‘Non-general government debt’ relates predominately to the guarantees for loans to the water industry and other entities within the public non-financial sector.

Non quantifiable contingent liabilities

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

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

Asset sales

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

Royal Melbourne Showgrounds

A contingent liability exists relative to any claims which may be made against the Showgrounds Nominees Pty Ltd arising from joint venture dealings as outlined in the Development and Operations Agreement for the Royal Melbourne Showgrounds.

An undertaking has been given by the joint venture parties to meet the unindexed service fees payable to the Concessionaire (Developer) under the Development and Operations Agreement as and when they fall due.

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

Under the State Commitment to Royal Agricultural Society (RAS), the State has agreed to support certain obligations of RAS that may arise out of the Joint Venture Agreement. In accordance with the terms, in the State Commitment to RAS, the State will pay (in the form of a loan) the amount requested by RAS. If any outstanding loan amount remains unpaid at the date, which is 25 years after the commencement of the operation term under the Development and Operation Agreement, RAS will be obliged to satisfy and discharge each such outstanding loan amount. This may take the form of the transfer to the State of the whole of the RAS' participating interest in the joint venture.

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 Melbourne 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 hosting of the Melbourne 2006 Commonwealth Games. The amount of compensation will be finalised in the near future. All compensation claims will be calculated in accordance with an agreed 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 reincorporated into the contractual arrangements of the Northern Stand redevelopment, under greater accountability and responsibility of the MCC to the MCG Trust.

Public transport rail partnership agreements

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

Contingent liabilities arising during the agreement period

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

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

Operational performance regime: The operational performance regime obliges the Director to make incentive payments for franchisees exceeding set punctuality and reliability performance targets.

Special event payments: The Director is obliged to make payments at a set rate for special event kilometres operated above a defined contractual limit.

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

Service growth incentive: The Director is obliged to make payment for certain additional services introduced to meet service standards.

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

The revenue guarantee payment will be based on the prior period's farebox, including an estimate for patronage growth and inflation. Under the above 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 obliged to pay any additional labour costs associated with training and deployment of staff in relation to the establishment of the new ticketing system.

Employee entitlements: Franchisees are required to manage employee entitlements to agreed forecast amounts. The Director is obliged to make payments where the provision for employee entitlements (excluding long service leave) is less than an agreed forecast amount, and actual long service leave payments are greater than an agreed forecast amount.

Access charge adjustment: Should the access charge regime for train rail access be reset, then the Director is obliged to make payment to the franchisee in respect of any increased cost as a result of the reset. The Director is also required to reimburse the franchisee's reasonable costs incurred in renegotiating the access charges.

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

Connex and Mainco indemnity

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

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

Adjustment event: The Director is obliged to increase the fixed monthly franchise sum as a result of any other defined adjustment event occurring, which has a fundamental impact.

Contingent liabilities on early termination or expiry of franchise agreement

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

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

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

Contingent liabilities arising from potential changes to existing conditions

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

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

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

National Express receivership

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

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

Country Train Safety Systems

Country Train Safety Systems is the project under which the Train Protection and Warning System is being installed. The Director of Public Transport undertakes to reimburse Pacific National (Victoria) Limited (previously Freight Victoria Limited) reasonable costs and expenses related to the installation, testing and rectification and repair of the Train Protection Warning System and will indemnify Pacific National (Victoria) Limited for any loss, or cost, or liability it suffers arising from the Director's installation.

Melbourne City Link

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

EastLink

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

Native Title

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

HIH Insurance

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

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

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

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 the Australian Steel Company (Operations) Pty Ltd is the plaintiff (TASCO). The plaintiff has claimed that Schedule 9A2 of the National Electricity Code, amongst 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 interest and costs. Origin Energy Electricity Limited are second defendants in this matter and have filed and served consequential claims against the SECV. Origin is seeking reimbursement of the Smelter Reduction Amounts previously paid by Origin, Powercor Australia Ltd and Citipower Pty Ltd. Origin also seeks reimbursement of the Smelter Reduction Amounts paid by those companies under the VicPool Rules and the Loy Yang B Uplift levy.

The Government discontinued the collection of the Smelter Reduction Amount from 30 June 2004.

The State of Victoria has entered into an agreement with the SECV, whereby the State has fully indemnified the SECV in respect of all legal costs and any other moneys payable by the SECV in the matter. The interests of the SECV are being managed by the State of Victoria.

Melbourne 2006 Commonwealth Games

In winning the bid to host the Melbourne 2006 Commonwealth Games, 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.

The Organising Committee for the Commonwealth Games is the Melbourne 2006 Commonwealth Games Corporation (M2006), a statutory corporation.

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 M2006 Corporation surplus resulting from the Games, after discharging 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 M2006 in relation to organising the Games. The contract includes the commitment the State outlined in its bid document to offer travel grants to competitors and team officials attending the Games.

The finalisation of accounts for the 2006 Commonwealth Games will continue into the 2006–07 financial year. The final financial outcome of the Games will not be known until this process is completed.

Land remediation – environmental concerns

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

Victorian Managed Insurance Authority – property and public liability

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

Victorian Managed Insurance Authority – public healthcare insurances

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

Gambling licences

In 1994, the State sold a wagering licence and a gaming licence to TABCORP Holdings Limited (TABCORP) for \$597 million. The *Gambling Regulation Act 2003* requires the State to provide a refund to TABCORP in 2012 of an amount equal to the licence value of the former licences or the premium payment paid by the new licensee, whichever is the lesser. While this creates an obligation on the State to refund the licence value to TABCORP, it will be offset by the premium payment from the issue of any new licences. In 1992, a gaming operator's licence was issued to the Trustees of the Will and Estate of the late George Adams (the licensee). The *Gambling Regulation Act 2003* entitles the licensee to be paid, at the end of its current licence period in 2012, an amount equal to the value of its current licence or the premium payment paid by the new licensee, whichever is the lesser. This entitlement is contingent on the licensee not being granted a new licence.

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

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) reinsurance support to builders' warranty insurance provider Dexta Corporation, following the withdrawal of some of its commercial reinsurance support. This support was subsequently extended to 30 September 2002. The Government determined that there would be no further extension.

The State received reinsurance premiums for this participation and is required to contribute to payment of reinsured 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 six and a half 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 reinsurers who are party to the agreement, to at least break even on these arrangements, the State retains a non-quantifiable 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. South Australia became a party to this agreement with effect from 31 December 2004. This agreement requires the insurer to pay reinsurance premiums to the three States that are estimated to be sufficient for the States to at least break even on these arrangements. However, the State retains a non-quantifiable contingent liability for additional claims. The State has executed a further reinsurance agreement in the same terms with another insurer.

To improve its supervision of builders' warranty insurance, the Government determined in its April 2006 response to the Victorian Competition and Efficiency Commission's final report *Housing Regulation in Victoria: Building Better Outcomes* that it will finalise and implement guidelines for the provision of information by builders' warranty insurers and introduce a code of conduct for them.

CHAPTER 7 – PRODUCTIVITY, PARTICIPATION AND THE REFORM AGENDA

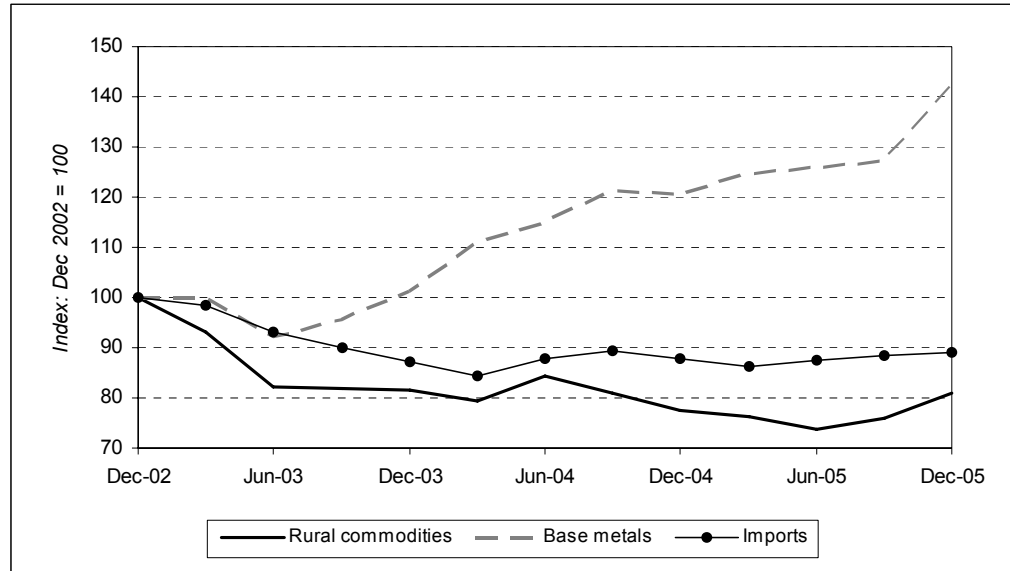
- Victoria and Australia are faced with several challenges to sustain economic growth.
- These challenges will be met by boosting productivity and labour force participation through Victoria's own policy initiatives and through a national reform agenda.
- This budget contributes to this agenda by promoting an improved business environment, by important investments in infrastructure, by support for human capital development and through the promotion of innovation and research.
- Victoria led the push for a new wave of national economic reform, through *A Third Wave of National Reform*, released in August 2005. Victorian proposals for national economic reform were substantially endorsed by the Council of Australian Government (COAG) in February 2006, as the *National Reform Agenda (NRA)*.
- If implemented, the NRA has the potential to permanently add, within ten years, around 5 per cent to GDP (or about \$2 700 a person in today's dollars) and after twenty-five years, around 14 per cent to GDP (or about \$8 500 a person in today's dollars).

MEETING THE CHALLENGES TO ECONOMIC GROWTH

Victoria faces several challenges to sustained economic growth: in the short-term the dual effect of high fuel prices and the impact of the recent interest rate rise; in the medium term, the effects of the commodity price boom on non-mineral exporters and import-competing businesses, and increasing international competitive pressures; and in the long-term the impact of population ageing and a slow-down in productivity growth. It shares these challenges with Australia as a whole, although the Victorian Department of Treasury and Finance estimates the mineral commodity price boom has meant that the higher Australian dollar has detracted around 0.5 per cent from Victoria's GSP growth each year.

Chart 7.1 shows trends in the prices of base metals, rural commodities and imports. Rural commodities form a large part of Victoria's export base while base metals form a very small part. While the price of base metals has soared over the last two years the price of the exports of importance to Victoria has fallen. At the same time the price of imports has fallen even more putting pressure on our import-competing industries.

Chart 7.1: Trends in commodity prices



Source: Department of Treasury and Finance

Notes:

- (a) Rural and base metals prices are taken from RBA Commodity Price Index, converted to quarterly averages and re-based to December 2002 = 100.
- (b) Import prices derived from ABS National Accounts, re-based to December 2002 = 100.

The key to meeting these challenges is to boost productivity and labour force participation. To do this the government has developed a blueprint for reform with the following key areas:

- further improving the business environment, through cutting business costs and reducing the burden of regulation;
- infrastructure investments;
- human capital reform to enhance the workforce including education, training, and health; and
- innovation, and research and development.

As well as promoting this agenda in Victoria, in August 2005, the Victorian Government took the lead in promoting a new *National Reform Agenda* (NRA). The Victorian proposals were outlined by the Premier in *A Third Wave of National Reform: A National Reform Initiative* and sought national agreement for reforms in human capital, better regulation, and competition. In February 2006, the Council of Australian Governments (COAG), endorsed the NRA. Over the course of 2006, the details of this agenda, including the funding arrangements, are to be negotiated.

The NRA aims to raise living standards in Australia by lifting productivity and workforce participation over the next decade and beyond. The new national reform agenda is expected to produce rewards at least of the magnitude delivered by the National Competition Policy (NCP). The Productivity Commission has estimated that national competition policies permanently increased Australia's gross domestic product (GDP) by 2.5 per cent or by \$20 billion per year.

A comprehensive reform agenda of the type advocated by Victoria has the potential, however, to boost GDP even more. Preliminary modelling by the Victorian Department of Treasury and Finance indicates that a comprehensive reform agenda aimed at increasing productivity and labour force participation above what it would otherwise be, has the potential to permanently increase GDP by up to 14 per cent after 25 years and bring annual fiscal dividends of around \$36 billion. Average incomes of Australians would be up to \$8 500 a year higher than they would be in the absence of reform.

Final sign up by COAG to the NRA will depend on agreement by the Commonwealth and the States and Territories (the States) to a governance and funding framework. The Commonwealth has indicated it is willing to provide funding to ensure a fair sharing of the cost and benefits of reform across jurisdictions. It is Victoria's view that funding arrangements should be designed to reward progress towards achieving stipulated outcomes. Meanwhile, Victoria continues to make progress in pursuing policies to increase labour force participation and productivity with a range of initiatives announced in this budget.

A REFORM BLUEPRINT

A competitive business environment

The Victorian Government has maintained ongoing reform of business costs. Continued reduction of business costs will improve the competitiveness of all Victorian businesses and, for some, help offset the increased pressure on non-mineral exporters and import-competing businesses arising from the effect of the commodity boom, as discussed in Chapter 2, *Economic Conditions and Outlook*.

Payroll tax

The 2006-07 Budget assists Victorian businesses by further reducing the payroll tax rate to 5 per cent over three years, from 5.75 per cent in 1999-2000. This will benefit over 20 000 businesses by \$533 million over the forward-estimates period.

Land tax

This budget also provides additional land tax reform worth around \$167 million over four years, benefiting around 27 000 taxpayers.

WorkCover

For the third successive year increased efficiencies have enabled the Government to lower *WorkCover* premiums by a further 10 per cent. This will save Victorian businesses \$170 million in the next financial year.

Better, simpler regulation

Regulation provides government with an important tool to promote efficient production. However, excessive regulation can stifle economic activity and suppress growth. The Government will reform regulation to determine the right balance of regulation for Victorian businesses and householders.

Achieving best practice

Victoria was the outstanding performer under NCP. NCP was enacted in the mid 1990s to provide a boost to efficiency by opening to competition. Throughout the life of NCP, Victoria received all of its payments for reforms (excluding water), demonstrating the Government's commitment to reducing barriers to competition and allowing markets to work more effectively. In 2004, building on this record, the Government announced the establishment of the Victorian Competition and Efficiency Commission (VCEC) to advise on regulation reform and identify opportunities for improving Victoria's competitive position.

Through an ongoing vigorous reform process, many Victorian entities are already achieving world best practice regulation. For instance, the State Revenue Office (SRO), the entity responsible for the collection of state-based taxes, has developed an internet-based delivery for its services that has received customer commendation and international praise for its efficiency, transparency and ease of use. In a recent customer survey 85 per cent of respondents rated SRO's e-Business services excellent or good. The SRO is the first government agency in the world to achieve *Information Technology Infrastructure Library* certification to the British Standard, widely recognised as the foremost approach to information technology service management in the world.

Reducing the regulatory burden

COAG agreed to a range of measures to ensure best practice regulation making and review, and to take action to reduce specific regulation hotspots. The six hotspots endorsed by COAG are rail safety regulation, occupational health and safety, national trade measurement, chemicals and plastics, development assessment arrangements, and building regulations.

Jurisdictions are also pursuing programs within their own jurisdictions to reduce the regulatory burden. They have agreed to:

- establish and maintain arrangements to maximise the efficiency of new and amended regulation and avoid unnecessary compliance costs and restrictions on competition;
- undertake targeted reviews of existing regulation to identify areas where regulation reduction would yield significant benefits;
- identify further reforms to enhance consistency across jurisdictions; and
- aim to adopt a common framework for benchmarking, measuring and reporting.

The Victorian Government will meet and far exceed its commitments in this area through the *Reducing the Regulatory Burden* initiative, which will cut red tape for the business and the not-for-profit sectors.

The initiative has three elements. The first two elements relate to the administrative burden of regulation, such as completing an application form. To reduce this burden, the Government is:

- committing to cut the existing administrative burden of regulation by 15 per cent over three years, with a target of cutting 25 per cent over the next five years; and
- ensuring the administrative burden of any new regulation is met by an ‘offsetting simplification’ in the same area.

The third element relates to the compliance burden of regulation, that is, the cost of the change required to achieve the desired changed outcomes, for example installing new machinery. To reduce this burden, the Government is undertaking a program of reviews with incentive payments, similar to NCP. Across Government, a pool of funds will be made available to undertake hotspot reviews in areas of undue compliance burden and to reward reduction of the burden.

To ensure the success of this initiative, the Government has set aside \$42 million over four years.

Infrastructure investment and reform

Infrastructure bottlenecks have the capacity to stifle business growth. The Government has markedly increased investment in social and economic infrastructure in recent years.

While public investment is important the Government has also been at the forefront in the exploration of a wide range of means of delivery of infrastructure projects. Two areas of particular interest here include the use of public-private partnerships to provide a better sharing of risk, and project management in certain cases; and the improvement of access arrangements between upstream and downstream firms in a network industry.

Infrastructure investment

The Victorian Government has increased infrastructure investment in this budget to a record \$4.9 billion focussing on transport, health and education. These investments are outlined briefly in Chapter 1, *Financial Policy Objectives and Strategy* and in more detail in Chapter 1 of Budget Paper No. 3, *Service and Budget Initiatives*. Improvements in transport infrastructure will directly improve productivity. Health and education infrastructure, especially the investment in schools, is an important ingredient in improving human capital, leading to increased participation and productivity.

Infrastructure regulation (COAG)

In February 2006 participants in COAG signed a Competition and Infrastructure Reform Agreement that provides a simpler and more consistent system of economic regulation for nationally significant infrastructure including ports, railways and other export-related infrastructure. It aims to reduce uncertainty for investors in infrastructure, and compliance costs for owners and users of infrastructure.

Reform will focus on a simpler access regulation for significant infrastructure facilities, and requires jurisdictions to review the regulation of ports, port authorities, handling and storage facilities, and ensure that regulation conforms with agreed access, planning and competition principles.

Infrastructure planning (COAG)

COAG agreed to implement a number of infrastructure measures at its previous meeting in June 2005. These measures were a commitment to: complete all corridor strategies under *AusLink* by mid 2007; extend the corridor strategies to include relevant capital city and regional ports; undertake a stock-take of logistics chains; and establish one-stop-shops for significant development projects. Jurisdictions also agreed to the format and content of forward-looking five-yearly infrastructure reports, the first of which is to be provided in January 2007.

Competition reform agenda (COAG)

The competition stream of the COAG reform agenda seeks to continue the work of the NCP. The extension of the NCP is concerned with reforms in energy, transport, infrastructure regulation, infrastructure planning and adaptation to climate change.

Education and training

Increasing education and skill levels are the best long-term means of raising workforce participation and improving productivity growth.

Skills

Victorians are living longer and having fewer children so that by 2010 the proportion of the population in the workforce will decline. This could lead to reduced economic growth and increased pressure on Government spending. However, there is potential to lift the workforce participation of many Victorians, particularly older workers, lower skilled workers and part-time workers who want more work. The most effective way to expand the workforce is by increasing further education, and strengthening the focus on skills.

The Victorian Government has made a major new investment in technical and further education training. The recent statement on skills (*Maintaining the Advantage: Skilled Victorians*) announced \$241 million of new investment in four areas:

- providing greater opportunities for students to participate in vocational education and training while still at school;
- encouraging people to aim higher and extend their skills throughout their working life;
- opening up employment opportunities that demand higher-level skills; and
- providing better information about career pathways and training opportunities to make the training system more responsive.

Additional support for apprentices is provided in this budget, complementing the investment. Sixty per cent of apprentices who drop out are in their first year. To encourage the take up and retention of apprenticeships the Government will provide a \$500 Trade Bonus. Year 1 apprentices will receive \$250 after the first six months and a further \$250 following the completion of Year 1 upon re-enrolment in Year 2. In addition funding is provided to increase the allowance to support apprentice and trainee costs associated with training in regional areas (the *Apprentice and Trainee Accommodation Allowance*) to \$25 per night.

Schools

Initiatives to invest in new schools and upgrade schools has been noted earlier. A number of initiatives also outlined in Budget Paper No. 3 Chapter 1, *Service and Budget Initiatives*, will improve literacy and numeracy, develop innovative teaching in mathematics and science, and build the strategic capabilities of school leaders.

Education and training agenda (COAG)

The initiatives outlined above complement Victoria's commitments to education and training under the COAG NRA. Proposed education and training reforms of the NRA will apply to people of all ages: from before school entry, through primary and secondary school, to higher and further education.

The reforms aim to improve life-time outcomes by increasing opportunities for children before they attend school. The early years are critical for personal development. Appropriate assistance at this stage can be a very cost-effective means of improving wellbeing for the disadvantaged and for society as a whole.

There is strong evidence that the attainment of core skills, including literacy and numeracy, is crucial for raising school retention rates, subsequent adult workforce participation and for providing the best base for improvements in productivity. The reforms aim to increase the proportion of young people attaining and meeting literacy and numeracy standards.

The reforms also focus on the transitions from school to work or further study. COAG has sought the development of policies ensuring students have access to appropriate further education and/or skill training, to enhance smooth and effective movement into adult working life.

The ageing of the population and associated increases in the relative size of the dependent population will place more pressure on those of working age to fully participate in employment. Reforms aim to maximise the opportunities for all adults to raise skill levels and extend working life, if that is what is desired.

Health

Poor health is a major impediment to economic growth. Improved health outcomes will increase productivity and capacity to work.

Healthy and Active Victoria

Increasing rates of obesity and the associated prevalence of diabetes and other chronic diseases represent a major new challenge to governments and the community. Healthy and Active Victoria is part of the State's commitment to the COAG reform initiatives (described below). There are four themes in Stage 2 of Healthy and Active Victoria:

- raising awareness of issues and motivation to change;
- support for healthy and active choices by individuals and communities;
- creation of supportive environments; and
- strengthening co-ordination, monitoring, evaluation and research.

There is additional investment in chronic disease prevention including:

- chronic disease management teams working with community health services to encourage detection and early intervention; and
- tobacco awareness and training initiatives aimed at reducing the prevalence of smoking among at-risk groups including pregnant women.

Improved support for mental health

In February 2006, COAG committed to the development of a five year national plan for mental health reform by July 2006. Through active participation in this process, the Victorian Government is pursuing a better deal for Victorians with mental illness and their families and carers into the future. The Government is keen to see the COAG plan have a strong focus on driving outcomes through a nationally agreed reform agenda and collaboration between governments.

Victoria welcomes the Commonwealth Government's recent contribution of \$1.85 billion over five years for a package of mental health initiatives to support this plan. The Victorian Government will deliver at least \$472 million¹ under the five year National Mental Health Action Plan. Victoria has a strong record of increasing funding and has pioneered a number of mental health reforms.

This Victorian investment will see the further growth and reform of specialist mental health services with a particular focus on improving hospital-based and community support and early intervention services. The Government is also boosting investment in promotion, prevention and research in mental health.

¹ This total includes an estimated \$36 million for future mental health related community education and promotion initiatives to be funded through VicHealth and allowance for growth in costs, and \$8 million in 2005-06.

Reform agenda in preventative health (COAG)

As well as the COAG mental health agenda, in the NRA COAG has identified the reduction of the incidence of chronic disease (such as diabetes, cancer and mental illness) as an important way of improving the work prospects for people with illness, injury or disability.

Implementation of policies to achieve these health outcomes may occur through the mitigation of risk factors such as poor diet, inactivity, smoking, excess alcohol consumption, obesity and so on. Policies are needed which place an increased focus on prevention and early detection, and improved health care management for people at risk or with a chronic disease.

A substantial proportion of health service delivery occurs through Commonwealth Specific Purpose Payments (SPPs). Financial incentives created by these payments need to support the health reform agenda. COAG has agreed to consider the structure of SPPs to ensure that the best possible health outcomes may be attained.

Innovation and Research and Development

Innovation is the ultimate engine room of growth and Victoria has sound fundamentals for an innovation economy; Melbourne was ranked by Richard Florida among the top five cities in the world for ethnic and lifestyle diversity and high skilled, high educated, innovative and artistically creative workforces. Victoria has significant competitive strengths, particularly in biotechnology and information and communication technology, with the largest bio-industry workforce in Australia and the highest number of computing, information technology and engineering graduates per year in Australia. It already has an outstanding international reputation in biomedical research. This is amply demonstrated by the fact that eight Australian scientists received 2005 Howard Hughes Medical Institute research awards and all were Melbourne based.

Victoria's recently announced Life Sciences Statement, *Healthy Futures* is designed to build on these strengths. It sets a long term goal of creating a life science industry in Victoria that is a world leader in translating scientific research into practical benefits.

CONCLUSION

Victoria continues to lead in reform

Victoria entered 2005-06 with strong reform credentials. It enters 2006-07 with even stronger credentials. In this year's budget, reforms have been undertaken to improve the business environment, increase infrastructure investment, increase investment in human capital and promote innovation and research and development. The Government has also taken a lead in proposing a national reform agenda through COAG and in this budget and other policy statements continues to vigorously pursue policies aimed at raising productivity and participation.

Over the coming weeks and months the Government aims to further progress reform by working with other States and the Commonwealth to implement the National Reform Agenda. This will require important progress in developing the governance and funding framework.

Implementing the NRA: key issues to resolve

The NRA proposes a new way of governments working together. Successful implementation of the NRA will depend critically on agreement on the form of intergovernmental arrangements, and an appropriate governance and funding framework.

Existing intergovernmental arrangements (such as SPPs) are counter to the way that national reform should be designed and implemented. A better approach would be for governments to work collaboratively to identify strategic outcomes to be achieved in human capital reform, and design intergovernmental arrangements focused on achieving those outcomes as efficiently as possible.

Current SPP arrangements do not permit realisation of one of the greatest strengths of a federal system; that it allows, and can be structured to actively promote, policy diversity (for more discussion of SPPs see Chapter 5, *Commonwealth-State Financial Relations*). Such diversity is a major driver of responsiveness, innovation and improvement. Intergovernmental arrangements should reflect a spirit of cooperation between governments, defining broad principles, outcomes and progress measures.

Much of the increased participation and productivity arising from the NRA will occur indirectly and over an extended period of time. To lock in sustained commitment from governments will require a strong governance framework that has a rigorous outcome-based focus that rewards performance.

Subject to an agreement on funding and other aspects of the reform agenda, it is proposed to implement the NRA through the establishment of the COAG Reform Council (CRC). This would be an independent body that would replace the National Competition Council that was responsible for the implementation of the NCP. The primary role of the CRC would be to report to COAG annually on progress measures, on progress towards outcomes and, where relevant, reform actions agreed by all governments.

At its meeting in February 2006, COAG agreed that the Commonwealth will provide funding to the States on a case by case basis once specific implementation plans have been developed. Victoria considers such funding essential to ensure a fair sharing of the costs and benefits of reform. This is because the States face a disproportionate share of the costs associated with implementing reforms, with the Commonwealth set to realise the majority of fiscal benefits. The Commonwealth can be expected to derive at least two thirds of the additional fiscal gains generated by the reforms. Combined with the need for substantial up-front investment by the States to implement some important components of the reforms, there is a strong case for the Commonwealth to provide funding to the States at an early stage.

Jurisdictions will need to work closely together to develop a robust funding framework that can apply across the three reform areas (human capital reform, competition policy and regulatory reform), and across the many different ways the two levels of government coordinate to deliver services.

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.

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