

CHAPTER 1: FINANCIAL OBJECTIVES AND ECONOMIC CONDITIONS

The *Financial Management Act 1994* requires the Government to operate in accordance with a set of sound financial management principles. These are to:

- prudently manage financial risks faced by the State, 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 financial effects on future generations; and
- provide full, accurate and timely disclosure of financial information relating to the activities of the Government and its agencies.

The Government's updated short and long-term financial objectives, as published in the *2009-10 Budget*, are summarised in Table 1.1. Progress made in 2008-09 against each of the five financial objectives is discussed in the following sections.

Table 1.1: Financial objectives

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

Source: Updated financial objectives as published in the 2009-10 Budget, Department of Treasury and Finance

Objective One: Net result from transactions (operating surplus)

In 2008-09, the Government announced an annual net result from transactions of at least 1 per cent of revenue. However, the deterioration in the global financial and economic environment after the *2008-09 Budget* was delivered, led the Government to revise its target in the *2009-10 Budget* to at least \$100 million each year. This was to ensure that the Government's short-term target remains relevant in these difficult times to allow for the provision of vital services while maintaining a sound fiscal position. Once the financial and economic environment permits, the Government is committed to returning to a budgeted net result from transactions of at least 1 per cent of revenue.

Table 1.2 shows that in 2008-09, the General Government (GG) sector achieved its updated short-term financial objective by delivering a net result from transactions of \$251 million. The net result from transactions is considered to be the most robust measure of the Government's financial management as it reflects the financial effect of government decisions and other factors controlled by government, and excludes actuarial adjustments and revaluations. By excluding these items, the net result from transactions provides a clear representation of the State's underlying financial performance. Other operating statement measures are discussed in Chapter 2.

Table 1.2: Summary operating statement for the period ending 30 June

	(\$ million)			
	2008-09 Actual	2008-09 Revised ^(a)	Change	% Change
Total revenue	39 284.8	39 152.1	132.8	0.3
Total expense	39 033.7	38 909.6	124.1	0.3
Net result from transactions – Net operating balance	251.2	242.5	8.6	3.6

Source: Department of Treasury and Finance

Note:

(a) *Reclassification of unilaterally decided bad debts expenses from a 'transaction' to 'other economic flows' has resulted in amendments to the revised net result from transactions of \$163.0 million (as published in the 2009-10 Budget) to \$242.5 million for 2008-09, in accordance with relevant accounting standard requirements.*

The 2008-09 GG net result from transactions of \$251 million was higher than the estimate in the *2009-10 Budget*. Despite achieving a slightly higher-than-expected net result from transactions, it is below the previous year's outcome due to the adverse impact of the global financial crisis. The 2008-09 net result from transactions (operating surplus) has been affected by:

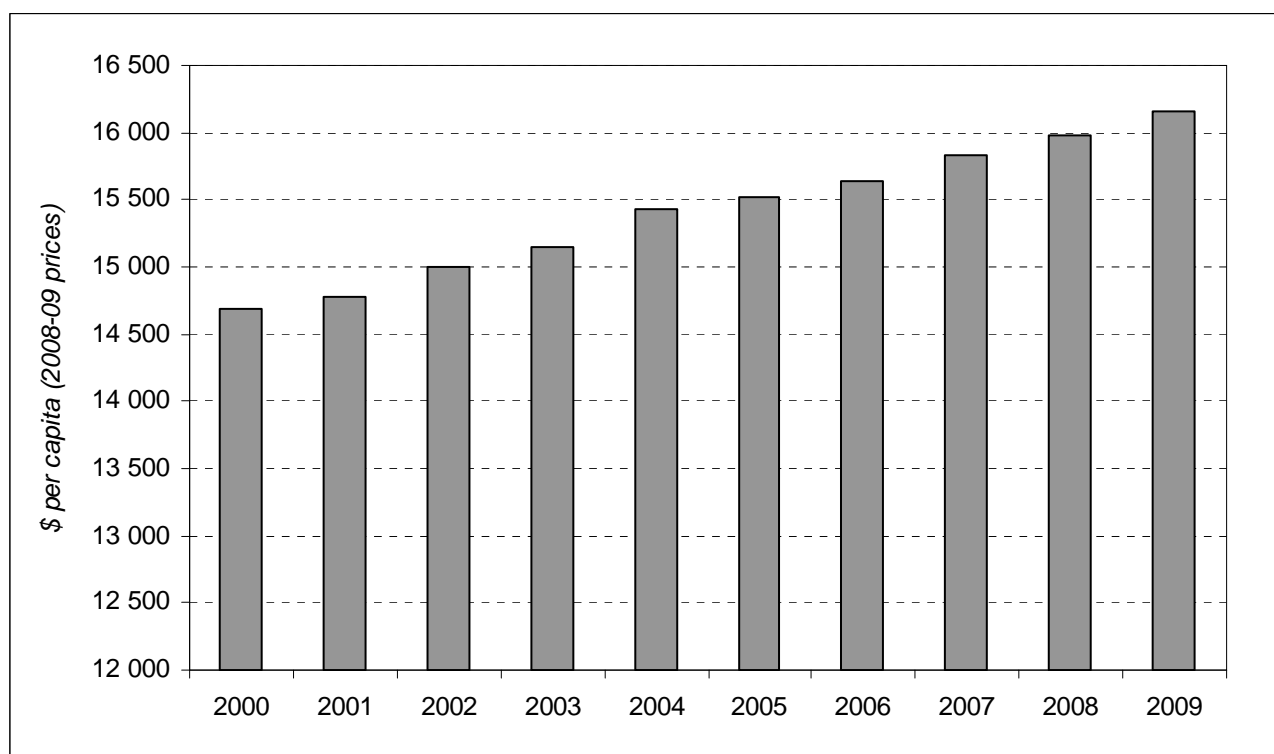
- higher than expected grants revenue, mainly due to unbudgeted Commonwealth Government funding;
- lower than expected employee expenses;
- lower state taxation as a result of the economic downturn;
- lower than expected revenue from the sale of services and third party revenue across the GG sector;
- an increase in grants and other transfers;
- an increase in interest expenses; and
- policy measures taken by the Government to support activity and meet emerging short-term needs, including the recovery from the 2009 Victorian bushfires.

Objective Two: Infrastructure

The Victorian Government expanded and accelerated its infrastructure investment program in 2008-09 as the global financial crisis emphasised the importance of investing in infrastructure to secure and support employment for Victorians. From 1999 to 2008-09, the GG sector invested over \$23.9 billion in the delivery of world-class infrastructure. In 2008-09, net infrastructure expenditure by the GG sector was \$4.1 billion, while whole of government net infrastructure expenditure totalled \$7.3 billion.

Chart 1.1 shows the general government real capital stock per capita as at 30 June 2009, over the last 10 years. Already at historically high levels, real capital stock per capita rose by 1.1 per cent in 2008-09.

Chart 1.1: General government real capital stock per capita as at 30 June ^(a)



Source: Department of Treasury and Finance

Note:

(a) Includes the revaluation of the capital stock, consistent with the 2008-09 and 2009-10 Budget presentation.

During 2008-09, significant capital expenditure occurred on the following projects:

- school rebuilding, renovation and extension works totalling \$433 million, which incorporates capital works as part of the Government's \$1.9 billion *Victorian Schools Plan*;
- Monash-West Gate Freeways Improvement Package (\$411 million from TEI of \$1.1 billion);
- Safer Roads Infrastructure Program 3 (\$102 million from TEI of \$722 million);
- construction of the Rectangular Sports Stadium (\$98 million from TEI of \$212 million); and
- the completion of the Melbourne Recital Centre/Melbourne Theatre Company (\$10 million from TEI of \$128 million).

The Victorian Government's substantial investment in these projects demonstrates its commitment to delivering world-class infrastructure to maximise economic, social and environmental benefits and secure jobs for Victorians.

Objective Three: Service delivery

The Government is committed to improving the quality of, access to, and equity of services provided to all Victorians and is continuing to meet the commitments made in *Growing Victoria Together* and the *2008-09 Budget*.

The Government's investment in key service delivery areas is leading to positive results. Examples of improved service delivery during 2008-09 include:

- the percentage of year three and year five Victorian students achieving the national literacy and numeracy minimum standards in 2008 was above the national average. In 2008, more than 95 per cent of Victorian year three students achieved the national minimum standard in reading, writing and numeracy. At year five, more than 94 per cent of Victorian students achieved the national minimum standard in numeracy and more than 93 per cent achieved the national minimum standard in reading and writing.
- since 1999, the Government has boosted the acute health budget for hospitals by \$3.8 billion. This has significantly increased capacity, with over 378 000 additional hospital patients treated and 10 000 more nurses and 3 000 more doctors employed in 2008-09 compared with 1999-00.
- in response to increasing public transport patronage (an estimated 495.3 million metropolitan public transport trips in 2008-09), the following service improvements were initiated: completion of the Clifton Hill rail project to alleviate a bottleneck; introduction of the full Red Orbital bus route; and the lease of five new 240 seat 'Bumblebee' (C2 Class) trams.

Through the Regional Infrastructure Development Fund (RIDF), the Government also provided significant support to build the competitive capacity of regional Victoria through the provision of economic and community infrastructure in 2008-09. This includes:

- the support of 68 RIDF projects during 2008-09, more than in any other year since the RIDF commenced operation in 2000. This included 29 Local Industry Road Upgrade projects across the State to enable the efficient and safe movement of B-double and higher mass limit vehicles on key regional transport routes, and a number of tourism infrastructure projects, including four significant pathways and rail trails that will assist in increasing tourism to regional Victoria; and
- an additional 103 Small Towns Development Fund (STDF) projects were supported to assist communities in small towns to create new opportunities for socio-economic growth and development. Forty-one of the STDF projects were supported under the Government's STDF drought programs, providing economic opportunities in small communities affected by drought.

Following the 2009 Victorian bushfires, the Victorian and Commonwealth Governments partnered with the Red Cross to set up the 2009 Victorian Bushfire Appeal Fund, which has raised more than \$380 million. In addition to the funds raised by the Red Cross, nearly \$1 billion has been spent on Victoria's recovery, including fire response and suppression activities; additional police resources; support for affected individuals and families through emergency assistance grants, temporary housing and the provision of case managers; support for affected businesses through grants, low interest loans and a tourism package to encourage visitors back to the regions; a clean-up and demolition program to ensure public safety in affected areas and to allow rebuilding to commence; a Community Recovery Fund which will provide grants for sporting clubs and community events; improved emergency services communication system; and upgraded fire-fighting equipment.

Objective Four: Taxation

A key financial objective of the Government has been to provide a fair and efficient tax system that is competitive with other states. Victoria's competitiveness and productivity growth depends on reforms and initiatives that reduce business costs and red tape to support business innovation and growth. Victoria was the first jurisdiction to abolish all eight taxes under the Intergovernmental Agreement (also known as the goods and services tax (GST) agreement) and one of only three jurisdictions to have fully complied with that agreement.

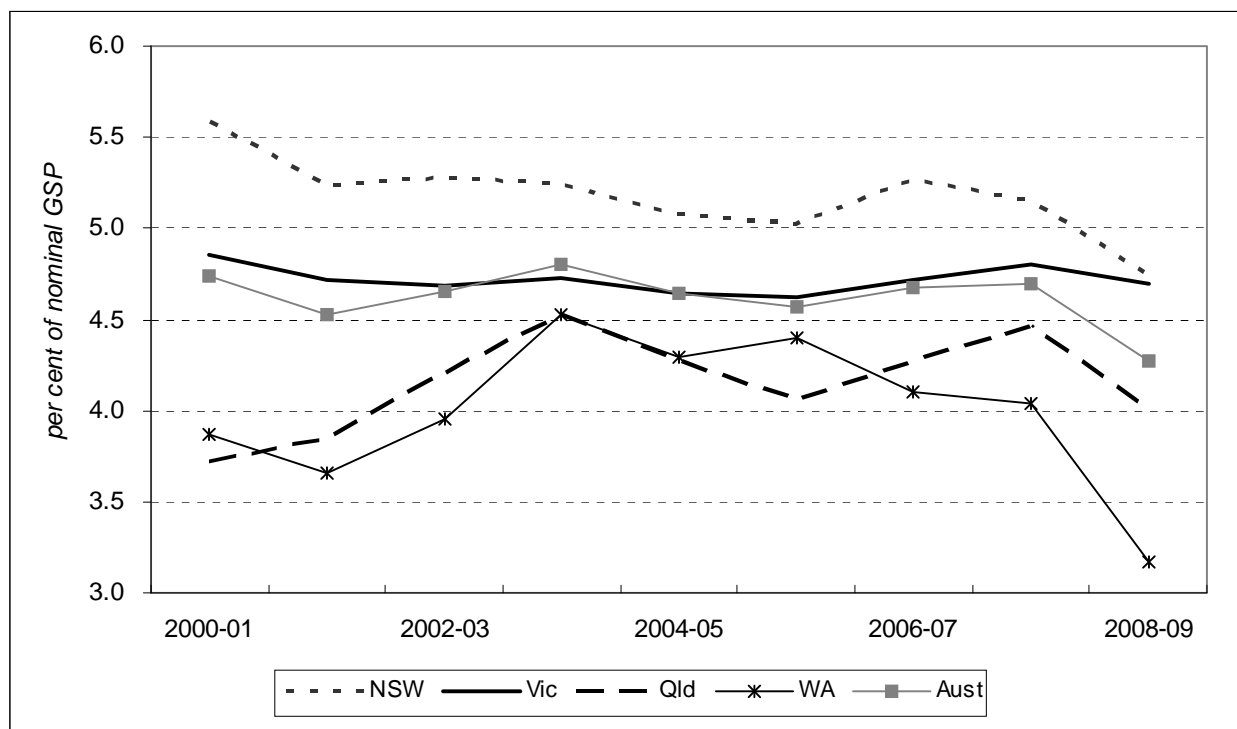
In the *2008-09 Budget*, the Government continued significant reform of Victoria's taxation system which will provide an estimated \$1 billion worth of net tax relief to Victorian taxpayers over the four years to 2011-12. The measures announced were:

- cutting the top land tax rate from 2.5 per cent to 2.25 per cent;
- applying an increase to land tax thresholds of around 10 per cent; and
- cutting the payroll tax rate from 5.05 per cent to 4.95 per cent.

Victoria's preferred measure of tax competitiveness is state taxation revenue expressed as a share of nominal GSP, as it aligns the level of taxation revenue to economic activity (see Chart 2.1). Taxation revenue is expected to fall in all jurisdictions in 2008-09, except the Northern Territory. This is largely related to deteriorating economic conditions and lower GSP levels. The main reason for the fall in some states is a large drop in land transfer duties of between 33 and 50 per cent, as a result of a sharp deterioration in the property market resulting from the global financial crisis.

Victoria's decrease in taxation revenue was a moderate 1.8 per cent as the State's economy has been relatively resilient in the global economic environment. In 2008-09, the drop in land transfer duty revenue was partly offset by growth in land tax revenue, as a result of an increase in site values following the two-yearly revaluation cycle. For these reasons, Victoria's taxation to GSP ratio showed a modest fall in 2008-09.

Chart 1.2: Taxation revenue as a share of nominal GSP^(a)



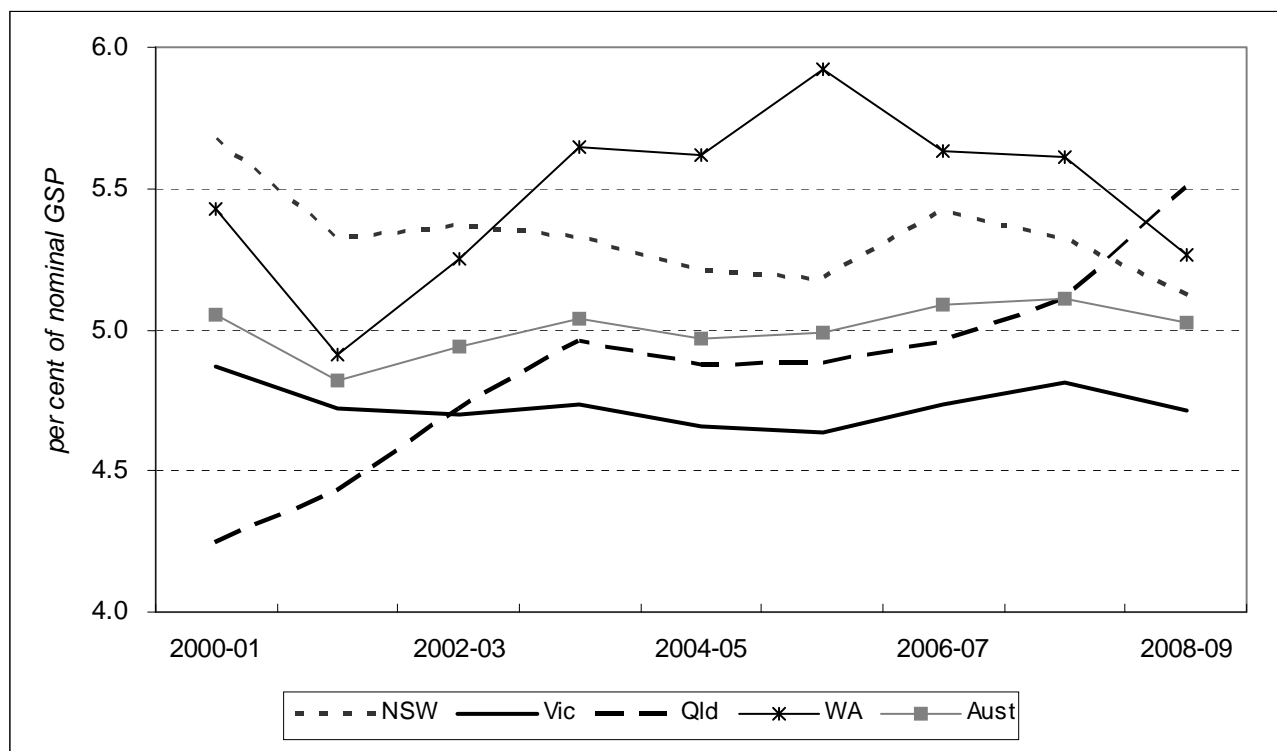
Sources: Australian Bureau of Statistics; Victorian Department of Treasury and Finance; and various state budgets.

Note:

(a) For 2008-09, actual taxation outcomes used for Victoria and budget estimates used for other jurisdictions and for the Australian average.

Making interstate comparisons of tax competitiveness is difficult and Chart 1.2 does not include the impact of various other considerations. For example, unlike other states, Victoria has only minimal access to mining royalty revenue. In 2008-09, Queensland collected over \$3.2 billion in royalties, Western Australia collected over \$3.6 billion and New South Wales collected over \$1.4 billion. Victoria only collected \$48 million. Revenue of this type can enable other states to reduce their reliance on taxation revenue. Chart 1.3 shows that Victoria's ratio of taxes plus royalties to GSP has been below that of the Australian average for nearly a decade since 2000-01.

Chart 1.3: Taxation and royalty revenue as a share of nominal GSP^(a)



Sources: Australian Bureau of Statistics; Victorian Department of Treasury and Finance; and various state budgets.

Note:

(a) For 2008-09, actual taxation outcomes used for Victoria and budget estimates used for other jurisdictions and for the Australian average.

Objective Five: Net financial liabilities

The Government is maintaining modest and sustainable levels of net financial liabilities, consistent with both its triple-A credit rating and its commitment to the provision of improved services and infrastructure. Victoria's balance sheet remained solid in 2008-09 despite the adverse impact of the global financial crisis.

Victoria's triple-A credit rating was re-affirmed by Moody's Investors Service in January 2009 and Standard and Poor's in September 2009. The agencies cited Victoria's strong balance sheet, diversified economy and prudent fiscal management as key reasons for the affirmation.

The 2008-09 result has produced the following outcomes:

- GG net debt of \$5.3 billion (2.0 per cent of GSP) reflecting the size of the Government's increased infrastructure investment;
- GG net debt plus superannuation liabilities in 2008-09 was \$26.0 billion (9.7 per cent of GSP); and
- Net financial liabilities were \$32.4 billion (12.0 per cent of GSP) in 2008-09, \$11.9 billion higher than the previous year. The increase in net financial liabilities during the year was mainly due to an increase in the superannuation liability, primarily driven by a reduction in the discount rate that is used to value this liability and lower than expected investment returns on superannuation assets. The increase in the superannuation liability resulting from the variation in the discount rate has no impact on the amount of cash that is required to fund this liability.

ECONOMIC CONDITIONS AND OUTCOMES

The global economic environment was particularly weak in 2008-09. Driven by a severe financial crisis and a wide-spread loss of confidence, the world economy has experienced a synchronised recession and the weakest outcome in over 60 years. Global production and trade dropped sharply toward the end of 2008 and in early 2009.

There have also been significant declines in asset prices, particularly equities. Credit markets have been strained, leading to tighter lending criteria and higher credit spreads. National governments around the world have responded to the global financial crisis by providing significant public support to financial systems, easing monetary policy and providing fiscal stimulus. These efforts appear to be working, with early signs of recovery in Asia and stabilisation in the Western advanced economies.

In response to the global financial crisis, the Commonwealth Government supported the Australian economy with short-term, medium-term and long-term fiscal stimulus packages. These include immediate tax relief and transfer payments to stimulate consumption and support private demand; the *Building the Education Revolution* and public and community housing packages; and the *Building Australia Fund*, respectively. The Victorian Government also assisted in stimulating the economy by implementing an expanded and accelerated infrastructure investment program. The Australian economy has also benefited from expansionary monetary policy, as the Reserve Bank of Australia aggressively cut official interest rates to an historic low of 3.0 per cent in April 2009, to stimulate domestic spending. However, this has started to be unwound more recently.

Against this background of a very weak global economy, the Australian economy has also weakened, though it has been relatively resilient. In 2008-09 national gross domestic product (GDP) rose by 1.0 per cent. The labour market has softened, and the national unemployment rate has increased from a low of 3.9 per cent in February 2008 to 5.8 per cent in August 2009. The largest deterioration in labour market conditions has occurred in the resource-rich states of Queensland and Western Australia. This has led to some easing in wages growth.

Headline inflation has also eased to 1.5 per cent over the year to the June quarter, driven by lower prices for transport, and financial and insurance services. Underlying inflation, however, remains relatively high, although it is expected to decline, reflecting lower commodity prices and capacity utilisation.

Growth has also slowed in Victoria, but the Victorian economy has been similarly resilient in the face of these global headwinds. The *2009-10 Budget* forecast Victorian gross state product (GSP) to grow by 0.5 per cent in 2008-09 and economic developments have been broadly consistent with this forecast. While state final demand rose by 1.8 per cent, driven by growth in public investment and dwelling investment, net trade and the balancing item could still detract from growth. Furthermore, poor weather conditions have resulted in the output of the Victorian agricultural sector being subdued in 2008-09.

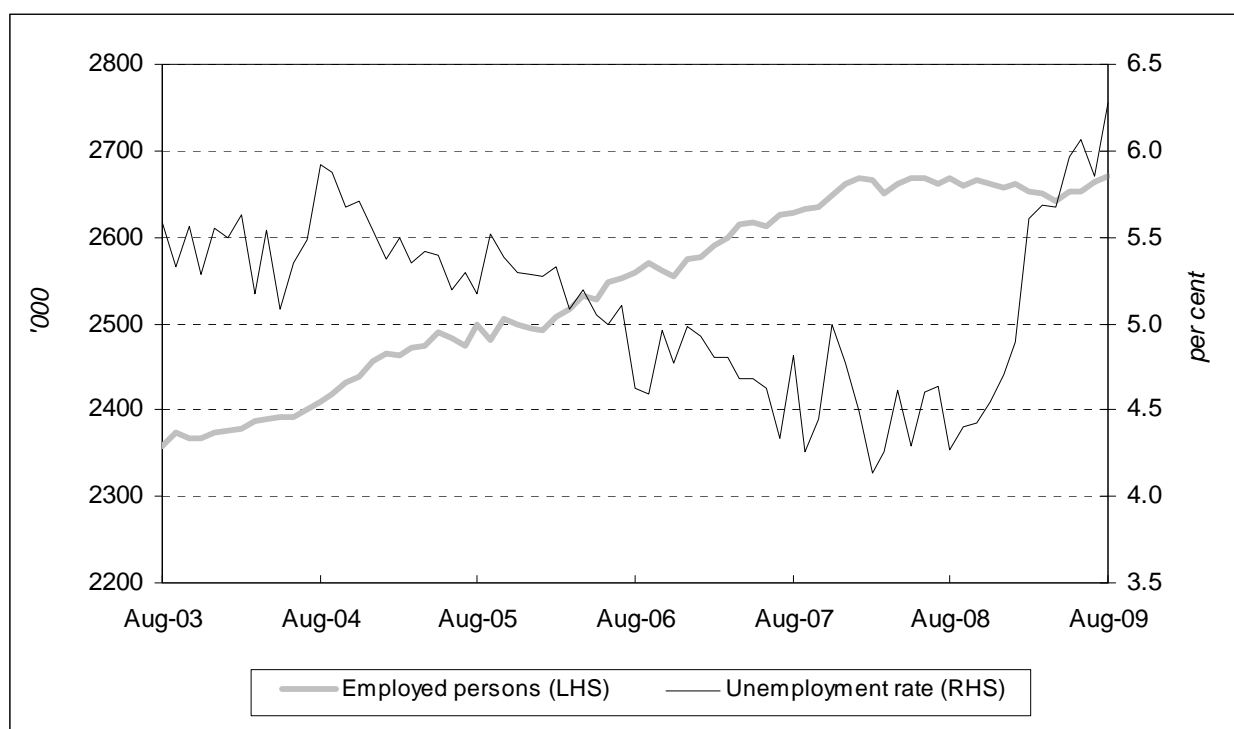
Household consumption rose only slightly in 2008-09. Consumption declined in the first half of the year but resumed growing in the first half of 2009, boosted by increased disposable income from fiscal stimulus payments, lower interest rates, and improvements in consumer confidence.

Housing activity recorded strong growth in 2008-09. There has been significant recovery in housing finance and dwelling approvals over the last half of 2008-09, driven by government support for first home owners and historically low interest rates. While initially the recovery was mainly driven by first home buyers, there are signs that the recovery is becoming more broadly based in the property market. Victoria's housing sector is clearly outperforming the rest of the nation. In the last two quarters of 2008-09, Victoria accounted for more than 30 per cent of national dwelling approvals.

Business investment in Victoria grew by 1.8 per cent in 2008-09. This was driven by increased investment in machinery and equipment, whereas investment in buildings and structures has declined. The slowing business investment growth reported for Victoria in 2008-09 reflects lower capacity utilisation rates, lower than normal business confidence and much tighter credit conditions flowing on from effects of the global financial crisis. Interest rates on business loans have declined by a lesser amount than residential mortgage rates.

Chart 1.4 illustrates how labour market conditions in Victoria have deteriorated in response to the global financial crisis, which has been largely in line with the *2009-10 Budget* forecasts. Reflecting the increasing flexibility of the labour market, employers have reduced hours more than head count. The level of employment in Victoria has been broadly unchanged over the past year, and the Victorian unemployment rate averaged 5.1 per cent in 2008-09, up from 4.5 per cent in the previous financial year. As is generally the case with economic slowdown, it will take some time for any sustained period of economic growth to reverse the damage to Victoria's unemployment rate caused by the global financial crisis. Wage growth has slowed in response to the weaker labour market. Victorian wages grew by 4 per cent in 2008-09, slightly below the forecast of 4.25 per cent growth.

Chart 1.4: Victorian unemployment rate and number of employed persons



Source: Australian Bureau of Statistics

One of the key factors underpinning the resilience of the Victorian economy is strong population growth. Victoria's estimated resident population grew by 2.11 per cent over the year to March 2009, which is the highest growth rate since current estimates began in 1971. Victoria's birth rate and net overseas migration also remain at a very high level.

Economic growth is expected to continue at a slower rate in 2009-10 than in 2008-09. The *2009-10 Budget* forecast Victorian GSP growth of only 0.25 per cent in 2009-10. As growth will be below trend, the unemployment rate is expected to continue rising and is forecast to average 7.0 per cent in 2009-10. However, some of the downside risks to growth have eased. For example, there has been a decisive recovery in consumer and business confidence, and the equity markets have recovered some of their losses, which will benefit household wealth. Nonetheless, the recovery from the global financial crisis will be slow and uneven, reflecting the synchronised nature of the global recession and the need to repair financial systems and balance sheets.