



# Victorian Budget

2010-11 Strategy and Outlook  
Budget Paper No.2

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Victorian Budget Overview

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# Strategy and Outlook

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## 2010-11



Presented by

**John Lenders MP**

Treasurer of the State of Victoria  
for the information of Honourable Members

**Budget Paper No. 2**



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## INTRODUCTION

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Budget Paper No. 2 *Strategy and Outlook*, describes the State's economic and financial position and performance while also outlining the Government's fiscal and economic reform strategy. This budget paper analyses how the Victorian economy is performing under the improving economic conditions. It demonstrates the Government's commitment to supporting the recovery from the downturn through infrastructure spending to boost productive capacity and through investment in skills, education and economic reform to drive long-term economic growth, competitiveness and productivity.

This budget paper takes into account the financial impacts of all policy decisions taken by the Victorian Government, as well as Commonwealth Government funding revisions and other information that affects the projected general government sector financial statements as at 27 April 2010 unless otherwise stated. Financial impacts of decisions taken after that date will be reflected in the *2010 Pre-Election Budget Update* and the *2010-11 Budget Update*.

Budget Paper No. 2 is the primary source for information on the State's financial performance, forward projections and strategy for the *2010-11 Budget*, and consists of the following chapters and appendices.

### **Chapter 1 – Economic and fiscal strategies and objectives**

Chapter 1 focuses on the Victorian Government's economic and fiscal strategies in the context of the *2010-11 Budget*, including the impact of the emerging global and domestic economic recovery. It details Victoria's financial policy objectives and strategies and discusses how the *2010-11 Budget* contributes to the achievement of these goals in the general government sector.

The *2010-11 Budget* confirms Victoria's solid fiscal position, which will support business and consumer confidence, private investment and jobs growth, and enable ongoing government investment in economic and social infrastructure.

### **Chapter 2 – Economic conditions and outlook**

Chapter 2 provides an overview of current economic conditions in Victoria in the context of the international and Australian economic environment. It provides a detailed discussion of the projected trends in the key economic indicators: gross state product, employment, unemployment, inflation, wages and population. The Victorian economy has handled the challenges posed by the global financial crisis and ensuing global recession with resilience. This is due to Victoria's diverse economy, strong population growth, effective policy responses and ongoing emphasis on reform. The chapter also details the key risks facing the Victorian economy.

### **Chapter 3 – Budget position and outlook**

Chapter 3 outlines the general government budget position as well as the forward year estimates. It shows how the Government's prudent financial management and economic and fiscal strategy, outlined in Chapter 1, will impact on the general government sector's financial performance and position.

The chapter includes a summary of the forecast movement in key financial aggregates across the forward estimates, along with the major factors behind these movements. It discusses the assumptions underpinning the financial projections and comments on their sensitivity to fiscal risks. The estimates take into account the financial impacts of all policy decisions taken by the Victorian Government, as well as Commonwealth funding revisions and other information that affects the projected general government sector financial statements as at 27 April 2010 unless otherwise stated.

### **Chapter 4 – Financial sustainability of Victorian Government**

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

The fiscal aggregates within the chapter demonstrate the Government's objective of maintaining net financial liabilities at prudent levels consistent with the maintenance of the State's AAA credit rating.

### **Chapter 5 – Economic reform agenda**

Chapter 5 discusses the economic reform agenda aimed at enhancing Victoria's productivity and competitiveness over the coming decade.

This chapter explains how economy-wide reforms, human capital reforms and planning and infrastructure reforms will position Victoria for a rapid recovery and ensure the State's continued prosperity in the face of the longer-term challenges of climate change, population growth and an ageing population.

### **Appendix A – Operating statement reconciliation**

Appendix A reconciles the movement in the general government's operating statement's forward estimates between those in the *2009-10 Budget Update* and those in the *2010-11 Budget*. As part of this reconciliation, explanations are provided on the key elements driving the movements in estimates.

### **Appendix B – Sensitivity analysis table**

Appendix B illustrates the impact that changes to the economic assumptions could have on the State's budget position.

## CHAPTER 1 – ECONOMIC AND FISCAL STRATEGIES AND OBJECTIVES

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- Victoria's economic outlook has improved and growth forecasts have been revised upwards. The resilience of the Victorian economy will see growth strengthen and broaden in 2010-11, and then return to trend rates.
- The *2010-11 Budget* confirms Victoria's strong fiscal position, despite the global downturn. The Government is forecasting an operating surplus of \$872 million in 2010-11, with an average surplus of \$1.2 billion over the forward estimates.
- Operating surpluses allow the Government to fund the delivery of the economic and social infrastructure needed for a growing Victoria while maintaining debt at prudent levels. The infrastructure program is expected to secure around 30 000 jobs in 2010-11.
- Net debt, both as a percentage of gross state product and in nominal dollars, is projected to be lower than at the time of the *2009-10 Budget Update*. The Government is committed to maintaining debt at prudent levels and will achieve this by constraining expenditure growth, maintaining operating surpluses and maintaining borrowings at sustainable levels in the medium term.
- General government net infrastructure investment is projected to be \$6.4 billion in 2010-11 and an average of \$4.6 billion a year from 2011-12 to 2013-14, as the Government continues to deliver a significant infrastructure program aimed at providing the services needed for a growing Victorian population. This investment focuses on areas such as transport, hospitals and schools, including strategically important projects such as Regional Rail Link undertaken in partnership with the Commonwealth.
- Strong, sustainable public finances remain essential to the long-term health of the Victorian economy. The Victorian Government's firm management of underlying expenditure and maintenance of borrowings at sustainable levels have protected the State's AAA credit rating, and will support business and consumer confidence, private investment and jobs growth.
- Ongoing reforms to regulation, taxation and WorkCover boost Victoria's competitiveness and productivity will be essential to supporting strong growth and raising standards of living over the medium term.

## THE ECONOMY AND THE BUDGET

In the *2010-11 Budget*, the Victorian Government is forecasting an operating surplus (net result from transactions) of \$872 million in 2010-11, with an average surplus of \$1.2 billion over the forward estimates period.

Since the publication of the *2009-10 Budget*, which responded to the challenges posed by the global financial crisis and the February 2009 bushfires, Victoria's economic outlook has improved and the State's economy has been relatively resilient. With the *2010-11 Budget*, the Government is acting to lock in and sustain the economic recovery, and support continued employment growth.

The budget continues to invest in the long-term drivers of economic prosperity for Victoria. The Government is increasing Victoria's competitiveness and productivity through investing in skills, education, health and transport services, continuing high economic and social infrastructure spending and maintaining an ongoing program of economic reform and action to reduce costs to business.

Strong, sustainable management of Victoria's finances remains essential to the State's long-term economic performance. The Government's disciplined approach underpins the State's AAA credit rating, sustainable levels of debt and a stable economic environment, which help to support business and consumer confidence, private investment and jobs growth. Despite the State's revenues not yet fully recovering from the ongoing impact of the global financial crisis, the Government has maintained service levels for the community. The budget maintains strong operating surpluses through the forward estimates period in order to fund the Government's infrastructure program, while keeping debt at sustainable levels. On average in the period 2010-11 to 2013-14, 74 per cent of the infrastructure program is funded by cash operating surpluses.

## CURRENT ECONOMIC CONDITIONS AND OUTLOOK

The economic outlook for Victoria has improved since the publication of the *2009-10 Budget Update* in November 2009. While the Australian and Victorian economies have not been immune to the global financial and economic turmoil, they have been more resilient than many other advanced economies. At the national level, a healthy banking system, the relative strength of Australia's major trading partners in Asia, supportive monetary policy settings and the Commonwealth's fiscal stimulus have mitigated the impact of the downturn. In addition, for Victoria, growth has been sustained through the Government's significant infrastructure program along with sound fiscal management, a competitive tax environment and the Government's active economic reform program (focussed on skills development, the provision of economic infrastructure, competition reform and reducing business costs).

Economic growth is expected to be higher than forecast in the *2009-10 Budget Update*, and Victoria has outperformed national benchmarks on a number of economic measures including job creation and dwelling approvals. Nevertheless, economic growth is expected to be below trend in 2009-10 due to the lingering effects of the global financial crisis, but is likely to strengthen and broaden in 2010-11. Victorian gross state product (GSP) is expected to grow by 2.25 per cent in 2009-10 and by 3.25 per cent in 2010-11. After 2010-11, it is expected that growth will return to trend rates of around 3 per cent per annum.

Further detail on the economy and the economic outlook is provided in Chapter 2 *Economic Conditions and Outlook*.

## **ENSURING STRONG LONG-TERM SUSTAINABLE GROWTH**

As the impact of the Commonwealth Government's fiscal stimulus passes its peak and economic recovery takes hold, resources in the economy will increasingly be freed up to allow the private sector to contribute more to growth. The Victorian Government's prudent fiscal management and budget settings continue to support a AAA credit rating and provide a basis for strong growth in private sector activity.

To support long-term sustainable growth and rising living standards, the Government continues to look for ways to make Victoria a competitive place to do business. For example, the Government has expanded the *Reducing the Regulatory Burden* initiative to achieve a \$500 million per annum reduction in regulatory burden by July 2012. Victoria's average WorkCover premium will be cut to 1.34 per cent in 2010-11, delivering savings of approximately \$60 million to Victorian employers. The cut makes Victoria's average premium second only to Queensland's rate of 1.30 per cent. In addition, the *2010-11 Budget* has further reduced payroll tax in Victoria to 4.90 per cent, creating savings of \$193 million over four years for around 31 000 businesses. Close to 100 000 new jobs have been created in the Victorian economy since March 2009, demonstrating the success of the Government's plan to support business confidence and secure local jobs through productivity enhancing infrastructure investment.

The State is also taking advantage of opportunities to improve the health and skills of Victoria's workforce, which will be critical for driving future productivity growth and economic prosperity. Under the Government's *Securing Jobs for Your Future* reform, Victoria is moving towards a demand driven vocational education and training system that is more responsive to the needs of individuals and businesses and will help ensure the state has the skills available to support growth and create jobs. Victoria is widely acknowledged as having a high performing and efficient health system, and additional investments made in the *2010-11 Budget* will help support this.

The Government is also investing to meet the challenges of Victoria's population growth. Ongoing investments in areas such as education, public safety and transport will underpin services for a larger population. The current review of the *Planning and Environment Act 1987* will consider how to reduce avoidable time delays in the planning and investment approval processes and facilitate household and private business investment.

Further detail on the Government’s fiscal strategy and investment program can be found in the sections below, while the Government’s economic reform agenda is outlined in Chapter 5 *Economic Reform Agenda*.

## SUSTAINABLE FISCAL STRATEGY

The Victorian Government entered the global financial crisis with a strong fiscal position. This has allowed it to weather the storm without placing its AAA credit rating at risk or cutting services to the community. As the economy recovers, the Government will continue to deliver key services to Victorian families and communities, while ensuring that its aggregate fiscal position remains sustainable.

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

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

The Government’s short and long-term financial objectives and targets are summarised in Table 1.1. Further detail on the objectives and a discussion of how the *2010-11 Budget* will support their achievement can be found in Chapter 3 *Budget Position and Outlook*.

**Table 1.1: 2010-11 financial objectives and strategies**

<i>Objective</i>	<i>Short-term target</i>	<i>Long-term target</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 the 2006 election commitments.	Provide improved service delivery to all Victorians.
Taxation	Implement reforms.	Provide a fair and efficient tax system that is competitive with other states.
Net financial liabilities	Maintain a AAA credit rating.	Maintain state government net financial liabilities at prudent levels.

*Source: Department of Treasury and Finance*

## Operating surplus

The Government is forecasting an operating surplus (net result from transactions) of \$872 million in 2010-11, with an average of \$1.2 billion over the forward estimates period (see Chart 1.1).

The Government remains committed to achieving its operating surplus targets and has maintained a strong operating position despite the impact of the global recession. These operating surpluses are required for the Government to continue undertaking significant capital expenditure each year. In line with prudent financial management, the cash generated by these surpluses is being used to fund the Government's investment in the infrastructure that Victoria needs.

In the *2009-10 Budget*, the Government revised its short-term operating surplus target from a goal of at least 1 per cent of revenue to at least \$100 million per annum. This allowed for the delivery of vital services and infrastructure while maintaining a sound fiscal position during the global financial crisis. The *2010-11 Budget* maintains the target of \$100 million per annum, with the Government committed to returning to a 1 per cent of revenue target over the longer term.

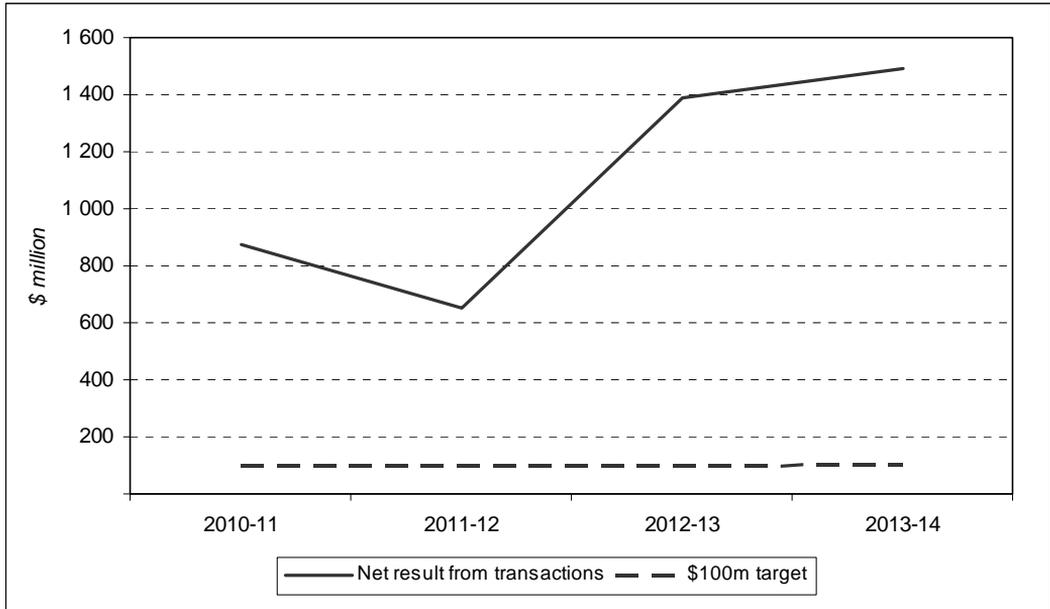
The operating surplus for 2010-11 is in line with that forecast in the *2009-10 Budget Update*, reflecting upward revisions to both revenue and expenses.

Taxation revenue has been revised upwards, consistent with the improved economic outlook and the strength of the Victorian property market. Higher goods and services tax (GST) revenue reflects both a larger than expected national GST pool and an increased share of the pool for Victoria, following the Commonwealth Treasurer's acceptance of the recommendations in the Commonwealth Grants Commission's *Report on GST Revenue Sharing Relativities – 2010 Review*. However, taxation and GST revenue in 2010-11 and 2011-12 is expected to remain over \$500 million per annum below what was projected in the *2008-09 Budget*.

Increases in expenditure are primarily related to additional service delivery initiatives in law and order, hospitals, transport and education, increased non-cash depreciation expenses resulting from asset revaluations, and an upward revision of grant expenses for first home owners.

Revenue and expenses are projected to grow by 3.3 per cent a year and 2.9 per cent a year on average, respectively, over the forward estimates, resulting in higher operating surpluses in the latter years. The operating surplus dips down temporarily in 2011-12, as Commonwealth grants to Victoria associated with the fiscal stimulus package fall sharply, resulting in slower growth in total revenue in that year, followed by stronger growth in the operating surplus in 2012-13.

**Chart 1.1: General government sector net result from transactions**



Source: Department of Treasury and Finance

## Infrastructure

The State's forecast operating surpluses will allow the Government to continue its delivery of a significant infrastructure program aimed at providing the services needed for a growing Victorian population, and at securing jobs.

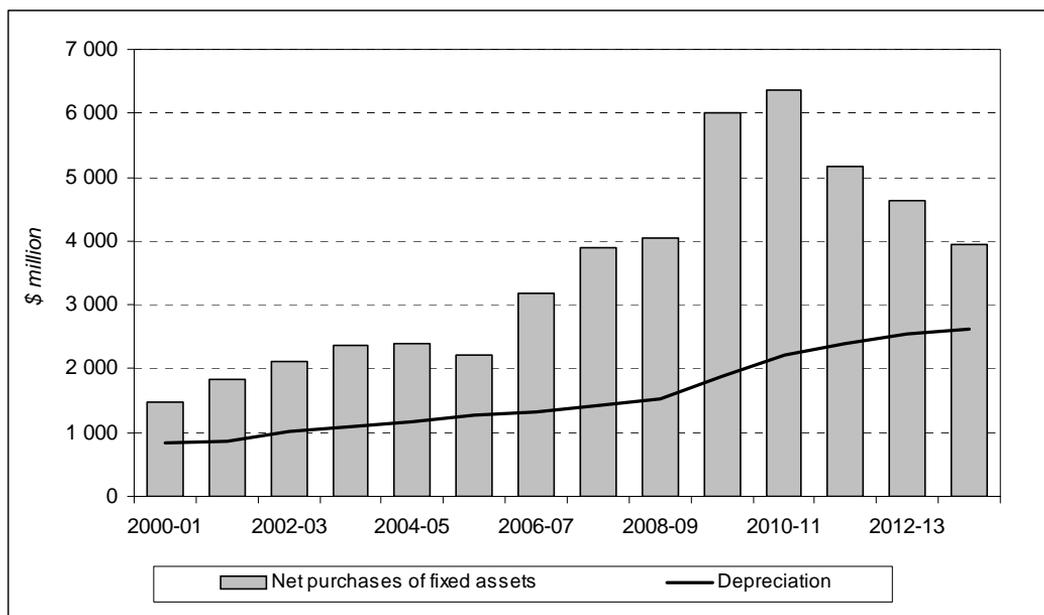
Net infrastructure investment by the general government sector is projected to be \$6.4 billion in 2010-11 and an average of \$4.6 billion a year from 2011-12 to 2013-14 (see Chart 1.2).

This investment, funded by the Victorian Government in partnership with the Commonwealth Government, will enhance the ongoing economic capacity of the State and improve longer-term productivity growth. The infrastructure program in Victoria is estimated to secure around 30 000 jobs in 2010-11.

General government net infrastructure investment is projected to remain at high levels throughout the forward estimates period, even as the investment associated with the Commonwealth fiscal stimulus and many substantial Victorian Government projects concludes.

Infrastructure investment is expected to exceed estimated depreciation between 2010-11 and 2013-14 (see Chart 1.2), resulting in growth of 3.2 per cent in the general government real capital stock over this period.

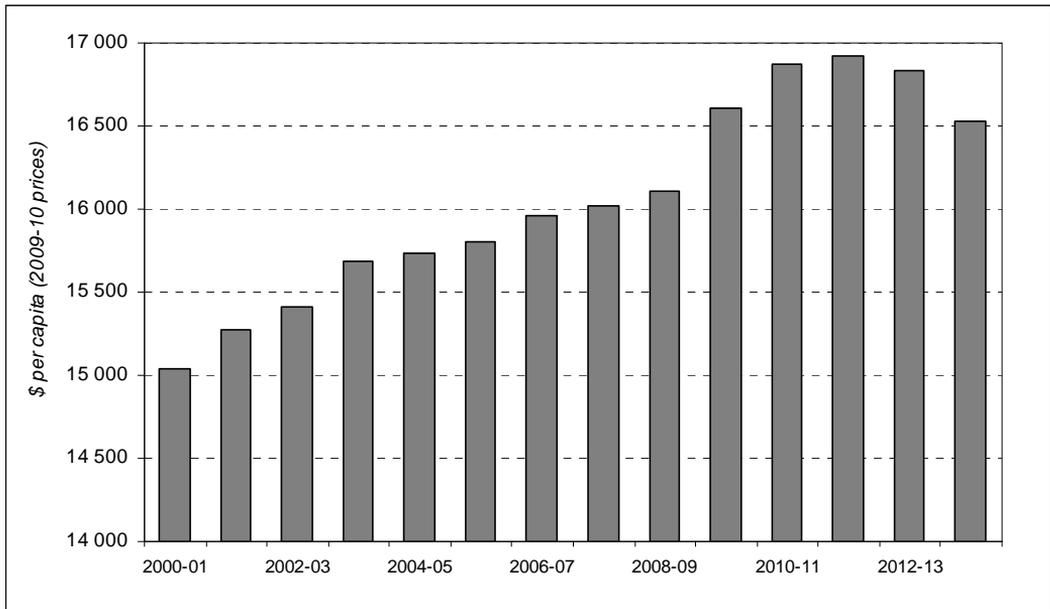
**Chart 1.2: General government sector net infrastructure investment**



Source: Department of Treasury and Finance

The general government sector real capital stock is the accumulation of past acquisitions of land, buildings, infrastructure, equipment and intangible assets, less amounts used up in depreciation. It represents an important part of the state’s capacity to grow, deliver quality services, and support private sector economic activity. There has been strong growth in Victoria’s real capital stock per capita in recent years despite the State’s record population growth. Real capital stock per capita is expected to remain at historically high levels across the forward estimates period, but to come off its 2011-12 peak in 2012-13 and 2013-14 as capital investment returns to more usual levels (see Chart 1.3).

**Chart 1.3: General government sector real capital stock per capita as at 30 June<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

(a) Real capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets in 2009-10 prices.

The 2010-11 Budget delivers a further \$1.2 billion asset investment for health, aged care and community health facilities, including \$618 million for facilities in regional Victoria.

The budget continues the implementation of the Victorian Transport Plan, with the funding of \$5.8 billion of transport projects, including funding of \$4.3 billion (in partnership with the Commonwealth) for the Regional Rail Link, and \$804 million for the purchase of 50 new trams to increase the capacity of Victoria's public transport system.

The 2010-11 Budget provides a \$381 million of asset investment as part of the Victorian Schools Plan. The Victorian Schools Plan, combined with the *Building the Education Revolution* program, has seen a record 1 300 schools being modernised in Victoria since 2006, surpassing the Government's 2006 election commitment.

The budget also concludes the Government's delivery of its *Labor's Financial Statement 2006* election commitments, with a further \$337 million of asset initiatives to complete the promised \$3.4 billion asset investment program. This complements the delivery of the Government's \$2.6 billion program of output election commitments, for which funding was completed in the 2008-09 Budget.

## Service delivery

The *2010-11 Budget* delivers Victorians quality services in health, education and public safety as well as responding to other high priority community needs.

To help meet the growing demand for Victoria's hospital services, the budget commits \$610 million of funding over five years. An additional \$150 million over three years is provided to support public hospitals to make the hospital system more effective, invest in clinical practice improvements and drive innovation in hospitals. Furthermore, as part of the COAG agreement on health reform, the Commonwealth is providing \$935 million over four years for additional services in Victorian hospitals.

In addition, the Government will provide \$561 million over five years plus \$112.3 million over four years to deliver an additional 1 966 frontline police to make Victorian communities safer.

The Government will also maintain its commitment to reducing disadvantage through *A Fairer Victoria*, investing \$42 million to further enhance the quality and robustness of the assistance provided to vulnerable children and their families. In addition, \$75 million over four years will be provided for a range of measures to further increase support for people experiencing mental illness and \$70 million over four years to improve services for Victorians with a disability.

The budget provides \$191 million over five years to meet demand for early childhood services and provide more support for children with a disability or a developmental delay.

The Government continues to help Victorians in reconstruction and recovery from the 2009 bushfires. Since the *2009-10 Budget*, \$211 million has been announced to support the reconstruction and recovery effort. This budget invests a further \$202 million over five years as well as \$52 million asset investment for bushfire related initiatives.

The Government has also provided a \$105 million package of initiatives to support Victoria's Land and Biodiversity White Paper, *Securing Our Natural Future*, which sets out a framework that will significantly change the way Victoria's natural resources are managed.

## Taxation

The Victorian Government has announced and implemented a substantial program of tax reform over the past 11 years. These reforms aim to improve economic outcomes by increasing the efficiency and equity of the Victorian tax system, and include:

- over \$5.7 billion worth of tax cuts as part of significant reform of land tax through flattening the rate scale and reducing the payroll tax rate; and
- being the first state or territory to abolish all eight taxes as agreed with the Commonwealth Government under the 1999 Intergovernmental Agreement on Federal Financial Relations.

In the *2010-11 Budget*, the Government has continued to reduce costs for Victorian businesses and other taxpayers by introducing further taxation reforms worth \$223 million over four years, including:

- cutting payroll tax by 0.05 per cent to 4.90 per cent at a saving of \$193 million over four years for 31 000 businesses meaning that businesses with a payroll of between \$5.5 million and \$17.95 million will pay the lowest rate in Australia;
- extending the current land tax exemption for retirement villages residential care facilities, supported residential services and residential services for people with disabilities to include the construction phase of these facilities (for a maximum construction period of two years), which will reduce costs to business and encourage private investment in the sector; and
- reducing compliance costs by developing a web-based system for the payment and ‘stamping’ of land transfer duty.

This Government’s tax reforms have moved the State from having the highest number of business taxes to now having the second lowest. These reforms create a more competitive business environment driving new investment and job opportunities in Victoria. In comparison, New South Wales, Queensland, Western Australia and South Australia have deferred to at least 1 July 2012 the abolition of States taxes under the 1999 Intergovernmental Agreement on Federal Financial Relations, resulting in over \$400 million in revenue to them collectively in 2009-10. To date, Victoria and Tasmania remain the only states to have fully delivered the agreed range of tax abolitions.

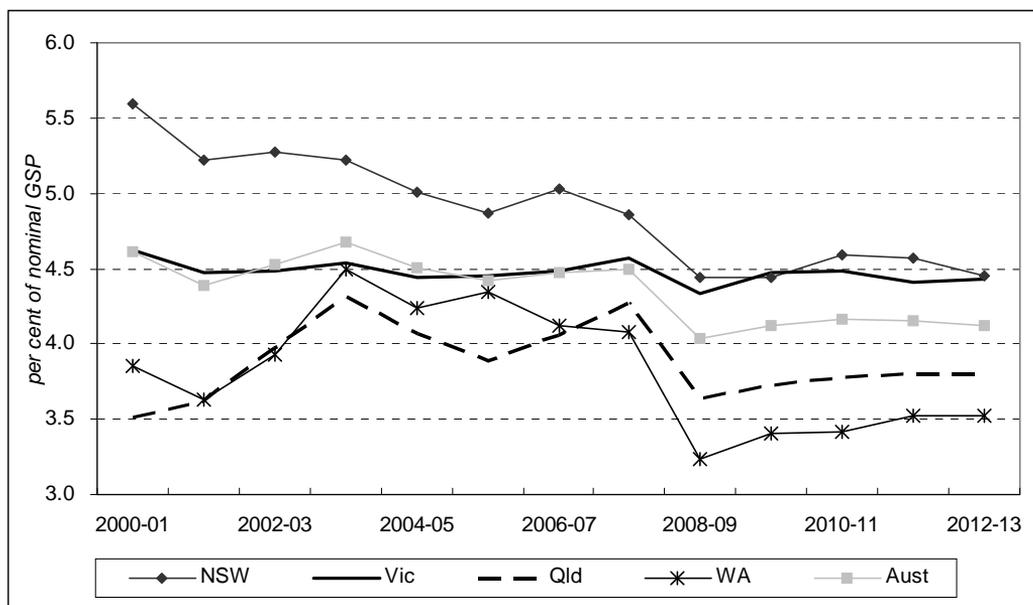
Victorian businesses will also benefit from lower WorkCover premiums announced for 2010-11, which cut the average premium to 1.34 per cent. This cut, the sixth in seven years, cements Victoria as having the second lowest average premium among the states with gap narrowing to Queensland which recently increased its premium to 1.30 per cent. Victoria’s trajectory on WorkCover average premium rates is testament to a resolute commitment to lower workplace injury while reducing the burden on business.

Chart 1.4 provides a comparison of Victoria’s taxation competitiveness with New South Wales, Queensland, Western Australia and the Australian average, based on forecasts published at a similar time to the *2009-10 Budget Update* (or equivalent publication) of these jurisdictions. Over most of the 2000-01 to 2012-13 period Victoria maintains a lower tax to GSP ratio than New South Wales.

The decline in Victoria’s tax competitiveness in 2008-09 largely reflects the impact of the global financial crisis on economic growth and revenue in Western Australia, New South Wales and Queensland. By comparison, Victoria’s economy proved relatively resilient. This has meant that Victoria’s revenues have held up better than many other jurisdictions.

To address deteriorating budget positions, some states introduced revenue raising measures in 2009. For example, New South Wales and Queensland increased their land tax rates and deferred abolition of taxes under the Intergovernmental Agreement on Federal Financial Relations.

**Chart 1.4: Taxation revenue as a percentage of GSP<sup>(a)</sup>**



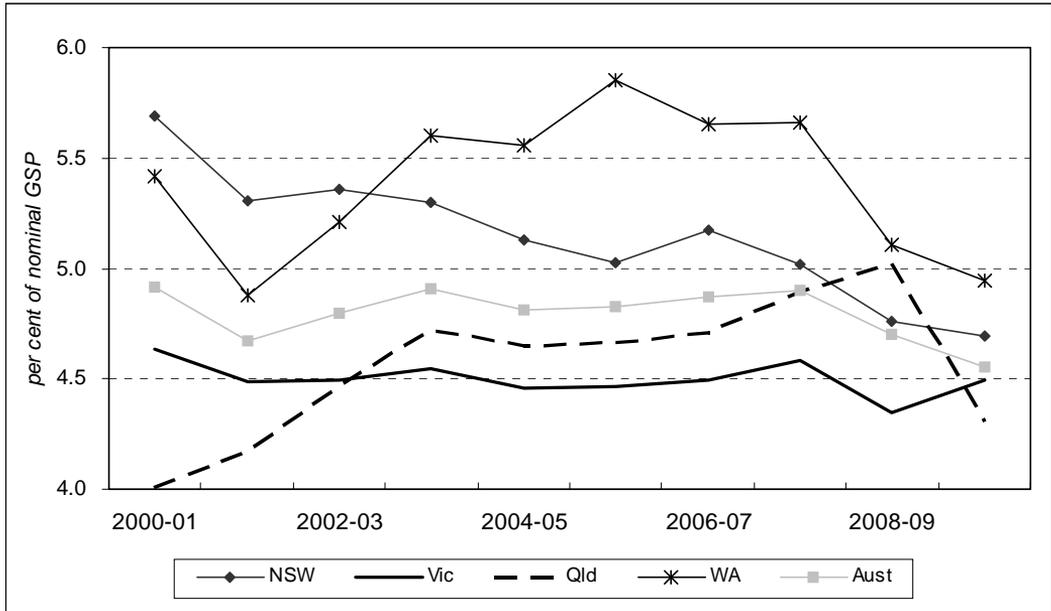
Sources: Australian Bureau of Statistics; Department of Treasury and Finance and various state publications

Note:

(a) Historical taxation data to 2008-09. Thereafter, taxation data are 2009-10 Budget Update (or equivalent publication) estimates, being the latest forward estimates available on a consistent basis across all jurisdictions.

Making interstate comparisons of tax competitiveness is difficult and Victoria’s position needs to be considered in the broader context. For example, unlike some other states, Victoria has only limited access to royalty revenue. In 2008-09, Western Australia, Queensland and New South Wales each collected in excess of \$1 billion in royalty revenue compared with less than \$50 million in Victoria. Chart 1.5 shows that Victoria’s ratio of taxes plus royalties to GSP is consistently below that of the other major states and the Australian average and provides a clear demonstration of the significant share of own source revenue that states with large natural resources take from royalties.

**Chart 1.5: Taxation and royalty revenue as a percentage of GSP<sup>(a)</sup>**



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

Note:

(a) Historical taxation and royalty data to 2008-09. Taxation and royalty data for 2009-10 are 2009-10 Budget or 2009-10 Budget Update (or equivalent publication) estimates.

## Net financial liabilities

The Government's balance sheet remains solid despite the State's revenues not yet fully recovering from the impact of the global financial crisis. A healthy balance sheet has been achieved through the disciplined management of operating expenditure and net financial liabilities. Victoria's AAA credit rating was reaffirmed by Standard & Poor's in September 2009 and by Moody's Investors Service in January 2009.

Net debt, both as a percentage of GSP and in nominal dollars, is projected to be lower than at the time of the *2009-10 Budget Update*. As a per cent of GSP, net debt now peaks at 4.3 per cent, rather than 5.1 per cent, reflecting the Government's prudent financial management and improved economic growth in Victoria. Net debt is expected to decline to 4.1 per cent of GSP by June 2014. Since the *2009-10 Budget*, projections of net debt as a percentage of GSP have been revised down substantially, by around 1 per cent, across the forward estimates years. This is the result of lower debt in dollar terms, as well as stronger growth in the economy.

Over the forward estimates period, the ratio of net financial liabilities to GSP is projected to rise from 11.2 per cent at June 2010, to 12.0 per cent at June 2012. This reflects an increase in the state's estimated net superannuation liability, as well as higher levels of general government net debt as the Government's significant infrastructure investment program is rolled out. Over the medium term the Government is committed to reducing net debt and returning Victoria's infrastructure program to more historical levels. Accordingly the ratio of net financial liabilities to GSP is forecast to reduce to 11.9 per cent by June 2013 and 11.3 per cent by June 2014, consistent with ongoing fiscal sustainability.

Victoria's operating surpluses have allowed the Government to continue undertaking significant capital expenditure while keeping net debt sustainable. Net debt over the forward estimates period has remained at fiscally prudent levels as constrained growth in operating expenditure has made possible cash operating surpluses, which contribute to the financing of infrastructure spending.

On average in the period from 2010-11 to 2013-14, it is expected that 74 per cent of the general government sector infrastructure program will be financed by cash operating surpluses, with the balance to be funded through borrowings. This approach is consistent with the Government's delivery of infrastructure to meet community needs as well as its commitment to prudent management of the State's finances.



## CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

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- The Victorian economy has proven relatively resilient to the challenges posed by the global financial crisis and the ensuing global recession. This is due to Victoria's diverse economy, strong population growth, effective policy responses and ongoing emphasis on reform.
- The global economic recovery is uneven, with strong growth in Asia offset by weaker recoveries in the advanced economies.
- Prospects for Victorian economic growth have been revised up. Gross state product is forecast to grow by 3.25 per cent in 2010-11. Growth is expected to be driven by most components of domestic demand, whereas weaker conditions are forecast for Victorian exports.
- Victorian employment has demonstrated significant strength. The forecast for employment growth has been revised up, and the unemployment rate is expected to be significantly lower than previously forecast.
- The central projection is for moderate growth in wages and prices. However, with the economy emerging from the downturn with much less spare capacity than previously anticipated, the risks to both are generally on the upside.
- Population growth in Victoria has been very strong. However, growth is forecast to ease over the estimates period.
- Since the domestic economy is coming out of a downturn, the economic outlook is generally positive. Nonetheless, uncertainty remains high and there are a number of short-term risks to the outlook, including the global economy, exchange rates and interest rates.
- The resumption of strong growth in the terms of trade and mining activity will likely see a return of the 'two speed' economy theme and pose risks for the Victorian economy. As a result, the Victorian Government will continue to focus on boosting productivity and flexibility to ensure that it maintains competitiveness.

## VICTORIAN ECONOMIC PROJECTIONS

The Victorian economy is improving and has demonstrated more resilience than other advanced economies in dealing with the global recession. Economic growth is forecast to be stronger than expected in the *2009-10 Budget Update*. Growth is still expected to be below trend in 2009-10, due to the lingering effects of the global financial crisis, but is likely to strengthen and broaden in 2010-11. Victorian gross state product (GSP) is expected to grow by 2.25 per cent in 2009-10 and by 3.25 per cent in 2010-11. After 2010-11, it is expected that growth will return to trend rates of around 3 per cent.

Higher GSP growth in 2010-11 is likely to be attributable to high levels of consumer confidence and household spending. Dwelling investment is also expected to contribute to growth in Victoria as dwelling approvals have recently been at high levels, reflecting low interest rates and first home buyer assistance. Conditions have been more challenging for business investment, particularly due to tighter lending conditions. However, over the past year business conditions and confidence have improved.

The Victorian labour market has been strong over the past year, generating the highest employment growth of all the states. Accordingly, employment growth forecasts have been revised upwards with lower projections for the unemployment rate. Inflation and wage growth forecasts are broadly unchanged from the *2009-10 Budget Update*.

Population forecasts have been revised upwards due to an increase in historical net overseas migration estimates. However, population growth is still expected to ease over the forecast horizon, due to expected lower net overseas migration.

As the domestic economy is coming out of a downturn, the economic outlook is generally positive. Nonetheless, uncertainty remains high and there are a number of risks to the outlook. The risk of overseas sovereign defaults may hamper growth and confidence in the global economy. The relatively strong performance of the Australian economy and China's demand for resources will put upward pressure on the exchange rate and interest rates, which will continue to pose challenges for Victorian businesses. The strong labour market and high levels of consumer and business confidence may offset some of these downside risks.

The economic projections for the *2010-11 Budget* are set out in Table 2.1. These projections assume constant exchange rates, and that oil prices follow the path implied by oil futures contracts.

**Table 2.1: Victorian economic projections<sup>(a)</sup>**

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Real gross state product	0.8	2.25	3.25	3.00	3.00	3.00
Employment	0.2	2.25	2.00	1.75	1.75	1.75
Unemployment rate <sup>(b)</sup>	5.1	5.50	5.50	5.25	5.25	5.25
Consumer price index	2.8	1.75	2.25	2.50	2.50	2.50
Wage price index <sup>(c)</sup>	4.0	3.00	3.25	3.50	3.50	3.50
Population <sup>(d)</sup>	2.2	2.10	1.90	1.80	1.70	1.70

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

Notes:

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

## ECONOMIC OVERVIEW

### International economic conditions and outlook

The outlook for the international economy has improved since the *2009-10 Budget Update*. The International Monetary Fund (IMF) has observed that the global recovery is off to a stronger start than anticipated. However, it also cautions that countries are recovering at different speeds in various regions. In its April 2010 *World Economic Outlook*, the IMF forecast world output to rise by 4.2 per cent in 2010 (Chart 2.1), an upward revision of 1.1 percentage points since October 2009. For most advanced economies, the IMF expects that the recovery will remain sluggish by past standards, while in many emerging and developing economies, activity is expected to be relatively vigorous.

China, India and other east Asian nations are leading the global economic recovery, with strong growth in production, investment and trade. As both China and India are major trading partners of Australia and Victoria, this will be an important stimulus to domestic growth. The share of Victorian merchandise exports going to China and India has more than doubled over the past decade.

China is demonstrating strong economic activity, with gross domestic product (GDP) rising by 12 per cent over the past year. The IMF forecasts growth to remain around 10 per cent a year in the coming years. However, fears of China's economy overheating are mounting due to high credit growth potentially creating asset bubbles and putting upward pressure on inflation. To restrain this authorities have implemented a number of tightening measures, such as raising the reserve requirement ratio for banks.

Rapid growth in China has spurred an increase in intra regional trade, benefiting other export orientated Asian economies, such as Korea, Taiwan and Singapore. These countries were also able to recover quickly because they did not experience the financial crisis seen in the advanced economies.

Although the Japanese economy was one of the hardest hit during the global financial crisis, conditions in Japan continue to improve, largely driven by trade with China and improved household spending. However, persistent deflation remains a concern for Japan. Japan is forecast to grow by 1.9 per cent in 2010 and 2.0 per cent in 2011.

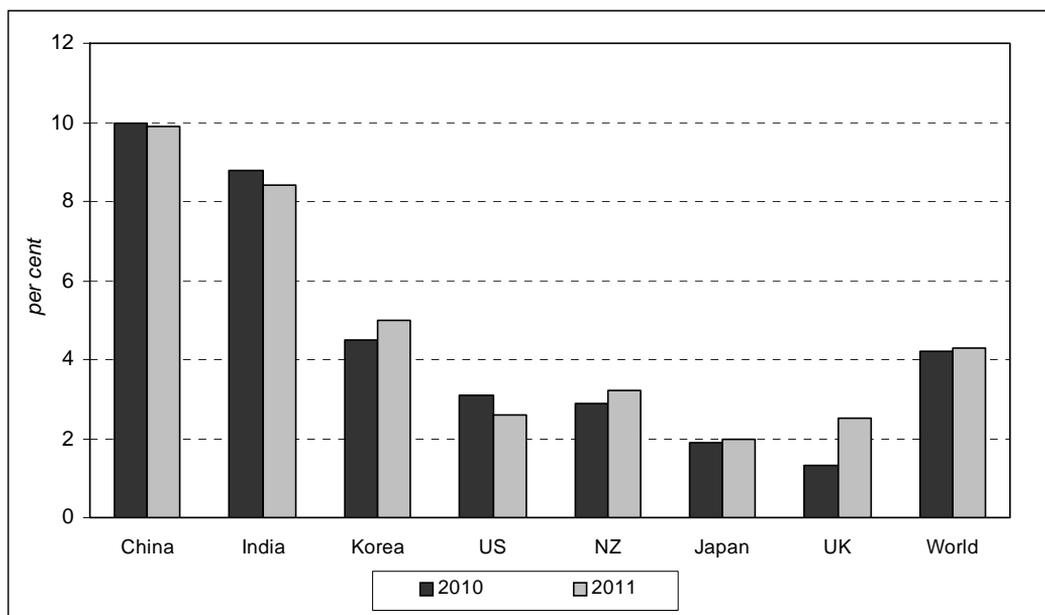
India's outlook remains largely positive with growth predominantly being driven by strengthening domestic demand, although like many other countries, this is largely supported by government stimulus measures. India is targeting 10 per cent annual GDP growth over the fiscal years between 2011-12 and 2016-17, partly driven by its investment in public infrastructure. As a result of increased demand for consumer durables, industrial production has also been strong. The primary risks for India are rising inflation and its high budget deficit.

The global financial crisis had its epicentre in the north Atlantic economies, and conditions there remain challenging. The recovery seems more promising in the United States. GDP growth was strong in the second half of 2009, and retail spending and manufacturing activity appear to have recovered. Although employment growth has recently become positive, unemployment remains high and consumer confidence is still fragile. The IMF forecasts 3.1 per cent growth in 2010 and 2.6 per cent in 2011 for the United States.

Conditions are weaker still in the United Kingdom and other parts of Europe. In addition to the cyclical challenges posed by the global financial crisis, these economies also have to deal with the structural challenges posed by ageing populations and high public debt burdens. GDP in the Euro area is forecast to grow by only 1.0 per cent in 2010 and 1.5 per cent in 2011.

Fears concerning sovereign risk have escalated as Greece, Spain and Portugal struggle to rein in their budget deficits. As a result, the tight borrowing conditions and the negative fiscal outlook are threatening the cohesion of the Euro area. While the risk of further losses in investor confidence may be a localised problem, the synchronised high levels of public debt around the globe may cause financial stability problems. Even in countries not suffering an immediate loss of investor confidence, tension exists between providing credible strategies to reduce public debt and continuing necessary stimulus spending to support the economy.

**Chart 2.1: Economic growth forecasts for major trading partners<sup>(a)</sup>**



Source: International Monetary Fund

Note:

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

## Australian economic conditions and outlook

The Australian economy has withstood the shock of the global financial crisis and the ensuing global recession relatively well. The health of Australia’s financial system meant that it did not experience the same financial strains experienced in the north Atlantic economies, and fiscal and monetary policies were eased significantly to mitigate the shocks stemming from overseas. GDP grew by 2.7 per cent over 2009, which was the among the strongest growth rates recorded by any Organisation for Economic Cooperation and Development (OECD) economy. Consensus forecasts suggest further strengthening in Australia’s growth, with GDP forecast to rise by 3.3 per cent in 2010 and 3.4 per cent in 2011.

During the depths of the global recession, commodity prices fell. This affected the resources industry and narrowed the growth differential seen previously among the Australian states and territories. With improving economic growth, particularly in Asia, the outlook for commodity prices and Australia’s resource exports is now more positive, especially in the energy sector. The rising terms of trade will buoy Australian incomes and activity, and growth in Australia in coming years will receive a significant boost from investment in the resources sector. However, the ensuing upward pressure on the Australian dollar will pose challenges for the non-resource rich states.

Strong population growth will also support GDP growth by underpinning demand for housing and associated services. Population growth in Australia has far outstripped the average population growth experienced in other OECD economies. While population growth has been strongest in the resource rich states, reflecting internal migration flows, all states have experienced a pick up in their population growth.

The national labour market has improved since mid-2009. Employment has grown by 2.1 per cent over the past nine months, and the unemployment rate has fallen from a peak of 5.8 per cent in mid-2009 to 5.3 per cent in March 2010. The labour force participation rate remains near record highs. In comparison to previous downturns, the labour market has held up relatively well due to increased flexibility. Employers were more likely to reduce average hours rather than headcount, and wages have grown modestly. National wage growth slowed to 2.9 per cent over 2009, compared to 4.3 per cent growth a year earlier.

Headline consumer price inflation has been moderating since late 2008. However, it has recently moved higher with a 2.9 per cent increase over the year to the March quarter 2010. While underlying inflation is at the top of the Reserve Bank of Australia's (RBA) target band at around 3 per cent, it is projected to ease back to the middle of the band. The risks to inflation are on the upside, owing to the limited spare capacity in the economy and the robust growth outlook.

The RBA lowered official interest rates to emergency levels at the height of the global financial crisis, with the cash rate falling to 3 per cent. As it became apparent that the Australian economy was performing better than expected, the RBA started to unwind this stimulus. The cash rate has been raised five times since late 2009, to currently be 4.25 per cent. While mortgage rates are now close to neutral levels, financial markets expect further rate rises over the coming year in order to alleviate inflationary pressures.

Overall, the Australian economy has performed well in very challenging circumstances and the immediate outlook is very positive. However, policy makers need to remain vigilant to ensure that growth remains sustainable.

## **Victorian economic conditions and outlook**

Like Australia, the Victorian economic outlook has improved over the past year. State final demand grew by 4.0 per cent over 2009, reflecting State and Commonwealth stimulus measures, improving confidence and a resilient labour market. On a number of measures, the Victorian economy has outperformed national trends, a reflection of a diversified economy with sound fundamentals and a competitive market environment.

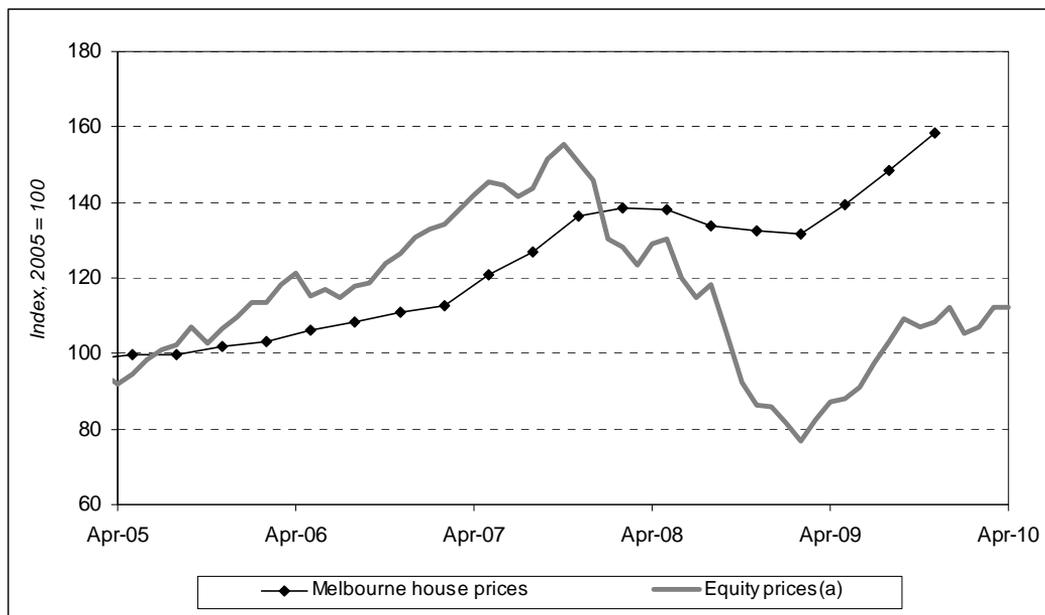
Victoria's GSP is expected to grow by 2.25 per cent in 2009-10 and 3.25 per cent in 2010-11. Dwelling investment and public investment are key drivers of near-term growth. As growth strengthens in 2010-11, the contribution is expected to be more broadly based across domestic final demand, while the outlook for Victorian exports is weaker due to a strong Australian dollar. Employment growth is expected to be solid, and the unemployment rate is forecast to remain at low levels. Population growth has been revised up, but is forecast to ease over the forward estimates period.

## Consumer spending

Victorian household consumption increased by a moderate 2.3 per cent over 2009. Household disposable incomes received a significant boost from government stimulus payments and significant cuts to interest rates. Some of this was reflected in a higher saving rate. While the one-off stimulus impacts have dissipated, households now benefit from the improving labour market and the recovery in household wealth (Chart 2.2). The sharemarket has risen by more than 50 per cent since its March 2009 trough, and Melbourne house prices are recording double-digit annual growth. As a result, consumer confidence has risen to a historically high level.

Victorian consumption growth is forecast to further improve in 2010-11, underpinned by the recovering labour market and strong population growth. While the outlook is generally positive, there is some downside risk. Predicted interest rate increases will reduce disposable incomes, especially for households with a high debt burden.

**Chart 2.2: Major asset prices**



Sources: Australian Bureau of Statistics; Australian Securities Exchange

Note:

(a) Equity prices as at the end of each month, except for April 2010, which is at 27 April 2010.

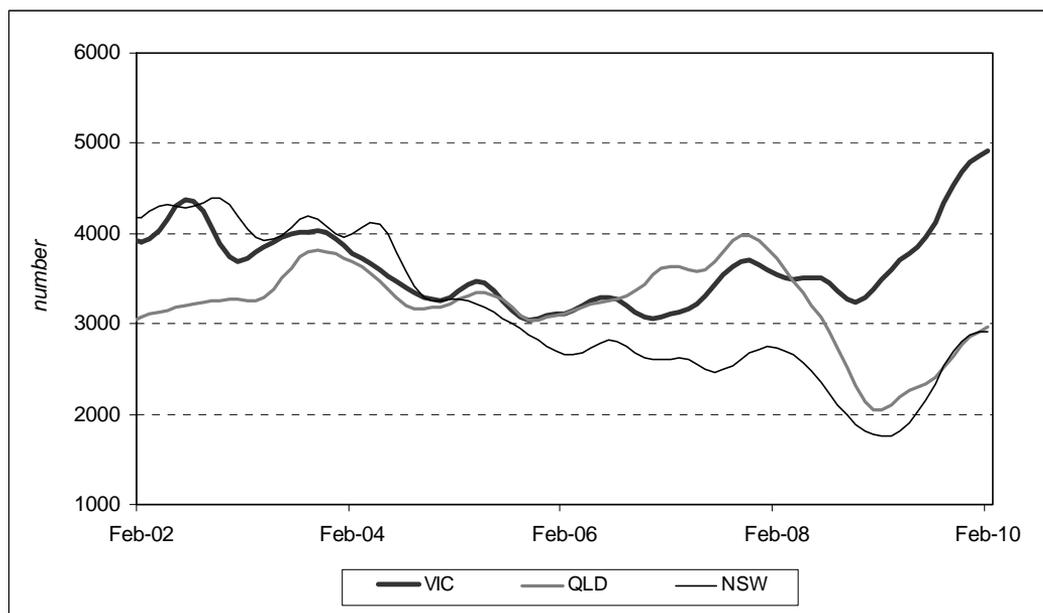
## Dwelling investment

Dwelling investment is expected to continue to grow strongly in 2009-10 and 2010-11. The number of dwelling approvals in Victoria reached a record high of more than 5 000 for the month of December 2009, far outstripping that seen in other states (Chart 2.3). The high level of dwelling approvals indicates that there is a substantial pipeline of work yet to be completed. This high level of activity is helping to meet the demands of a strongly growing population and partly reflects the relative availability and affordability of land in Victoria, as well as the effectiveness of the Government's First Home Bonus. This bonus has been retargeted to have an even greater focus on new housing construction in 2010-11.

The strength of housing demand is also evident in the established housing market. The auction clearance rate has remained above 80 per cent since December 2009 with turnover at high levels, similar to those seen during 2007. House prices in Melbourne increased by 20 per cent over 2009.

However, there has been some recent tapering off in demand following the end of the Commonwealth's First Home Owner Boost. Housing finance has softened, especially among first home buyers, although demand from investors is continuing to rise. The rise in interest rates will also temper housing demand so that dwelling investment is expected to be more moderate beyond 2010-11.

**Chart 2.3: Dwelling approvals<sup>(a)</sup>**



Source: Australian Bureau of Statistics

Note:

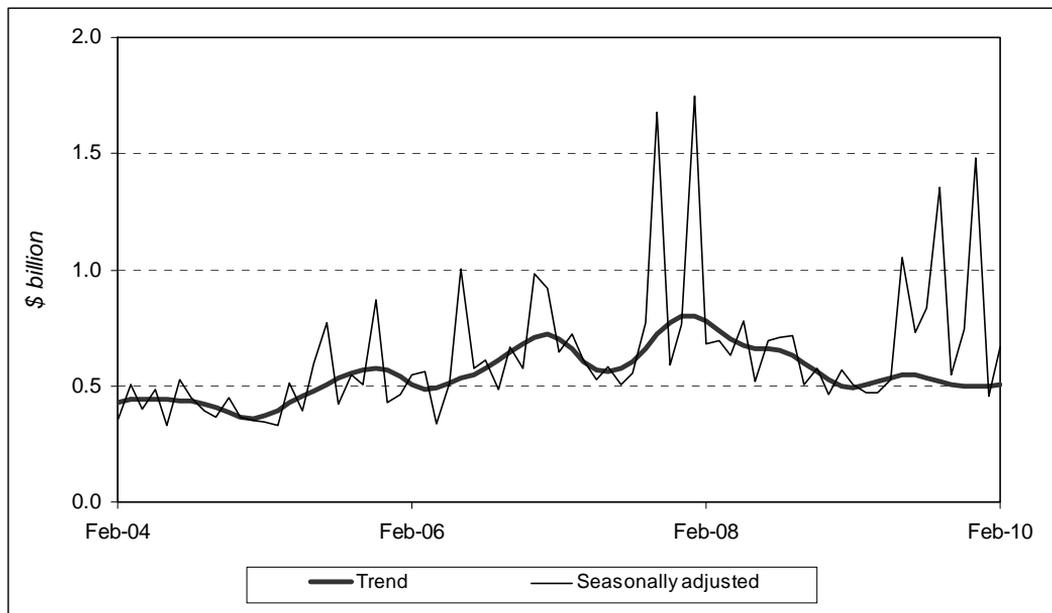
(a) Trend data.

## Business investment

Private business investment intentions were affected sharply by the global financial crisis, as business confidence deteriorated and lending conditions were tightened. However, Victorian business investment held up better than expected in 2009, partly reflecting the influence of stimulus measures. Machinery and equipment investment rose by almost 10 per cent and engineering construction by almost 40 per cent over 2009, whereas non-residential building investment fell by 10 per cent. Public investment has increased by a strong 20 per cent over the past year, boosted by the State Government's infrastructure investment.

The outlook for business investment has improved, though it is not without risk. Business confidence and conditions have recovered to pre-global financial crisis levels, and capacity utilisation rates are rising. Furthermore, engineering construction work yet to be done has increased to record levels. Nationally, businesses are revising up capital expenditure intentions, although much of this is in the mining industry, and with the exception of education-related building, the trend for non-residential building approvals remains weak (Chart 2.4). The cost and availability of credit remains a constraint for some businesses.

**Chart 2.4: Victorian non-residential building approvals<sup>(a)</sup>**



Source: Australian Bureau of Statistics

Note:

(a) Trend data exclude Building the Education Revolution approvals.

## ***International trade***

In contrast to the generally positive outlook for domestic final demand, the outlook for Victoria's exports is softer. Victoria's merchandise exports declined in 2008-09 and are forecast to fall further in 2009-10. This reflects the lingering effects of the global recession, the high level of the Australian dollar, and weakness among some agricultural outputs. Some improvement is expected in 2010-11 in light of the anticipated improvement in the global economy and better prospects for agricultural output.

Victoria's service exports are forecast to continue growing, although there will be some moderation from the rapid growth experienced prior to the global financial crisis. Some of this is due to economic factors such as the exchange rate, but it also reflects tighter visa requirements for international students, with education being one of Victoria's largest export categories.

Victorian international imports fell in 2008-09, but are now recovering. Growth in imports is expected to be solid, reflecting the positive outlook for the domestic economy. Overall, net international exports are forecast to contribute negatively to Victorian growth in coming years. This may be offset by positive net interstate trade.

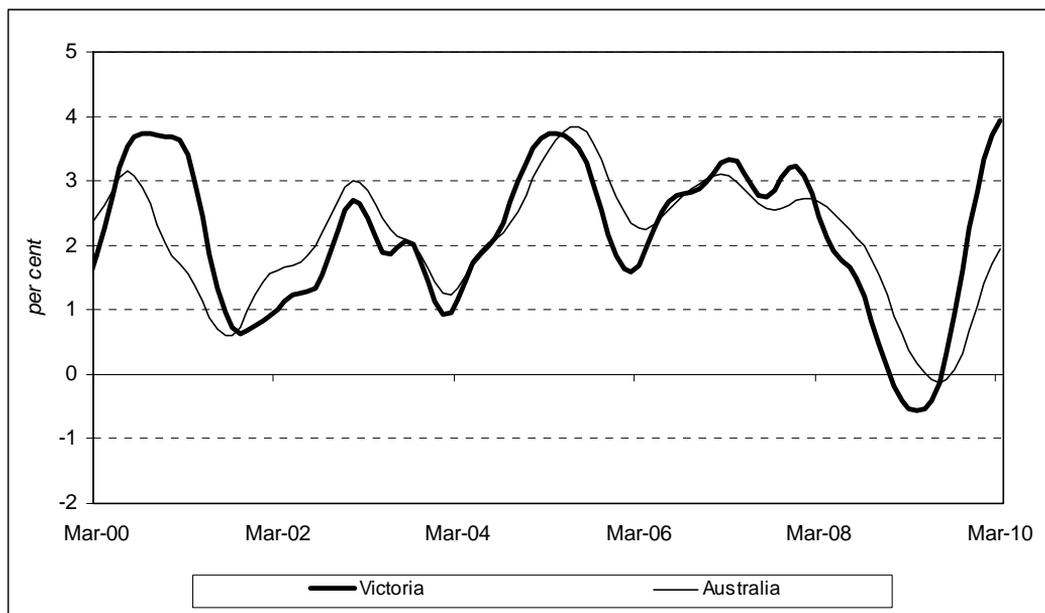
## ***Labour market***

The labour market has been surprisingly resilient through the economic downturn, and unemployment has not increased by as much as initially anticipated. Similar to the national experience, much of the impact on the labour market has materialised through a reduction in average hours worked. This reflects improvements to labour market flexibility over recent decades and business sensitivity to the skills shortages that were prevalent prior to the downturn.

Among the Australian states, the Victorian labour market has been one of the strongest, generating almost 100 000 extra jobs, equivalent to a growth rate of 3.8 per cent, over the past year (Chart 2.5). Most of this increase has been in full time jobs. The largest jobs increases have been in the finance and insurance, and retail trade industries. The unemployment rate is currently 5.4 per cent, down from a peak of 6.0 per cent in mid-2009, and labour force participation is at near record highs.

Employment growth is expected to remain solid in 2010-11. Business surveys suggest an improvement in business confidence and greater hiring intentions, and measures of job advertisements are increasing. Employment in Victoria is expected to rise by 2.0 per cent in 2010-11, with the unemployment rate likely to remain around current low levels.

**Chart 2.5: Victorian and Australian annual employment growth<sup>(a)</sup>**



Source: Australian Bureau of Statistics

Note:

(a) Trend data.

## Wages

Wage growth in Victoria has slowed over the past year in line with earlier weakness in the labour market. The Victorian wage price index grew by 2.7 per cent over the year to the December quarter 2009, the lowest since at least 1998. The result was mainly due to weakness in private sector wages, which rose by only 2.4 per cent over this period. These trends were also evident in lower labour costs identified in business surveys and slower growth in enterprise bargaining agreements. The Victorian Government has also emphasised wage moderation through the implementation of its wages policy in the public sector.

Growth in wages is expected to increase over the forecast period, consistent with the improving economy and labour market, but is nonetheless expected to be relatively moderate at 3.25 per cent in 2010-11 and 3.50 per cent for the following three years. The risks to wage growth are generally on the upside, reflecting possible 'catch up' wage increases and emerging skills shortages.

## ***Inflation***

Consumer price inflation over the year to March 2010 was broadly within the RBA's target band of 2 to 3 per cent. Annual inflation was 2.9 per cent for Australia and 2.8 per cent for Melbourne. Although there were strong rises in transport and housing prices, there has been a fall in clothing and footwear prices.

Overall, headline inflation is forecast to remain consistent with medium-term inflation targets. Melbourne consumer price inflation is expected to average 2.25 per cent in 2010-11 and 2.50 per cent for the following three years. Upward pressure is likely to come from rising unit labour costs and higher rents and house prices. Conversely, a high Australian dollar is likely to restrain imported inflation, as will lower import tariffs for cars, clothing and footwear from 1 January 2010. More generally, as economic activity expands, the RBA is expected to raise the official cash rate further to ensure that inflationary pressures do not become excessive and unsustainable.

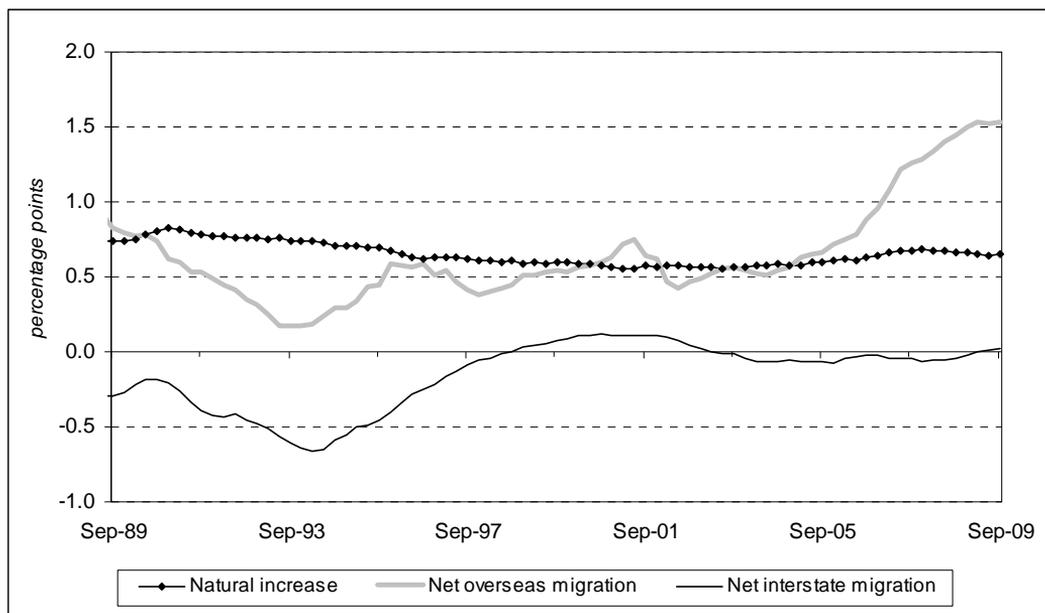
## ***Population***

The Victorian population grew by 2.2 per cent over 2008-09, the highest rate since at least 1971. While population growth at the national level has started to ease, it is continuing to rise in Victoria due to its rising share of national net overseas migration. Net overseas migration has made up two thirds of Victoria's population increase, with the remainder due to natural increase. Net interstate migration is relatively small, but has recently been positive for Victoria (Chart 2.6).

The Australian Bureau of Statistics has revised historical net overseas migration significantly. The 2007-08 final national net overseas migration figure was revised by 64 000 to 277 000. The revision reflects actual movements of people whereas the previous figure was based on migrants' stated intentions. These upward revisions to historical data are the primary reason why population growth forecasts have been revised upwards.

While population growth has been revised up, it is forecast to moderate over the forecast horizon. Commonwealth Government policies for some visa categories have been tightened and are already starting to have some effect. Both the number of temporary business visa applications granted and the number of overseas student commencements have declined in recent months.

**Chart 2.6: Contribution to Victorian annual population growth**



Source: Australian Bureau of Statistics

### **Regional Victoria**

Victoria’s overall strong economic performance can also be observed in regional Victoria. Over the year to March 2010, employment in regional Victoria increased by 3.6 per cent. According to Building Commission data, the value of regional building approvals increased to \$4.9 billion in 2009, up from \$4.1 billion in 2008. This strong growth in building is partly driven by the impact of the State Government’s targeted First Home Bonus in regional Victoria. More than 5 000 bonuses were paid in regional Victoria in the 12 months to March 2010, which has seen more than a quarter of all newly constructed homes in Victoria for first home buyers being built in regional areas. This property market activity has been underpinned by strong population growth. Regional Victoria recorded population growth of 1.6 per cent in 2008-09, the highest of the non-resource states, and the largest growth rate since 1982.

Victoria’s winter crop was favourable for 2009-10, and production is estimated to be 61 per cent higher than the 2008-09 season’s crop. This is despite the area sown to winter crops in 2009-10 falling by around 4 per cent from 2008-09. The improvement was a result of average to above-average rainfall for a majority of the State through spring.

The Victorian dairy sector is expected to remain subdued due to fluctuations in international milk prices and lower milk yields per cow in the northern districts. The livestock sector is likely to enter a period of herd and flock rebuilding as more favourable grazing conditions return.

While there has been welcome rainfall in Victoria in recent months, longer term deficiencies remain. It is anticipated that the State Government's significant investment in water infrastructure in regional Victoria will make certain agricultural output more resilient to rainfall variability.

## **RISKS TO THE OUTLOOK**

Since the *2009-10 Budget Update*, the Victorian economy has performed better than expected. While the economic news has generally been positive, there is still a large degree of uncertainty and a number of risks to the outlook.

At the global level, there are a number of legacy risks from the global financial crisis, which may hamper the recovery. Concerns about high levels of public debt and sovereign risk are particularly prevalent in Europe. The housing situation in the United States is yet to be fully resolved and risks to financial institutions remain. High levels of unemployment in the United States and Europe are a risk to the recovery of private demand. In China, where activity is stronger, there are concerns regarding the state of the property sector, with strong lending growth having driven up property investment and prices.

The Australian dollar has already increased to high levels, and is 27 per cent above its average since it was floated in 1983. Australia's relatively strong economic performance and China's demand for resources could put further upward pressure on the exchange rate and interest rates, which will continue to pose challenges to Victoria's traditional industries.

In Australia, the official cash rate has started to rise again, reflecting the strong rebound in economic activity following the global financial crisis. The labour market has performed better than anticipated – especially in Victoria – and consumer and business confidence have also quickly returned to levels experienced prior to the global financial crisis. These factors could lead to stronger than expected growth. There are risks, however, that this could lead to stronger than expected inflation and wages growth and that skills shortages could re-emerge.

In line with returning confidence levels, the housing market has been buoyant over 2009 and into 2010 with house prices, transaction volumes and clearance rates stronger. However, there is a risk that this momentum is unsustainable and could quickly unwind with further interest rate rises. This would pose a risk to confidence and spending. On the other hand, strong population growth is likely to provide a strong base for housing sector activity.

In the medium term, the Victorian economy faces challenges from global and domestic competitors, demographic changes, shifts in industry composition and climate change. As a result, the Victorian Government will continue to focus on economic reforms that boost the State's productivity and competitiveness.

## CHAPTER 3 – BUDGET POSITION AND OUTLOOK

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- Despite the ongoing impact of the global financial crisis, the Government's prudent fiscal management has ensured that Victoria remains in a strong fiscal position. The Government is budgeting to achieve an operating surplus (net result from transactions) for the general government sector of \$872 million in 2010-11 and an average of \$1.2 billion a year over the forward estimates period.
- This strong operating performance underpins the Government's substantial infrastructure investment and supports service delivery, economic growth and the creation of jobs while maintaining net debt at fiscally responsible levels.
- Revenue is projected to be \$46 billion in 2010-11 and increase by an average of 3.3 per cent over the forward estimates period consistent with the improved economic outlook. Expenditure is forecast to be \$45 billion in 2010-11 and increase by an average of 2.9 per cent over the forward estimates.
- Net infrastructure investment by the general government sector is projected to be \$6.4 billion in 2010-11 and projected to average \$4.6 billion a year over the forward estimates. This reflects significant investment in transport, hospitals, schools and other major capital projects.
- Net debt, both as a percentage of gross state product (GSP) and in nominal dollars is expected to be lower than in the *2009-10 Budget*. Net debt is expected to decline to 4.1 per cent of GSP by June 2014. This is the result of prudent fiscal management as well as stronger growth in the economy.
- By 2013-14, cash surpluses are forecast to fund the Government's entire infrastructure program without the need for additional borrowings.

### FISCAL OVERVIEW

While prospects for Victoria's economic growth have been revised upwards, the impacts of the global financial crisis have had a significant impact on the State's finances, with discretionary revenue in the form of goods and services tax (GST) and taxation yet to return to levels forecast prior to the onset of the global downturn.

The Government is forecasting strong budgeted operating surpluses over the budget and forward estimates period. As shown in Table 3.1, the Government will again meet its budget surplus target of at least \$100 million per year, delivering a net result from transactions for the general government sector of \$872 million in 2010-11, with surpluses averaging \$1.2 billion over the forward estimates. The Government has achieved this result while maintaining key services, constraining expenditure growth and delivering a significant infrastructure program aimed at promoting economic growth, securing jobs and providing vital services. The strong budget position provides capacity for the State to weather uncertain economic times ahead.

The value of general government net debt, both in nominal dollars and as a percentage of the Victorian economy, is projected to be lower than forecast at the *2009-10 Budget Update*. Net debt is forecast to decline from 2013-14 in line with the Government's commitment to maintain a sustainable level of debt, consistent with Victoria's AAA credit rating.

Total general government revenue is projected to increase by an average of 3.3 per cent over the three years to 2013-14, mainly reflecting growth in GST grants and taxation revenue consistent with a rebound in economic growth. However, taxation and GST revenue in 2011-12 is expected to remain over \$500 million below what was projected in the *2008-09 Budget*.

Revenue growth is forecast to decline to 1.8 per cent in 2011-12, reflecting the unwinding of the Commonwealth Government's *Nation Building – Economic Stimulus Plan*. In 2012-13, revenue growth is forecast to increase to 5.5 per cent, primarily reflecting increases in GST grants, the National Healthcare specific purpose payment (SPP) and Commonwealth funding for the Regional Rail Link project as well as growth in taxation revenue.

General government sector expenses from transactions are projected to increase moderately, by an average 2.9 per cent over the three years to 2013-14, primarily reflecting increased demand for services from a growing population and new policy decisions to meet priority needs.

**Table 3.1: General government net result from transactions 2010-11 to 2013-14<sup>(a)</sup>**

(\$ million)

	2010-11 Budget	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Revenue</b>				
Taxation	14 437.8	14 915.3	15 649.4	16 484.9
Interest	358.0	592.5	858.6	859.0
Dividends and income tax equivalent and rate equivalent revenue	504.9	525.0	510.8	754.3
Sales of goods and services	5 847.4	6 306.2	6 542.4	6 623.2
Grants	22 893.1	22 527.9	24 009.8	24 056.7
Other current revenue	1 718.0	1 728.6	1 597.9	1 622.1
<b>Total revenue</b>	<b>45 759.3</b>	<b>46 595.5</b>	<b>49 169.1</b>	<b>50 400.1</b>
% change	4.6%	1.8%	5.5%	2.5%
<b>Expenses</b>				
Employee expenses	16 221.0	17 036.2	17 939.4	18 560.3
Superannuation interest expense	884.1	910.8	935.1	944.5
Other superannuation	1 597.8	1 624.8	1 670.3	1 667.3
Depreciation	2 214.3	2 381.2	2 557.7	2 630.7
Interest expense	939.5	1 320.9	1 762.9	1 894.9
Other operating expenses	15 120.6	15 559.8	15 788.7	16 122.1
Grants and other transfers	7 910.1	7 111.4	7 127.4	7 087.2
<b>Total expenses</b>	<b>44 887.4</b>	<b>45 945.1</b>	<b>47 781.5</b>	<b>48 906.9</b>
% change	3.5%	2.4%	4.0%	2.4%
<b>Net result from transactions</b>	<b>871.9</b>	<b>650.4</b>	<b>1 387.6</b>	<b>1 493.2</b>
<b>Total other economic flows included in net result</b>	<b>( 19.5)</b>	<b>( 11.6)</b>	<b>( 14.4)</b>	<b>( 48.6)</b>
<b>Net result</b>	<b>852.3</b>	<b>638.7</b>	<b>1 373.2</b>	<b>1 444.7</b>

Source: Department of Treasury and Finance

Note:

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

## Alternative measures of operating performance

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

**Table 3.2: Summary of alternative measures of financial performance**

(\$ million)

	2010-11	2011-12	2012-13	2013-14
	Budget	Estimate	Estimate	Estimate
Net result from transactions (net operating balance) <sup>(a)</sup>	871.9	650.4	1 387.6	1 493.2
Net lending/(borrowing) <sup>(b)</sup>	(1 225.2)	(1 511.3)	(175.4)	1 558.4
Net result	852.3	638.7	1 373.2	1 444.7
Cash surplus/(deficit) <sup>(c)</sup>	(697.4)	(390.5)	870.7	1 457.1

Source: Department of Treasury and Finance

Notes:

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

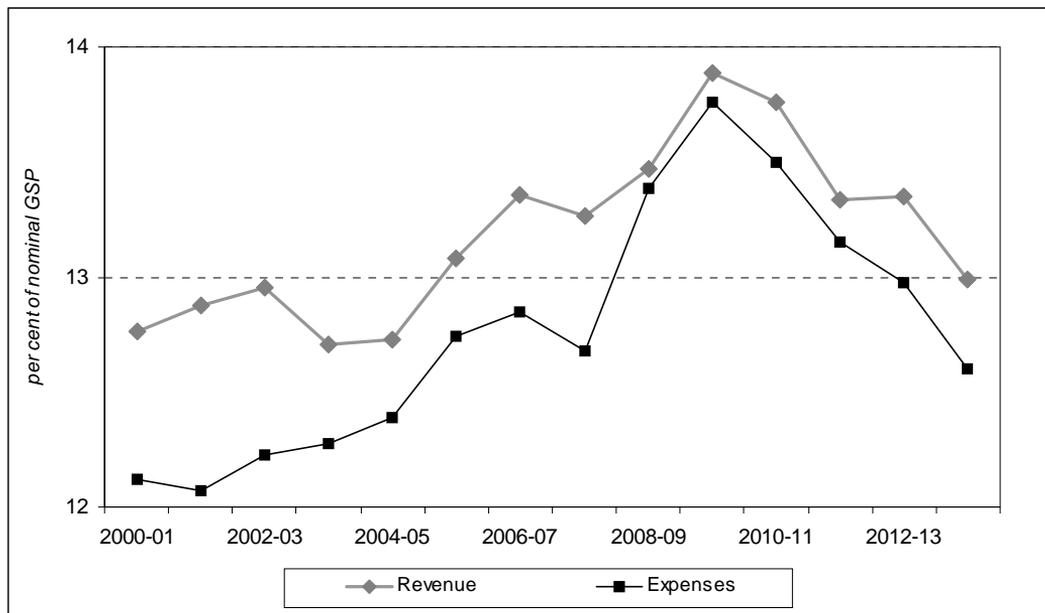
In summary, these measures of operating performance show that Victoria's financial performance remains strong over the forward estimates period. The net operating balance (equivalent to the net result from transactions), which is now the basis for measuring the budget estimates on an accrual basis in all Australian states and the Commonwealth (providing comparability with these jurisdictions), remains in surplus throughout the period to allow the Government to fund projects such as the Regional Rail Link, the Parkville Comprehensive Cancer Centre, the Victorian Schools Plan and the Victorian Transport Plan.

Under the net lending/(borrowing) measure, the Government is borrowing \$1.2 billion in 2010-11 in order to support the Government's infrastructure program. The Government's strategy of maintaining high operating surpluses over the forward estimates period ensures that borrowings will be maintained at prudent levels, as the State's infrastructure program begins to be funded by operating surpluses rather than through increased borrowings.

The net result for 2010-11 is \$852 million and averages \$1.2 billion a year over the forward estimates period. The net result is obtained by adding various revaluation gains and losses on assets and liabilities, such as those arising from movements in market prices, or the disposal of physical assets, to the net result from transactions.

The Government will be in a net cash deficit position in 2010-11 and 2011-12, reflecting the profile of capital expenditure under the Government’s significant infrastructure program as well as the impact of the global financial crisis on the State’s discretionary revenue. A return to cash surpluses is expected in 2012-13 and 2013-14 as the economy and budget position return to trend rates.

**Chart 3.1: Revenue and expenses relative to nominal GSP**



Source: Department of Treasury and Finance

### OPERATING STATEMENT ANALYSIS

Chart 3.1 shows that both general government sector revenue and expenditure increased as a proportion of GSP as global growth declined in 2008-09 and 2009-10, and are forecast to return to trend as the economy recovers. The strong budget position allowed service delivery to be maintained throughout the global downturn despite a significant revenue shock. This is reflected in the narrowing gap between revenue and expenses. However, prudent management of operating expenditure will ensure that this gap will increase as the economy improves facilitating the funding of infrastructure spending.

## Revenue

Total revenue is forecast to be over \$2 billion higher on average a year from 2010-11 to 2012-13 than forecast in the *2009-10 Budget Update*. This primarily reflects an upwards revision to state taxation in line with the strength of the economy, the strength of the property market and a projected increase in GST revenue.

The main sources of State revenue are outlined below.

## Grants

Grants, mainly from the Commonwealth Government, represent the State's largest source of revenue, accounting for \$22.9 billion (or 50 per cent) of total revenue in 2010-11.

Overall, grants revenue is expected to increase by \$1.5 billion in 2010-11, compared to the *2009-10 Budget Update* estimate for 2010-11. This is mainly due to an increase in GST revenue of \$770 million in 2010-11 due to expected growth in the national GST pool and Victoria's share of this pool, as well as a rephasing of Commonwealth funding under the *Nation Building – Economic Stimulus Plan* from 2009-10 to 2010-11.

Between 2010-11 and 2013-14 grants revenue is expected to increase by \$388 million on average. This growth is due to:

- increased funding for the National Healthcare and National Schools SPPs as well as Commonwealth funding for the Regional Rail Link project;
- annual average growth in GST revenue of \$604 million or 5.1 per cent reflecting anticipated growth in the national GST pool;

partially offset by the:

- wind back of Commonwealth grants revenue under the *Nation Building – Economic Stimulus Plan* which was distributed to assist the State in mitigating the impacts of the global financial crisis; and
- cessation of funding for the Parkville Comprehensive Cancer Centre project and a reduction in funding for Nation Building road projects from 2012-13 to 2013-14.

## Taxation Revenue

Taxation revenue is forecast to be \$14.4 billion (or around 32 per cent) of general government revenue in 2010-11.

Taxation revenue is expected to grow by 5.8 per cent in 2010-11. This in part reflects the recent strength in the property market and its effects on land transfer duty and land tax revenue (with 2010-11 revenue reflecting the 1 January 2010 revaluation). Moreover, the continued economic recovery, strong population and employment growth, as well as other factors such as the impact of rising insurance premiums on insurance taxation revenue will also contribute to taxation revenue growth in 2010-11.

Taxation revenue is expected to grow, on average, by 4.5 per cent a year over the three years to 2013-14, reflecting the following factors:

- payroll tax revenue is projected to grow by an average of 6.4 per cent a year, reflecting further jobs growth and wage increases;
- stamp duty on land transfer revenue is projected to increase by 4.7 per cent a year on average. Land transfer duty revenue is projected to show no growth in 2011-12 reflecting expected subdued volume growth and a small decline in average duty per transaction. This is mainly due to the impact of the return to more normal levels of interest rates. However, continued economic growth and population increases will support growth in subsequent years;
- average increases in land tax revenue of 0.8 per cent a year, reflecting expectations of only modest growth in land valuations over the forward estimates period, offset by the ongoing disaggregation of land holdings which will likely reduce the land tax base;
- revenue from gambling taxes (including the Health Benefit Levy) is projected to increase by an average of 4.2 per cent a year, principally reflecting expected growth in consumer spending, changes to Crown Casino's licence conditions (including a progressive increase in the tax rate on the Casino's gaming machines) and expectations of wagering, gaming and Keno licence revenue from 2012-13. These are partially offset by the impact of reductions in wagering tax rates, which are to apply from mid August 2012; and
- motor vehicle tax revenue is expected to increase by an average of 4.7 per cent a year, principally reflecting expected inflation and economic activity. The same factors are expected to drive annual average growth in total insurance taxation revenue of 3.5 per cent, partly offset by an average decline of 1.7 per cent a year in insurance contributions to fire brigades over this period due to the expected sunseting of some Country Fire Authority initiatives.

### ***Dividends, income tax and rate equivalent, and interest revenue***

Dividend, income tax and rate equivalent (ITEs) payments from government business enterprises and interest revenue are projected to be \$863 million in 2010-11, around \$55 million higher than the revised 2009-10 estimate.

Interest revenue is expected to increase across the forward estimates period at a rate comparable with that published in the *2009-10 Budget Update*. Increases in interest revenue in 2011-12 and 2012-13 largely relate to interest paid by the public non-financial corporations (PNFC) sector to fund delivery of the substantial infrastructure program.

Dividend and ITEs revenue is forecast to remain stable between 2010-11 and 2012-13. However, growth forecasts of these revenue sources have been reduced from those forecast in the *2009-10 Budget Update*, reflecting lower dividends from the Transport Accident Commission (TAC) as a result of actuarial reviews, revealing higher claims costs arising from common law action. The increase in dividend revenue in 2013-14 reflects a forecast dividend payment by the State Electricity Commission of Victoria.

In calculating dividends and ITEs for public financial corporations (PFCs) that hold financial assets, an assumption is made that investment earnings will revert to the long-term average. This assumption affects the profile of expected revenue over the forward estimates period. It should be noted, however, that declines in financial markets since the onset of the global financial crisis have resulted in carry forward tax losses for the TAC and Victorian WorkCover Authority (VWA). No income tax equivalent revenue is expected to be payable during the forward estimates period from these agencies due to utilisation of the losses.

### **Other revenue**

Together, grants, taxation revenue, dividends, income tax equivalent and interest are estimated to account for approximately 83 per cent of Victoria's revenue in 2010-11. The remainder is made up of sales of goods and services and other income including fines and regulatory fees.

Forecast sales of goods and services have been revised upwards since the *2009-10 Budget Update*. This primarily relates to changes to the arrangements for public transport fare revenue, where fare revenue is received by the state and then paid to rail operators. Under the previous Franchise Agreements, rail operators received fare revenue directly.

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

### **Expenses**

Throughout the global downturn, the Government actively managed expenditure growth to enable it to continue providing essential services to the community, while maintaining an operating surplus and borrowing at prudent levels.

Since the *2009-10 Budget Update* there has been an upward revision to expenditure over the forward estimates period. The increase in expenditure primarily reflects additional service delivery initiatives approved by the Government in law and order, hospitals, transport and education – required to meet the needs of Victoria's growing population and demand for high quality services. Forecast increases in non-cash depreciation expenses that have resulted from asset revaluations and an upward revision in anticipated grant expenses for first home owners have also contributed to increases in expenditure across the forward estimates period.

Total expenses from transactions are forecast to be \$44.9 billion in 2010-11. Compared with the estimates published in the *2009-10 Budget Update*, total expenses are forecast to be \$2.3 billion higher in 2010-11, and \$2.3 billion a year higher on average over the period 2011-12 to 2012-13.

The main drivers of the State's expenditure are outlined below.

## **Employee expenses**

Employee expenses (including superannuation but not superannuation interest expense) are forecast to be \$17.8 billion in 2010-11, representing 40 per cent of total expenditure.

Growth in employee expenses over the forward estimates period is expected to average \$803 million, or 4.3 per cent, a year which is similar to the forecast in the *2009-10 Budget Update*.

The year on year growth primarily reflects the wages costs associated with growth in services required for a growing community, including the delivery of additional police officers, as well as anticipated increases in the cost of wages in line with the Government's existing wages policy.

## **Other operating expenses**

Other operating expenses, which include purchases of supplies and services, maintenance expenses, and operating lease payments, are forecast to be \$15.1 billion in 2010-11, representing 34 per cent of total expenditure.

In 2010-11, operating expenses have increased considerably as a result of the changes to the arrangements for public transport fare revenue which is offset by associated revenue adjustments outlined in the Other revenue section of this chapter.

These expenses are projected to increase by an average of \$334 million (or 2.2 per cent) a year over the forward estimates. This growth mainly reflects the government's policy initiatives, including new initiatives in the *2010-11 Budget* and projected growth in revenue over the forward estimates. Further increases relate to flow-on expense impacts associated with Commonwealth specific purpose grants, expenditure associated with own source revenue by general government entities related to meeting the anticipated increase in demand for services and also contingency provisions to support future expenditure.

## **Grants and other transfers**

Grants and other transfers are projected to be \$7.9 billion in 2010-11, or 18 per cent of total expenditure. This represents a 6.1 per cent rise in expenditure since the 2010-11 estimate in the *2009-10 Budget Update*, primarily reflecting a rephase of the social housing component of the *Nation Building – Economic Stimulus Plan* from 2009-10 to 2010-11.

Grants and other transfers are projected to decrease by \$799 million between 2010-11 and 2011-12, primarily reflecting the wind down of *Nation Building – Economic Stimulus Plan* for social housing and the Commonwealth's *Building the Education Revolution* initiative. From 2011-12 onwards, grants and other transfers are projected to be relatively stable over the forward estimates period.

### **Depreciation expense**

Depreciation expense is projected to increase to \$2.2 billion in 2010-11 (up by \$380 million since the *2009-10 Budget Update*) primarily driven by increased depreciation expense associated with the revaluation of health sector assets. Depreciation expense is projected to grow by 5.9 per cent a year on average over the forward estimates period in line with the significant infrastructure investment program and the projected impact of asset revaluations.

### **Interest expense**

Even with the Government's continuing commitment to its capital expenditure program, servicing costs for interest expenses are anticipated to remain at prudent and financially responsible levels over the forward estimates period. Interest expenses are forecast to be \$940 million in 2010-11 and estimated to increase by an average of \$319 million a year over forward estimates period. This coincides with the level of borrowings used to fund the Government's significant social and economic infrastructure program.

### **New output initiatives by department**

The *2010-11 Budget* delivers new initiatives to support quality services in the areas of law and order, health, transport and education, as well as providing additional investment to respond to high-priority immediate community needs.

Table 3.3 shows the budget impact of the new output initiatives which will be implemented in order to deliver the Government's policy objectives for the *2010-11 Budget*. These new initiatives have a net impact of \$419 million in 2010-11 and an average of \$414 million a year from 2011-12 to 2013-14. This is in addition to the net impact of \$202 million a year on average from 2010-11 to 2012-13 from *2009-10 Budget Update* output initiatives.

**Table 3.3: Net impact of 2010-11 Budget new output initiatives<sup>(a)(b)</sup>**

(\$ million)

	2010-11 Budget	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
Education and Early Childhood Development	60.2	45.8	26.0	25.6
Health	283.0	196.6	205.4	170.6
Human Services	44.1	39.7	30.1	30.8
Innovation, Industry and Regional Development	67.2	52.3	40.6	25.8
Justice	114.3	166.8	197.6	246.6
Planning and Community Development	48.3	30.7	22.9	18.2
Premier and Cabinet	7.7	6.2	3.7	3.7
Primary Industries	3.4	3.6	4.1	5.0
Sustainability and Environment	10.9	12.8	9.8	9.5
Transport	26.8	6.2	10.7	14.5
Treasury and Finance	96.5	51.4	4.7	..
Parliament	1.5	1.4	1.4	1.4
Government-wide	157.8	162.7	166.5	172.3
<b>Subtotal</b>	<b>921.7</b>	<b>776.1</b>	<b>723.4</b>	<b>724.1</b>
Less funding from demand and other efficiencies	-503.2	-395.8	-281.5	-304.2
<b>Net impact of 2010-11 Budget new output initiatives</b>	<b>418.5</b>	<b>380.3</b>	<b>441.9</b>	<b>419.8</b>
Add: net impact of 2009-10 Budget Update output initiatives <sup>(c)</sup>	214.6	218.7	172.4	na
<b>Net budget impact of output initiatives since 2009-10 Budget</b>	<b>633.1</b>	<b>599.0</b>	<b>614.3</b>	<b>419.8</b>

Source: Department of Treasury and Finance

Notes:

- (a) These numbers show the net impact on the general government sector net result from transactions and differ from Budget Paper No. 3, Appendix A Output, Asset Investment and Revenue Initiatives as amounts funded from internal reprioritisation or other existing sources have been deducted from the figures above.
- (b) Variance is primarily attributable to initiatives funded from within the 2010-11 Budget.
- (c) Net impact of 2009-10 Budget Update output initiatives is net of funding from demand contingency and other efficiencies. This number has been revised following a reconciliation of the timing of output decisions.

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

### Other economic flows

Differences between the net result from transactions and the net result are due to other economic flows. Other economic flows include actuarial adjustments, gains and losses on the disposal of non-financial assets such as land and property, plant and equipment and other income and expenses.

## **FISCAL RISKS**

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

### **Revenue risks**

#### ***Commonwealth grants***

Commonwealth grants are a major source of revenue for the Victorian Government with estimated grants income of approximately \$22.9 billion in 2010-11. Commonwealth grants include general purpose grants (e.g. GST grants), SPPs and national partnership agreement payments (NPs).

Due to the agreement on health and hospitals reform between the Commonwealth Government and all other Australian states and territories (other than Western Australia) reached on April 20, 2010, there will be additional Commonwealth funding for a range of health and hospital services now provided. Details are provided in the *Putting Patients First* statement as Budget Information Paper No. 2.

The level of GST grants is affected by the general level of activity in the Australian economy and the GST revenue sharing relativities determined by the Commonwealth Treasurer on the basis of recommendations from the Commonwealth Grants Commission (CGC). Any changes to economic conditions will have a direct impact on the amount of GST revenue to be distributed among the states.

The CGC updates its relativities annually to reflect movements in data, with a comprehensive methodology review every five years. The latest methodology review was completed in February 2010 and is discussed in Budget Paper No. 4, Chapter 4 *State Revenue*. The recommendations of the 2010 review will be used to distribute GST revenue in 2010-11.

#### ***Taxation revenue***

The State's tax revenues are, for the most part, forecast on an assumed or estimated relationship between taxation revenue and projected economic variables. As a result, there are two main sources of risk to the taxation estimates. Firstly, changes in economic conditions from those projected will affect taxation revenue. For example, higher than expected economic activity or inflation will tend to lead to higher taxation revenue. This risk is quantified in Appendix B *Sensitivity Analysis Table*. Secondly, there is a risk of changes in the relationship between the economic variables and taxation revenue. For example, the impact on land transfer duty when interest rates change may vary over time due to changes in lending practices by financial institutions or changes in the composition of market participants.

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

As with the *2009-10 Budget Update*, the *2010-11 Budget* includes provisional estimates of the expected revenue outcome of re-licensing of the State's electronic gaming machine (EGM), wagering and Keno licences and tendering a new monitoring licence for the EGM sector. Because of the risk of pre-empting market outcomes and sending incorrect signals to licence applicants, these provisional estimates will not be separately disclosed and have been aggregated in this budget with broader gambling tax revenue estimates.

## **Expenditure risks**

General expenditure risks can be broadly classified into those affecting all government departments and those that are department specific.

The main risks to specific departmental expenditures relate to growth in the demand for government services, Government commitments contingent on external factors, and government responses to unforeseen events such as the global financial crisis and the 2009 bushfires.

The *2010-11 Budget* estimates include a contingency provision to allow for the likelihood that some expenditure risks will eventuate during the budget year or during the forward estimates period. This contingency is for:

- changes to the growth and composition of Victoria's population, and consequent derived demand for government services;
- an allowance for depreciation expenditure associated with future infrastructure investment, which is funded from the capital provision approved but not yet allocated (subject to government approval);
- a number of existing programs that will conclude in 2010-11 or the following years that the Government may endorse to continue or be or replaced to meet service delivery priorities; and
- other expenditure risks which were unforeseen or not quantifiable, or were not formalised at the time of producing the budget estimates.

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

## **Sensitivity analysis**

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

## USE OF CASH RESOURCES

As the global economic recovery continues, the Government is forecasting strong operating surpluses which will provide a firm foundation for investment in key infrastructure whilst maintaining net debt at prudent levels. The Government's infrastructure investment program underpins the provision of services to the people of Victoria in the key areas of law and order, health, transport and education services.

The Government's strategy of generating higher surpluses to fund key infrastructure projects keeps net debt at sustainable levels and helps the State to maintain its AAA credit rating while driving economic growth and generating jobs across Victoria.

Table 3.4 provides a summary of cash generated through the operations of Victorian government departments and other general government sector agencies, and how that cash is applied to infrastructure investment and the associated impact on net debt.

**Table 3.4: Application of cash resources**

	(\$ million)			
	2010-11 Budget	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Net result from transactions</b>	<b>871.9</b>	<b>650.4</b>	<b>1 387.6</b>	<b>1 493.2</b>
Add back: Non-cash income and expenses (net) <sup>(a)</sup>	2 620.9	2 571.8	2 759.0	2 529.2
<b>Net cash flow from operating activities</b>	<b>3 492.8</b>	<b>3 222.2</b>	<b>4 146.6</b>	<b>4 022.4</b>
Less:				
<b>Net investment in fixed assets</b>				
Expenditure on approved projects	6 614.4	5 215.8	4 472.8	3 583.1
Capital provision approved but not yet allocated	..	215.0	411.0	581.0
Proceeds from asset sales	<b>( 244.9)</b>	<b>( 268.6)</b>	<b>( 257.4)</b>	<b>( 225.9)</b>
<b>Total net investment in fixed assets</b>	<b>6 369.5</b>	<b>5 162.2</b>	<b>4 626.5</b>	<b>3 938.3</b>
Finance leases <sup>(b)</sup>	121.0	840.1	844.8	..
Other investment activities (net)	( 8.8)	( 8.1)	38.6	44.5
<b>Decrease/(increase) in net debt</b>	<b>(2 989.0)</b>	<b>(2 772.0)</b>	<b>(1 363.2)</b>	<b>39.7</b>

Source: Department of Treasury and Finance

Notes:

- (a) Includes depreciation and movements in the unfunded superannuation liability and liability for employee benefits.
- (b) The finance leases in 2010-11 is in relation to the Partnerships Victoria in Schools project; 2011-12 is in relation to the Royal Children's Hospital redevelopment and 2012-13 is in relation to the Peninsula Link.

The Government's net infrastructure investment program (which includes total purchases of property, plant and equipment, capital contributions to other sectors of government and net proceeds from sale of assets) is projected to be \$6.4 billion in 2010-11 and to average \$4.6 billion over the forward estimates period. Budgeted cash surpluses from operating activities will be used to fund around 74 per cent of the \$20 billion infrastructure program over the four years to 2013-14, with borrowings funding the remainder of the program over the forward estimates, until 2013-14 when no new borrowings will be required.

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

The Victorian Government measure of net investment in fixed assets is measured on a cash basis and is equal to the investment by the general government sector for fixed assets, including investment by PNFCs which is funded by the general government sector, less asset sales.

In contrast, the ABS measure of gross fixed capital formation is an accrual measure, but which includes transfers to and from the PNFC sector and purchases and sales of non-produced assets.

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

(\$ million)

	2010-11 Budget	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Net investment in fixed assets</b>	<b>6 369.5</b>	<b>5 162.2</b>	<b>4 626.5</b>	<b>3 938.3</b>
Add:				
Acquisitions under finance leases and similar arrangements	121.0	840.1	844.8	..
Assets received/(given) free of charge (net)	1.0	90.7	0.7	1.0
	6 491.5	6 093.0	5 472.0	3 939.3
Less:				
Net (purchase)/disposal of investments for policy purposes	2 179.4	1 549.5	1 350.5	1 372.9
Non-produced assets	110.7	149.4	124.3	18.8
Assets given free of charge	..	..	..	..
	2 290.0	1 698.9	1 474.8	1 391.7
<b>Gross fixed capital formation</b>	<b>4 201.5</b>	<b>4 394.2</b>	<b>3 997.2</b>	<b>2 547.5</b>

Source: Department of Treasury and Finance

Total net investment in infrastructure includes expenditure on new projects approved in the 2010-11 Budget. Table 3.6 shows the new asset funding by department in 2010-11, which commits substantial funding for large-scale hospital developments, including redevelopment of the Bendigo and Box Hill Hospitals and, in partnership with the Commonwealth Government, around \$1 billion for construction of the Parkville Comprehensive Cancer Centre over the forward estimates period.

The 2010-11 Budget also commits substantial funding to the Victorian Transport Plan including \$804 million for the procurement of 50 new trams and supporting tram infrastructure. In partnership with the Commonwealth Government, \$4.3 billion will be provided for the Regional Rail Link, which will deliver capacity for an extra 9 000 regional and suburban passengers every hour and will allow regional rail services to run express into Melbourne. The Commonwealth's *Building the Education Revolution* funding and the State's Victorian Schools Plan investment in the 2010-11 Budget also provides significant funding for Victorian schools.

By 2013-14, the forecast cash surplus will fund the Government's entire infrastructure program, without the need for additional borrowings. This highlights the Government's commitment to investing in infrastructure for long-term growth, while maintaining borrowings and debt at prudent levels.

As discussed in Chapter 1 *Economic and Fiscal Strategies and Objectives*, this strategy ensures prudent levels of debt, underpins the State's AAA credit rating and provides a stable economic environment which promotes consumer and business confidence and drives jobs growth.

**Table 3.6: 2010-11 Budget new asset funding<sup>(a)</sup>**

(\$ million)

	2010-11 Budget	TEI <sup>(a)</sup>
Education and Early Childhood Development	82.5	236.4
Health	142.5	1 285.0
Human Services	3.1	11.1
Innovation, Industry and Regional Development	43.1	80.1
Justice	22.6	153.2
Planning and Community Development	80.2	414.5
Premier and Cabinet	13.7	13.7
Primary Industries	2.8	9.6
Sustainability and Environment	10.8	21.9
Transport	221.5	1 521.0
Treasury and Finance	..	..
Parliament	..	..
Government wide	50.9	65.9
<b>Total 2010-11 Budget asset funding</b>	<b>673.7</b>	<b>3 812.4</b>
Add: 2009-10 Budget Update asset funding	863.7	6 230.4
<b>Asset funding since the 2009-10 Budget</b>	<b>1 537.4</b>	<b>10 042.8</b>

Source: Department of Treasury and Finance

Note:

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

Budget Paper No. 3, Appendix A *Output, Asset Investment and Revenue Initiatives* includes a detailed list and description of all asset initiatives announced in the 2010-11 Budget.

## FINANCIAL POSITION

The general government net asset position, measured by subtracting liabilities from assets, is an important indicator of the sector's financial strength. The strong net asset position enables the Government to continue its significant infrastructure investment program, while maintaining prudent borrowing levels and maintaining the State's AAA credit rating.

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

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

	(\$ million)				
	2010	2011	2012	2013	2014
	Revised	Budget	Estimate	Estimate	Estimate
	GFS-	GFS-	GFS-	GFS-	GFS-
	GAAP	GAAP	GAAP	GAAP	GAAP
<b>Assets</b>					
Non-financial assets	93.3	97.7	104.6	108.4	113.1
Financial assets	7.7	7.8	12.3	12.6	12.9
Investments in other sector entities					
PNFC <sup>(a)</sup>	61.6	64.6	66.5	68.2	69.5
PFC <sup>(a)</sup>	1.9	2.3	2.8	3.2	3.7
<b>Total assets</b>	<b>164.5</b>	<b>172.5</b>	<b>186.1</b>	<b>192.5</b>	<b>199.2</b>
<b>Liabilities</b>					
Superannuation	20.3	20.7	21.1	21.4	21.3
Borrowings <sup>(b)</sup>	13.5	16.7	23.9	25.6	25.8
Other liabilities	9.2	9.3	9.4	9.5	9.6
<b>Total liabilities</b>	<b>43.0</b>	<b>46.7</b>	<b>54.3</b>	<b>56.4</b>	<b>56.7</b>
<b>Net assets</b>	<b>121.4</b>	<b>125.8</b>	<b>131.8</b>	<b>136.1</b>	<b>142.5</b>

Source: Department of Treasury and Finance

Notes:

(a) PNFC: Public non-financial corporations, PFC: Public financial corporations.

(b) Borrowings include deposits held and advances received.

## Assets

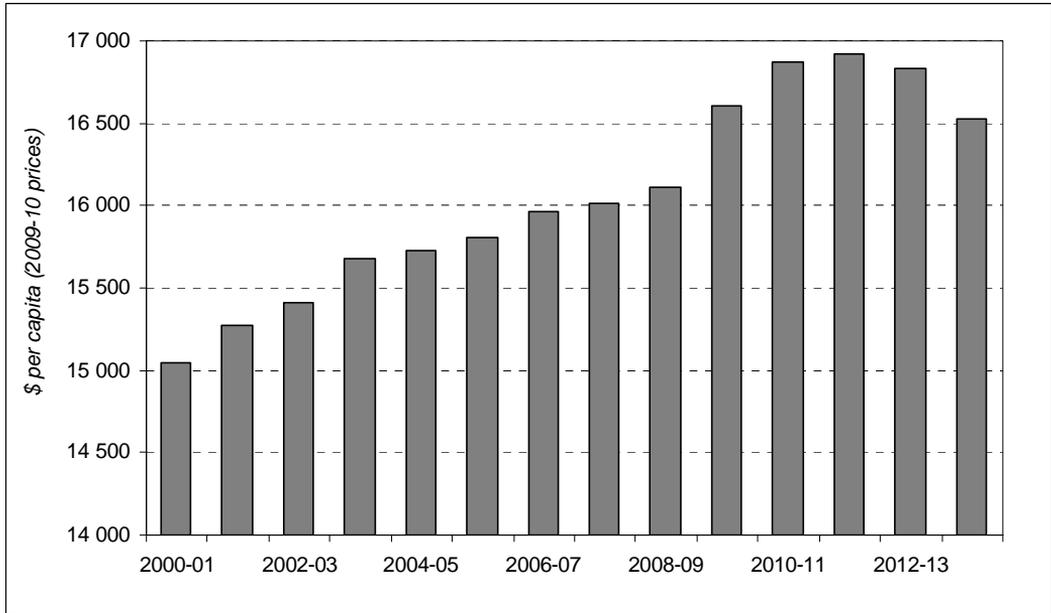
General government sector assets are forecast to be \$165 billion by 30 June 2010 and to rise by \$34 billion to \$199 billion by 30 June 2014.

### Non-financial assets

The growth in non-financial assets is driven by the Government's significant infrastructure program which has created and secured jobs in the short term, promotes sustained long-term growth and has positioned Victoria to take advantage of economic recovery as it occurs. Non-financial assets are projected to be \$93 billion at 30 June 2010 and to grow to \$113 billion by 30 June 2014.

Chart 3.2 shows that there has been strong growth in the real capital stock per capita in recent years, reflecting delivery of the Government's significant infrastructure program. This strong growth in Victoria's real capital stock per capita in recent years has occurred despite the State's record population growth, and is expected to remain at historically high levels across the forward estimates period, maintaining the Government's asset base in order to support service delivery and to promote economic growth. In 2012-13 and 2013-14 real capital stock per capita comes off its peak as capital investment returns to more usual levels.

**Chart 3.2: General government sector real capital stock per capita as at 30 June<sup>(a)</sup>**



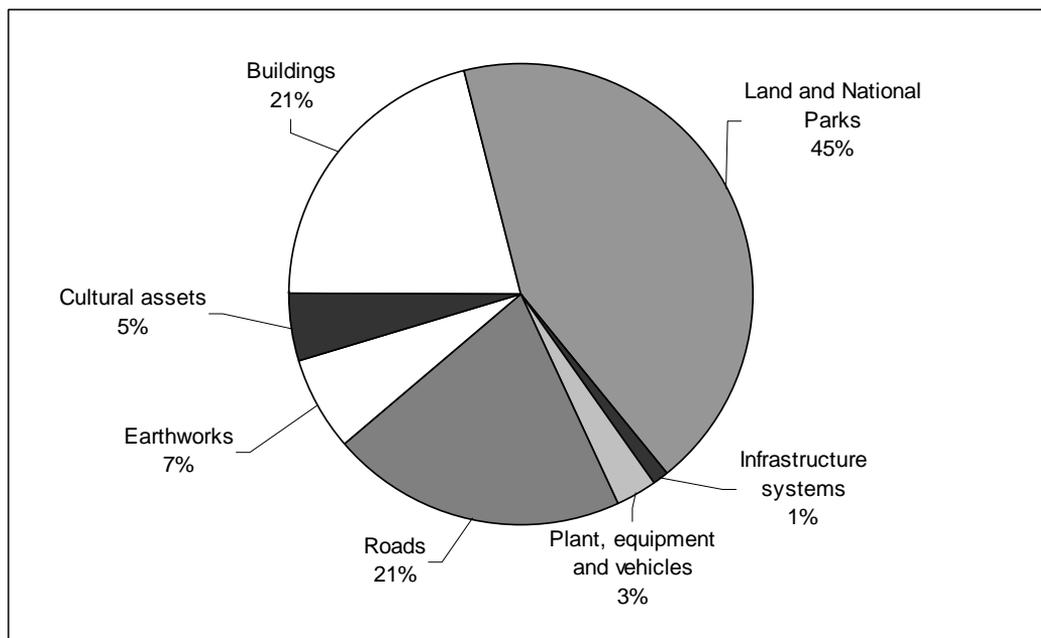
Source: Department of Treasury and Finance

Note:

(a) Real capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets in 2009-10 prices.

Chart 3.3 shows the general government sector’s anticipated real capital stock at 30 June 2010 by asset class. The four largest classifications are land and National Parks – including land under roads (45 per cent of the total capital stock), buildings (21 per cent), roads (21 per cent) and earthworks (7 per cent). The composition of the capital stock differs from previous budget publications with the inclusion of land under roads for the first time in the *2008-09 Annual Financial Report* generating a larger percentage for the land and National Parks category.

**Chart 3.3: Projected general government sector capital stock at 30 June 2010<sup>(a)</sup>**



Source: Department of Treasury and Finance

Note:

(a) Capital stock is equal to total non-financial assets less inventories, non-financial assets held for sale and other non-financial assets.

### **Investments in other sector entities**

Investments in other sector entities consist of the net assets of the State's PFCs and PNFCs. Investments in PNFCs and PFCs are expected to increase from \$64 billion in June 2010 to \$73 billion by June 2014. This increase will be largely driven by an increase in capital expenditure in the PNFC sector and by the anticipated growth in investment portfolios for insurance agencies in the PFC sector.

## **Financial and other assets**

The general government sector also holds other financial assets including cash and deposits, receivables and investments, loans and placements. Cash and deposits are expected to increase by around \$1.0 billion by June 2014, restoring cash balances for liquidity management purposes.

## **Liabilities**

General government liabilities are projected to be \$43 billion as at 30 June 2010 and are projected to grow to \$57 billion by 30 June 2014.

### **Superannuation liability**

The State recognises a liability in respect of its defined benefit superannuation schemes based on the difference between the assets of these schemes and the present value of the underlying obligation to members.

The State's reported superannuation liability is projected to decrease by approximately \$400 million in 2009-10.

This reduction in the liability is attributable to:

- better than expected investment returns on superannuation assets totalling \$1.4 billion; and
- ongoing accrual of benefits and changes in some key valuation assumptions by actuaries, which had the effect of increasing the liability.

The *2010-11 Budget* adopts a revised approach to setting the assumptions used to value the superannuation liability. The key difference is that the inflation assumption is now based upon the relationship between nominal and index linked bond yields of similar duration. This approach ensures that the inflation assumption reflects market expectations and is compatible with the market based discount rate that is required to be adopted under current Australian accounting standards.

The revised approach will significantly reduce the volatility that the superannuation liability previously exhibited in response to movements in the discount rate. It will ensure that the reported superannuation liability is of more value to users of the State's financial reports.

It is important to be aware that changes in the reported superannuation liability that arise solely from changes in the discount rate have no impact on the amount of cash required to fund the State's superannuation liability over time. Funding requirements continue to be calculated using a long-term investment return, currently 8 per cent a year before tax.

Beyond 2009-10, the State's reported superannuation liability is projected to increase from \$20.3 billion as at 30 June 2010 to \$21.3 billion by 30 June 2014. The projected increase is primarily attributable to the fact that some schemes are only partially funded, thus the return on assets is not sufficient to offset growth in the accrued liability.

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

## Borrowings

During the global financial crisis, the Government made a strategic decision to increase borrowings to fund its significant infrastructure program. Total borrowings (including deposits held) for the general government sector are expected to increase from \$14 billion in June 2010 to \$26 billion by June 2013, lower than the amount of borrowings forecast at the *2009-10 Budget Update*. Moderate growth in borrowings is forecast from 2012, as the infrastructure program returns from its peak and the Government fulfils its commitment to maintaining debt at prudent levels.

## KEY FINANCIAL INDICATORS

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

	2010 <i>Revised</i> GFS- GAAP	2011 <i>Budget</i> GFS- GAAP	2012 <i>Estimate</i> GFS- GAAP	2013 <i>Estimate</i> GFS- GAAP	2014 <i>Estimate</i> GFS- GAAP
	<i>(\$ billion)</i>				
Net debt <sup>(a)</sup>	8.7	11.7	14.5	15.8	15.8
Net financial liabilities <sup>(b)</sup>	35.3	38.8	42.1	43.8	43.8
	<i>(per cent)</i>				
Net debt to GSP <sup>(c)</sup>	2.8	3.5	4.1	4.3	4.1
Debt service cost <sup>(d)</sup>	1.1	1.3	1.6	1.8	2.1
Net financial liabilities to GSP <sup>(c)</sup>	11.2	11.7	12.0	11.9	11.3
Liability service cost <sup>(e)</sup>	3.1	3.2	3.5	3.7	3.9

*Source: Department of Treasury and Finance*

### Notes:

- (a) *Net debt is the sum of deposits held, advances received and borrowings less the sum of cash deposits, advances paid, and investments, loans and placements.*
- (b) *Net financial liabilities is the sum of superannuation, borrowings and other liabilities less financial assets.*
- (c) *Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.*
- (d) *Debt service cost is net interest to total revenue, where net interest equals interest expense less interest revenue.*
- (e) *Liability service cost is net interest plus superannuation interest expense to total revenue.*

## Net debt

The Government's strategy of maintaining high cash operating surpluses to fund its infrastructure program has enabled it to constrain growth in net debt to fiscally responsible levels, while ensuring the State's infrastructure program continues to drive economic growth and to ensure delivery of quality services in health, education and community affairs.

This strategy of maintaining high cash surpluses has ensured that the State's balance sheet has remained strong even in the midst of the global financial crisis. A key measure of balance sheet strength is net debt, which is calculated by subtracting liquid financial assets from gross debt. General government net debt is expected to increase from \$8.7 billion in June 2010 to \$15.835 billion by June 2013 before declining to \$15.795 billion in June 2014.

Net debt is expected to decline to 4.1 per cent of GSP by June 2014. Since the *2009-10 Budget*, projections of net debt as a percentage of GSP have been revised down substantially, by around 1 per cent, across the forward estimates years. This is the result of lower net debt in dollar terms, as well as stronger growth in the economy, which was supported by the Government's substantial infrastructure program.

### **Victorian Government Debt Strategy**

The Government made a strategic decision in the *2009-10 Budget* to increase borrowings, within prudent levels, to fund infrastructure in the global financial crisis to promote economic growth. The debt strategy aims to:

- maintain Victoria's AAA credit rating;
- deliver services and invest in social and economic infrastructure to promote growth;
- fund infrastructure predominately from cash generated from operating surpluses; and
- return infrastructure investment to sustainable levels.

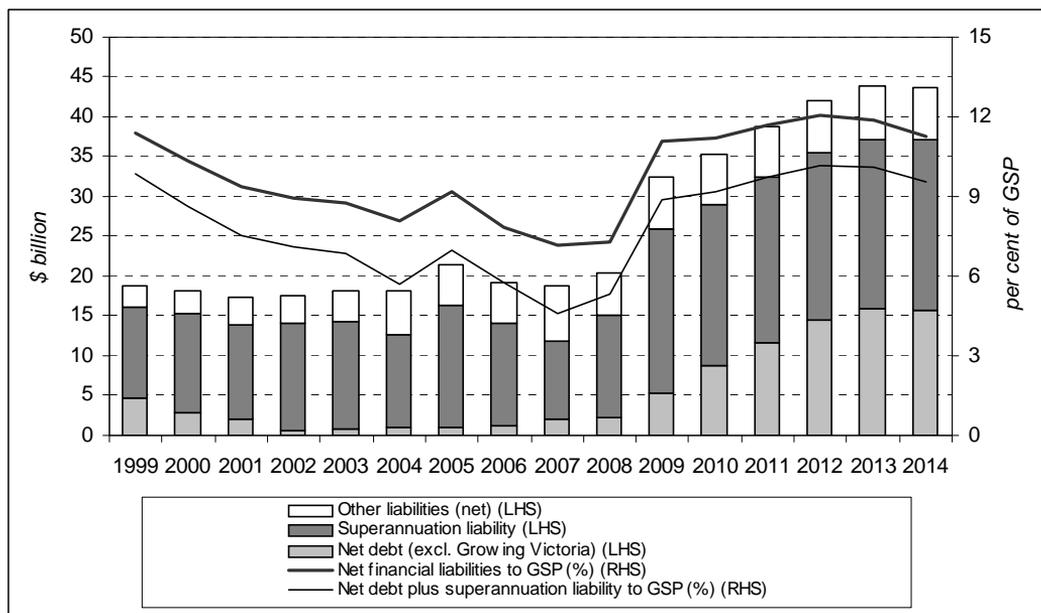
The Government's commitment to this strategy is illustrated by net debt to GSP being around 1 per cent lower at the end of the forward estimates compared to the *2009-10 Budget*, and by general government net debt declining from \$15.835 billion in June 2013 to \$15.795 billion in June 2014.

Victoria's AAA credit rating was reaffirmed by Standard & Poor's in September 2009 and Moody's Investors Service in January 2009. The Government's continued sound management of its balance sheet underpins this rating. Further details on the Government's credit rating are provided in Chapter 4 *Financial Sustainability of Victorian Government*.

### **Net financial liabilities**

In examining the liabilities of governments, the financial community focuses on net financial liabilities as a measure of indebtedness. Table 3.8 shows that net financial liabilities of the general government sector are expected to increase from \$35 billion in June 2010 to \$44 billion by June 2014.

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



Source: Department of Treasury and Finance

As depicted in Chart 3.4, the ratio of net financial liabilities to GDP will increase in comparison to recent levels. This is primarily driven by the increase in net debt as previously discussed and growth in the superannuation liability as a result of the fact some schemes are only partially funded, thus the return on assets is not sufficient to offset growth in the accrued liability.

While there is a forecast increase in net financial liabilities, by June 2012 the increase is expected to moderate, with the level of borrowings stabilising and cash flows from operating activities expected to meet in excess of 90 per cent of net infrastructure investment. Higher economic growth also contributes to net financial liabilities as a percentage of GDP falling from its peak of 12.0 per cent to 11.3 per cent by June 2014.



## CHAPTER 4 – FINANCIAL SUSTAINABILITY OF VICTORIAN GOVERNMENT

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- This chapter builds on the information presented in Chapter 3 by incorporating the broader public sector, through the addition of the State's public non-financial corporations (PNFC) sector to the general government sector, thereby producing the non-financial public sector (NFPS).
- The NFPS is expecting an operating surplus (net result from transactions) of \$721.6 million in 2010-11, increasing above \$1 billion by 2012-13 due to the Government's firm management of underlying expenditure growth.
- NFPS spending on new infrastructure (excluding capital grants paid to other sectors under the Commonwealth's fiscal stimulus) will total \$8.8 billion in 2010-11, and \$19.1 billion over the remaining three forward estimate years. This reflects significant investment in water, transport and other essential infrastructure.
- NFPS net debt is expected to increase from 5.1 per cent of gross state product (GSP) at 30 June 2010 to an estimated 8.4 per cent by 30 June 2013, before decreasing to 8.2 per cent of GSP by 30 June 2014 as borrowings stabilise and Victorian economic growth increases. The Government's strategy of maintaining strong, sustainable finances while continuing to provide key services to Victorian families and communities has seen this result improve upon that presented in the *2009-10 Budget Update*.
- NFPS net financial liabilities are expected to increase to 16.3 per cent of GSP by 30 June 2012, dropping to 15.4 per cent of GSP by 30 June 2014 as economic growth increases. Despite the increase from current levels, total net financial liabilities will remain at prudent and sustainable levels and within the current parameters required to secure the State's AAA credit rating.

## INTRODUCTION

This chapter provides an overview of the activities of the broader public sector, by adding the State's PNFC sector to the general government sector, to form the State's NFPS. The NFPS is being managed appropriately to ensure the AAA credit rating objective is met. However, other budget specific targets are not relevant when looking at NFPS fiscal aggregates.

## FINANCIAL PERFORMANCE OF THE PUBLIC NON-FINANCIAL CORPORATIONS SECTOR

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

**Table 4.1: Public non-financial corporations operating statement for the financial year ending 30 June<sup>(a)</sup>**

(\$ million)

	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Revenue</b>				
Interest	46.0	45.4	43.8	44.8
Dividends income tax equivalent and rate equivalent revenue	58.7	62.0	71.8	69.0
Sales of goods and services	4 538.1	4 875.2	5 423.6	5 667.2
Grants	2 695.9	2 419.3	2 443.8	2 458.5
Other current revenue	502.9	530.2	500.2	506.5
<b>Total revenue</b>	<b>7 841.6</b>	<b>7 932.1</b>	<b>8 483.2</b>	<b>8 746.0</b>
<b>Expenses</b>				
Employee expenses	870.8	887.7	909.6	927.7
Other superannuation	75.1	76.3	76.1	77.7
Depreciation	1 454.1	1 573.7	1 675.3	1 724.4
Interest expense	671.1	960.3	1 287.5	1 339.8
Other operating expenses	4 123.2	4 161.0	4 377.8	4 507.1
Grants and other transfers	485.1	213.9	211.9	174.8
Other property expenses	146.2	123.4	89.8	139.1
<b>Total expenses</b>	<b>7 825.5</b>	<b>7 996.4</b>	<b>8 628.0</b>	<b>8 890.6</b>
<b>Net result from transactions – net operating balance</b>	<b>16.1</b>	<b>( 64.3)</b>	<b>( 144.8)</b>	<b>( 144.6)</b>

Source: Department of Treasury and Finance

Note:

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

## **Net result from transactions**

The PNFC sector is forecasting an operating surplus (net result from transactions) of \$16.1 million in 2010-11. The sector is expecting a deficit result for the remaining forward estimate years, largely driven by higher depreciation charges on capital investments and revalued water and transport assets. The Government is committed to bringing the PNFC sector to a surplus position (on an accruals basis) in the medium term. However, it is important to note that from a cash flow perspective the sector remains cash positive and in a sustainable position.

It should also be noted that the net result from transactions reported is after income tax expense, which is captured under other property expenses within the PNFC sector operating statement above. As the PNFC sector generally operates under commercial principles, it could be considered more appropriate to view the net result on a pre-tax basis. When this is the case, the net result from transactions in 2011-12 moves into surplus, and the deficit results in 2012-13 and 2013-14 are reduced significantly.

## **Revenue**

Total revenue is forecast to increase an average of 4.8 per cent a year over the period 2009-10 to 2013-14. Sales of goods and services, which account for an estimated 57.9 per cent of total PNFC sector revenue in 2010-11, are expected to increase by an average of 9.8 per cent a year over the same period. This is largely driven by an increase in the regulated water price for sales by water entities as set by the Essential Services Commission, which help offset the cost of the major infrastructure upgrades that will work towards securing our water future.

The other major source of revenue for the PNFC sector is grants income, which accounts for an estimated 34.4 per cent of total revenue in 2010-11. Grants income is projected to decline moderately to \$2.5 billion by 2013-14. This is largely due to the re-phasing of revenue and the completion of social housing programs associated with the Commonwealth Government's funding agreement with the Office of Housing. However, this is offset to some extent by an increase in grants to the transport sector to cover higher operating expenses.

The other sources of PNFC sector revenue represent a relatively small component of total revenue, or are projected to remain relatively steady over the period.

## **Expenses**

The average expected rate of growth in expenses over the period 2009-10 to 2013-14 is 4.6 per cent a year. However, peaks above this level in 2012-13 as new infrastructure comes online. For the period 2009-10 to 2013-14, depreciation expense is expected to grow by an average 7.1 per cent a year to \$1.7 billion. The increase is driven by the adoption of fair value accounting standards and the subsequent revaluation of water, transport and housing assets to fair value for the first time as at 30 June 2009, as well as the purchase of capital assets such as rolling stock and irrigation infrastructure.

Interest expense is forecast to increase to \$1.3 billion by 2013-14. This represents an average annual growth rate of 26.2 per cent, and is driven by the expected increase in borrowings from \$9.3 billion at June 2010 to \$16.8 billion by June 2014, funding the Government's investment in infrastructure to support service delivery objectives. Interest expense includes finance lease costs associated with the Desalination Project at Wonthaggi, as well as Victorian Rail Track rolling stock, and remain in line with numbers published in the *2009-10 Budget Update*.

Other operating expenses largely consist of operating supplies and consumables in the water and transport sectors, and account for an estimated 52.7 per cent of total expenses in 2010-11. Other operating expenses are projected to increase to \$4.5 billion by June 2014. The increase is largely attributed to operational costs associated with new water infrastructure, and in particular the Victorian Desalination Project at Wonthaggi which is expected to commence operations by December 2011. It also reflects higher capital asset charges incurred by Victorian Rail Track on new rail infrastructure.

At \$485.1 million, grants and other transfers represent 6.2 per cent of total PNFC sector expenditure in 2010-11. The decline from recent highs is driven by the unwinding of Commonwealth fiscal stimulus for items such as grants to social housing organisations. This trend continues until grants and other transfers return to a more normal level in 2011-12.

Other property expenses consists of income tax expenses, which are expected to increase by 25.6 per cent to \$146.2 million in 2010-11 due to improved trading results in the metropolitan water sector. There is a decline in the following two forward estimate years as profitability within the sector deteriorates on the back of higher depreciation expenses. This trend is reversed in 2013-14 as the profitability of the Port of Melbourne and within the metropolitan water sector improves to push income tax expenses higher.

The other sources of PNFC sector expenditure represent a relatively small component of total expenditure, or are projected to remain relatively steady over the period.

## **FINANCIAL PERFORMANCE OF THE NON-FINANCIAL PUBLIC SECTOR**

The NFPS comprises the general government and PNFC sectors (i.e. it excludes the public financial corporations sector, which is not required to report forward estimates under the Uniform Presentation Framework). Table 4.2 shows the summary operating statement for the NFPS which combines and consolidates the results for the general government and PNFC sectors. Transactions between the general government and PNFC sectors are eliminated, including dividends payable by PNFCs.

**Table 4.2: Non-financial public sector operating statement for the financial year ending 30 June<sup>(a)</sup>**

(\$ million)

	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Revenue</b>				
Taxation revenue	14 209.3	14 668.5	15 463.2	16 292.2
Interest	387.6	417.3	414.2	421.3
Dividends and income tax equivalents and rate equivalents	226.5	252.6	299.0	337.7
Sales of goods and services	9 069.4	9 612.7	10 279.3	10 556.1
Grants	22 883.7	22 523.9	24 003.3	24 050.2
Other current revenue	2 170.5	2 208.3	2 047.7	2 078.1
<b>Total revenue</b>	<b>48 946.9</b>	<b>49 683.3</b>	<b>52 506.7</b>	<b>53 735.6</b>
<b>Expenses</b>				
Employee expenses	17 053.4	17 884.5	18 808.6	19 446.7
Superannuation interest expense	884.1	910.8	935.1	944.5
Other superannuation	1 672.8	1 701.1	1 746.4	1 745.0
Depreciation	3 668.4	3 954.9	4 233.0	4 355.1
Interest expense	1 593.7	2 266.6	3 034.2	3 218.0
Other operating expenses	17 738.1	17 758.6	17 881.5	18 297.3
Grants and other transfers	5 614.8	4 813.6	4 800.4	4 708.4
Other property expenses	0.0	0.0	0.0	..
<b>Total expenses</b>	<b>48 225.4</b>	<b>49 290.2</b>	<b>51 439.1</b>	<b>52 715.0</b>
<b>Net result from transactions – net operating balance</b>	<b>721.6</b>	<b>393.1</b>	<b>1 067.6</b>	<b>1 020.6</b>
Less: net acquisition of non-financial assets from transactions	5 437.8	8 709.8	2 895.7	1 237.0
<b>Net lending/(borrowing)</b>	<b>(4 716.2)</b>	<b>(8 316.7)</b>	<b>(1 828.2)</b>	<b>( 216.4)</b>

Source: Department of Treasury and Finance

Note:

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

The net result from transactions is expected to show an operating surplus of \$721.6 million in 2010-11, before growing above a \$1.0 billion surplus by 2012-13.

Growth in revenue is expected to average 3.8 per cent a year over the period 2009-10 to 2013-14. Both taxation and grants revenue, which account for an estimated 75.8 per cent of total revenue in 2010-11, have been discussed in the previous chapter. Sales of goods and services are expected to grow by an average of 7.0 per cent a year over the same period, and include the impact of strong growth in the water sector as discussed above.

Growth in total expenses is expected to average 3.3 per cent a year over the period 2009-10 to 2013-14, reflecting the Government's firm management of underlying expenditure growth within the NFPS. With the average growth in expenditure 0.5 per cent a year below the average rate of revenue growth, the result is a projected continuing strong net result from transactions across the forward estimates period. As discussed previously, the above average growth in depreciation and interest expense is primarily driven by the Government's infrastructure program.

Employee and other operating expenses, as well as grants and other transfers represent the most significant expenditure items in 2010-11 at 83.8 per cent of total expenses. All items are predominantly driven by the general government sector, and as such have been discussed within Chapter 3.

All other items within the NFPS operating statement represent a relatively small component of the net result from transactions, or are projected to remain relatively steady over the period.

## USE OF CASH RESOURCES BY THE NON-FINANCIAL PUBLIC SECTOR

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

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

(\$ million)

	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Net result from transactions</b>	<b>721.6</b>	<b>393.1</b>	<b>1 067.6</b>	<b>1 020.6</b>
Add back: Non-cash income and expenses (net) <sup>(a)</sup>	3 785.5	3 886.1	4 145.6	3 944.1
<b>Net cash flow from operating activities</b>	<b>4 507.1</b>	<b>4 279.3</b>	<b>5 213.1</b>	<b>4 964.7</b>
Less:				
<b>Net investment in fixed assets</b>				
Expenditure on approved projects	9 129.6	7 636.0	6 479.5	5 836.4
Proceeds from asset sales	( 368.0)	( 257.4)	( 301.2)	( 269.7)
<b>Total net investment in fixed assets</b>	<b>8 761.5</b>	<b>7 378.6</b>	<b>6 178.3</b>	<b>5 566.7</b>
Finance leases <sup>(b)</sup>	133.3	5 056.7	859.8	16.5
Other investment activities (net)	74.5	142.4	197.6	200.4
<b>Decrease/(increase) in net debt</b>	<b>(4 462.2)</b>	<b>(8 298.3)</b>	<b>(2 022.6)</b>	<b>( 819.0)</b>

Source: Department of Treasury and Finance

Notes:

- (a) Includes depreciation and movements in the superannuation liability and liability for employee benefits.
- (b) The finance lease in 2010-11 is in relation to the Partnerships Victoria in Schools project; 2011-12 is in relation to the Royal Children's Hospital redevelopment and the Victorian Desalination Project at Wonthaggi; and 2012-13 is in relation to the Peninsula Link. A finance lease is also recorded across the forward estimates period in relation to Victorian Rail Track rolling stock.

## Investment in non-financial assets

Total net investment in fixed assets includes expenditure on new projects approved in the *2010-11 Budget* (however excludes capital grants paid to other sectors under the Commonwealth's fiscal stimulus), and is expected to total \$8.8 billion in 2010-11, and \$19.1 billion over the remaining three forward estimate years. Around 68 per cent of the new infrastructure over the forward period will be funded by cash operating surpluses, with the remainder by borrowings. This significant investment builds upon the \$25.2 billion undertaken in the four years from 2006-07 to 2009-10, and reflects the Government's strategy of continuing to invest in essential infrastructure to support jobs and the economic recovery, as well as provide key services to Victorian families.

In addition to the general government sector investments and initiatives discussed within Chapter 3, the Government also has a number of key infrastructure projects within the PNFC sector, including:

- the Victorian Desalination Project at Wonthaggi which will see the construction of a desalination plant at Wonthaggi and associated infrastructure, including an 84 kilometre pipeline to connect the plant to Melbourne's water supply system. The plant will have capacity to provide an additional 150 billion litres of water a year to Melbourne, Geelong, Westernport and South Gippsland. The project is scheduled to commence delivery of water by December 2011;
- the Northern Victoria Irrigation Renewal Project (NVIRP), of which Stage 1 is designed to save up to a long-term average of 225 billion litres of water in the Goulburn and Murray irrigation systems currently lost through leaks, evaporation and other inefficiencies. The water saved will be shared equally by irrigators, the environment and (up to 75 billion litres) to Melbourne. The project is due for completion in 2012-13; and
- as part of the Victorian Transport Plan, the purchase of additional rolling stock and VLocity passenger trains. Regional Rail Link will deliver a 50 kilometre dual track from West Werribee to central Melbourne's Southern Cross Station, increasing capacity by 9 000 regional and suburban passengers every hour, as well as allowing regional rail services to run express to Melbourne.

## Procuring new infrastructure

All new investment in infrastructure undergoes significant analysis around its commerciality and preferred method of delivery. Project funding methods include utilising cash reserves, operating surpluses or the use of long-term borrowings that match the expected life of the project. Projects can be procured either by traditional methods or via the *Partnerships Victoria* method of public private partnership (PPP).

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

There are currently 20 *Partnerships Victoria* projects in existence with a capital investment of approximately \$10.3 billion. Of significance is the Victorian Desalination Project at Wonthaggi, which reached financial close in September 2009 despite significant volatility in global financial markets. Of the 20 PPP projects in existence, 14 of these have reached commissioning and are now operational.

### **Future Partnerships Victoria projects**

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

- Ararat Prison – In July 2008, it was announced that the new 350 bed medium security Ararat Prison would be procured as a PPP, adjacent to the existing Ararat prison. The prison is a key part of the progressive upgrade of Victoria's correctional system and will provide upgraded correctional services to meet future projected prisoner growth. The private sector partner will design, construct, finance and maintain the facilities over the contract period, while core custodial services will be delivered by the State. Financial close is expected to take place in the final quarter of 2009-2010, with the prison expected to be completed in 2012; and
- Parkville Comprehensive Cancer Centre (Parkville CCC) – The new world-class Parkville CCC will bring together six clinical and research partners: the Peter McCallum Cancer Centre, the Ludwig Institute for Cancer Research, Melbourne Health (the Royal Melbourne Hospital), the University of Melbourne, the Walter and Eliza Hall Institute of Medical Research and the Royal Women's Hospital. The Parkville CCC aims at driving leadership and innovation in the fields of cancer treatment, research and education by having the largest concentration of cancer clinicians and researchers in the southern hemisphere, ranking it among the top ten cancer centres in the world. Capital costs of the project are to be equally funded by the Commonwealth and Victorian Governments, each contributing \$426.1 million, and will be complemented by the sale of surplus assets, partner contributions and philanthropic donations. A private consortium will design, build, finance and maintain the Parkville CCCs facilities, with responsibility of all core clinical, research and education services to be retained by the project partners including the State. A contract is expected to be entered into in the first half of 2011, and construction completed by 2015.

## FINANCIAL POSITION OF THE NON-FINANCIAL PUBLIC SECTOR

Table 4.4 shows the summary balance sheet of the NFPS. Net assets are expected to increase to \$145.9 billion by 30 June 2014. The projected increase is underpinned by prudent balance sheet management, including the fact that a substantial proportion of infrastructure spending will be financed by operating cash flow surpluses.

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

	(\$ billion)					
	2009	2010	2011	2012	2013	2014
	Actual	Revised	Estimate	Estimate	Estimate	Estimate
	GFS- GAAP	GFS- GAAP	GFS- GAAP	GFS- GAAP	GFS- GAAP	GFS- GAAP
<b>Assets</b>						
Non-financial assets <sup>(a)</sup>	158.0	166.6	175.3	189.2	195.2	201.9
Financial assets <sup>(b)</sup>	11.8	11.0	11.1	11.2	11.5	11.4
Investments in other sector entities <sup>(c)</sup>	0.8	1.9	2.3	2.7	3.2	3.6
<b>Total assets</b>	<b>170.6</b>	<b>179.4</b>	<b>188.6</b>	<b>203.2</b>	<b>209.9</b>	<b>216.9</b>
<b>Liabilities</b>						
Superannuation	20.8	20.3	20.7	21.1	21.4	21.3
Borrowings <sup>(d)</sup>	18.4	23.3	27.7	36.0	38.2	38.8
Other liabilities	11.6	11.2	11.2	11.1	11.0	10.9
<b>Total liabilities</b>	<b>50.8</b>	<b>54.8</b>	<b>59.6</b>	<b>68.2</b>	<b>70.6</b>	<b>71.0</b>
<b>Net assets</b>	<b>119.8</b>	<b>124.6</b>	<b>129.0</b>	<b>135.0</b>	<b>139.3</b>	<b>145.9</b>

Source: Department of Treasury and Finance

Notes:

- (a) Non-financial assets include inventories, non-financial assets held for sale, land, buildings, infrastructure, plant and equipment, and other non-financial assets.
- (b) Financial assets include cash and deposits, advances paid, investments, loans and placements, receivables, and investments accounted for using the equity method.
- (c) Consists of investment in public financial corporations.
- (d) Borrowings include deposits held and advances received.

Non-financial assets account for the majority of total assets, and consist of land and buildings, plant and equipment, and other fixed assets. Non-financial assets are expected to increase to \$201.9 billion by 30 June 2014 due to the substantial infrastructure investment over the period.

Other assets comprise financial assets, as well as investments in other sector entities. Investments in other sector entities consist of the net assets of the State's public financial corporations, which are expected to rise to \$3.6 billion by 30 June 2014, primarily as a result of an expected increase in the market value of investments as a result of recovery in global financial markets.

Borrowings (including advances received and deposits held) are expected to rise by \$15.5 billion from \$23.3 billion to \$38.8 billion over the period 30 June 2010 to 30 June 2014, driven by the \$27.9 billion infrastructure program. While rising over the period, borrowings remain at a sustainable level, and below that published within the 2009-10 Budget Update.

## FINANCIAL SUSTAINABILITY

The growth in borrowings over the forward estimates period will result in a corresponding increase to both net debt and net financial liabilities. As shown in Table 4.5, net financial liabilities are expected to increase to \$59.6 billion, or 15.4 per cent of GSP by 30 June 2014. This is largely driven by an increase in borrowings over the forward estimates period, as well as an increase in the net superannuation liability. As discussed in Chapter 3, the projected increase in the superannuation liability is primarily attributable to the fact that some schemes are only partially funded, thus the return on assets is not sufficient to offset growth in the accrued liability.

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

	2009 Actual GFS- GAAP	2010 Revised GFS- GAAP	2011 Estimate GFS- GAAP	2012 Estimate GFS- GAAP	2013 Estimate GFS- GAAP	2014 Estimate GFS- GAAP
	(\$ billion)					
Net debt <sup>(a)</sup>	10.7	16.1	20.6	28.9	30.9	31.7
Net financial liabilities <sup>(b)</sup>	39.0	43.8	48.6	57.0	59.1	59.6
	(per cent)					
Net debt to GSP <sup>(c)</sup>	3.7	5.1	6.2	8.3	8.4	8.2
Debt service cost <sup>(d)</sup>	1.6	2.1	2.5	3.7	5.0	5.2
Net financial liabilities to GSP <sup>(c)</sup>	13.4	13.9	14.6	16.3	16.0	15.4
Liability service cost <sup>(e)</sup>	3.0	4.0	4.3	5.6	6.8	7.0

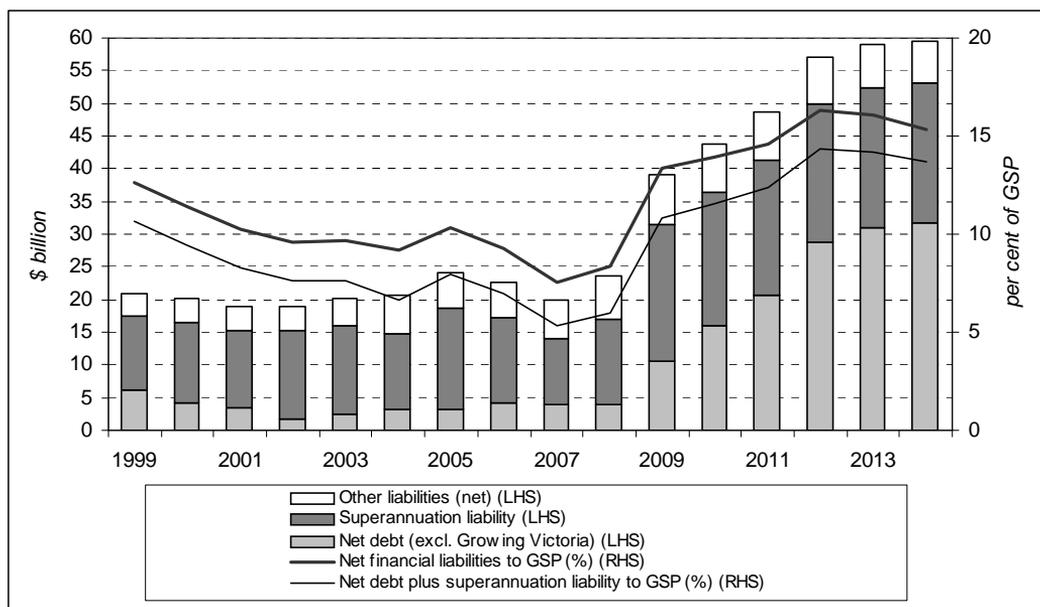
Source: Department of Treasury and Finance

Notes:

- (a) Net debt is the sum of deposits held, advances received and borrowings less the sum of cash deposits, advances paid, and investments, loans and placements.
- (b) Net financial liabilities are the sum of superannuation, borrowings and other liabilities less financial assets.
- (c) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
- (d) Debt service cost is net interest to total revenue, where net interest equals interest expense less interest revenue.
- (e) Liability service cost is net interest plus superannuation interest expense to total revenue.

As shown in Chart 4.1, after increases in net debt and net financial liabilities in the short term, the budget strategy will see debt moderate from 30 June 2012, with cash operating surpluses expected to meet at least 84 per cent of net infrastructure investment by 30 June 2013. The Government is committed to maintaining fiscal discipline, and has undertaken a number of initiatives to bring expenditure growth below revenue growth, thus boosting the operating surplus over time. It is through this strategy that the Government will maintain debt at prudent and sustainable levels over the longer-term, while providing capacity to invest in infrastructure.

**Chart 4.1: Non-financial public sector net financial liabilities**



Source: Department of Treasury and Finance

### Commonwealth Guarantee of State Borrowings

As a result of the global financial crisis, it became increasingly difficult for all Australian jurisdictions to raise long-term funds, especially those that had either suffered a downgrade in their credit rating or were under the threat of one. In response, the Commonwealth Government announced in March 2009 it would provide a guarantee over state and territory government borrowings. The guarantee formally commenced in July 2009, and was adopted by New South Wales and Queensland.

Due to the Government’s strong financial position, Victoria took the position that it would not utilise the guarantee on existing or future borrowings unless there was a significant deterioration in financial markets. As a result of this decision, the issuance of all state borrowings to date has been without the Commonwealth guarantee, resulting in significant interest cost savings for Victoria. This interest saving is expected to exceed \$100 million over the life of existing debt. Victoria’s decision not to utilise the guarantee is expected to continue until the scheme is withdrawn at the end of 2010.

## STATE FINANCIAL INDICATORS AND CREDIT RATINGS

Victoria receives credit ratings from two ratings agencies: Standard and Poor's (S&P) and Moody's Investors Service (Moody's). Both agencies examine a wide range of financial and non-financial indicators when assessing the credit worthiness of jurisdictions.

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

One of the S&P key indicators is net debt (excluding advances paid) plus the superannuation liability of the NFPS as a proportion of NFPS operating revenue. In Victoria's case, S&P has indicated that the trigger point for a ratings downgrade from AAA would be if this ratio were to exceed 130 per cent. It is important to note that this trigger point varies across Australian jurisdictions, with all other states having a lower trigger point than Victoria. Victoria's high trigger point is a reflection of the breadth of its economic base combined with its strong fiscal position and high quality infrastructure. By June 2014, Victoria's ratio is forecast to reach 98.8 per cent, well short of the published S&P trigger point. S&P reaffirmed Victoria's credit rating in September 2009.

Moody's has provided similar endorsements of Victoria's financial management in reaffirming its Aaa credit rating of the state in January 2009.

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

## CHAPTER 5 – ECONOMIC REFORM AGENDA

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- Prudent economic management and an outstanding record of past reforms have placed Victoria in a strong position to weather the effects of the global financial crisis.
- Further strengthening Victoria’s competitiveness will be important to secure the benefits of recovery in a more subdued global economy.
- Victoria also faces longer-term demographic, industry composition and climate change challenges that will require solid growth in productivity.
- Victoria’s strategy for boosting productivity and competitiveness includes maintaining a low-cost business environment, efficient and effective regulation and a program of priority reforms to key areas of the State’s economic and policy environment.
- Victoria remains committed to undertaking key reforms at the state level, and to taking a leadership role to foster genuine cooperation and collaboration between the Commonwealth and state governments, which will be crucial to many aspects of the reform agenda.

While the worst of the global financial crisis appears to have passed, its magnitude will have ongoing implications for the global economy, with an overhang of debt and unemployment in many countries moderating growth in the world economy for some time to come. Australia has weathered these events relatively well and, with its strong links to the more rapidly growing Asian economies, is already set on a solid recovery path.

Compared to other Australian jurisdictions, Victoria’s solid financial position and strong record of economic reform left this State better positioned to absorb the impacts of the recent downturn while still maintaining a AAA credit rating. This has left Victoria better poised for recovery than some other states.

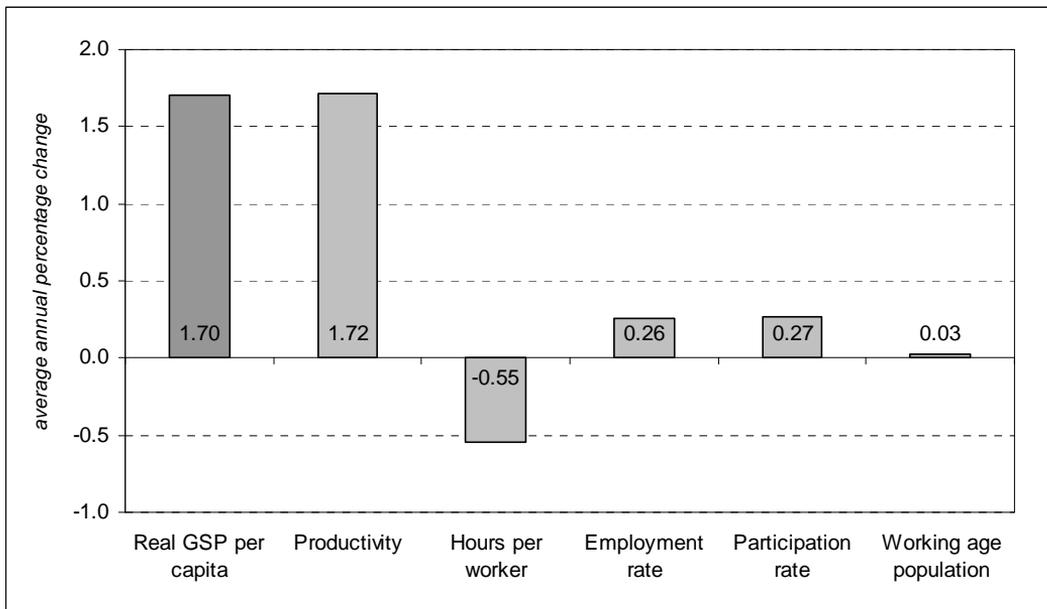
Nevertheless, it remains important for Victoria to continue to improve its competitiveness – the ability to attract investment and talent, and to develop and employ its people, resources and infrastructure efficiently. Many of our global competitors are likely to emerge leaner and more efficient in the aftermath of the global financial crisis. Meanwhile, capacity constraints that eased during the downturn could quickly re-emerge as the recovery gathers pace. This will make competitiveness in non-resource states like Victoria particularly important if the ‘two-speed’ economy related to the commodity boom takes hold again.

One of the most notable features of the impact of the global financial crisis on Victoria's economy was that unemployment did not increase as much as expected. Instead, much of the shock to the labour market was absorbed through a reduction in average hours worked, as a result of greater flexibility in the labour market.

This phenomenon of reduced average hours per job is not just a short-term response to the recent downturn. It is also attributable to a pronounced longer-term trend towards part-time employment, more evident in the non-resource states such as Victoria. In part, this shift reflects long-term structural changes in the industry composition of the economy towards service industries, but it also reflects the preferences of some demographic groups for part-time work.

These trends in part-time work and participation present both opportunities and challenges. On the one hand, greater flexibility in hours worked provides opportunities for groups such as students, older workers and carers to participate in the labour force. On the other hand, with increased labour force participation rates largely offset by reduced hours per job, future increases in living standards will continue to depend on productivity growth. This is clearly demonstrated in Chart 5.1, which shows that productivity growth was the crucial contributor to Victoria's economic growth over the past decade.

**Chart 5.1: Contribution to growth in real GSP per capita – 1999 to 2009**



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

The Commonwealth Government's latest *Intergenerational Report* also highlighted the importance of productivity in meeting the longer-term challenges of population growth, population ageing and climate change. To address these challenges to the living standards of Victorians while maintaining fiscal sustainability, fresh action is required to improve our underlying productivity.

With significant and far-reaching productivity-enhancing microeconomic reforms, such as those made under National Competition Policy and the Council of Australian Governments (COAG) Reform Agenda, largely completed or underway, the challenge for governments now is to extend the reach of reform into new areas to achieve the required boost to productivity. The emphasis of the Victorian Government's productivity and competitiveness strategy is two-fold:

- maintain focus on the fundamental building blocks for a competitive, productive and innovative economy – a skilled workforce, high quality infrastructure, best practice regulatory structure, well-functioning markets and sound financial management; and
- continue to pursue a vigorous economic reform agenda to address medium-term and long-term challenges.

In economic fundamentals, Victoria already has a significant record of achievement. Victoria has a AAA credit rating, is in the midst of delivering a significant infrastructure program and has long been a national leader in regulatory reforms. Victoria also benefits from a skilled and healthy workforce and liveability that attracts talent and investment.

To continue to build on these very solid foundations, and place Victoria in a strong position to respond to future challenges, there are a number of priority areas for the next phase of reform aimed at enhancing Victoria's productivity and competitiveness over the coming decade. These are:

- economy-wide reforms (such as competition reforms and regulation);
- human capital reforms (including measures to improve skills and health); and
- planning and infrastructure reforms.

Commonwealth Government cooperation and collaboration will be of crucial importance to achieving key reform outcomes. In addition, the system of financial arrangements between the Commonwealth and the states is important in driving economic reform processes. Commonwealth-state financial relations are also pivotal to the State's delivery of many of the quality services and enhancements to physical and human capital that can help improve competitiveness and productivity.

## **ECONOMY-WIDE REFORMS**

Some policy areas and government processes have impacts across many areas of the economy. A new focus on competition in markets not previously exposed to microeconomic reforms and further improvements in the regulatory environment will enhance Victoria's competitiveness. In addition, climate change policy has far-reaching economic implications and reform is needed to ensure that Victoria's transition to a low-carbon economy, particularly in light of any national response, occurs at least cost to the community.

## Competition and market reform

Over the last forty years, the two significant eras of pro-competitive economic reform in Australia opened up previously sheltered areas of the economy to the discipline of the market place. In the 1970s and 1980s tariff reform, financial market deregulation and the floating of the Australian dollar exposed Australian firms to greater international competition, and in the 1990s National Competition Policy and a broader suite of public sector reforms extended competitive discipline to non-trade exposed areas of the economy, including the public sector.

Another era of microeconomic reform is now in prospect. Recent advances in market design are enabling the development of market-like instruments in many domains where markets do not currently exist, and thus which have previously been untouched by economic reform.

Market-based approaches that are well-designed can deliver more efficient solutions to policy problems by allocating scarce resources to those who value them most. Allocation processes can be fairer and more transparent, and the community can receive greater value for money. Another important advantage of market design techniques is that incentive structures can be custom-designed for the specific policy problem, rather than using a 'one-size-fits-all' regulatory approach.

Through the design of customised mechanisms (such as auctions) that harness the power of competition, these developments have the potential to extend the frontier of microeconomic reform to a wide range of non-market systems. In Victoria, markets have been designed, created and employed in a range of new policy domains including: the allocation of gaming machine licences; the distribution of irrigation water; conservation of important habitat; reduced nutrient runoff to rivers and streams; carbon sequestration on farm land; water quality improvement in urban areas; and allocation of native timber and also aquaculture sites in Port Phillip Bay.

Building on its past leadership in applying evidence-based and innovative market approaches to selected policy problems, the Government is building capacity across government and the university sector in applying these techniques. Using this expertise to extend the application of market design to a broader range of policy and service delivery issues is an area of increasing focus and reform, particularly in sectors such as: the environment and natural resources; transport and communication; and procurement of goods and services by government.

## Reducing regulation

Efficient and effective regulation is essential to improving the competitiveness of the Victorian economy and meeting community needs. Victoria is a national leader in streamlining and reducing the regulatory burden on business and, in 2006, was one of the first jurisdictions in Australia to introduce regulatory targets through the *Reducing the Regulatory Burden* initiative. The Government is on track to reach its aim of cutting the net administrative burden of regulation (red tape) by 25 per cent (\$256 million per annum) by July 2011, having already achieved net reductions of \$246 million per annum, based on current initiatives.

Accordingly, in September 2009 the Government set a new challenge of reducing regulatory burden by \$500 million per annum by July 2012, including substantive compliance and delay costs. Although businesses and not-for-profit organisations will continue to receive the primary benefits of these reductions, the Government has also decided to extend this initiative to include costs associated with local government regulation, government service delivery and employment-related requirements on individuals.

Moreover, measures were also announced to enhance Victoria's regulatory system including:

- updating the *Victorian Guide to Regulation* to ensure that it incorporates the very latest best practice principles for designing efficient regulation;
- enhancing the way that government agencies work together to minimise the burden on the community when designing regulation; and
- strengthening the Victorian Government's approach to ensuring the ongoing effectiveness and viability of existing regulations.

The Government is proposing to further improve the regulatory environment by enhancing the scrutiny processes of all subordinate legislation that will impose an 'appreciable burden'. The proposed reforms will:

- broaden the scope of the *Subordinate Legislation Act 1994* (SLA) so that it applies to a broad range of subordinate legislation, not just statutory rules; and
- provide more guidance on the definition of 'appreciable burden' to ensure subordinate legislation which has a considerable impact on the community is subject to the full scrutiny processes of the SLA.

Recent enhancements to the cabinet process will also ensure that Regulatory Impact Statements with a high impact will be subject to increased scrutiny.

Since its establishment in 2004, the Victorian Competition and Efficiency Commission (VCEC) has completed nine inquiries, and the Government has accepted in full, in part or in principle, 95 per cent of the VCEC's recommendations.

The VCEC is expected to deliver its final report on streamlining local government regulation by 24 August 2010. The inquiry will examine scope for improving the efficiency of regulation by further streamlining regulation and procurement processes administered by local government.

This will follow the receipt by the Government by June 2010 of the final report of the VCEC inquiry into the regulatory impediments in the financial services sector. The review is aimed at supporting the competitiveness of Victoria's financial services sector by identifying options for removing regulatory and other barriers to investment.

The Government has also made significant progress on its commitment to reduce the number of principal Acts of Parliament by 20 per cent by 2010. A total of 211 Acts have already been repealed and a further Legislation Reform Bill is being considered by the Parliament that seeks to repeal another 63 spent and redundant Acts. The seventh of the Government's Legislation Reform Bills will be introduced in 2010 and a number of Acts will be repealed by the new Consumer Reform legislative package and other Bills during the year.

As the Government continues to strive to lower the burden of regulation, future reform efforts will include the broader use of market-based solutions to reduce the reliance on regulatory approaches. Advances in economic design techniques could be applied to design and fine-tune the incentive structures embodied in regulation, and to develop and recommend new quality assurance processes for the design of regulations to ensure that proposed regulations are well-designed and tested.

Meanwhile, under the COAG *National Partnership Agreement to Deliver a Seamless National Economy*, a significant Intergovernmental Agreement was signed in 2008 to underpin the establishment of the national Australian Consumer Law, based on existing consumer protection provisions, and new product safety regulation and enforcement regimes. Victoria has also led the development of model legislation for harmonised national occupational health and safety.

In 2010, Victoria will implement the next key steps in COAG's reform agenda to enhance Australia's productivity and competitiveness. This includes further implementation of Australian Consumer Law, reforming business names registration and introducing key legislation as host jurisdiction for the national licensing system.

### **Least-cost transition to a low-carbon economy**

Climate change is a global problem that will require Australia to be part of a coordinated international solution. Although there is currently uncertainty about Australia's broader climate change policy settings, the challenge for Victoria, in terms of maintaining competitiveness, remains the transition to a low-carbon economy at least cost to the community while maximising opportunities for new investment and jobs. Victoria supports the Commonwealth Government's efforts to implement a national market-based response to reducing greenhouse gas emissions and to meet our international obligations.

Putting a price on carbon remains the most efficient and effective way of reducing greenhouse gas emissions. Such a market response provides strong private incentives to cut emissions where the costs of doing so are lowest, and drives ongoing innovation without requiring overly prescriptive or interventionist approaches.

State climate change mitigation policies should be aligned with action at the national and international level. In this context, there will remain the need to facilitate basic research and development into technologies or knowledge that benefit Victoria, and to improve the management of government assets and services. For example, the Greener Government Buildings program, announced as part of the *Jobs for the Future Economy: Victoria's Action Plan for Green Jobs* statement, will reduce energy costs and water use in schools and community and government buildings, reducing the Government's exposure to higher energy costs in future and providing demonstration and leadership to the private sector.

Irrespective of current and future mitigation actions, there will be a need to adapt to the unavoidable impacts of climate change, for example rising sea levels. Uncertainty surrounding the impacts of climate change requires governments to take a risk-management approach to adaptation. Where action is needed, it will be important to adequately take account of climate risks, keep options open where possible or adopt a staged approach to investments. Governments must retain flexibility in their responses to climate change and review decisions to ensure that they remain appropriate.

Adapting to climate change will require a wide range of localised responses over time, and adaptation actions by Victorian households and businesses will generally result in the most innovative, locally appropriate and cost effective adaptation responses. This will need to be supported by an appropriate institutional, market and regulatory environment. The Government also provides information, invests in basic research and manages risks of climate change to public services and assets and the natural environment. In this regard, the Government has announced several initiatives including:

- creating the Victorian Centre for Climate Change Adaptation Research to help the Government address knowledge gaps and build on existing capacity and learning regarding climate change;
- undertaking a preliminary study, *Climate Change and Infrastructure – Planning Ahead*, on the potential impacts of climate change on the State's infrastructure;
- releasing the Victorian Coastal Strategy in December 2008 outlining how the Government will address climate change along the coast; and
- providing detailed mapping of the Victorian coastline under the Future Coasts Program to help assess the physical vulnerability of coastal areas to the impacts of sea level rise.

In 2009 the Government released the *Victorian Climate Change Green Paper*. Since then, the Government has consulted widely about the best strategies for Victoria in responding to the challenges of climate change. Over the coming months the Government will complete and release a white paper on climate change that will set Victoria's climate change strategy for the next 10 years. It will also introduce a Climate Change Bill to give effect to policies announced in the white paper requiring legislation.

## HUMAN CAPITAL REFORMS

Improving the health and skills of Victoria's workforce is crucial to ensuring Victoria's future labour force participation and productivity growth. In March 2008, all Australian governments committed to work in partnership to deliver a new reform agenda (the COAG Reform Agenda) with a heavy emphasis on human capital reforms, including healthcare, education and skills. In parallel with this national reform, Victoria continues to promote state-based reform opportunities to enhance health, knowledge and skills.

### Health

Australia's health system ranks well compared to other OECD countries, achieving better than average health outcomes at lower than average cost (as measured by the ratio of health spending to GDP).

Victoria has been a leader in Australia in evolving and improving its health system. Victoria devolved the governance of hospitals to independent hospital boards, giving more control to local decision-makers to meet the particular needs of local patients. Casemix funding was introduced in Victoria in 1993, rewarding lower cost hospitals and creating incentives for additional throughput. Victoria has an advanced sub-acute care sector, and provides more services in community settings, thereby reducing unnecessary hospital utilisation.

Nonetheless, there are significant challenges ahead. These include managing strong projected growth in demand for health services over coming decades, and addressing projected shortfalls in the health workforce.

At its April meeting, COAG – with the exception of Western Australia – agreed to a plan to reform Australia's health and hospitals system.

The plan agreed by COAG builds on many aspects of Victoria's existing system. It includes local hospital networks to locally manage groups of hospitals, accelerating the national roll-out of activity-based funding to increase hospital efficiency, and introducing national standards for hospitals and primary care.

The Commonwealth will: increase its share of hospital funding to 60 per cent of the efficient price of hospital services; fund 60 per cent of capital, research and training in public hospitals; and progressively increase funding to 100 per cent of the efficient price of 'primary care equivalent' outpatient services. The Commonwealth will increase its share of funding through dedicating an amount of goods and services tax (GST) revenue as required, on top of the current health specific purpose payment funding. The amount of GST to be allocated to health and hospitals will be fixed from 2014-15, based on 2013-14 costs. The Commonwealth has also guaranteed that it will contribute the estimated difference between the growth rates of GST revenue and health costs from 2014-15 to 2019-20. This involves a minimum guaranteed benefit of \$3.8 billion to Victoria. State-based joint intergovernmental funding authorities will be established which will receive activity-based funding contributions from both the Commonwealth and the State. The funding authority will then pay relevant local hospital networks directly. The level and mix of services that local hospital networks provide will be determined by a service agreement between each network and the State Government.

The Commonwealth will provide an additional \$935 million over four years to Victoria for emergency departments, elective surgery, long stay older patients in hospitals, sub acute beds and multi purpose services (which provide aged care and step down services in small rural communities). As part of the COAG agreement, the Commonwealth also committed to spending \$386 million in Victoria on GP payments for coordinated care for diabetes patients, additional aged care and mental health places, and additional health workforce training places. This extra funding secured for Victoria will improve the system and deliver additional services to more Victorian patients.

The *2010-11 Budget* is accompanied by the *Putting Patients First* statement (Budget Information Paper No. 2) which reflects the agreement on health and hospitals reform. *Putting Patients First* can be viewed at [www.budget.vic.gov.au](http://www.budget.vic.gov.au).

## **Knowledge and skills**

A skilled labour force is critical to Victoria's wellbeing and will be particularly important to drive future growth given the ageing population. Raising the skills of the population improves productivity and helps to support labour force participation. An ageing population will present longer-term economic challenges and will require increased participation in the labour force by people of working age. New skills will also be required to adapt to structural changes in the economy associated with climate change. Victoria is well placed to meet these demands, through investment in early childhood and school education and reform of the vocational education and training sector.

The *Blueprint for Education and Early Childhood Development* launched in 2008 sets out the Government's five-year agenda for learning and development from birth to adulthood. Reforms are being implemented in three broad areas: system improvement, partnerships with parents and communities, and workforce. These reforms will provide Victorian children with a good start in life and provide a strong foundation for lifelong learning.

The Government supports young people in the transition from compulsory schooling to work and life as independent adults by providing quality education and training systems. While the majority of young people make a successful transition, some young Victorians need more support to do so. Victoria, in partnership with the Commonwealth under the *National Partnership Agreement on Youth Attainment and Transitions*, is putting in place new arrangements to re-engage young people who have disengaged from education and training.

Through the reforms and extra funding announced in August 2008 in *Securing Jobs for Your Future – Skills for Victoria*, the Victorian vocational education and training sector is being transformed into a more flexible system that is demand-driven and responsive to market needs. These reforms will help to maintain and improve Victoria's competitiveness and continue creating sustainable jobs. A flexible skills system will respond more quickly to the changing training needs of industry and business, and ensure that students at different life stages can access training.

Implementation of *Securing Jobs for Your Future* began in July 2009 with eligible Victorians able to access the Victorian Training Guarantee to undertake training at the Diploma and Advanced Diploma level at a wider range of providers. The Victorian Training Guarantee is also available to eligible individuals under 25 years under the Youth Compact (from 1 July 2009 for 15 to 19 year olds and 1 January 2010 for 20 to 24 year olds) and to eligible retrenched workers over the age of 25 under the Compact with Retrenched Workers (from 1 July 2009). The reformed system – guaranteed funding for eligible Victorians at a wider range of providers – applies to a substantial proportion of the training system in 2010 and will be fully implemented in 2011, applying to all qualification levels for all ages.

## **PLANNING AND INFRASTRUCTURE**

In response to the economic downturn, the Victorian Government supported construction to help secure jobs by exercising ‘call-in’ planning powers to fast-track many major projects, including housing, retail and office space developments. A review of the *Planning and Environment Act 1987* identified actions to progress permanent improvements in planning and investment approval processes to reduce avoidable time delays and facilitate household and private business investment. These actions are contained in a draft Planning and Environment Amendment (General) Bill, which was released for public comment in December 2009 and comments are currently being considered. The Bill seeks to update Victoria’s planning objectives, improve the amendment and permit processes, introduce new processes for projects declared as state significant developments, improve the operation of s173 agreements, and enhance the reporting on the planning system’s performance.

### **Planning for a sustainable future**

Victoria’s population continues to grow strongly and with this growth comes opportunities and challenges for Melbourne and regional Victoria.

Melbourne’s population growth is increasing demand for housing. To meet this demand, the Government has estimated that around 600 000 additional dwellings will need to be built in Melbourne over the next 20 years. Just over half of these homes will need to be built in Melbourne’s established areas to capitalise on existing infrastructure and balance demand for housing in Melbourne’s urban growth boundary.

Melbourne’s housing development industry is responding to this increase in demand, with dwelling approvals in Victoria far exceeding approvals in other states.

The Government is improving planning processes through initiatives to better manage planning for housing and employment growth. These initiatives include the collection of detailed housing and employment data to assist local councils develop housing strategies, supporting housing and employment in Central Activity Districts and along key employment corridors and providing local councils with specialist technical advice to complete and implement plans for Melbourne 2030 activity centres.

The Government is increasing land supply for housing. Already, the Growth Area Authority's Precinct Structure Plan Program is on track to approve land for an additional 110 000 residential lots by 2012. In addition, as outlined in the Victorian Integrated Housing Strategy, the Government will free up surplus government land and make it available for development, working with the private sector to develop housing at several government-owned sites and refocusing VicUrban towards supporting more housing in established urban areas.

Meanwhile, the Government is working with the Commonwealth to review its capital city strategic planning system, consistent with COAG-agreed objectives and criteria, that will ensure that Victoria continues to responsibly manage population and economic growth in Melbourne.

COAG has also agreed to the development of a housing supply and affordability reform agenda. The agenda focuses on the primary areas where gains may be achieved in decreasing the time it takes to bring housing to the market, reforming government policies that act as barriers to supply or that artificially stimulate demand and ensuring efficient use of existing housing stock.

A key challenge of population growth in regional Victoria is to balance the demand for land for increased housing with the demand for land for agriculture and other non-urban uses. To help achieve this balance the Government is promoting growth in Victoria's regional cities such as Geelong, Ballarat and Bendigo and in key towns along regional transport corridors through measures such as the Regional First Home Bonus. In those cities and towns that are likely to benefit from improved regional transport networks, the Government is assisting local planning authorities plan for increasing development across Australia.

As Victoria's population and economy grows, there is also greater pressure on Victoria's natural assets. Climate change is expected to pose additional risks to Victoria's environment. An ageing population will also have significant fiscal consequences for the State. To manage these demographic, environmental and fiscal challenges and maintain Victoria's competitiveness, it is important that Victoria uses its natural resources in a more sustainable, efficient and cost-effective way. In responding to growing demands for more sustainable outcomes, the Government will continue to ensure that policies and programs in areas like waste recycling, energy use, biodiversity, mineral extraction, land use and carbon emissions have clear and demonstrable net benefits. The Government will also continue to look for opportunities to use market-based solutions to environmental policy problems, to reduce the cost and create greater flexibility in the delivery of natural resource management outcomes.

## Using infrastructure more efficiently

Government can play an important role in ensuring the most efficient use of infrastructure assets by enabling planning and providing a coordinating and organising function. There is a clear need for infrastructure investment to take place in carefully designed and planned networks. Victoria welcomed the creation of Infrastructure Australia, which signalled the Commonwealth's acknowledgement of the need for a long-term vision for, and intelligent analysis of, the nation's infrastructure development.

The promotion of competition in public and private infrastructure markets can assist in a more efficient allocation of resources and funding. Public private partnerships (PPPs) are another way of introducing market-based incentives to drive greater innovation and efficiency in the supply of public infrastructure.

The role of infrastructure construction as a tool of counter-cyclical macroeconomic policy in response to the global financial crisis exposed the need for improved infrastructure planning and development.

Victoria has continuously improved asset investment decision processes to support sound investment choices. Moreover, Victoria is Australia's leading jurisdiction in PPPs, receiving national and international recognition for its desalination plant PPP project, including Global Deal of the Year 2009 from the international *Infrastructure Journal*.

With the Victorian Transport Plan forming the long-term vision for the State's transport infrastructure, Victoria was in a good position to respond quickly to the Infrastructure Australia processes and thereby received a significant initial funding allocation from the Building Australia Fund to construct a new heavy rail project – the Regional Rail Link. This represents the largest upgrade to Melbourne's rail network since construction of the Melbourne Underground Rail Loop and will substantially increase capacity and service frequency for rail users in the west of Melbourne and key regional centres. The challenge now is to continue to deliver on this infrastructure vision and work with Infrastructure Australia on long-term infrastructure planning and investment issues.

Augmentation of infrastructure is only part of the story. Using market signals to drive the more efficient use of existing infrastructure is also important. A particular challenge for Victoria is the re-engineering of freight flows across metropolitan and regional Victoria to better manage the expected two-fold increase in freight by 2020. In addition, Victoria is working with other jurisdictions through COAG to introduce more cost-reflective heavy vehicle price reforms and national regulatory frameworks to reduce the compliance burden for industry and to kickstart increased freight movements by rail.

## REFORMING COMMONWEALTH-STATE FINANCIAL RELATIONS

As COAG has recognised, a national approach is required to continue to ensure Australia remains economically competitive, and productivity is maximised in the face of demographic, economic, social and environmental challenges.

A feature of Australia's federation is the disparity between state and territory revenue raising capacity and expenditure responsibilities. This means service delivery and infrastructure provision is heavily reliant on cooperative relationships with the Commonwealth Government, and the nature of financial relationships will be a key determinant of the success of nation building and service delivery reforms.

The Intergovernmental Agreement on Federal Financial Relations (the IGA), which came into effect on 1 January 2009, provided a basis for cooperative federalism. Recent changes to health funding arrangements will require amendment to the IGA, and possibly also supporting Commonwealth legislation. Implementation of these arrangements, and other national reforms, will require genuine collaboration and commitment to the principles of flexible federal financial arrangements inherent in the IGA.

Other critical issues which will continue to shape fiscal federalism include the Commonwealth Government's tax review, *Australia's Future Tax System* (the Henry Tax Review) released on 2 May 2010 and further reform of approaches to horizontal fiscal equalisation.

The Henry Tax Review is a broad-based review of Australia's tax and transfer system. This review – the first comprehensive review of both Commonwealth and state taxes in 50 years – is a significant opportunity to enhance our tax system while supporting the delivery of high quality public services.

### **Commonwealth Grants Commission 2010 Review**

While Victoria continues to support the principle of horizontal fiscal equalisation (HFE), it does have concerns with the methodology developed by the Commonwealth Grants Commission (CGC) for GST distribution in its most recent review of methodology (completed in February 2010).

Acknowledging that efforts have been made to improve and simplify the CGC methodology, the process for determining relativities still remains costly, overly complex and subject to arbitrary judgements. The proposed treatment of Commonwealth Government funding for major nation building projects, including Victoria's Regional Rail Link project, provides a pertinent example of perverse policy outcomes that can result from the methodology.

Under the proposed treatment, one-off funding under the Commonwealth Government's *Nation Building Plan for the Future* will be treated like the funding provided each year for regular state infrastructure investment. This approach ignores the nature and scope of these projects, which are well in excess of normal state infrastructure works. The impact of this approach is to substantially offset Commonwealth funding for the Regional Rail Link project through reduced GST share (from 2012-13). This will place an unreasonable additional budget burden on Victoria, reducing capacity to provide other key services. More broadly, the possibility of losing hundreds of millions of dollars in GST funding could significantly discourage states from collaborating in other projects of national and generational significance.

Victoria is seeking to have this issue addressed immediately, but it is also an example of the need for a wide ranging review of how HFE outcomes can be achieved. A more cost effective, simpler and more transparent method that encourages reform and rewards innovation should be achievable.

## **THE RECOVERY AND BEYOND**

As the global economic recovery gathers pace, strong fundamentals and extensive past reforms have positioned Victoria well for the economic upturn. However, Victoria faces challenges to its competitiveness in the face of renewed effort on the part of global competitors, who will emerge from the global downturn leaner and more efficient, and domestic competitors that have mineral resources that Victoria lacks.

Growth in Victoria's productivity has been the key driver of economic expansion over the last decade. Continuing this growth will be crucial to enable Victoria to respond to longer-term challenges to economic growth and prosperity expected to arise from demographic changes, shifts in industry composition and climate change.

The Victorian Government is committed to strong economic fundamentals and has an ambitious and comprehensive program of economic reforms that will secure opportunities and prosperity for current and future generations of Victorians.

## **APPENDIX A – OPERATING STATEMENT RECONCILIATION**

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### **INTRODUCTION**

This appendix supports the commentary provided in Chapter 3 *Budget Position and Outlook*, by providing a reconciliation and explanations of the key movements in the 2010-11 to 2012-13 net result from transactions since these estimates were published in the *2009-10 Budget Update*.

**Table A.1: Reconciliation of 2009-10 Budget Update to 2010-11 Budget estimates <sup>(a)</sup>**

(\$ million)

	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
<b>Net result from transactions: 2009-10 Budget Update<sup>(a)</sup></b>	<b>925.4</b>	<b>738.8</b>	<b>1 790.2</b>
<b>Plus: Variations in income from transactions since 2009-10 Budget Update</b>			
Policy decision variations	( 11.9)	56.0	53.1
<b>Economic/demographic variations</b>			
Taxation	376.0	421.6	371.7
Investment income <sup>(b)</sup>	15.5	( 46.7)	( 58.7)
<b>Total economic/demographic variations</b>	<b>391.5</b>	<b>374.8</b>	<b>313.0</b>
<b>Commonwealth grant variations</b>			
General purpose grants	769.9	766.1	926.8
Specific purpose payment grants	660.7	267.4	383.6
<b>Total Commonwealth grant variations</b>	<b>1 430.6</b>	<b>1 033.5</b>	<b>1 310.4</b>
<b>Increase in own source revenue</b>	<b>657.2</b>	<b>707.4</b>	<b>665.5</b>
<b>Administrative variations</b>	<b>( 235.6)</b>	<b>( 161.7)</b>	<b>( 241.4)</b>
<b>Total variation in income from transactions since 2009-10 Budget</b>	<b>2 231.8</b>	<b>2 010.0</b>	<b>2 100.6</b>
<b>Less: Variations in expenses from transactions since 2009-10 Budget Update</b>			
Policy decision variations <sup>(c)</sup>	418.5	380.3	441.9
Commonwealth variations	280.3	143.3	167.9
Variations due to changes in own source revenue	804.7	782.6	850.8
<b>Administrative variations</b>			
Superannuation variations	73.6	71.9	70.3
Other administrative variations	708.2	720.3	972.3
<b>Total administrative variations</b>	<b>781.9</b>	<b>792.2</b>	<b>1 042.6</b>
<b>Total variation in expenses from transactions since 2009-10 Budget</b>	<b>2 285.4</b>	<b>2 098.4</b>	<b>2 503.2</b>
<b>Revised net result from transactions</b>	<b>871.9</b>	<b>650.4</b>	<b>1 387.6</b>

Source: Department of Treasury and Finance

Notes:

(a) Totals may not add due to rounding.

(b) Investment income includes dividends, income tax and rate equivalent revenue and interest.

(c) Policy decisions are net of funding from contingencies and other efficiencies.

## Variations to income from transactions

When compared to the estimates published in the *2009-10 Budget Update* total income from transactions is estimated to be \$2 232 million higher in 2010-11, \$2 010 million higher in 2011-12 and \$2 101 million higher in 2012-13.

Revenue policy decision variations made by government are expected to reduce revenue by \$12 million in 2010-11 and increase revenue by an average of \$55 million a year in 2011-12 and 2012-13. This mainly reflects reductions in payroll tax and land tax arising from policy changes announced in this Budget (\$53 million on average between 2010-11 and 2012-13); offset by increased revenue from policy decisions including bushfire preparedness and landfill levies.

The impact of the improved economic outlook and the strength of the property market on the Victorian economy and other economic and demographic variables have resulted in upward revisions in taxation revenue of \$376 million in 2010-11 and an average of \$397 million a year in 2011-12 and 2012-13.

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

- an upwards revision to land transfer duty (up by \$226 million in 2010-11 and by an average of \$164 million a year in the following two years) mainly reflecting the stronger than expected growth in property prices in recent quarters as well as the improved outlook for the economy and population growth;
- greater than expected strength in property prices, which coincided with the biennial land valuation on 1 January 2010, is reflected in an upwards revision to land tax (up by \$198 million in 2010-11 and by an average of \$201 million a year in the following two years);
- an upwards revision to insurance tax (up by \$28 million in 2010-11 and by an average of \$44 million a year in the following two years) reflecting the improved economic outlook and stronger industry expectation of premium increases;
- a downward revision to payroll tax (down by \$56 million in 2010-11 and by an average of \$24 million a year in the following two years) reflecting lower than expected revenue collections for the 2009-10 year. This has occurred despite higher than expected employment, in part reflecting lower than expected average hours worked per employee;
- a downward revision to gambling tax in 2010-11 (of \$22 million) reflecting lower than expected revenue for the year to date. The improved economic outlook is, however, expected to support gambling revenue going forward, and the estimates are broadly unchanged for 2011-12 and 2012-13; and
- higher than expected duty on motor vehicle registrations (up by \$21 million in 2010-11 and by an average of \$25 million a year in the following two years). This is largely offset by lower than expected motor vehicle registration revenue (down by \$23 million in 2010-11 and by an average of \$12 million a year in the following two years).

Investment income is higher in 2010-11 due to increased dividends from the Treasury Corporation of Victoria (TCV) reflecting improved profitability; and lower in the following two years reflecting a reduction in dividends from the Transport Accident Commission (TAC) as a result of actuarial reviews, revealing higher claims costs arising from common law action.

Total Commonwealth grants have been revised upwards by \$1 431 million in 2010-11, \$1 034 million in 2011-12 and \$1 310 million in 2012-13.

General purpose grants in the form of Goods and Services Tax (GST) have been revised upwards by \$770 million in 2010-11 and by an average of \$846 million a year in 2011-12 and 2012-13. This increase reflects higher than expected national GST pool collections and a higher share of this pool following the Commonwealth Treasurer's acceptance of the recommendations of the Commonwealth Grants Commission's *Report on GST Revenue Sharing Relativities – 2010 Review* in February 2010.

Upwards revisions to Commonwealth SPP grants revenue since the *2009-10 Budget Update* mainly reflect the revised timing of the *Nation Building – Economic Stimulus Plan* payments for social housing and Council of Australian Governments (COAG) funding for various health services including sub-acute care, emergency care, elective surgery, financial assistance for long stay older patients, and multi-purpose services.

Own source revenue has been revised upwards by \$657 million in 2010-11 and an average of \$686 million a year in 2011-12 and 2012-13. This primarily reflects changed administrative arrangements for public transport receipts that are matched by a corresponding increase in expense and a downwards revision to farebox revenue as a result of updated patronage growth estimates.

Administrative variations to revenue estimates primarily reflect:

- lower expected receipt of assets received free of charge from the Murray Darling Basin Commission in 2010-11; and
- amendments to growth area infrastructure contributions revenue due to the delays in legislation passing through Parliament.

These administrative variations to revenue are partially offset by higher estimates of unclaimed monies that the State Revenue Office expects to collect in 2010-11 and across the forward estimates period.

### **Variations to expenses from transactions**

Compared to the *2009-10 Budget Update*, total expenses from transactions are estimated to be \$2 285 million higher in 2010-11, \$2 098 million higher in 2011-12 and \$2 503 million in 2012-13.

New output policy decisions (net of funding from contingencies and other efficiencies) made by the Government since the *2009-10 Budget Update* account for \$419 million in 2010-11, \$380 million in 2011-12 and \$442 million in 2012-13. This reflects the Government's commitment to delivering quality services in health, transport, education, community safety and responding to high priority community needs.

Expenditure revisions associated with Commonwealth grant variations account for additional expenditure of \$280 million in 2010-11, \$143 million in 2011-12 and \$168 million in 2012-13. This mainly reflects the revised timing of the *Nation Building – Economic Stimulus Plan* payments for social housing and expenditure of COAG funding for various health services previously mentioned under the heading of Commonwealth SPP revenue.

Budget Paper No. 3, Chapter 1 *Service and Budget Strategies*, provides more detailed information on the Government's service delivery commitments, while Budget Paper No. 3, Appendix A *Output, Asset Investment and Revenue Initiatives*, provides a detailed list and description of all service delivery initiatives announced in the *2010-11 Budget*.

Expenditure associated with variations in own source revenue has been revised upwards by \$805 million in 2010-11 and an average of \$817 million a year in 2011-12 and 2012-13. This expenditure is associated with the changed administrative arrangements for public transport fund receipts associated with metropolitan rail refranchising and additional health services revenue (including TAC and private patients).

Administrative variations have revised expenses by \$782 million in 2010-11, \$792 million in 2011-12 and \$1 043 million in 2012-13.

Superannuation related expenses have been revised upwards by \$74 million in 2010-11 and by an average of \$71 million a year in 2011-12 and 2012-13. This increase is primarily due to the fact that the superannuation liability is not yet fully funded and so the interest cost associated with the gross superannuation liability exceeds the investment return on superannuation assets. Furthermore, while investment returns on superannuation assets have exceeded expectations in 2009-10, the favourable impact of this was more than offset by an increase in the discount rate that is used to calculate the superannuation interest cost.

Other administrative variations include the impacts of:

- an increase in non-cash depreciation expenses, largely resulting from revaluations of hospital assets, in accordance with accounting standards;
- higher First Home Owner Grant and First Home Bonus expense due to strong population growth and the improved economic outlook, and a greater than anticipated proportion of first home buyers purchasing or building a new home; and
- an increase in contingency provisions to better reflect likely growth in expenditure driven by the demands emanating from strong population growth. This reflects sound budget management principles and supports the State's capacity to respond to unexpected events.



## **APPENDIX B – SENSITIVITY ANALYSIS TABLE**

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### **INTRODUCTION**

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

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

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

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

**Table B.1: Impact on the general government fiscal results of selected economic indicators being one per cent higher than expected in 2010-11<sup>(a)(b)(c)</sup>**

(\$ million)

	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>GSP</b>				
Income from transactions	156	164	173	179
Expenses from transactions	-2	-11	-20	-28
<b>Net result from transactions</b>	<b>158</b>	<b>175</b>	<b>192</b>	<b>207</b>
Other economic flows	..	..	..	..
<b>Net result</b>	<b>158</b>	<b>175</b>	<b>192</b>	<b>207</b>
<b>Employment</b>				
Income from transactions	49	53	56	59
Expenses from transactions	-4	-8	-11	-14
<b>Net result from transactions</b>	<b>54</b>	<b>60</b>	<b>67</b>	<b>73</b>
Other economic flows	..	..	..	..
<b>Net result</b>	<b>54</b>	<b>60</b>	<b>67</b>	<b>73</b>
<b>Consumer prices<sup>(d)</sup></b>				
Income from transactions	272	281	294	300
Expenses from transactions	92	92	87	77
<b>Net result from transactions</b>	<b>180</b>	<b>189</b>	<b>207</b>	<b>223</b>
Other economic flows	-142	..	..	..
<b>Net result</b>	<b>38</b>	<b>190</b>	<b>208</b>	<b>223</b>
<b>Average weekly earnings</b>				
Income from transactions	56	59	62	66
Expenses from transactions	2	-1	-4	-7
<b>Net result from transactions</b>	<b>53</b>	<b>59</b>	<b>66</b>	<b>73</b>
Other economic flows	..	..	..	..
<b>Net result</b>	<b>53</b>	<b>59</b>	<b>66</b>	<b>73</b>
<b>Enterprise bargaining agreements<sup>(e)</sup></b>				
Income from transactions	25	25	25	26
Expenses from transactions	183	228	249	265
<b>Net result from transactions</b>	<b>-158</b>	<b>-203</b>	<b>-223</b>	<b>-239</b>
Other economic flows	-214	..	..	..
<b>Net result</b>	<b>-372</b>	<b>-203</b>	<b>-223</b>	<b>-239</b>
<b>Domestic share prices</b>				
Income from transactions	..	..	..	..
Expenses from transactions	..	-4	-4	-4
<b>Net result from transactions</b>	<b>..</b>	<b>4</b>	<b>4</b>	<b>4</b>
Other economic flows	45	..	..	..
<b>Net result</b>	<b>45</b>	<b>4</b>	<b>4</b>	<b>4</b>
<b>Overseas share prices</b>				
Income from transactions	..	..	..	..
Expenses from transactions	..	-3	-4	-4
<b>Net result from transactions</b>	<b>..</b>	<b>3</b>	<b>4</b>	<b>4</b>
Other economic flows	43	..	..	..
<b>Net result</b>	<b>43</b>	<b>3</b>	<b>4</b>	<b>4</b>

**Table B.1: Impact on the general government fiscal results of selected economic indicators being one per cent higher than expected in 2010-11<sup>(a)(b)(c)</sup>**

(\$ million)

	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate	2013-14 Estimate
<b>Property prices</b>				
Income from transactions	51	72	76	81
Expenses from transactions	-5	-10	-14	-19
<b>Net result from transactions</b>	<b>56</b>	<b>82</b>	<b>90</b>	<b>100</b>
Other economic flows	14	..	..	..
<b>Net result</b>	<b>71</b>	<b>83</b>	<b>91</b>	<b>102</b>
<b>Property volumes</b>				
Income from transactions	38	38	40	43
Expenses from transactions	-3	-6	-8	-10
<b>Net result from transactions</b>	<b>41</b>	<b>43</b>	<b>48</b>	<b>53</b>
Other economic flows	..	..	..	..
<b>Net result</b>	<b>41</b>	<b>43</b>	<b>48</b>	<b>53</b>
<b>Interest rates<sup>(f)</sup></b>				
Income from transactions	40	41	41	39
Expenses from transactions	32	133	161	176
<b>Net result from transactions</b>	<b>8</b>	<b>-92</b>	<b>-119</b>	<b>-137</b>
Other economic flows	1050	..	..	..
<b>Net result</b>	<b>1059</b>	<b>-92</b>	<b>-119</b>	<b>-137</b>

Source: Department of Treasury and Finance

Notes:

- (a) A positive number for income from transactions denotes an increase in revenue. A positive number for expenses from transactions denotes an increase in expenses (and hence a reduction in the net result from transactions and net result). A positive number for other economic flows represents an increase in revenue. A positive number for the net result from transactions and net result denotes a higher surplus or lower deficit. Numbers may not balance due to rounding.
- (b) The sensitivity from a 1 per cent lower-than-expected outcome of an economic variable would, in most instances, simply be the opposite of the impact shown in the table. However, for some results, the impacts of changes are not symmetrical and therefore care should be exercised when using the table to estimate the impact of lower-than-expected economic variables.
- (c) Only reasonably quantifiable data has been included in the analysis.
- (d) Reflecting the Government's departmental funding arrangements, it is assumed that an increase in consumer prices within the budget year does not impact on employee entitlements.
- (e) Represents a 1 per cent increase in all government enterprise bargaining agreements.
- (f) Assumes a one percentage point increase across the entire term structure, i.e. short and long rates, over the forward estimates period.

## Sensitivity to economic growth

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

## **Sensitivity to employment**

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

## **Sensitivity to consumer prices**

Higher consumer prices are assumed to lead to higher Commonwealth-sourced revenue, revenue from sales of goods and services (reflecting indexation and changes in other charges), as well as higher GST and taxation revenue as the value of tax bases rises in nominal terms. However, the higher revenue is partly offset by the higher cost of supplies and services, and some increases in outlays on grants and transfers. Reflecting the operation of the Government's departmental funding arrangements, the increase in expenses is limited to the extent that departments can fund it from increased revenue from specific purpose grants and sales of goods and services.

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

## **Sensitivity to average weekly earnings**

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

## **Sensitivity to enterprise bargaining agreements**

An across-the-board rise in the Government's enterprise bargaining agreements in excess of the level set out in its wages policy would result in an increase in employee entitlements and a corresponding decline in the net result from transactions. This is only partially offset by increased revenue from indexation arrangements and user chargers (which are based on the cost of providing services).

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

## **Sensitivity to domestic and overseas share prices**

Higher domestic and international share prices raise the profits (or reduce the losses) of the State's public financial corporations (PFCs), which have holdings of domestic and international shares as part of their respective investment portfolios. As such, the associated income tax equivalents (ITEs) from PFCs generally rise.

As there have been substantial decreases in share and other asset prices in previous years, accumulated carry forward tax losses mean there will be little or no impact of share prices on ITEs.

Higher share prices reduce the value of the superannuation liability due to the associated increase in superannuation fund assets. This gives rise to an actuarial gain which would increase the net result in the budget year. The expected investment return on the higher level of superannuation fund assets also reduces the superannuation expense beyond the budget year, thereby improving the net result from transactions in these years.

## **Sensitivity to property prices**

Higher property prices have an immediate impact on the net result from transactions through increased collections of stamp duty on land transfer revenue.

Akin to the impact of higher share prices, higher property prices reduce the value of the superannuation liability (due to the increased value of holdings of property in superannuation funds' investment portfolios). This reduction in the superannuation liability gives rise to an actuarial gain, which increases the net result in the budget year.

In later years, the higher property prices continue to be reflected in higher stamp duty on land transfer and land tax revenues, while the expected investment return on the higher level of superannuation assets reduces ongoing superannuation expenses. Overall, higher property prices are expected to increase the net result from transactions beyond the budget year.

## **Sensitivity to property volumes**

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

## **Sensitivity to interest rates**

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

At the same time, the increase in interest rates reduces the value of the superannuation liability, giving rise to an actuarial gain, which increases the net result in the budget year. In terms of ongoing superannuation expenses, higher interest rates are expected to increase the superannuation expense, primarily due to an increase in the interest cost that is associated with the superannuation liability. Accordingly, both the net result from transactions and the net result fall beyond the budget year.

## STYLE CONVENTIONS

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

The notation used in the tables and charts is as follows:

LHS	left-hand-side
RHS	right-hand-side
s.a.	seasonally adjusted
n.a. or na	not available or not applicable
Cat. No.	catalogue number
1 billion	1 000 million
1 basis point	0.01 per cent
nm	new measure
..	zero, or rounded to zero
tbd	to be determined
ongoing	continuing output, program, project etc
(xxx.x)	negative numbers



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