



2005-06 Strategy and Outlook

Budget Paper No. 2
Presented by the Honourable John Brumby MP
Treasurer of the State of Victoria
on the occasion of the Budget 2005-06

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Strategy and Outlook

2005-06



Presented by

The Honourable John Brumby, M.P.

Treasurer of the State of Victoria

for the information of Honourable Members

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CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

- The Government is committed to maintaining its \$100 million budget surplus target, ensuring that businesses and families in Victoria have a stable financial environment in which to invest and plan for their future. The target will be achieved with a surplus of \$365 million in 2005-06 and averaging \$394 million over the forward estimates period.
- This year will see a further enhancement to the transparency and accountability of Victoria's resource management through the adoption of the new Australian equivalents to International Financial Reporting Standards (A-IFRS).
- The Government is helping create greater capacity for economic growth through significant investments in infrastructure projects. This budget provides new asset funding with total estimated investment of \$2.0 billion. Over the next four years, general government real capital stock will grow by 12.2 per cent, around three times the expected rate of population growth.
- The Government continues to make significant progress against its key social objectives, including rebuilding schools, hospitals, aged care facilities and community centres. All of the Government election output commitments have now been funded and about 98 per cent of its election asset commitments.
- This budget finances *A Fairer Victoria – Creating Opportunity and Addressing Disadvantage* which aims to reduce disadvantage by improving access to key services, providing assistance to disadvantaged groups, strengthening communities, expanding choices and improving opportunities for all Victorians.
- Victoria leads the way in providing a competitive business environment, through significant and enduring reform of Victoria's land tax system, reducing WorkCover premiums by a further 10 per cent, abolishing debits tax (from 1 July 2005) and rental business duty from (1 January 2007). Victoria's overall tax level is below the Australian average and significantly below that of New South Wales.
- Victoria is maintaining modest and sustainable levels of net financial liabilities, consistent with its triple-A rating. The Government is using its strong balance sheet to debt fund key investment projects that generate long-term benefits.

FINANCIAL STRATEGY, OBJECTIVES AND PRIORITIES

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

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

In its 2002 election policy statement, *Delivering Financial Responsibility*, the Government announced its financial strategy, objectives and priorities. The broad strategic priority is to provide a sound and stable financial basis from which growth can be promoted across the whole State. This continues to be carried out by delivering world-class infrastructure to drive economic growth; improving the quality, access and equity in key services to all Victorians; and maintaining a sound financial position.

Since the re-election of the Government in 2002, several policies have been implemented to support these objectives and priorities.

In its Economic Statement, *Victoria: Leading the Way*, released on 20 April 2004, the Government reinforced its strategic focus of building a more competitive, innovative and productive economy, through programs to cut red tape and reduce the cost of doing business; to improve infrastructure through new investments; to create new export opportunities and innovative industries; and to boost Victoria's services sector.

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

- creating more quality jobs and innovative industries, and growing and linking all of Victoria;
- providing high quality and accessible health and community services, education and training services;
- protecting the environment and reducing the level of greenhouse gas emissions and solid waste;

- building safe and friendly communities that respect diversity and reduce the disadvantages in health, education and housing; and
- promoting sound financial management and an accountable government that encourages the participation of all Victorians in public affairs.

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

Table 1.1: 2005-06 Financial objectives

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

OBJECTIVE ONE: OPERATING SURPLUS

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

The 2005-06 Budget is the first financial report prepared by the Victorian Government under the Australian equivalents to International Financial Reporting Standards (A-IFRS). The Victorian Government is one of the first institutions in Australia to report under the new standards. As part of the implementation of A-IFRS, the Government reviewed the financial measure against which the \$100 million operating surplus is to be achieved, and determined that the A-IFRS net result from transactions is the most robust measure of the Government's financial management under the new standards.

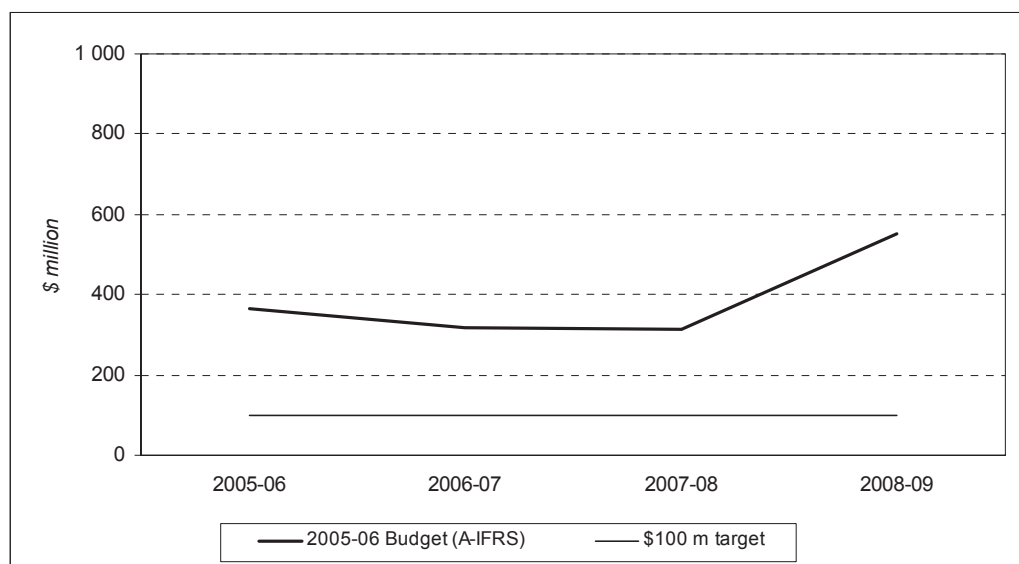
The A-IFRS net result from transactions shows the outcome of the financial decisions made by Government, and excludes those items, such as actuarial adjustments, over which the Government has no control. Conceptually, it is similar to the standardised operating surplus previously used in Victoria's financial reports, which removed the

difference between the actual rate of return and the expected rate of return on superannuation fund and other financial assets. Because it excludes these remeasurement items, the A-IFRS net result from transactions is a more meaningful representation of the structural budget position of Victoria. Further information about the A-IFRS operating statement and financial measure is available in Budget Paper No. 4.

The A-IFRS net result from transactions is similar to the Government Finance Statistics (GFS) net operating balance which is the conceptual basis of most state budgets. This allows comparability with other state budgets and brings the budget measure closer to the expected harmonisation of GFS and the generally accepted accounting principles (GAAP) reporting standards in 2006-07.

Chart 1.1 shows the general government operating surplus on an A-IFRS basis. The A-IFRS net result from transactions is expected to reach \$365 million in 2005-06 and to average \$394 million in the forward estimates.

Chart 1.1: General government operating surplus^(a)



Source: Department of Treasury and Finance

Note:

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

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

Alternative measures of operating performance

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

Table 1.2: A-IFRS and GFS budget measures

	(\$ million)			
	2005-06 Budget	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate
A-IFRS net result from transactions	365	319	313	551
A-IFRS net result	324	278	270	513
GFS net operating balance	365	319	313	551
GFS net lending	-1 433	- 667	- 337	- 361
GFS cash surplus ^(a)	183	- 378	- 422	- 451

Source: Department of Treasury and Finance

Note:

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

When various revaluation gains and losses on assets and liabilities and provision for doubtful debts are added to the A-IFRS net result from transactions, the A-IFRS net result is obtained. However, revaluation gains and losses on assets and liabilities add substantial volatility to the A-IFRS net result through the revaluation of superannuation liabilities in the current financial year.

Chapter 7, *Statement of Risks* estimates that a 1 per cent increase in interest rates would bring about a \$2.9 billion increase in the A-IFRS net result in the current financial year. In addition, the day-to-day valuation of unrealised capital gains on Australian equities held by Victoria's superannuation funds impacts on the A-IFRS net result.

At any point in time, movements in interest rates or share markets may produce widely differing estimates of the net result in the current financial year, with no significant implications for the forward estimates. Such volatility is beyond the control of government and is the primary reason why the A-IFRS net result from transactions is a more appropriate measure of the Government's financial management.

Budget Paper No. 4, Appendix B, *Revised 2004-05 Budget Outcome*, shows that the impact of movements in superannuation liabilities on the net result, measured at slightly different points in time during the 2004-05 financial year, are sufficient to create significant surpluses or deficits that may change dramatically again at the next measurement point.

Another GFS measure of operating performance is net lending. This measure is equal to the *GFS net operating balance* less net capital formation. This is similar to the Government's savings-investment gap on a national accounts basis, which corresponds to the Government's call on the financial market. Negative net lending or net borrowing reflects an increase in the Government's financial liabilities. As net lending records asset expenditure as an immediate expense, rather than over time through depreciation, it is lower than the *GFS net operating balance* and the A-IFRS net result from transactions.

The GFS cash surplus is equal to net cash flows from operating activities less net acquisition of non-financial assets and acquisition under finance leases. As a flow measure of operating performance, the cash surplus excludes non-cash expenses such as superannuation and employee entitlements.

In summary, the A-IFRS net result from transactions and the GFS net operating balance show that Victoria's financial performance remains sound. Reflecting the Government's substantial infrastructure investment, GFS net lending in 2005-06 shows an increase in net borrowing or the Government's call on the financial markets. In the forward estimates period, GFS net lending is forecast to decline to a more modest level.

OBJECTIVE TWO: INFRASTRUCTURE

The Government is committed to delivering world class infrastructure. In the edition of *Growing Victoria Together*, released on 29 March 2005, the following priority infrastructure actions have been reaffirmed:

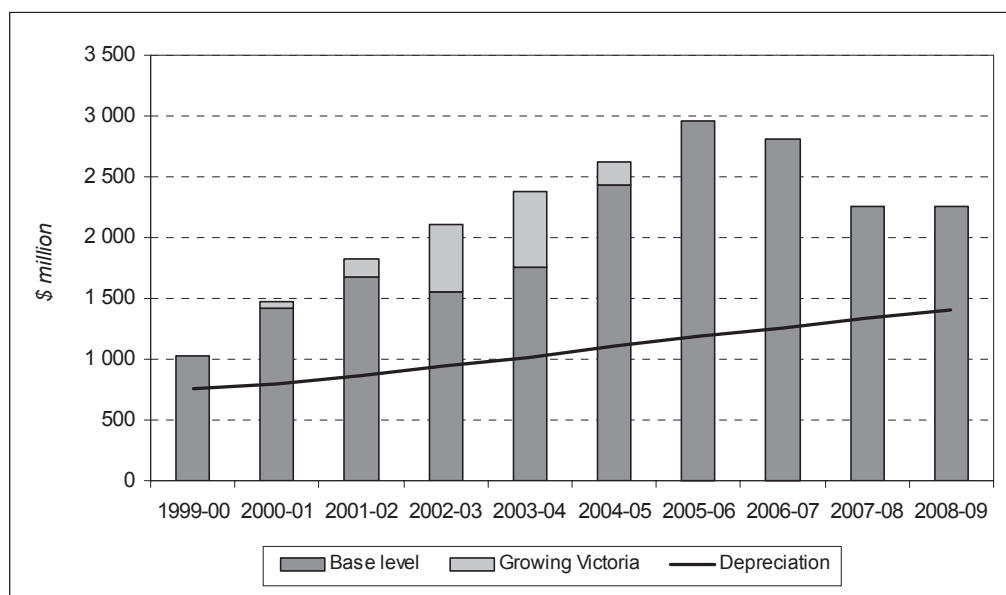
- building fast, reliable and efficient transport and communication infrastructure to link Melbourne and Provincial Victoria;
- linking regional ports to commercial, industrial and agricultural centres across Victoria;
- increasing the use of public transport in Melbourne;
- connecting more Victorians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

Since 2000-01, the Bracks Government has invested over \$10 billion in infrastructure, averaging over \$2 billion a year. This is around double the annual average investment in the preceding five years.

Infrastructure spending will increase again in the 2005-06 Budget and will help minimise bottlenecks in the transport chain and promote growth in the export sector. The Government is continuing to enhance the governance framework for public entities to ensure that existing infrastructure is fully utilised and optimal investment decisions are made for the future. Investments in capital and human resources, together with governance reform, are important elements that underpin productivity growth, economic competitiveness and social participation in Victoria.

Chart 1.2 shows the general government net infrastructure investment since the beginning of the decade, together with projections for the forward estimates period. The level of investment is expected to average \$2.6 billion a year over the next four years.

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



Source: Department of Treasury and Finance

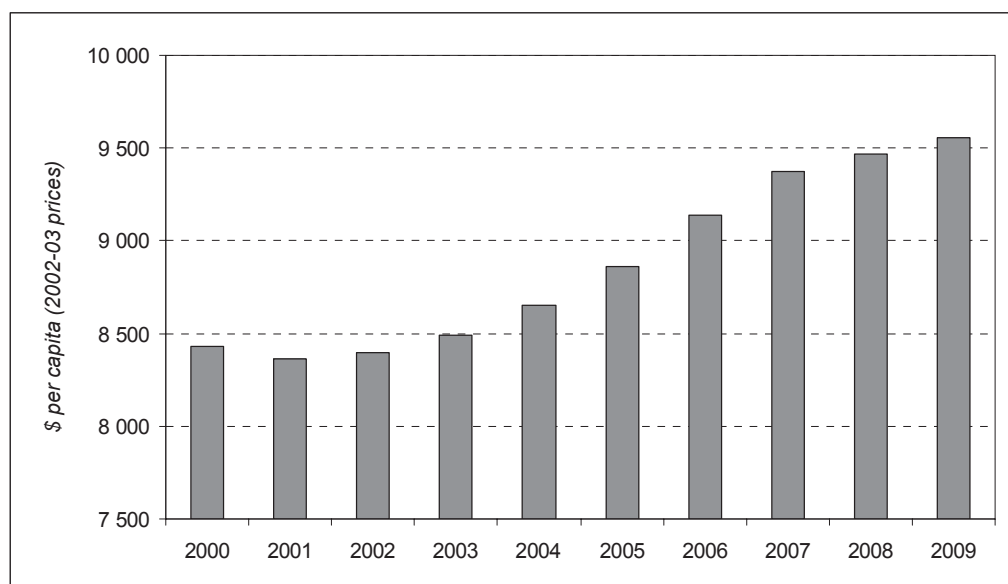
Note:

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

Over the period 2005-06 to 2008-09, general government net infrastructure investment will exceed estimated depreciation by around \$1.3 billion a year, resulting in a 12.2 per cent growth in the real capital stock over the four years to June 2009. This is triple the 4.1 per cent projected population growth over the same period. Chart 1.3 shows that in real per capita terms, the average stock of public infrastructure for each Victorian will grow from \$8 431 in 2000 to \$9 555 by 2009.

Capital spending continues to be strong in the 2005-06 Budget with new asset funding expected to reach \$2.0 billion total estimated investment (TEI). This is in addition to the *2004-05 Budget Update* capital investment worth \$310 million TEI.

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



Source: Department of Treasury and Finance

Some of the Government's capital spending is also delivered through *Partnerships Victoria*, which provides the framework for a whole-of-government approach to the provision of public infrastructure and related ancillary services through public-private partnerships. Under *Partnerships Victoria*, the Government focuses on the services to be provided from the new facility and enters into a long-term contract with a private party for the provision of the facility and equipment. A *Partnerships Victoria* delivery method is used where the Government can achieve better value for its money than the use of a more traditional procurement approach. With the exception of EastLink (formerly known as the Mitcham-Frankston Project), which was contracted in October 2004 and has a capital value of \$2.5 billion, balance sheet treatment has not been a factor in the use of *Partnerships Victoria*. All other existing projects delivered under *Partnerships Victoria* have to bid for budget allocation in competition with all other proposals.

Since 2002-03, *Partnerships Victoria* projects have accounted for approximately 10 per cent of annual public asset investment commitments and they represent a similar proportion of investments announced in this budget. To date, 13 *Partnerships Victoria* projects with a total capital value of around \$4 billion have been contracted with private parties. Presently, two *Partnerships Victoria* projects are in the market, a further three projects have been approved for *Partnerships Victoria* delivery and there are a number of others in the pipeline. The projects in the market are the Royal Melbourne Showgrounds redevelopment and the development of a new Melbourne Convention Centre.

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

OBJECTIVE THREE: SERVICE DELIVERY

Major progress is being made against the Government's key social objectives, bringing back teachers, nurses and police into the system; and rebuilding schools, hospitals, aged care facilities and community centres. Since 1999, the Government has increased its investment in the education sector, improving literacy and numeracy levels, reducing average class size for prep to year 2, and raising the proportion of Victorians completing year 12. Investments in health, aged care and community facilities have grown, supporting the treatment of more patients, reducing waiting times, doubling the support package for people with disabilities and boosting support for families with young children.

These achievements support the election commitments outlined in *Labor's Financial Statement 2002*, most of which were funded in the 2003-04 and the 2004-05 Budgets. Table 1.3 reports on the election commitments under *Labor's Financial Statement 2002*. To date, the Government has funded all of these output commitments and about 98 per cent of the asset commitments. Details on the election commitments can be found in Budget Paper No. 3, Chapter 3, *Election Commitments: Implementation Report Card*.

Table 1.3: Labor's Financial Statement 2002 - summary of asset and output funding to date

<i>Item</i>	<i>Labor's Financial Statement costings</i>	<i>Funded in 2003-04 Budget</i>	<i>Funded in 2004-05 Budget</i>	<i>Funded in 2005-06 Budget</i>	<i>Total funding to date</i>	<i>To be considered in future budgets</i>	<i>Per cent funded to date</i>
Output							
LFS output costing (\$ million)	2 520	1 941	766	..	2 707	..	107%
Number of initiatives	138 ^(a)	120	18	..	138	..	100%
Asset							
LFS asset TEI (\$ million)	1 916	540	940	393	1 872	89	98%
Number of initiatives	52 ^(b)	27	14	11 ^(c)	52	^(d)	100%

Source: Department of Treasury and Finance

Notes:

- (a) Represents the 133 output initiatives published in Labor's Financial Statement 2002, as well as six asset initiatives that were subsequently funded as output and the combination of the Koori maternity services and the improved maternity services for rural hospital output initiatives. These two output initiatives were combined to emphasise the development of new models of care for maternity services in rural hospitals and Aboriginal Health Cooperatives.*
- (b) Represents the 59 asset initiatives published in the Labor's Financial Statement 2002, less six asset initiatives that were subsequently funded as outputs and the combination of the new schools and school replacement program asset initiatives into the Building Better Schools: new and replacement schools asset initiative.*
- (c) Includes the Bendigo Physiotherapy refurbishment that was funded within existing resources of the Department of Human Services.*
- (d) Full implementation of five initiatives, which have received partial funding to date will occur as part of the 2006-07 Budget.*

The 2005-06 Budget provides additional funding for new output initiatives of \$740 million in 2005-06 and an average \$656 million over the next three years. After allowing for savings initiatives and utilising funding from existing forward estimates contingencies put aside for service delivery demand growth, the net budget impact of the 2005-06 output initiatives is \$495 million in 2005-06, averaging \$390 million a year over the forward estimates period. This is in addition to the output initiatives announced in the *2004-05 Budget Update* of \$90 million in 2005-06. Details on the costing of these output and asset initiatives can be found in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*.

A substantial part of this additional spending provides for the initiatives in *A Fairer Victoria – Creating Opportunity and Addressing Disadvantage* released in April 2005. The statement provides the framework to reduce disadvantage and enhance the opportunities of all Victorians to build a better future for themselves, in five key ways:

- ensuring that universal services provide equal opportunity for all;
- reducing barriers to opportunity;
- strengthening assistance to disadvantaged groups;
- providing targeted support to the highest risk areas; and
- involving communities in decisions affecting their lives and making it easier for them to work with Government.

To reduce disadvantage, the 2005-06 Budget allocates new funds for disability services, children's services, affordable housing, public transport, aged care and the *Neighbourhood Renewal* program to ensure that everyone has a fair chance to participate and contribute to the social and economic life of Victoria.

In education and training, the 2005-06 Budget provides new initiatives to build schools, increase the capital funding for schools, invest in teaching and learning facilities, support programs for students with disabilities, improve facilities in TAFE institutes, and improve the quality and condition of our learning environment.

The 2005-06 Budget continues the Government's investment to expand hospital services and reduce elective surgery waiting lists, ensure that Victorian's emergency care services meet growing demand, implement a new approach to mental health services with a focus on early intervention and community-based services, strengthen the home and community care program, and improve access to services for disadvantaged Victorians aged 60 years and over.

The Victorian Government will also continue to address housing affordability by providing first homebuyers with a \$5 000 *First Home Bonus* until 31 December 2005. From 1 January 2006, the *First Home Bonus* will be set at \$3 000 until 30 June 2007. When combined with the \$7 000 First Home Owner Grant, total assistance provided by the Victorian Government for first homebuyers will be \$12 000 until December 2005 and \$10 000 until June 2007. Additional information on the *First Home Bonus* is available in Budget Paper No. 4, Chapter 3, *State Revenue*.

Other key budget priorities are to build friendly, confident and safe communities; to build a cohesive transport network for Melbourne; to protect and manage Victoria's environment and maintain an efficient and sustainable use of natural resources; and to build innovative infrastructure that will create more quality jobs and thriving and innovative industries across Victoria. Details on these new initiatives can be found in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*.

OBJECTIVE FOUR: TAXATION

Victoria maintains a fair and competitive tax system that provides strong incentives for business to grow, workforce participation to expand and population to increase.

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

The 2005-06 Budget continues crucial reform of Victoria's land tax system by extending a substantial relief package to taxpayers worth around \$823 million over five years (including \$72 million in 2004-05). The major focus of these reforms is to provide targeted relief to those taxpayers that have experienced large increases in their land tax liabilities in recent years as a result of rising property prices. The package comprises:

- significant reductions to the middle land tax rates for property holdings valued between \$750 000 and \$2.7 million, to benefit 23 000 taxpayers;
- increasing the tax free threshold by \$25 000 to \$200 000, to benefit 21 000 taxpayers;
- accelerating the timing of the reduction in the top marginal rate by one year;
- giving rebates on 2005 land tax equal to half the savings taxpayers would have gained this year if the middle rate cuts and bracket adjustments delivered in this budget had applied;
- capping of increases in land tax liabilities in 2005-06; and
- providing a full land tax exemption for aged care facilities, supported residential services and rooming houses, with a full refund for those institutions which paid the tax in 2004 or 2005.

Other taxation relief measures include the abolition of rental business duty from 1 January 2007 (at a full year cost of \$65 million) following a review under the 1999 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. This follows the announcement of the abolition of debits tax from 1 July 2005 (at a cost of around \$280 million per year) in the *2004-05 Budget*, under the same agreement.

These taxation relief measures have been partly offset by:

- a long-stay car park levy on the owners of non-residential off-street car parking spaces in the Melbourne central business district and adjacent highly congested areas (with the revenue raised to be used for important metropolitan transport initiatives);
- revenue from reform of the land tax regime on certain trusts to provide clarity in an area of the law which has been disputed in recent years; and
- an increase in the annual health benefit levy on electronic gaming machines by \$1 500 per machine, raising an additional \$45 million each year which will be transferred into the Hospitals and Charities Fund.

The taxation reform measures announced in this budget will provide net tax relief to Victorian taxpayers of \$582 million over five years. Detailed information on these initiatives can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives* and Budget Paper No. 4, Chapter 3, *State Revenue*.

The Government is committed to ensuring a fair and efficient tax system, which is highlighted by its provision of well-targeted tax concessions. In addition to the land tax exemption for aged care facilities, supported residential services and rooming houses discussed above, this Budget also includes payroll tax exemptions for government school councils to bring the treatment of government schools more in line with private schools. Since the previous Budget, the Government has also granted a land tax exemption for privately owned caravan parks.

Tax competitiveness

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

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

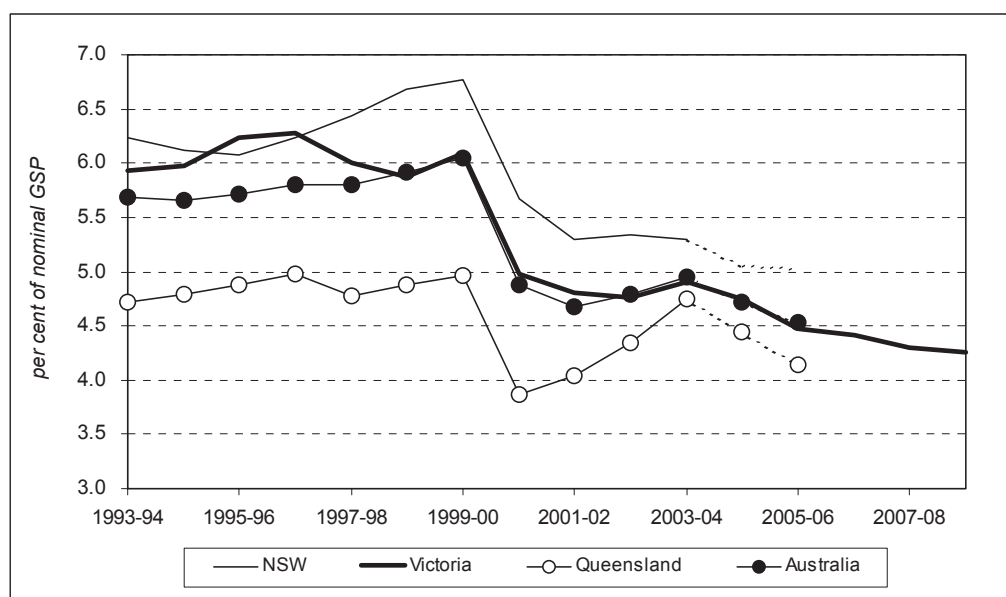
The general increase in taxation as a share of GSP between 2001-02 and 2003-04 reflects the buoyant economic activity in these years, particularly in the property market, which has yielded increases in conveyancing revenue. The increase has been most notable for Queensland, which benefited most from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

In 2003-04, the latest full year for which data are available, Victoria's taxation revenue was 4.90 per cent of nominal GSP. Victoria's tax ratio was 0.40 percentage points (\$830 million) below New South Wales and 0.05 percentage points (\$101 million) lower than the Australian average.

In 2005-06, Victoria's tax ratio is estimated to be 0.55 percentage points (\$1 266 million) below New South Wales and 0.05 percentage points (\$113 million) below the Australian average. Over the forward estimates period, Victoria's taxation as a share of nominal GSP is forecast to steadily decline to 4.30 percentage points of nominal GSP in 2007-08 and 4.25 percentage points in 2008-09.

While tax competitiveness is an important part of business decision making, WorkCover premiums are another business cost that also affects the attractiveness of Victoria as a business location. In this budget, sound management has enabled the Government to cut the average WorkCover premium rate by a further 10 per cent, bringing Victoria's premium rate to an historic low and the second lowest among the States, 30 per cent lower than New South Wales and 40 per cent lower than South Australia. This rate cut lowers business costs by \$170 million in 2005-06.

Chart 1.4: Taxation revenue^(a)



Sources: Australian Bureau of Statistics, Department of Treasury and Finance, 2003-04 Financial Reports of all jurisdictions

Notes:

(a) Historical taxation data from 1993-94 onwards, revised estimates for 2004-05 and forecasts for the forward estimates period. Victorian data represent 2005-06 Budget estimates. Data for all other jurisdictions represents their 2004-05 Budget Update estimates. There has been no adjustment to reflect any subsequent policy changes by other jurisdiction.

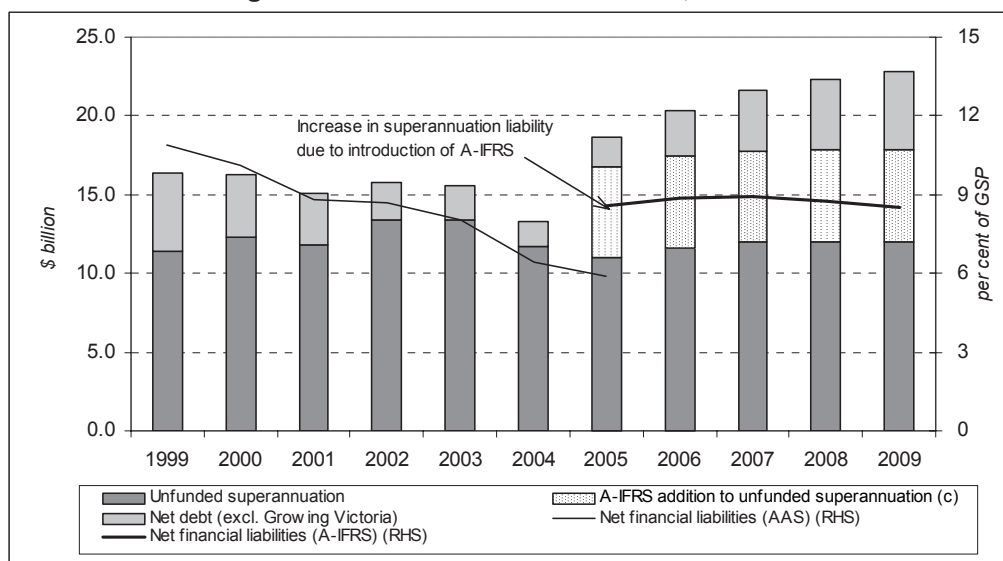
OBJECTIVE FIVE: NET FINANCIAL LIABILITIES

Victoria's balance sheet is strong. This is evident from its triple-A credit rating, which was affirmed by international credit rating agencies, Moody's Investors Service in December 2004 and Standard & Poor's in July 2004. Both agencies cited Victoria's strong fiscal position, low debt levels and prudent financial management as the key factors behind its triple-A credit rating.

The general government infrastructure program will largely be financed by the operating surplus, depreciation and other provisions. For the remainder, the Government will use the strength of its balance sheet to debt fund key public investment projects that have a long-term pay off. Accordingly, Chart 1.5 shows that general government net debt is projected to increase from \$1.9 billion at June 2005 to \$5.0 billion at June 2009. Net debt will remain at low levels by historical and international standards and consistent with prudent financial management that maintains the State's triple-A credit rating. The projected general government net debt of 1.9 per cent of GSP at June 2009 compares with 3.3 per cent of GSP in 1999 and 16.3 per cent in 1995.

As a proportion of GSP, the servicing burden of the State's largest liability, the unfunded superannuation liability, will ease over the forward estimates period. This will more than offset the servicing burden of rising net debt. The ratio of net financial liabilities to GSP is expected to decline from 8.6 per cent in June 2005 to 8.5 per cent in June 2009 (A-IFRS basis), and the ratio of superannuation and interest expense from 7.3 per cent of revenue to 6.9 per cent over the same period. It is notable that, despite increasing by 2.7 percentage points under the new A-IFRS methodology in 2005, (see chart below), net financial liabilities to GSP remains significantly lower than the 10.9 per cent level recorded in June 1999.

Chart 1.5: General government net financial liabilities, as at 30 June^{(a)(b)}



Source: Department of Treasury and Finance

Notes:

- (a) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.
- (b) Net debt is calculated as gross debt less liquid financial assets. Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.
- (c) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liabilities in 2005 has also been separately identified in the period 2006 to 2009.

The adoption of the A-IFRS has introduced a significant change in the measurement of the State's unfunded liabilities under the defined benefit superannuation schemes. Prior to A-IFRS, the Government's liabilities for defined benefit schemes were calculated based on the long-term earnings rate of the superannuation funds. This rate presently stands at 7.5 per cent and is determined by an independent actuary. Under A-IFRS, the State's future superannuation liabilities are calculated on the basis of the Commonwealth government ten-year bond rate.

Under A-IFRS, the estimated superannuation liability at 30 June 2005 is \$16.8 billion. This is \$5.8 billion higher than under the previous methodology. The adjustments comprise an opening balance adjustment of \$4.1 billion at 1 July 2004 and an increase of \$1.7 billion since that time due to the change in the Commonwealth Government bond rate. For comparative purposes, the transitional adjustment to the unfunded superannuation liabilities in 2005 has been highlighted in Chart 1.5 and identified in the period 2006 to 2009. It is important to understand that these increases in liability reflect accounting changes and do not affect the amount of cash required to fund the defined benefit scheme. Based on current projections, the State is on track to achieve full funding of these superannuation liabilities by the target date of 2035.

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- The Victorian economy has grown solidly over the past five years. Growth has been broadly based across consumer spending, dwelling construction and business investment. Victorian productivity growth has been especially rapid, and population growth rates have risen strongly. Substantial inroads have been made into unemployment, and labour force participation is at historically high levels.
- Nationally, there is some uncertainty about how demand and labour market pressures will be resolved, but it is likely that economic growth is now entering a weaker phase. Victorian GSP is expected to grow by 2.75 per cent in 2004-05 and 3.0 per cent in 2005-06.
- Growth is expected to recover to 3.5 per cent in 2006-07 and 2007-08, before easing to around 3.25 per cent in later years as the economic implications of the ageing of the Victorian population begin to emerge.
- The momentum in the labour market during the first half of 2004-05 means that Victorian employment is likely to grow by 3.0 per cent in 2004-05, easing to 1.0 per cent in 2005-06, before recovering to around 1.25 per cent in later years.
- The main risks to the economic outlook relate to movements in interest rates, the Australian dollar, the price of crude oil and, on the positive side, continued strength in housing activity.

VICTORIAN ECONOMIC PROJECTIONS

The Victorian economy grew by 3.7 per cent in 2003-04, and by an average of 3.3 per cent over the past five years. Growth has been accompanied by solid increases in employment and profits and, through the property and share markets, household wealth. This growth has been broadly based, with consumer spending, dwelling construction and business investment all rising strongly. There are signs that the State's competitiveness has improved: Victorian productivity growth has been especially rapid, and population growth rates have risen strongly to substantially exceed the national average for the first time since the mid-1960s. Substantial inroads have been made into unemployment in Melbourne and regional areas, and labour force participation is at historically high levels.

Nationally, there is some uncertainty about how demand and labour market pressures will be resolved, but it is likely that economic growth is now entering a weaker phase. The protracted rise in housing prices in Melbourne and Sydney has come to an end, removing a large impetus to growth from rising levels of wealth. The prospect of moderate rises in interest rates, combined with historically high levels of debt servicing among households, is likely to restrain consumers. High and rising minerals prices continue to boost incomes for the resources sector, but the associated strength of the exchange rate is adversely affecting other trade-exposed industries. The current minerals price boom can be expected to unwind as global production levels respond.

Victorian economic fundamentals remain solid. Recent high levels of Victorian business and infrastructure investment have contributed to strong growth in capacity and there is a substantial pipeline of construction work in place across the State. Provided interest rates are not raised aggressively, economic growth should pick up again during 2005-06.

The economic projections used in the 2005-06 Budget are set out in Table 2.1. The remainder of this chapter contains an overview of the international, national and Victorian economic environment and a discussion of key issues and risks to the Victorian economic outlook.

Table 2.1: Victorian economic projections^(a)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>
Real gross state product	3.7	2.75	3.00	3.50	3.50	3.25
Employment	1.3	3.00	1.00	1.25	1.50	1.25
Unemployment rate ^(b)	5.6	5.75	5.50	5.25	5.25	5.25
Consumer price index	2.2	2.25	2.75	2.50	2.50	2.50
Wage price index ^(c)	3.2	3.75	3.75	3.50	3.50	3.50
Population ^(d)	1.2	1.10	1.00	1.00	1.00	1.00

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

Notes:

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

ECONOMIC OVERVIEW

The world economy

Strong world growth in 2004 was driven primarily by the United States and China, both of which are major trading partners of Australia and Victoria. Continued positive world economic conditions are expected to support Victorian exports over the coming year. The Consensus Economics survey of April 2005 forecasts that the world economy will grow by 3.0 per cent in 2005 and 3.1 per cent in 2006. In its December 2004 *Economic Outlook*, the Organisation for Economic Co-operation and Development (OECD) forecast gross domestic product (GDP) growth in the OECD region to moderate from 3.6 per cent in 2004 to 2.9 per cent in 2005.

The second half of 2004 saw the return of solid employment growth in the United States, after a long period of soft labour market conditions. Improved employment prospects and rising household wealth, driven by house prices, have provided a boost to consumer spending. The US budget and current account deficits remain a concern, although the weaker US dollar (particularly against the yen and euro) is translating into improved export results, with US producers benefiting from improved competitiveness. The Chinese economy remains very strong, with through-the-year growth remaining above 9 per cent over 2004 as government measures to slow the economy had mixed results.

Confidence that Japan had emerged from its extended slump proved premature, as growth slowed in the second half of 2004. Growth in the European Union remains slow, with domestic demand yet to experience a convincing recovery. While the United Kingdom has outperformed mainland Europe in recent years, its economy also appears to be slowing, due in part to the end of a long housing boom.

Although the Indian Ocean tsunami disaster involved incalculable human losses, the International Monetary Fund expects a limited impact on economic growth in the major economies (India, Indonesia and Thailand) affected.

The rapid expansion of China's industrial sector has been a major contributor to the surge in commodity prices currently benefiting Australia's resource-exporting states. This issue is discussed in more detail later in this chapter.

Australian economic conditions and outlook

The central issue for the Australian economy in early 2005 is how the recent surge in global commodity prices will influence an environment in which signs of capacity constraints are already appearing. On balance, demand appears to be abating through various channels that should obviate the need for significant tightening of monetary policy. In the short term, domestic demand is likely to moderate as households increase saving to restore their balance sheets in light of the weaker outlook for house prices and risk of higher interest rates.

The Australian economy grew by only 1.5 per cent over 2004, reflecting a large deterioration in net export volumes but strong growth in consumer spending and business investment. Shortages of labour and materials have been widely reported, imports are growing strongly, and there are signs of cost pressures in some sectors. The Reserve Bank of Australia increased the cash rate in March in anticipation that demand would continue to approach capacity, due partly to the income effects of further increases in the terms of trade. However, demand pressures may already be moderating, and historically high levels of household debt have made demand more vulnerable to interest rate increases. At the same time, a loss of price momentum in the housing market has withdrawn an important stimulus to consumer spending.

In the context of relatively weak GDP growth by the standards of recent years, the performance of the Australian labour market in the second half of 2004 was somewhat surprising. Employment grew by 2.7 per cent through 2004, sufficient to reduce the unemployment rate by half a percentage point, to 5.1 per cent. There are early indicators of more moderate employment growth ahead, including softer newspaper job ad numbers reported by the ANZ Bank, although Australian Bureau of Statistics figures on job vacancies continue to rise.

In its March 2005 survey, the Consensus Economics panel of private forecasters expected, on average, Australian economic growth to slow from 4.1 per cent in 2003-04 to 2.2 per cent in 2004-05, before recovering to 3.3 per cent in 2005-06.

Victorian economic conditions and outlook

The strength of national demand and the impact of rising commodity prices on the terms of trade and income will be important influences on the Victorian economic outlook. Victorian economic growth averaging 3.3 per cent over the past five years is in line with average national growth of 3.4 per cent over the same period. Victorian productivity growth (gross state product per hour worked) has averaged a strong 2.2 per cent over the past five years, ahead of the national rate.

The main drivers of Victorian economic growth over the past year have been consumer spending and new business investment, which grew by 4.4 per cent and 10.9 per cent, respectively, in the year to December 2004. Within business investment, a 12.5 per cent increase in machinery and equipment investment over the year was particularly encouraging. However, net exports continue to restrain Victorian growth. Although Victorian merchandise exports grew by 5.5 per cent over 2004, this was more than offset by a 10.8 per cent increase in imports. While there has been an upward trend in Victorian exports since mid-2003, exports remain below the pre-drought levels of 2001-02.

Demand has been growing strongly in Western Australia and Queensland, due in part to higher commodity prices. Apart from coal deposits in New South Wales and some gold in Victoria, the benefits of strong growth in commodity prices have been less pronounced in Victoria and New South Wales. In trend terms, real quarterly state final demand grew by between \$400 and \$500 per capita during the past year in

Western Australia and Queensland, compared with less than \$300 in Victoria and New South Wales. The difference is partly attributable to stronger growth in consumer spending (and possibly incomes) in Western Australia and Queensland, and in business investment in Queensland.

Economic growth in Victoria has also been restrained by agricultural conditions. The Australian Bureau of Agricultural and Resource Economics (ABARE) estimates that Victorian winter crop production in 2004-05 will be 38 per cent lower than the previous year's record because of below average rainfall and high temperatures in October.

Economic growth in Victoria is expected to be 2.75 per cent in 2004-05, down from the *2004-05 Budget Update* forecast of 3.25 per cent. Continuing pressure on manufacturing and a sluggish export response, compounded by weaker agricultural production, are likely to contribute to the moderation in Victorian growth in 2004-05. Nevertheless, Victoria is expected to grow more rapidly than the consensus national forecast of 2.2 per cent. Slower national growth may be partly due to the softer performance of the New South Wales economy, which accounts for approximately one third of national output. Employment growth and hours worked in Victoria have been above the national average in the first half of 2004-05, and the momentum in the labour market during the first half of the year means that Victorian employment is likely to grow by 3.0 per cent in 2004-05.

Conditions are likely to remain subdued during much of 2005. Dwelling investment and property market activity more generally are expected to slow further, and consumer spending can be expected to moderate in response to the combination of high levels of consumer debt and the threat of further interest rate rises. Employment growth is expected to ease back to 1.0 per cent in 2005-06. Victorian gross state product (GSP) is forecast to grow by 3.0 per cent in 2005-06, close to the consensus national forecast of 3.3 per cent.

Beyond 2005-06, annual growth is assumed to recover to 3.5 per cent, although the reduction to 3.25 per cent in 2008-09 reflects an easing in labour force growth as the first signs of the ageing of the Victorian population emerge. The unemployment rate is expected to decline to 5.25 per cent by 2006-07.

Cost pressures and increases in materials prices are expected to contribute to a moderate rise in consumer price inflation to 2.75 per cent in 2005-06, before returning to 2.5 per cent in later years. Similarly, a modest increase in wage pressure is forecast in 2005-06, with the wage price index expected to grow by 3.75 per cent before easing to 3.5 per cent in later years.

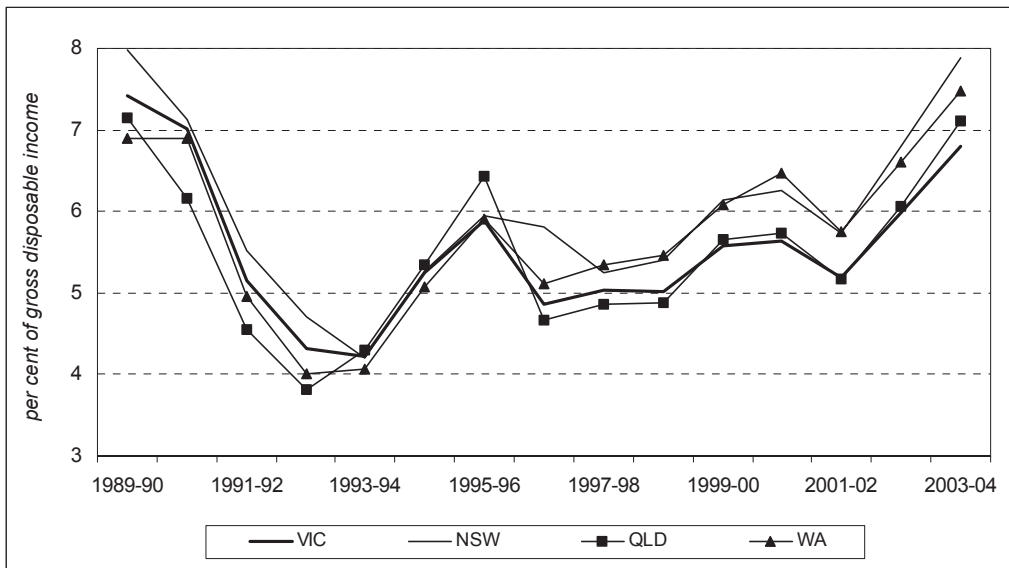
The forecasts assume that net interstate migration is broadly in balance in the longer term.

Consumer spending

Victorian consumer spending growth of 4.4 per cent in the year to December 2004 remains above the average rate of growth over the past five years, and above the Australian average. Although Victorian retail trade grew by only 3.1 per cent in volume terms over the past year, non-retail components of consumer spending, such as energy, motor vehicles, transport, education and financial services, all grew strongly in the December quarter.

Some moderation in the growth of consumer spending is likely over the coming year, as households respond to the prospect of higher interest rates and a cessation in the growth of house prices by increasing saving. The weaker outlook for the housing market is also likely to reduce the attractiveness of financing consumption by borrowing against housing equity. Interest on mortgage and consumer debt, as a share of household disposable income, is now approaching levels last seen during the high interest rate period of the late 1980s, further suggesting that some restoration of household balance sheets is likely (Chart 2.1).

Chart 2.1: Household interest on dwellings and consumer debt – major states^(a)



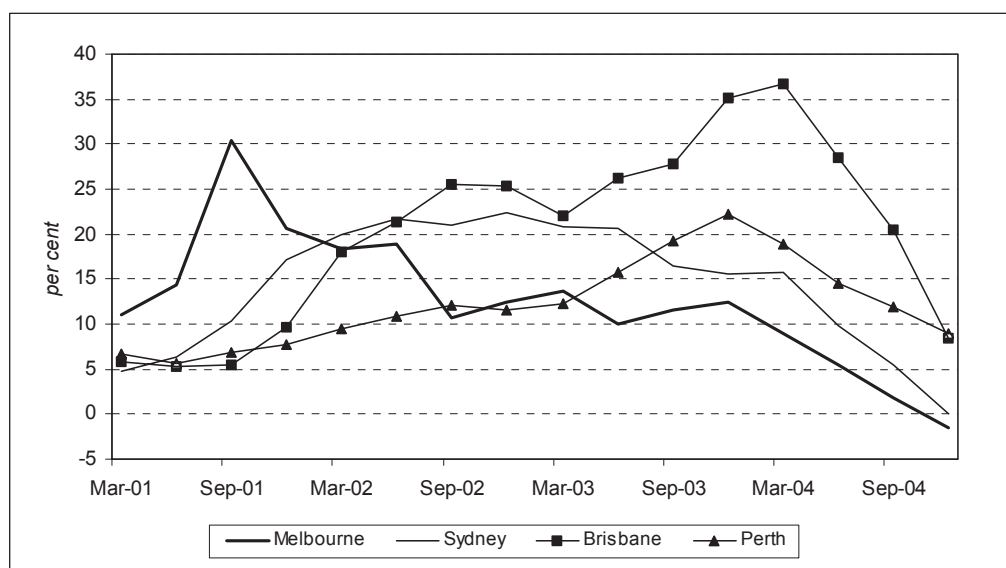
Source: Australian Bureau of Statistics

Note:

(a) Share of interest on dwellings and consumer debt interest in household disposable income.

However, there are signs that Victorian households may be less vulnerable to financial shocks than those in other major states. Chart 2.1 shows that Victorian households currently devote a smaller proportion of disposable income to interest payments, and Melbourne housing price growth appears to have been more subdued than elsewhere (Chart 2.2). Household balance sheet data from the Household, Income and Labour Dynamics in Australia (HILDA) survey also show that Victorian households on average hold more financial assets than those in other major states. Victorian households also appear to be less highly geared on their own homes and other properties than other states. There is also evidence that although household dis-saving has grown, once capital gains are included, households have continued to increase their wealth in recent years.

Chart 2.2: House price index – major capital cities^(a)



Source: Australian Bureau of Statistics

Note:

(a) Percentage change on same quarter in previous year.

Labour market

Victorian employment grew particularly strongly during 2004 (running at 3.7 per cent through the year, compared with 2.7 per cent nationally). At the same time, the Victorian participation rate surged, partly reflecting increased confidence among job-seekers, so that almost half of the increase in the national labour force during 2004 occurred in Victoria. The rise in labour force participation was so strong in Victoria that the unemployment rate began to drift up in the middle of 2004, although it has since resumed its downward trend, reaching 5.4 per cent in March.

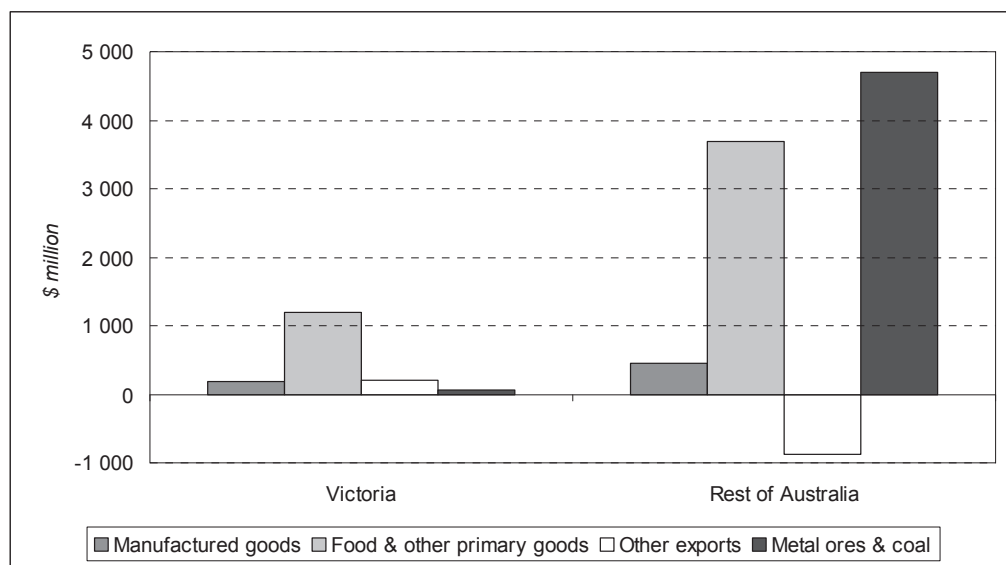
Robust employment growth has been reflected in skills shortages in many industries. While widespread labour shortages are not yet evident, discussions with Victorian businesses highlight cost pressures in some areas of the labour market and difficulties in attracting and retaining apprentices. In the longer term, training and education policies will be important in removing any obstacles to the supply of labour, especially in view of the ageing of the labour force.

In line with the easing in retail trade and the slowdown in the property market, employment in Victorian retailing and property and business services has been contracting. However, strong employment growth has continued in Victorian construction, agriculture, transport and storage, government administration and health and community services.

International trade

Although the value of Victoria's exports has recovered strongly since the drought, exports from other states are being bolstered by the commodity price boom. In 2004, the value of Victorian exports increased by \$1.6 billion compared with nearly \$8 billion for the rest of Australia. However, over half of the increased export value in other states was attributable to just two categories: metal ores and scrap, and (black) coal, coke and briquettes. Abstracting from these two export commodities, which Victoria lacks, the improvement in the value of exports in the rest of Australia was less than \$3.3 billion, compared with over \$1.5 billion for Victoria (see Chart 2.3).

Chart 2.3: Increase in value of exports by commodity group, 2004



Source: Australian Bureau of Statistics, unpublished data

The value of Victorian food and other primary exports appears to be recovering, although the drought has had lingering effects. Victoria is Australia's main exporter of dairy products and volumes of milk powder exports remain low, although prices are improving. Last year's record Victorian winter crop of 6.3 million tonnes has contributed to a recovery in the value of exports of cereals (mainly wheat, barley and canola), and exports of meat products have also made up some lost ground. However, ABARE estimates that Victoria's winter crop production will decline to 3.9 million tonnes in 2004-05, while the Bureau of Meteorology considers the rainfall outlook for the next few months to be broadly neutral. Consequently, prospects for many agricultural exports appear no more than moderate, and farm incomes are also being negatively affected by the strength of the Australian dollar.

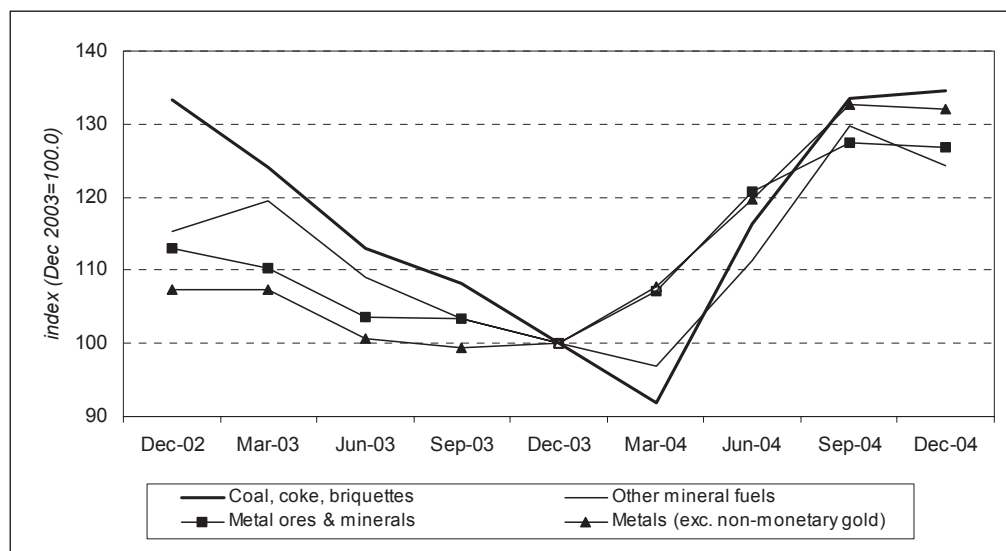
Manufacturing business surveys have pointed to weakness in exports in recent months. Business liaison conducted by the Department of Treasury and Finance confirms that the high exchange rate is contributing to strong import competition in manufacturing, although to a lesser extent for producers of more specialised or customised goods.

Overall, Victoria's trade balance deteriorated by slightly less than \$300 million in 2004, following a much larger drought-induced reduction in 2003. Higher net imports were recorded for elaborately transformed manufactures (up \$800 million), including telecommunications equipment, road vehicles and specialised machinery. This reflected the strength of domestic consumer spending and business investment. Net imports of petroleum also rose (up \$650 million) as a result of higher crude oil prices. Partly offsetting this, net exports of food and other primary goods rose by over \$900 million. Bilateral trade with China increased by over \$1 billion in 2004, and now accounts for 10 per cent of Victorian exports and 14 per cent of Victorian imports. Increased exports of wool to China were offset by higher imports of clothing, telecommunications equipment and other manufactured goods.

The terms of trade

A significant influence on the economic outlook for Victoria is the steady rise in global commodity prices and the associated rapid industrialisation of China, which has contributed to substantial gains for many minerals producers. From December 2003 to December 2004, the export prices of mining commodities increased by approximately one third (see Chart 2.4). However, Victoria's lack of black coal and metals resources compared to the other major states means that the growth in commodity prices has been of little benefit. As Chart 2.5 shows, the prices of Victoria's exports increased by only 5.6 per cent in 2004, compared to 23.5 per cent for Queensland.

Chart 2.4: National export commodity prices^(a)



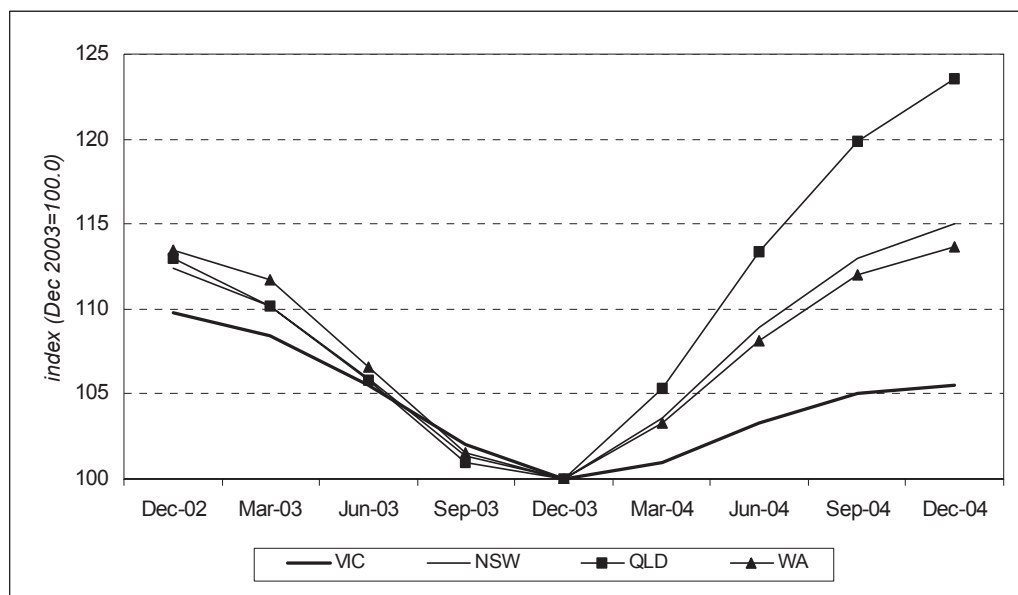
Source: Australian Bureau of Statistics

Note:

(a) Export price indices.

It is important not to overstate the direct regional impacts of the minerals price boom. The mining sector is not a major source of employment and some of the additional export income is likely to be repatriated overseas by foreign owners. Indirect effects may be more pervasive. Upward pressure on the exchange rate has adversely affected other trade-exposed sectors, including agriculture and manufacturing, with negative implications for Victorian businesses.

Chart 2.5: Prices of goods exports – major states^(a)



Source: Australian Bureau of Statistics

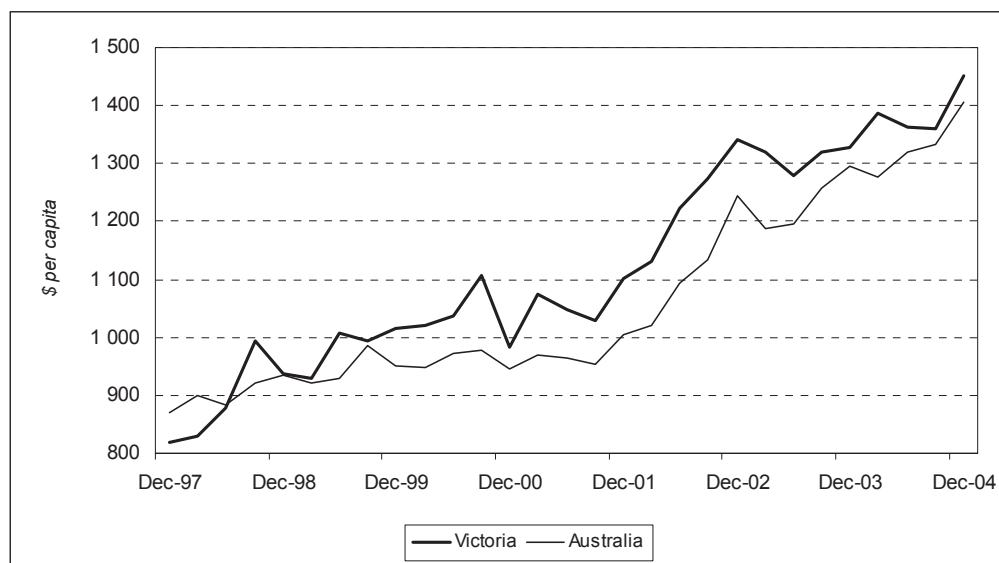
Note:

(a) Implicit price deflators.

Private investment

New private business investment grew by 10.9 per cent in Victoria during 2004, from an already historically high base. Growth was particularly strong in machinery, equipment and intangibles, which were up 12.5 per cent over the same period. In real per capita terms, Victorian new private business investment has been higher than the national level for over six years (see Chart 2.6).

Chart 2.6: New private business investment per capita – Victoria and Australia^(a)



Source: Australian Bureau of Statistics, Department of Treasury and Finance estimates

Note:

(a) Chain volume measures, 2002-03 prices.

Investment in housing has remained at high levels over the past year, although growth has been relatively flat, and Victoria was the only state to record an increase in dwelling investment in the December quarter 2004. However, forward indicators of residential construction activity, such as private dwelling unit approvals, softened during 2004 (see Chart 2.7). On balance, the Victorian property market appears to have cooled, but with no signs of a significant slump in dwelling investment.

Chart 2.7: Private dwelling units approved – Victoria^(a)



Source: Australian Bureau of Statistics

Note:

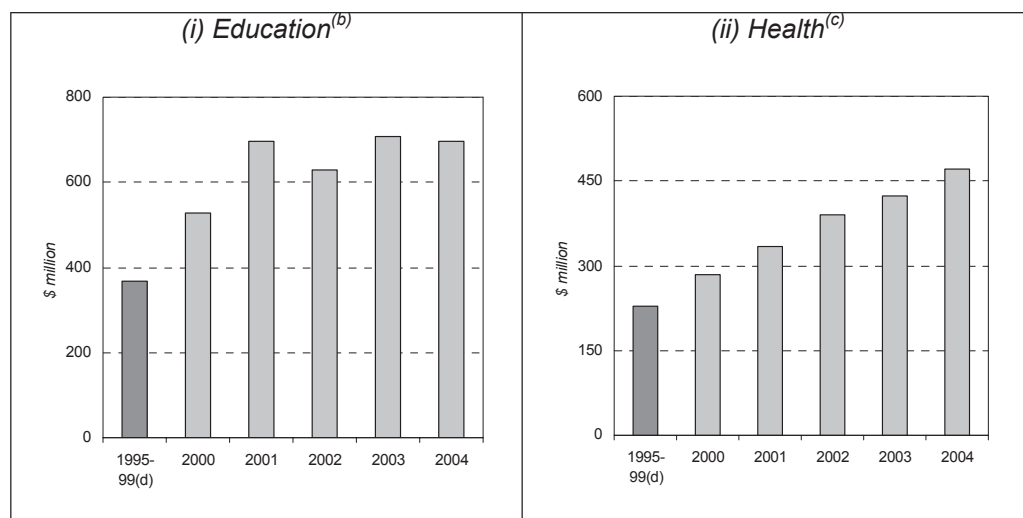
(a) Trend data.

Infrastructure

Both public and private infrastructure investment are important to the economic development of Victoria. In line with the Victorian Government's objectives set out in Chapter 1, *Financial Policy Objectives and Strategy*, infrastructure expenditure by the Victorian Government has increased strongly. Since 2000-01, the Government has invested an average of \$2 billion in infrastructure annually. This is around double the annual average investment in the previous five years. The private sector has also made a major contribution to the growth in infrastructure creation in Victoria in recent years.

In the key social infrastructure areas of education and health, there has been a substantial increase in overall investment. Chart 2.8 shows that the value of Victorian building work done for educational and health facilities has increased strongly in recent years. In the five years ending 2004, the average value of public sector building approvals for both educational and health facilities increased by more than 50 per cent compared with the average of the preceding five years. In the case of the private sector, the average value of building approvals more than doubled over the same period.

Chart 2.8: Value of building work done – Victoria^(a)



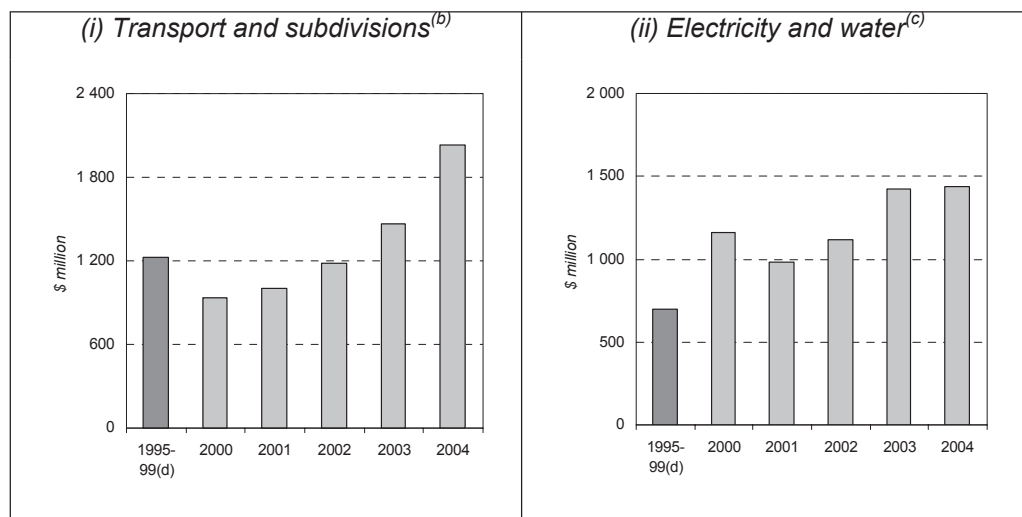
Source: Australian Bureau of Statistics

Notes:

- (a) At current prices, total of private and public sectors.
- (b) Buildings used in the provision or support of educational services, including group accommodation buildings (e.g. classrooms, school canteens, dormitories).
- (c) Buildings used in the provision of non-aged care medical services.
- (d) Average annual value over 1995 to 1999.

Substantial increases in the value of engineering construction work in areas such as transport and subdivisions (Chart 2.9(i)) and electricity and water (Chart 2.9(ii)) are also evident in Victoria in the past five years.

Chart 2.9: Engineering construction – Victoria^(a)



Source: Australian Bureau of Statistics

Notes:

- (a) At current prices, total of public and private sectors.
- (b) Includes roads, highways, bridges, railways, harbours and subdivisions.
- (c) Includes electricity generation, transmission and distribution, pipelines, water storage and supply, sewerage and drainage.
- (d) Average annual value over 1995 to 1999.

The Government continues to report a strong balance sheet which supports investment in key infrastructure necessary for continued economic growth and the provision of social services. Chapter 4, *Balance Sheet Management and Outlook*, discusses the Government's future investment in social, environmental and economic infrastructure in detail.

Risks to the outlook

In the short to medium term, movements in interest and exchange rates and the threat of sustained high oil prices represent the main downside risks to the Victorian economic projections. However, continued strength in the construction sector, particularly the continued resilience of the housing sector, represents an upside risk to the economic outlook.

With relatively high levels of debt in the household sector at present, a larger than anticipated increase in interest rates could place some pressure on the growth forecast over the coming year. Continued strength in the Australian dollar would further reduce returns to Victoria's agricultural and manufacturing exporters, and place additional pressure on import-competing firms.

The continuation of current high crude oil prices presents an upside risk to the inflation outlook. Similarly, skilled labour shortages in some occupations and industries may lead to further upward pressure on wages, and hence business costs. However, the current sensitivity of households to interest rate movements represents a downside risk to inflation, as monetary tightening may prove more effective than expected in dampening demand.

These risks are discussed in detail in Chapter 7, *Statement of Risks*.

The economic reform challenge

In the longer term, the Victorian economy faces some important challenges. Competitive pressures resulting from the penetration of East Asian economies into new markets are already being felt, and will almost certainly intensify in the years ahead. Over the forward estimates period, Victoria is expected to return to a sustainable rate of economic growth below that experienced during the 1990s, reflecting the effects of population ageing on labour force participation. Population ageing could detract as much as half a percentage point from Victoria's sustainable annual economic growth rate by 2030. A return to slower rates of productivity growth would further reduce the pace of economic growth.

All these forces pose significant risks to the extent to which Victorians can expect to enjoy higher living standards on a sustainable basis. The Victorian Government has developed a reform strategy to meet these challenges. Chapter 6, *Economic Reform*, discusses these issues in more detail.

CHAPTER 3 – BUDGET POSITION AND OUTLOOK

- The Government is budgeting to achieve an operating surplus (net result from transactions) of \$365 million in 2005-06.
 - Total expenses from transactions are expected to increase by 5.2 per cent in 2005-06, reflecting the net impact of output initiatives, with growth averaging 2.9 per cent a year over the forward estimates period.
 - Total income from transactions is expected to increase by 4.3 per cent in 2005-06, reflecting higher Commonwealth grants and investment income, partly offset by lower taxation, with projected average annual growth of 3.0 per cent over the forward estimates period.
- Over the forward estimates period, operating surpluses are now projected to average \$394 million a year.
- The net budget impact of output initiatives is \$495 million in 2005-06, averaging \$390 million a year over the forward estimates period.
- Initiatives to improve Government efficiency have an impact of \$131 million in 2005-06, averaging \$134 million a year over the forward estimates period.
- Tax initiatives announced in this budget will benefit taxpayers by \$130 million in 2005-06, before averaging \$127 million a year over the forward estimates period. This includes a major land tax relief package worth \$823 million over five years (including \$72 million in 2004-05).
- The budget includes new asset funding with a total estimated investment of \$2.0 billion.
- Net infrastructure investment spending is expected to average \$2.6 billion a year over the four years to 2008-09.

This chapter provides an overview of the projected budget position for the period 2005-06 to 2008-09 for the general government sector, and a reconciliation of movements in income and expenses since the 2004-05 Budget released in May 2004 and the *2004-05 Budget Update* published in December 2004.

The budget and forward estimates years are based on the economic projections outlined in Chapter 2, *Economic Conditions and Outlook*, and reflect the accounting policies and assumptions documented in Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*. The estimates take into account the financial impacts of all policy decisions announced by the Victorian Government, as well as Commonwealth Government funding revisions and other factors that affect the projected general government sector financial statements. Specific policy decisions taken since the 2004-05 Budget that have an effect on the budget position are summarised in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

The State's budget (2005-06) and forward estimates years (2006-07 to 2008-09) represent planning projections based on unchanged policy and other assumptions. Outcomes could differ from these projections for many reasons, including the potential realisation of the risks described in Chapter 7, *Statement of Risks*.

The estimates from 2005-06 (detailed in Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*) are formulated in accordance with the Australian equivalents to International Financial Reporting Standards (A-IFRS), which is applicable for reporting periods commencing on or after 1 January 2005. Reflecting this change in accounting standards, Table 3.5, which details the summary operating statement from 2004-05 to 2008-09, will also present the 2004-05 revised estimates under an A-IFRS basis. Furthermore, in accordance with the Government's operating surplus target measure (see Chapter 1, *Financial Policy Objectives and Strategy*), this summary operating statement presents the net result from transactions rather than detailing the other economic flows or the overall net result. This detail is provided in Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*.

2005-06 BUDGET INITIATIVES

The 2005-06 Budget maintains the Government's national leadership in infrastructure investment and taxation reform, while delivering a breakthrough social policy package, *A Fairer Victoria – Creating Opportunity and Addressing Disadvantage*, to reduce disadvantage and create a more prosperous Victoria.

The Budget also includes substantial further cuts in the costs of doing business in Victoria, delivering additional land tax relief worth \$823 million over five years, abolishing rental business duty at a cost of \$65 million a year and providing a further 10 per cent reduction in average WorkCover premiums, saving Victorian business an additional \$170 million each year. (see Budget Paper No. 3, Chapter 1, *Service And Budget Initiatives*, for more details).

As discussed below under the *Asset investment initiatives* section, the 2005-06 Budget also continues the delivery of the Government's election commitments as set out in *Labor's Financial Statement 2002*.

Initiatives affecting operating expenses

Table 3.1 shows that the 2005-06 Budget provides additional funding to departments for new output initiatives of \$740 million in 2005-06 before averaging \$656 million a year over the next three years.

This new funding is partly offset by a range of government efficiencies of \$131 million in 2005-06, averaging \$134 million a year over the forward estimates period, including:

- a reduction in annual expenditure on consultants and contractors to reflect a cutback in their future involvement in government projects and programs;
- the consolidation of government print, media and communication services; and
- general departmental savings through head office efficiencies and the rescoping of existing initiatives.

These efficiencies have been reinvested back into service delivery and will ensure that the Government continues to maximise the delivery of core services to the Victorian community.

After allowing for these savings, and utilising funding from the existing forward estimates contingency put aside for service delivery demand growth (\$115 million in 2005-06, averaging \$132 million a year over the forward estimates period), the net budget impact of output initiatives is \$495 million in 2005-06, averaging \$390 million a year over the forward estimates period. As indicated in Table 3.1, this is in addition to \$90 million in new 2005-06 output funding previously approved and announced in the *2004-05 Budget Update*.

Table 3.1: New output funding since 2004-05 Budget

	(\$ million)			
	2005-06 Budget	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate
2005-06 Budget new output funding	740.4	733.9	620.9	612.9
Less:				
Demand contingency	114.7	127.0	136.0	133.0
Government efficiencies	131.0	135.4	133.3	131.9
Net budget impact of new 2005-06 Budget output funding	494.7	471.5	351.5	347.9
Add: <i>2004-05 Budget Update</i> output funding	90.1	94.8	100.4	n.a.
Net budget impact of output funding since 2004-05 Budget ^(a)	584.8	566.3	451.9	347.9

Source: Department of Treasury and Finance

Note:

(a) Excludes initiatives funded through internal reprioritisations or other existing fund sources.

Table 3.2 shows the total value of new output funding by department in the 2005-06 Budget. Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*, provides more detailed information on the Government's service delivery and strategy, while Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, provides a detailed list and description of all service delivery initiatives implemented in this budget.

Table 3.2: 2005-06 Budget new output initiatives funding by department

	(\$ million)			
	2005-06 Budget	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate
Education and Training	99.9	132.6	142.8	158.6
Human Services	241.8	225.0	232.7	241.2
Infrastructure	84.2	141.4	68.7	38.9
Innovation, Industry and Regional Development	24.2	12.3	20.8	41.0
Justice	53.9	60.9	63.1	68.3
Premier and Cabinet	19.0	19.5	21.7	17.2
Primary Industries	12.0	3.1	6.1	3.5
Sustainability and Environment	23.4	24.5	26.0	25.6
Treasury and Finance	105.7	102.6	27.7	9.9
Victorian Communities	74.3	10.0	9.2	6.8
Parliament	2.1	2.0	2.1	1.9
Total 2005-06 Budget new output funding	740.4	733.9	620.9	612.9
Less funding from demand contingency and efficiencies	245.7	262.4	269.3	264.9
Net budget impact of new 2005-06 Budget output funding^(a)	494.7	471.5	351.5	347.9

Source: Department of Treasury and Finance

Note:

(a) Excludes initiatives funded through internal reprioritisations or other existing fund sources and 2004-05 Budget Update output initiatives.

Asset investment initiatives

The 2005-06 Budget provides funding for the commencement of new infrastructure investment projects with a total estimated investment (TEI) of \$2.0 billion (in addition to \$310 million announced in the *2004-05 Budget Update*).

This funding includes \$393 million TEI for the Government's *Labor's Financial Statement 2002* election commitments. See Budget Paper No. 3, Chapter 3, *Election Commitments: Implementation Report Card*, for more information.

The scale of the 2005-06 infrastructure program and the scope and nature of projects approved demonstrate the Government's commitment to promoting economic, social and environmental development across the whole State. Over the four years to 2008-09, general government expenditure on infrastructure investment is expected to average \$2.6 billion a year.

Table 3.3 provides a summary of new asset investment funding by department. Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, provides more detailed information on the Government's 2005-06 Budget infrastructure investment initiatives.

Table 3.3: 2005-06 Budget new asset funding by department

	(\$ million)	
	2005-06 Budget	TEI ^(a)
Education and Training	178.0	345.2
Human Services	224.0	471.4
Infrastructure	208.9	571.5
Innovation, Industry and Regional Development	..	..
Justice	46.3	133.4
Premier and Cabinet	26.1	53.2
Primary Industries	..	307.9
Sustainability and Environment	19.0	86.2
Treasury and Finance	2.7	2.7
Victorian Communities	12.6	18.7
Parliament	1.8	10.0
Total 2005-06 Budget asset funding	719.5	2 000.3
Add: 2004-05 Budget Update asset funding	143.3	309.5
Asset funding since the 2004-05 Budget	862.8	2 309.7

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. See Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*, for more detail.

Revenue initiatives

Table 3.4 provides a summary of the tax and other revenue measures the Government has introduced in the 2005-06 Budget, which includes further major land tax reforms. Total tax initiatives announced in this budget will benefit taxpayers by \$130 million in 2005-06, averaging \$127 million a year over the forward estimates period.

Table 3.4: 2005-06 Budget Revenue initiatives^(a)

	(\$ million)				
	2004-05 Revised	2005-06 Budget	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate
Budget tax relief initiatives					
Land tax relief package	-71.6	-206.1	-188.4	-195.9	-161.1
Rental business duty			-17.2	-64.0	-67.5
Motor vehicle registration and compulsory third party insurance for concession card holders	0.0	-8.0	0.0	0.0	0.0
Payroll tax: exemption for government schools		-0.2	-0.2	-0.2	-0.2
Other budget tax initiatives					
Health benefit levy		45.0	45.0	45.0	45.0
Long-stay inner city car parks levy		19.4	38.8	39.7	40.6
Compliance on trusts reform		20.0	20.0	20.0	20.0
Total budget tax initiatives	-71.6	-129.9	-102.0	-155.4	-123.2
Other budget non-tax revenue initiatives	0.0	20.3	24.7	25.4	32.0
Total budget initiatives	-71.6	-109.6	-77.3	-130.0	-91.3
Tax initiatives announced since 2004-05 Budget					
Our Water Our Future	44.7	60.5	60.7	62.1	..
Land tax exemption for caravan parks	-3.0	-3.0	-3.0	-3.0	-3.0
Total tax initiatives announced since 2004-05 Budget	41.7	57.5	57.7	59.1	-3.0
Total tax initiatives announced in previous budgets that are yet to be implemented (Debits tax)^(b)		-257.8	-283.9	-286.7	-289.5
Total revenue initiatives	-29.9	-309.8	-303.5	-357.7	-383.8

Source: Department of Treasury and Finance

Notes:

(a) A negative figure indicates reduced revenue.

(b) Estimates as agreed in 1999 as part of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations.

The 2005-06 Budget continues crucial reform of Victoria's land tax system by providing land tax relief worth \$823 million over five years (including \$72 million in 2004-05). The focus of these reforms is to provide targeted relief to those taxpayers that have experienced large increases in their land tax liabilities in recent years as a result of rising property prices brought about by the high demand for property in premium locations. Rate cuts are estimated to benefit around 23 000 payers of land tax, providing savings of up to 44 per cent. The main features include:

- cuts to the middle land tax rates:
 - the 1 per cent rate (starting at \$750 000) will be cut to 0.5 per cent;
 - the 1.75 per cent rate (starting at \$900 000) will be cut to 1 per cent;
 - the 2.75 per cent rate (starting at \$1.19 million) will be cut to 1.5 per cent; and
 - the 3 per cent rate (starting at \$1.62 million) will be cut to 2.25 per cent;
- an increase in the tax-free threshold by \$25 000 to \$200 000 from 2005-06, removing approximately 21 000 taxpayers from the land tax base;
- bringing forward the reduction in the top marginal rate announced last year by one year so that the top rate will be 3.5 per cent in 2005-06, 3.25 per cent in 2006-07 and 3 per cent in 2007-08;
- rebates on 2005 land tax equal to half the savings taxpayers would have gained this year if the middle rate cuts and bracket adjustments delivered in this budget had applied;
- the capping of increases in land tax liabilities in 2005-06, so that no payer of land tax will experience an increase in their land tax liability greater than 50 per cent for the 2006 land tax year with respect to the same properties; and
- a full land tax exemption for aged care facilities, supported residential services (SRSs) and rooming houses applying from 1 January 2004, with a refund available to any aged care facility, SRS and rooming house which paid land tax during 2004 or 2005. Under these exemptions, special land tax will apply when the use of exempt land changes.

The 2005-06 Budget also removes rental business duty from 1 January 2007 following a review under the 1999 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA). This is in addition to the abolition of debits tax from 1 July 2005, which was announced in the 2004-05 Budget. These measures continue to ensure the Government meets all of its commitments under the IGA.

Other tax relief initiatives being delivered in the 2005-06 Budget include:

- a full payroll tax exemption for government school councils from 1 July 2004, bringing the treatment into line with non-government schools; and
- introducing, from 1 January 2006, an option for eligible concession card holders to have a six month registration period for their vehicle registration and compulsory third party insurance.

Other changes to Victoria's taxation system implemented in this budget include:

- an increase in the annual health benefit levy from \$1 533.33 to \$3 033.33 on each electronic gaming machine (EGM) with the additional revenue being directly hypothecated to the Hospitals and Charities Fund;
- a separate levy on the owners of non-residential, long-stay, off-street car parking spaces in the Melbourne central business district (CBD) and adjacent highly congested areas, such as Southbank, Docklands and the St Kilda Road precincts, with the revenue raised to be used for important metropolitan transport initiatives. The Government will also be providing the Melbourne City Council with \$5 million a year to fund urban and transport improvements in the CBD; and
- changes to the land tax regime applying to certain trusts to provide clarity in an area of the law that has been under dispute in recent years.

Other departmental non-tax revenue initiatives include:

- an increase in the brown coal royalty rate from 1 January 2006, with the new rate better reflecting the value of the resource;
- an increase in mortgage registration and discharge fees to ensure better matching of costs and benefits associated with the fees;
- a 25 per cent discount on driver licence renewal, from 1 January 2006, for drivers who have not received any demerit points in the previous three years; and
- other revenue initiatives to reflect updated market values of government resources and services, and greater cost recovery on government services.

Revenue initiatives announced in the *2004-05 Budget Update* include:

- the introduction from 2004-05 onwards of an annual environmental contribution by water authorities to ensure that prices better reflect the scarcity of water and costs related to the environmental impacts associated with the provision of water-related services; and
- a full land tax exemption for privately-owned caravan parks. Special land tax will apply when the use of exempt land changes.

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

2005-06 BUDGET ESTIMATES AND OUTLOOK

Table 3.5 sets out the revised 2004-05 estimate, together with the projected outlook over the budget and forward estimates period. As mentioned previously, all years are presented on an A-IFRS basis.

Table 3.5: Summary operating statement 2004-05 to 2008-09^(a)

	(\$ million)				
	2004-05	2005-06	2006-07	2007-08	2008-09
	Revised	Budget	Estimate	Estimate	Estimate
Income from transactions					
Taxation	10 355.6	10 306.2	10 729.8	11 016.2	11 441.3
Investment income	1 323.0	1 397.9	1 260.2	1 235.2	1 138.3
Grants	13 365.7	14 262.1	14 733.3	15 263.7	15 992.0
Sales of goods and services	2 313.1	2 397.1	2 449.8	2 490.8	2 521.6
Other income ^(b)	1 996.3	2 260.2	2 281.4	2 251.0	2 409.2
Total income from transactions	29 353.7	30 623.6	31 454.5	32 257.0	33 502.4
% change		4.3%	2.7%	2.6%	3.9%
Expenses from transactions					
Employee benefits	10 625.3	11 201.5	11 552.7	11 887.8	12 191.8
Superannuation	1 670.6	1 759.3	1 784.9	1 785.0	1 802.0
Depreciation and amortisation	1 167.2	1 235.1	1 291.6	1 383.3	1 444.5
Financing costs	482.2	492.1	500.7	503.8	524.1
Supplies and services	9 633.3	9 991.2	10 465.0	10 838.4	11 414.4
Other expenses ^(c)	5 197.0	5 579.7	5 540.3	5 545.7	5 574.7
Total expenses from transactions	28 775.5	30 258.9	31 135.2	31 944.0	32 951.5
% change		5.2%	2.9%	2.6%	3.2%
Net result from transactions	578.2	364.7	319.3	313.0	550.8

Source: Department of Treasury and Finance

Notes:

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

As highlighted in Chapter 1, *Financial Policy Objectives and Strategy*, the Government has committed to achieving operating surpluses of at least \$100 million a year on a 'net result from transactions' basis. Table 3.5 shows that the Government is forecast to achieve this financial objective. Following the projected operating surplus of \$578 million for 2004-05, the operating surplus is budgeted to be

\$365 million in 2005-06, before averaging \$394 million a year over the following three years.

These strong forecast surpluses demonstrate the Government's solid performance in continuing to responsibly manage the State's finances. Operating surpluses are an important funding source for the Government's substantial capital investment program, thereby restraining the call on debt to finance infrastructure (see the *Use of Cash Resources* section below).

Expenses from transactions

2005-06 Budget estimates

Total expenses from transactions are budgeted at \$30 259 million in 2005-06, representing an increase of \$1 483 million or 5.2 per cent on the revised estimate for 2004-05. The increase in 2005-06 expenses relative to the previous year is largely the result of:

- net new policy funding of \$585 million (including \$90 million announced as part of the *2004-05 Budget Update*). These output initiatives require front-line service delivery staff (including additional teachers, police, nurses and health staff), and increased other non-wage costs, thereby contributing to the budgeted 2005-06 growth of \$576 million in employee benefits, and \$358 million in supplies and services;
- the impact of indexation on total departmental expenses under the departmental funding model of 2.5 per cent a year across the budget and forward estimates period. This expense growth provides for:
 - general wages growth as a result of the flow on impacts of agreements reached in prior years, consistent with government wages policy (including the impacts of the enterprise bargaining agreements finalised in 2004-05 for nurses and teachers);
 - the impact of general inflation on public sector non-wage costs, which increases purchases of supplies and services;
- the associated flow-on expense impacts arising from the forecast \$380 million growth in Commonwealth specific purpose grants compared with the 2004-05 revised estimate (including grants for on-passing);
- associated expenditure impacts resulting from an increase in sales of goods and services of \$84 million in 2005-06 compared with the 2004-05 revised estimate; and
- an increase in grants provision of \$160 million in 2005-06 to the Victorian Rail Track (VicTrack), resulting from its requirement to pay a higher capital charge due to its increased net asset position.

Forward estimates outlook

Expenses from transactions are projected to increase by an average of 2.9 per cent a year over the forward estimates period. This is slightly below expected price inflation and Victorian population growth.

Over the forward estimates period, employee entitlements, purchases of supplies and services and other expenses are expected to increase by a modest 3.7 per cent a year on average. This growth is reflective of the Government's continuing commitment to improve services such as health, education and community safety, and is broadly in line with expected inflation and population growth.

Depreciation expense is expected to increase by 5.6 per cent a year on average, reflecting growth in the capital stock as a result of the Government's continuing substantial infrastructure investment program and revaluations of physical assets.

Financing costs are projected to increase by an average of 2.1 per cent a year over the forward estimates. As discussed in Chapter 4, *Balance Sheet Management and Outlook*, this is largely due to the impact of an increase in the general government sector debt portfolio from 2007-08.

Marginal growth in superannuation expense (averaging 0.8 per cent a year) reflects the peaking of the unfunded superannuation liability in real terms and the assumption that asset returns on state superannuation schemes return to long-run actuarial rates.

Income from transactions

2005-06 Budget estimates

Total income from transactions is projected to be \$30 624 million in 2005-06, which represents a \$1 270 million (4.3 per cent) increase on the 2004-05 revised estimate. Driving this growth are increases in Commonwealth grants and investment income, slightly offset by a decrease in taxation.

Taxation in 2005-06 is projected to decrease by \$49 million (0.5 per cent) relative to the revised estimate for 2004-05. Major impacts on the change in taxation from the previous year are:

- the abolition of debits tax from 1 July 2005, currently estimated to be worth \$235 million;
- a \$160 million reduction in duty on conveyancing associated with an expected continuing moderation in property market activity through a slowdown in the growth of house prices and reductions in the volume of sales;
- land tax in 2005-06 is forecast to be \$31 million lower than in 2004-05. In the absence of the one-off rebate in 2004-05, land tax would have been lower by \$102 million;

- higher payroll tax growth of \$185 million, primarily reflecting expectations of modest increases in wages and, to a lesser extent, continuing growth in employment;
- introduction of a long-stay car park levy on the owners of non-residential, long-stay, off-street car parking spaces in the Melbourne CBD and adjacent highly congested areas (\$19 million);
- growth in gambling taxation of \$103 million, in line with estimated growth in household final consumption expenditure, together with the increase in the annual health benefit levy from \$1 533.33 to \$3 033.33 on each EGM. The additional revenue will be directly hypothecated to the Hospitals and Charities Fund; and
- growth in insurance (\$41 million) and motor vehicle (\$74 million) taxes which are generally in line with growth in economic activity.

The increase in investment income of \$75 million (5.7 per cent) in 2005-06, compared to the revised 2004-05 estimate, reflects growth in dividend income from the public non-financial corporations sector, together with an increase in the brown coal royalty rate from 1 January 2006.

Grants are expected to increase by \$896 million (6.7 per cent) in 2005-06. This growth, relative to the previous year, is largely a result of:

- Commonwealth general purpose grants increasing by the combined impact of \$383 million associated with growth in the GST pool (as published in the *2004-05 Mid-year Economic and Fiscal Outlook*), together with \$110 million due to an upwards revision to Victoria's share (mainly resulting from the Commonwealth Grants Commission's *2005 Update of State Revenue Sharing Relativities*); and
- Commonwealth specific purpose grants (including on-passing) increasing by \$380 million. This growth largely reflects increases in assistance to government and non-government schools, together with increased health care grants (allowing for population growth and ageing, demand growth and cost indexation), higher road grants, and the provision of \$62 million in 2005-06 towards the Melbourne 2006 Commonwealth Games.

Revenue from the sale of goods and services is estimated to increase by \$84 million (3.6 per cent) in 2005-06, largely as a result of annual indexation of fees and charges, an increase in mortgage registration and discharge fees to ensure better matching of costs and benefits associated with the fees, and departmental own-source revenue generating activities. This revenue growth largely supports additional departmental expenditure.

Increases in other income of \$264 million, compared with the 2004-05 revised estimate, include:

- a higher capital charge applied to VicTrack (\$160 million in 2005-06) as a result of the improvement in its net asset position. This impact is offset through the provision of an associated grant; and
- increases in fees and fines of \$99 million, largely reflecting the net impact of lower than expected revenue from traffic infringements in 2004-05 arising from the identification of issues associated with the fixed road safety cameras, together with a progressive roll-out of these cameras during 2005-06 as part of the Government's road safety initiative.

Importantly, from 1 July 2005, revenue raised from traffic cameras and on the spot speeding fines will be channelled into improving Victoria's roads through the Better Roads Victoria Trust Account. This will establish a transparent link between traffic camera revenue and the Government's expenditure on roads, road safety and road maintenance programs.

Forward estimates outlook

Beyond 2005-06, income from transactions is expected to increase on average by 3.0 per cent a year. This represents projected growth in taxation and Commonwealth grants, partly offset by an expected decline in investment income.

Taxation is projected to grow on average by 3.5 per cent a year over the forward estimates period, less than growth in nominal gross state product (GSP), reflecting continuing underlying growth, partly offset by:

- a continuation in subdued property market conditions, leading to relatively minor growth in land transfers;
- the impact of the land tax reform package, whereby land tax is estimated to increase by only \$1 million between 2006-07 and 2008-09;
- removal of rental business duty from 1 January 2007 following a review under the 1999 IGA; and
- the impact of the introduction of a complete smoking ban within enclosed licensed premises (with some exceptions) from 1 July 2007.

Investment income is projected to decline over the forward estimates period (6.6 per cent a year on average) as it returns to long-term trends beyond 2005-06. In particular, dividend income from the Transport Accident Commission (TAC) is anticipated to return to normal levels following unusually strong investment performance over the previous two years.

Grants are projected to grow over the forward estimates at an average annual rate of 3.9 per cent reflecting growth in GST grants and higher specific purpose grants, particularly for schools and health programs. This growth has been partly offset by the Commonwealth Government's decision to cease making National Competition

Policy payments to the States and Territories from 2006-07, and decreases in road grants.

RECONCILIATION OF FORWARD ESTIMATES TO PREVIOUSLY PUBLISHED ESTIMATES

Table 3.6 compares the net result as published in the *2004-05 Budget Update* to the 2005-06 Budget operating surplus (net result from transactions) through detailing the key movements in total incomes and expenses that have impacted on the net result, and allowing for the other economic flows that are excluded from the net result from transactions.

The projected operating surplus (net result from transactions) is expected to be \$365 million 2005-06, falling slightly to be \$313 million in 2007-08.

Table 3.6: Reconciliation of 2005-06 Budget estimates to 2004-05 Budget^(a)

	(\$ million)		
	2005-06 <i>Budget</i>	2006-07 <i>Estimate</i>	2007-08 <i>Estimate</i>
Operating surplus - 2004-05 Budget^(b)	505.4	530.5	675.7
Add: Income variations in <i>2004-05 Budget Update</i>	363.0	355.1	255.1
Less: Expense variations in <i>2004-05 Budget Update</i>	401.3	370.1	304.0
Operating surplus - 2004-05 Budget Update^(b)	467.1	515.5	626.8
Plus: Income variations since 2004-05 Budget Update			
Policy variations			
Taxation initiatives	-129.9	-102.0	-155.4
Other non-tax revenue Initiatives	20.3	24.7	25.4
Total policy variations	-109.6	-77.3	-130.0
Economic/demographic variations			
Taxation	62.0	132.0	179.3
Investment income	142.0	48.8	35.4
Total economic/demographic variations	204.0	180.9	214.7
Commonwealth grant variations			
General purpose grants	73.6	21.7	-25.8
Specific purpose payment grants	117.7	143.8	90.3
Total Commonwealth grant variations	191.3	165.5	64.5
Increase in own-source revenue	36.5	53.6	68.6
Administrative variations	217.5	211.1	77.1
Total variation in income since 2004-05 Budget Update	539.7	533.7	294.8
Less: Variations in expenses since 2004-05 Budget Update			
Policy decision variations ^(c)			
New output funding	740.4	733.9	620.9
Less: Contingency provision	-114.7	-127.0	-136.0
Less: Government efficiencies	-131.0	-135.4	-133.3
Total policy decision variations	494.7	471.5	351.5

Table 3.6: Reconciliation of 2005-06 Budget estimates to 2004-05 Budget^(a)
(continued)

	(\$ million)		
	2005-06 Budget	2006-07 Estimate	2007-08 Estimate
Commonwealth funding revisions	77.7	83.7	75.5
Variations due to changes in own-source revenue	41.9	55.0	77.3
Administrative variations			
Superannuation variations	-130.3	-149.4	-143.9
Other administrative variations	198.7	310.2	290.9
Total administrative variations	68.4	160.8	147.0
Total variation in expenses since 2004-05 Budget Update	682.7	771.0	651.3
2005-06 Budget net result	324.1	278.2	270.3
Add back: Other economic flows^(d)	40.6	41.0	42.6
2005-06 Budget net result from transactions	364.7	319.3	313.0

Source: Department of Treasury and Finance

Notes:

- (a) Totals may not add due to rounding.
- (b) Operating surplus in the 2004-05 Budget and 2004-05 Budget Update refers to net result.
- (c) Output policy decisions reflect the total cost of decisions. The total expenditure for each year may differ to Budget Paper No. 3, Appendix A, Output, Asset Investment and Revenue Initiatives, for each initiative due to departmental reprioritisations being included in Appendix A.
- (d) As presented in Budget Paper No. 4, Chapter 1, Estimated Financial Statements and Notes, 'Other economic flows', while forming part of the net result, are excluded from net result from transactions. See Budget Paper No.2, Chapter 1, Financial Policy Objectives and Strategy, for a detailed discussion.

Variations to income

Total income is projected to be higher by \$537 million on average in 2005-06 and 2006-07, and \$295 million higher by 2007-08, relative to the estimates projected at the time of the 2004-05 Budget Update.

Policy decisions have decreased overall income by \$106 million a year on average from 2005-06 to 2007-08. As highlighted in Table 3.4, major changes include:

- a reduction in land tax of \$206 million in 2005-06, and \$192 million on average over the next two years, reflecting the impact of the package of land tax relief measures announced in the 2005-06 Budget, which includes increasing the tax free threshold, bringing forward by one year the scheduled reduction in the top rate, and restructuring and simplifying the rate scale;
- a reduction of \$17 million in 2006-07 and \$64 million in 2007-08, as a result of the removal of rental business duty from 1 January 2007 following a review under the 1999 IGA;

- an increase in the annual health benefit levy from \$1 533.33 to \$3 033.33 on each EGM, increasing revenue by \$45 million each year, with revenue collected to be hypothecated to the Hospitals and Charities Fund;
- reforms to the land tax regime applying to certain trusts; and
- the introduction of a long-stay car parks levy on the owners of non-residential off-street car parking spaces in the central business district and adjacent highly congested areas.

Economic and demographic factors have caused taxation estimates to be revised upwards by \$62 million in 2005-06, rising to be \$179 million higher in 2007-08, with major changes including:

- an upward revision to the payroll tax estimate (up \$132 million a year on average) following stronger than expected employment growth and increases in the average hours worked by Victorian employees during 2004-05;
- a downward revision to land tax forecasts in 2005-06 (\$49 million) reflecting further information relating to general levels of property values as at January 2004 with subsequent upward revisions (\$8 million in 2006-07 and \$53 million in 2007-08) reflecting estimated growth in property values over the forecast period. The rate of growth is largely offset by the Government's land tax reforms announced in this budget; and
- lower expected gambling taxation, particularly from electronic gaming machines, of \$26 million a year on average following subdued activity during the second half of 2004-05.

Investment income has been revised upwards as a result of economic and demographic conditions by \$142 million in 2005-06, and \$42 million a year on average over the next two years, with major changes including:

- higher dividends and income tax equivalent payments from 2005-06 from the public financial corporations sector (particularly from the TAC) as a result of higher than expected profit performance; and
- lower than expected income tax equivalent payments from the Victorian WorkCover Authority due to a further 10 per cent reduction in the WorkCover average premium rate for the 2005-06 financial year, which follows the 10 per cent reduction for 2004-05 announced in the 2004-05 Budget. The cumulative effect of these reductions is that the average rate will fall to 1.80 per cent in 2005-06, and employers will save approximately \$350 million that they would otherwise have paid in premiums in 2005-06 and in each future year.

Commonwealth grants have been revised upwards by \$178 million on average in 2005-06 and 2006-07, and \$65 million in 2007-08. The major changes include:

- higher GST grants of \$74 million in 2005-06 before declining to be \$26 million lower by 2007-08. This reflects the net impact over the forward estimates period of Victoria's share of the GST revenue pool being revised upwards by the Commonwealth Grants Commission in its 2005 Update, combined with lower than expected growth in the GST revenue pool as disclosed in the Commonwealth's 2004-05 *Mid-Year Economic and Fiscal Outlook*; and
- higher than expected specific purpose grants of \$117 million a year on average including increases in Commonwealth funding for government and non-government schools, health care, and *AusLink* funding for roads.

Own-source revenue is \$53 million higher a year on average, mainly as a result of increased third party revenue to hospitals and increased ambulance subscription revenue.

Administrative variations have resulted in upwards revisions of \$214 million on average in 2005-06 and 2006-07, and \$77 million in 2007-08, and largely reflects the net impact of:

- a higher charge applied from 2005-06 to VicTrack from (\$160 million in 2005-06, to be \$123 million higher by 2007-08) as a result of the improvement in its net asset position. This impact is offset through the provision of an associated grant;
- an additional \$11 million in 2005-06 and \$99 million in 2006-07 as part of TAC funding to improve Victoria's road safety and infrastructure in both rural and metropolitan areas;
- an additional \$18 million a year on average in payroll tax from increased compliance activity by the State Revenue Office;
- the recognition of 205 hectares of land at Point Nepean which is expected to be transferred from the Commonwealth in 2005-06; and
- a reduction in interest income of around \$29 million in 2005-06, to be \$96 million lower by 2007-08, as a result of lower projected financial assets since the time of the *2004-05 Budget Update*.

Variations to expenses

Total expenses have been revised upward by \$702 million a year on average from 2005-06 to 2007-08.

New output policy initiatives are the main driver for the increase in expenses, with the net addition to total operating expenses as a result of policy decisions being \$495 million in 2005-06, before averaging \$412 million over the next two years (after allowing for savings and deducting the contingency provision set aside in previous budgets for additional demand pressures).

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

Changes to Commonwealth funding have had a moderate impact on expenses, (\$79 million a year on average) over the budget and forward estimates period compared with the *2004-05 Budget Update*. These revisions mainly relate to expenditure on schools, health care and the BlackSpots program.

Expenses associated with the previously mentioned own-source revenue generating activities are expected to be \$58 million higher on average (particularly relating to increased health care activities).

Other administrative variations are expected to be \$68 million higher in 2005-06 rising to be \$147 million higher by 2007-08. This variation reflects a number of factors including:

- superannuation expenses being \$141 million lower a year on average as a result of:
 - the introduction of A-IFRS which uses a ten year Commonwealth bond rate as the discount rate to value the accrued superannuation liabilities held by the schemes;
 - the stronger than expected domestic equity market performance in 2004-05 which increases the value of the investment assets held by the schemes. It follows that over the forward years the expected return on the higher asset base leads to a reduced superannuation expense;
 - bringing forward scheduled superannuation payments into 2004-05 from the out years, which has generated higher returns on scheme assets;
- an increase from 2005-06 in operating grants to VicTrack (up \$160 million in 2005-06, to be \$123 million higher by 2007-08) resulting from an adjustment to its net asset position; and
- an increase in departmental expenses of \$41 million in 2005-06 rising to be \$133 million higher in 2007-08, associated with an increase in revenue provided to departments following a higher consumer price index (CPI) forecast. This escalation is in accordance with the principles underpinning the departmental funding model, whereby escalation of departmental expenses in each budget is based on the CPI forecast in the preceding budget update.

USE OF CASH RESOURCES

The operating surplus is an important funding source for the Government's substantial capital investment program. Table 3.7 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 together with any requirements for additional cash through financing activities.

Table 3.7: Application of cash resources

	(\$ million)				
	2004-05 Revised	2005-06 Budget	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate
Net result from transactions	578.2	364.7	319.3	313.0	550.8
Add back: Non-cash income and expenses (net) ^(a)	1 671.9	2 213.9	1 579.9	1 308.0	1 194.0
Net cash flow from operating activities	2 250.1	2 578.6	1 899.2	1 621.0	1 744.9
Plus: Net drawdown of Growing Victoria infrastructure reserve	196.6	..	..	..	..
Total cash available for asset investment	2 446.6	2 578.6	1 899.2	1 621.0	1 744.9
Less:					
Net investment in fixed assets					
Expenditure on approved projects	2 737.4	3 098.9	2 569.0	1 396.4	845.8
Unallocated provision for future allocation	..	..	385.0	1 072.8	1 526.7
Proceeds from asset sales	(118.2)	(134.0)	(142.5)	(208.8)	(119.8)
Total net investment in fixed assets	2 619.2	2 965.0	2 811.5	2 260.3	2 252.7
Finance leases	..	615.1	..	..	..
Other investment activities (net)	150.6	14.4	3.5	0.3	16.6
Decrease/(increase) in net debt (excluding Growing Victoria)	(323.1)	(1 015.8)	(915.8)	(639.7)	(524.4)

Source: Department of Treasury and Finance

Note:

(a) Includes depreciation and non-cash movements in liabilities such as unfunded superannuation and employee benefits.

Table 3.7 shows an expected budget operating surplus for 2005-06 of \$365 million, before averaging \$394 million a year over the forward estimates. Adjusting for a number of expense and income items that do not require or provide cash resources during the year (principally depreciation, but also including growth in unfunded superannuation liabilities and employee benefit liabilities) yields a projected net cash inflow from operating activities for 2005-06 of \$2 579 million, and an average of \$1 755 a year from 2006-07.

This cash surplus from operating activities is a significant source of financing for the Government's infrastructure investment program, funding around 75 per cent of the net \$2 572 million a year on average to be spent on fixed assets over the four years to 2008-09. The Government is utilising its strong balance sheet to fund the remainder of its infrastructure program, through a moderate increase in net debt over the forward estimates period.

Nearly \$3 billion of the planned infrastructure spending from 2006-07 represents the provision of a contingency to allow for future government capital spending. This allocation is in accordance with previous budget practice to ensure realistic forward projections of asset investment consistent with the Government's desire to ensure that an appropriate asset base exists to support ongoing service delivery. As part of the annual budget process, funds from this provision will be allocated to specific capital projects.

Of the \$1 016 million increase in net debt in 2005-06, \$615 million is due to the recognition of new finance lease arrangements, with an equivalent increase in fixed assets, following the expected completion and handover of the Spencer Street Station redevelopment and the completion of two new prisons in Ravenhall and Lara. These projects are being delivered under the *Partnerships Victoria* model. In addition, there are a number of projects still to be delivered under the *Partnerships Victoria* model that may also be classified as a finance lease, including the Metropolitan Mobile Radio initiative for the State's emergency services.

Over the forward estimates period, general government net debt rises by \$693 million a year on average. As a percentage of GSP, net debt is expected to be a modest 1.9 per cent as at 30 June 2009, well below 16 per cent in 1995 and 3.3 per cent in 1999. Furthermore, as shown in Chapter 4, *Balance Sheet Management and Outlook*, 'net financial liabilities' which represents a broader measure of indebtedness is declining as a percentage of GSP over the forward estimates period, from 8.6 per cent as at 30 June 2005 to 8.5 per cent as at 30 June 2009.

CHAPTER 4 – BALANCE SHEET MANAGEMENT AND OUTLOOK

- The Government continues to report a strong balance sheet, which supports investment in key infrastructure necessary for ongoing economic growth and the provision of social services, including those to address social disadvantage.
- With infrastructure investment over the four years from 2005-06 in excess of \$10 billion, the real capital stock is expected to grow by 12.2 per cent, around three times the expected rate of population growth.
- Around 75 per cent of this investment program will be financed by the operating surplus, depreciation and other provisions. For the remainder, the Government will use the strength of its balance sheet to debt fund key public investment projects which have a long-term pay off. Accordingly, general government net debt is projected to increase from \$1.9 billion at June 2005 to \$5.0 billion at June 2009.
- Net debt will remain at low levels by historical and international standards, and is consistent with prudent financial management that maintains the State's triple-A credit rating. Projected general government net debt of 1.9 per cent of GSP at June 2009 is still low compared to 3.3 per cent of GSP in 1999 and 16.3 per cent in 1995.
- The servicing burden of the State's largest liability (unfunded superannuation) as a proportion of GSP will ease over the forward estimates period. This will more than offset the servicing burden of rising net debt. The broader ratios of net financial liabilities to GSP are expected to decline from 8.6 per cent in June 2005 to 8.5 per cent in June 2009 (A-IFRS basis), and superannuation and interest expenses from 7.3 per cent of revenue to 6.9 per cent over the same period.
- With a projected \$1.8 billion of net infrastructure spending in 2005-06, the public non-financial corporations sector is also investing to upgrade and provide additional infrastructure to ensure public services are maintained at an appropriate standard.
- The Government continues to improve governance frameworks and investment processes to ensure accountability for managing the State's assets and liabilities and to achieve value for money in the delivery of services to all Victorians.

BALANCE SHEET

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

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

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

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

As shown in Table 4.1, general government total liabilities as a proportion of GSP declined between June 1999 and June 2005, and, when measured on a comparable (A-IFRS) basis, are expected to decline further by 2009. Care is needed when making these comparisons to allow for a \$5.8 billion increase in superannuation liabilities in 2005-06 due to the different valuation methodologies in A-IFRS. As explained later in this chapter, this change is solely due to changed reporting conventions and does not alter the amount of cash required to discharge and service these liabilities.

Due to the low level of financial liabilities, the proportion of general government revenue directed towards servicing liabilities, and therefore not available for service provision, are below 1999 levels and are expected to further decline over the forward estimates period.

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

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

(\$ billion)								
	1999	2004	2005	2005	2006	2007	2008	2009
	Actual	Actual	Revised	Revised	Budget	Estimate	Estimate	Estimate
	AAS	AAS	AAS	A-IFRS	A-IFRS	A-IFRS	A-IFRS	A-IFRS
FINANCIAL POSITION								
(\$ billion)								
Assets								
Physical assets ^(a)	32.2	44.5	50.6	49.8	53.8	57.2	60.5	64.3
Financial assets ^(b)	2.0	4.2	4.3	4.3	3.9	3.0	2.7	2.6
Receivables, etc ^(c)	1.6	2.3	2.3	2.3	2.2	2.2	2.4	2.5
Growing Victoria ^(d)	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Total assets	35.7	51.1	57.2	56.3	59.8	62.5	65.6	69.4
Liabilities								
Superannuation	11.4	11.7	11.0	16.8	17.4	17.8	17.9	17.8
Borrowings	7.1	5.5	5.8	5.8	6.4	6.4	6.7	7.2
Other liabilities	3.6	7.6	7.8	7.8	8.0	8.1	8.1	8.2
Total liabilities	22.2	24.8	24.5	30.4	31.9	32.3	32.7	33.2
Net assets	13.5	26.3	32.6	26.0	27.9	30.1	32.8	36.2
KEY RATIOS - ACCOUNTING								
(per cent)								
Growth in non-current physical assets	4.2	7.2	14.6	12.5	6.5	6.8	6.0	6.5
Total liabilities to GSP	14.7	12.0	11.2	13.9	13.8	13.3	12.8	12.3
Borrowing costs to total revenue	3.6	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Superannuation expenses and borrowing costs to total revenue ^(e)	9.7	2.8	4.3	7.3	7.3	7.3	7.1	6.9
KEY RATIOS - GFS								
(per cent)								
Net debt to GSP	3.3	0.8	0.9	0.9	1.3	1.6	1.8	1.9
Net financial liabilities to GSP	10.9	6.4	5.9	8.6	8.8	8.9	8.7	8.5

Source: Department of Treasury and Finance

Notes:

- (a) Physical assets include land and buildings, plant and equipment, and roads and earthworks, cultural collections and other non-current assets.
- (b) Financial assets include cash assets, and investments, loans and placements. It does not include the Growing Victoria infrastructure reserve.
- (c) Receivables etc. include receivables, prepayments and inventories.
- (d) Even though the Growing Victoria infrastructure reserve invests in financial assets, it is earmarked for physical asset investment and therefore is treated as non-financial.
- (e) For data on an A-IFRS basis, only expenses from transactions are included.

TOTAL ASSETS

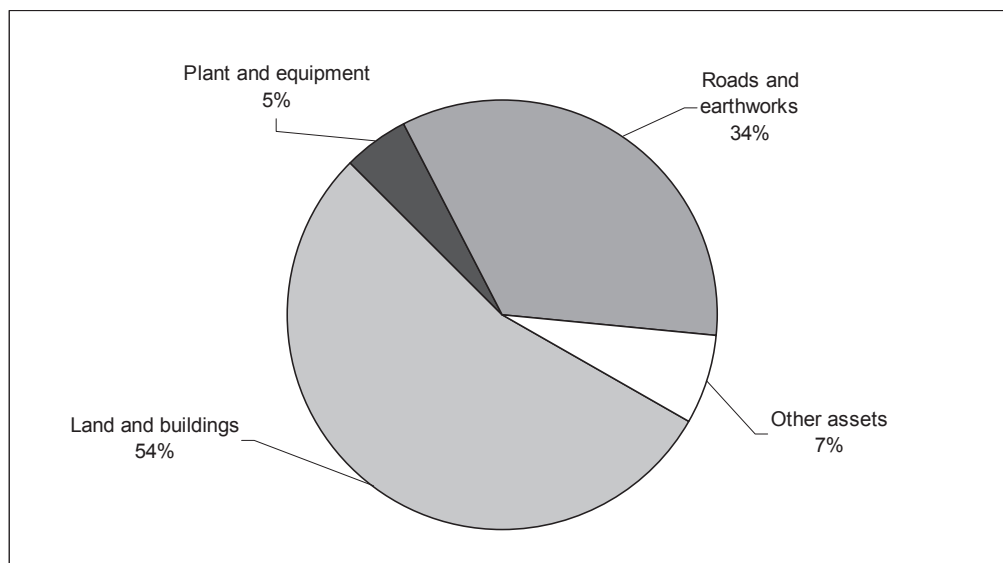
Growth in general government total assets is expected to average 5.4 per cent a year between June 2005 and June 2009 (A-IFRS basis), due to the Government's strong commitment to infrastructure and the impact of normal asset revaluations.

General government capital stock

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

Chart 4.1 shows the main components of the general government's \$50 billion capital stock as at 30 June 2005 (A-IFRS). These are land and buildings (54 per cent of the total capital stock), roads and earthworks (34 per cent), plant and equipment (5 per cent) and other assets (7 per cent).

Chart 4.1: General government capital stock as at 30 June 2005 (A-IFRS basis)



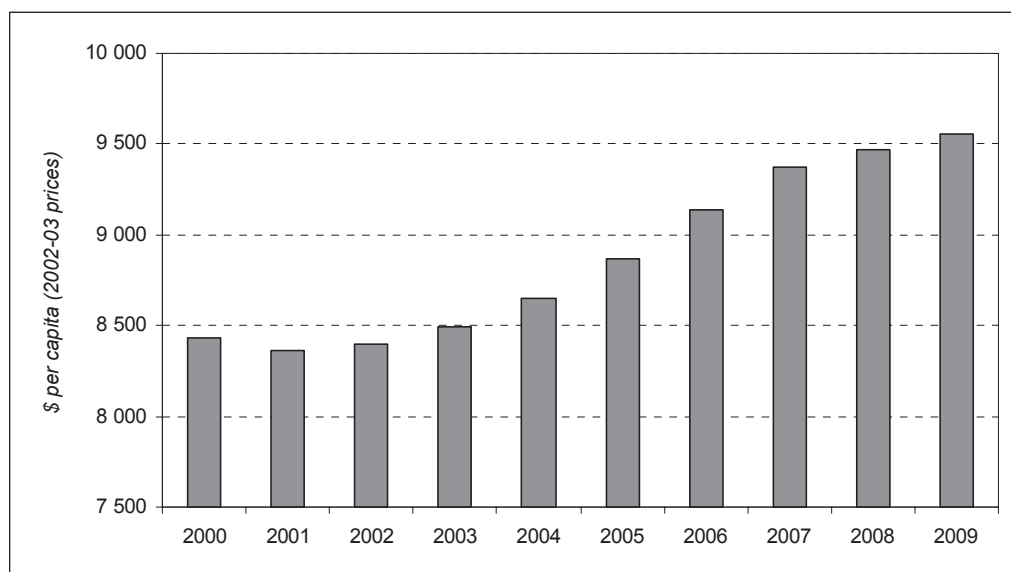
Source: Department of Treasury and Finance

The 2005-06 Budget delivers a significant infrastructure program, which will further enhance the State's capital stock. This is to ensure that bottlenecks do not occur in the economy, key social infrastructure is in place, and Provincial Victoria fully shares in the benefits of a strong economy.

Taking into account past and 2005-06 Budget decisions, infrastructure investment is expected to average \$2.6 billion a year between 2005-06 and 2008-09, well in excess of depreciation of around \$1.3 billion a year.

As a result, estimated growth in the real capital stock of 12.2 per cent is around three times the expected 4.1 per cent rate of growth in the population over the four years to June 2009. This is reflected in strong growth in real capital stock per capita (see Chart 4.2).

Chart 4.2: General government real capital stock per capita as at 30 June



Source: Department of Treasury and Finance

Asset initiatives

The Government is committed to investing over \$10 billion in infrastructure investment over the next four years. This investment is targeted at assets that support quality and accessible health and community services, support education and training for lifelong learning, and protect and sustain the environment for future generations.

Of the asset investment announced in the 2005-06 Budget, around 47 per cent is to sustain the asset base by renewal or replacement of the existing assets. The remaining 53 per cent is for additional and enhanced infrastructure.

Social and environmental infrastructure

In this budget, commitments to asset investment in social and environmental infrastructure include:

- \$323 million total estimated investment (TEI) representing a major boost in investment to build better schools, to modernise schools, and to provide them with broadband to improve student learning outcomes and environments;
- ongoing investment to restore health facilities, such as \$473 million TEI to upgrade hospitals, aged care facilities, disability services and to provide super clinics which will offer an alternative to hospital-based services by providing diagnostic, treatment, and follow-up care for patients;
- \$78 million TEI to complete the *Labor's Financial Statement* police facilities program, complete Footscray police station, and to build a new police station at North Wyndham. This ensures the modernisation of police facilities across the State; and
- \$59 million TEI in sustainable management of Victorian parks. Major statewide investment is being put in place to restore and upgrade assets to enhance visitor experiences.

Economic infrastructure

This budget commits to investment in economic infrastructure that addresses the need to grow and link Victoria and to promote thriving and innovative industries. Key projects include:

- around \$300 million TEI for the Melbourne Wholesale Markets relocation and redevelopment as part of the *Victoria: Leading the Way* Economic Statement to maximise production, distribution and retail opportunities for Victoria's fruit and vegetable industry and broader business communities;
- the duplication of the Calder Highway to provide a faster, more reliable and more efficient highway. This budget provides \$58 million TEI for the final stage of the \$211 million project to provide a four-lane divided road between Faraday and Ravenswood and is being delivered in partnership with the Commonwealth Government;
- \$97 million TEI, as part of the Government's *Linking the Suburbs* initiative, in new road projects in the growth corridors of outer metropolitan Melbourne which will improve road safety, transport links between major regional centres and metropolitan Melbourne. This investment will enhance linkages for freight to connecting activity service and facility centres; and
- \$9.2 million TEI to Victoria's 13 local ports to reduce immediate financial pressures on the port operators and to assist with the upgrading of assets.

Further details of the 2005-06 Budget asset investment program can be found in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*, and Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

Better asset management and delivery

A new asset management framework

In 2004, the Government reviewed public sector asset management policies. The review has led to the introduction of the Victorian Government asset management framework for the general government sector. The framework will give Government greater strategic control over the asset base, and provide an improved management platform to support the Government meeting its service delivery goals objectively and effectively. It is envisaged that the framework will achieve this through a shift from a short-term to a medium and long-term focus for improved whole-of-life planning and financial support of assets.

A key feature of the framework is a requirement for departments to prepare enhanced asset strategies, leveraging the multi-year strategy already provided under the Gateway Initiative, and a new service strategy prior to each annual budget process, to deliver the best asset mix for the State. These strategies will support improved decision making and will explicitly identify the links to *Growing Victoria Together* outcomes, service delivery, demand drivers, service standards and whole-of-life asset plans.

Most aspects of the framework will be operational by July 2006.

Gateway Initiative

The Victorian Government introduced the Gateway Initiative in August 2003 to reduce the risk of project cost and time overruns, to ensure alignment of projects with strategic objectives, and to better coordinate initiatives across all areas of government.

The four elements of the Gateway Initiative are:

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

- introduction of Gateway review process: to independently review key projects at critical stages from initiation to completion to ensure achievement of milestones and the delivery of benefits. Between August 2003 and April 2005, 46 projects with a combined value in excess of \$6.5 billion have been subjected to 60 Gateway reviews, of which 13 projects have had multiple reviews. The greatest benefit from the Gateway process is achieved when reviews are undertaken through the life-cycle of the project. None of the 13 projects that have undergone multiple reviews have sought additional resourcing; and
- enhanced asset investment reporting: to give improved exception-based asset monitoring as an integral part of an overall risk management framework.

Partnerships Victoria

The *Partnerships Victoria* policy provides the framework for a whole-of-government approach to the provision of public infrastructure and related ancillary services through public-private partnerships. The policy focuses on whole-of-life costing and full consideration of project risks and optimal risk allocation between the public and private sectors.

Since 2002-03, *Partnerships Victoria* projects have accounted for approximately 10 per cent of annual public asset investment commitments and they represent a similar proportion of investments announced in this budget. *Partnerships Victoria* aims to use the innovative skills and abilities of the private sector in a way that is most likely to deliver value for money and improved services to the community.

Partnerships Victoria is most useful where there are major and complex capital projects with opportunities for innovation and risk transfer. The potential for this is likely to occur in larger projects where there is scope for some or all of the following attributes:

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

Under *Partnerships Victoria*, the Government retains direct control over the core services (such as custodial services in prisons and judiciary functions) associated with the infrastructure.

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

The following projects are currently in the market as at 28 April 2005:

- Royal Melbourne Showgrounds redevelopment: The principal aim of the redevelopment of the site is to transform the Showgrounds land portion of the site into a high quality multipurpose venue for the staging of the annual Royal Melbourne Show and other events; and
- Melbourne Convention Centre development: A new Melbourne Convention Centre (comprising a 5 000 seat flexible plenary hall and ancillary facilities) to be built and fully integrated with the Exhibition Centre. The State, through the Melbourne Convention and Exhibition Trust, will retain operational control of the new facility.

The following projects are currently being considered for delivery under *Partnerships Victoria*:

- Melbourne Wholesale Markets redevelopment;
- Barwon Water – biosolids management; and
- Central Highlands Water – Ballarat North water reclamation.

A number of projects are currently under consideration to be delivered under the *Partnerships Victoria* guidelines. These projects span a range of sectors, including social housing, aged care, health care, research facilities, water, and justice.

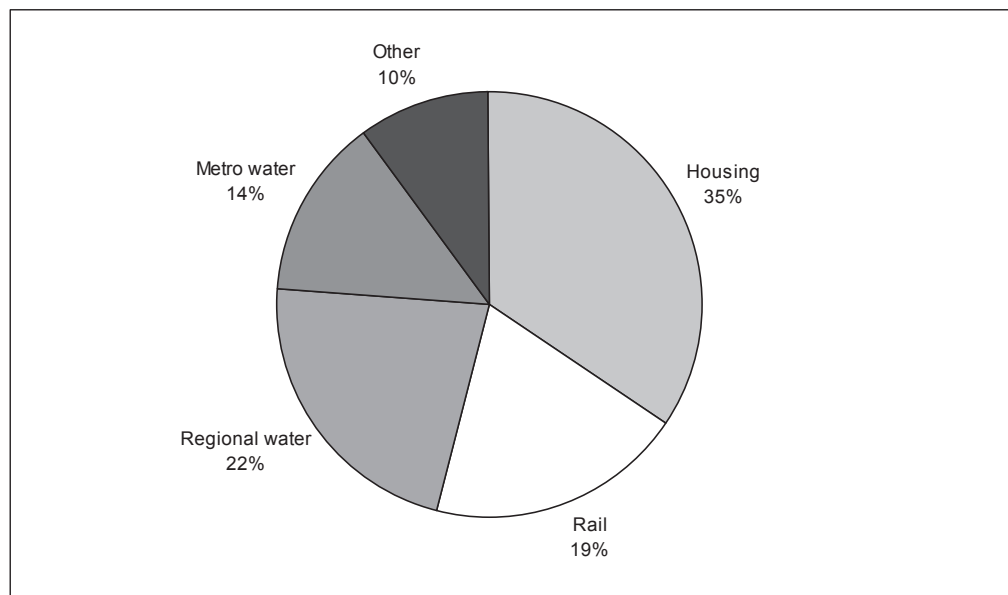
Other assets

The general government sector also holds financial assets and other assets, including receivables, prepayments and inventories. Financial assets are expected to decline over the forward estimates period, as they are used to fund the Government's infrastructure program. As shown in Table 4.1, general government financial assets are expected to decline from \$4.3 billion in June 2005 to \$2.6 billion in June 2009.

Public non-financial corporations

A significant component of the State's capital stock is held by the public non-financial corporations sector. Victorian public non-financial corporations operate in a range of sectors, including ports, metropolitan and rural water, urban development, public housing, public transport, culture and recreation, and the primary industry sector (see Chart 4.3). The sector is projected to hold land and fixed assets of \$37 billion at June 2005.

Chart 4.3: Public non-financial corporation sector capital stock as at 30 June 2005^(a)



Source: Department of Treasury and Finance

Note:

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

While the sector is predominantly user funded, it also receives contributions from the general government sector where the Government sees broader public benefits above those accruing to the primary users of the sector's assets. Over the period 2005-06 to 2008-09, the general government sector will be making net contributions to other sectors of Government of \$1.4 billion, primarily for capital purposes in the public non-financial corporations sector. In 2005-06, this includes:

- \$214 million to Victorian Rail Track for the purchase of rail infrastructure assets, including Regional Fast Rail assets, Knox tram works, Craigieburn rail line electrification and upgrades to country train tracks;
- \$35 million to Victorian Rail Track for mandatory capital improvements to the rail networks undertaken by the public transport operators on behalf of the Government; and
- \$97 million to the Melbourne Convention and Exhibition Trust for the Melbourne Convention Centre redevelopment project.

In addition, the public non-financial corporation sector can also finance asset investment through its own sources – through retained earnings and borrowing. In 2005-06, net purchases of non-financial assets by the sector is projected to be \$1.8 billion (Government Finance Statistics (GFS) basis). As a result, net purchases of non-financial assets by the non-financial public sector (comprising the general government and public non-financial corporations sectors) is estimated to be \$4.2 billion (GFS basis) in 2005-06.

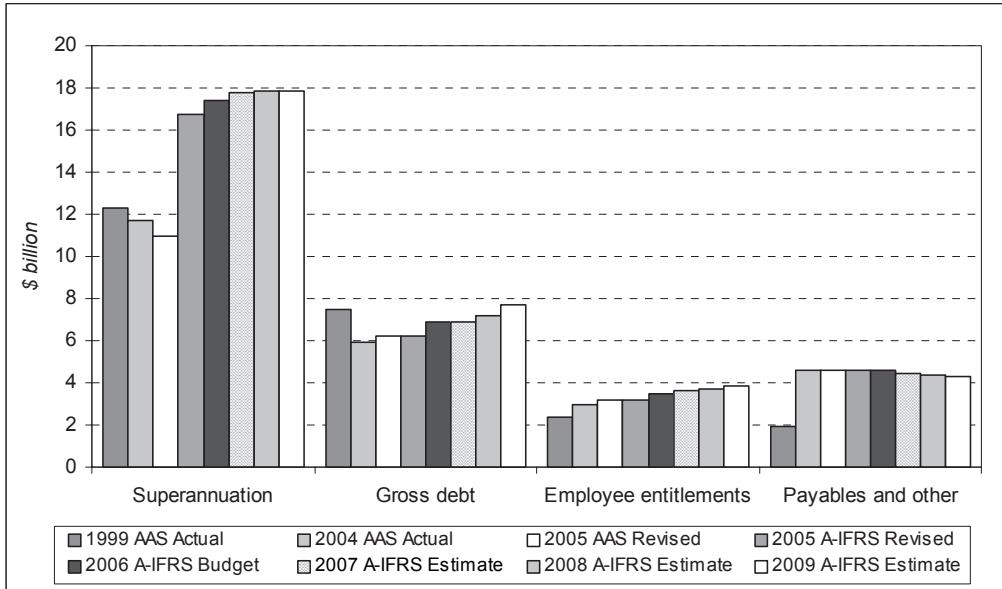
Infrastructure investment underway in the public non-financial corporations sector includes: new cargo terminal at Victoria Dock; new V'Locity trains for country passenger services; introducing smartcard technology for public transport ticketing; helping to deliver the transit cities initiative; the Docklands redevelopment; public housing improvements and additions; and establishment of significant new development sites to address population and household growth within the *Melbourne 2030* growth boundaries, for example, Epping ('Aurora') in the north, Officer in the east, Keilor in the west and Point Cook in the south west.

Victorian water authorities are undertaking works associated with network growth, as well as infrastructure upgrade and renewal, in part to comply with environmental and recycling policies. Regional urban water authorities are involved in a range of projects to improve service quality for customers in Provincial Victoria and to comply with regulatory requirements for environmental protection and drinking water quality. Major projects include an upgrade of Torquay's sewerage network by Barwon Water and the development of a biosolids treatment facility associated with Barwon Water's Black Rock sewerage treatment plant. In Ballarat, Central Highlands Water is undertaking a major upgrade of its Ballarat North sewerage treatment plant and will pursue opportunities for re-use of treated water from the upgraded plant as part of this project.

TOTAL LIABILITIES

The liabilities of the general government sector are projected to remain at prudent levels. The main liabilities are unfunded superannuation liabilities, gross debt and employee benefits. General government liabilities at June 2005 are projected to be \$30.4 billion (A-IFRS basis). Chart 4.4 shows the trends in the various liability categories.

Chart 4.4: General government sector liabilities by category as at 30 June



Source: Department of Treasury and Finance

Unfunded superannuation liabilities

Unfunded superannuation liabilities are the most significant liability on the State’s balance sheet. The measurement of this liability has changed since the 2004-05 Budget due to the introduction of A-IFRS from 2005-06.

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

In previous budgets, the present value of the underlying obligation was calculated using a discount rate equal to the expected long-term earning rate on scheme assets, typically around 7.5 per cent. Using this methodology (the ‘funding basis’), the estimated superannuation liability at 30 June 2005 is \$11.0 billion (see Table 4.1).

On adoption of A-IFRS, the present value of the underlying obligation must be calculated using a long-term bond rate as the discount rate, specifically, the ten-year Commonwealth Government bond rate.

The long-term bond rate is likely to differ from the long-term earning rate leading to a different present value of the underlying obligation. This flows through to the unfunded liability that is recognised in the general government sector. Under A-IFRS, the estimated superannuation liability at 30 June 2005 is \$16.8 billion or approximately \$5.8 billion higher than under the previous ‘funding basis’ methodology. This comprises an opening balance adjustment of \$4.1 billion on

1 July 2004 and a further movement of approximately \$1.7 billion since that time, being primarily due to the change in the Commonwealth bond rate.

It is important to note that the increase in reported unfunded superannuation liability that arises from the application of A-IFRS is due only to a change in valuation methodology. The amount of cash that is required to finance superannuation liabilities is unaffected by this change.

The calculation of the State's superannuation expense also changes upon the introduction of A-IFRS. Previously, movements in unfunded superannuation liabilities directly affected superannuation expenses recorded in the operating statement. Over recent years, this approach, in conjunction with investment market volatility, has resulted in considerable variability in superannuation expenses and the operating surplus.

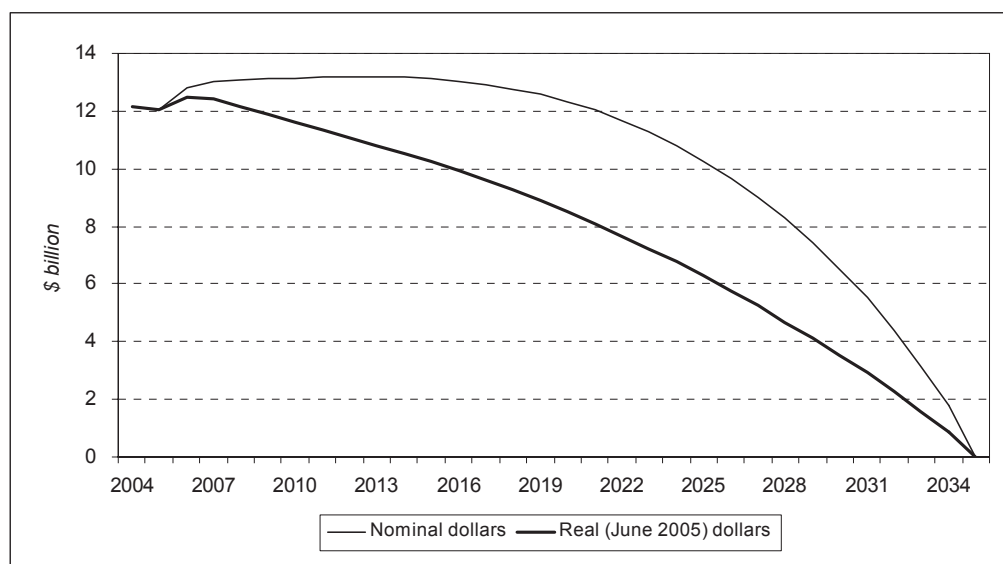
Under A-IFRS, the calculation of the superannuation expense is prescribed by accounting standards to reflect the accrual of benefits over the reporting period. An adjustment is then made to reflect any variation between actual experience and the assumptions underlying the liability valuation. This is reported as a separate item which does not affect the operating surplus. Therefore, while volatility will remain under A-IFRS, it will be reported as a separate 'below the line' item, clearly showing the impact of investment market volatility. This approach recognises that certain market factors are beyond the control of the Government.

State Superannuation Fund

The State's unfunded superannuation liabilities were largely accrued prior to 1995 when previous governments funded the State Superannuation Fund (SSF) on a 'pay as you go' basis. In 2000, the Government adopted a funding framework aimed at fully funding these liabilities by 2035. This funding framework is based on actuarial advice and is reviewed annually. Under this framework, funding requirements are determined based on the expected long-term earning rate of the scheme's assets. As discussed previously, the assumed earning rate typically differs from the discount rate that is required to be used to value the liability under the A-IFRS accounting standards. However, the earning rate is appropriate for funding purposes as it reflects the best estimate of the earnings of the scheme over the long term. This enables the determination of a more meaningful estimate of the amount that Government actually needs to contribute to fully fund superannuation liabilities. The 2035 full funding date ensures that the cost of funding these liabilities is spread over a reasonable period and does not fall entirely on the current generation of taxpayers. The elimination of these unfunded liabilities will result in increased budget flexibility in future years.

Chart 4.5 below shows the expected profile of the unfunded liability of the SSF until 2035. For the purpose of preparing this chart, the liability has been determined using the ‘funding basis’ (i.e. the scheme’s assumed long-term earning rate is used as the discount rate). The use of the funding basis for this chart is appropriate given that it is the basis of the funding framework that was adopted in 2000. In addition, it means that the chart more clearly indicates the point at which scheme assets are expected to be sufficient to meet accrued superannuation liabilities, and the expected progress towards achieving full funding.

Chart 4.5: General government sector unfunded superannuation liabilities of the State Superannuation Fund – long-term projections^(a)



Source: Department of Treasury and Finance

Note:

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

Under the 2035 full-funding framework, additional payments are made to the SSF from the Consolidated Fund. These additional payments are over and above the regular payments made by departments and agencies to meet the accruing cost of benefits. During 2003-04, additional payments of \$966 million were paid into the SSF. This amount exceeded the amount required as it included \$341 million that was brought forward from 2004-05. Similarly, the additional payment to the SSF in 2004-05, of \$477 million, exceeded that required due to amounts being brought forward from future years.

The Government's sound financial management over the past five years has allowed it to make payments to the SSF over and above the schedule originally set out by the actuary to fully fund the State's liabilities in that scheme by 2035. Between 1999-2000 and 2003-04, the State made additional payments of \$4 278 million compared to the \$2 488 million required under the original funding framework. At 30 June 2004, the Government was around \$1.8 billion ahead of the original payment schedule. Based on current projections, the State is on track to achieve full funding of these superannuation liabilities by the target date of 2035.

The SSF's unfunded superannuation liabilities calculated on a 'funding basis' are now expected to peak, in nominal terms, at \$13.3 billion in 2013, before declining slowly to \$12.9 billion by 2018 and declining rapidly thereafter (see Chart 4.5). The unfunded liability is projected to rise slowly in the short-term due to members' benefits accruing a little more rapidly than the SSF's assets. The unfunded liability then declines as government contributions and investments earnings outweigh accrued liability growth. In real terms, the peak is reached in 2007.

Managing superannuation liabilities

The Government continues to actively manage its superannuation liabilities and to explore opportunities to reduce these liabilities. An example of this is the Emergency Services Superannuation Scheme's move to paying taxed benefits from 1 July 2005. This change will result in a one-off reduction in the scheme's liabilities of around \$180 million and will result in slightly lower employer contribution rates. Members will also benefit as their after-tax retirement benefits will, on average, increase by around 2.2 per cent.

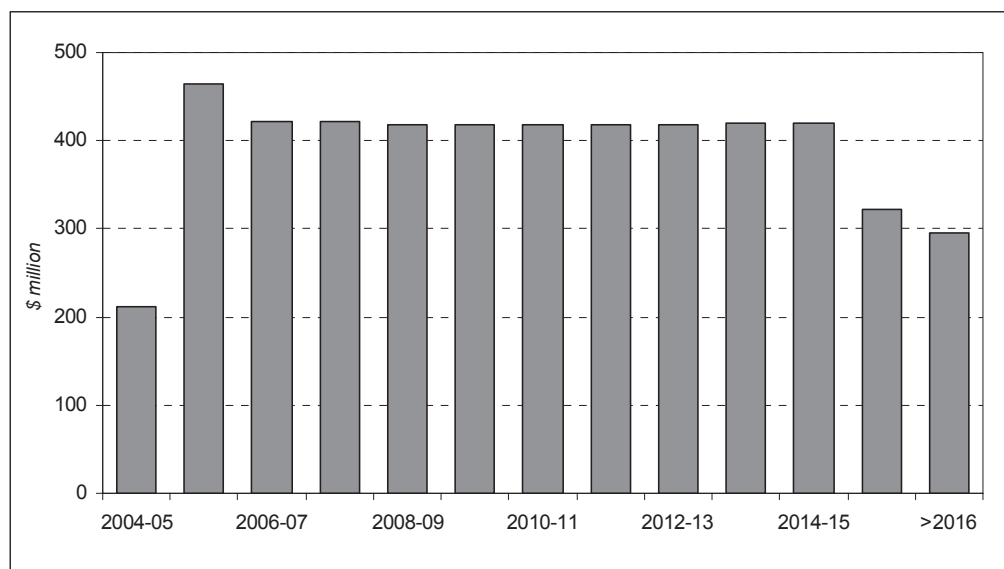
Gross debt

General government gross debt is expected to increase over the forward estimates period, from \$6.3 billion at June 2005 to \$7.7 billion at June 2009. The Government will be utilising the strength of the balance sheet to fund the Government's strong infrastructure program. It is worth noting that the bulk (around 75 per cent) of the infrastructure program is being funded by operating surpluses, depreciation and other provisions. The balance is funded from using financial assets and increasing borrowings.

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

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

Chart 4.6: Maturity profile of the core debt borrowings of the general government sector as at 31 March 2005



Source: Department of Treasury and Finance

Employee liabilities

Employee liabilities represent the third largest liability after unfunded superannuation liabilities and gross debt, and are projected to increase from \$3.2 billion as at June 2005 to \$3.9 billion by June 2009, an average growth rate of 4.8 per cent a year.

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

FINANCIAL ANALYSIS

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

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

General government net debt

The standard measure used to assess general government indebtedness is net debt, as defined and reported in Budget Paper No. 4, Chapter 6, *Uniform Presentation of Government Finance Statistics*. Under this framework, net debt is determined by deducting liquid financial assets from gross debt. The rationale for deducting liquid financial assets is that, in a period of financial difficulty, liquid assets would be readily available to redeem debt.

Net debt is projected to be 0.9 per cent of GSP at June 2005, which is very low by historical and international standards. As noted previously, the Government is prudently making use of its strong financial capacity to debt fund key public investments. As a result, general government net debt will increase from \$1.9 billion at June 2005 to \$5.0 billion at June 2009, which is comparable to June 1999 levels. Importantly, as a proportion of GSP, net debt will still remain at low levels, consistent with maintaining the State's triple-A rating. Projected net debt of 1.9 per cent of GSP at June 2009 remains low in comparison to 3.3 per cent at June 1999 and 16.3 per cent at June 1995 (see Chart 4.7). On an international comparison basis, this level of debt is very low. Victoria is in a select group of regional and local governments that have a triple-A rating. Standard & Poor's noted in June 2003 that of the 180 regional governments outside the United States rated by Standard & Poor's, only 16 per cent have a triple-A rating.

Of the increase in net debt in 2005-06, \$615 million is due to the recognition of new finance lease arrangements, with an equivalent increase in fixed assets, following the expected completion and handover of the Spencer Street Station redevelopment and the completion of two new prisons. These projects are being delivered under the *Partnerships Victoria* model.

State net debt

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

Non-financial public sector net debt comprises general government sector net debt and public non-financial corporation sector net debt. Public non-financial corporations sector net debt is expected to increase from \$2.8 billion in June 2005 to \$3.4 billion in June 2006 (A-IFRS basis). While the sector can finance part of its significant asset investment program from its cash surplus from operations, the size of the program means that it must be partly funded through increased borrowings and contributions from the general government sector.

The increase in public non-financial corporations net debt is due to increased net debt across a range of entities, including \$0.3 billion in the water authorities, \$0.1 billion in the Director of Housing, \$0.1 billion in the Port of Melbourne Corporation, and \$0.1 billion for Victorian Rail Track. The increased debt of these authorities is mainly associated with their capital expenditure programs that were discussed earlier in this chapter.

As these projects generate long-term positive benefits to the community, the use of debt finance is appropriate. In relation to metropolitan and regional water authorities, the Essential Services Commission will allow for the recovery of capital and debt servicing costs in their regulated price paths. Moreover, the State's low debt ratios can easily accommodate a modest increase in debt.

Table 4.2 and Chart 4.7 show that non-financial public sector net debt is projected to grow from \$4.7 billion (2.2 per cent of GSP) at June 2005 (A-IFRS basis) to \$8.4 billion (3.1 per cent of GSP) at June 2009. The increase of \$3.7 billion is mainly attributable to the increase of \$3.1 billion in general government net debt (discussed above) and an estimated \$0.6 billion in public non-financial corporations net debt in 2005-06. (As it is not practical to project this sector's debt beyond 2005-06, it is assumed to be constant.)

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

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

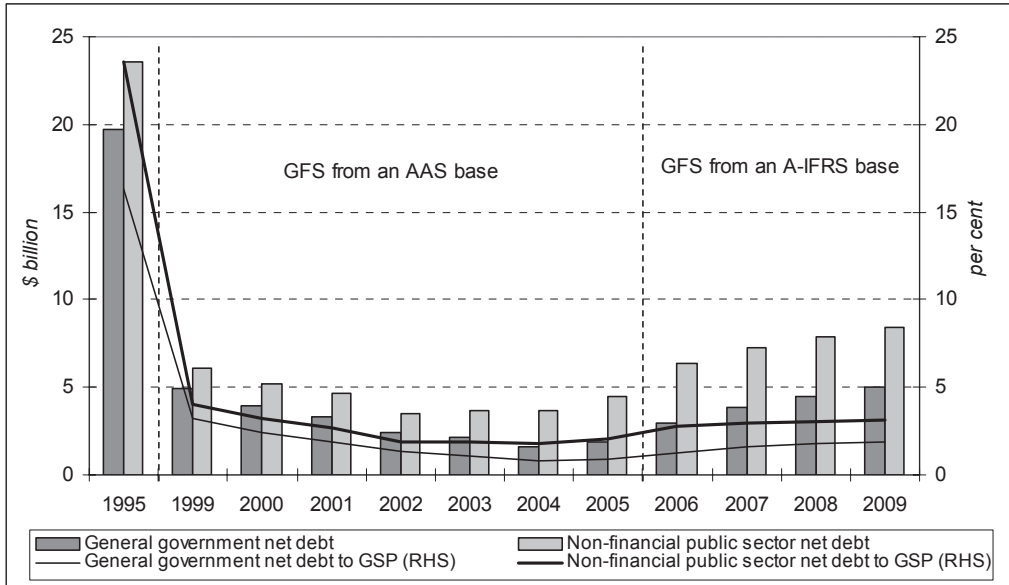
	1999 Actual AAS	2004 Actual AAS	2005 Revised AAS	2005 Revised A-IFRS	2006 Budget A-IFRS	2007 Estimate A-IFRS	2008 Estimate A-IFRS	2009 Estimate A-IFRS
	(\$ billion)							
Financial assets (excluding Growing Victoria)								
Cash and deposits	0.7	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Advances paid	0.5	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Investments, loans and placements	1.3	3.0	3.0	3.0	2.6	1.7	1.3	1.3
	2.5	4.5	4.3	4.3	4.0	3.1	2.7	2.7
Financial liabilities								
Deposits held	0.2	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Advances received	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Borrowings	7.1	5.5	5.8	5.8	6.4	6.4	6.7	7.2
	7.4	6.0	6.3	6.3	6.9	6.9	7.2	7.7
General government net debt	4.9	1.6	1.9	1.9	2.9	3.9	4.5	5.0
Unfunded superannuation	11.4	11.7	11.0	16.8	17.4	17.8	17.9	17.8
General government net financial liabilities	16.3	13.3	12.9	18.7	20.4	21.6	22.3	22.9
Non-financial public sector net debt ^{(b)(c)}	6.1	3.7	4.4	4.7	6.3	7.3	7.9	8.4
	(per cent)							
General government net debt to GSP	3.3	0.8	0.9	0.9	1.3	1.6	1.8	1.9
General government net financial liabilities to GSP	10.9	6.4	5.9	8.6	8.8	8.9	8.7	8.5
Non-financial public sector net debt to GSP ^{(b)(c)}	4.1	1.8	2.0	2.2	2.8	3.0	3.1	3.1

Source: Department of Treasury and Finance

Notes:

- (a) The Growing Victoria infrastructure reserve is excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.
- (b) Non-financial public sector net debt is the sum of general government net debt plus public non-financial corporations net debt, less inter-sector transactions. As public non-financial corporations data are not available for the years 2006-07 to 2008-09. Net debt for this sector has been assumed to be constant from the year 2005-06.
- (c) The difference between 2005 AAS and A-IFRS is due to an A-IFRS opening balance adjustment resulting from the recognition of \$0.3 billion of finance leases, previously classified as operating leases in the public non-financial corporations sector.

Chart 4.7: General government and non-financial public sector net debt (excluding Growing Victoria) as at 30 June



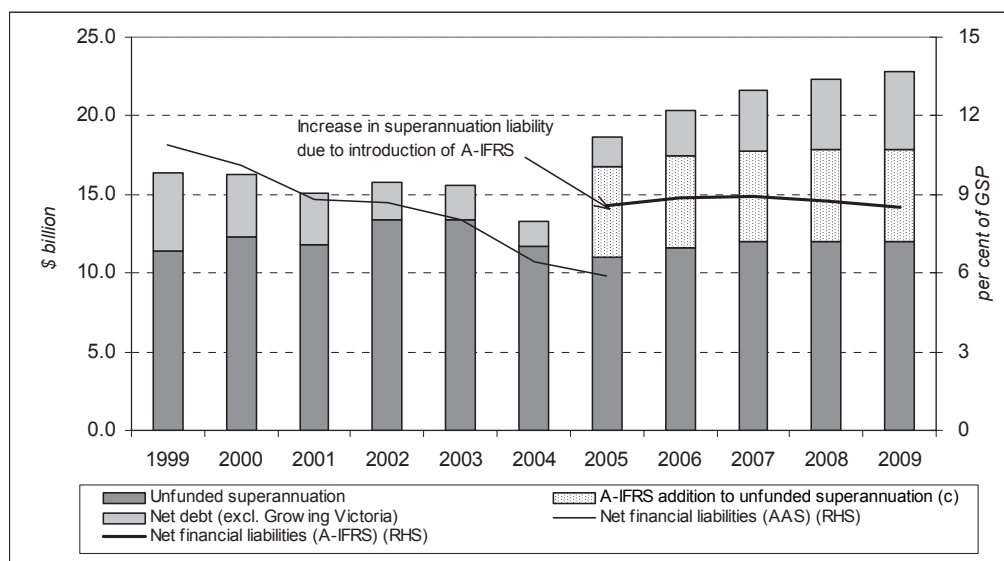
Source: Department of Treasury and Finance

Net financial liabilities

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

Chart 4.8 shows that, as a share of GDP, general government net financial liabilities are projected to decline from 8.6 per cent at June 2005 to 8.5 per cent at June 2009 (A-IFRS basis). Despite being boosted by 2.7 percentage points by the new A-IFRS valuation methodology (in 2005), this ratio is still significantly below the June 1999 figure of 10.9 per cent.

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



Source: Department of Treasury and Finance

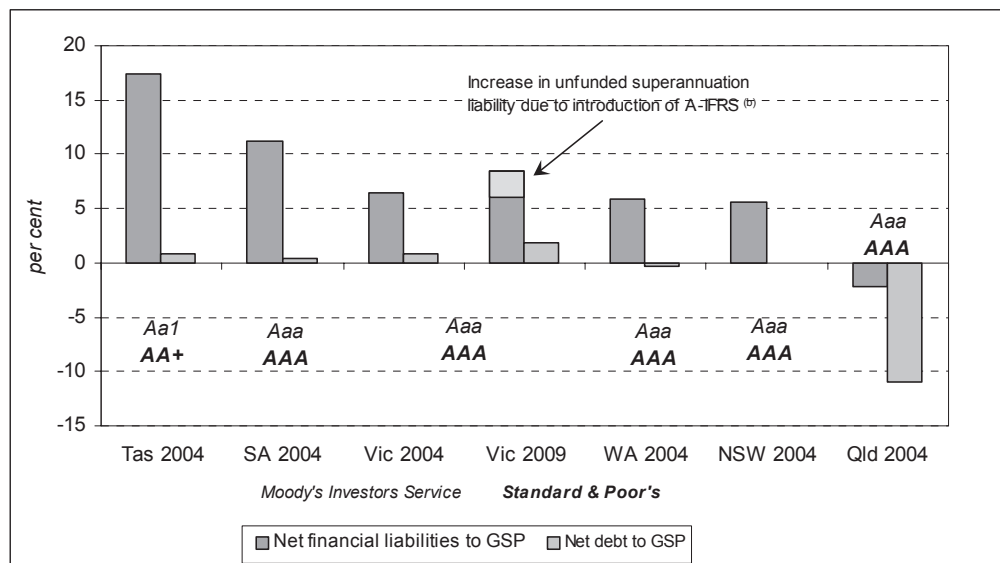
Notes:

- (a) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.
- (b) Net debt is calculated as gross debt less liquid financial assets. Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.
- (c) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liabilities in 2004-05 has also been separately identified in the period 2006 to 2009.

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

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

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



Source: Australian Bureau of Statistics, Department of Treasury and Finance

Notes:

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

CHAPTER 5 – COMMONWEALTH-STATE FINANCIAL RELATIONS

- The Victorian Government is seeking a more collaborative relationship with the Commonwealth, recognising that cooperation between both levels of government is necessary to maximise the opportunities and benefits of taxation and wider economic reform.
- Victoria has been proactive in state tax reform and has now completed the review of taxes under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, with rental business duty being abolished from 1 January 2007 at a full year cost of \$64 million in 2007-08.
- Victoria and New South Wales collectively continue to shoulder an enormous horizontal fiscal equalisation subsidy burden. This year, the subsidy is larger than ever, with a total of \$3.9 billion being redistributed from Victoria and New South Wales to the rest of Australia.
- The fairness of the distribution of GST funds can be assessed by comparing the GST raised within each State, with the GST distributed to each State. On this basis, the shortfall for Victoria in 2005-06 is around \$1.6 billion or \$313 per person, with the State receiving only 83 cents for every \$1 it raises. If unchanged, it is projected that Victoria's subsidy will grow to \$1.9 billion in 2008-09. The continued growth of the subsidy is inefficient and unsustainable.
- Victoria supports the principle of equalisation and redistribution to those states with a narrow economic base. However, States with a substantial financial capacity, such as Queensland, Western Australia and the Australian Capital Territory should at a minimum be able to stand on their own, and as well help support those states in need of assistance. In Victoria's view, despite some progress in establishing a review of horizontal fiscal equalisation, the need for more comprehensive reform remains stronger than ever.
- Commonwealth funding to Victoria has been significantly reduced following the termination of National Competition Policy (NCP) payments from 2006-07. NCP payments to Victoria had averaged around \$200 million a year.

THE NEW COMMONWEALTH-STATE ENVIRONMENT

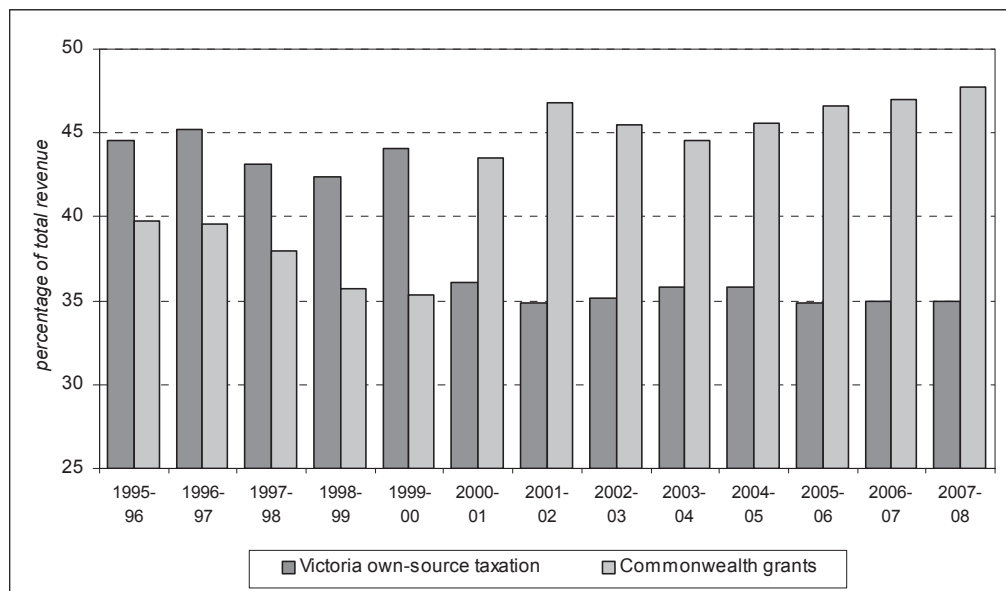
Australia's federal system has major strengths. It decentralises power, enables local decisions to be made at the local level and provides strong incentives for the States to be innovative, efficient and competitive – much stronger incentives than would apply under a centralised, or unitary, system.

There is a wide range of government services where the benefits to the community will not be fully realised when one level of government acts alone. Substantial improvements in these service delivery areas can be achieved only with the cooperation of all levels of government across Australia.

One area where working together is considered important is in reinvigorating the national microeconomic reform agenda. Victoria's contribution to this wider reform agenda is detailed in Chapter 6, *Economic Reform*.

Resolution of other threshold issues, such as a fundamental change to federal financial relations, also requires the cooperation of all Australian governments. This is because Victoria – like the other States – is increasingly reliant on revenue from the Commonwealth. Since the striking down by the High Court of one-sixth of State taxes in 1997, and the introduction of the GST on 1 July 2000, grants from the Commonwealth have grown from 35 per cent of Victoria's revenue to an estimated 45 per cent in 2004-05 (see Chart 5.1). As a result, Victoria now has reduced control over its revenue sources. At the same time, Victoria is experiencing growth in demand for services such as health and education, much of it driven by an ageing population.

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



Source: Department of Treasury and Finance

The aim of the GST taxation reform was to give the States access to a growing revenue source that would provide the financial capacity to meet the community’s demands for services. However, integral to this is the recognition that the GST is provided to States on a completely untied basis and States need to have autonomy in deciding how it is to be spent – be it on improved services, reductions in state taxes or an appropriate mix of the two.

The Victorian Government is seeking a collaborative approach with the Commonwealth Government to deliver sensible longer-term reforms, particularly in health, education and taxation, which are so vital to our future wellbeing.

The Commonwealth, in contrast, is increasingly taking a more unilateral approach, bypassing the States or imposing restrictive conditions on funding.

Policy decisions that only affect interests within a particular State are best made by the Government of that State. This ensures that those interests can be properly heard and represented in reaching the decision. However, where States and the Commonwealth need to work together – for example, on a reform agenda to tackle national problems and meet national challenges – Victoria is committed to working towards a more cooperative federalism.

REVIEW OF STATE TAXES UNDER THE INTERGOVERNMENTAL AGREEMENT

A case in point in relation to cooperative reform is the 2005 Review of State Taxes under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the IGA), which introduced the GST.

When both the Commonwealth and the States and Territories (the States) signed the IGA in 1999, the Commonwealth recognised that the IGA gave the States a secure revenue base to provide essential community services such as roads, police, schools and hospitals. This access to a secure revenue base was why the States were prepared to sign.

The opening pages of the IGA state three objectives:

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

The IGA specified that the States would abolish a number of taxes that were levied in Victoria:

- financial institutions duty, from 1 July 2001;
- stamp duties on quoted marketable securities, from 1 July 2001; and
- bank account debits tax, from 1 July 2005, subject to review by the Ministerial Council.

Victoria abolished both of the taxes scheduled for removal from 1 July 2001 in line with the IGA. Further, it was agreed at the Ministerial Council meeting in March 2004 that all States, including Victoria, would abolish debits tax from 1 July 2005.

Other taxes that applied in Victoria were listed for review in the IGA by 2005. These comprised duty on:

- non-quotable marketable securities;
- leases;
- mortgages, bonds, debentures and other loan securities;
- non-residential conveyances: stamp duty levied on the value of conveyances other than residential property conveyances;
- the price of goods purchased under instalment purchase arrangements; and
- rent paid in respect of the hire of goods, including consumer and produce goods.

At the Ministerial Council meeting in March 2005, the Commonwealth Government put forward a proposal that it would honour its commitments under the IGA to maintain GST revenues, conditional upon the States agreeing to abolish all taxes specified for review by 2007-08.

Under the Commonwealth proposal, the States would abolish stamp duty on business conveyances other than real property, and then review the need to retain stamp duty on business conveyances on real property at a later, yet to be specified, date.

Victoria has been proactive in state tax reform to date having announced removal of almost all of the taxes scheduled for review under the IGA in 2005 ahead of schedule (lease duty from April 2001, duty on unquoted marketable securities from July 2002 and mortgage duty from July 2004).

The 2005-06 Budget also removes rental business duty from 1 January 2007 at a full year cost of \$64 million in 2007-08, following a review under the IGA. With respect to stamp duty on business conveyances of real property, on both administrative and public policy grounds, Victoria does not support having different stamp duty treatment of residential and business property and so has supported retention of stamp duty on business property.

HOW GST FUNDS ARE BEING DISTRIBUTED

Under the IGA, the States receive all Goods and Services Tax (GST) revenue collected by the Commonwealth. The GST revenue is shared between the States on a basis determined by the Commonwealth Grants Commission (CGC), based on the principle of horizontal fiscal equalisation. The system distributes over \$37 billion in GST revenue and represents a significant share of States' overall revenue. For Victoria, GST grants represent about 25 per cent of total revenue.

The CGC attempts to comprehensively equalise the financial capacities of all States based on estimates of their revenue-raising capacities and the cost of providing the full range of state services. The CGC updates its relativities annually to reflect movements in data, with a comprehensive methodology review every five years. The 2005 Update, released in March, was based on application of the methodologies developed by the 2004 methodology review.

Outcomes from the Commission's 2005 Update

Based on the relativities recommended in the 2005 Update, Victoria's GST grant share for 2005-06 will increase by around \$106 million. According to the CGC, the main factor behind Victoria's increased GST grant share was Victoria's reduced capacity to raise revenue from property stamp duty, relative to States such as Queensland and New South Wales.

After gaining a significantly larger share of GST revenue as a result of the 2004 methodology review, Queensland (-\$94 million) and Western Australia (-\$24 million) have lost some of that gain after the 2005 Update. South Australia and Tasmania will also suffer reductions to their grant shares, while New South Wales and the Australian Capital Territory will enjoy increased grant shares in 2005-06.

The burden of the subsidy

Despite the 2005 Update's redistribution of GST funds towards Victoria (and to a lesser extent New South Wales), the subsidy provided by Victoria and New South Wales to the other States is expected to continue growing over the forward estimates period. The continued growth of the subsidy is inefficient and unsustainable.

The fairness of the distribution of GST funds can be assessed by comparing the GST raised within each State, with the GST distributed to each State. On this basis, the shortfall for Victoria in 2005-06 is around \$1.6 billion or \$313 per capita, with the State receiving only 83 cents for every \$1 it raises (see Table 5.1 and Chart 5.2).

Table 5.1: Fiscal subsidy for 2005-06 based on GST raised

	<i>GST revenue CGC distribution</i> ^(a) (\$ million)	<i>GST raised</i> ^(b) (\$ million)	<i>Redistribution compared with GST raised</i> (\$ million) (\$ per capita)	
NSW	10 373.7	12 712.4	-2 338.7	-342.8
Vic	7 827.4	9 412.6	-1 585.2	-313.4
Qld	7 680.8	7 168.2	512.6	127.9
WA	3 806.7	3 400.1	406.6	200.0
SA	3 431.7	2 664.4	767.3	496.6
Tas	1 493.7	787.8	705.9	1 448.4
ACT	719.1	702.3	16.8	51.5
NT	1 826.9	312.1	1 514.7	7 434.5
	37 160.0	37 160.0		

Source: Department of Treasury and Finance

Notes:

(a) Relativities recommended by the CGC's 2005 Report on Revenue Sharing Relativities.

(b) Australian Bureau of Statistics Catalogue No. 5206.0.

Chart 5.2: Fiscal subsidy for 2005-06 based on GST raised



Source: Department of Treasury and Finance

Notes:

- (a) Relativities recommended by the CGC's 2005 Report on Revenue Sharing Relativities.
- (b) Australian Bureau of Statistics Catalogue No. 5206.0.

Victoria and New South Wales collectively continue to shoulder an enormous subsidy burden. This year, the subsidy is larger than ever, with a total of \$3.9 billion being redistributed from Victoria and New South Wales to the rest of Australia.

The amount being redistributed continues to grow substantially. Between 2001-02 and 2005-06, Victoria's subsidy to the other States based on the amount of GST raised has increased by 11 per cent to \$1.6 billion. It is projected that Victoria's subsidy will continue to grow to \$1.9 billion in 2008-09, if the current unsustainable arrangements are maintained.

REFORM OF HOW GST REVENUE IS SHARED BETWEEN THE STATES

Victoria has long held the view that the current system of sharing GST revenue between the States is too complex, relies heavily on dubious data and methodologies and creates perverse incentives and negative efficiency effects. Given this, Victoria has consistently taken the lead in pushing for significant reform.

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

Following the conclusions in the CGC's own 2004 review that it had 'serious concerns' about the data it used, and that it was not clear that the level of detail actually produced a better equalisation outcome, Victoria gained support from the Commonwealth and the majority of the State Treasurers for a Treasuries' review of the current approach to equalisation. While the terms of reference were very narrow (for example, they excluded the examination of the underlying principles of equalisation) they went some way in reviewing key aspects of the system.

The review, which was overseen by Heads of Treasuries, considered:

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

The review findings were considered at the meeting of the Commonwealth and State Treasurers in March 2005. The findings reinforced Victoria's view regarding shortcomings of the data used in the current system, the lack of transparency and the need to improve the robustness of decisions.

Changes in methodology following five-yearly CGC reviews have added to complexity, increased reliance on poor quality data and had major impacts on grants shares, but there is no evidence that these have resulted in better equalisation outcomes. Further, there are perverse incentives operating between jurisdictions and the CGC that lead to ever more complexity and more data intensive assessments.

Of the large number of assessments that are used in the system, approximately half distribute less than \$5 million; in addition, the small assessments tend to benefit certain states, particularly the Northern Territory. The Northern Territory has unique characteristics and this contributes another layer of complexity as the CGC attempts to ensure equalisation between the States.

Based on its investigations, the review found that there are four options for simplification which deserve further close consideration by the CGC:

- aggregating categories;
- applying materiality thresholds;
- adopting indicators of revenue capacity and expenditure need; and
- eliminating unreliable category assessments.

Further, the Heads of Treasuries concluded that the CGC's present approach could benefit from a program of simplification.

All of the State, Territory and Commonwealth Treasurers accepted in full the recommendations of the review at their meeting in March 2005. The outcomes are to be implemented through the terms of reference for the next methodology review by the CGC (the 2010 Review). In undertaking the review, the CGC will:

- simplify its assessments;
- address issues relating to quality and fitness for purpose of data and methodology; and
- develop mechanisms to maintain simplification and improve quality assurance processes.

The CGC will report back to future Commonwealth and State Treasurers meetings on progress made against the terms of reference set by the Treasurers and on actions it will undertake. This should build on the shortcomings identified by the heads of treasuries in their report to Treasurers.

Victoria will be vigilant in holding the CGC to account on implementing the outcomes of the review. Additionally, in Victoria's view, despite some progress in establishing a review of horizontal fiscal equalisation, the need for more comprehensive reform remains stronger than ever. For example, the abolition of further state own-source revenue streams following reviews under the IGA exposes a higher proportion of state revenues to the vagaries of the CGC's distribution process.

Victoria supports the principle of equalisation and redistribution to those states with a narrow economic base. However, states with a substantial financial capacity, such as Queensland, Western Australia and the Australian Capital Territory should at a minimum be able to stand on their own, and as well help support those states in need of assistance.

Victoria considers that there should be a high burden of proof, based on quality data, to justify disabilities. Victoria is concerned that the assessment of disabilities associated with small-scale, rural and remote services, and indigenous populations appear to rely on a high degree of judgement. This compares with the treatment of disabilities experienced by larger states associated with communities from non-English speaking backgrounds and with low English fluency, and the costs of maintaining urban arterial roads and providing public housing.

NET IMPACT OF GRANTS ON VICTORIA'S FINANCIAL POSITION

GST grants

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

Victoria required transitional grants until 2003-04, but with stronger growth in GST revenue than previously forecast, no payments were required in 2004-05 (see Table 5.2). However, in 2005-06, following the removal of debits tax and the potential removal of other state taxes as proposed at the 2005 Ministerial Council meeting, Victoria's GST revenue share is only marginally above the level where GST transitional grants would be required. As a result, any minor adverse change in GST revenue or in revenues forgone will lead to Victoria again requiring GST transitional grants.

In addition, the increasing reliance on GST revenue whilst favourable in terms of longer-term revenue buoyancy, does introduce a new source of volatility into Victoria's annual budget estimates.

Table 5.2: Impact of the GST on the Victorian budget

	(\$ million)				
	2004-05	2005-06	2006-07	2007-08	2008-09
	Revised	Budget	Estimate	Estimate	Estimate
Change in revenue					
GST revenue ^(a)	7 362.4	7 854.9	8 261.2	8 695.8	9 147.4
Growth dividend ^(b)	79.3	96.2	112.3	126.8	143.2
Financial institutions duty ^(b)	- 410.2	- 422.6	- 435.4	- 448.5	- 462.1
Debits tax ^(b)		- 257.8	- 283.9	- 286.7	- 289.5
Marketable securities ^(b)	- 250.7	- 265.8	- 281.8	- 298.8	- 316.8
Gambling taxes	- 416.7	- 438.3	- 462.9	- 460.9	- 458.9
Safety net revenues	-1 769.3	-1 824.7	-1 879.0	-1 937.3	-1 998.2
Off-road diesel rebate	60.1	61.3	62.4	63.5	64.7
Financial assistance grants forgone	-4 105.8	-4 331.4	-4 476.4	-4 633.0	-4 793.4
Total change in revenue	549.1	471.8	616.5	820.9	1 036.4
Change in expenditure					
First Home Owner Grant	252.1	269.3	270.8	272.3	273.8
Reimbursement of ATO administration costs	143.9	146.9	150.0	152.9	155.7
Total change in expenditure	396.0	416.2	420.8	425.2	429.5
Net budget impact prior to adjustments	153.1	55.6	195.7	395.7	606.9
End of year adjustments	- 17.1				
Add: Embedded tax savings ^(b)	131.5	140.5	154.2	164.5	175.5
Net budget impact prior to Commonwealth transitional guarantee	267.5	196.1	349.9	560.2	782.4

Source: Department of Treasury and Finance

Notes:

- (a) These estimates differ from those in Table 5.1 due to the inclusion of Commonwealth small business compensation arrangements.
- (b) These estimates were agreed in 1999 and will not be subject to further negotiation with the Commonwealth.

National Competition Policy payments

Victoria will no longer be receiving National Competition Policy (NCP) payments from 2006-07 after the Commonwealth Government's decision last year to end the NCP arrangements. NCP payments to Victoria had averaged around \$200 million a year.

The Victorian Government supports the application of the NCP model to other key areas of reform as it was highly successful in achieving its objectives. The institutional arrangements that underpinned the success of NCP would be a crucial element of any new reform agenda. In this regard, it is noted that the acting president of the National Competition Council has recently placed on the public record his view that three main attributes needed for the successful implementation of wide-scale microeconomic reform are:

- a formal and binding commitment by Commonwealth and state governments to a reform agenda;
- an independent agency to monitor and assess governments' performance against those commitments; and
- financial incentives for governments to advance reforms, including financial penalties for failure to meet commitments.

The Victorian Government is committed to an ongoing process of microeconomic reform, and as such, considers that this can best be achieved in cooperation with the other States and the Commonwealth, in a similar way to what occurred with the NCP arrangements.

Specific purpose payments

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

The Commonwealth has recently been linking SPP funding to a range of conditions such as implementation of the Commonwealth's industrial relations policy framework. The Commonwealth is insisting that all SPPs with a significant capital component be subject to its Code of Practice for the Construction Industry and the Commonwealth Government's Implementation Guidelines. The States are concerned at this unnecessary intrusion of the Commonwealth's industrial relations policy into areas of state responsibility and the use of SPP funding to try to achieve this.

Another issue of significant concern to the States has been the recent tendency for the Commonwealth to attempt to bypass the States in areas of traditional state responsibility. For example, the Commonwealth recently announced that it would bypass the States and set up its own technical education colleges.

The Victorian Government believes that it is in the national interest that SPP agreements are negotiated in a cooperative and constructive manner rather than on a unilateral basis by the Commonwealth.

In 2005-06, it is estimated that SPPs to Victoria will be about \$4.2 billion. Victoria's share of SPPs is approximately \$300 million less than the amount Victoria would receive if SPPs were distributed on an equal per capita basis. The Victorian Government does not believe that this is a fair distribution by the Commonwealth and it adds to the grossly unfair distribution of GST revenue away from Victoria.

A summary of the total grants provided to Victoria is shown in Table 5.3.

Table 5.3: Summary of Commonwealth grants

	(\$ million)				
	2004-05 <i>Revised</i>	2005-06 <i>Budget</i>	2006-07 <i>Estimate</i>	2007-08 <i>Estimate</i>	2008-09 <i>Estimate</i>
GST grants	7 362.4	7 854.9	8 261.2	8 695.8	9 147.4
National Competition Payments	201.6	195.5	0.0	0.0	0.0
Specific purpose payments to the State	3 919.6	4 186.1	4 293.4	4 377.7	4 548.5
Specific purpose payments for on-passing	1 704.7	1 818.6	1 934.0	2 043.1	2 159.9
Other	177.4	207.0	244.6	147.2	136.2
Total grants	13 365.7	14 262.1	14 733.2	15 263.8	15 992.0

Source: Department of Treasury and Finance

CHAPTER 6 – ECONOMIC REFORM

- The last decade has seen improvements in productivity due to Victoria's wide-ranging economic reform, which has enhanced the competitiveness, openness and flexibility of the Victorian economy.
- Victoria has enjoyed a period of sustained economic growth. Over the past ten years, Victoria's annual economic growth rate was around 3.9 per cent, considerably above the rate in comparative overseas economies.
- In the longer term, the Victorian economy faces major challenges that, if ignored, threaten to spell the end of the long boom – slower productivity growth, increased international competition and fewer people participating in the labour force.
- The Victorian Government has formulated a plan for further reform built around ensuring a best practice business environment, delivering world-class infrastructure, boosting workforce participation, improving Commonwealth-State relations and continued strong population growth.

In this chapter, options for further economic reform are explored. Drawing on material presented in earlier chapters, the positive influence of past economic reform on Victorian economic performance is noted. Some important economic challenges which underpin the need for further reform are explained. The budget is part of the Victorian Government's strategy of further reform. A five-point agenda outlining the reform strategy is presented.

ECONOMIC CHALLENGES FOR THE FUTURE

The Victorian economy faces significant challenges associated with increased global competition, population ageing and a potential slowdown in the long-term rate of productivity growth. The Victorian Government is committed to maintaining its leadership role in tackling these issues at the state level by maximising Victoria's economic performance and maintaining economic growth.

Economic reforms and increases in investment have boosted growth

Recent Victorian reforms have led to a strong economy, with more jobs, more skills, more capital, more buildings, and more people. Over the past five years, Victorian growth has only been surpassed by Western Australia and Queensland, and these States have benefited from recent large increases in demand for resources and buoyant commodity prices. Victorian growth has been even more remarkable because, with a mature industry structure, it has been evenly distributed across all sectors.

Victoria's economy has been consistently strong in comparison to world standards, and current expectations are for continued performance above the OECD average. It has been particularly impressive given the global environment and relatively weak performance of some of our major trading partners.

Victoria had the largest increase in the number of employees in Australia during 2004. Strong participation growth has generated a growing pool of workers to satisfy the strong demand from growing Victorian industries. The current workforce participation rate for Victorian residents over the age of 15 is around 65 per cent, the highest since 1990.

Nevertheless, international competition is likely to intensify, particularly for manufactured goods. As China has increasingly dominated world trade in manufactured goods, Victorian firms will need to be able to take advantage of the opportunities and, to some extent, move into more high value areas. Government policies in science, research and development and innovation are fostering these adjustments.

Victoria's leadership in microeconomic and structural reform has been a catalyst for strong Victorian performance. Reforms have been undertaken in competition and regulation policy and in taxation, and investment in human capital and infrastructure has been increased.

Competition and regulation policy

Victoria has played a leading role in reform under the NCP. The following have been achieved:

- structural reform of infrastructure services and government monopolies, together with related pricing reforms;
- prices oversight in key industries such as electricity, gas and water through the independent Essential Services Commission; and
- competitive neutrality policy has been implemented by all state and local government bodies.

Victoria has largely completed its agreed reform agenda under the NCP guidelines. In 2003 and 2004, the National Competition Council noted that Victoria had out-performed all other Australian jurisdictions, reforming 84 per cent of priority legislation and 85 per cent of non-priority legislation under the NCP.

The Productivity Commission has recently noted substantial economic gains from actions associated with the NCP. Modelling undertaken by the Department of Treasury and Finance suggests Victoria accounts for more than one third of national gains arising from implementing the NCP. When fully realised, the reforms will lead to at least a 2 per cent increase in Victorian gross state product and a 1.5 per cent increase in Australian gross domestic product.

Examples of some recently-announced or completed reforms include:

- deregulation of farm gate prices for market and manufactured milk has seen consumer prices fall, rationalisation in the farm and processing sectors, a higher level of specialist production of dairy products, and a larger range of choice for consumers;
- the removal of all restrictions on the sale, delivery and purchase of barley for domestic stockfeed purposes has facilitated greater grower choice, investment, innovation and marketing;
- the implementation of a pro-competitive package of liquor licensing reforms in a supportive transitional environment has enabled small businesses to adapt and improve their capacity to compete in the future; and
- the White Paper, *Saving our Water Future*, announced the Government's intention to separate water entitlements from land, simplify the entitlement structure and reduce constraints to trade, in order to enhance the water trading market in northern Victoria and provide Victorian agricultural industries with the capacity for further growth.

Business costs

There have also been major reforms to reduce business costs. These include:

- the reduction of 10 per cent in the WorkCover average premium in 2004-05 to be followed by a further 10 per cent reduction in 2005-06, with the average rate reduced to 1.8 per cent in 2005-06. The cumulative effect of these reductions is that employers will save about \$350 million that they would otherwise have paid in premiums in 2005-06 and in each future year;
- reductions in the average payroll tax rate of 9 per cent (from 5.75 per cent to 5.25 per cent) and an increase in the payroll tax threshold from \$515 000 to \$550 000 so that Victoria now has the second lowest payroll tax rate in Australia;

- significant land tax relief in this and last year's budgets, including an increase in the land tax threshold from \$85 000 to \$200 000, upward adjustment of thresholds in land tax brackets between \$675 000 and \$1 080 000 and reduction of the top rate from 5 per cent to 4 per cent to be phased down to 3 per cent by 2007-08; and
- abolition of taxes included under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Arrangements* as discussed in Chapter 5, *Commonwealth-State Financial Relations*. Duty on non-residential leases, financial institutions duty, duty on marketable securities, duty on unquoted marketable securities and duty on mortgages have been abolished, and bank account debit tax will be abolished on 1 July 2005 while rental business duty will be abolished from July 2007.

The reduction in business costs resulting from these reforms has stimulated business investment and will drive economic growth over the next decade.

Investment

Government infrastructure investment has helped Victoria avoid the development of serious bottlenecks that would otherwise constrain Victorian production. As discussed in earlier chapters (particularly Chapter 1, *Financial Policy Objectives and Strategy*), Victorian government investment has roughly doubled since the mid-1990s, and is expected to average \$2.6 billion a year over the period to 2008-09. Over the last three years, the Victorian Government has lifted the share of general government expenditure devoted to investment by three percentage points.

In addition, private investment has been fostered and new business investment grew by 11 per cent during 2004. Currently, more than \$11 billion of major projects are being delivered across the State as part of the Government's *Linking Victoria* program. These projects create employment, investment, manufacturing and contracting opportunities throughout Victoria for industry and businesses of all sizes.

The Victorian Government has been a major supporter of research infrastructure, most notably the Australian Synchrotron. Victoria's leadership in research and development has led to a larger base to support industry and a growing pool of highly-skilled researchers. Victoria's skilled and highly educated workforce has meant that firms have the appropriate workforce to generate sustainable growth. Investments in research and development have included:

- an Innovation Agenda commitment in excess of \$900 million;
- \$120 million investment through Science, Technology and Innovation Competitive Infrastructure Grants;
- funding of just over \$100 million has been provided for the Energy Technology Innovation Strategy;

- the 2004 Biotechnology Plan – which builds on an original strategy to make Victoria a top five biotechnology location by 2010 and includes a feasibility study to establish a National Biosecurity Centre;
- major support of the Australian Synchrotron – Australia’s only leading-edge research and development facility of its type; and
- new technology clusters including the Defence and Aerospace Cluster Company and the Australian Small Technologies Alliance.

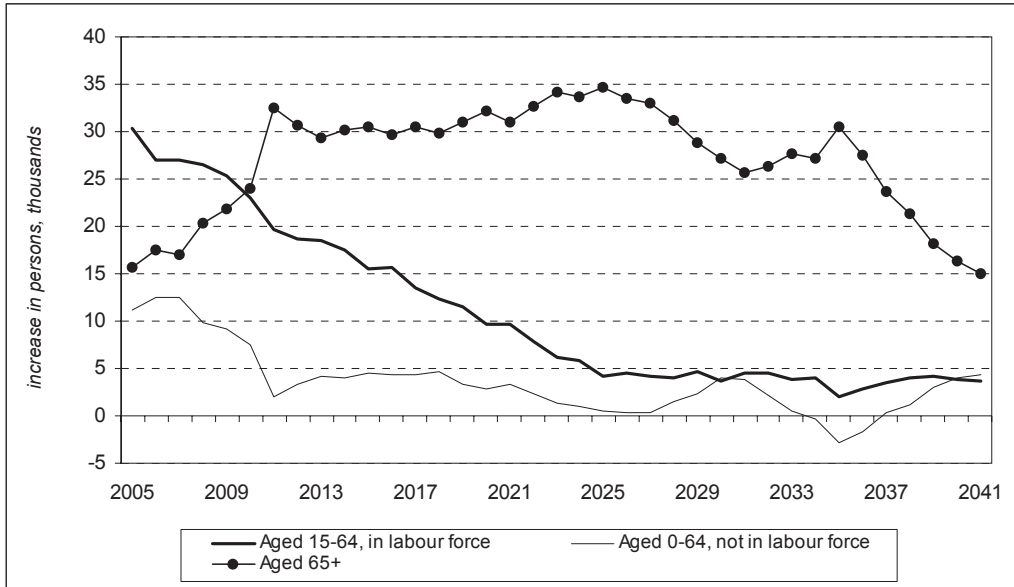
Challenges ahead

As globalisation continues, the world economy is becoming more competitive. There is a fundamental shift at work as internationalisation of production processes means countries with low labour costs and large workforces – such as China, India and the Asian Tiger economies – are now able to reach and dominate new markets, such as high volume manufacturing and data processing services. The impetus from this competition is likely to lead to further growth of high value added goods and services and further industry specialisation.

Population ageing is also a critical challenge. Increased longevity combined with low fertility rates will lead to a shrinking working-aged population for Victoria and Australia as a whole. Population ageing will inevitably reduce the proportion of the population participating in the labour force unless there are significant changes in age-specific patterns of labour force participation.

Since older people have lower rates of labour force participation, overall participation rates are set to decline as the proportion of older people in the population increases. Demographic projections (Chart 6.1) show a decline in the growth of the labour force from about 30 000 persons a year now, to about 80 000 for the entire 2020s (around 8 000 a year). The projections show that, over much of the period to 2040, the number of aged dependants will increase by around 30 000 a year.

Chart 6.1: Projections of growth in population by age and workforce status, Victoria

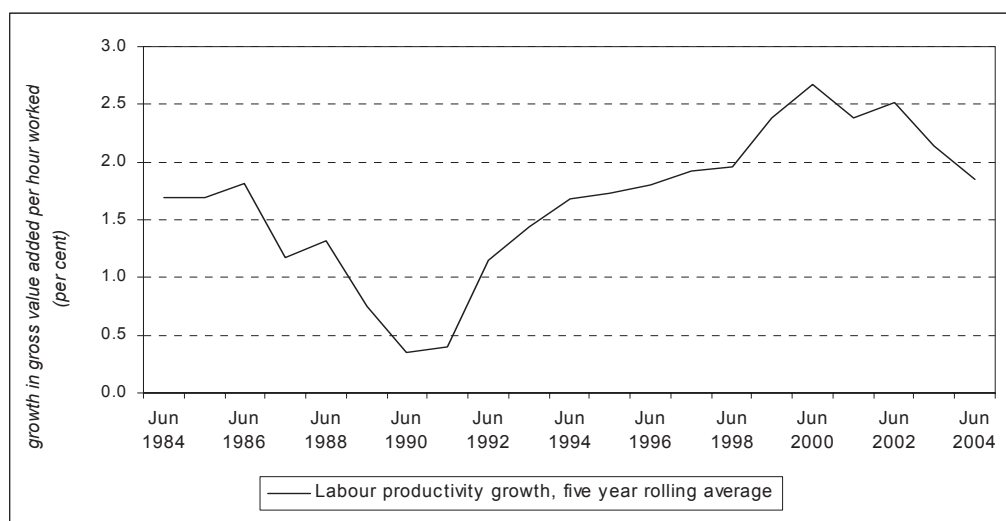


Source: Department of Treasury and Finance

On current population projections, and assuming no change in behaviour or unemployment, the declining participation rate will reduce Victoria’s average rate of economic growth by about half a percentage point. For instance, with unchanged labour productivity growth, falling participation would lead to a reduction in gross state product from around 3.5 per cent in recent years, to closer to 3 per cent after 25 years.

In the more immediate future, Victoria (and Australia) may also need to deal with lower rates of long-term productivity growth. In Australia, labour productivity growth measured by output per hour worked has averaged over 2 per cent over the last ten years, but closer to 1 per cent over the previous ten years (Chart 6.2). A return to historical rates of labour productivity growth would lead to significant falls in economic growth.

Chart 6.2: Smoothed annual average growth in labour productivity



Source: ABS Catalogue Number 5204.0 (Labour productivity) and calculations by Department of Treasury and Finance

A new reform agenda

The Government's strategy to meet these challenges emphasises the following:

- **Ensure a best practice business environment** – The Government will ensure a competitive environment for Victorian business, including a best practice approach to business regulation and use of new economic tools to better assign property rights so markets can be defined and private organisations provided with incentives to invest.
- **Deliver world-class infrastructure** – Victoria has a well-developed transport, communications and energy network and a sound knowledge and health base which deliver a major competitive advantage to Victorian business and a high standard of living for Victorians. The Government will continue to build on this base to provide the strongest possible path for the future.
- **Boost workforce participation** – The Government aims to help every person to realise their capacity to participate socially and economically. This will help avoid a future with a relatively smaller workforce supporting a larger dependent population.
- **Grow our population** – The Victorian Government has a vision for growing Victoria's population in an economically, socially and environmentally sustainable manner. One ingredient towards this end and a more prosperous future is attracting more skilled migrants, particularly to Provincial Victoria.
- **Reform Commonwealth-State relations** – Reform of Commonwealth-State arrangements is necessary to realise the full benefits of Australia's federal system.

Ensure a best practice business environment

Victorian businesses will work best when they are unfettered by unnecessary regulation. The Victorian Competition and Efficiency Commission (VCEC) was established by the Victorian Government to drive further regulation reform and a 'best practice' approach where regulation is in the public interest. This will further reduce business costs and improve Victoria's competitiveness. During 2004-05, VCEC handed down its first report into regulatory barriers in regional Victoria, and is currently conducting a second inquiry into regulatory barriers in housing construction.

The new tax initiatives and further reduction in WorkCover premiums discussed in Chapter 1, *Financial Policy Objectives and Strategy*, will reduce costs for business.

Both the OECD in its 2004 *Economic Survey of Australia*, and the Productivity Commission in its final report, *Review of National Competition Policy Reform*, have urged further microeconomic reform. The Productivity Commission has identified a number of further areas for reform that need to be included in a new program with common governance and monitoring arrangements. These include:

- strengthening the operation of the national electricity market;
- building on the National Water Initiative to enhance water allocation and trading regimes and to better address negative environmental impacts;
- developing coordinated strategies to deliver an efficient and integrated freight transport system;
- addressing uncertainty and policy fragmentation in relation to greenhouse gas abatement policies;
- improving the effectiveness and efficiency of consumer protection policies; and
- introducing a more targeted legislation review mechanism, while strengthening arrangements to screen any new legislative restrictions on competition.

However, as outlined in Chapter 5, *Commonwealth-State Financial Relations*, a number of important issues need to be resolved to enable Victoria's involvement in national reforms to promote productivity. These include:

- resolution of the existing NCP agenda;
- consideration of financial arrangements between the Commonwealth and the States;
- future reforms to be based on a credible case for reform, with demonstrated net benefits to the community;
- institutional arrangements and guidelines agreed by the Council of Australian Governments; and
- reforms to reflect future challenges, such as population ageing and environmental sustainability.

Deliver world-class infrastructure

Over the past few years, the Victorian Government has markedly increased investment in social and economic infrastructure. Chapter 1, *Financial Policy Objectives and Strategy*, recalls some of these past investments and Chapter 4, *Balance Sheet Management and Outlook*, describes measures in the current budget. Chapter 4 also describes the delivery processes that ensure Government infrastructure investment is made within ‘best practice’ risk management approaches.

However, the commitment to world-class infrastructure is broader than government provision. A major part of infrastructure investment is drawn from the private sector, so encouragement and facilitation of private sector participation – by, for instance, allocating appropriate property rights – is a key role. Two matters of particular relevance are:

- use of public-private partnerships – these can result in better risk sharing around infrastructure provision, better management of infrastructure projects and taking advantage of private sector expertise; and
- improvement of access arrangements between upstream and downstream firms within a network industry – poorly defined access arrangements can limit the extent to which firms will invest.

Boost workforce participation

Labour force participation rates need to be boosted in the face of pressure from an ageing population. If current rates of participation for age and gender groups are only maintained over time, population-wide participation (persons aged 15 and older) is likely to fall from about 65 per cent currently to 54 per cent over the next four decades.

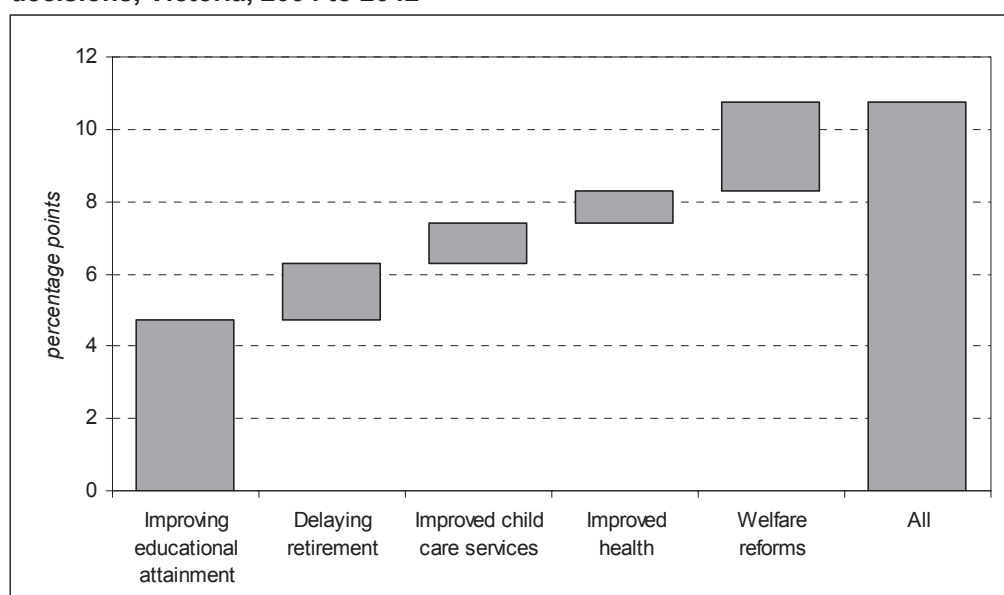
While some of the main policy instruments available are Commonwealth responsibilities (pensions, superannuation and income tax), states can also make a major contribution by improving education outcomes, by improving their record as employers, and by encouraging a favourable regulatory environment.

Work undertaken by the Department of Treasury and Finance suggests completion of year 12 or its equivalent is the single largest positive influence on participation, although participation increases with every increment of education. Depending on qualification, age and gender, participation was raised by between 1 and 13 percentage points for additional years of education or additional qualifications. The marginal effects of health were found to be more modest than those of education; attaining good health raises participation rates, but by less than 1 percentage point for men and by around 2 percentage points for women.

More broadly, a range of policies will be needed to maintain participation rates. Chart 6.3 illustrates how the aggregate participation might be maintained by action in relation to five areas of reform:

- improving educational attainment;
- delaying retirement;
- improved child care services;
- improved health; and
- welfare reforms.

Chart 6.3: Projected increments in aggregate participation from policy decisions, Victoria, 2004 to 2042



Source: Department of Treasury and Finance

The State is also a leading employer and regulator. In these roles, a number of key principles can be applied to encourage labour force participation:

- allowing greater labour market flexibility – for example, through flexibility in employment options, family-friendly policies and practices that help parents with family responsibilities to remain active in the workforce;
- supporting older workers to continue working or return to work, improving career pathways for older workers, and targeting discriminatory employment practices;

- promoting good occupational health and safety outcomes (without limiting the flexibility of working arrangements); and
- ensuring regulation of child care does not reduce the number of child care places, and therefore prevent those parents who wish to access child care and return to work from doing so.

Continue strong population growth

Historically, migration has played a major part in Victoria's population growth. In addition to creating a multicultural and tolerant society, it has been one of the key underpinnings of Victoria's economic growth and prosperity.

In December 2004, the Victorian Government released its population policy. The Government's vision is for the Victorian population to grow in an economically, socially and environmentally sustainable manner. A key objective is '*to maintain and build on our current levels of migration attraction of 25 per cent of the Australian total skilled migrant intake*'.

Skilled migration is one of the key policy levers that could be used more effectively to manage the impacts of an ageing population. It can boost Victoria's productivity and economic growth if migrants possess skills that are in short supply (especially in Provincial Victoria), and have a younger age profile.

In a recent study commissioned by the Commonwealth Department of Immigration and Multicultural and Indigenous Affairs, modelling estimates of the longer-term economic impact of migration were reported. The study found that, even by conservative estimates, maintaining our current levels of migration over the next 20 years would add 2 per cent to living standards in Victoria. This improvement would be driven by significant gains in labour productivity and labour force participation resulting from skilled migration.

Improve Commonwealth-State relations

Chapter 5, *Commonwealth-State Financial Relations*, outlines the advantages of Australia's federal system of governance. However, these advantages depend on the development of mutually beneficial arrangements for disbursement of Commonwealth revenue and sharing of expenditures. Dialogue needs to be initiated with other states and the Commonwealth to work together on options to improve financial relations leading to better service delivery.

Health and education, two key areas of service delivery, involve overlapping jurisdictional responsibilities that are impeding economic reform. Education and training activities play a critical role in improving workforce productivity and participation and thereby facilitating economic growth. Health expenditures present the primary fiscal pressure on Victoria over coming decades, driven by population ageing, rising community expectations and the cost of new health technologies. The Victorian Government is committed to building upon the significant improvements in resource use and productivity that have been witnessed in recent years. However, the ability of the States to continue to make these improvements in a fair and responsible manner will depend in part on constructive arrangements with the Commonwealth.

CHAPTER 7 – STATEMENT OF RISKS

- The budget projections are sensitive to a number of upside and downside risks (both economic and fiscal) and contingent assets and liabilities.
- The major risks to the Victorian economic projections include rising interest rates, the strong Australian dollar and high oil prices and, on the positive side, continued strength in housing activity.
- Contingency provisions within the budget provide general protection against fiscal risks, including increased demand for government services.
- A number of contingent assets and liabilities have been identified, in particular relating to the public transport rail agreements.

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

ECONOMIC RISKS

The main risks to the Victorian economic projections stem from prospective financial market developments, including movements in interest rates, the Australian dollar and the price of crude oil. In addition, reports of growing capacity constraints in the economy, including skilled labour shortages, have the potential to contribute to higher inflation and interest rates.

The Reserve Bank raised interest rates by 25 basis points in March 2005, to 5.5 per cent, the first increase in the official cash rate since December 2003. Following the increase in rates, and comments from the Bank about growing inflation pressures, financial markets are anticipating an additional 25 basis point increase in the cash rate in the near term. Given relatively high debt levels in the household sector, a larger increase in rates could place some pressure on the growth forecast over the coming year.

There have been growing reports of capacity constraints in certain sectors of the Australian economy; in particular, shortages of skilled labour have been reported in several industries, notably construction. With many businesses operating near capacity, there is a risk that shortages of skills and materials will contribute to higher costs, which could push inflation above the Reserve Bank's medium-term target

range of 2 to 3 per cent. Such a scenario could see interest rates rise above the profile expected by financial markets, which would put pressure on the medium-term growth forecast and prospects for the real estate market. The Reserve Bank has noted faster growth in producer prices, including in the construction sector, in the second half of 2004.

The Australian dollar continues to trade at high levels, extending the broad upward trend seen over the past few years. The strength in the currency appears to reflect numerous factors, including Australia's rising terms of trade, relatively high interest rates (by global standards) and concern over the size of the US current account deficit, which has caused the US dollar to weaken. Further increases in the terms of trade could place upward pressure on the exchange rate. Although a positive for the inflation outlook, continued strength in the Australian dollar could threaten returns to Victorian farmers, manufacturers, local tourism and firms exposed to import competition.

On the international front, the US economy recorded strong growth last year, continuing the recovery from the 2001 slowdown. The economy appears to have reasonable momentum, although analysts expect more moderate growth outcomes over the next two years due in part to higher interest rates. The main risks to the US outlook stem from the record high current account deficit, and some signs of emerging inflation pressures. Both scenarios could result in higher interest rates in the US than are currently anticipated by financial markets, with implications for the global economic outlook. Weaker growth in Victoria's major trading partners could negatively affect the projections for exports and economic growth.

The price of crude oil has remained at persistently high levels, and has revisited the peaks seen in October 2004. Financial markets are expecting the oil price to remain broadly steady over the coming year. If the current high oil price is sustained or rises further, this would likely have some effect on both growth and inflation projections for 2005-06.

On the positive side, continued strength in dwelling construction represents an upside risk to the economic outlook. The housing sector has been surprisingly resilient, partly reflecting increases in Victoria's population growth rate (driven by higher international migration).

Sensitivity analysis

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

To assess sensitivity to change, the level of the economic indicator in each case is permanently increased by one percentage point in the first year above the forecast growth rate and then allowed to grow at the forecast rate. It is assumed during the analysis of each indicator that all other indicators follow their forecast growth rates.

Table 7.1: Impact on the general government operating surplus of a one percentage point increase in selected economic indicators in 2005-06^{(a)(b)}

	(\$ million)			
	2005-06 Estimate	2006-07 Estimate	2007-08 Estimate	2008-09 Estimate
GSP				
Taxes, regulatory fees and fines	34	36	37	39
Other income ^(c)	98	109	120	132
Superannuation expenses	..	..	..	..
Other expenses	..	..	1	2
Net result from transactions	132	145	156	169
Superannuation - actuarial gains (losses)	..	..	..	..
Net result	132	145	156	169
Employment				
Taxes, regulatory fees and fines	32	33	35	36
Other income ^(c)	1	3	5	7
Superannuation expenses	..	..	..	..
Other expenses	..	..	..	..
Net result from transactions	33	36	40	43
Superannuation - actuarial gains (losses)	..	..	..	..
Net result	33	36	40	43
Consumer prices				
Taxes, regulatory fees and fines	44	46	47	49
Other income ^(c)	163	173	177	176
Superannuation expenses	..	6	6	7
Other expenses	38	183	187	183
Net result from transactions	168	30	31	36
Superannuation - actuarial gains (losses)	-121	..	..	..
Net result	47	30	31	36
Average weekly earnings				
Taxes, regulatory fees and fines	32	33	35	36
Other income ^(c)	-13	-12	3	5
Superannuation expenses	..	17	18	19
Other expenses ^(d)	..	..	..	..
Net result from transactions	18	4	20	22
Superannuation - actuarial gains (losses)	-167	..	..	..
Net result	-149	4	20	22
Domestic share prices				
Taxes, regulatory fees and fines	..	..	..	..
Other income ^(c)	5	5	1	1
Superannuation expenses	..	-3	-3	-3
Other expenses	..	..	..	..
Net result from transactions	5	8	4	4
Superannuation - actuarial gains (losses)	52	..	..	..
Net result	57	8	4	4

Table 7.1: Impact on the general government operating surplus of a one percentage point increase in selected economic indicators in 2005-06^{(a)(b)}
(continued)

	(\$ million)			
	2005-06	2006-07	2007-08	2008-09
	Estimate	Estimate	Estimate	Estimate
Overseas share prices				
Taxes, regulatory fees and fines	..	..	..	..
Other income ^(c)	4	4	..	..
Superannuation expenses	..	-1	-1	-1
Other expenses	..	..	..	..
Net result from transactions	4	5	1	1
Superannuation - actuarial gains (losses)	12	..	..	..
Net result	16	5	1	1
Property prices				
Taxes, regulatory fees and fines	29	29	47	49
Other income ^(c)	2	4	5	8
Superannuation expenses	..	-1	-1	-1
Other expenses	..	..	..	..
Net result from transactions	31	34	53	58
Superannuation - actuarial gains (losses)	9	..	..	..
Net result	40	34	53	58
Property volumes				
Taxes, regulatory fees and fines	20	21	22	23
Other income ^(c)	2	3	3	4
Superannuation expenses	..	..	..	..
Other expenses	..	..	..	..
Net result from transactions	22	24	25	27
Superannuation - actuarial gains (losses)	..	..	..	..
Net result	22	24	25	27
Interest rates ^(e)				
Taxes, regulatory fees and fines	..	..	..	..
Other income ^(c)	77	80	41	43
Superannuation expenses	..	5	16	28
Other expenses	..	5	9	13
Net result from transactions	77	70	16	2
Superannuation - actuarial gains (losses)	2856	..	..	..
Net result	2933	70	16	2

Source: Department of Treasury and Finance

Notes:

- (a) A positive number for taxes, regulatory fees and fines, and other income denotes an increase in revenue. A positive number for superannuation expenses and other expenses denotes an increase in expenses (and hence a reduction in the operating surplus). A positive number for the net result denotes an improvement in the operating surplus. Numbers may not balance due to rounding.
- (b) An equivalent one percentage point decrease in each indicator would have an opposite impact to that shown.
- (c) Other income includes general and specific purpose grants, including grants for on-passing, as well as changes in dividends and income tax equivalent payments from public authorities. Dividends and income tax equivalent payments are based on an estimated dividend payout ratio. However, dividends paid by government business enterprises are determined by the Treasurer

Notes (continued):

having regard to relevant commercial considerations, including reported profit/loss, operating cash flow, gearing and interest cover, capital requirements and the views of the Board and the portfolio Minister. Therefore, the actual impact on this revenue source is dependent on the current circumstances of the relevant public authority.

- (d) Following the implementation of the departmental funding model, employee entitlements, included as part of other expenses, are now sensitive to changes in prices, whereas in previous years these impacts would have been identified under average weekly earnings.*
- (e) Assumes a one percentage point increase in the cash rate over the entire forward estimates period, resulting in a one percentage point increase in the term structure.*

The move to Australian equivalents to International Financial Reporting Standards (A-IFRS) has resulted in a significant change to the impact of several economic and financial variables on the targeted operating surplus. In particular, the impact of consumer prices, average weekly earnings, volatility in asset markets, and changes to interest rates has changed under A-IFRS when compared to the 2004-05 Budget. The sensitivity analysis presented in Table 7.1 presents the sensitivity of both the net result from transactions and the net result to selected economic and financial indicators.

The Government's fiscal target, the net result from transactions, is most sensitive to economic growth and property markets. The net result (which also takes into account the impact of other economic flows) is also sensitive to interest rates and share markets.

Sensitivity to economic growth

A 1 per cent increase in gross state product (GSP) would improve both the net result from transactions and the net result by \$132 million in 2005-06, rising to \$169 million in 2008-09. This primarily reflects higher GST grant revenue and taxation revenue.

Sensitivity to employment growth

An increase in employment growth of 1 per cent would increase payroll tax revenue, improving both the net result from transactions and the net result by \$33 million in 2005-06, rising to \$43 million in 2008-09.

Sensitivity to prices

A 1 per cent increase in consumer prices is expected to increase the net result from transactions by \$168 million in 2005-06. This is the result of higher GST and other Commonwealth revenue, as well as higher taxation revenue. The higher revenue is partly offset by a higher cost of supplies and services, and some increases in outlays on grants and transfers.

The increase in consumer prices would also result in an actuarial based increase in superannuation liabilities of \$121 million in 2005-06. This would reduce the improvement in the net result to \$47 million in 2005-06. The higher superannuation liabilities will increase the superannuation expense in the remaining forward years. In accordance with the departmental funding model, while higher prices will have no impact in the budget year, they will flow through into increased output funding for departmental expenses in the forward years, resulting in an impact on the net result from transactions and the net result of \$36 million by 2008-09.

Sensitivity to wages

A 1 per cent rise in the level of economy-wide wages would improve the net result from transactions by \$18 million in 2005-06. The improvement in the net result from transactions reflects higher payroll tax revenue, which is partially offset by lower Transport Accident Commission (TAC) revenue as a result of an increase in the value of liabilities. The increase in wages would increase estimated superannuation fund liabilities by \$167 million in 2005-06 and result in a reduction in the net result of \$149 million in 2005-06. The higher superannuation fund liabilities will increase the superannuation expense in the remaining forward years. The net result from transactions and the net result are expected to improve by \$22 million by 2008-09.

The absence of an impact on other expenses reflects that, under the departmental funding model, departments are funded for total expenses according to increases in the CPI in subsequent forward years.

Sensitivity to domestic and overseas share prices

An increase in domestic share prices of 1 per cent would lead to an improvement in the net result from transactions of \$5 million in 2005-06 through increased TAC dividends. The net result will increase by \$57 million with an associated increase in superannuation fund assets. Over the remaining forward estimates, the net result from transactions and net result will improve by approximately \$4 million with additional TAC dividends combining with a reduction in superannuation expenses. Similarly, an increase in overseas share prices will increase the net result from transactions by \$4 million in 2005-06, with a gain on superannuation fund assets increasing the net result to \$16 million. In the remaining forward years, there will be a small improvement on the net result from transactions and net result of \$1 million.

Sensitivity to property prices

A 1 per cent increase in property prices is expected to result in a \$31 million increase in the net result from transactions in 2005-06, primarily reflecting additional conveyancing duty. A gain on superannuation fund assets held as property will result in a total improvement in the net result of \$40 million. As higher property prices flow through to higher land tax collections in later years, the improvement in the net result from transactions and the net result would rise to \$58 million by 2008-09.

Sensitivity to property transaction volumes

A 1 per cent increase to property transaction volumes would increase conveyancing duty revenue, flowing through to an improvement in the net result from transactions and net result of \$22 million in 2005-06. The improvement grows to \$27 million in 2008-09.

Sensitivity to interest rates

A 1 per cent increase in interest rates would result in higher public authority income and interest receipts, resulting in an improvement in the net result from transactions of \$77 million in 2005-06. At the same time, the increase in interest rates generates a revaluation of superannuation fund liabilities of \$2.86 billion in 2005-06, improving the net result by \$2.93 billion. As the higher public authority income ceases after the first two years and superannuation expenses grow over subsequent forward years, the improvement in both the net result from transactions and the net result declines to \$2 million by 2008-09.

FISCAL RISKS

Expenditure risks

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

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

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

The 2005-06 Budget and forward estimates include a contingency provision to allow for the likelihood that some of these department-specific and government-wide expenditure risks will be realised during the budget year or over the course of the forward years. The contingency provision includes a general allowance for:

- growth in Victoria's population, and consequent derived demand for government services;
- an allowance for depreciation expenditure that would be associated with new asset investments funded from the unallocated capital provision (subject to government approval); and
- other expenditure risks, which are unforeseen or not able to be quantified at the time of construction of the budget estimates.

In addition, the budget estimates include a contingency from 2007-08 that acknowledges funding for a number of initiatives will conclude in 2006-07 or 2007-08. A provision is provided on the basis that the Government may endorse a number of these initiatives to continue or be replaced to meet service delivery priorities.

The inclusion of an operating contingency provision in the budget estimates mitigates the potential impact of expenditure risks on the overall budget position. Realised expenditure risks will only impact on total expenditure and the annual budget position to the extent that they cannot be accommodated within the contingency provision built into the budget estimates. The aggregate level of the contingency provisions contained within the budget estimates is shown in Note 9 of the Estimated Financial Statements. (See Budget Paper No. 4, Chapter 1, *Estimated Financial Statements and Notes*).

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

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

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

AusLink

From July 2004, the Commonwealth Government introduced a new funding model for Australia's land infrastructure called *AusLink*. The Commonwealth will fund rail, in addition to road, projects as part of a declared national network. The Commonwealth has announced a preference to introduce reciprocal funding arrangements with State and Territory governments for *AusLink* projects. The Victorian Government may be required to provide funding for projects announced under the *AusLink* program.

Insurance exposures

The availability and affordability of commercial insurance has improved during the past year, although difficulties remain for particular clients and risks, particularly professional indemnity insurance for some highly specialised professions. Apart from heritage and tourist railways, which are covered under the State's broad Government Rail Insurance Program, the State no longer provides cover for tourism ventures, which have reverted to commercial insurance.

Pressures on private sector medical indemnity premiums have also eased, but there is still a risk that increasing medical costs and lack of availability of private doctors in some regions may result in the State assuming larger numbers of high risk medical procedures. The possibility of such movement, together with the impact of claims that arise from current levels of public medical services, means that there is a continuing need to monitor closely the State's medical indemnity liabilities and expenses.

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

Wimmera-Mallee pipeline

In the 2002-03 Budget, the Government committed funding of \$77 million nominal total estimated investment (TEI) for Victoria's contribution to the Wimmera-Mallee water pipeline project over the next decade. Victoria's share was based on the \$301 million preliminary business case for the project. This initiative will replace the existing 17 500 kilometres of open channels with a new pipeline system in the Wimmera-Mallee region. This funding was subject to Commonwealth matching funding and confirmation of feasibility.

In November 2003, an interim business case revised the TEI from \$301 million to \$501 million. The Government reviewed the interim business case and, in August 2004, increased the Victorian contribution to \$125 million, subject to matching Commonwealth funds.

During the election campaign, the Commonwealth committed to a contribution of up to \$167 million using funding previously allocated to National Competition Policy payments to the States and Territories, subject to the State providing matching funding.

On 2 March 2005, the State Government announced its support for the National Water Initiative. Accordingly, the State has publicly stated that it will contribute \$167 million to the Wimmera-Mallee Pipeline project, based on the total project cost being shared equally between the Commonwealth, the State and end users. However, to date, the Commonwealth has yet to formally commit funding at this level.

Revenue risks

Commonwealth grants

Commonwealth grants are a major source of revenue for the Victorian Government, with an estimated grants income of approximately \$14.3 billion in 2005-06. Commonwealth grants include general purpose grants (GST grants and National Competition Policy payments) and specific purpose payments.

The level of specific purpose payments is determined by the policies of the Commonwealth Government, and is published on an annual basis in the Commonwealth budget papers. The level of general purpose grants, and in particular GST grants, is affected by the general level of activity in the Australian economy and the GST revenue sharing relativities calculated by the Commonwealth Grants Commission.

Variations to the revenue sharing relativities and expected GST revenue forecast by the Commonwealth have a direct impact on Victoria's GST grants throughout the forward estimates period. The Commonwealth grants estimates in this Budget are based on data published in the *2004-05 Mid-year Economic and Fiscal Outlook* released in December. The Commonwealth will release its 2005-06 Budget on 10 May 2005, which will outline the Commonwealth Government's latest expectations on Australia-wide economic activity. This will have a direct impact on the amount of GST to be distributed among the States.

The current Review of State Taxes has resulted in a demand by the Commonwealth Treasurer that the States and Territories cease collecting certain taxes. Victoria and five other States have proposed a counter offer that achieves the same objectives over a longer time period. It appears that this offer will be accepted; however, if it is not, there is a risk that the distribution of GST revenue could be disrupted. These issues are explained in detail in Chapter 5, *Commonwealth-State Financial Relations*.

Legal dispute with the Port of Melbourne

The Valuer-General is currently in dispute with the Port of Melbourne regarding the interpretation of the term ‘works relating to a port’ in the *Valuation of Land Act 1960*. Because the Act excludes works relating to a port from the valuation of port land, it has the potential to reduce the land tax payable by the Port of Melbourne if the term is interpreted in its broadest possible sense. The matter remains before the Supreme Court.

Income tax equivalents

The Victorian WorkCover Authority (VWA) and Transport Accident Commission (TAC) are required to make annual income tax equivalent payments to the State. This arrangement is consistent with National Competition Policy principles.

As a result of the adoption of A-IFRS, the methodology used to calculate the outstanding insurance claims liability of the State will change. Under A-IFRS, the outstanding claims liability is to be discounted using risk-free rates and include a risk margin to reflect the inherent uncertainty in the estimate of the present value of expected future payments.

The key difference between the old and revised accounting standards, with respect to liability valuation, is that the new standards mandate the use of the risk free rate in determining the valuation of the liability provision. The old standard was more flexible and allowed insurers to discount at an earnings rate.

Although the old accounting standards allowed the use of a risk margin, it did not require a risk margin to be included in the determination of the claims liability provision.

Should the Australian Taxation Office treat the increase in liabilities to both TAC and VWA arising from the A-IFRS changes as deductible, it will adversely affect the State’s income tax equivalent revenue from the public financial corporations sector in 2005-06 and 2006-07. The impact is difficult to quantify at this stage as it is also dependant on the level of prudential margins that the government considers appropriate for the insurance funds.

CONTINGENT ASSETS AND LIABILITIES

Contingent assets

Contingent assets are either:

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

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

Quantifiable contingent assets

Table 7.2: Quantifiable contingent assets

	(\$ million)	
	As at June 2004	Estimate for June 2005
Guarantees, indemnities	0.6	0.6
Potential early termination of contractual arrangements	100.0	100.0
Legal proceedings and disputes	0.0	0.0
Other	65.1	176.1
Total contingent assets	165.7	276.7

Source: Department of Treasury and Finance

Included in Table 7.2 under ‘potential early termination of contractual arrangements’ are any additional costs arising to the Director of Public Transport on early termination of the public transport partnership agreements. The operator must, to the extent of the performance bonds, indemnify the Director for any losses, damages or costs incurred by him as a result of early termination. If the operator does not do so, the Director has the right to draw on the operator’s performance bonds for the amount of losses, damages or costs. The expected value of these bonds is \$100 million.

‘Other’, under Table 7.2, relates to a dispute existing between Transurban City Link Limited and the Australian Tax Office in respect of the taxation treatment of concession fees payable by Transurban to the Victorian Government of \$84.1 million and EastLink bonds of \$92 million.

Transurban City Link

A dispute exists between Transurban City Link Limited and the Australian Tax Office (ATO) in respect of the deductibility for taxation purposes of concession fees payable by Transurban to the Victorian Government. The amount in dispute is \$84.1 million. The Federal Court had previously found against Transurban in this matter; however, a recent appeal by Transurban to the full bench of the Federal Court was determined in its favour in October 2004. The ATO has recently announced that it is seeking leave to appeal.

The value of concession fee notes held by the Victorian Government as at 31 December 2004 is estimated to be \$290.6 million (assuming Transurban is successful and the tax deduction is allowed) or \$206.5 million (if the ATO is successful and the tax deduction is not allowed).

EastLink

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

Non-quantifiable contingent assets

Public transport partnership agreements

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

Profit sharing: The Director is entitled to receive payment from operators should operator profits exceed defined thresholds.

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

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

Newport depot: The annual amount payable to Connex is to be reduced by the value of the Newport lease rental at the expiry or early surrender of the lease.

OneLink service contract: The Director will be paid compensation payments under the OneLink service contract for failure to meet required performance standards.

Employee entitlements: Operators are required to manage employee entitlements to agreed forecast amounts.

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

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

EastLink

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

Additional lease rental

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

Compensable enhancements

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

Refinance benefits

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

Contingent liabilities

Contingent liabilities are either:

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

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

Quantifiable contingent liabilities

Table 7.3: Quantifiable contingent liabilities

	<i>(\$ million)</i>		
		<i>As at June 2004</i>	<i>Estimate for June 2005</i>
Guarantees, indemnities		272.5	320.7
Potential early termination of contractual arrangements		622.4	622.4
Legal proceedings and disputes		212.2	208.3
Other		12.6	12.6
Non-general government debt		2 881.4	3 184.7
Total contingent liabilities		4 001.1	4 348.7

Source: Department of Treasury and Finance

Table 7.3 includes 'guarantees, indemnities' totalling \$320.7 million, comprising Cooperative Housing Societies guarantees and indemnities of \$52.2 million, Melbourne Cricket Club guarantees of \$239.2 million (for the redevelopment of the Melbourne Cricket Ground for the Melbourne 2006 Commonwealth Games) and various other guarantees of \$29.3 million. This figure has increased since June 2004 due to the ongoing Melbourne Cricket Ground redevelopment.

Under 'potential early termination of contractual arrangements' is a contractual agreement of \$622 million relating to the cost of correctional services beyond the current contract period. The State has the option to re-tender for the provision of correctional services every three years, after the initial five-year period for each contract.

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

'Non-general government debt' relates predominately to the guarantees for loans to the water industry and other entities within the public non-financial sector. The increase since June 2004 is mainly due to increased water industry capital works and the recognition of finance leases in the rail sector.

Non-quantifiable contingent liabilities

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

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

Asset sales

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

Melbourne Cricket Ground redevelopment

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

These agreements include:

- indemnities to the MCG Trust and the MCC in the event that there should be insufficient trading surpluses to meet scheduled debt servicing and repayments, or if the total project construction cost exceeds \$450 million;
- agreement for compensation to the Australian Football League (AFL) as a result of the hosting of the Melbourne 2006 Commonwealth Games. The amount of compensation will be finalised following the completion of the 2006 AFL draw. All compensation claims will be calculated in accordance with an agreed compensation formula; and
- previously provided indemnities to the MCC and MCG Trust in the context of the 1990 Great Southern Stand development, which have been reincorporated into the contractual arrangements of the Northern Stand redevelopment, under greater accountability and responsibility of the MCC to the MCG Trust.

Former Public Transport Corporation lease arrangements

Under various transport lease arrangements made by the former Public Transport Corporation, the State of Victoria indemnified the lessors against adverse tax rulings and third-party personal injury claims, where the third party is injured by the operation of the equipment during the period of the lease. The last of these lease arrangements was terminated by June 1999. The normal statute of limitations is six years for personal injury claims.

Public transport rail partnership agreements

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

Contingent liabilities arising during the agreement period

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

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

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

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

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

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

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

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

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

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

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

Employee entitlements: Operators are required to manage employee entitlements to agreed forecast amounts.

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

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

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

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

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

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

Contingent liabilities on early termination or expiry

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

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

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

Contingent liabilities arising from potential changes to existing conditions

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

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

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

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

National Express receivership

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

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

Melbourne City Link

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

EastLink

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

Native Title

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

HIH Insurance

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

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

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

Smelter Reduction Amount

The State Electricity Commission of Victoria (SECV) is the first defendant in a matter before the High Court of Australia commenced by summons dated 5 June 2003 in which the Australian Steel Company (Operations) Pty Ltd is the plaintiff. The plaintiff has claimed that Schedule 9A2 of the National Electricity Code, amongst other legislation, imposing a charge known as the Smelter Reduction Amount, is invalid. The plaintiff seeks reimbursement of Smelter Reduction Amounts previously paid together with interest and costs. Origin Energy Electricity Limited are second defendants in this matter and have lodged consequential cross-claims against the SECV.

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

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

Melbourne 2006 Commonwealth Games

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

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

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

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

The Host City Contract specifies the rights and obligations of M2006 in relation to organising the Games. The contract includes the commitment the State outlined in its bid document to offer travel grants to competitors and team officials attending the Games.

Land remediation – environmental concerns

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

Victorian Managed Insurance Authority – property and public liability

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

Victorian Managed Insurance Authority – public sector medical indemnity

The Government has agreed to indemnify VMIA for losses on its public sector medical indemnity portfolio that exceed 120 per cent of claims estimates in any future claims year.

Gambling/gaming licences

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

Builders' warranty

The builders' warranty insurance market, like other insurance markets, was affected by the 11 September 2001 terrorist attacks in the United States and adverse claims experience. In mid-April 2002, the State agreed to provide temporary (to 30 June 2002) reinsurance support to builders' warranty insurance provider Dexta Corporation, following the withdrawal of some of its commercial reinsurance support. This support was subsequently extended to 30 September 2002. The Government determined that there would be no further extension.

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

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

On 13 March 2002, Victoria and New South Wales jointly announced a series of reforms to builders' warranty insurance arrangements. This announcement included a commitment to provide a catastrophe fund capable of supporting claims above \$10 million. Since builders' warranty insurance commenced, there have been no losses exceeding this amount by an insurer to any one builder. To meet this commitment, the two States offered reinsurance arrangements to all builders' warranty insurers covering claims in respect of any one builder exceeding \$10 million, with each of the two States reinsuring claims relating to properties in that State. A reinsurance agreement giving effect to these arrangements was concluded in December 2002 (effective from 1 January 2003) with one insurer. South Australia became a party to this agreement with effect from 31 December 2004. This agreement requires the insurer to pay reinsurance premiums to the three States that are estimated to be sufficient for the States to at least break even on these arrangements. However, the State retains an unquantifiable contingent liability for additional claims.

STYLE CONVENTIONS

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

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

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

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