

CHAPTER 1 – FINANCIAL POLICY OBJECTIVES AND STRATEGY

- Victoria's good fiscal outcomes in recent years have contributed to the strength of the economy, enabling the government to provide more services and to deliver new asset investment projects, while maintaining Victoria's strong fiscal position. In response to an increasingly uncertain economic environment, the Victorian Government remains committed to ongoing economic reform to maintain the prosperity of current and future generations.
- The government has changed its short-term operating surplus target from at least \$100 million to at least 1 per cent of revenue each year, ensuring the surplus target grows in line with revenue. It will also allow the government to fund its substantial infrastructure program and continue to provide services to the Victorian community, while maintaining prudent levels of debt.
- In the 2008-09 Budget, the government is forecasting an operating surplus of \$828 million in 2008-09 and an average of \$907 million a year over the forward estimates.
- The budget period provides net funding for new output initiatives of \$182 million in 2008-09, and an average \$127 million each year over the forward estimates period. This is in addition to the net funding provided in the *2007-08 Budget Update* of \$83 million a year on average from 2008-09 to 2010-11.
- The increased operating surpluses will enable the government to continue significant investment in infrastructure, maximising economic, social and environmental benefits for all Victorians. This budget provides funding for new asset projects with a total estimated investment (TEI) of \$3.2 billion. This is in addition to \$1.1 billion TEI provided for infrastructure investment in the *2007-08 Budget Update*.
- The 2008-09 Budget includes tax reforms, worth over \$1 billion over the forward estimates, which build on earlier reforms and will maintain Victoria's tax competitiveness. The cost burden on Victorian businesses is further reduced by the fifth consecutive cut to WorkCover insurance premiums from 1 July 2008.
- The government has continued to maintain a AAA credit rating. By implementing sound fiscal strategies, the government is able to keep net financial liabilities at modest and sustainable levels.

FINANCIAL STRATEGY, OBJECTIVES AND PRIORITIES

This chapter sets out the Victorian Government's financial policy objectives and strategies as required by the *Financial Management Act 1994* (the Act). The financial policies and objectives are built on the following principles of sound financial management, which are set out in the Act:

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

With the broad strategic priority of promoting sustainable growth across the whole state on a sound and stable financial basis, the government will continue to deliver world-class infrastructure to drive economic growth and improve quality, access and equity in key services to all Victorians, while maintaining a sound financial position.

The government's short-term and long-term financial objectives and targets are summarised in Table 1.1 below. The rationale for, and progress against, each of the five objectives is discussed in the following sections of this chapter, including how the 2008-09 Budget will continue to support the achievement of the objectives.

Table 1.1: 2008-09 Financial objectives and strategies

<i>Objective</i>	<i>Short-term target</i>	<i>Long-term target</i>
Operating surplus	At least 1 per cent of revenue in each year	Maintain a substantial budget operating surplus that allows for the delivery of the government's infrastructure objectives
Infrastructure	Implement strategic infrastructure projects	Deliver world-class infrastructure to maximise economic, social and environmental benefits
Service delivery	Implement the 2006 election commitments	Provide improved service delivery to all Victorians
Taxation	Implement reforms	Provide a fair and efficient tax system that is competitive with other States
Net financial liabilities	Maintain a AAA credit rating	Maintain State government net financial liabilities at prudent levels

Source: Department of Treasury and Finance

OBJECTIVE ONE: OPERATING SURPLUS

The Victorian Government's good fiscal outcomes in recent years have contributed to the strength of the economy. Importantly, these fiscal outcomes have ensured that the operating surpluses delivered by the government are strong and have enabled the delivery of important services and the provision of key infrastructure, while keeping finances in a solid position.

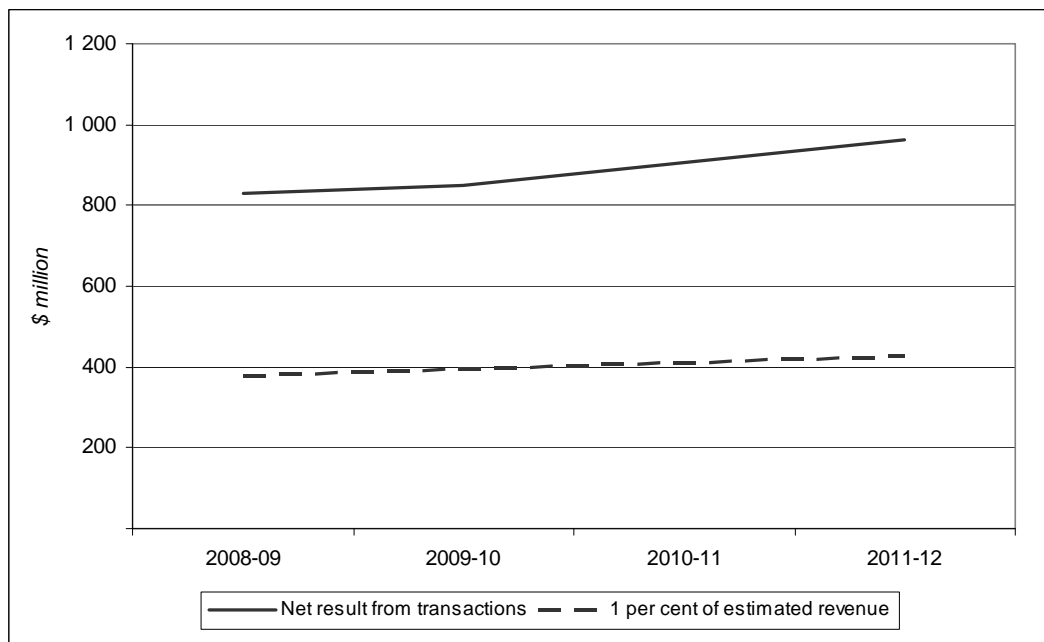
In 1999, when the government came into office, it set itself an operating surplus target of at least \$100 million in each year, which at the time represented just under 0.5 per cent of revenue. In 2008-09, a \$100 million operating surplus target is forecast to represent 0.3 per cent of operating revenue, 0.2 percentage points below 1999-2000 levels.

The government has reassessed its operating target to ensure it remains relevant in the current fiscal environment. In this context, the government has set a new target of at least 1 per cent of revenue each year, which will allow the operating surplus target to grow in line with operating revenue. In 2008-09, 1 per cent of operating revenue is projected to be \$378 million.

The government is forecasting an operating surplus of \$828 million in 2008-09 and an average of \$907 million a year over the forward estimates, significantly above the new target. The government's fiscal strategy is to maintain high surpluses that will enable current and future generations to benefit from further infrastructure investment, while continuing to maintain Victoria's AAA credit rating. The government's infrastructure investment is funded from surplus cash generated from operating activities and prudent levels of additional borrowing.

Chart 1.1 compares the forecast operating surplus with the government's new operating surplus target for the budget and forward years.

Chart 1.1: General government sector net result from transactions



Source: Department of Treasury and Finance

Alternative measures of operating performance

From the 2008-09 Budget, the new accounting standard issued by the Australian Accounting Standards Board in October 2007, AASB 1049 *Whole of Government and General Government Financial Reporting* will be implemented. Under this standard, the report for the general government sector must include key fiscal aggregates determined in a manner consistent with the Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS) manual. Consistent with the government's desire for continuous improvement, the implementation of this standard will further enhance the transparency and accountability of Victoria's resource management.

In addition to the operating surplus, the government also uses other financial results to measure its performance. Table 1.2 below presents these alternative measures.

Table 1.2: Alternative budget measures

	(\$million)			
	2008-09 Budget	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
Net operating balance/Net result from transactions	827.5	851.1	906.0	962.6
Net result	716.9	711.5	771.8	840.1
Net lending/(borrowing) ^(a)	(441.7)	(351.9)	(626.8)	(1 836.2)
Cash surplus/(deficit) ^(b)	10.2	(450.7)	(580.9)	(979.9)

Source: Department of Treasury and Finance

Notes:

- (a) *Net borrowing, or fiscal balance, includes net capital expenditure but excludes depreciation, thereby giving a measure of the state's call on financial markets. Net borrowing also equals net transactions in financial assets less net transactions in liabilities.*
- (b) *Cash surplus/(deficit) equals the net cash flows from operating activities less investments in non-financial assets.*

The *net operating balance* is the terminology used by the ABS and is equivalent to the net result from transactions. Both measures exclude the effects of revaluation (holding gains or losses) arising from changes in market prices and other changes in the volume of assets. The net operating balance/net result from transactions is now the basis for measuring the budget estimates on an accrual basis in all other Australian states and the Commonwealth, and provides comparability with these jurisdictions.

The *net result* is obtained by adding various revaluation gains and losses on assets and liabilities to the net result from transactions.

The *net lending/borrowing* is a GFS key fiscal aggregate and is equal to the net operating balance less net acquisitions of non-financial assets. Net borrowing represents, in broad terms, the extent to which the general government sector's net acquisition of physical assets has been funded by incurring liabilities to other sectors. As it takes into account total net spending on fixed assets, assets received free of charge and assets acquired under finance lease agreements during the period, rather than just the current year's expense, it is generally lower than the net operating balance/net result from transactions. The government has a net borrowing position of \$442 million in 2008-09, and an average \$938 million a year over the forward estimates, reflecting the financing of a portion of the substantial infrastructure investment. The magnitude of the net borrowings is appropriate in the context of the state's strong balance sheet.

The *cash surplus/deficit* result is equal to net cash flows from operating activities, less net cash investment in non-financial assets. Although both net borrowing and the cash surplus include the immediate impact of expenditure on fixed assets, the cash surplus removes non-cash revenues and expenses (including the superannuation interest cost and employee benefits, and assets received free of charge and assets acquired under finance lease) and allows for cash contributions made to the unfunded superannuation

liability. The cash position is expected to be a \$10 million surplus in 2008-09 and then to be in deficit by an average \$671 million a year over the forward years. These cash deficits enable the government to invest in significant assets while maintaining net debt at prudent levels.

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

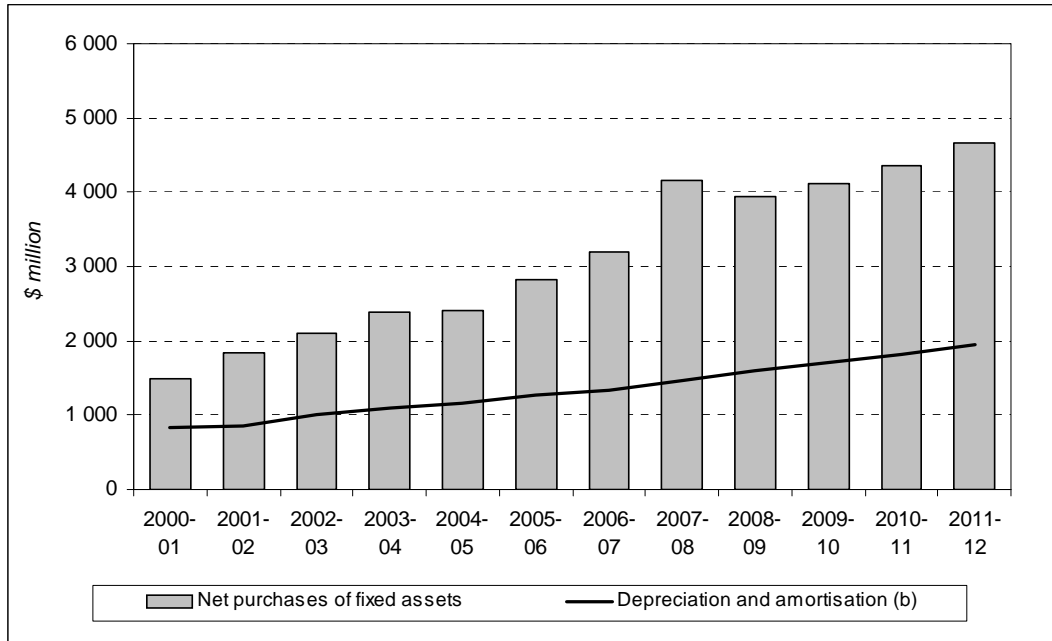
OBJECTIVE TWO: INFRASTRUCTURE

Victoria's growing population necessitates a greater ongoing investment in important infrastructure by the government. The provision of an effective infrastructure base is a key driver of economic growth as it facilitates the relief of congestion and the transportation of freight. It also supports the delivery of quality services and provides facilities that ensure the future development of the state. From 1999-2000 to 2006-07, the government has invested over \$17 billion to the delivery of world-class infrastructure, representing an average investment of over \$2.2 billion a year.

This substantial infrastructure investment is forecast to continue with a projected net investment of \$4.0 billion in 2008-09. Net capital commitments over the forward estimates period, are currently expected to average \$4.4 billion a year.

Chart 1.2 shows the growth in the net infrastructure investment by the general government sector since the beginning of the decade, together with projected net infrastructure investment to 2011-12.

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



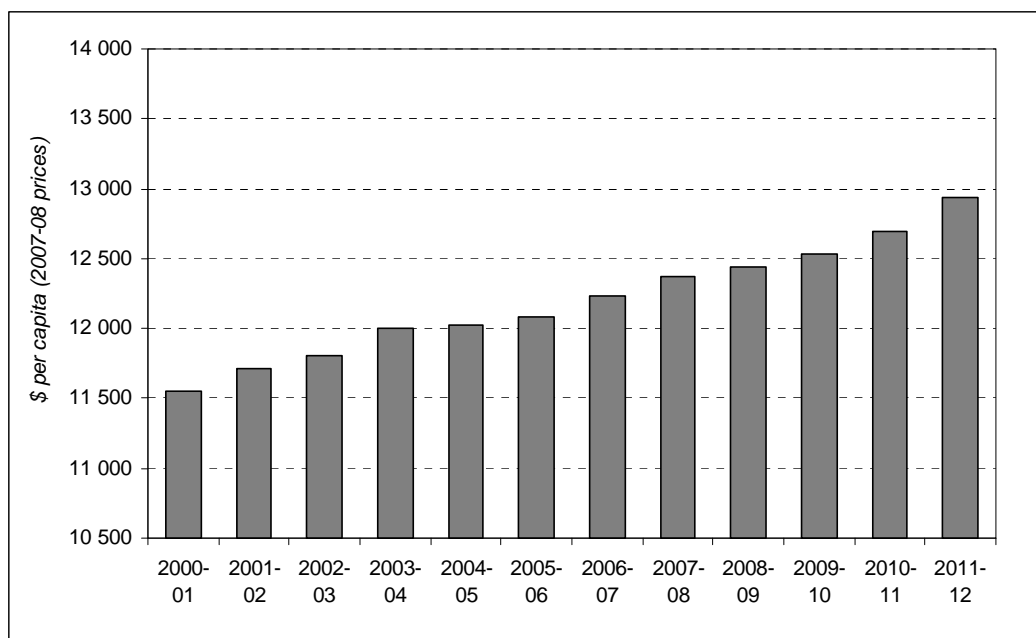
Source: Department of Treasury and Finance

Notes:

- (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. The 2005-06 net investment figure excludes \$600 million return of surplus TAC capital.
- (b) Includes depreciation and amortisation of fixed assets within the general government sector only.

Over the period 2008-09 to 2011-12, general government net infrastructure investment will exceed estimated depreciation by an average of around \$2.5 billion a year, which translates to a 10.8 per cent growth in real capital stock over the four years to June 2012. As this growth rate is significantly more than the 6.0 per cent projected population growth over the same period, the average stock of public infrastructure for each Victorian will increase from \$11 486 in 2000 to \$12 936 by June 2012. This trend is illustrated in Chart 1.3.

Chart 1.3: General government sector real capital stock per capita as at 30 June^(a)



Source: Department of Treasury and Finance

Note:

(a) Due to a change in methodology by including the revaluation of the capital stock, effective from the 2007-08 Budget, this chart is not directly comparable with similar charts shown in previous years.

To date, the state's strong fiscal position has enabled the government to significantly boost Victoria's capital assets. This is set to continue as the surpluses projected over the forward estimates will enable further substantial investment in infrastructure, while maintaining debt at prudent levels.

Around 64 per cent of the government's infrastructure program over the four years to 2011-12 will be funded by the cash generated from operating activities. The remainder of the infrastructure program will be funded by using the strength of the balance sheet.

The 2008-09 Budget provides funding for new asset investment projects with a TEI of \$3.2 billion. This is in addition to \$1.1 billion provided for infrastructure investment in the 2007-08 Budget Update.

The 2008-09 Budget continues the government's commitment to investing in health, community and aged care facilities, to ensure more Victorians stay healthy and have access to quality care and treatment.

Substantial investment funding has also been allocated to a range of projects that will upgrade and expand the rail and road network in metropolitan and regional Victoria. These projects will contribute towards the provision of efficient and safe transport connections across the state and will address increased transportation demands.

In addition, the 2008-09 Budget includes substantial infrastructure funding allocated towards the modernisation, regeneration and replacement of government schools across Victoria, including in provincial areas. This investment, together with other education service initiatives, will improve educational outcomes for the state.

A comprehensive discussion of the impact of asset investments on the state's balance sheet is included in Chapter 3, *Budget Position and Outlook*.

Further discussion on major infrastructure projects is provided in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*. Information on the initiatives listed above, and all the asset initiatives committed to since the *2007-08 Budget Update*, can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

OBJECTIVE THREE: SERVICE DELIVERY

The government remains committed to improving the quality, access and equity of services that are important to all Victorians.

Victoria continues to pursue a program of state-based reform in key areas, including infrastructure and business competitiveness. To meet future challenges to economic growth, investments have also been made in initiatives that respond to climate change and ensure water security. A description of the government's wider reform agenda can be found in Chapter 5, *Economic Reform Agenda*.

The Victorian Government has now delivered, or commenced the delivery of, all its 2006 election output commitments and made further substantial progress towards its asset commitments. Funding provided in the 2008-09 Budget is aimed at ensuring significant progress is made towards achieving the goals in *Growing Victoria Together*. This investment will build on successes to date, including:

- in 2006, Victoria was at or above the national average against the benchmark level for reading, writing and numeracy for years 3 and 5 and had a higher result than any other state or territory in year 3 and year 5 writing, and equal highest in year 5 numeracy. In 2003 the government achieved its target of reducing average Prep to year 2 class sizes to 21 students from 24.3 in 1999. Since then, this has been further reduced to 20.7;
- as a result of the government's investment in health and community services, between 1999-2000 and 2007-08, over 300 000 additional hospital patients are now being treated each year, hospitals are employing 8 000 more nurses and 1 800 more doctors, and more assistance is being provided to people with a disability. Over the same period, the government has boosted hospital funding by \$3.3 billion;
- implementation of significant improvements in the public transport system, including the completion of the Regional Fast Rail project and Southern Cross Station. In 2006-07, there was an increase of 14.5 per cent in the number of regional rail services. In the year up to 2006-07, regional rail patronage increased by 31.7 per cent; and

- significant investments have been made since 2003-04 which have addressed disadvantage and created opportunity, with 41 new children's centres delivering a range of children's services. Victorian immunisation rates for children have increased steadily since 1999, and in 2007 Victoria was the only state in Australia to achieve greater than 90 per cent in all 3 age cohorts for each quarter.

In order to deliver on the government's service delivery objectives, the 2008-09 Budget provides net funding for new output initiatives of \$202 million in 2008-09, and an average \$143 million each year over the forward estimates. This is addition to the net funding provided in the *2007-08 Budget Update* of \$83 million a year on average from 2008-09 to 2010-11.

This budget boosts investment in maternal and child health and improves education services, which will enable Victorian children to get the best start in life as well as provide key services that families need. Support is also provided towards the continued growth of provincial communities, with a strong focus being placed on reshaping and strengthening services and assistance for farmers and rural communities.

Funding has also been allocated to increase the level of assistance provided for vulnerable Victorians and their families, which will further strengthen communities and address disadvantage. The government will also boost public transport services in outer urban and regional areas to improve access to workplaces and services, relieving social isolation.

A discussion of the service delivery initiatives is provided in Budget Paper No. 3, Chapter 1, *Service and Budget Initiatives*. Information on the initiatives listed above, and the output initiatives committed to since the *2007-08 Budget Update*, can be found in Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

OBJECTIVE FOUR: TAXATION

The government will continue to implement a range of tax reforms to provide a fair and efficient tax system that is competitive with other states. Victoria's competitiveness and productivity growth depend upon reforms and initiatives that reduce the cost of doing business and support business innovation and competition.

Since 1999, the government has shown leadership in tax reform through the implementation of a range of initiatives, including being the first State to abolish all inter-governmental agreement taxes. Together, these reforms have resulted in over \$4.5 billion worth of tax cuts. 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), as well as in individual budget initiatives.

These reforms have enabled the government to meet its aim of ensuring Victoria's taxes are competitive with the national average. Along with tax relief, businesses have also benefited from significant reductions in WorkCover insurance premiums.

The 2008-09 Budget will provide further tax relief for business, including new reductions to payroll tax, land tax and stamp duty on land transfers, as well as the provision of targeted exemptions to land tax and stamp duty on land transfers.

In addition to the changes made to the taxation system, the government has also extended the First Home Bonus by \$3 000 for newly constructed homes in rural and regional Victoria. This is designed to support population growth and will make regional Victoria a more attractive place for young families to buy their first home. It will also have the added benefits of boosting construction and employment in the regions. This brings the first home assistance for newly constructed first home purchases in regional areas to \$15 000.

These new taxation initiatives will provide tax relief to Victorian taxpayers of more than \$1 billion over four years, including further targeted assistance for first home buyers and enhanced stamp duty on land transfer concessions for pensioners. These reforms take the total value of tax cuts announced by the government since 1999 to over \$5.5 billion and will ensure Victoria's taxes on business remain competitive with that of other States.

The 2008-09 reforms ensure Victoria's land tax and payroll tax rates compare favourably with those of the other States. Victorian businesses effectively pay the second-lowest land tax for landholdings valued between \$0.4 million and \$5.7 million and the lowest payroll tax for payrolls valued between \$4.0 million and \$13.5 million.

Further information on tax reforms and initiatives can be found in Chapter 3, *Budget Position and Outlook* and Budget Paper No. 3, Appendix A, *Output, Asset Investment and Revenue Initiatives*.

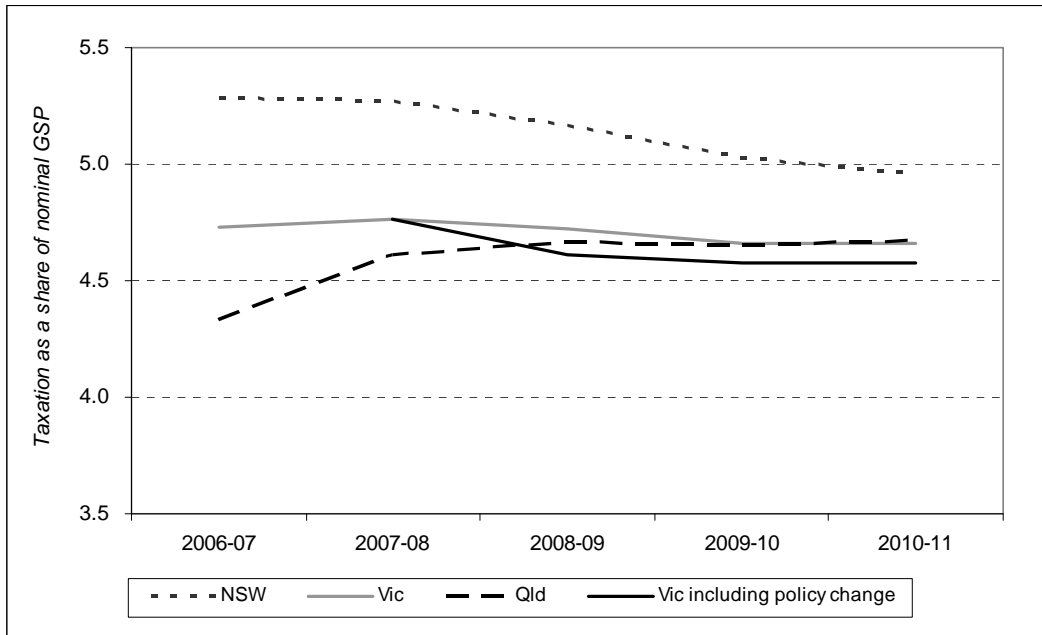
Tax competitiveness

Victoria's tax regime is competitive against the national average despite not receiving its full per capita share of GST revenue and other grants from the Commonwealth. Tax competitiveness is measured as taxation revenue as a share of nominal gross state product (GSP). This measure aligns the level of state taxation to economic capacity.

Chart 1.4 provides a comparison of Victoria's taxation competitiveness with New South Wales (NSW) and Queensland based on estimates, published at a similar time, in the *2007-08 Budget Update* (or equivalent publication) of these jurisdictions. Over the period 2006-07 to 2010-11 Victoria maintains a lower tax to GSP ratio than NSW, and is expected to close the gap with Queensland by 2009-10.

The effect of the 2008-09 Budget measures can clearly be seen in Chart 1.4 as the projected GSP ratio of Victoria is set to fall below that of Queensland (based on comparable estimates). If this eventuates it would be a significant milestone in Victoria's taxation competitiveness as it will be the first time that Victoria's tax to GSP ratio will fall below Queensland for the period that data is available.

Chart 1.4: Taxation revenue as a percentage of GSP^(a)



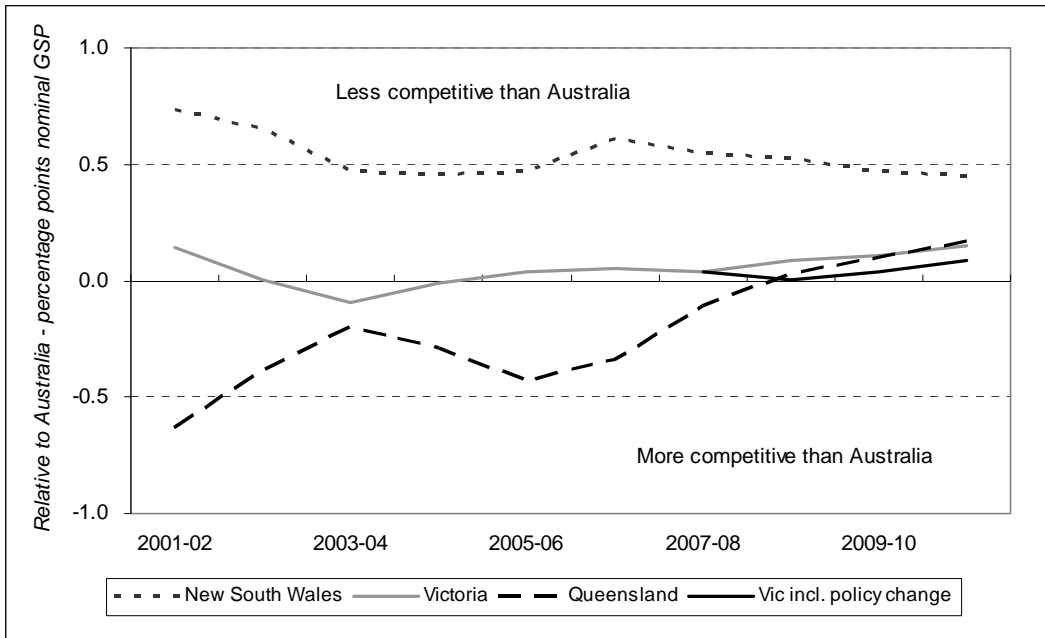
Sources: Australian Bureau of Statistics, Department of Treasury and Finance and various state publications (refer to note below)

Note:

- (a) Historical taxation data to 2006-07. Thereafter, taxation data are 2007-08 Budget Update (or equivalent publication) estimates, being the latest forward estimates available on a consistent basis across all jurisdictions. The line 'Vic incl. policy change' is the same as 'Vic' except that the estimated value of taxation policy changes announced in the 2008-09 Budget is included.

Chart 1.5 presents the same information as in Chart 1.4, but over a longer time period and shows the taxation to GSP ratio relative to the average taxation to GSP ratio of all states and territories. Chart 1.5 shows that Victoria's tax to GSP ratio remains competitive particularly when the taxation initiatives announced in this budget are taken into account. Victoria's tax to GSP ratio remains far more competitive than NSW and the budget measures reinforce this position.

Chart 1.5 Taxation revenue relative to the Australian average^(a)



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

Note:

(a) Historical taxation data to 2006-07. Thereafter, taxation data are 2007-08 Budget Update (or equivalent publication) estimates, being the latest forward estimates available on a consistent basis across all jurisdictions. The line 'Vic incl. policy change' is the same as 'Vic' except that the estimated value of taxation policy changes announced in the 2008-09 Budget is included.

WorkCover reform

While tax competitiveness is an important part of business decision-making, low WorkCover insurance premiums are another factor that improves the attractiveness of Victoria as a business location. The 2008-09 Budget provides a further 5 per cent reduction in the WorkCover insurance average premium rate. This brings Victoria's average premium rate to 1.387 per cent of wages and ensures the WorkCover scheme continues to have the second-lowest average premium rate in Australia. The latest 5 per cent cut will save Victorian employers an additional \$88 million in 2008-09. As a result of five successive cuts, Victorian employers will benefit from accumulated savings of \$775 million in 2008-09.

OBJECTIVE FIVE: NET FINANCIAL LIABILITIES

Victoria's finances are strong and provide the basis for the government to continue to deliver its substantial infrastructure program. Prudent financial management will position the government to absorb potential fiscal shocks and meet financial obligations, in an increasingly uncertain economic environment.

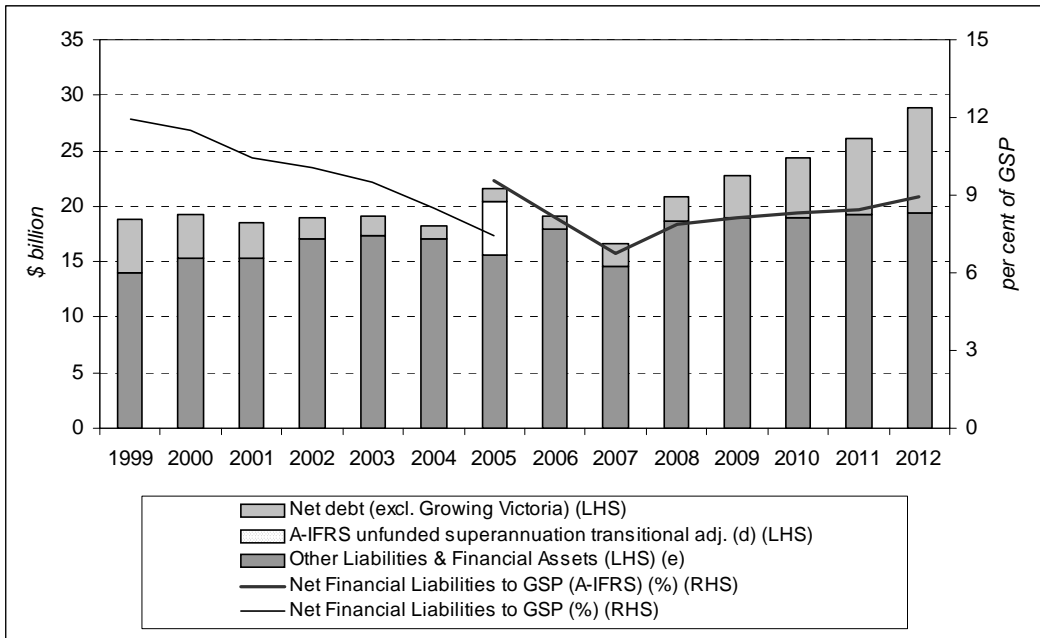
Victoria's strong balance sheet is evident in its AAA credit rating, which was reaffirmed by international credit rating agencies Standard & Poor's in September 2007 and Moody's Investors Service in April 2008. Both agencies cited Victoria's strong fiscal position, modest debt levels and prudent financial management as the key factors behind the AAA credit rating.

Over the budget and forward estimates period, around 64 per cent of the general government sector infrastructure program will be financed by the net cash inflow from operations, which is equivalent to the operating surplus less depreciation and other non-cash provisions. For the remainder, the government will use the strength of its balance sheet to fund key public investment projects that provide long-term economic and social benefits to Victoria.

With the adoption of the new accounting standard relating to government reporting as adopted in the revised Uniform Presentation Framework, the measure of net financial liabilities is broader than that used by Victoria in the past. Rather than the measure being net debt plus the net unfunded superannuation liability, it now includes total liabilities less all financial assets, excluding equity investments in other sectors. While the absolute measures are different than in the past, the overall trend for Victoria remains unchanged.

Chart 1.6 below shows that the ratio of net financial liabilities (total liabilities less financial assets, other than equity in public non-financial corporation and public financial corporation sectors) to GSP is set to decline from 11.9 per cent in June 1999 to 7.9 per cent in June 2008, and is expected to remain stable in the forward estimates period. This represents a reduction in net financial liabilities as a percentage of GSP by 4.0 percentage points, which is equivalent to more than \$10 billion in real terms.

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



Source: Department of Treasury and Finance

Notes:

- (a) General government net financial liabilities are calculated as total liabilities less financial assets, other than equity in PNFC and PFC.
- (b) Net debt is calculated as gross debt less liquid financial assets. In the years applicable, Growing Victoria investments are excluded as an offset to gross debt on the grounds that these investments are earmarked for infrastructure projects and are therefore not available to redeem gross debt.
- (c) Due to a change in methodology regarding how net financial liabilities are calculated, this chart is not directly comparable to similar charts shown in previous years.
- (d) For comparative purposes only, the transitional adjustment applied to unfunded superannuation liability in 2004-05.
- (e) Unfunded superannuation liability between 1999 and 2004 are calculated under the old Australian accounting standards, whereas from 2005 onward the relevant A-IFRS standard has been applied.

The prudent strategy of using available cash surpluses to pre-pay superannuation liabilities and retire gross debt has meant that even with a substantial infrastructure program, the state’s net financial liabilities to GSP is significantly lower than when the government came to office.

General government net debt is projected to increase from \$2.3 billion at June 2008 to \$9.5 billion at June 2012. The projected general government net debt of \$9.5 billion in 2012 is equivalent to 2.9 per cent of GSP, compared with 3.0 per cent in 1999.

In addition, superannuation liability will ease over the forward estimates period. As a proportion of GSP, superannuation liability is forecast to decline from 4.9 per cent in June 2008 to 4.1 per cent in June 2012.

Detailed information on net debt and financial liabilities can be found in Chapter 3, *Budget Position and Outlook*.