

CHAPTER 3: BUDGET OVERVIEW

Key Findings of the Committee:

- 3.1** In 2003-04 the estimated actual expenditure was \$27,299 million, an increase of \$945 million or 3.6 per cent from the original budget estimate for the year of \$26,354 million. The increase in expenditure was substantially influenced by a one-off expenditure of \$1,250 million involving the decision to cease collection of a levy payable to the State Electricity Commission of Victoria and the assumption of this obligation by the general government sector. The Committee observed that the expenditure over-run was able to be absorbed due primarily to a downward revaluation of unfunded superannuation liabilities.
- 3.2** Estimated actual revenue for 2003-04 was \$27,731 million, around \$1,133 million greater than the budget projection of \$26,598 million. Although the reasons for the increase were attributed to greater than expected revenue, the outcome reflected the volatility of budget projections and a need for the Government to closely monitor revenue and expenditure estimates if election commitments for 2004-05 are to be fully met.
- 3.3** The international ratings agency, Standard and Poor's confirmed Victoria's AAA rating in July 2004, but drew attention to the Commonwealth-State financial arrangements whereby Victoria benefits less than most other states under this system, receiving less than the average per capita grant from the Commonwealth. Some aspects of these financial arrangements are currently under review by the Commonwealth and all states.
- 3.4** The ability of the Government to commit to a substantial asset investment program of an estimated \$10 billion over the forward estimates period, within projected debt increase levels, will rely on the generation of ongoing accrual operating surpluses over the next four years. This source of funding emphasises the importance for the Government in maintaining operating surpluses.
- 3.5** Approximately 14 per cent of the total capital value of new infrastructure projects announced in the 2004-05 Budget are anticipated to be delivered under the public private partnership arrangements, including the Melbourne Convention Centre.

- 3.6 Employee benefits costs for 2004-05 are budgeted to increase by \$643.2 million from the revised 2003-04 estimate. The information in the Budget Papers does not separately identify employee benefit increases by wages and staffing levels. According to Standard and Poor's, the Government's wages policy has resulted in most major wage agreements being settled at a cost of less than 4 per cent per annum to the Government. The Victorian Economic News shows that the wage cost index for Victorian public sector wages grew by 3.4 per cent during the year to March 2004, below the national index growth of 4.3 per cent. Enterprise bargaining arrangements need to be complemented by public sector wide workforce planning to ensure the continuity of a skilled and efficient workforce.**
- 3.7 Recent public sector wage agreements have resulted in changes to some employee entitlements, including earlier availability of long service leave. The impact of changes to these employee entitlements will need to be closely monitored in order to maintain control over this major component of Government expenditure.**

3.1 Budget strategies and priorities

The Government is committed to maintaining a substantial budget operating surplus of at least \$100 million in each year.¹ The Government has estimated an operating surplus of \$545 million in 2004-05, with estimated surpluses averaging \$571 million over the next three years.² Revenue for 2004-05 is estimated to increase by \$1,253.7 million, or 4.5 per cent from the 2003-04 estimated actual result.³ This is slightly higher than the estimated expenditure growth of \$1,141.2 million, or 4.2 per cent.⁴ The slight margin between revenue and expenditure growth is a signal for the Government that it will need to firmly control its expenditure in 2004-05, particularly given that the generation of surpluses is a key source of funding for the Government's capital works program.

The Government's stated budget priorities are directed towards:⁵

- boosting children's health services; protecting vulnerable children; and assisting families with schooling costs, health care and housing;

¹ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.4

² *ibid.*

³ *ibid.*, p.41. The Committee's review was based on the Government's estimate of the actual results for 2003-04. The Government released the actual results for 2003-04 on 13 October 2004.

⁴ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.39

⁵ Hon. J. Brumby, MP, Treasurer, media release, *Budget 2004-05: Putting families first*, 4 May 2004

- building and modernising infrastructure; with \$10 billion in infrastructure spending over the next four years;
- providing an extra \$2 billion for the health system over the next four years to meet hospital demand, ensuring the ongoing financial stability of public hospitals, developing health and aged care facilities and expanding public dental services;⁶
- increasing education funding by \$486.3 million over four years to employ 250 additional teachers and provide new or upgraded schools; improving access to TAFE and upgrading TAFE buildings and equipment;⁷
- increasing the capacity of the Victoria Police Forensic Science Department; providing Victoria Police with state-of-the-art surveillance and IT equipment; constructing 19 new police stations; and boosting funding for court diversion programs;
- increasing the capacity of the fire fighting services, including the provision of 190 new trucks for the Country Fire Authority;
- improving outer metropolitan and rural roads through \$552.7 million in funding;
- assisting Victorian homebuyers through initiatives such as cash grants of \$5,000 for first home buyers; abolishing stamp duty on mortgages; expanding property stamp duty exemptions; and expanding access to public housing for low income families;
- encouraging business investment and jobs growth by reducing land tax by \$1 billion over five years; and reducing average WorkCover premiums;
- providing benefits totalling \$1 billion for regional Victoria, including upgrading school and TAFE facilities; improving rural and regional roads; and upgrading hospital and health services;
- boosting funding to the Arts by \$52.1 million; and
- strengthening Indigenous communities.

The Treasurer also advised the Committee that the Government's recurrent initiatives announced in *Labor's Financial Statement* in 2002 would be fully satisfied in the 2004-05 Budget. In addition, around 80 per cent of the capital commitments would be satisfied in the 2004-05 Budget, with the remainder being delivered over future budgets.⁸

⁶ Hon. B. Pike, MP, Minister for Health, media release, *More than \$2 billion to strengthen health system*, 4 May 2004

⁷ Hon. L. Kosky, MP, Minister for Education and Training, and Hon. J. Allan, MP, Minister for Education Services, media release, *\$486.3 million school building program, new teachers*, 4 May 2004

⁸ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.10

Revenue for 2004-05 is projected to be \$28,984.9 million, an increase of \$1,253.7 million from the 2003-04 estimated actual result.⁹ The increase in revenue is anticipated from taxation (\$144.1 million),¹⁰ police fines - mainly reflecting the rectification of issues leading to the suspension of fixed site speed cameras in 2003 (\$117 million),¹¹ higher dividends derived from government business enterprises - mainly from the recommencement of dividend payments by the Transport Accident Commission (\$177 million),¹² and grants from the Commonwealth Government (\$734.8 million).¹³

The Committee noted that the original 2003-04 Budget provided for revenue of \$26,598.4 million, as compared to the estimated actual result of \$27,731.2 million, an increase of \$1,132.8 million or 4.3 per cent.¹⁴ The unexpected increase in revenue was attributed by the Treasurer to higher than expected returns on superannuation fund assets, an increase in taxation revenue due to the continuing growth in the Victorian property market (\$647 million),¹⁵ and increased investment income mainly from higher dividends and tax equivalent payments derived by the Government from government business enterprises and interest revenue (\$138 million).¹⁶ It is difficult for the Committee to determine whether the economic assumptions used in the determination of estimated revenue for 2003-04 were conservative, leading to the extra revenue of \$1,132.8 million for the year, or whether the economic upturn should have reasonably been foreseen. The situation in 2003-04 illustrates the volatility of budget projections, and the need for the Government to closely monitor revenue projections if the commitments for 2004-05 are to be fully met.

Expenses for 2004-05 are projected to be \$28,439.9 million, an increase of \$1,141.2 million, or 4.2 per cent from the 2003-04 estimated actual result.¹⁷ The projections assume the superannuation expense will return to normal levels after the higher than anticipated superannuation investment returns achieved in 2003-04 and an increase in employee entitlement expenditure flowing from increases in wages and employee numbers.

The Committee also noted that the initial 2003-04 Budget provided for expenditure of \$26,353.9 million as compared to the estimated actual expenditure of \$27,298.7 million, an increase of \$944.8 million or 3.6 per cent.¹⁸ The unbudgeted increase in expenditure included the one-off expense of \$1,250 million relating to the

⁹ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.41

¹⁰ Budget Paper No. 4, *2004-05 Statement of Finances*, pp.119-120

¹¹ *ibid.*, p.120, 133

¹² *ibid.*, p.120, 134

¹³ *ibid.*, p.120, 137

¹⁴ *ibid.*, p.216

¹⁵ *ibid.*

¹⁶ *ibid.*, p.218 and the Treasurer's response to the Committee's follow up questions, p.4. The Committee intends to follow up on dividend payments paid by government business enterprises to the Government in its 2003-04 Budget Outcomes report.

¹⁷ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.39

¹⁸ Budget Paper No. 4, *2004-05 Statement of Finances*, p.216

Government's decision to cease collection of the smelter reduction amount levy.¹⁹ This increase was partially offset by the lower than budgeted superannuation expense of \$1,176 million, as a result of higher than anticipated investment returns on superannuation fund assets in 2003-04, and a reduction in the unfunded superannuation liability of the State Superannuation Fund following the 2003 triennial review of the fund.²⁰ The budget variation further illustrates a need for the Government to restrain expenditure within budget estimates, without a reliance on potential unbudgeted revenue increases to fund expenditure over-runs.

The Government has included in its expenditure estimates for 2004-05 contingency provision funding of \$268.1 million to supplement non-wage related expenses which may arise during the year from unexpected and unforeseen events, and to fund public sector salary costs associated with enterprise bargaining agreements concluded prior to 30 June 2004.²¹ The inclusion of this contingency provision strengthens the Government's projections of its financial position.

The estimates in the Commonwealth Budget Papers for 2004-05 did not specify national competition policy payments beyond 2005-06.²² The Victorian Government anticipated that the payments would continue into the future and has factored the continuation of these payments into its estimates for 2006-07 and 2007-08.²³

Since preparation of the Victorian budget, the Federal coalition parties announced in September 2004 that, if re-elected, it would apply \$1.6 billion in funding previously included as an allowance in a contingency reserve for the continuation of payments to the states under competition reform to a new national water fund, effective from 2006-07.²⁴ Subsequently, the Federal Opposition announced that, if elected, it would apply \$800 million from those contingency reserve funds towards its health policy.²⁵ With the re-election of the Federal Coalition Government in October 2004, the Committee noted that national competition policy payments to the states are expected to cease from 2006-07.

The Committee draws attention to the impact on the budget estimates of a cessation of this funding. A shortfall in revenue will result in the Government needing to amend the forward estimates for future output and asset investment initiatives for 2006-07 and 2007-08.

¹⁹ *ibid.*, p.220

²⁰ *ibid.*; Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.60

²¹ Budget Paper No. 4, *2004-05 Statement of Finances*, p.33

²² Commonwealth Government, Budget Paper No. 3, *Federal Financial Relations 2004-05*, p.21

²³ Hon. J. Brumby, MP, Treasurer, media release, *Howard tears up national competition agreement*, 13 September 2004

²⁴ Liberal Party of Australia, *Securing Australia's Water Future*, www.liberal.org.au, accessed 6 October 2004

²⁵ The Courier-Mail, *Labor stakes \$1b on health*, 23 September 2004

Commencing from the 2004-05 Budget, departmental funding was allocated through a new funding model. The funding model provides departments with an 'inclusive' budget within which they are required to manage expenditure within productivity constraints. Under the funding model, departments are funded for the period from 1 July 2004 for award wage increases consistent with the Government's wages policy, without access to the contingency provision to supplement wage related increments. The new funding model will moderate the potential for large budget fluctuations due to wage increases, which were previously met from contingency funds. In effect, individual departments and recipients of departments' services, rather than the budget as a whole, will carry the risk of wage increases in excess of the Government's wages policy, while potentially benefiting from wages increases below that level.

The Government's expenditure on infrastructure investment in 2004-05 is projected to be \$2.9 billion.²⁶ In 2004-05, infrastructure expenditure will be funded mainly from net cash flows from operating activities totalling \$2,540.6 million, with additional funding sourced from drawdowns on the Growing Victoria infrastructure reserve (\$186 million) and other increases in net debt (\$143 million).²⁷ With the run down of the Growing Victoria infrastructure reserve in 2005-06, over the forward estimates period the incurring of other moderate increases in net debt will be a secondary source of funding for the Government's asset investment program.²⁸ Public private partnerships will form a small but crucial part of infrastructure delivery in Victoria in the future.²⁹

The 2004-05 Budget did not provide additional funding for the continuation of the Growing Victoria infrastructure reserve after 2005-06.³⁰ The remaining funding in the Growing Victoria infrastructure reserve of \$4.5 million is to be fully expended in 2005-06.³¹

The *Appropriation (2004/05) Act* 2004 provided a total net appropriation of \$23,351.8 million for the Government to meet its service delivery responsibilities in 2004-05.³² This amount excludes funds that are credited to departments pursuant to section 29 of the *Financial Management Act* 1994 which allows departments to retain certain revenue, mainly generated from the recoupment of costs associated with service delivery.³³ Included in the net appropriation is an amount representing an advance to the Treasurer of \$474.2 million to meet urgent claims that may arise before Parliament's sanction is obtained.³⁴

²⁶ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.2

²⁷ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.5, 47

²⁸ *ibid.*, p.5

²⁹ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.13

³⁰ Treasurer's response to the Committee's follow up questions, p.4

³¹ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.9

³² *Appropriation (2004/2005) Act* 2004, p.5; Budget Paper No. 1, *2004-05 Treasurer's Speech*, p.12

³³ Budget Paper No. 1, *2004-05 Treasurer's Speech*, p.12

³⁴ *Appropriation (2004/2005) Act* 2004, p.14

3.2 Basis for preparation of the 2004-2005 Budget

The 2004-05 Budget is framed around the Government's financial management policy to provide a sound and stable financial basis from which growth can be promoted across the whole state.³⁵ To meet the aim of this policy the Government has established short term and long term financial objectives (see exhibit 3.1).

Exhibit 3.1: Victorian Government 2004-05 financial objectives

| |
|---|
| Long-term financial objectives: |
| <ul style="list-style-type: none"> • maintain a substantial budget operating surplus; • deliver world-class infrastructure to maximise economic, social and environmental benefits; • provide improved service delivery to all Victorians; • provide a fair and efficient tax system that is competitive with other states; and • maintain State Government net financial liabilities at prudent levels. |
| Short-term financial objectives: |
| <ul style="list-style-type: none"> • maintain an operating surplus of at least \$100 million in each year; • implement strategic infrastructure projects, including those funded from the Growing Victoria infrastructure reserve; • implement 2002 election commitments; • implement reforms to Victoria's business taxation system; and • maintain a triple-A credit rating. |

Source: Budget Paper No. 2, 2004-05 Strategy and Outlook, p.3

The Committee notes that the Government's financial management policy has been reviewed by the international ratings agency Standard and Poor's. On 26 July 2004, the ratings agency confirmed Victoria's AAA credit rating. The agency listed Victoria's strengths as:³⁶

- *very strong balance sheet. A conservative measure of financial obligations, non-financial public sector net financial liabilities are only 55.5 per cent of operating revenue. Less stringent measures show an even stronger position: net direct debt of the general government sector is only 6.4 per cent of operating revenue;*
- *strong management capacity. The government's commitment to fiscal discipline is evident in its traditionally prudent approach to fiscal budgeting;*
- *strong and diverse economic base;*

³⁵ Budget Paper No. 2, 2004-05 Strategy and Outlook, p.2

³⁶ Standard and Poor's, *Credit ratings: State of Victoria*, p.1, <http://www2.standardandpoors.com>, accessed 26 August 2004

- *good financial performance. The state has typically recorded non-financial public sector cash surpluses even after capital spending. Some small deficits are projected over the next few years, but this is consistent with the 'AAA' rating given the strong balance sheet and a track record of conservative budgeting; and*
- *"low risk" revenue stream. Following the sale of its energy assets, the state's revenue is dominated by "core" government revenues and "low risk" government-owned trading enterprises engaged in areas such as water and waste water.*

At the 2004-05 estimates hearing, the Treasurer advised the Committee that only 10 states in America had a AAA rating, and that outside of America, only 16 per cent of world economies had the same rating.³⁷ The Committee notes that as of October 2004, all Australian mainland states and the ACT have a AAA rating.

Standard and Poor's drew attention to Australia's institutional framework under which Victoria relies on grants from the Commonwealth Government over which it had no control, for 45 per cent of total revenue, despite reliance on this revenue for major spending responsibilities such as health, education and transport.³⁸ The agency further commented on the Commonwealth-State financial arrangements, under which the *'less well-off states [receive] more on a per capita basis than other states, [with the result that] Victoria benefits less than most other states under this system, receiving less than the average per capita grant'*.³⁹ In addition, around 40 per cent of the grants received must be used for specific purposes.⁴⁰

The issue of whether Victoria receives its fair share of Commonwealth Government funds by comparison with other states under Commonwealth-State financial agreements has been contentious for many years. The Committee is pleased to note that at the Ministerial Council for Commonwealth-State Financial Relations meeting in Canberra in March 2004, a majority of states and territories, with the support of the Commonwealth Government, agreed to review some aspects of the existing grants system.⁴¹ The review is to be conducted by Treasury heads from all Australian jurisdictions.

The Committee noted that general government net debt⁴² is expected to increase from \$1.8 billion at June 2004 to \$2.6 billion at June 2008.⁴³ As a percentage of Gross State Product (GSP), net debt is expected to remain around 1 per cent.⁴⁴

³⁷ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.6

³⁸ Standard and Poor's, *Credit ratings: State of Victoria*, p.4, <http://www2.standardandpoors.com>, accessed 26 August 2004

³⁹ *ibid.*, p.2

⁴⁰ *ibid.*, p.4

⁴¹ Hon. J. Brumby, MP, Treasurer, media release, *Victoria's push for grants review accepted*, 26 March 2004

⁴² The Government's position is that the financial assets in the Growing Victoria infrastructure reserve are not deducted from net debt because these financial assets are committed to fund Growing Victoria infrastructure projects (Source: Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.64)

General government net financial liabilities⁴⁵ are expected to increase from \$14 billion at June 2004 to \$16.4 billion at June 2008. As a share of Gross State Product, these liabilities are projected to fall from 6.8 per cent to 6.5 per cent.⁴⁶

3.3 New initiatives funding for 2004-2005

The 2004-05 Budget provided additional funding for new service delivery initiatives of \$1,078.3 million in 2004-05, with further funding of \$2,517.4 million⁴⁷ over the following three years (see exhibit 3.2). After allowing for funding from existing forward estimates demand and other contingencies put aside for service delivery and demand growth of \$390.7 million, the net budget impact of 2004-05 output funding is \$687.6 million (see exhibit 3.2).

The 2004-05 Budget provided funding for the commencement of new infrastructure projects with a total estimated investment of \$2,010 million,⁴⁸ with funding of \$608.5 million for 2004-05 (see exhibit 3.2).

⁴³ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.49

⁴⁴ *ibid.*

⁴⁵ Net financial liabilities are the sum of unfunded superannuation liabilities and general government net debt. The financial assets in the Growing Victoria infrastructure reserve are excluded (Source: Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.67)

⁴⁶ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.49

⁴⁷ *ibid.*, p.34

⁴⁸ *ibid.*, p.36

Exhibit 3.2: New output and asset initiatives funding for 2004-05

| Departments | 2004-05 Output initiatives \$ million | 2004-05 Asset initiatives \$ million |
|--|--|---|
| Education and Training (a) | 89.9 | 142.7 |
| Human Services (a) | 349.6 | 180.9 |
| Infrastructure | 301.6 | 155.9 |
| Innovation, Industry and Regional Development | 33.2 | 23.8 |
| Justice | 78.9 | 37.7 |
| Premier and Cabinet | 12.9 | 17.9 |
| Primary Industries | 10.7 | 0.0 |
| Sustainability and Environment | 18.0 | 2.0 |
| Treasury and Finance | 133.3 | 21.4 |
| Victorian Communities | 10.7 | 5.4 |
| Parliament | 2.1 | 4.0 |
| Government-wide | 37.5 | 17.0 |
| Total | 1,078.3 | 608.5 |
| Less: Funding from contingencies | -390.7 | n/a |
| Net budget impact of new 2004-05 Budget funding (b) | 687.6 | 608.5 |

Notes: (a) includes funding for the taxation concessions program
 (b) excludes initiatives funded through internal reprioritisation or other existing fund sources and 2003-04 Budget Update output initiatives
 n/a not applicable
 Some figures may not add up due to rounding

Source: Budget Paper No. 2, 2004-05 Strategy and Outlook, pp.35–36

Examples of major new output initiatives announced by the Government include:

- \$128 million in 2004-05 for the First Home Bonus, providing one-off \$5,000 grants to first home buyers for homes up to \$500,000;⁴⁹
- \$177 million over four years to boost children’s health and dental services; extra support for foster-carers; and child protection;⁵⁰
- \$1.6 billion over four years to continue the hospital sustainability and demand management strategy aimed at treating an extra 35,000 hospital patients and 50,000 emergency department patients and employing an extra 900 nurses and health staff;⁵¹

⁴⁹ Budget Paper No. 3, 2004-05 Service Delivery, p.37, 301

⁵⁰ *ibid.*, p.5

⁵¹ *ibid.*, pp.13–14, 275–276

- \$243.2 million over four years to employ extra teachers, introduce specialised education and training programs, provide extra resources for TAFE and training and boost school maintenance programs;⁵²
- \$35 million for major events over the next three years;⁵³
- \$212.6 million over four years to assist Victoria Police, emergency service organisations, correctional services and the legal system to increase operational resources and services. Funding to Victoria Police will be directed towards more intelligent policing using the latest technology and crime fighting methodology, in conjunction with a greater emphasis on community policing and working with other agencies and groups;⁵⁴ and
- \$28.5 million over four years towards the Victorian On Line Titles System, document imaging and search services.⁵⁵

Examples of new asset initiatives include:

- \$157.1 million to build new and replacement schools and modernise existing schools;⁵⁶
- \$86.5 million for Kew residential services redevelopment;⁵⁷
- an estimated \$250 million for the new Royal Women's Hospital;⁵⁸
- an estimated \$357 million for new assets to improve hospital health care services, aged care facilities and ambulance services;⁵⁹
- an outer metropolitan road upgrade program costing \$164 million;⁶⁰
- funding of \$186 million for the Geelong Western Bypass;⁶¹
- improvements to Victoria's road safety infrastructure with funding of \$130 million from the Transport Accident Commission;⁶²
- a new Melbourne Convention Centre (\$367 million);⁶³ and
- \$67.5 million to the Victorian Water Trust for a range of projects to improve water supplies and sewerage treatment in rural towns, upgrade irrigation systems and use of recycled water.⁶⁴

⁵² *ibid.*, p.270

⁵³ *ibid.*, p.289

⁵⁴ *ibid.*, p.291

⁵⁵ *ibid.*, p.299

⁵⁶ *ibid.*, p.272

⁵⁷ *ibid.*, p.279

⁵⁸ *ibid.*, p.280

⁵⁹ *ibid.*, pp.279–280

⁶⁰ *ibid.*, p.287

⁶¹ *ibid.*

⁶² *ibid.*

⁶³ *ibid.*, p.290

⁶⁴ *ibid.*, p.300

The 2004-05 Budget provided funding of an estimated \$2,010 million to be expended on asset investment over the forward years.⁶⁵ The Government indicated that approximately 14 per cent of the total capital value of new infrastructure investment projects funded from the 2004-05 Budget are anticipated to be delivered under the public private partnership arrangements, including the Melbourne Convention Centre.⁶⁶

After taking into account projects in progress from prior years, the Government anticipates spending around \$10 billion in infrastructure over the next four years.⁶⁷ Infrastructure projects already in progress include the Fast Rail Project (\$617 million), Spencer Street Station Redevelopment (\$700 million), Australian Synchrotron (\$206 million) and the Austin Hospital Redevelopment (\$376 million).⁶⁸

The Committee observes that the ability of the Government to commit to its large asset investment program within projected debt levels is a result of the accrued operating surpluses which have been generated over recent years. It will be important for the Government to maintain operating surpluses over the next four years in order to meet the infrastructure commitments within those debt levels.

3.3.1 Changes to departmental funding arrangements

A new departmental funding model was introduced commencing from the 2004-05 year. The Treasurer indicated that the new funding arrangements will drive productivity growth and improve policy outcomes across departments.⁶⁹

The funding model provides departments with a fixed budget indexed to a price escalation factor to maintain alignment with movements in the rate of inflation and is inclusive of funding for wages growth within the Government's wages policy.⁷⁰ The funding model abolished the 1.5 per cent productivity dividend previously applied to departments. While the fixed productivity dividend no longer applies, the drive for productivity has not been abolished. Under the funding model, departments are able to take into account their individual circumstances to achieve productivity improvements.⁷¹ With the funding model, departments are presented with greater certainty of future funding levels.⁷²

⁶⁵ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.36

⁶⁶ *ibid.*, pp.57-58

⁶⁷ Hon. J. Brumby, MP, Treasurer, media release, *Record infrastructure spending drives growth and jobs*, 4 May 2004, p.2

⁶⁸ *ibid.*

⁶⁹ Budget Paper No. 1, *2004-05 Treasurer's Speech*, p.4

⁷⁰ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.13, 92

⁷¹ *ibid.*, p.13

⁷² *ibid.*, p.12

Previously, wages supplementation funding for enterprise bargaining agreement outcomes was provided to departments from the contingency provision managed centrally by the Department of Treasury and Finance.⁷³ Under the new model and effective from 1 July 2004, the Government has provided departments with funding for enterprise bargaining agreement wage increases that are consistent with the Government's wages policy.⁷⁴ The Committee will monitor if departments are able to contain wage pressures under the new arrangements.

The Committee noted that according to Standard and Poor's the Government wages policy has resulted in most major wage agreements being settled at a cost of less than 4 per cent per annum to the Government – close to national averages and well below the initial claims.⁷⁵ According to the Department of Treasury and Finance publication *Victorian Economic News*, the wage cost index for Victorian public sector wages grew by 3.4 per cent during the year to March 2004, below the national index growth of 4.3 per cent.⁷⁶

The Committee notes the significant enterprise bargaining agreements that have been finalised and accordingly, Government wages costs for 2003-04 were expected to be \$240 million higher than was estimated in the 2003-04 budget.⁷⁷

In relation to 2004-05 the Treasurer advised the Committee that:⁷⁸

Employee benefits for 2004-05 are budgeted to increase by \$643 million, which is a 6.25 per cent rise from the revised 2003-04 estimate, and that rise largely reflects the government's wages policy, obviously, plus additional expenditure as a result of higher staffing levels in health and education.

The 2004-05 budget estimates for employee entitlements are \$503 million higher than the estimates for 2004-05 in the 2003-04 budget.⁷⁹

The Budget Papers do not contain data that separately disclose employee benefit increases due to wage increases and increases due to higher staffing levels.

The Committee notes that most of the wage agreements negotiated were for three year periods, which should provide a period of certainty for budget purposes. The Treasurer also advised the Committee that a contingency provision is included in the

⁷³ *ibid.*, p.92

⁷⁴ *ibid.*

⁷⁵ Standard and Poor's, *Credit ratings: State of Victoria*, p.4, <http://www2.standardandpoors.com>, accessed 26 August 2004

⁷⁶ Department of Treasury and Finance, *Victorian Economic News*, June 2004, p.12

⁷⁷ Budget Paper No. 4, *2004-05 Statement of Finances*, p.216

⁷⁸ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.12

⁷⁹ Refers to employee entitlement expenses for 2004-05, see Budget Paper No. 2, *2003-04 Budget Statement*, p.164 and Budget Paper No. 4, *2004-05 Statement of Finances*, p.8

2004-05 Budget to provide for employee costs associated with wage agreements that were settled prior to 30 June 2004.⁸⁰

Based on its inquiry into the Victorian Public Service,⁸¹ the Committee considers that the Government's wages policy needs to be complemented by sector-wide workforce planning which takes into account labour market movements, market shortages such as occur with the nursing, medical and dental professions and salary levels for skilled professionals where the public sector competes with the private sector for placements.

3.4 Economic projections for 2004-2005

The Government identified the new challenges for the Victorian economy as: the stronger Australian dollar putting additional pressure on manufacturers and exporters; rises in interest rates increasing business costs; and an increasingly competitive global economy.⁸²

The Budget Papers estimate that economic growth for 2004-05 will be 3.25 per cent, the same growth as occurred in 2003-04.⁸³ In 2004-05, economic growth is anticipated to be led by increased demand for Victorian exports as the global economy improves, domestic demand strengthens and business investment increases.⁸⁴ Housing construction activity is anticipated to slow in 2004-05, which will have some impact on property taxes collected by the Government.⁸⁵

At the estimates hearing the Treasurer informed the Committee that the projected economic growth of 3.25 per cent is broadly consistent with private sector forecasts.⁸⁶ However, Access Economics' *Business Outlook* March Quarter 2004 forecasts that the Victorian economy will grow by only 2.9 per cent in 2004-05.⁸⁷

Employment growth is estimated to remain strong, with projections of a 1.5 per cent growth in 2004-05, signifying a 0.25 percentage point increase from the revised projections for 2003-04.⁸⁸ Inflation is expected to ease from 2.25 per cent in 2003-04 to 2 per cent in 2004-05, largely reflecting the '*impact of the unexpected strength of the Australian dollar on the price of imported consumer goods.*'⁸⁹

⁸⁰ Treasurer's response to the Committee's follow up questions, p.3

⁸¹ Public Accounts and Estimates Committee, *Report on the Review of the Victorian Public Service*, October 2002

⁸² *2004-05 Victorian Budget Overview*, p.8

⁸³ *ibid.*

⁸⁴ *ibid.*

⁸⁵ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.26

⁸⁶ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.3

⁸⁷ Access Economics, March 2004, *Business Outlook*, p.97

⁸⁸ *2004-05 Victorian Budget Overview*, p.8

⁸⁹ *ibid.*; Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.26

Population growth for 2004-05 is expected to remain at 1.1 per cent, unchanged from the revised forecast for 2003-04.⁹⁰ Overseas migration is the main attributor to Victoria's population growth.⁹¹ The projection assumes there will be no net interstate migration into and out of Victoria.⁹²

The Government has projected the unemployment rate and wages growth to remain unchanged from the current projections of 5.5 per cent and 3.5 per cent respectively.⁹³

The Government identifies the key risks to its economic projections as: weaker export recovery; larger than expected decline in housing sector activity; re-emergence of drought conditions; and weaker than expected population growth.⁹⁴

The Government's projected operating surplus will be affected by variations to the Government's forecast for the economic indicators. A one percentage point decrease in economic growth will have the effect of reducing the operating surplus by \$125 million in 2004-05.⁹⁵ A one percentage point increase in wages (assuming public sector wages increased by one per cent above the Government's wages policy without productivity offsets or additional departmental funding) could reduce the operating surplus by \$94 million, and a one percentage point increase in interest rates could reduce the operating surplus by \$24 million.⁹⁶

3.5 Budget surplus for 2004-05

The estimated operating surplus for 2004-05 of \$545 million represents an increase of \$112.5 million from the revised surplus of \$432.5 million for 2003-04⁹⁷ (see exhibit 3.3). In 2004-05, revenue is projected to increase by \$1,253.7 million, compared to growth in expenses of \$1,141.2 million (see exhibit 3.3). In essence, the projected increase in revenue will be offset by increased expenditure, except for a margin of \$112.5 million which will contribute to the operating surplus.

Total revenue for 2004-05 is estimated to be \$28,984.9 million, an increase of 4.5 per cent from the 2003-04 revised estimates (see exhibit 3.3). The revenue estimates were prepared after taking into account Government policy decisions such as land tax relief, extending payroll tax to employment agencies and abolishing certain stamp duties while extending others. The projected revenue growth shows vulnerability in taxation revenue with the Government projecting an increase of only \$144.1 million from the 2003-04 revised estimates (see exhibit 3.3). The key driver of taxation revenue growth in previous years, land transfer duty, is projected to decrease

⁹⁰ 2004-05 Victorian Budget Overview, p.8

⁹¹ Budget Paper No. 2, 2004-05 Strategy and Outlook, p.25

⁹² *ibid.*, p.26

⁹³ 2004-05 Victorian Budget Overview, p.8

⁹⁴ Budget Paper No. 2, 2004-05 Strategy and Outlook, pp.85-86

⁹⁵ *ibid.*, p.87

⁹⁶ *ibid.*, pp.87-88

⁹⁷ The Committee's review was based on the Government's estimate of the actual results for 2003-04. The Government released the actual results for 2003-04 on 13 October 2004

by \$278.3 million, mainly in anticipation of the slowdown in housing market activities.⁹⁸ The net effect of the taxation policy changes that take effect in 2004-05 is expected to reduce taxation revenue by \$136.8 million in 2004-05 compared with the position if these policy changes had not been made.⁹⁹ The Government's decision to reduce the motor vehicle registration fees concession will result in reduced taxation expenditures of \$64.3 million which are redirected to other concession programs.¹⁰⁰

A greater than expected decline in budgeted taxation revenue will increase reliance on other revenue sources such as fines and dividends from government business enterprises to sustain the operating surplus.

Revenue from fines and regulatory fees is expected to return to 'more normal operational conditions'¹⁰¹ in 2004-05 following the suspension of fixed site speed camera operations in November 2003.¹⁰² Police fines are estimated to increase by \$117 million in 2004-05, representing a 50.1 per cent increase on collections in 2003-04.¹⁰³

GST revenue grants from the Commonwealth are expected to increase by \$286.4 million in 2004-05 mainly reflecting the growth in the Commonwealth's GST revenue collections.¹⁰⁴ In accordance with the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, Victoria does not anticipate it will require GST transitional grants in 2004-05, reflecting the Commonwealth's analysis that *'from 2004-05 onwards, every State and Territory (the States) will receive more revenue from the GST than they would have under the previous system of Financial Assistance Grants and the state taxes that were abolished by the New Tax System. ... From 2004-05 onwards, no State will require Budget Balancing Assistance.'*¹⁰⁵

In September 2004 the Commonwealth Government announced revised estimates for GST revenue grants, indicating that Victoria would receive \$7,321.1 million¹⁰⁶ in 2004-05 which includes an additional \$169.7 million above that estimated in the May 2004 Commonwealth Budget.

Total expenses for 2004-05 are estimated to be \$28,439.9 million, an increase of 4.2 per cent from the 2003-04 revised estimates (see exhibit 3.3). While expenses are projected to increase at a rate lower than revenue, growth in expenses, particularly employee entitlements and superannuation expenses will place further pressure on the Government to prudently manage its finances.

⁹⁸ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.41

⁹⁹ *ibid.*, p.37

¹⁰⁰ *ibid.*, p.38

¹⁰¹ Budget Paper No. 4, *2004-05 Statement of Finances*, p.133

¹⁰² *ibid.*

¹⁰³ *ibid.*

¹⁰⁴ *ibid.*, p.137

¹⁰⁵ Commonwealth Government, Budget Paper No. 3, *Federal Financial Relations 2004-05*, p.1

¹⁰⁶ Hon. P. Costello, MP, Commonwealth Treasurer, media release, *GST revenue windfall to the States and Territories*, Attachment A, 17 September 2004

The Committee observed that under new public sector agreements, pro-rata long service leave will now be available after seven years rather than ten years. The Committee sought to determine the potential impact of this new provision on costs and employee working patterns. The Treasurer assured the Committee that the 2004-05 Budget and forward estimates were adjusted to reflect the estimated changes to long service leave entitlements based on information available at the time of preparing the budget.¹⁰⁷ The Committee considers that the eventual impact of changes to employee entitlements will need to be closely monitored in order to retain control over this major component of Government expenditure.

In 2004-05 superannuation expenses are projected to return to their assumed level after the higher than anticipated superannuation investment returns achieved in 2003-04, hence the significant increase of \$1,014.5 million compared to the 2003-04 revised estimates (see exhibit 3.3). Although there was a strong global equity market performance in 2003-04, the Government has provided for a superannuation fund investment earnings rate of 7.5 per cent a year in 2004-05, which is only slightly higher than the previous budget projections of 7 per cent.¹⁰⁸

Exhibit 3.3 illustrates the revenue and expenses projections for 2004-05.

¹⁰⁷ Treasurer's response to follow up questions, p.4

¹⁰⁸ Budget Paper No. 4, *2004-05 Statement of Finances*, p.36

**Exhibit 3.3: Statement of Financial Performance
2003-04 and 2004-05**

| | Column 1 | Column 2 | Column 2-1 | Column (2-1)/1 |
|------------------------------|---|--|---|--------------------------------|
| | 2003-04 Revised \$ million | 2004-05 Budget \$ million | Variation (a) \$ million | Variation (a) % |
| Taxation | 10,240.1 | 10,384.2 | 144.1 | 1.4 |
| Fines and regulatory fees | 483.1 | 617.0 | 133.9 | 27.7 |
| Investment revenue | 1,034.0 | 1,225.4 | 191.4 | 18.5 |
| Grants | 12,345.7 | 13,080.5 | 734.8 | 6.0 |
| Sales of goods and services | 2,165.0 | 2,231.3 | 66.3 | 3.1 |
| Other revenue (b) | 1,463.3 | 1,446.5 | -16.8 | -1.1 |
| Total revenue | 27,731.2 | 28,984.9 | 1,253.7 | 4.5 |
| Employee benefits | 9,837.3 | 10,480.5 | 643.2 | 6.5 |
| Superannuation | 774.7 | 1,789.2 | 1,014.5 | 131.0 |
| Grants and transfer payments | 6,025.0 | 5,087.7 | -937.3 | -15.6 |
| Supplies and services | 8,970.4 | 9,311.0 | 340.6 | 3.8 |
| Other expenses (c) | 1,691.3 | 1,771.3 | 80.0 | 4.7 |
| Total expenses | 27,298.7 | 28,439.9 | 1,141.2 | 4.2 |
| Net surplus | 432.5 | 545.0 | 112.5 | 26.0 |

Notes: (a) a negative variation denotes a decrease compared to 2003-04 Revised Budget
(b) includes gain/loss on disposal of assets, assets received free of charge or for nominal consideration, capital asset charge revenue and other miscellaneous revenue
(c) includes depreciation and amortisation, borrowing costs and other miscellaneous expenses

Some figures may not add up due to rounding

Sources: Budget Paper No. 4, 2004-05 Statement of Finances, p.8, 216

The above exhibit shows a revised surplus of \$432.5 million for 2003-04. The Committee's analysis disclosed that this figure was arrived at after two large abnormal factors affected the surplus in opposite directions. The first of these factors was an actuarial revaluation of the liabilities of the State Superannuation Fund which, when coupled with the recovery in global equity markets, produced a superannuation expense result of \$1,176 million¹⁰⁹ which was lower than budgeted. The second factor was an abnormal one-off expenditure item of \$1,250 million involving the cessation of the Smelter Reduction Amount.¹¹⁰ In the absence of this latter factor, the revised

¹⁰⁹ *ibid.*, p.220

¹¹⁰ *ibid.*

surplus for 2003-04 would have been in the vicinity of \$1,682 million, or \$1,437 million more than the initial budget estimate.¹¹¹

The Smelter Reduction Amount was a levy introduced in 1997 on wholesale purchases of electricity from the National Electricity Market, with the proceeds of the levy used to fund the State Electricity Commission's obligations to subsidise the aluminium smelters at Portland.¹¹² Following a legal challenge the levy was dropped and replaced by imposing land taxes on electricity transmission easements held by electricity transmission companies. To replace the \$1,250 million smelter reduction amount levy held as a receivable by the State Electricity Commission, it was necessary for the Government to undertake to pay an equivalent amount to the State Electricity Commission, and to record that amount as expenditure in its statement of financial performance in 2003-04.

The accounting treatment associated with the cessation of the Smelter Reduction Amount was accepted by the Auditor-General as appropriate.¹¹³ This is an example of an unexpected event that has an impact on budget estimates, which illustrates the volatility in budget projections.

3.6 Asset investment

At the estimates hearing, the Committee requested details of each department's purchases of physical assets for 2004-05 and the forward estimate years, which was previously included in the Budget Papers. This information is illustrated in exhibit 3.4.

¹¹¹ The initial budget estimate of the operating surplus for 2003-04 was \$244.5 million (source: Budget Paper No. 4, *2004-05 Statement of Finances*, p.216)

¹¹² Budget Paper No. 4, *2004-05 Statement of Finances*, pp.220–221

¹¹³ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.17

Exhibit 3.4: Fixed asset purchases by departments

| Departments | 2004-05 Budget \$ million | 2005-06 Estimate \$ million | 2006-07 Estimate \$ million | 2007-08 Estimate \$ million |
|--|--|--|--|--|
| Education and Training | 471 | 412 | 294 | 277 |
| Human Services | 665 | 480 | 327 | 165 |
| Infrastructure | 615 | 513 | 343 | 165 |
| Innovation, Industry and Regional Development | 73 | 41 | 4 | 4 |
| Justice | 339 | 130 | 71 | 62 |
| Premier and Cabinet | 78 | 34 | 36 | 34 |
| Primary Industries | 6 | 6 | 6 | 6 |
| Sustainability and Environment | 69 | 79 | 67 | 64 |
| Treasury and Finance | 65 | 100 | 55 | 24 |
| Victorian Communities | 57 | 22 | (b) -14 | (b) -7 |
| Parliament | 7 | 5 | 3 | 3 |
| Other general government sector agencies (a) | 99 | 89 | 84 | 84 |
| Not allocated to departments | (b) -74 | 337 | 738 | 1,224 |
| Total | 2,471 | 2,250 | 2,013 | 2,107 |

Notes: (a) represents government agencies classified as external to the general government sector

(b) negative figures represent instances where proceeds arising from the sale of assets are retained by departments and exceeds the value of asset purchases during that year

Some figures may not add up due to rounding

Source: Treasurer's response to the Committee's follow up questions, p.1

The Committee considered that the table which was previously in the Budget Papers, should be reinstated as it provides the reader with information on all capital works expenditure over the forward estimates period, inclusive of new asset initiatives. The table also provides an overview of capital expenditure in the major areas of health, education and transport.

The Committee recommends that:

Recommendation 11: The Government include in the Budget Papers a table summarising fixed asset purchases by departments.

The budget estimates include a capital provision that is not allocated to departments and which effectively sets aside funding for future capital investment projects.¹¹⁴ The unallocated capital provision is projected to rise from \$337 million in 2005-06 to \$1,224 million in 2007-08 (see exhibit 3.4). The inclusion of this provision in the budget estimates provides the Government with some flexibility to manage capital expenditure pressures, including variations to major projects.

While the estimates assume that capital expenditure pressures will be managed within the budgeted amounts in order to avoid putting additional pressure on the budget, the Government can apply any of the following three methods should project costs exceed initial capital budgets:¹¹⁵

- reallocate resources within departments' global capital budgets;
- re-scope a project to fit within funding parameters; and
- apply funding from the unallocated capital provision.

3.7 Unfunded superannuation liability

Unfunded superannuation is the state's most significant liability and represents the present value of future benefits accrued by members of the superannuation fund that are not covered by investments of the superannuation fund.¹¹⁶ The bulk of the unfunded superannuation liability is with the State Superannuation Fund.

The 2004-05 Budget projections of the unfunded superannuation liability are significantly lower than the level projected in the 2003-04 Budget, as a result of subsequent developments (see exhibit 3.5 for the projected unfunded superannuation liability of the State Superannuation Fund). These developments included the better than expected global equity market performance during 2003-04 and the 2003 triennial actuarial review of the State Superannuation Fund.¹¹⁷ The unfunded superannuation liability is estimated to be \$12,877.4 million at 30 June 2005.¹¹⁸ Based on the 2004-05 budget projections, the unfunded superannuation liability is expected to peak at \$13,866.5 million in 2007.¹¹⁹

¹¹⁴ Budget Paper No. 2, *2004-05 Strategy and Outlook*, p.93

¹¹⁵ *ibid.*

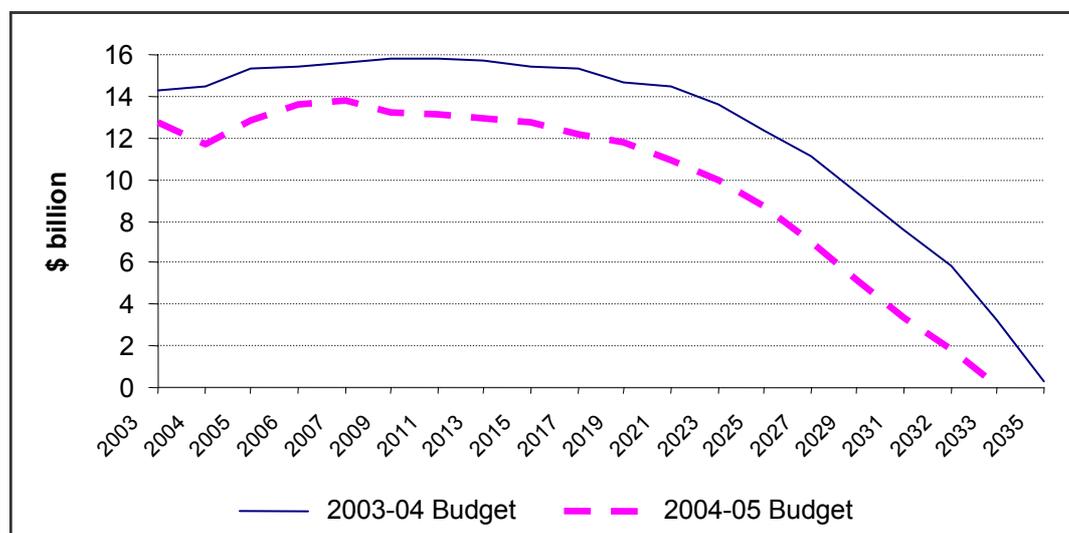
¹¹⁶ *ibid.*, p.59

¹¹⁷ *ibid.*, pp.59–60

¹¹⁸ Budget Paper No. 4, *2004-05 Statement of Finances*, p.36

¹¹⁹ *ibid.*

**Exhibit 3.5: State Superannuation Fund
Long-term projections for unfunded
superannuation liability**



Note: Projections are based on nominal values

Sources: Budget Paper No. 2, 2003-04 Budget Statement, p.120; Budget Paper No. 2, 2004-05 Strategy and Outlook, p.61

At the estimates hearing, the Treasurer indicated that the dip shown in the 2004-05 Budget projection in exhibit 3.5 reflects two factors:¹²⁰

- the prepayment of the unfunded superannuation liability; and
- movements in equity markets.

The Government has made additional payments totalling \$1.8 billion (since 2000) to the State Superannuation Fund to reduce the unfunded superannuation liability.¹²¹ The Treasurer indicated that based on the Government's present payment schedule, the unfunded superannuation liability will be extinguished by 2033, two years ahead of the Government's target of 2035.¹²² The Committee notes the explanation in the Budget Papers that the unfunded superannuation liability is projected to rise *'in the short term due to member benefits accruing more rapidly than the State Superannuation Fund's assets, [and that] after 2007, the unfunded liability declines as government contributions and investment earnings outweigh accrued liability growth.'*¹²³

¹²⁰ Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.10

¹²¹ Hon. J. Lenders, MP, Minister for Finance, transcript of evidence, 15 June 2004, p.3

¹²² Hon. J. Brumby, MP, Treasurer, transcript of evidence, 19 May 2004, p.6

¹²³ Budget Paper No. 2, 2004-05 Strategy and Outlook, p.61

The Committee was advised that the unfunded superannuation liability projections and its associated extinguishment will be affected by changes arising from the adoption of international financial reporting standards from 1 January 2005.¹²⁴ The unfunded superannuation liability is expected to be higher as a result of changes to the basis for discounting of future liabilities under the reporting standard.¹²⁵ The Minister for Finance indicated that *‘any increase in the State’s **reported** unfunded superannuation liability arising from the new accounting standards will not adversely impact on the Government’s **real** financial position. The amount of cash needed to actually fund future benefit payments will be unchanged.’*¹²⁶

The Committee understands that the Department of Treasury and Finance is currently coordinating the transition to the adoption of the international financial reporting standards and it may be too early for the impact on the reported budget position to be known. The Committee notes the assurance from the Minister for Finance that the reporting of the unfunded superannuation liability under the new regime will not have an adverse affect on the state’s actual financial position. However, the Committee believes it is important in the interests of transparency that estimates of the affects on the budget estimates and outcomes of the adoption of international financial reporting standards be made public as soon as possible, and prior to the first use of international financial reporting standards in the state budget, budget updates or annual reports.

The Committee recommends that:

Recommendation 12: **The Department of Treasury and Finance publish as soon as possible, and prior to the first use of international financial reporting standards in budget papers or annual reports, estimates of the effects of those standards on budget sector estimates and outcomes.**

¹²⁴ Hon. J. Lenders, MP, Minister for Finance, transcript of evidence, 15 June 2004, pp.3–4

¹²⁵ Minister for Finance’s response to the Committee’s follow up questions, p.10

¹²⁶ *ibid.*

