Victorian State Budget 2008-09

07 May 2008

Key Themes from the Budget

Three key themes emerge from Victorian Treasurer John Lenders' first budget:

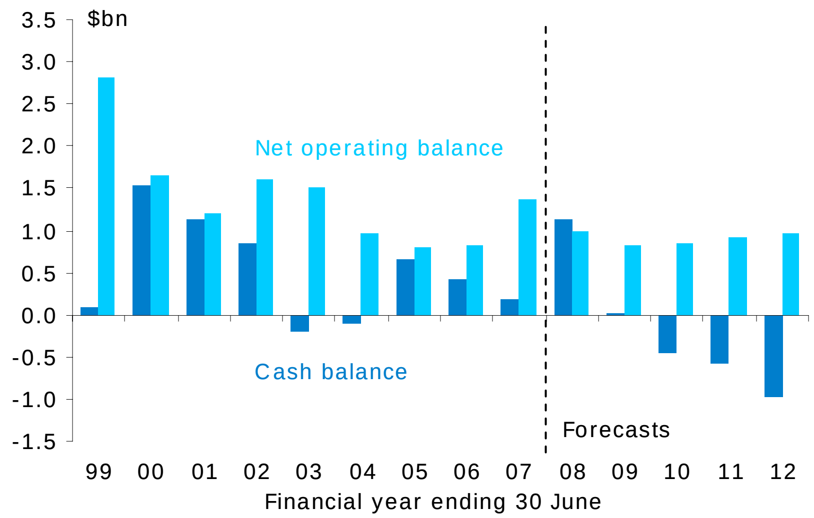
- a solid operating surplus and new fiscal target;
- spending to address the needs of a rapidly growing population; and
- higher public sector debt.

The Bottom Line

Against the backdrop of a robust economy, the Victorian Government is projecting a solid operating surplus of $996mn in 2007-08 and $828mn in 2008-09.

One of the most striking features of the 2008-09 Budget is the Government's commitment to maintaining a budget surplus of at least 1% of revenue. This is a particularly welcome and sensible initiative. In contrast to the previous objective of maintaining a budget surplus in excess of $100mn, the new target allows fiscal policy to adjust to variations in economic activity. In particular, it achieves a greater level of savings in good times while allowing the flexibility to deal with downturns in economic growth and revenues.

General government's net operating surplus remains healthy



Source: Budget Papers

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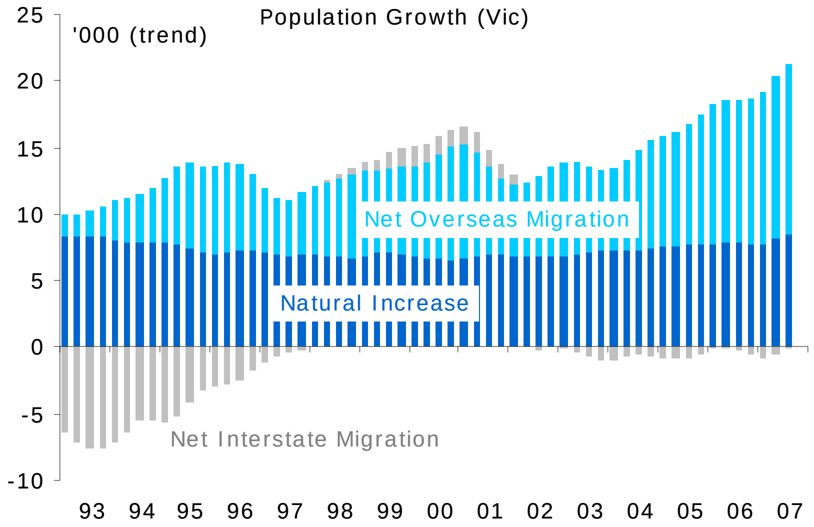
Addressing the needs of a growing population

Treasurer John Lenders has dubbed his first budget the "baby-boom budget". And certainly, with almost 74,000 births registered in Victoria in 2007 (the highest since 1971), an image of bustling maternity wards comes to mind. The fact is, however, that the State's population growth has been driven by increasing immigration.

Population growth driven by increasing immigration



Sources: ABS and Economics@ANZ

Strong population growth has boosted the State's economy, with increasing demand for housing and services. Concomitantly, increased immigration has boosted the workforce and helped to alleviate labour shortages at the margin.

While bringing benefits to Victoria, the expanding population is also placing greater demand on publicly provided services. To this end, this budget's spending measures on transport, health, education and energy build on previously announced measures. Over the period 2008-09 to 2011-12, real growth in infrastructure expenditure is forecast to be 10.8%, significantly above the 6.0% projected population growth rate over the same period.

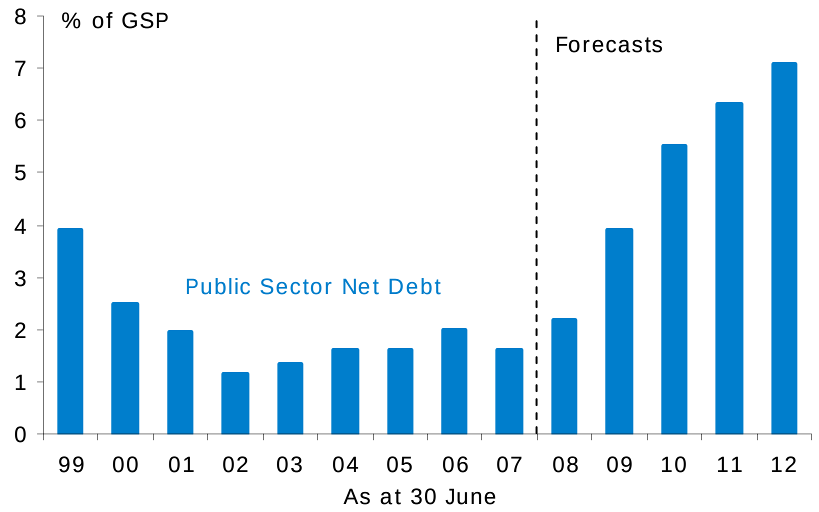
In addition, the budget contains incentives for increased population flows to regional Victoria. For example, first homebuyers purchasing new homes in regional areas will receive an additional $3,000 bonus.

Higher Public Sector Debt

One area of concern raised in the budget is the increase in the public sector's net debt which is forecast to rise from $5.7bn (2.2% of GSP) as at 30 June 2008, to $22.9bn (7.1% of GSP) by 30 June 2012. On the positive side, S&P have advised that this increase will not threaten the State's triple-A rating. And the increase is consistent with the fiscal strategies of other States such as New South Wales, Queensland and Western Australia which are engaging in significant capital expenditure programmes.

Nevertheless, in an environment of higher funding costs and economic uncertainty, the increased debt level represents a risk which will be faced by future generations. And although much of the spending associated with the debt is necessary to support the State's growing population (such as spending on water infrastructure expansions), the fiscal strategy appears to be at odds with enunciations at the Federal level that fiscal policy needs to remain tight so as not to add pressure to inflation and hence interest rates. At a more detailed level, a distinction could be drawn between those measures which increase the supply capacity of the economy and help to ease inflation in the longer term, and those measures which stimulate demand. Falling squarely into the latter category are the budget's measures for home buyers. *Prima facie*, the assistance to first home-buyers is welcome, but any gain is likely to be quickly eroded by the higher prices which flow from the increased demand.

Public sector net debt is set to rise



Source: Budget Papers

Summary of Key Budget Measures

The budget contains a range of revenue measures primarily benefiting young families and businesses. These include, *inter alia*:

- cuts to the top land tax rate from 2.5% to 2.25% and adjustments to land tax thresholds at a cost of $490mn over 4 years;
- further reductions in the payroll tax to 4.95% from 1 July 2008;
- changes to stamp duty thresholds to help businesses and homebuyers, worth $332mn over 4 years; and
- a 5% reduction in WorkCover premiums, saving employers $88mn in 2008-09.

On the expenditure side, measures include:

- $1.8bn for transport, including funds to construct a rail loop around Westall Station, track upgrades at Laverton and Cragieburn stations and more parking at outer Melbourne train stations;
- $1bn to support disadvantaged Victorians and communities, including disabled and the indigenous people;
- $703mn for hospital services, including funds for a new day hospital in Sunbury;
- $657mn for community protection, including more police station upgrades;
- $592mn for the *Victorian Schools Plan*;
- $295mn for climate change programmes including a carbon capture and storage project;
- $205mn to boost services to farmers and for agricultural research; and
- $165mn for maternity and early childcare services.

Economic forecasts

Outlook remains solid, but there are downside risks to growth

The Victorian Treasury forecasts that **economic growth** will be a solid 3.25% in 2007-08, before easing marginally to 3% in 2008-09. Household consumption, dwelling investment, business investment and a recovery in the farm sector are expected to be the main drivers of growth in 2008-09.

As acknowledged by the Victorian Treasury, there is a greater than usual degree of uncertainty surrounding the growth forecasts and the risks are clearly weighted to the downside. Given Victoria's industrial structure, which is heavily skewed towards the services, financial and manufacturing sectors, the economy is vulnerable to higher interest rates, reduced availability of credit on capital markets and the high exchange rate. In addition, households also appear to be entering a period of financial consolidation, with indicators of household spending slowing in the early months of 2008.[1]

Turning to Treasury's other forecasts, they expect **inflation** to be 3.25% in 2007-08, and to remain elevated at 3% in 2008-09. **Wages** are expected to increase by 3.75% in 2007-08 and in 2008-09. The risks to both wages and inflation lie on the upside, with the possibility higher inflation expectations begin to affect wage and price setting.

The Victorian Treasury forecasts **employment** growth to ease from above trend growth of 2.75% in 2007-08 to 1.5% in 2008-09, as domestic demand moderates.

Victorian Economic Forecasts

	2006-07 Actual	2007-08 Forecast	2008-09 Forecast	2009-10 Forecast
Real Gross State Product	2.7	3.25	3	3
Employment	2.7	2.75	1.5	1.5
Unemployment rate	4.8	4.5	4.75	4.75
Consumer Price Index	2.7	3.25	3	2.75
Wage Price Index	3.6	3.75	3.75	3.75

Source: Australian Bureau of Statistics; Victorian Department of Treasury and Finance

[1] For further details, please refer to *ANZ States and Territories Economic Update: June Quarter 2008*.

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