INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

BUILDING AUSTRALIA TOGETHER

2015-16 FEDERAL BUDGET SUBMISSION:

Holding the line: the case for continued Commonwealth focus on infrastructure

APRIL 2015

Infrastructure Partnerships Australia is a national forum, comprising public and private sector CEO Members, advocating the public policy interests of Australia's infrastructure industry.

INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
BUILDING AUSTRALIA TOGETHER

FOR MORE INFORMATION PLEASE CONTACT:

BRENDAN LYON
CHIEF EXECUTIVE OFFICER
INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
Level 8, 8-10 Loftus Street, Sydney NSW 2000
PO Box R1804, Royal Exchange NSW 1225
P | 02 9240 2051
E | brendan.lyon@infrastructure.org.au

ADRIAN DWYER
HEAD OF POLICY
INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
Level 8, 8-10 Loftus Street, Sydney NSW 2000
PO Box R1804, Royal Exchange NSW 1225
P | 02 9240 2056
E | adrian.dwyer@infrastructure.org.au

DAVID JIANG
POLICY OFFICER
INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
Level 8, 8-10 Loftus Street, Sydney NSW 2000
PO Box R1804, Royal Exchange NSW 1225
P | 02 9240 2062
E | david.jiang@infrastructure.org.au

ABOUT IPA

Infrastructure Partnerships Australia is the nation's peak infrastructure body – formed in 2005 as a genuine and enduring policy partnership between Australia's governments and industry.

IPA's formation recognises that through innovation and reform, Australia can extract more from the infrastructure it's got, and invest more in the infrastructure we need.

Through our research and deep engagement with policymakers and industry, IPA seeks to capture best practice and advance complex reform options to drive up national economic prosperity and competitiveness.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how Australia does business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policy reforms and priority projects that will build Australia for the challenges ahead.

CONTENTS

EXECUTIVE SUMMARY

It is widely accepted that Australia's demand for infrastructure is immediate and growing. Faced with a growing population coupled with the existing infrastructure backlog, it's clear that Australia needs more infrastructure, not less.

Despite this requirement for more and better infrastructure, actual activity has declined by $16 billion in the past fiscal year, and will drop by a further $16.5 billion this fiscal year. This means that across just two years, Australia has reduced infrastructure activity by $32.5 billion.

This retreat can only be partially explained by the evaporation of mining and energy related, privately funded resource infrastructure. Public infrastructure activity will fall by 10 per cent in the coming year.

The reduction in non-mining infrastructure activity is not due to the Commonwealth. The 2014-15 Commonwealth budget increased the central government's funding to a record high level of 1.62 per cent of General Government Expenditure (GGE). Indeed, successive Federal Governments have approximately doubled the level of Commonwealth investment between 2003 and present.

Rather, it is a reflection that Australia's states and territories do not have the fiscal capacity to sustain infrastructure investment, let alone increase the pace of delivery of major road, rail and other projects, without substantial structural reform to both infrastructure markets and their respective fiscal settings.

Many of the challenges and reforms needed to 'fix' infrastructure must occur at a state level, but there is a compelling case for increased national investment to incentivise and shape these changes. Indeed, it is in the national interest that policy reforms are facilitated, led and influenced at the Commonwealth level. This means that, at a minimum, the Commonwealth should continue to maintain its infrastructure investment above 1.62 per cent of GGE.

A strong policy case also exists for the Commonwealth to use new borrowings to substantially increase its level of funding support for state infrastructure projects. However this additional funding must be conditional on the states making the necessary reforms to rebase infrastructure markets, or restore the capacity of their budgets to routinely invest in their own infrastructure projects.

Policy leadership from the Commonwealth also requires it to enhance the transparency of its own infrastructure investments. We therefore submit that the Commonwealth should combine its array of existing capital funding programmes into a single, visible and observable funding line. This combined funding programme could be achieved through establishing a National Infrastructure Fund (NIF) and would include existing capital programmes and any additional borrowings. The NIF would operate as a funding programme, rather than a 'fund' in an accounting sense.

Grant allocations from the NIF should also be subject to evaluation by *Infrastructure Australia* including a transparent Benefit Cost Ratio assessment.

In recommending that the Commonwealth consider substantial additional borrowings to increase infrastructure investment, this submission is mindful of the healthy economic debate and political focus on the Commonwealth's level of debt. We submit that this debate would be advanced if the budget's reporting of overall debt provided a greater differentiation between capital borrowings and debt used to fund a shortfall between public revenue and expenditure. For the purposes of this submission, we will refer to these uses of debt respectively as 'good debt' and 'bad debt'.

It is clear that Australia cannot meet its economic infrastructure requirements or broader social objectives, without change to the status quo.

We hope that our submission is of assistance to the Commonwealth in framing its 2015-16 budget.

IS THERE A CASE FOR INCREASING NATIONAL INFRASTRUCTURE INVESTMENT?

On current settings Australian Government infrastructure investment is already at its highest ever level, having doubled to circa 1.62 per cent of General Government Expenditure between 2003 and now.

However, in spite of the doubling of central government infrastructure investment, total public and mining related infrastructure investment are each continuing to fall rapidly.

Indeed, the latest forecast produced by Infrastructure Partnerships Australia and BIS Shrapnel shows that aggregate infrastructure investment will fall by 15.2 per cent in the coming 12 months – with circa $16.5 billion less construction activity this year, compared to last year.

This substantial contraction follows a circa $16 billion fall in the preceding 12 months (12.8 per cent) - a cumulative fall of $32.5 billion or 26 per cent in two years.[1]

Figure 1: Civil Engineering Construction Work Done actual/forecast 2014-15 and 2015-16

	2014-15 ($ million)	2015-16 ($ million)	Difference ($ million)	Difference (per cent)
Total	**108,737**	**92,188**	**-$16,549**	**-15.2%**
Mining	*53,900*	*42,529*	*-$11,371*	*-21.1%*
Non-Mining	*54,837*	*49,658*	*-$5,178*	*-9.4%*

Source: Infrastructure Partnerships Australia-BIS Shrapnel Australian Infrastructure Metric

This substantial and continuing retreat in construction is only partly explained by the evaporation of privately funded mining related investment. In spite of the strong narrative around the requirement for public infrastructure activity has been continuing to fall for a period of years.

Indeed, far from public infrastructure 'replacing' the mining capital spend, public infrastructure activity began retreating before the reductions in new mining capital investment, which had served to mask the reduced levels of public investment until recently.

The Australian Infrastructure Metric forecasts that 2015-16 will see:

- Mining related infrastructure fall by 21.1 per cent, or $11.4 billion
- Public infrastructure activity fall by 9.4 per cent or $5.2 billion.

Accordingly, we submit that:

1. **The Commonwealth must maintain current investment levels:** At a minimum 2015-16 Budget should retain Federal infrastructure funding at 1.62 per cent of General Government Expenditure, despite enabling savings across the Budget having so far failed to achieve Senate support;

[1] Note – The final two quarters of 2014-15 are also forecasts (based on Metric trends), due to ABS "work done" data not yet being available.

And we further submit that:

2. **The Commonwealth should establish a single infrastructure grant programme, with allocations overseen by *Infrastructure Australia* and consider additional Commonwealth borrowings to increase national investment in the immediate term.**
    a. The Commonwealth should consolidate the suite of existing capital funding programmes into a single National Infrastructure Fund (NIF) grant line to make national infrastructure funding grants explicit and observable.
    b. Grant allocations from the NIF would be subject to evaluation by *Infrastructure Australia* including a transparent Benefit Cost Ratio assessment.
    c. The Commonwealth should consider substantial borrowings to increase the availability of project funding grants available to the states from the NIF.
    d. States should only be able to qualify for funding from NIF in return for implementation of agreed fiscal or microeconomic reforms.
    e. The NIF would operate only purely a grant programme, and would not contribute equity or debt to projects and must not operate as an investment vehicle.

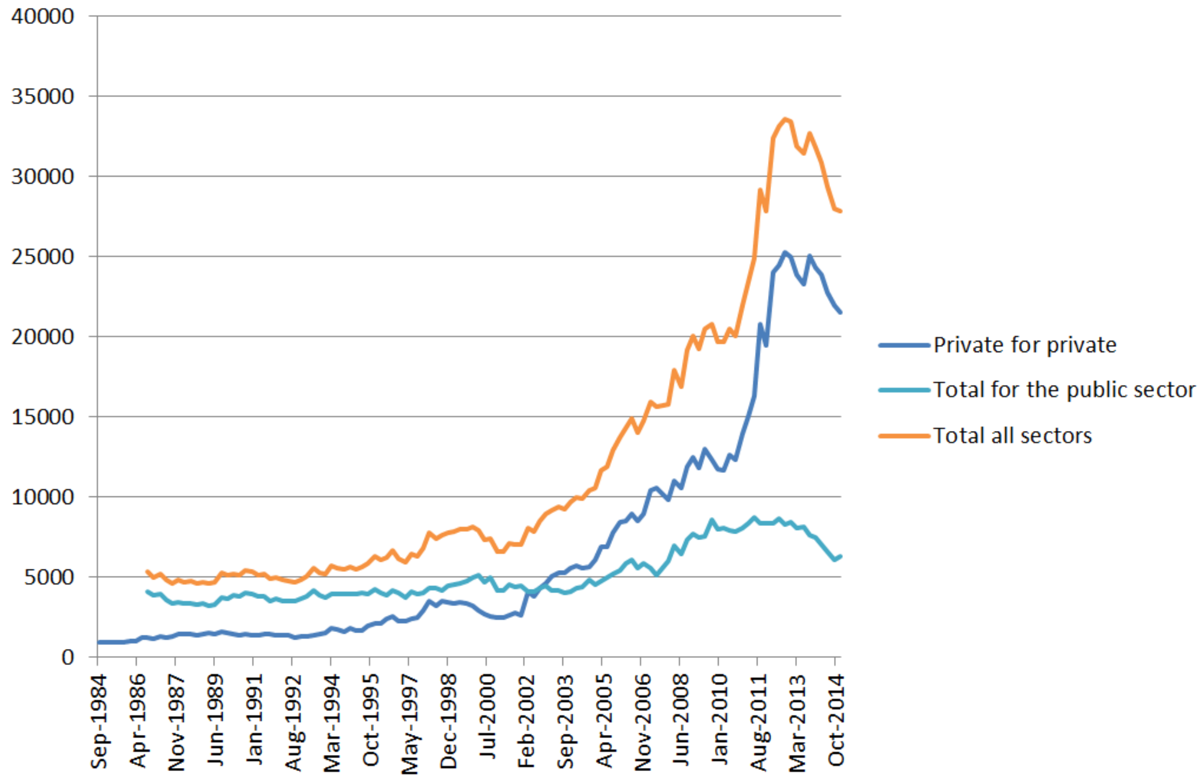
3. **Commonwealth Budget reporting should be adjusted to differentiate between 'good' and 'bad' debt.**
    a. The Commonwealth should consider additional reporting so that capital borrowings (good debt) is distinguishable from borrowing to fund operating activities (bad debt), better reflecting the economic and fiscal benefit of productive infrastructure investment.

AUSTRALIA'S FALLING LEVELS OF INFRASTRUCTURE ACTIVITY AND INVESTMENT

Figure 2 shows Australia's substantial increase in total infrastructure activity between 2003-04 and the peak in 2011-12.[2] However, Figure 2 also shows the substantial recent tailing in work done, with public and mining infrastructure both showing substantial and accelerating retreats.

[2] Australia Bureau of Statistics, 8762.0, Engineering Construction Activity, Australia Sep 2014

Figure 2: ABS, Engineering Construction Activity (work done), 1984-2014, ($Million)



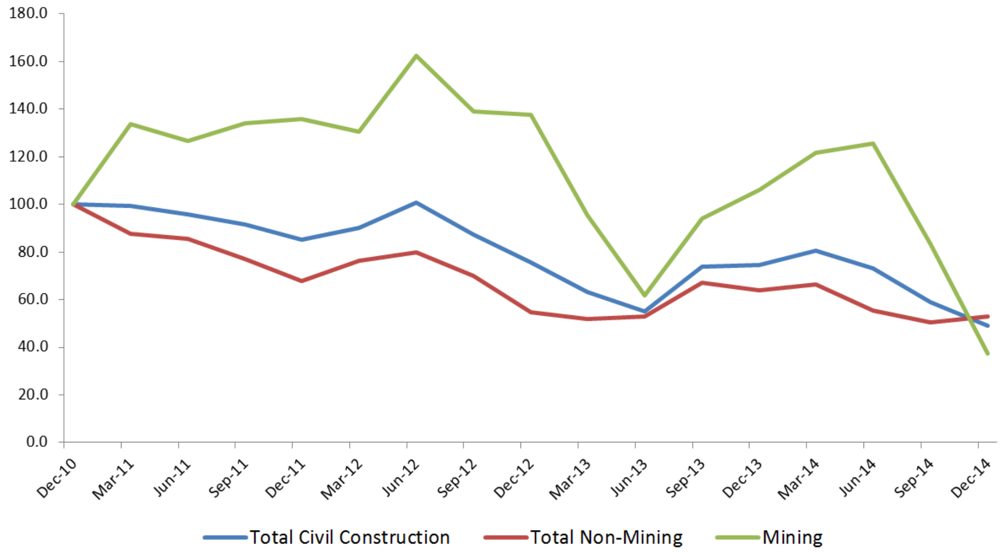
Source: Australia Bureau of Statistics, 8762.0, Engineering Construction Activity, Australia Sep 2014

Our latest release of the Australian Infrastructure Metric indicates that the drop in civil engineering construction activity will get substantially worse before it gets better, based on current investment trends.

The Australian Infrastructure Metric, which surveys 'work won' data capturing circa 30 per cent of Australia's civil construction activity, is a robust leading indicator of actual project investments made by the public and private sectors.

Figure 3 from the December 2014 quarter of the Metric indicates this sustained decline in both mining and non-mining capital investment. Indeed, this measure shows that non mining (public) infrastructure has been declining since early 2011.

Figure 3: Australian Infrastructure Metric, Work Won, Index Value (Dec 2010 = 100)



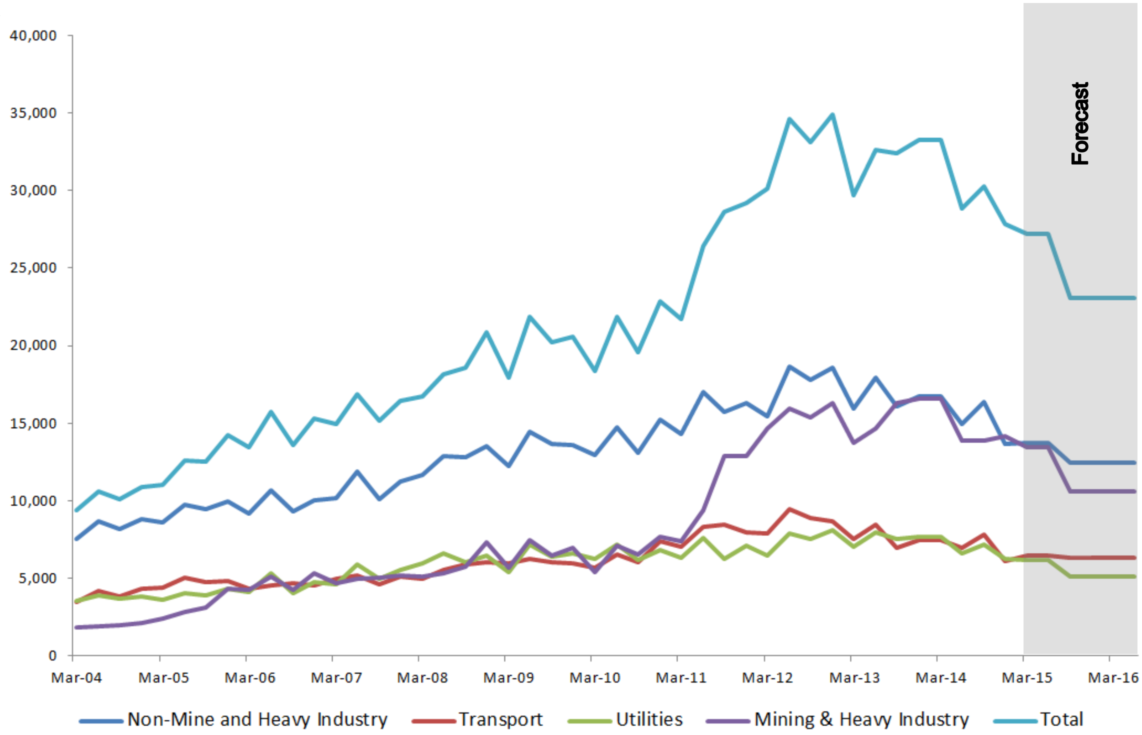
Source: Infrastructure Partnerships Australia-BIS Shrapnel Australian Infrastructure Metric

An analysis of Australian Bureau of Statistics (ABS) data further illustrates this downward trend and confirms that previous weak levels of investment are now hitting the real economy.[3]

Figure 4 below shows a sustained fall in non-mining 'work done' (civil engineering work actually carried out in the quarter) since late 2012, consistent with the decline in work won (or new investment) since late 2010 as measured by the Metric. Figure 4 also shows a retreat in mining activity, again consistent with the fall in mining work won as identified by the Metric.

[3] Note – Direct comparisons in 'work won' (as measured by the Metric) and 'work done' (as measured by the ABS) trends should be avoided, reflecting the lag and size variance between work being awarded and being delivered in any given quarter.

Figure 4 – ABS Civil Engineering Construction Work Done ($Million) (Constant prices)



Source: IPA-BIS Shrapnel Australian Infrastructure Metric; ABS 8762.0

Using work won as an indicator, BIS Shrapnel forecasts that future ABS work done will continue to trend downwards (see Figure 4 above).

As illustrated in Figure 5 below, The IPA/BIS Shrapnel forecasts shows that civil engineering work done will fall $16.5 billion, or 15.2 per cent, over the course of 2015-16 (relative to 2014-15), with non-mining work done falling 9.4 per cent over the same period.

Figure 5: ABS Civil Engineering Construction Work Done ($Million) (Forecast 2014-15 to 2015-16)

	2014-15 ($ million)	2015-16 ($ million)	Difference ($ million)	Difference (per cent)
Total	**108,737**	**92,188**	**-$16,549**	**-15.2%**
Mining	*53,900*	*42,529*	*-$11,371*	*-21.1%*
Non-Mining	*54,837*	*49,658*	*-$5,178*	*-9.4%*

Source: Infrastructure Partnerships Australia-BIS Shrapnel Australian Infrastructure Metric

Both the Australian Infrastructure Metric and ABS data show that infrastructure construction is continuing to fall, despite the economic requirement and public appetite for enlarged investment.

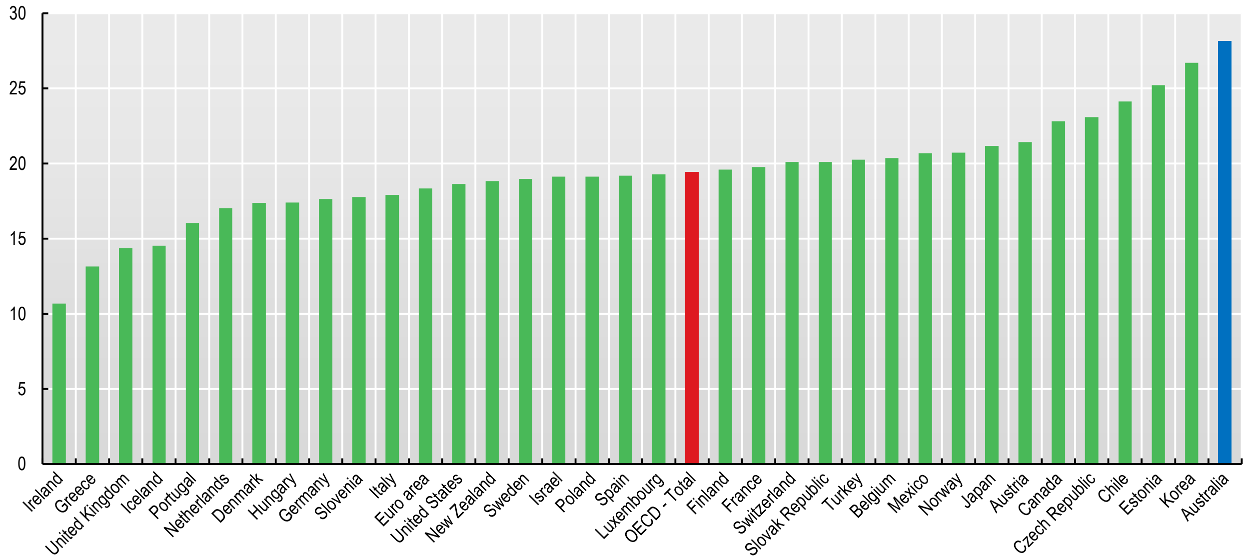
BENCHMARKING AUSTRALIA'S INFRASTRUCTURE INVESTMENT

On first glance, the OECD's *National Accounts at a Glance 2014,*[4] suggests that Australia leads the OECD in terms of its proportional level of infrastructure investment (GFCF), as shown in Figure 6 below.

[4] OECD, National Accounts at a Glance 2014, retrieved from http://www.oecd-ilibrary.org/economics/national-accounts-at-a-glance-2014_na_glance-2014-en

However, this aggregate measure does not adequately reflect the level of investment in public infrastructure.

Figure 6: Gross fixed capital formation, volume (Percentage of GDP, 2012)



Source: OECD, National Accounts at a Glance, 2014

Once capital investment attributable to the household and corporate sectors is removed, it becomes apparent that far from leading the OECD, Australia lags the OECD average in public infrastructure investment, shown in Figure 7 (below).[5]

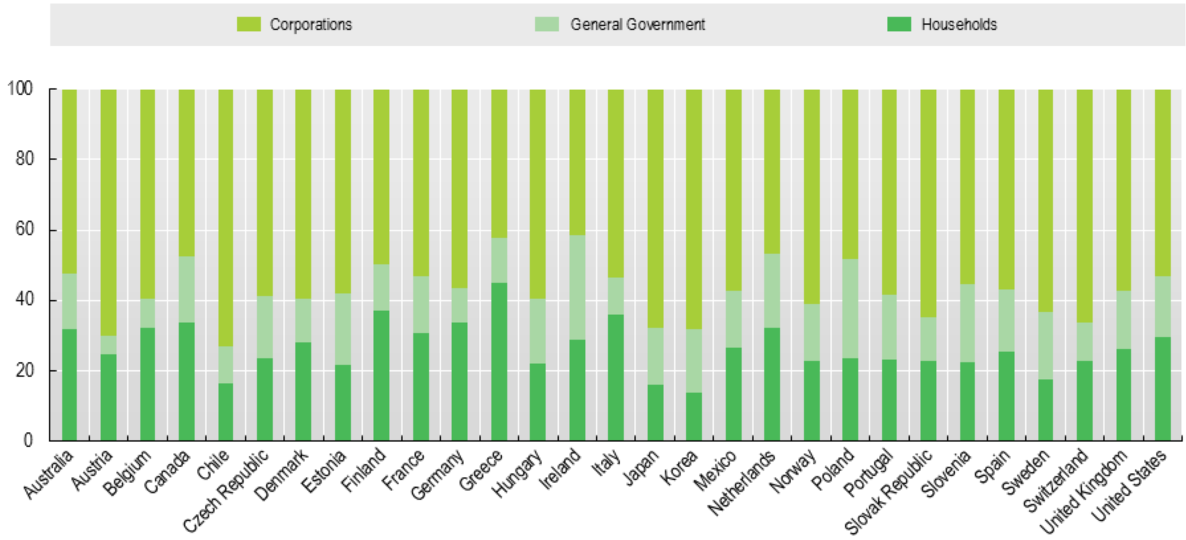
Figure 7 shows that in 2010,[6] 15.6 per cent of total GFCF in Australia was attributable to general government spending – compared to an average of 16.2 per cent across the OECD. It is very unlikely that this situation will have reversed in the intervening years, given that Australia's governments have collectively reduced public infrastructure investment since 2011.

Indeed, the OECD's work bears out the consistent findings of previous releases of the Australian Infrastructure Metric, which have also shown that Australia's favourable levels of total investment have been substantially underpinned by privately funded mining and energy capital investments – rather than investment in public roads, railways and similar public infrastructure.

[5] OECD, National Accounts at a Glance 2014, retrieved from http://www.oecd-ilibrary.org/economics/national-accounts-at-a-glance-2014_na_glance-2014-en

[6] The latest version of the report (updated with 2012 data), does not include Australia, therefore the previous report was used.

Figure 7: Gross fixed capital formation, by sector of the economy, 2011



Source: OECD, National Accounts at a Glance 2011

WHY DOES PUBLIC INFRASTRUCTURE MATTER?

Economic infrastructure services, such as roads, railway, port, telecommunications and utility services, are essential inputs in the production and movement of goods and services.

In this way, the quality, capacity, efficiency and monetary cost of economic infrastructure services have a predictable and fundamental effect on the competitiveness of the national economy and the prosperity of the household sector.

Infrastructure also has a stimulatory effect, because of the economic activity and employment that is created during the delivery of major projects.

The strong relationship between economic infrastructure investment and economic growth has been well established. Research from the OECD estimates that each dollar invested in infrastructure increases economic output by $1.30.[7] The International Monetary Fund estimates a higher impact of circa $1.80 for each dollar invested.[8] It is estimated that an increase of Australia's infrastructure stock by 10 per cent would increase GDP per capita by between 0.7 and 1 per cent.[9]

Infrastructure serves to increase economic activity during construction and enhance economic efficiency in its operational phase. In this way, we can consider that sound infrastructure programmes are in the public sector's own direct fiscal interest. By creating economic activity and employment, the

---

[7] Commonwealth of Australia, Budget Strategy and Outlook: Budget Paper No. 1, 2009-10, p 4-6, retrieved from http://www.budget.gov.au/2009-10/content/bp1/downloads/bp_1.pdf

[8] Ibid

[9] PwC 2013, 'Report to the Business Council of Australia on infrastructure funding and financing'.

public sector benefits through increased taxation revenues, through income and corporate taxes, and wider economic activity created by sound project investments.

The case to further increase the Commonwealth's commitment to infrastructure is strengthened, given that circa 80.2 per cent of the increased government revenue from infrastructure is collected by the national government through income taxes. State and local governments share the balance.[10]

Assuming well-selected economic infrastructure projects, there is a very clear case for increased investment into public infrastructure, given:

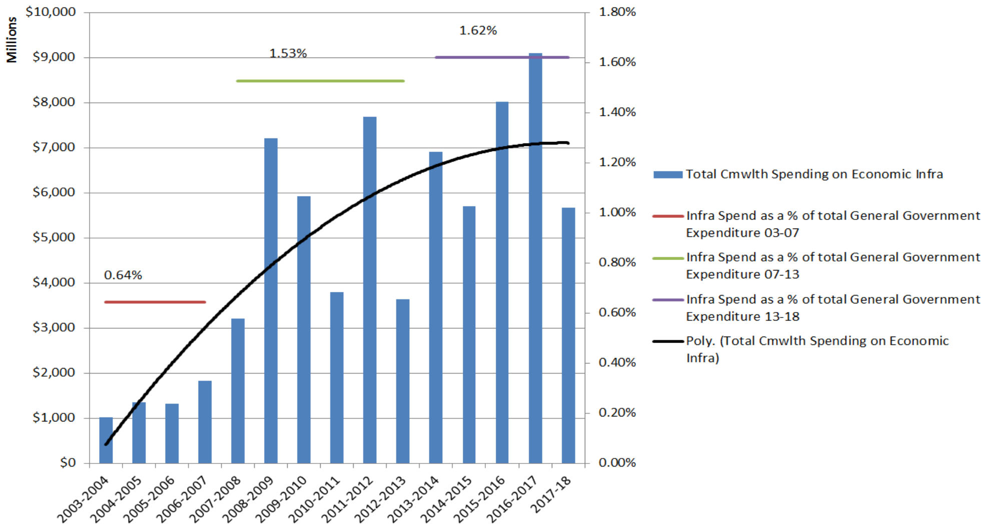
- Softening economic indicators;
- The short-term stimulatory employment and economic activity provided by capital projects; and
- The well documented costs of urban congestion, freight network inefficiency and higher-than-necessary utility costs.

It is also very clear that only the Commonwealth level of government retains sufficient immediate capacity to fund that investment

HOW CAN NATIONAL ACTIVITY BE FALLING WHEN COMMONWEALTH FUNDING HAS DOUBLED?

Figure 8 shows that the Commonwealth has doubled its infrastructure investment between the early 2000s and present, rising from an average 0.64 per cent of General Government Expenditure to an average of 1.62 per cent of GGE, on FY 2014-15 settings.

Figure 8: Commonwealth infrastructure investment, historical and projected – 2003-2018 (nominal and per cent of GGE)



Source: IPA Analysis of Commonwealth Budget Papers 2003-04 to 2014-15

[10] Australian Government, *Federal Budget 2013-2014*, retrieved from http://www.budget.gov.au/2013-14/

The public might ponder how public infrastructure has been in decline since 2011 if national investment has been in a period of sustained growth. This reflects that the Federal Government is actually a relatively modest, albeit strategically important, source of total public infrastructure funding.

Indeed, even at the highest-ever level, the Commonwealth's total investment is equal to about half of what NSW spends in a given year. Or put another way, even at its highest level of investment, the national government will provide less than one seventh of national public infrastructure funding this year.

It is important to understand that this is not a criticism of the Commonwealth's historic or contemporary approach to infrastructure. The constitution and established Commonwealth-state financial relations see states as the principal funder, owner and regulator of infrastructure.

WHY ARE THE STATES REDUCING THEIR INFRASTRUCTURE SPENDING?

Australia's states and territories (with the notable exception of NSW) are reducing their level of investment because they do not have the budget capacity to fund additional capital investment.

Figure 9 shows actual/forecast levels of state government infrastructure investment, by jurisdiction. This figure, based on state government budget papers, show that all states bar NSW and Victoria will reduce infrastructure investment over the forward estimates.

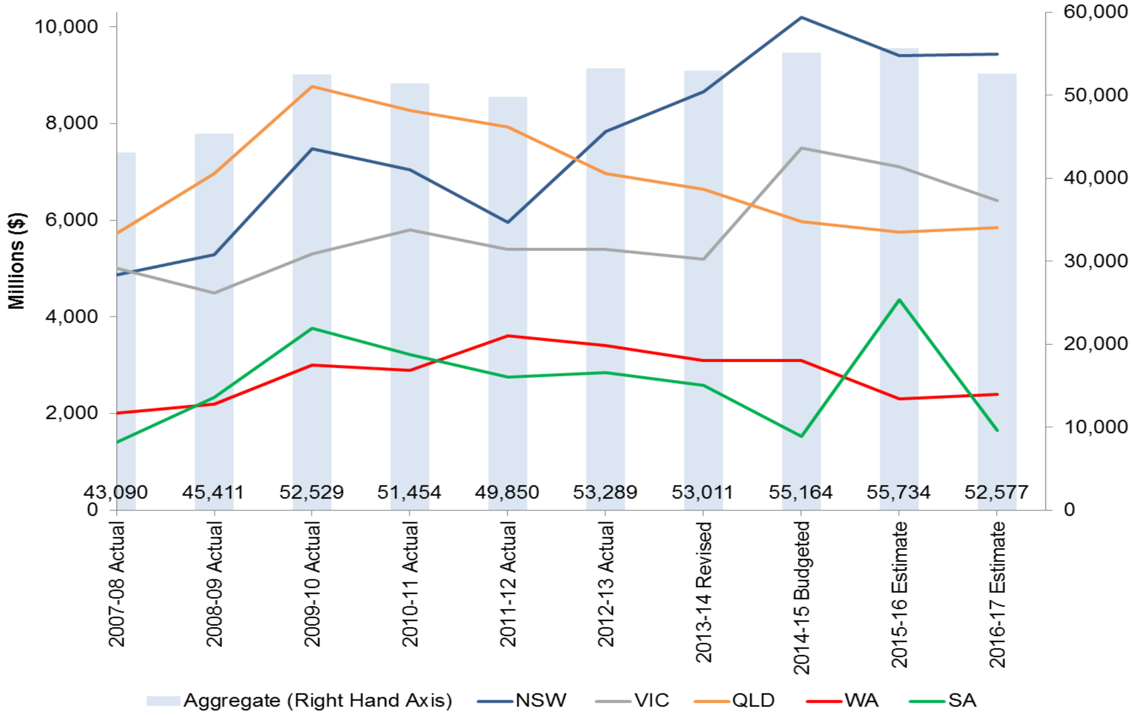
Indeed the situation has since deteriorated, given that Victoria's East West Link motorway project has subsequently been cancelled, depressing Victoria's committed investment.

This analysis shows that despite the strong political, policy and community requirement for more (and better) infrastructure investments, there is a lack of capacity by state governments to fund the infrastructure required. This is a reflection of already-high levels of debt carried by state and territory governments – a factor which has seen WA, Queensland and South Australia each downgraded by ratings agencies – and leaves all states barring NSW and perhaps Victoria with insubstantial 'headroom' for additional public sector debt.

This situation is unlikely to resolve itself anytime soon, given that sustained operating surplus positions will remain elusive for states.

So while this submission identifies that *someone* should fund a larger and more developed programme of infrastructure investment, it is also apparent that Australia's states do not have the fiscal capacity to do so themselves without major reform to their budgets and balance sheets, leaving only the Commonwealth with sufficient immediate capacity to invest.

Figure 9 General Government infrastructure investment by major states, 2007-08 to 2016-17



Source: IPA analysis of 2014-15 Budget papers.

COULD AN IMMEDIATE INCREASE IN COMMONWEALTH INVESTMENT BE A CATALYST FOR STATE FISCAL REFORM?

As noted above, Australia's states broadly face a capital investment task which is beyond their capacity to fund on current settings. Moreover, many state governments are politically committed to infrastructure programmes which are asymmetrical to their capacity to pay for this investment.

The Commonwealth Government has a comparatively strong fiscal position, with capacity for substantial borrowings within the constraints of the AAA rating.

On this basis, we submit that policy case appears to exist for the Commonwealth to access long-term borrowings at historically (very) favourable interest rates, with these borrowings then available to the states for major infrastructure.

It is important that such additional investment is made available in a way which does not blunt the increasingly strong drivers on state governments to rehabilitate their fiscal positions through asset privatisations and reforms to recurrent service delivery models and costs.

The final report of the Infrastructure Finance Working Group (IFWG) (2012), found that the Commonwealth should create a formal and actionable link between immediate Commonwealth funding support in return for state reforms such as asset sales.

The IFWG (2012) described the traditional Commonwealth Government model as *"the Commonwealth giving 'gifts' to the states with little conditionality and little ability to reclaim direct financial returns"*.

If the Commonwealth chose to substantially increase funding for infrastructure in the immediate term through additional Commonwealth debt, access to this funding must require states to execute reforms, to improve their own fiscal position.

This broad view was echoed in the National Commission of Audit and the Harper Competition Review Report which both recognised the weaknesses in the current payments structure of the Federation. The Harper Review went further, offering support for a structure where Federal payments would be tied to reform outcomes at the state and territory level, drawing on the success of the Competition Policy Payments which drove consistent national reforms across the states.

Indeed, the Commonwealths' $5 billion asset recycling policy provides a contemporary example of the powerful reform driver created by the prospect of national funding for state infrastructure programmes.

Importantly, this submission does not suggest that the national government should replace the states as the principal funders of infrastructure. Rather, the Commonwealth's principal focus in infrastructure policy should be on driving consistent national reforms to reform state government budget positions, and the development and refinement of efficient national markets for infrastructure services.

In terms of Budget reforms, this submission contends that the array of existing capital grant lines be amalgamated into a single funding stream. This aggregated, National Infrastructure Fund (NIF) should:

- bring together all existing economic capital funding lines into a single funding programme;
- be endowed with the forward committed funding in the various existing capital funding programmes;
- only consider projects assessed through the *Infrastructure Australia* process including a transparent Benefit Cost Ratio assessment (discussed below);
- States should only be able to qualify for funding from NIF in return for implementation of agreed fiscal or microeconomic reforms;
- operate purely a grant programme, and would not contribute equity or debt to projects and must not operate as an investment vehicle; and
- finally, the Commonwealth should consider substantial borrowings to increase the availability of project funding grants available to the states from the NIF.

CLARITY OF INSTITUTIONAL ARRANGEMENTS

Achieving substantially better outcomes from national capital investment will require the Commonwealth to evolve into a smarter co-funder of infrastructure, with a clear understanding of the logical limits of its experience and expertise. In infrastructure, this means that the states and territories will logically retain the responsibility for project delivery.

However, this does not mean eroding the role of the Commonwealth in the infrastructure market. Rather, the Commonwealth should be clear that its proper role is in the regulation of national infrastructure markets and co-funding capital investment alongside the states.

Importantly, all investments from the National Infrastructure Fund, and by implication all Commonwealth capital funding, should progress through the *Infrastructure Australia* process. A robust and rigorous *Infrastructure Australia* process should lead to a circumstance where states are effectively competing for Commonwealth dollars on the basis of sound project economics and relative national significance.

IS DEBT BAD?

The public debate about debt often sees public sector borrowings viewed as inherently bad; however there are substantial merits to the use of debt for public capital investment.

Beyond the stimulatory benefits discussed elsewhere in this submission, the case for using debt for infrastructure also presents a compelling equity argument, in that long-term borrowing shares the cost of infrastructure across generations, rather than just contemporary taxpayers.

If infrastructure investments are funded solely out of revenue surpluses or today’s tax base (that is, with no public debt component), current taxpayers are paying for the entirety of infrastructure which will also benefit future generations. In this way, public sector borrowings for infrastructure ensure inter-generational equity.

Given the erroneous perception that all debt is bad, there is a case to change the budget's reporting of their overall debt positions to increase the transparency of 'good' versus 'bad' debt. Good debt can be considered to be borrowings for capital investment – bad debt can be considered to be borrowings used to fill a deficit between annual public revenues and services costs.

Subject to appropriate checks and balances, debt raised for projects which have undergone a rigorous and transparent economic appraisal, and achieved a definitively positive BCR outcome, could be included under a separate 'infrastructure debt' reporting line rather than being clustered with wider borrowings.

This would increase transparency on the government's debt liabilities and allow the public to draw a clear distinction between 'good debt' and 'bad debt'.

CONCLUSION

The case for preserving and enhancing the Commonwealth's infrastructure investment programme is clear, but current economic and fiscal circumstances are unstable. With a largely non-discretionary national infrastructure requirement, a contraction of the Commonwealth's ambitious infrastructure investment aspirations to meet short-term needs would not serve taxpayers and the community well.

In that context, this submission has sought to build the case for a continued focus on infrastructure investment in the 2015-16 Commonwealth Budget, but also develop the basis of an investment architecture and institutional framework to support an increasing role for the Australian Government in the national infrastructure task.