

Reform Of Public Private Partnerships:

How To Harness Private Capital
To Genuinely Work In Partnership With
The Public Sector

Report by

Policy Solutions

for

**THE CONSTRUCTION FORESTRY MINING &
ENERGY UNION**

JUNE 2006

TABLE OF CONTENTS

1. Executive summary	1
1.1 Report scope	2
1.2 Structure of the report	4
2. Infrastructure	5
2.1 A fundamental driver of economic growth.....	5
2.2 Decline in infrastructure investment.....	7
2.3 The need for higher rates of investment	8
2.4 The scale of the task	8
2.5 The expected economic benefits from investment	10
2.6 A unique class of asset	11
3. Background on private infrastructure	13
3.1 History of public infrastructure investment.....	13
3.2 Size of private infrastructure investment.....	14
3.3 Public private partnerships.....	14
3.4 Forms of public private partnerships.....	16
4. Benefits of private infrastructure provision	18
4.1 Summary of claimed benefits.....	18
4.2 More detailed discussion of claimed benefits	18
4.3 Conclusions.....	20
5. Criticisms of private infrastructure financing	21
5.1 Fiscal policy constraint.....	21
5.2 Net debt of the commonwealth	22
5.3 Net debt of the states/territories	23
5.4 The comparative international position	23
5.5 Ineffective risk transfer	24
5.6 higher borrowing costs & supernormal profits.....	26
5.7 Higher transaction costs.....	28
5.8 Public accountability.....	29
5.9 Anticipating future needs.....	29
6. A new model of public private partnership	30
6.1 A better approach to financing	30
6.2 States and territories retain responsibility	30
6.3 A new role for the commonwealth – the NIFC	31
6.4 Benefits of the NIFC approach.....	33
6.5 Partnering with superannuation funds	34
7. Improving the incentives to invest through taxation reform	35
7.1 Superannuation funds are widely held and largely represent taxpayers	35
7.2 Taxation is a key variable.....	35
7.3 Taxation options	36
7.4 Estimated costs	38

While every effort has been made to ensure the accuracy of this document, the uncertain nature of the taxation system means that Balrog Consulting Pty Limited is unable to make any warranties in relation to the information contained herein. Balrog Consulting Pty Limited, its employees and agents disclaim liability for any loss or damage which may arise as a consequence of any person relying on the information contained in this document.

8. Specific categories of infrastructure	40
8.1 public housing	40
8.2 Railways	40
8.3 Roads and bridges	41
8.4 Social infrastructure	42
9. Conclusions	43
Appendix A: Paying for private profit	44
Appendix B: Fiscal policy in Australia: Some thoughts on change	51

TABLE OF FIGURES

Figure 2-A Output elasticity of Australian infrastructure investment	6
Figure 2-B Public consumption compared to public capital expenditure	7
Figure 2-C Public fixed capital expenditure as a share of GDP	7
Figure 2-D Estimates of livings standards and price effects from infrastructure investment	10
Figure 5-A Consolidated non-financial public sector net debt by sector	22
Figure 5-B Commonwealth non-financial public sector net debt	22
Figure 5-C Total state/territory non-financial public sector net debt by sector	23
Figure 5-D Total general government net debt selected countries 1997-2006	23
Figure 5-E Victorian PSC Process	27
Figure 6-A NIFC Ownership Structure And Financing Chain	32

TABLE OF TABLES

Table 2–A Infrastructure ratings in the 2001 Report Card	9
Table 2–B Estimates of under–investment and rate of return* by sector	9
Table 3–A Private Sector Ownership of Infrastructure 2003	14
Table 7–A Superannuation Fund Tax Payable	36
Table 7–B Estimated cost of tax concessions for infrastructure investment	38
Table 7–C Estimated cost of tax concessions for infrastructure investment	38
Table 7–D Estimated cost of tax concessions for infrastructure investment	39
Table 7–E Estimated cost of tax concessions for infrastructure investment	39

1. EXECUTIVE SUMMARY

Infrastructure – investment sunk in land, such as roads, railways, telecommunications, electric power, sea, airports and the like – is a fundamental prerequisite to economic growth. Throughout history it has played an essential role in human progress.

Infrastructure investment impacts chiefly on the supply side of the economy by improving economic efficiency and resource allocation. Investment in social infrastructure also has a long-term impact on productivity and hence on economic performance.

After more than a century and a half of occupying a central place in the pro-development thrust of Australia's economic policy, infrastructure investment began to decline as a share of public expenditure in the 1980s as Australian governments, both Commonwealth and State, moved to increase the share of public consumption expenditure in their annual budgets at the expense of public investment. The ratio of public consumption expenditure to public capital expenditure has increased from 2:1 in 1973/74 to 5:1 in 2003/04.

The decline over the last 2 decades has in public infrastructure investment has united many commentators on the need for higher rates of infrastructure investment.

The total estimated value of infrastructure under-investment in Australia in the five areas of electricity, gas, rail, road and water is \$24.8 billion. This under-investment covers the deficiency in infrastructure in meeting the then current demand.

Undertaking this investment will improve living standards in Australia.

Investing in infrastructure provides a stable long-term return to investors which is ideal for superannuation funds. The general pool of superannuation fund members is also generally representative of the general body of taxpayers – so profitable investment by superannuation funds is broadly equivalent to public investment by taxpayers.

Whilst greater levels of direct public investment in infrastructure are desirable from both a social and economic viewpoint, the reality is that governments are increasingly examining private sector involvement in major projects. Public private partnerships (PPPs) are often the result of these processes.

Many of the claimed benefits of PPPs have not always been realised and PPPs can result in poor fiscal outcomes for government and/or infrastructure users.

Equally, however, fair analysis shows that there is a role for PPPs in the infrastructure task facing Australia as PPPs can provide value for money in appropriate circumstances.

That said, PPPs need to be closely scrutinised and there should be no presumption that a PPP is a superior method of infrastructure delivery.

There are a variety of legitimate criticisms of PPPs, the most important of which is that the financing arrangements may lead to windfall gains to project investors at the expense of taxpayers and/or users.

One way to address this shortcoming is for the Commonwealth Government to enter into a genuine partnership with the private sector by establishing a National Infrastructure Financing Corporation (NIFC).

The NIFC would have equal capital provided by the Commonwealth and pooled superannuation funds and would act as a financier of proposed PPPs. The costs of funds from such a body would be lower than fully priced private sector bids so the NIFC would lower the cost of PPPs by providing substantial competition to the current financiers involved in PPP markets.

A further method for lowering the cost of PPPs to government and to induce further investment by superannuation funds is by way of taxation concessions. The best method of this is to provide concessions on returns earned by superannuation funds in appropriate infrastructure investments. A variety of possible approaches are discussed.

In addition some particular areas of potential investment for PPPs are discussed with some of the benefits of such investment considered.

1.1 REPORT SCOPE

Balrog Consulting Pty Ltd has been requested by the CFMEU to provide a paper which aims to:

- Detail the large infrastructure backlog in Australia and the need for, and indeed, desirability of higher levels of private as well as public funds being invested in infrastructure over the next few decades.
- Describe the real environment that governments, especially state/territory governments, have to operate under and the constraints that this applies to optimal infrastructure investment in practice.
- Examine what is meant by the term PPP and describe the various project forms that private financing arrangements can take.
- Document the major problems that can arise with PPPs as well as any obvious successes:
- Illustrate that the problems with PPPs largely arise from the excessive profits designed around the financing and pricing arrangements of PPPs.
- Show that there are better models which can address the shortcomings of the current arrangements for both taxpayers and users, yet still harness private sector capital to assist in the infrastructure task.
 - Reform taxation arrangements to stimulate widely held investment in infrastructure projects (by major superannuation funds) so as to more broadly distribute the gains accruing to equity holders in PPPs away from the financiers (investment banks etc) who currently dominate the sector
 - options include higher capital gains tax discounts for qualifying investments; and
 - lower tax rates on interest for loan capital for PPPs, including infrastructure bond type of arrangements.

- Create a new public sector financing vehicle (the National Infrastructure Financing Corporation (NIFC)) at the Commonwealth level which would operate as a wholly owned Government Business Enterprise which operates commercially
 - this would pay tax on its earnings, have a board of directors etc
 - any gains in value over time from financing would then flow through to the public through public ownership
 - this could enter into joint ventures with other widely held capital providers (eg major superannuation funds) to finance PPPs
 - The NIFC would be capitalised by the Commonwealth, either directly or through equity provided by the Future Fund
 - The NIFC could then borrow on behalf of the Commonwealth Government at a low rate – the key source of funds could be superannuation funds
 - special instruments could be created, eg national infrastructure bonds which would pay a premium on standard debt, say the Commonwealth Government bond rate + 50 basis points
 - The NIFC could compete for PPPs (mostly at the state government level) against other providers, this would dramatically reduce the cost to government through a lower cost provider competing in the market
 - It could also be integrated into the national infrastructure planning model which Labor has proposed with Invest Australia
- Demonstrate the different types of investment approaches that could be applied sector by sector to the Australian economy which take into account the various structures of industries and the public finance options that are feasible in the contemporary political/economic environment.

1.2 STRUCTURE OF THE REPORT

The report is structured as follows:

- ❑ **Chapter 1** – Executive Summary
- ❑ **Chapter 2** – Infrastructure
- ❑ **Chapter 3** – Background of private infrastructure
- ❑ **Chapter 4** – Benefits of private infrastructure provisions
- ❑ **Chapter 5** – Criticisms of private infrastructure financing
- ❑ **Chapter 6** – A new model of public private partnership
- ❑ **Chapter 7** – Improving the incentives to invest through taxation reform
- ❑ **Chapter 8** – Specific categories of infrastructure
- ❑ **Chapter 9** – Conclusions

2. INFRASTRUCTURE

Infrastructure investment impacts chiefly on the supply side of the economy by improving economic efficiency and resource allocation. Particularly at the present time when Australia's current account deficit is at record levels, it is important that the huge demand for Australian commodities, notably from China, is serviced with a rapid increase in our export infrastructure.

Investment in social infrastructure also has a long-term impact on productivity and hence on economic performance.

Infrastructure: Economic benefits

It is beyond dispute that investment in economic infrastructure, much of it traditionally publicly provided, affects the productivity of the private sector capital stock. Obviously, for example, the productivity of a truck depends very much on the availability and quality of roads where the goods are to go. No one, therefore, doubts that the efficiency of, say, our ports and airports – and our transport and handling system as a whole – is an important ingredient in our international competitiveness.¹

2.1 A FUNDAMENTAL DRIVER OF ECONOMIC GROWTH

Infrastructure – investment sunk in land, such as roads, railways, telecommunications, electric power, sea, airports and the like – is a fundamental prerequisite to economic growth. Throughout history it has played an essential role in human progress.

Infrastructure, provided in many countries by public investment and in others more by private-sector models, typically accounts for a significant share of a nation's capital stock and features prominently in the progressive accumulation of capital in modern societies.

These economic services (quite apart from the national security, cultural, educational and personal lifestyle dimensions of infrastructure) are essential inputs to production and also final consumption goods in modern advanced economies. Infrastructure, in its quantitative and qualitative aspects, has therefore long been recognised as a key element of economic growth.

The debate on the relationship between infrastructure and economic output began with Aschauer². He found that public infrastructure investment in the United States (US) is an important input to private production because it leads to cost savings and a reduction in overall business costs. Aschauer found that a 1 per cent increase in public infrastructure spending resulted in a 0.4 per cent increase in economic output.

¹ FitzGerald, V. 1994, *Sustainable Growth and Infrastructure Investment, Investing in Infrastructure*; ISBN0730648087, The Australian Urban and Regional Review, AGPS, Canberra. page 14.

² Aschauer, D. A. 1989; "Is public expenditure productive?", *Journal of Monetary Economics*, Vol. 23, pp. 177–200.

There is controversy surrounding Aschauer's views and differing interpretations of his results. Some significant work has now been done on Australian conditions.

Otto and Voss³, were the first to examine the economic benefits of public spending on different types of infrastructure in Australia. The authors found that a 1 per cent increase in spending on public infrastructure led to an increase in economic output of 0.17 per cent. They also found that economic infrastructure services contribute more to economic output than other types of public expenditure. For example, road investment generates a higher return than investment in social security services.

In a later study, Kam⁴ questioned the quantum of benefit suggested by Otto and Voss but nonetheless found that infrastructure investment generated positive economic benefits. In addition, he argued that the accumulation of public capital has a permanent effect on the economy by encouraging private investment in capital.

More recently, Song⁵ found that a 1 per cent increase in public infrastructure resulted in an output increase of between 0.27 to 0.39 per cent. The higher estimate was attributed to the use of more recent data, where the marginal product of public capital was found to be higher.

There have been several international studies that have examined the link between infrastructure investment and economic growth. For example, Pereira⁶ compares the output elasticity across 12 OECD countries, including Australia, between 1960 and 1980. Pereira found a strong correlation between infrastructure investment and economic growth, with output elasticity ranging between 0.17 and 1.4. Pereira estimated an output elasticity for Australia of 0.17, which supports the Otto and Voss estimate.

Figure 2-A Output elasticity of Australian infrastructure investment

Author	Output elasticity*
Otto and Voss (1996)	0.17
Pereira (2001)	0.17
Kam (2001)	0.10
Song (2002)	0.27–0.39

*The increase in economic output from a 1 per cent increase in infrastructure investment

All of this leads to one inescapable conclusion, Australian infrastructure investment levels need to rise to sustain our economic performance and enhance social conditions into the future. This is especially the case due to the aging of the population and the consequent impact on productivity that that phenomenon implies.

³ Otto, G. D. and Voss, G. M. 1996; *The Macro-economic Benefits of Public Infrastructure Investment*, NRMA, Sydney.

⁴ Kam, T.C.Y. 2001, *Public Infrastructure Spillovers and Growth: Theory and Time Series Evidence for Australia*, Department of Economics, The University of Melbourne, http://www.economics.unimelb.edu.au/research/workingpapers/wp00_01/wp00_01.htm.

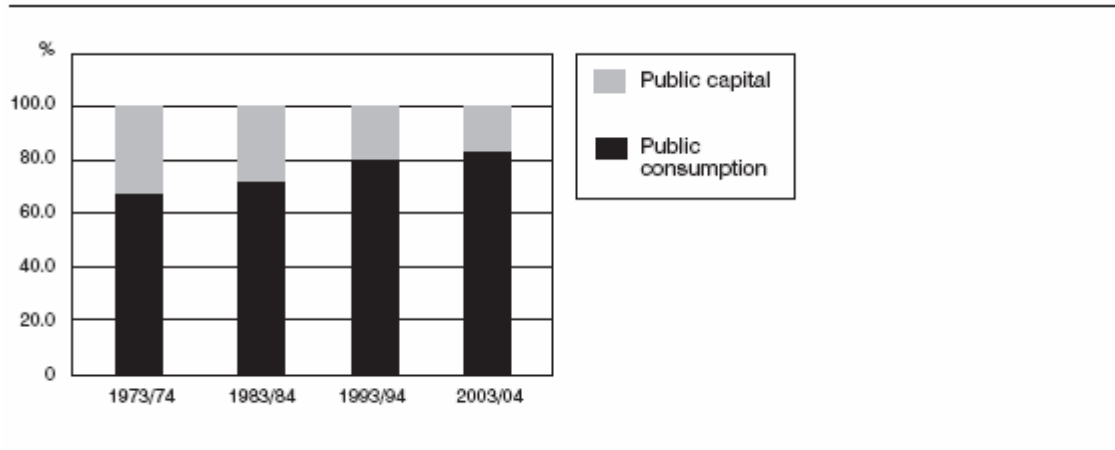
⁵ Song L. L. 2002, *Public Capital, Congestion and Private Production in Australia*, Melbourne Institute of Applied Economic and Social Research, The University of Melbourne, November.

⁶ Pereira, A. M. 2001, *Public Investment and Private Sector Performance – International Evidence*, www.spaef.com/PFM_PUB/v1n2/1_2/1_2_7_pereira.pdf.

2.2 DECLINE IN INFRASTRUCTURE INVESTMENT

After more than a century and a half of occupying a central place in the pro-development thrust of Australia’s economic policy, infrastructure investment began to decline as a share of public expenditure in the 1980s as Australian governments, both Commonwealth and State, moved to increase the share of public consumption expenditure in their annual budgets at the expense of public investment. The ratio of public consumption expenditure to public capital expenditure has increased from 2:1 in 1973/74 to 5:1 in 2003/04.

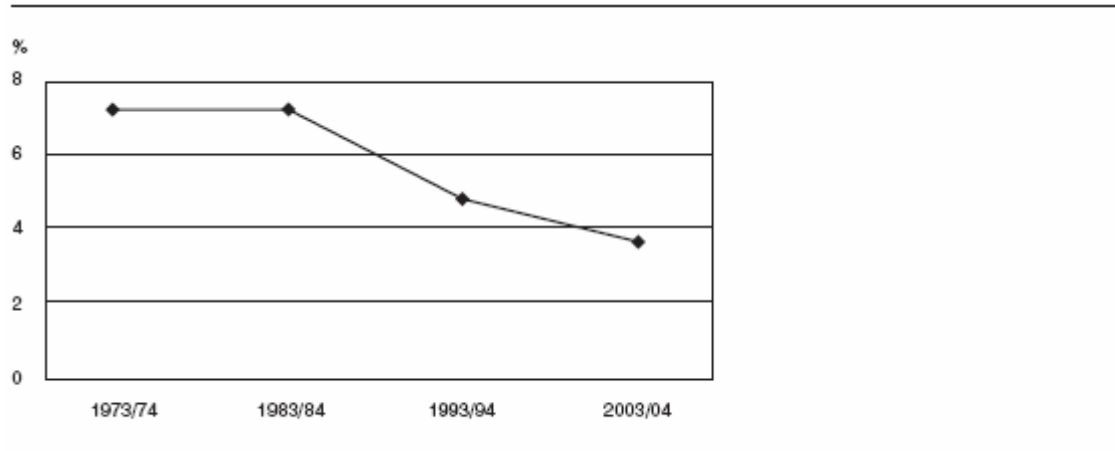
Figure 2-B Public consumption compared to public capital expenditure



Source: ABS Cat. 5204.0

The level of public capital investment has halved as a proportion of the economy over the past 20 years. To some extent this decline simply reflects the removal of large historical backlogs, eg the finalisation of national sewerage schemes, the maturity of large electricity modernisation programs etc. In addition, there is no doubt that efficiency of infrastructure provision has increased significantly over recent decades. Nonetheless, there is now a large backlog of urgent works that needs to be undertaken including roads, railways, port expansions etc.

Figure 2-C Public fixed capital expenditure as a share of GDP



Source: ABS Cat. 5204.0

2.3 THE NEED FOR HIGHER RATES OF INVESTMENT

The decline over the last 2 decades has in public infrastructure investment has united many commentators on the need for higher rates of infrastructure investment.

Infrastructure reform must continue to be a high priority

Infrastructure services are a large part of the Australian economy. They are key inputs for Australian businesses – and their costs, reliability and quality have a major bearing on Australia’s international competitiveness. Moreover, affordable and reliable infrastructure services are central to quality of life in the community. Economic infrastructure is highly capital intensive, requiring major investment expenditure on long-lived assets. Poor investment decisions or under-investment could constrain Australia’s growth and living standards for many years.⁷

CEDA in a recent report strongly argued the case for increased investment. In summary, there is strong evidence that investment in infrastructure has a positive and permanent effect on economic output, with a 1 per cent increase in infrastructure spending increasing output between 0.17 and 0.39 per cent. Moreover, investment in infrastructure in the economy generates higher returns than investment in other sectors⁸.

A similar point was made by the Reserve Bank in its typically cautious style

*“A continuation of a robust expansion will, it seems, be increasingly dependent on enhancing the supply side: **growing the capital stock**, more effectively matching the supply of and demand for both skilled and unskilled labour, and innovation to lift the productivity of all the factors of production⁹.”*

Many other major business groups have also echoed this theme including the Business Council of Australia, AUSCID, the Minerals Council and Australian Automobile Association. There are a myriad of studies which also support this view.

2.4 THE SCALE OF THE TASK

In 2001 Engineers Australia identified deficiencies in Australia’s infrastructure condition and performance in a major study *The National Infrastructure Report Card for 2001*.

The Report Card rated infrastructure services in 13 sectors including, electricity, gas, rail, roads, airports, telecommunications, and ports. The ratings for the 13 sectors are in the Table below.

The Report Card rated Australia’s infrastructure on a scale from “A” to “F”. An “A” rating indicated that the level of infrastructure in 2001 was sufficient for current and future purposes, whereas an “F” rating indicated that the level of infrastructure in 2001 was inadequate for current and future purposes.

⁷ Productivity Commission, *Review of National Competition Policy Reforms*, Canberra, October 2004 p xxvii.

⁸ *Infrastructure: Getting on with the job* Growth 54 April 2005 CEDA page 20.

⁹ Address by Glenn Stevens, Deputy Governor, Reserve Bank of Australia, to the Australian Business Economists and Economic Society of Australia, 14 December 2004.

At the broad level, this national infrastructure assessment did not return any “A” ratings. The report found that investment in infrastructure for rail, irrigation, stormwater and local roads was assessed as being in a “disturbing state”, each receiving a score of D or D–.

Only ports, airports and telecommunications received a B rating, indicating that while investment was sufficient to meet current needs, it was still insufficient to meet future needs.

Table 2–A Infrastructure ratings in the 2001 Report Card

Infrastructure	Rating
Ports	B
Airports	B
Telecommunications	B
Electricity	B–
National roads	C
Potable water	C
Gas	C
State roads	C–
Waste-water	C–
Local roads	D
Storm water	D
Irrigation	D–
Rail	D–

Source: Engineers Australia 2001

AusCID has extended the Report Card ratings by estimating the value of the under-investment (or backlog) in five key sectors: electricity, gas, road, rail and water.

In assessing the current level of infrastructure under-investment, AusCID drew on a number of professional reports and also on advice from experts in each of the five sectors. The estimates of under-investment include the land transport projects announced in the AusLink white paper. This is because these projects are designed to correct current deficiencies in infrastructure.

The total estimated value of infrastructure under-investment in Australia in the five areas of electricity, gas, rail, road and water is \$24.8 billion (see Table below). This under-investment covers the deficiency in infrastructure in meeting the then current demand.

Table 2–B Estimates of under-investment and rate of return* by sector

Sector	Under-investment (\$bn)	Rate of return %
Electricity	1.15	10.5
Gas	2.60	12.5
Road	10.00	12.5
Rail	8.06	12.5
Water	3.00	9.0
Total	24.81	

*The rate of return is the nominal pre-tax rate of return
Source: AusCID (Econtech 2004)

Previous estimates of infrastructure under-investment are as high as \$150 billion because they take into account the inadequacy of current infrastructure services to meet future needs, as well as current needs and they range over a wider set of infrastructure areas.

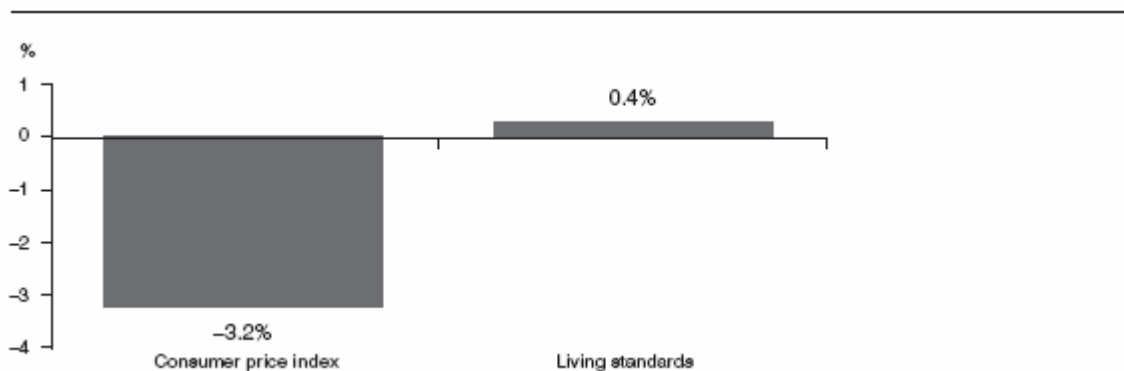
2.5 THE EXPECTED ECONOMIC BENEFITS FROM INVESTMENT

Analysis by Econtech¹⁰ for AusCID estimates¹¹ the economic impacts of overcoming infrastructure under-investment by using the estimates of under-investment mentioned above. This involved two scenarios:

- the “baseline scenario” reflects a situation where infrastructure underinvestment is not addressed; and
- the simulated (or “reform scenario”) reflects a situation where the problem of under-investment in each sector is overcome.

Differences in outcomes between the “reform” scenario and the “baseline” scenario show the economic impacts of overcoming infrastructure under-investment in Australia.

Figure 2-D Estimates of livings standards and price effects from infrastructure investment



The results show a marked improvement in economic performance if the needed investment is undertaken - resulting in lower consumer prices, higher GDP, higher business investment, higher levels of exports and lower prices for infrastructures services themselves. This results in higher living standards (see table above).

¹⁰ Econtech 2004, *Modelling the Economic Effects of Overcoming Under-investment in Australian Infrastructure*, Report for AusCID; Econtech, Canberra, August.

¹¹ The model was based on transforming the estimates of infrastructure under-investment into inputs suitable for the MM600+ model.

2.6 A UNIQUE CLASS OF ASSET

Infrastructure provides services to a large number of consumers and involves complex and costly distribution networks such as those found in the utilities, transport, telecommunications and health sectors of the economy.

Infrastructure assets that are stand-alone hubs of economic activity such as airports and ports generally require complementary infrastructures such as road and rail services for their efficient operation. Infrastructure services are generally regulated in terms of both output pricing and service quality standards¹².

From an investment perspective, the important characteristics of infrastructure are the high capital cost, long holding periods, significant risk and low returns.

The financial performance of these assets has more to do with the negotiation of commercial terms with government than market forces.

Infrastructure assets are generally capital intensive with high sunk costs and long payback periods. Infrastructure is installed with a long-term service horizon and provides an ongoing stream of output structured to meet long-term estimates of demand.

Infrastructure assets are generally site and use-specific and have low utility. Infrastructure also possesses elements of exclusivity and limited competition arising from the need to observe economies of scale and to meet long term planning objectives. In vertically integrated markets such as electricity or gas generation, transmission and distribution, greater competition has taken the form of the 'unbundling' or vertical divestment of the various industry segments, which are then opened to other market entrants. Policy frameworks that favour horizontal diversification and competition have been less successful and vertical divestment is difficult to implement unless it forms part of a major industry restructure. In networked sectors operating across state boundaries, such as the energy and transport industries, vertical divestment has required coordinated national reform.

Where infrastructure assets and services are provided by the private sector pursuant to 'contracting out' and franchise arrangements at regional and local economy level, limited competition is a natural consequence of exclusive dealing arrangements or long term tenure at strategic locations. The limited competition that is a feature of franchises is an important component of private sector investment economics. The demand for infrastructure services is steady and generally price inelastic and output pricing does not always reflect marginal cost. In many cases, service pricing might include community service obligations (CSO) and cross-subsidisation, in which event, pricing is generally economically sub-optimal. The pricing of infrastructure services is regulated although there are significant differences in pricing structures between markets, between sectors and to the extent to which markets might have been deregulated and opened to competition.

To private investors, infrastructure offers long-term predictable revenues, which might be supported by "shadow tolls", government subsidies and other non-market interventions¹³. Shadow tolls are per vehicle amounts paid to a facility operator by a third party such as a

¹² Economic Planning Advisory Commission 1995 Private Infrastructure Taskforce, Commissioned Studies, AGPS Canberra

¹³ Infrastructure Trust of Australia 1996, Prospectus

sponsoring governmental entity and not by facility users. Shadow toll amounts paid to a facility operator would be based upon the type of vehicle and distance travelled¹⁴.

Infrastructure service prices are frequently linked to the Consumer Price Index (CPI)¹⁵ and investment is generally highly leveraged with early stage cash flows directed at debt reduction.

As the project matures, risk decreases and cash flow stabilises. Infrastructure investment return is supposedly priced commensurate with risk although there is evidence of significant pricing variations between industry sectors, between firms in the same sector and between listed and private investments.

Infrastructure also involves investment in finite tenure assets such as franchises where the investment might have no residual value and must fully repay capital as well as provide a satisfactory return to investors during the tenure or franchise period. Many road projects are structured in this manner with ownership transferring to the public sector at the end of the term of the project.

¹⁴ Benefits include motorists do not face liability for tolls thus securing better utilisation for asset, better traffic flow as no need for tollbooths, adjustments to tolls have no effect on traffic volumes. US Department of Highway Administration Innovative Finance found at <http://www.fhwa.dot.gov/innovativefinance/stchap1.htm>

¹⁵ Albon, R 2000. *Incentive Regulation, Benchmarking and Utility Performance* a paper prepared for the Utility Regulators Forum, ACCC Melbourne

3. BACKGROUND ON PRIVATE INFRASTRUCTURE

3.1 HISTORY OF PUBLIC INFRASTRUCTURE INVESTMENT

Whilst Government provision of most key infrastructure is the experience of Australian development, the private franchising of public services is not new. For example, in the early Roman Empire at the time of Augustus, bridges and ferries were tolled, the collection of taxes was contracted out and water supply in major cities was franchised to private contractors.¹⁶

Early British conquests in India were made by the East India Company acting under a franchise in the form of royal charter. In the 17th and 18th Centuries, the company conducted colonial administration on behalf of the Crown and similar arrangements existed in the Levant, North America and the Far East.

Furthermore, privately owned communications and transport infrastructure and private finance were major contributors to the industrial revolution in the period 1760-1830 and included post and telegraphs, toll roads, canals, port and railway assets¹⁷.

The enormous rise in the role for government provision of infrastructure and the resultant services grew out of a complex series of circumstances including market failure, private capital shortage, concerns about equity and improvements in the understanding of economics that applied in the late nineteenth century and twentieth century.

The expansion and rapid development of the Australian economy, particularly with the gold-rushes and pastoral boom after the 1850s, followed by Federation in 1901, saw substantial infrastructure investment, with the public sector taking a leading role in promoting and progressing Australia's infrastructure investment and its institutions.

Throughout this era Britain provided the major source of capital with Commonwealth and State governments actively tapping the London market for long-term borrowing. The government leadership in initiating and executing infrastructure works, and in the financing of infrastructure, continued to be accepted by Australian society as a prime responsibility of Australian governments. This largely reflects the time period over which the major development of Australia occurred and the fact that Australia's remoteness and lack of domestic private capital precluded major private sector infrastructure developments such as railways.

This era of large public infrastructure investments, and the public administration apparatus that supported it, is often characterised as the classic era of "development" in Australia's economic history.

¹⁶ Scullard, H.H. 1963, *From the Gracchi to Nero, A History of Rome from 133BC to AD68*, Methuen and Company, London. Pages 337-8,342.

¹⁷ Blum, J. Cameron, R. Barnes, T.G. 1967, *The European World Since 1815: Triumph and Transition*, Routledge and Kegan Paul, London pages 63-72

3.2 SIZE OF PRIVATE INFRASTRUCTURE INVESTMENT

Privately funded, owned and operated public infrastructure is a very significant component of the Australian economy. The Australian Council on Infrastructure Development surveys the level and composition of privately owned infrastructure in Australia. In 2003 it estimated¹⁸ the level of total investment at \$113,559 million – a very significant sector of the economy.

Table 3–A Private Sector Ownership of Infrastructure 2003

Sector	Industry	Total Value of Private Sector Investment (\$m)	% Share of Total Investment	Gross Turnover of Assets (\$m)	Gross Employment Costs (\$m)	Number of Employees
Energy	Electricity	37,500	33.0	7,200	800	13,600
	Gas	19,300	17.0	3,400	600	9,600
Water		2,300	2.0	400	50	700
Transport	Roads	9,100	8.0	1,200	26	600
	Rail	6,500	5.7	400	160	2,400
	Ports	1,200	1.1	300	28	600
	Airports	10,000	8.8	1,100	120	36,800
Telecommunications		23,600	20.7	17,200	1,200	34,000
Social	Hospitals	2,200	2.0	400	240	5,200
	Justice	1,000	0.9	500	350	1,300
	Stadiums	800	0.7	21	13	500
	Total	113,400	100.0	32,321	3,587	105,000

3.3 PUBLIC PRIVATE PARTNERSHIPS

Public Private Partnerships (PPPs) are arrangements for the procurement of goods and services utilising franchises and similar arrangements with the private sector.

Technically PPPs are not privatisations, as privatisations involve the sale of an existing government owned asset or business to the private sector. However, many people use the terms interchangeably and this question is still a significant part of the public debate in Australia.

Indeed, in many instances where PPPs have been claimed to be privatisations, the asset will be automatically transferred to public ownership at the end of the franchise period (after say 30 or 40 years).

¹⁸ AUSCID Infrastructure Survey 2003 Summary of Results. The survey has counted in excess of 200 items including both individual infrastructure assets, such as a pipeline or power station and items aggregated on a company basis.

Specifically, PPPs refer to circumstances where public services are provided by private operators for, or on behalf of, government to third parties. Typically, they include franchises, leases and licences for the construction and/or operation of toll roads, airports, public buildings, health and educational facilities, prisons, public transport and other public services.

PPPs were introduced as a component of the microeconomic reform process that was undertaken in the United Kingdom, Australia and other developed economies throughout the 1990s. Other components of the “economic reform” process included product and labour market deregulation, an enhanced role for competition policy, reform of state-owned businesses along private sector business lines and a generally reduced role for government in the operation of the economy.

In the United Kingdom, PPPs were introduced in 2000 and formed part of the broader Private Finance Initiative (PFI) program that was introduced in 1992. PPPs are not, in fact, partnerships but contractual arrangements for the provision of goods and or services to or on behalf of government.

The difference between PFI and PPPs is the wider scope of PPPs to include:

- private ownership of previously state-owned businesses (full or partial privatisation of government owned enterprises)
- long-term service procurement arrangements including those where the private sector provides the infrastructure (PFI)
- partnership arrangements to sell public services into wider markets and exploit the commercial potential of public assets (PPP).¹

Other jurisdictions, such as Australia, have never used the PFI designation. Enterprise sales and long-term (99 year) leases of assets such as airports were privatisations and limited tenure franchises were termed Private Finance Projects (PFPs) in New South Wales and PPPs everywhere else.

There is not a widely accepted definition of PPPs operating in Australia. The Government of Victoria Partnership Victoria program refers to a PPP project in the following terms:

“... a contract for a private party to deliver public infrastructure-based services. The policy does not cover outsourcing or other service delivery arrangements where no capital investment is required.”¹⁹

Partnerships Victoria does not employ a particular model. In structuring the right approach,

“ ... the best value for money to government is achieved by focusing on the output specifications, the public interest, the capabilities of both government and the private sector, the optimal risk allocation environment and commercial viability ... The objective is to achieve effective and efficient value for money outputs”²⁰

¹⁹ Government of Victoria 20001 *Practitioners' Guide*, Department of Treasury and Finance, Partnerships Victoria Guidance Material, Melbourne (available from www.partnerships.vic.gov.au on 27 February 2005). Page 4

²⁰ Ibid page 5.

3.4 FORMS OF PUBLIC PRIVATE PARTNERSHIPS

The Australian Council on Infrastructure Development (AUSCID) has identified²¹ various types of PPPs. They are listed below.

Contract Type	Characteristics
Design & Construct (D&C)	The government specifies the asset it requires in terms of its functions and the governments desired outcomes. The private sector is responsible for designing and building the asset and any related risks. The asset is then passed to the government to operate.
Operate & Maintain (O&M)	An existing, government owned asset is managed by a private sector organisation for a specified period. The contractor will be responsible for providing the services to the customer (retail or wholesale), maintaining the asset to a specified condition and ensuring that management practices are efficient.
Design Build Operate (DBO)	Effectively a design and construction contract and an operation and maintenance contract rolled together. The service provider is responsible for design and construction, finance, operations, maintenance and commercial risks associated with the project. It owns the project throughout the concession period. The asset is transferred back to the government at the end of the term, often at no cost.
Build Own Operate Transfer (BOOT)	The service provider is responsible for design and construction, finance, operations, maintenance and commercial risks associated with the project. It owns the project throughout the concession period. The asset is transferred back to the government at the end of the term, often at no cost.
Build Own Operate (BOO)	Similar to BOOT projects, but the service provider retains ownership of the asset in perpetuity. The government only agrees to purchase the services produced for a fixed length of time.

²¹ AUSCID Submission to the Parliamentary Inquiry into Public-Private Partnerships October 2005 pp 6,7.

Lease Own Operate (LOO)

Similar to a BOO project but an existing asset is leased from the government for a specified time. The asset

may require refurbishment or expansion but no 'new build' assets are necessary.

Alliance

An agreement between the private contractor and the government to share the pain or the gain associated with project risks. The parties agree to a benchmark price, time and service standard and any benefits (or costs) achieved are shared between the parties according to a pre-agreed formula.

These different types of arrangements show the flexibility of PPPs, ie that virtually any ownership or risk transfer structure can be designed depending upon the particular circumstances of the projects and the needs of the relevant government.

The threshold question of whether or not a PPP is appropriate for a particular project is a different matter. The next section of the Report discusses the claimed benefits of PPPs.

4. BENEFITS OF PRIVATE INFRASTRUCTURE PROVISION

4.1 SUMMARY OF CLAIMED BENEFITS

There are many benefits that proponents of private sector investment claim private sector involvement can bring to the task of delivering infrastructure which can be broadly summarised under the following headings:

- earlier project delivery than might otherwise be possible through traditional means
- the application of innovative solutions
- access to broader funding sources
- benefits in the areas of risk allocation
- economically sound decision making

Despite these claimed attributes, it is important to recognise that private sector involvement will not be appropriate in every project. A careful and rigorous assessment needs to be undertaken in each case of what benefits private sector involvement can bring to any project.

4.2 MORE DETAILED DISCUSSION OF CLAIMED BENEFITS

AusCID claims²² the following specific benefits from private sector involvement in infrastructure projects. Many other commentators supporting private sector involvement echo many, or all, of these sentiments. The AusCID example is cited as it is the major representative body for private infrastructure providers and has been active in the debate since its inception in Australia. Comments are provided in italics after each benefit.

Risk allocation

One of the fundamental benefits of adopting a PPP approach to project delivery is the reduced level of risk to which the State, and taxpayers, are exposed. Where appropriate risks are transferred to the private sector the contingent liabilities to the State are reduced and a better project should result.

In many ways this is the major justification for PPPs. The impetus for this type of approach arose over time in the context of some major cost blowouts for some public sector projects. This “construction risk” was a significant issue during periods of higher inflation, and has continued to be an issue in some jurisdictions. However, changes in market practice have seen all major construction contracts operate on a fixed price basis for at least this decade. That is, construction risk is transferred in practice to private contractors now irrespective of whether the projects are publicly or privately funded projects.

The other major area of risk transfer occurs with the transfer of financial viability of a piece of economic infrastructure. Transport projects are generally the most controversial of these types of projects – ie where the traffic risk for a bridge or tunnel or patronage risk for a public transport service are accepted by the private investor. The funds invested in such projects by financiers are genuinely “at risk” as the recent example of Sydney’s Cross City Tunnel

²² Submission to the Parliamentary Inquiry into Public-Private Partnerships October 2005 pages 10-11.

demonstrates. However, critics argue that not such risks are ultimately transferable as the political accountability for the outcome of the project ultimately resides with the Government.

Earlier project delivery

While the State is capable of procuring most projects directly, often funding constraints and interface difficulties with private building contractors lead to delays that are not necessary. Experience has shown that projects that are designed and constructed or, even better, designed, constructed and financed by the private sector, are delivered consistently earlier than they would have been if they had been procured by traditional methods. Earlier project delivery leads to increased benefits for customers and the wider economy.

As stated above this construction risk can be successfully transferred irrespective of the financing method chosen. To the extent that this translates into early project delivery it is welcome but this result is determined by the construction contract not the financing method.

There is a further benefit from PPPs which arises because using non-traditional finance can allow projects to be brought forward from when they would be built under a more limited public sector budget. It is claimed that some projects can be brought forward years from when they would otherwise have been delivered under more traditional financing arrangements.

Enhanced efficiency

It has been widely documented that when there are competitive pressures from a marketplace or competitive tendering, the private sector usually delivers capital works for a lower cost than for public procurement options. This enhanced efficiency is also present when private companies operate and maintain assets.

The reasons for this are many but include the greater accountability and financial discipline of private sector firms and the desire to maximise shareholder profits. By contrast, the public sector has a tradition of providing detailed specifications that reduce the scope for innovation.

Private sector involvement often provides enhanced efficiency, especially through competitive tendering. However, there is no guarantee of greater efficiency if a project is financed through a PPP. Indeed, in some circumstances the business case of the private proponent is flawed - such as the Sydney Airport Rail Link which means that the project reverts back to public ownership, or where additional subsidies are required to continue a service such as the Melbourne public transport example.

Better customer focus

In a PPP environment, the private contractor depends on continued use of the services it produces in order to maintain profits. As a result, private firms are focused on the customer. This service ethic leads to better quality services for infrastructure users.

In many circumstances such as toll roads or bridges or other effectively monopoly assets there is neither substantive customer interaction nor a viable alternative so this general assertion, which is true in many private markets, is often not relevant for infrastructure provision.

Access to broader funding

Private sector organisations have much broader sources of capital than governments which are generally restricted to issuing guaranteed bonds and hence pass on all project risks to taxpayers. The ability of the private sector to use structured finance allows project risks to be allocated to investors with an increased appetite for risk bearing and therefore helps to

reduce overall funding costs. By contrast, when the State funds a project directly taxpayers have no choice regarding the risks they bear.

By definition this must be true or else almost all PPPs would not even be contemplated. Yet, this is a much-disputed point as critics point to the almost limitless availability of funds to governments because of their ability to tax. However, the theoretical bounds of public finance are constrained in the real world by political judgements – it is ultimately up to a government to determine if it wants to fund a project itself or go to other financiers.

Whole of life approach

Traditional models of asset procurement separate the design, construction, operation and sometimes maintenance tasks. This leads to conflict between the parties responsible for each role and inefficient outcomes.

One of the great advantages of PPP projects is that they can be structured so a single party is responsible for designing, constructing, operating and maintaining the asset. That party is required to assess the asset on a *whole of life* basis. This means that trade-offs between investments during the various life cycle stages of the asset need to be considered. Ultimately this leads to lower cost services for consumers.

This is accepted as a benefit – although it is unclear whether or not this would be significant in many cases.

Access to latest technology

Private sector organisations which deliver infrastructure services tend to be reasonably large and are often multi-national. These firms often have extensive experience in operating infrastructure elsewhere. They may have access to operating philosophies and patented technology which would not be available to the government if the project was undertaken within the public sector. By involving private organisations in the delivery of services, the quality and standard of those services may therefore be improved.

This is accepted as a benefit – although it is unclear whether or not this would be significant in many cases.

Economically sound decision-making

When private companies choose to invest in infrastructure, they perform detailed studies of potential markets for those services, and the costs of providing them. As a result, only financially viable projects proceed. This process removes the temptation for politicians to choose winners and potentially create white elephants.

Clearly this is not a correct assertion. Whilst detailed studies are invariably conducted, the business models that flow from them are not all soundly based. The Sydney Airport Rail Link is a well-known example of poor business case not surviving in that form. The Cross City Tunnel financiers have already downgraded their investment values, however it is too early to tell how the project will perform in the longer-term.

4.3 CONCLUSIONS

There are benefits which can arise from private sector infrastructure provision but these need to be carefully evaluated according to all the circumstances of a particular project. Private sector involvement, and some private sector management techniques, have undoubtedly benefited public sector infrastructure delivery and processes. However, some of the claims used to justify PPPs lack rigour when applied in a general sense.

5. CRITICISMS OF PRIVATE INFRASTRUCTURE FINANCING

There are a variety of significant criticisms made about private sector involvement in the provision of hitherto publicly provided infrastructure.

A summary of these criticisms yields the following key points:

- There is no need for direct private involvement in financing infrastructure as there is ample capacity for the public sector to do so itself.
- Government's cannot adequately transfer some aspects of risk and therefore the rationale for the involvement of private parties disappears.
- The higher borrowing costs of the private sector mean that taxpayers can rarely, if ever, get value for money from private infrastructure financing.
- Unjustified supernormal profits can be earned by financiers in some cases.
- PPPs involve the creation of a whole new set of transaction and management costs for the public sector that do not arise under traditional infrastructure provision models.
- Accountability for public monies is weakened under PPP style arrangements.
- Governments cannot adequately anticipate major future issues and make appropriately structured contracts which have the flexibility to deal with unforeseen events and risks.

In addition, Appendix B contains an expanded list of criticisms of PPPs at a conceptual level which involve debunking the myths that are claimed to surround PPPs

5.1 FISCAL POLICY CONSTRAINT

Probably the key driver for the utilisation of PPPs for infrastructure programs is the aversion to undertaking new debt financing by Australian governments.

Despite this obvious conclusion, the avoidance of visible levels of government debt has been denied as a motivating factor for the use of PPPs by both the Victorian and NSW state governments. Both governments insist that value for money is the sole driver for the adoption of PPP²³.

PPPs generally result in very little short term capital expenditure from government and therefore allow government to announce multi-billion dollar projects with little to no impact on net government debt.

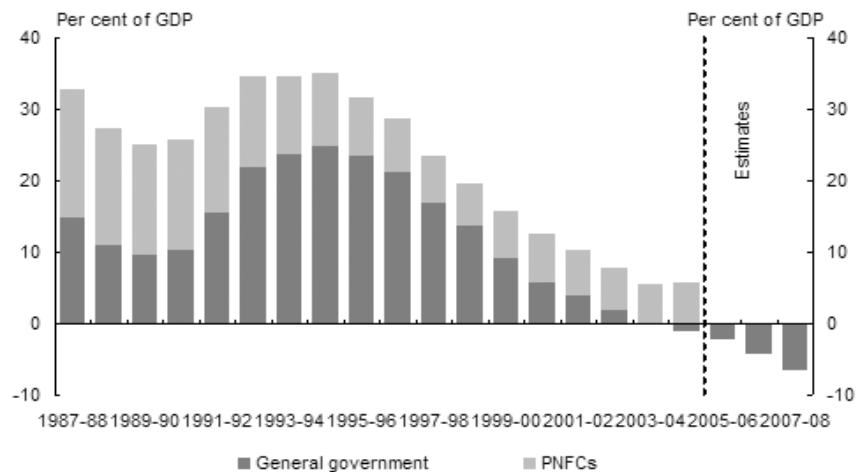
Despite this political convenience, there is no credible economic argument that there is insufficient public funding available for large scale increases in debt to finance public infrastructure investment. Indeed, as the following sections show Australia has a virtually unmatched ability to prudently increase public debt funding of infrastructure should it wish to.

²³ New South Wales Treasury Office of Financial Management, (2002), "Private Provision of Public Infrastructure and Services", *Research and Information Paper*, Sydney. Page 2.

5.2 NET DEBT OF THE COMMONWEALTH

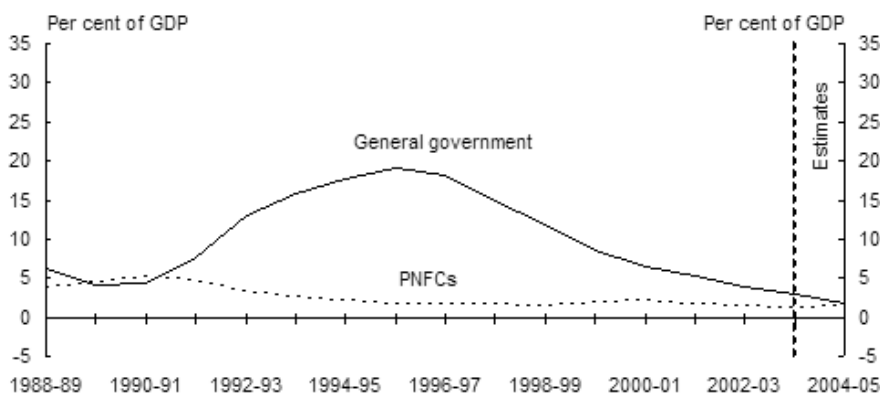
The fiscal position of the Australian public sector is exceedingly strong, both in absolute terms and in comparison to both developed and under-developed nations. The table below shows that the absolute level of total public debt for both the general government sector and the government trading enterprises sector (described in the table as PNFCs)²⁴ are negligible.

Figure 5-A Consolidated non-financial public sector net debt by sector²⁵



The table below contains the Commonwealth’s net debt position, showing it enjoys a strong fiscal position with general government net debt forecast to be negative²⁶ by the end of 2005-06 and government trading enterprise debt at negligible levels.

Figure 5-B Commonwealth non-financial public sector net debt²⁷



²⁴ PNFC refers to Public Non-Financial Corporations.

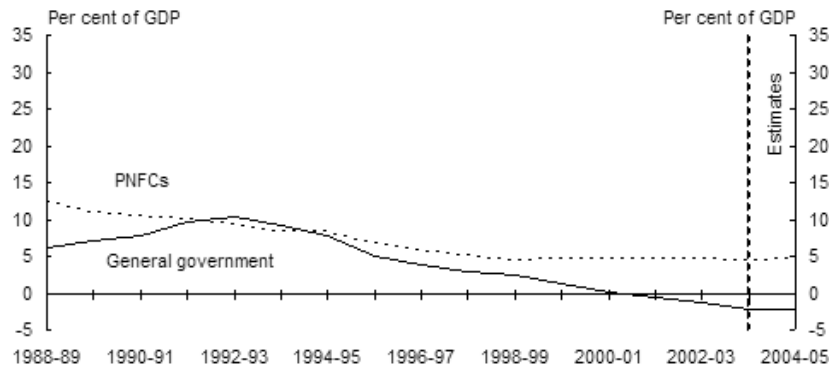
²⁵ 2005-06 Budget Paper No 1 page 12-15

²⁶ Treasurer Costello has announced that he estimates the Commonwealth General Government sector achieved zero net debt status on 21 April 2006 – Treasurer Media Release Speech To The Committee For Economic Development Of Australia “Debt-Free Day” Shangri-La Hotel, Sydney, Thursday, 20 April 2006.

²⁷ Ibid page 12-15

5.3 NET DEBT OF THE STATES/TERRITORIES

Figure 5-C Total state/territory non-financial public sector net debt by sector²⁸



As the above chart shows the states and territories in aggregate also enjoy very low levels of public debt. The negative net debt position of the general government sector largely reflects the extraordinary strength of the Queensland Government’s fiscal position.

The higher levels of net debt in the government trading enterprise sector simply reflect the historical constitutional responsibility of the states/territories to provide basic services especially electricity, water and railways which remain in public ownership despite being corporatised and put into a generally private sector equivalent trading framework.

5.4 THE COMPARATIVE INTERNATIONAL POSITION

In addition to the absolutely low level of net debt faced by Australian governments, the relative position compared to other comparable countries should also be examined.

Australia competes with these nations in many international markets and the relative level of productivity and financial health of these foreign governments is directly relevant to Australia’s policy makers.

Figure 5-D Total general government net debt selected countries 1997-2006



²⁸ Ibid.

The comparative international performance also demonstrates that Australian governments do have a very significant capacity to incur public debt to finance appropriate infrastructure investment.

This point is expertly made by former Secretary to the Commonwealth Treasury and former Head of the Productivity Commission, Mr Tony Cole. He states²⁹, inter alia,

'We have urban rail systems that are breaking down and where timetables are providing for slower travel time because tracks are unsafe. The electricity network is unreliable. We are rationing water in almost every city. Our ports are clogged and hamper exports vital to our market credibility and balance of payments. We know that the best way to cut the road toll is

to improve the roads and that will also make business more efficient. We need more investment in hospitals and universities. I said at the start of this article that there are always more good ideas for spending than we can finance. But it is clear that in so many of these areas the returns will exceed the cost to the Commonwealth of some additional debt.

A full copy of Mr Coles article appears at Appendix B of this report.

On the basis of both the absolute fiscal position of Australian governments, and the relatively excellent position compared with relevant international nations. It is impossible to conclude other than that the governments of Australia have a significant ability to debt finance much of the backlog of infrastructure projects in Australia without leading to net debt levels which are in anyway imprudent. Indeed, many argue that the elimination of net debt is imprudent as a goal *per se*.

Nonetheless, the fact is that governments make choices to utilise PPPs rather than directly invest in some infrastructure projects knowing the fiscal situation. To them the benefits of utilising private sector vehicles to deliver a particular project outweigh the potential opportunity cost of not using public finance.

5.5 INEFFECTIVE RISK TRANSFER

A further argument against the use PPPs is the question of whether government is actually able to effectively transfer risks associated with the delivery of large projects to the private sector³⁰.

Given that such a large part of the value of PPPs rests on the ability of government to transfer risks to the private sector, whether the government is actually able to complete such a transfer is a key issue for the viability of PPPs.

The biggest obstacle to the effective transfer of risk from government to a private provider is the fact that regardless of the outcome of contractual negotiations, the public will still (rightly) hold the Government responsible for the delivery of core services. Political pressure on governments to ensure the delivery of services may result in the perverse outcome of a

²⁹ CEDA Growth 54 Infrastructure Getting On With the Job p76.

³⁰ Barrett, P. (2003), "Public-private partnerships – Are there gaps in public sector accountability?", Paper delivered to Australasian Council of Public Accounts Committees, 3 February 2003, Melbourne. Page 5.

government paying for the transfer of risk under a PPP contract without actually receiving the benefit of this transfer. The NSW Auditor-General has noted that:

“Whether or not there is a contractual obligation for the private sector partner party to continue to meet obligations is one thing, but in reality, many of these projects become perceived by the public as a public sector project, as a government project. If the private sector entity were, for example, to become bankrupt...the risk will quit often fall for public policy reasons or revert to the government.”³¹

Such arguments appear persuasive. At the end of the day if a risk of non-delivery of an essential service eventuates, government may be forced to step in to ensure continuity of service regardless of the terms of any PPP contract.

The most celebrated example of this is the NSW Airport Rail Link where the whole ownership and operation of the service had to be transferred to the NSW Government after the private owners became financially unviable. Similarly, the Victorian Government had to make an emergency cash injection to Melbourne public transport operators who were financially unable to continue under the tender arrangements that they had originally agreed to.

The transfer back to the public sector as the “operator of last resort” of itself does not necessarily mean that the failed PPP was a complete failure on public policy grounds – at least the project was built, which may not have happened otherwise than as a PPP. Furthermore, nor does it necessarily mean that the net financial impost on taxpayers is larger than if the project were traditionally financed. As with all these issues the details depend upon the particular circumstances of each individual case. For example, the Airport Rail Link in Sydney is now on the market. Should the NSW Government conclude a sale for an advantageous price³² it may be that in the long run the project did represent good value for taxpayers.

Similarly, the value of the Sydney Cross City Tunnel has already been written down by the project owners and financiers³³. Should the project become financially unviable the Government may be forced to acquire it, or it may simply be sold at market price which may be less than construction cost.

³¹ New South Wales Public Accounts Committee, (2001), “Inquiry into the Funding of Capital Projects by the New South Wales Government: Parramatta Rail Link Pre-Tender Procurement – A Case Study”, *Report No. 126*, Sydney. Page 31.

³² This is reported to raise “several hundred million dollars” *For sale: ghost train to Sydney Airport* Jordan Baker and Sherrill Nixon Sydney Morning Herald March 11, 2006.

³³ Funds hit by tunnel vision. Robert Chow The Australian April 11 2006 page 19 – Hong Kong based CKI has written down its accounts by \$HK578 million and Industry Funds Management and the CSS/PSS were also looking at valuation losses.

5.6 HIGHER BORROWING COSTS & SUPERNORMAL PROFITS

Probably the major criticism of PPPs is their potential to yield very high profits to investors who are accused of “ripping off” taxpayers and/or infrastructure users for what may in fact be low risk transactions.

5.6.1 THE '5 PER CENT CLUB'?

Critics³⁴ have labelled the institutional investors, lawyers, accountants, merchant bankers and other private sector service providers, who are involved in PPPs as the “5 per cent Club”. They question the value for money that taxpayers get in some of these arrangements, describing the financing and advisory arrangements as follows: .

“Institutional investors seek a minimum risk adjusted return. For private equity in private companies, that minimum return is what is achieved for listed equities plus 5 per cent. For private equity in infrastructure projects, that return is the long term bond rate plus 5 per cent. Add to that the margin on debt financing, and a list of fees as long as the list of wines on offer at Dan Murphy’s, and one begins to get a feel for what the 5 per cent Club does when the private sector gets involved in public infrastructure.”³⁵

“There are legal fees, due diligence fees, a wide range of technical, financial and other advisory fees, success fees for winning a project, underwriting fees for fund raising, performance fees for exceeding the expected returns of 5 per cent Club members, and ongoing management fees for a variety of services provided through the life of the project. This is all before we get into the list of fees and penalty payments that arise, should a dispute occur between the public and private sector, such as that at Seal Rocks, over the terms and conditions of contract performance. It is also before the fees and public sector top up subsidies funded by taxpayers when commercial or political realities require it.”

While some of this criticism is overstated, the general point about potential additional costs to taxpayers and/or uses of infrastructure is well founded, especially in the context of some of the early deals that were entered into which have yielded very high returns to investors.

5.6.2 PUBLIC SECTOR COMPARATOR

In order to allow for accurate comparisons of bids for provision of infrastructure an objective analysis tool is needed. A specific tool has been developed which is known as the Public Sector Comparator (PSC). The Victorian Government describes the PSC and its purpose as follows:

³⁴ *Welcome to the 5% Club* Nixon Apple DISSENT No. 9 Spring, 2002.

³⁵ Eg Sharan Burrow Speech to the Australian Financial Review Infrastructure Summit Melbourne 15 August 2002 reproduced in Evatt Foundation Publication *There are other ways PPPs and public policy*.

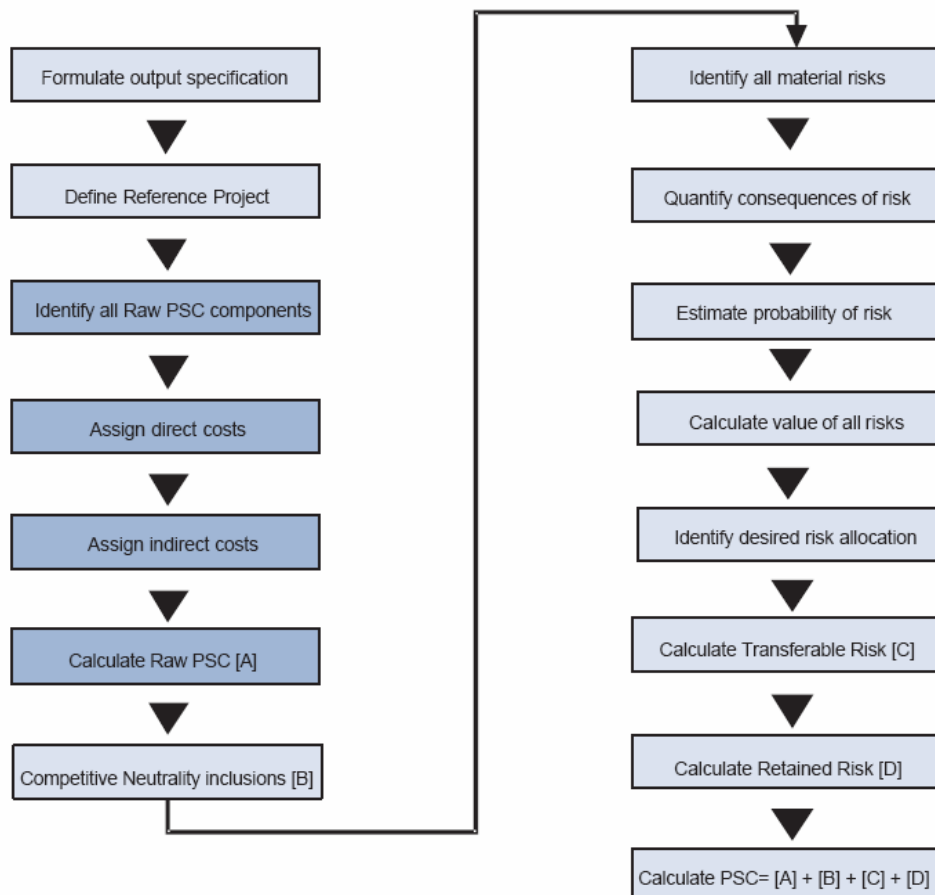
The construction of a PSC is necessary in almost all Partnerships Victoria projects to test whether a private investment proposal offers value for money in comparison with the most efficient form of public procurement.³⁶

The Public Sector Comparator (PSC) is calculated as the net present cost (NPC) of the expected whole-of-life cost to government of the particular project. It is based on cash flow projections and comprises the following components:

- Transferable Risk;
- Competitive Neutrality;
- Raw PSC (base costing); and
- Retained Risk.

There is no generic PSC, each particular project has a specific PSC designed for it taking into account the particular circumstances. That said, there is a general process undertaken in formulating a PSC (see figure below).

Figure 5-E Victorian PSC Process³⁷



³⁶ *Public Sector Comparator Technical Note Partnerships Victoria June 2001 page 1.*

³⁷ *Ibid page 14.*

Critics claim that the PSC is fundamentally flawed as it is too generous to private project proponents. *The Review of Partnerships Victoria Provided Infrastructure*³⁸ examined, inter alia, the methodology used in the PSC in Victoria and other jurisdictions, especially the United Kingdom.

The Review recommended a significant revision to the risk adjustment and evaluation methods used in assessing PPPs. Mr Fitzgerald recommended³⁹ that the calculations concerning pricing of transferred risk should be improved. In particular, he proposed that where no market risk is transferred a discount rate that does not include a premium for risk. In addition, Mr Fitzgerald proposed reforming the PSC and discontinuing its use where public provision is not a realistic option since in those circumstances it would not yield a valid comparison. The State Government rejected these recommendations but did flag them as appropriate for discussion at the national level.

5.7 HIGHER TRANSACTION COSTS

A further argument against the use of PPPs is the extremely high transaction costs associated with their use. Depending on the model chosen to be implemented, PPPs can be some of the most complex commercial and financial arrangements in Australian business. As a result PPPs inevitably result in high transaction costs for all parties involved⁴⁰.

Private companies tendering for PPPs expend significant amounts of money developing project proposals, tendering for the PPP and then negotiating the complex legal and financial structures for the PPP. The sponsor of the Melbourne City Link project (a \$1.8 Billion project) has stated that the winning private consortium spent \$28 million tendering for the project prior to financial close. Government also incurs substantial costs in determining PPP project feasibility, managing the tendering process and negotiating the legal and financial structures that govern the PPP.

On top of this, government will have significant on-going service monitoring and contract management costs. These significant transaction costs ultimately mean that PPPs will rarely be appropriate for small scale government projects.

It should however be noted that the significance of transaction costs for PPPs has been reduced in recent times through state governments conforming their tendering and contract negotiation procedures.

The Victorian, Queensland, New South Wales, Tasmanian and South Australian governments have all developed guidelines setting out how private partners can become involved in PPPs in that state⁴¹. In addition, a National PPP Forum is now in operation, allowing Ministers and departmental staff from various Australian jurisdictions responsible for PPPs to share experiences and cooperate on approaches to specific issues.

³⁸ Peter Fitzgerald January 2004.

³⁹ Recommendation 6,7 & 8.

⁴⁰ Department of the Parliamentary Library, (2002), "Public Private Partnerships: An Introduction", *Research Paper No. 1 2002-03*, Department of the Parliamentary Library, Canberra. Page 12.

⁴¹ Eg *Partnerships Victoria 2000, Working with Government Guidelines for Privately Financed Projects 2001, Public Private Partnership Policy: Achieving Value for Money in Public Infrastructure and Service Delivery 2001, Partnerships SA 2002, Commonwealth Policy Principles for the Use of Private Financing 2002*.

5.8 PUBLIC ACCOUNTABILITY

The replacement of the traditional government delivery with private delivery under PPPs also raises serious issues of public accountability. Commentators have queried the role and relevance that parliamentary committees, auditors-general and regulators can have in an environment where government retains accountability to the electorate but the private sector has taken on responsibility for service delivery⁴².

As the Commonwealth Auditor-General has warned

*“accountability for Government spending can be at risk if arrangements involve parties who are not directly accountable to a Minister and not subject to parliamentary scrutiny”*⁴³.

These problems of responsibility have been compounded by the substantially increased complexity of PPP arrangements and “commercial in confidence” obligations being used to obscure public scrutiny of PPP arrangements⁴⁴.

To date, adequate checks and balances for the creation and ongoing monitoring of PPPs have not been developed by Australian governments. Without the development of measures like this, the accountability of PPP arrangements to the electorate will remain a significant short-coming of PPP arrangements when compared with government delivery.

5.9 ANTICIPATING FUTURE NEEDS

One major potential problem with the increasing reliance on PPPs for infrastructure and/or other service provision is the lack of flexibility that creating private sector rights might entail.

Governments often need to be flexible in changing priorities to meet emergencies or to deal with structural shifts in the community or the economy or to simply deal with an unanticipated need. Creating private sector owners of infrastructure may lead to unforeseen compensation claims in the future if government needs involve changing infrastructure usage that is contrary to a PPP contract.

A short-term example of this type of issue is currently emerging in the NSW Government's proposed changes to traffic arrangements arising from the controversy surrounding the new Cross City Tunnel. There is a very significant potential compensation liability which will accrue to the NSW Government should they adjust the traffic conditions surrounding the tunnel.

Obviously over the very long-term there is a greater chance of unanticipated needs, changing priorities arising and significant compensation being triggered if alterations are needed which are not provided for in the PPP agreements.

⁴² Hodge, G. (2004), “The trouble with public-private partnerships”, *The Age*, 19 July 2004.

⁴³ Barrett, P. (2003), “Public-private partnerships – Are there gaps in public sector accountability?”, Paper delivered to Australasian Council of Public Accounts Committees, 3 February 2003, Melbourne. Page 11.

⁴⁴ *Ibid* pages 14, 26.

6. A NEW MODEL OF PUBLIC PRIVATE PARTNERSHIP

The forms that a partnership between a government and a private service provider can take are varied. The partnership agreement should be structured to utilise the skills of the respective parties as effectively as possible so that they are responsible for the aspects of service delivery they are best capable of managing. The exact nature of this structure will vary depending on the nature of the sector and the specific project details⁴⁵.

6.1 A BETTER APPROACH TO FINANCING

As discussed earlier, even though the economic arguments are weak, the environment in which state and territory governments have to operate is one in which deficit funding is largely deplored in the media, and by mainstream political parties, irrespective of the uses to which the funds are to be applied.

This irrational position, however undesirable, is unlikely to change in the short term. Accordingly, a new approach is needed to achieve the national development objectives that further sensible infrastructure investment can provide.

Australia's federal structure provides a perfect framework to achieve institutional reform of the financing arrangements which could provide a far more rational approach to funding infrastructure investment.

The overwhelming financial dominance of the Commonwealth government coupled with the continuing constitutional responsibilities of the states and territories to provide essential services and infrastructure offers an opportunity for positive reform of institutional arrangements concerning infrastructure.

6.2 STATES AND TERRITORIES RETAIN RESPONSIBILITY

All major PPPs up to this point in time have been conducted by the state and territory government sector. Even though the Commonwealth has recently announced an intention to require compulsory consideration of private financing for all projects over a value of \$100 million, the reality is that no new major Commonwealth projects⁴⁶ have been approved and none appear likely to be approved in the foreseeable future.

Therefore, the driving force within the Australian economy for PPPs is overwhelmingly the budgetary position of the state and territory governments. They maintain responsibility for the roads, bridges, public housing, railways, urban public transport systems, universities, schools, hospitals, childcare centres etc that will be the target of PPPs into the future.

⁴⁵ AusCID Submission to the NSW Parliamentary Inquiry into Public-Private Partnerships October 2005 page 5

⁴⁶ The Defence Headquarters project near Queanbeyan/Bungendore was approved years before the guidelines but has yet to be completed.

6.3 A NEW ROLE FOR THE COMMONWEALTH – THE NIFC

In recognition of the financial strength of the Commonwealth and the leadership role in managing the national economy that the Commonwealth has assumed over time. It is suggested that the Commonwealth undertake a new role in the area of infrastructure.

It is recommended that the Commonwealth establish a new public sector financial institution, known as the National Infrastructure Financing Corporation (NIFC). The NIFC's functions, inter alia, will be to:

- provide equity finance in PPPs;
- provide debt finance in PPPs; and
- raise debt finance for use in PPPs.

Half of the capital for the NIFC will be provided from the earnings of the Future Fund, at say \$1 billion. This is consistent with the policy position announced by Federal Labor⁴⁷.

This public capital can be provided in one initial tranche or successively over time depending upon the appropriate arrangements and the availability of appropriate projects.

Superannuation funds, through an appropriate pooled vehicle, will be able to subscribe to the other 50% of the capital of the Corporation. Thus the NIFC will genuinely be a public/private partnership run on strictly commercial lines.

The NIFC will be able to enter into any type of arrangements it thinks prudent in the context of financing PPPs – ie joint venture or partnership arrangements with other private equity and/or borrowings providers, arrangements directly with state, territory and/or local government bodies etc. However, at least initially, the NIFC should be restricted to investing in projects based in Australia.

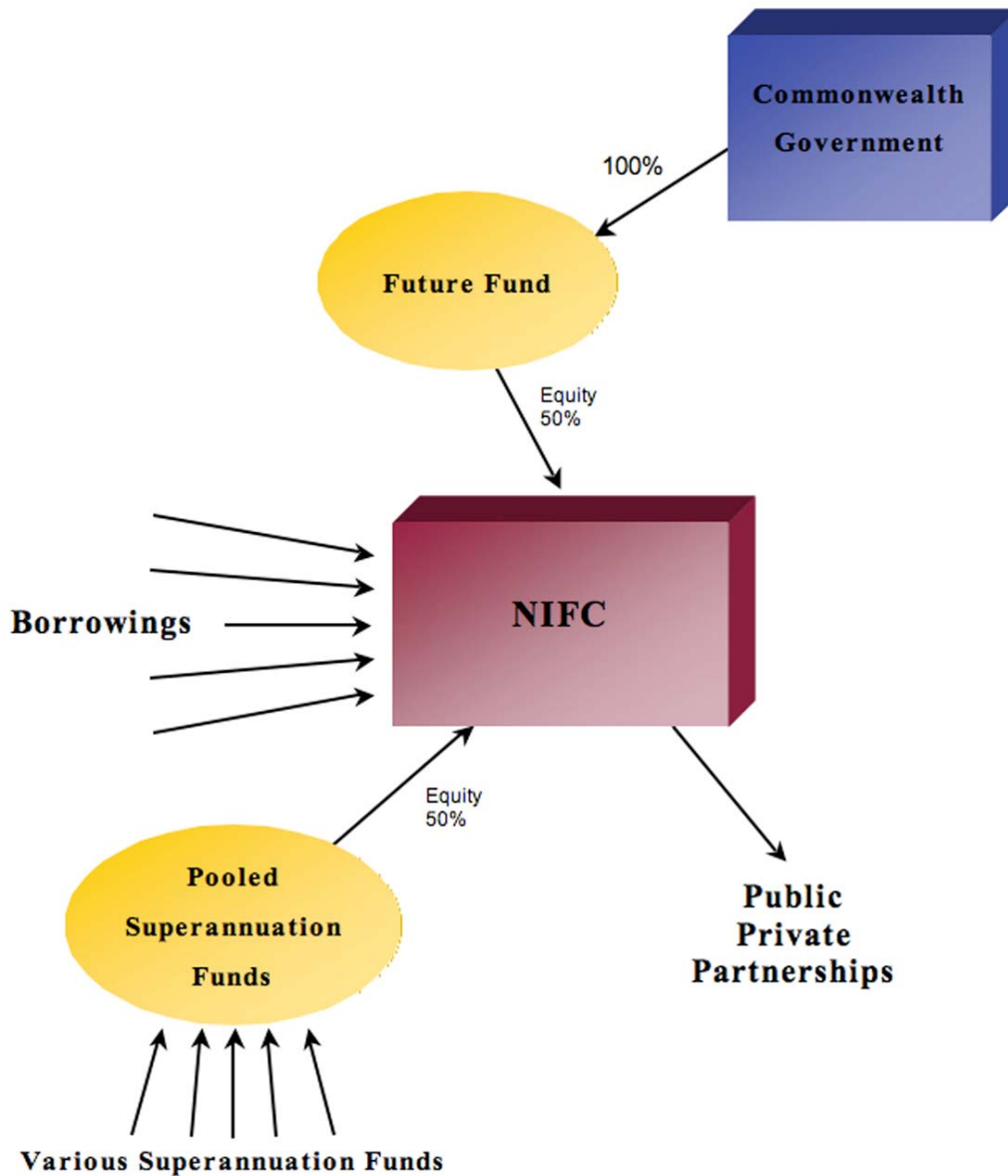
Governance arrangements will be crucial and need to be carefully designed, including ministerial responsibility and reporting arrangements. The NIFC relationship with the proposed advisory body *Infrastructure Australia*⁴⁸ would also need to be considered.

With such a substantial capital base, and the consequent capacity to access very large amounts of debt finance, the NIFC would be able to bid for every major infrastructure project in Australia. Thus the NIFC could be expected to significantly increase the competitiveness of the private infrastructure market, thus lowering finance costs and hence benefiting taxpayers and infrastructure users over the long-run.

⁴⁷ Federal Labor proposes to reform the Future Fund converting it into the Building Australia Fund and using the income generated to invest for productive purposes including into infrastructure. Source: Kim Beazley *Address To The Ausrail Conference Sydney Convention & Exhibition Centre 24 November 2005 Building Australia: Infrastructure And Investment*.

⁴⁸ As announced by Stephen Smith MP Shadow Minister for Industry, Infrastructure and Industrial Relations Media Release *Infrastructure Australia* 12 May 2005.

Figure 6-A NIFC Ownership Structure And Financing Chain



Australia’s federal system more often than not results in most jurisdictions having a different political party forming the state or territory government from that which forms the Commonwealth government. There are already occasions when the Commonwealth and a particular state government disagree on particular infrastructure proposals. This potential for disagreement between levels of government will continue if the NIFC model goes ahead.

Given that the corporation should act on a strictly commercial basis, no direct interference from the Commonwealth Government in matters of policy, i.e whether to bid for a particular project offered by a state/territory which is not supported by the Commonwealth would be allowed. The legislation setting up the NIFC could cover this type of situation.

6.4 BENEFITS OF THE NIFC APPROACH

The benefits of such an approach are very significant. This model addresses the two major criticisms of PPPs, namely:

- the additional cost of using private sector borrowings to finance public investment; and
- the supernormal returns that can accrue to private equity investors in some cases.

Involving the Commonwealth in financing infrastructure investment means that the objectives of the state and territories in undertaking PPPs (whatever they are) can be achieved whilst the aggregated benefits to the nation of accessing cheaper finance to invest in public infrastructure can be realised. Indeed, the Commonwealth can borrow at rates even lower than the separate states and territories⁴⁹.

In addition, to the extent the the NIFC invests equity capital into a project, any above normal returns that are generated on the 50% taxpayers' equity would be captured beneficially by Commonwealth taxpayers to be used for public purposes whatever that may be. The balance of the equity return would be spread across the millions of superannuation fund members who have indirectly invested in the project.

The Commonwealth has played a role in assisting the financing of Australia's infrastructure since the establishment of the Loans Council in the 1923⁵⁰.

Under this arrangement, the Commonwealth borrowed on behalf of the states in order to lower aggregate borrowing costs which would have been higher had the states continued to compete against each other in the capital markets.

The NIFC approach suggests a broadly similar role for the Commonwealth for infrastructure projects in a more modern context.

⁴⁹ The savings vary but should involve 20 or more basis points over the long-run.

⁵⁰ Throughout the early 1920s Commonwealth and State financial conferences sought to resolve conflict over national revenues. Out of it arose the Loan Council in 1923, initially voluntary and informal, to coordinate the loan raisings of all Australian governments. In 1927 all Australian States agreed to join a statutory Australian Loan Council of Commonwealth and State Treasurers.

6.5 PARTNERING WITH SUPERANNUATION FUNDS

The policies described by PPPs are commercial government business deals. No more. No less. The arrangements are no more 'partnerships' than are a home mortgage, an employment contract or any other long-term commercial transaction. Far from constituting partnerships in any meaningful sense, PPPs provide for the contracting parties to pursue their separate, diverse and potentially conflicting public and private interests.⁵¹

The other major advantage of the NIFC model is that it would allow a genuine public private partnership to be established. Critics have often claimed that the use of the term “partnership” is simply for presentational reasons and the PPPs generally do not have any of the desirable attributes of partnerships such as:

- working towards common goals;
- common interests and responsibilities; and
- equality between the partners etc.

Establishing the NIFC would allow the public sector to genuinely partner private sector financiers eg pooled superannuation funds, in financing PPPs.

One popular model for financing PPPs currently is for an investment bank to partner superannuation funds eg through a specific investment pool dedicated for infrastructure investment.

In effect, the NIFC could take the place of the private sector investment bank in teaming up with the superannuation fund investment pool on a permanent basis.

This approach would distribute much more widely the returns accruing to the investment banks whilst also injecting considerable competition into the market.

Superannuation funds could provide significant amounts of debt capital to the NIFC at rates much closer to the Commonwealth bond rate for investment into infrastructure projects, but still at rates lower than would be achieved through normal PPP channels. This would simultaneously improve returns for super fund members (relative to investing in government bonds), reduce the risk of loss through investment in infrastructure and lower the cost of financing of PPPs for state and territory governments.

⁵¹ Christopher Sheil PPPs – *Its time to take the PIIS*, contained in *PPPs: Beneath the rhetoric* Evatt Foundation 15 APRIL 2002.

7. IMPROVING THE INCENTIVES TO INVEST THROUGH TAXATION REFORM

There is no shortage of funds available, but rather a shortage of investible projects. The fact of the matter is funding is actually available and queued up. Portfolio asset allocation to infrastructure has been constrained not by our willingness to invest but by deal flow.⁵²

7.1 SUPERANNUATION FUNDS ARE WIDELY HELD AND LARGELY REPRESENT TAXPAYERS

One of the key dilemmas of PPPs is the potential disparity of interests between project proponents and taxpayers in general. Investors obviously want higher returns and taxpayers are best served through lower costs. The NIFC broadly reconciles these competing interests.

Harnessing a portion of the retirement savings of employees through the pooling of public offer superannuation funds to be used in infrastructure investment in conjunction with the NIFC is a reasonable proxy for direct public investment.

The number of taxpayers is approximately 10.6 million⁵³, the same statistics show that there were 10.0 million⁵⁴ superannuation fund members. Accordingly, superannuation fund members are essentially the same population as taxpayers.

Therefore, their collective interests can be met either through investment of public resources by government or through investment of pooled resources by a consortium of superannuation funds. The NIFC proposal combines both approaches ensuring value for money for taxpayers and good investment opportunities for superannuation fund members.

7.2 TAXATION IS A KEY VARIABLE

Even though superannuation taxation is low relative to other entities such as corporations, nevertheless taxation represents the simplest variable to attempt to voluntarily adjust investment behaviour.

Adjusting the relative taxation treatment of returns from differing types of investment, can significantly improve the incentives to invest in a particular type of asset. Any policy providing concessions should ensure that only “worthy” investments qualify for the more generous concessional treatment, thus the concept of a “qualifying infrastructure investment” needs to be refined. This cannot be conclusively decided at this time, however some possibilities include whether or not the project comes within a rational national development framework,

⁵² *Hot Button Investing*, Janine Mace Superannuation Funds February 2006

⁵³ Taxation Statistics 2002-03 Australian Taxation Office page 7 Table 2.1

⁵⁴ Taxation Statistics 2002-03 Australian Taxation Office page 112 – figure as at 30 June 2004

i.e. has it been approved by a relevant body such as a Commonwealth Minister or a more independent body such as the proposed *Infrastructure Australia*.

There are three points at which taxation arrangements for superannuation funds could be adjusted, at the time of contribution, when earnings are derived or when benefits are paid to members on retirement⁵⁵. In theory concessions could be designed to provide concessions to superannuation fund members through concessional taxation treatment of contributions to a fund if these funds were invested into qualifying infrastructure projects. Similarly, special concessions could be devised for that proportion of a fund member's' retirement benefit which reflected an investment in infrastructure⁵⁶. However, the taxation regime that applies to superannuation is already overly complex - any concession design process should, therefore, also have a focus on simplicity.

Accordingly, the preferred method of stimulating investment by superannuation funds into infrastructure is to provide concessions on fund earnings.

Specific separate figures are not provided on taxes raised from contributions and earnings⁵⁷. The following is the official Budget estimate of total taxes payable by superannuation funds over the forward estimates period.

Table 7–A Superannuation Fund Tax Payable ⁵⁸

	2005-06 (\$m)	2006-07 (\$m)	2007-08 (\$m)	2008-09 (\$m)
Superannuation Funds Contributions and Earnings	5070	5380	5770	6220

7.3 TAXATION OPTIONS

Some specific options for concessions for superannuation funds investing in infrastructure projects include:

- Exemption for the earnings derived from qualifying infrastructure investment.
 - Options include exempting the interest received from investments in debt finance for qualifying infrastructure projects
 - Exempting dividends that accrue on equity investments in qualifying infrastructure

⁵⁵ The 2006 Commonwealth Budget announced significant proposed changes to the taxation of superannuation benefits for those people retiring after reaching age 60. Whilst open for consultation, it is expected the main components will become law from 1 July 2007, namely tax-free benefits for those aged 60 or more from a taxed superannuation fund.

⁵⁶ This would not provide any benefit to a person retiring aged 60 or above from a taxed superannuation scheme from 1 July 2007 and is hence not considered a realistic option.

⁵⁷ Note, however, that Finance Minister Senator the Hon Nick Minchin was quoted in January 2006 as claiming that the contributions tax raised \$3.3 billion per year.

⁵⁸ Budget Paper No. 1 2005-06 page 5-11

Care would need to be taken in these types of arrangements to not allow these taxation benefits to accrue to non-superannuation fund taxpayers. Should these types of benefits be available to individual taxpayers or other entities with higher tax rates than large superannuation funds then significant risk of tax avoidance would arise.

- Reducing the capital gains tax payable on equity investments in qualifying infrastructure.
 - Currently all taxable capital gains earned by superannuation funds are subject to a “discount” of 33% - i.e. only two-thirds of the gain is subject to tax in the hands of the superannuation fund.
 - Individuals, by contrast, enjoy a capital gains tax discount of 50%. There is no rational policy reason for the rate differential.
 - At the very least the discount applied to superannuation funds for equity investments in qualifying infrastructure investments could be extended to alignment with the personal rate (i.e. from 33% to 50%)
 - Alternatively, a complete exemption could be provided for such gains
 - There could, for example be a minimum qualifying period of, say, 10 years
 - The cost of either of these policies would be very modest but would grow over time. The estimated cost would be nil over the forward estimates period were the above regime to apply only to new investment (see section 7.4 below).
- Providing a full or partial deduction for equity investments in qualifying infrastructure
 - This would effectively expense the investment at the time of contribution which would be a highly concessional treatment. This would significantly lower the cost of investment in PPPs and should be reflected in a lower cost structure for governments
 - Such a concession could be shared by all fund members or specifically applied to certain members (i.e. those that elect to specifically invest in infrastructure projects where this is not undertaken by the fund in general).

Indeed, given the low rate of tax applicable to superannuation funds, and therefore the relatively low level of utility that taxation concessions can provide, there is a strong case for combining more than one of the above concessions in order to make qualifying infrastructure investment more attractive.

That is, particular projects with a high priority could qualify for both (full or partial) exemption for earnings flowing from the investment and concessional treatment on capital gains or deductibility of equity contributions. Market forces should ensure that the gains from these types of concessions would be shared between the investors (i.e. the superannuation funds) and the relevant governments through lower project costs.

7.4 ESTIMATED COSTS

7.4.1 EQUITY EARNINGS EXEMPTION

The table below estimates the cost over the forward estimates period of exempting dividends arising from equity investments in qualifying infrastructure projects were such a concession to be introduced immediately (i.e. for new investment occurring after 1 July 2006).

No cost is estimated to arise from exemption from tax for dividends arising from equity investments over the forward estimates as the time taken for approval, construction of the project and operation prior to profitability is assumed that minimal if any dividends would flow over the period.

Table 7–B Estimated cost of tax concessions for infrastructure investment

	2006-07 (\$m)	2007-08 (\$m)	2008-09 (\$m)	2009-2010 (\$m)
Exemption for dividends	nil	nil	nil	Nil

7.4.2 INTEREST EARNINGS EXEMPTION

The table below estimates the cost over the forward estimates period of exempting interest arising from equity investments in qualifying infrastructure projects were such a concession to be introduced immediately (i.e. for new investment occurring after 1 July 2006).

Table 7–C Estimated cost of tax concessions for infrastructure investment

	2006-07 (\$m)	2007-08 (\$m)	2008-09 (\$m)	2009-2010 (\$m)
Exemption for interest	5	31	73	105

Notes: Average interest rate assumed at 7%; Loans rising to \$10 billion in 2009-2010

As the table shows, the cost of this initiative would be very modest in the context of the scale of the Commonwealth Budget. The assumptions regarding \$10 billion worth of debt financing is totally arbitrary but nonetheless substantial, demonstrating the affordability of such a proposal over the long term.

7.4.3 CAPITAL GAINS EARNINGS EXEMPTION

The table below estimates the cost over the forward estimates period of exempting capital gains arising from equity investments in qualifying infrastructure projects were such a concession to be introduced immediately (ie for new investment occurring after 1 July 2006).

No cost is estimated to arise from exemption from tax for capital arising from equity investments over the forward estimates as the time taken for approval, construction of the project and operation prior to profitability is assumed that minimal if any gains would be earned over the period. Were there to be a minimum qualifying period for such a concession (ie 10 years) then, by definition, no funds could qualify until after the end of the forward estimates period.

Table 7–D Estimated cost of tax concessions for infrastructure investment

	2006-07 (\$m)	2007-08 (\$m)	2008-09 (\$m)	2009-2010 (\$m)
Exemption for capital gains	nil	nil	nil	nil

7.4.4 DEDUCTION FOR CAPITAL INVESTMENTS

The table below estimates the cost over the forward estimates period of providing superannuation funds with a deduction for the value of qualifying equity investments in qualifying infrastructure projects were such a concession to be introduced immediately (ie for new investment occurring after 1 July 2006).

The costs shown in the table below are based on assumed level of equity investment in qualifying projects of \$0.5 billion in 2006-07 rising to \$3 billion in 2009-2010.

Table 7–E Estimated cost of tax concessions for infrastructure investment

	2006-07 (\$m)	2007-08 (\$m)	2008-09 (\$m)	2009-2010 (\$m)
Deduction for equity investment	75	150	300	450

8. SPECIFIC CATEGORIES OF INFRASTRUCTURE

This chapter seeks to discuss some of the unique attributes of some potential asset classes that could be involved in PPPs in the future.

The undeniable reality is that for whatever reasons governments have not invested adequately in a variety of forms of basic infrastructure and that economic and social outcomes are therefore worse than they otherwise would be.

8.1 PUBLIC HOUSING

As an asset class public housing provides many positive attributes as a potential investment. It is considered that this has been an under-utilised asset class for PPPs.

First, there is a significant shortage of public housing and/or affordable private rental accommodation as evidenced by large and continuously growing public housing waiting lists.

Secondly, housing is a natural economic asset in that it generates a rental income stream, albeit differing in detail, in both the public and private sector.

Thirdly, over the longer term a (potentially significant) increase in capital value should arise on the housing stock.

Fourthly, there is an income tested subsidy available under Commonwealth social security arrangements for rent assistance payable to those renting in the private market which may be relevant in designing a system to assist low income tenants.

Fifthly, real estate as a class of investment is very well understood by trustees, funds managers etc so transactions costs can be expected to be low relative to some other more complex types of assets.

Lastly, providing new public housing should not lead to any competition related problems of exclusivity or non-compete arrangements that can arise with transport related investments.

Public housing would also be an excellent asset class for the proposed NIFC to invest in as the Commonwealth has historically been a provider of finance to the states under various Commonwealth/State Housing Agreements for most of the last half of the 20th century.

8.2 RAILWAYS

The railway network is complex and provides in many ways a practical example of how a federal system of government can result in sub-optimal infrastructure arrangements. Reform of the unwieldy institutional arrangements and overlapping and inconsistent regulatory arrangements is underway, however progress is very slow.

Due to the historically shared responsibilities, the almost complete absence of Commonwealth investment in mainline railways until the 1990s and the significant competitive advantages enjoyed by the road freight industry, there is a substantial backlog of

high benefit/cost investments that could be made to improve national economic performance by investment in rail infrastructure.

Notwithstanding these significant difficulties, the structure of the main interstate infrastructure body the National Rail Track Corporation (NRTC), and the existence of a rational pricing system for use of railways (ie access charges), means that infrastructure investments by the Commonwealth are treated as investments rather than expenses. The practical impact of this is that were the Commonwealth to provide additional funds to the NRTC only the annual interest cost of those funds is recorded as an expense in the Budget⁵⁹.

This means that the budgetary issue that causes governments to consider PPPs, namely the fact that general government sector investment is generally treated as an expense in the Budget, does not arise for investments in the NRTC. Additionally, private sector investors can be confident of returns arising from investments via the NRTC because a comprehensive system of charging already exists across the inter-state network.

8.3 ROADS AND BRIDGES

Toll roads, tunnels and bridges are now well established in Sydney, Melbourne and Brisbane and significant expansion continues to occur in this sector. Motorist resistance to tolls has been remarkably restrained, although the recent issue of the new Cross City Tunnel in Sydney has sparked a debate about the equity of directly tolling motorists.

One potential solution to the unpopularity of tolls is for a system of “shadow tolls” to be introduced.

Shadow tolls are per vehicle amounts paid to a facility operator by a third party such as a sponsoring governmental entity and not by facility users. Shadow toll amounts paid to a facility operator would be based upon the type of vehicle and distance travelled.

Shadow tolls can be an element of a road finance approach whereby a public or private sector developer/operator accepts certain obligations and risks — such as construction, operations and most specifically traffic — and receives periodic shadow toll payments in place of, or in addition to, real or explicit tolls paid by users. Funds for shadow tolls can come from diverse (and multiple) government and/or private sector sources.

Shadow tolls automatically spread periodic or annual payments to a facility operator over a concession or franchise period; this can place the initial financing responsibility on the developer/operator rather than placing this burden on the public sector agency sponsoring the project. The reasons that shadow tolls may appeal to governments are that:

- Traffic risk can be transferred to a developer/operator;
- Traffic levels are not impaired by real tolls or toll increases;

⁵⁹ The relevant Budget document, Budget Paper No.2 2001-02, explains the treatment as follows. “*Explanation The Government will provide an equity injection of \$111.0 million for the Australian Rail Track Corporation to fund rail track initiatives in New South Wales. This funding is provided for in the Contingency Reserve because it is subject to a business case being agreed with the Government. As the injection of equity outside the General Government sector only affects the composition of the Commonwealth’s investment in financial assets, this measure has no impact on the fiscal balance.*”

- Multiple sources of revenues can be drawn upon to contribute to a shadow toll fund; and
- Project cost obligations to the public sector sponsor (capital, maintenance and operations) can be reasonably known in advance and guaranteed for a particular traffic level.

The traffic risk given to a developer/operator need not be an all-or-nothing proposition. There are several methods by which traffic risk may be dampened by thresholds or guarantees. For example, if traffic is significantly greater than specified, a portion of the additional shadow toll revenues resulting therefrom could be withheld or shared with the government sponsoring entity. Conversely, if the traffic is less than specified in the concession agreement, a portion of the revenue shortfall could be made up by the Government.

Shadow tolls are not a financing source in themselves, but rather a payment approach which can employ a range of financing methods, innovative or traditional, and can permit a viable financing structure that fits the characteristics and needs of certain projects. The concept of shadow tolls is, therefore, particularly applicable to public/private partnerships.

Whether or not it is considered equitable to make the general body of taxpayers bear the cost of a particular group of citizens using a PPP is a complex question that depends upon the particular circumstances.

8.4 SOCIAL INFRASTRUCTURE

The three key areas of social infrastructure other than housing that are available as PPPs are schools, hospitals and childcare facilities.

There is absolutely no need to involve service provision in such arrangements, although this could be done if it is considered desirable.

Utilising the proposed NIFC model the costs of building these “core” public sector infrastructure assets would be much closer to the optimal arrangements of direct public sector borrowing, yet the flexibility to the relevant governments would be that available under the PPP model. No excessive profits would flow to investment banks as the only beneficial financiers would be taxpayers and superannuation fund members.

Indeed, in an era when a hostile Commonwealth Government is undermining the public provision of core public services in these areas through unfair subsidy arrangements to private providers, a fairer system of introducing significant new physical investment into “public” facilities may be the best way for the public system to retain its key role.

9. CONCLUSIONS

There is a significant ongoing role for private capital to be invested in infrastructure projects in Australia. However, the circumstances under which PPPs are undertaken by governments need to be more rigorously evaluated. Not all projects are appropriate to be financed using private sector participation, it depends on the particular circumstances. The key issues should be value for money and satisfying the legitimate infrastructure needs of the community.

What is needed to better protect the public interest is to design a new set of arrangements whereby a genuine partnership is established between the public sector and the private sector. Superannuation fund membership is very broad so drawing on significant superannuation fund resources to finance public infrastructure will distribute the returns from the investment very widely and hence equitably.

In order to ensure better value for money for taxpayers, the cost of financing PPPs needs to decrease substantially. The creation of a National Infrastructure Financing Corporation is an innovative solution to the need to reduce the cost of financing of PPPs which equitably shares the legitimate returns that flow to investors in PPPs. It would also operate as a key national development institution in the context of a national infrastructure strategy.

This will improve the competitiveness of the Australian PPP market resulting in reduced costs to state and territory governments which, in turn, should see the expansion of private infrastructure investment over time. This lower cost structure should also allay a lot of the criticisms concerning some aspects of PPPs.

The taxation system can also act as a powerful incentive to stimulate direct investment by superannuation funds into infrastructure projects. A variety of options for improving the returns on superannuation investment are discussed in the report. Adoption of a combination of these will also improve the investment climate for superannuation funds, which can assist in addressing the significant backlog of major infrastructure projects facing Australia.

APPENDIX A: PAYING FOR PRIVATE PROFIT

By Graham Larcombe and Paul Fitzgerald

The PPP model is often inappropriate, poorly understood and expensive, explain Graham Larcombe and Paul Fitzgerald.

A large body of government and private sector reports has been generated by the emergence of PPPs. Little of it is objective and it depends on the vested interest of the particular group. Many myths about PPPs need to be challenged.

MYTH 1

By reducing the call on public funds the amount of funds available for other essential services is increased.

A reason often stated for the adoption of PPP arrangements is that it frees up public funds that could be used in other essential services. This argument would have some validity if in practice these 'savings' were applied in this way. There is little evidence of this actually happening. Funds saved in this way have mostly been allocated to consolidated revenue to be used to retire debt and not used in the provision of better community services and infrastructure.

A number of commentators point to the higher cost of financing infrastructure through PPPs compared to traditional public sector debt financing. According to economics writer Ken Davidson, the private sector requires a rate of return of around nine per cent per year compared to 6 per cent per year for the public sector.¹ Davidson suggests that, using these rates, a project costing \$4 billion through conventional public sector financing would cost \$5.6 billion if financed through a PPP. The \$1.6 billion difference could have been used to finance new schools or health services.

This impacts on government finance and the government's capacity to maintain and expand existing services.

MYTH 2

Private sector investment accelerates the availability of community goods and services.

Another key argument put forward by advocates of PPPs is that the injection of private sector funds into community assets and services accelerates their creation. The argument is that without the injection of private investment much needed goods and services would have to be deferred or not undertaken. While this has some short term attraction it fails to recognise:

- the longer term financial liabilities that accumulate with such a strategy,
- changes that will occur to the investment strategies of the partnering organisation over the life of the project due to a change of ownership or board direction; and,

- the asset allocation decision making process that comes with the partnering, which can see a partnering organisation remove itself or be wound up.

This latter issue is often not recognised but is important in terms of equity and is inherent in the nature of these projects.

Typically PPPs emerge when an investor or government identifies an opportunity. They are rarely developed out of any identified priority of need or, if they are, they are developed at a premium to government.

In NSW the government has contracted a private sector consortium comprising ABN AMRO, St Hilliers, Hansen Yuncken and SSL Facilities Management (Spotless) to build, maintain and provide security in nine state schools, which the government will lease back for 30 years.

Although this PPP was announced with much fanfare, the government has acknowledged that, if all goes well, the project will produce only a four per cent saving over 30 years to taxpayers. The benefit according to the government is that the schools can be built in 2005 rather than 2010 with the involvement of the private sector. This assumes that funds cannot be raised in other ways such as through traditional public sector debt financing.

PPP agreements can produce significant unforeseen outcomes and reduce the capacity of governments to provide adequate services.

In California the existence of a 'non-compete clause' in the state's franchise agreement with a private toll road operator has forced the Orange County Transportation Authority to buy back the 91 Express Lane Toll Road from its private operator. The County paid over US\$380 million to allow much needed road upgrades in the area surrounding the private toll roads. Non compete clauses are common in infrastructure PPPs where assumptions are made as to the level of patronage/toll that can be expected. Similar clauses exist in a number of tollways operating in Victoria and NSW.

MYTH 3

The private sector is inherently better at providing services.

Supporters of PPPs argue that the private sector is able to deliver services in a more effective and efficient manner than the public sector. Advocates of PPPs often argue that the introduction of PPPs into the provision of public sector goods and services will improve the provision of services through better management and systems. The private sector is motivated by bottom line profit, and hence it has an incentive to continually reduce costs and to improve delivery mechanisms. While this is superficially appealing, it fails to recognise some of the distinct differences that exist between the two sectors and therefore the fallacy of such comparisons. The public sector has different responsibilities compared to the private sector. Not all services can be provided profitably. That is not to say that the public sector does not need to constantly improve its performance. However the criteria for comparing the two sectors needs to be differentiated. Private sector failure is sufficiently well documented to demonstrate the fallacy of any 'inherent' argument.

Inherent within the debate over the introduction of PPPs into what has been traditional public sector service provision is that the private sector will bring better service delivery. Through the prescription, monitoring and measurement of service provision, it is argued that a better

service outcome can be achieved in the provision of community infrastructure and services. While it is generally true that any service can be delivered better where the outputs are clearly stated, this is true for both sectors and not an argument for or against the provision of services by the public or private sector. Secondly, there is sufficient evidence of high quality service provision delivered by the public sector to illustrate the fallacy of this proposition.

A recent report on the private financing of health services in the UK concludes that there are serious problems with privately financed projects.² The report, compiled with a series of interviews with health care workers in nine hospitals involved in privately financed projects, identifies four major problems:

- All hospitals were desperately short of beds, putting pressure on hospital staff to get patients out as quickly as possible.
- All trusts running the hospitals were under severe financial pressure, partly as a result of the escalating costs associated with PFIs.
- There were concerns over poor quality of design of buildings, including poor ventilation, lack of space and inadequate fittings and materials.
- The quality of care had declined, with concerns about time spent with patients and the level of multi skilling required.

MYTH 4

Private sector involvement in the provision of goods and services is free of political interference.

Many advocates of both privatisation and PPPs argue that, by removing the provision of services from the public sector, the capacity for political interference is reduced. Political interference is seen as causing inefficiency, corruption and poor resource allocation. Such an argument fails to recognise that inefficiency, corruption and poor resource allocation can also exist in the private sector. In many instances, the growing interrelationship between the public and private sector associated with PPPs increases political pressure for governments to endorse projects that may or may not be required.

Private sector companies are putting forward unsolicited proposals to government and then mobilising public opinion to support the project. The Very Fast Train is a good example. There have been various proposals over the past 15 years to construct a Very Fast Train link between Melbourne Sydney, Sydney Canberra and Melbourne Brisbane. Despite intense private sector lobbying for these mega projects, it was clear they required massive public subsidies and government would not take them on. The Inland Railway linking Melbourne and Brisbane was heralded by the federal government in many rural electorates during the 2001 national election campaign, only to be quietly downgraded after the election.

The public sector does not have a monopoly on corruption or interference in decision making. The HIH Royal Commission exposed a corporate culture of boards or senior executives interfering to secure rewards for themselves, demonstrating that 'political'

interference can exist in any culture and is not removed just by the presence of private as against public sector management. What is important is robust governance processes whatever the ownership structure.

MYTH 5**Private sector involvement reduces the level of financial risk to government.**

One reason for the introduction of PPPs in recent times is the desire of governments of all persuasion to reduce public sector financial risk. The argument is that by transferring debt and risks to the private sector, the public sector balance sheet is improved. This may be true in the short term.

However, the use of private funds as against public funds increases the level of contingent liability exposure when service contracts fail. As the Sydney Airport Rail Link contract (New Southern Railway) demonstrates, when essential services provided by the private sector fail, the public sector is forced to act as guarantor. The public sector risk can be greater as the ability to directly manage the risk is reduced.

The New Southern Railway linking central Sydney CBD with Kingsford Smith Airport shows that government must continue to underpin major infrastructure projects even if they are run by the private sector. Professor Bob Walker has estimated that in the case of the Sydney Airport Rail Link, the private sector stood to make a 23 per cent rate of return despite incurring minimal risks.³ On the other hand, the NSW government incurred construction and volume risks, contributed most funding, and may only break even after 23 years and at best earn only 2 per cent pa on its investment.

The public sector remains the provider of last resort. In cases where the private sector loses money and walks away from a contract the public sector must intervene to maintain services. After reporting a loss of \$6.2 million in 1999, the 257 bed La Trobe Hospital, which had been owned and operated by private company Australia Health Care (AHC), was handed back to the Victorian government.⁴

There is currently no accredited accounting standard being applied by any government in Australia to quantify the contingent liabilities inherent in PPPs. What this means is that government accounts do not accurately reflect the risks they are carrying within their accounts, leaving them exposed to significant expenditure for which they have not made allowance.

MYTH 6**PPPs reduce taxation.**

Advocates of PPPs argue that through the injection of private funds overall taxation rates can be reduced. Reduced government spending can mean reduction in the need for revenue. However, in practice, this is only true in the short term.

PPPs don't provide free goods and services. The public sector borrows funds to meet annual lease payments to the private sector over the life of project, normally in the order of 20 30 years. This simply passes the costs onto future generations. According to a UK paper on

public services and the private sector, additional costs, problems and deficiencies will fall on future taxpayers and users.⁵

With many infrastructure PPPs having an operational life of over 20 years the real cost and therefore tax liability could be significant. This is especially the case as replacement and

refurbishment costs accumulate over the life of the project but the income stream is channelled to only one of the partners. To date, taxation has not been reduced but has increased through the application of user charges for example, freeway charges in effect are an indirect tax. Consumers and often the environment bear most of the costs of privatisation.

The costs of establishing and maintaining PPPs are high for governments. Governments pursuing PPPs have to create bureaucracies to administer and manage them. Transaction costs are high. This includes establishing guidelines, tendering procedures, legal documents and negotiating with the private sector.

MYTH 7

The user pay principle is inherently a fairer way of paying for services.

Inherent in the use of PPPs is that the end users of such services pay a fee to the PPP partners. Rather than the community paying through general taxation, it is argued that the users of such services should pay, and that this is more equitable. However, in practice this is difficult to demonstrate. As the application of rebates paid to users of motorways illustrate, the application of the user pay principle is not equitable as it charges a fixed fee to all users regardless of their ability to pay.

Motorists dependent on motorways are often lower income earners living long distances from workplaces at the centre of our major cities. To ensure a reliable rate of return to the operators of such motorway schemes, governments have tended to enter exclusive supply agreements with the partnering developers, whereby alternative and pre-existing services are downgraded, and in the case of some infrastructure removed, as a way of reducing competition.

The closure and incorporation of existing public infrastructure into new PPP motorways is a case in point.

MYTH 8

Private sector involvement can inject world best practice into service provision.

Some advocates of PPPs argue that the introduction of private sector partners can produce important and required organisational change through the introduction of new techniques and processes. While there is little doubt that partnership arrangements can lead to learning opportunities, PPPs do not inherently produce this result. Sometimes in practice the transfer of knowledge flows in the opposite direction, with the operating partner learning information of a critical nature that makes the relationship one of dependency rather than a real partnership. In addition, in practice there appears to be a tendency to transfer personnel from the purchaser partner to the provider partner, which can see a reduction in the skill base of the former.

PPPs can unnecessarily increase complexity. For example, under the PPP arrangement for London Underground, infrastructure companies maintain the tracks, stations and trains. The public authority London Underground manages the day to day operations of the network and has overall responsibility for the safe operation of the system. In April 2003, Tubeline Cleaners, one of the maintenance contractors undertook a cleaning project on the Central Line Station. In the process of cleaning, considerable dust residues were dislodged which in turn stuck to glue left by another contractor placing advertising hoarding at the station. This

seemingly simple demarcation of responsibilities produced a fire within the system and the temporary closure of the line. Despite provision within the contract, no fines were demanded for lack of performance, essentially due to the difficulties of apportioning responsibility in such a complex arrangement.

In the case of British Rail privatisation, the rail sector was fragmented beyond recognition. Today there are 25 train operating companies; six freight operators, three rolling stock operators, two infrastructure controllers and seven infrastructure maintenance contractors. Under this complex regime are some 1,500 subcontractors. A once integrated whole has become a patchwork of competing interests that have seen costs rise from \$3.75 billion in 1999 to \$12.5 billion in 2003. When responsibilities are split between a number of parties through contractual arrangements, responsibility is reduced. Contract competition has not led to overall savings. The problem has not been a lack of competition but a failure to invest properly in the maintenance and upgrading of the infrastructure.

MYTH 9

The introduction of new players will increase employment and improve conditions.

The claimed capacity of PPPs to accelerate investment is said to increase new employment opportunities. While new investment in infrastructure and services will create new jobs, it may not increase overall employment. Experience suggests that if the PPP takes over an existing project, the net employment in the post-construction phase will reduce as a means of reducing costs. Where a new project is created, net employment may increase. In the case of a competitive market, cost competition may see a reduction in employment. Unlike most commercial transactions, PPPs rarely allow for an increase in charges to occur, therefore operators have little choice but to reduce outlays if their shareholders' interests are to be protected.

British health workers are concerned about the transfer of staff from public to privately financed projects.⁶ Unions representing health workers rejected the UK government offer of "retention of employment" rights to blue collar workers such as cleaners and porters because it excluded 200,000 staff, including clerical staff, receptionists, building maintenance workers and patient transport vehicle drivers. A two tiered workforce has emerged in the UK with workers remaining with an existing but privatised entity remaining with public sector wage parity, but with workers recruited after the privatisation being recruited at lower levels of pay and conditions.

MYTH 10

PPPs improve accountability.

Proponents of PPPs argue that through the use of performance contracts, transparency is created and therefore greater levels of performance accountability can be achieved. While it is true that greater specificity can lead to greater accountability of performance, such arrangements presuppose strong contract administration skills and capacity. Performance indicators often depend on data provided by the service provider, and many mechanisms can be used to inflate or deflate statistics. Strongly prescribed performance contracts have led to increased costs in terms of accountability regimes and contract variations made during the life of the contract, often at a high cost to the community.

The use of performance contracts with measurable outputs is a key characteristic of PPPs. However, they are not unique to PPPs, and the use of PPPs is not the only way to ensure robust performance. There are significant risks in establishing fixed outputs in service contracts that can span a number of years over a period of uncertainty. Because of the cost, complexity and time involved in setting up PPP contracts, governments are reluctant to break a contract with a private sector partner once a project is up and running. Once a private sector partner has been awarded a project the government is "locked in" and will seek to renegotiate rather than terminate a contract. There is a tendency for costs to escalate once projects are up and running, with public and private sector partners sitting down to accommodate cost increases. Higher prices to sustain profitability is normally a better option than terminating a private sector partner, because the costs of bringing in a new private sector partner or getting the public sector to take over the project is too high in both practical and political terms as well as financial terms.

Graham Larcombe and Paul Fitzgerald are the authors of the report, *Paying for Private Profit: A Review of the Public Private Partnership Model in the Provision of Community Infrastructure and Services*, Strategic Economics, which was launched at the Evatt Foundation Breakfast Seminar on 11 November 2003. Copies of the report are available from the Rail, Tram and Bus Union National Office, the Australian Education Office (Federal Office), the Australian Nursing Federation (Federal Office) and the Community & Public Sector Union - SPSF Group (Federal Office).

NOTES

1. Kenneth Davidson, "Brumby ignores Labor and we pay the price", *The Age*, 23 May 2002.
2. John Lister, *The PFI experience: Voices from the Frontline, A PFI report for UNISON*, March 2003.
3. Bob Walker, "Privatisation, Infrastructure and Local Government", address to the NSW State Assembly NSW Local Government and Shires Association, Sydney, 2001.
4. Allyson Pollock, Jean Shaoul, David Rowland and Stewart Player, *Public services and the private sector*, Catalyst Working Paper, November 2001.
5. Allyson Pollock, Jean Shaoul, David Rowland and Stewart Player, *Public services and the private sector a response to the IPPR*, A Catalyst Working Paper, November 2001.
6. Patrick Butler, Government faces union challenge on NHS staff rights, *Guardian Weekly*, Tuesday March 26, 2002.

APPENDIX B: FISCAL POLICY IN AUSTRALIA: SOME THOUGHTS ON CHANGE

Tony Cole^s

A good deal of my public service career was spent as a Treasury economist helping the government to “economise”. What this means is that I helped ministers to put together budgets that met their priorities but stayed within their means. There is never a shortage of ideas as to where the government could solve a problem by spending some money or more money. As public servants we provided analysis to help ministers decide which should be taken up, and to what extent, and what existing programs could be terminated to make room for more effective or necessary programs.

While every budget represented the collective decisions of Cabinet and Cabinet Committees, the Treasury and Finance economists who assisted them were always allocated part of the blame for any existing program that was axed or a good idea for a new one that was not taken up. This was fair enough. Our analysis did contribute to these decisions. But our analysis also contributed to the decisions to introduce new programs and to their effective design. Whatever the public perception we were never opposed to all new programs and we did not want effective programs slashed and burned.

Against the background of public perceptions of Treasury economists as Scrooges it is hardly surprising that the current approach of budgeting for surplus after surplus is assumed to reflect the policies of the dreaded economic rationalists. It doesn't. It represents political fashion, not economics. The United States (US) is often the source of political fashions adopted in Australia and it appears to have had an influence here, too.

For more than a quarter of a century there has been a continuing political campaign in the US to amend the constitution to require the federal budget always to be at least balanced (if not in surplus). The balanced budget amendment campaign gained strength from the Regan deficits in the early 1980s (a Bill to implement it was passed by the Senate in 1982), lost momentum with a series of surpluses under Clinton, but is topical again with the huge Bush deficits.

The main argument US opponents of the balanced budget proposition use is that it would require the federal budget to be tightened whenever a sluggish economy was holding down revenue and increasing spending, but allow extra spending or tax cuts whenever a booming economy was creating large surpluses. In other words, it would result in pro-cyclical fiscal policy.

A former Treasury colleague, Ric Simes, has demonstrated that Australia's current stance presents the same problem. Neither the government nor the opposition has been moved by the analysis. They both continue to promise surplus after surplus.

There has been concern among economists in Europe at the levels of debt run up by various countries through regular deficit budgeting. There did not seem to be the political will to raise the taxes needed to cover large public-spending programs. As a reaction to this, most of the countries in the EU agreed to restrict future deficits to no more than 3 per cent of GDP and to rein in their debt levels over time to no more than 60 per cent of GDP. This is a far cry from our surpluses every year. Even this less restrictive budget rule has implications for fiscal policy and the economic cycle, especially since implementation of the single currency has taken away domestic monetary policy as a swing instrument for macroeconomic policy.

I am pleased that Germany and France have sensibly found ways to avoid implementing the fiscal tightening required by these rules at a time when their economies were in recession and in need of stimulus. As Table 5.1 shows, there is little international support for our policy of surplus after surplus and for abolishing net public debt. Are there any lessons from the private sector that are more supportive?

Table 5.1: International budget balances

	Budget balance % of GDP	Net debt % of GDP	Official short rates	10-year bonds
US	-4.9	48.9	1.75	4.08
Germany	-3.9	60.8	2.0	3.88
France	-3.4	54.6	2.0	–
Italy	-2.9	99.4	2.0	–
UK	-3.0	34.8	4.75	4.75
Japan	-6.9	85.2	0.00	1.49
Australia	0.6	2.3	5.25	5.3

Economists trying to find an explanation for the anti-deficits, anti-debt policy of both sides of politics say it is based on a mistaken view that the national budget should be managed in the same way as a household manages its finances.

There is no support for an aversion to debt at the household sector. As we are regularly reminded by the Reserve Bank, Australian households have been on a debt spree over the last couple of decades. As a proportion of disposable income, household debt has more than doubled since 1990. Relative to the rest of the OECD, the debt/income ratio has gone from the lowest to the highest, although it is only a little higher than the pack. What is important, however, is that this large increase in debt has caused no problems for household balance sheets. On average Australian household net wealth has grown from five times disposable income in 1990 to almost eight times today.

This is not really surprising. How many people do you know who got wealthy by saving alone? The way to build wealth is to invest and borrowing to finance greater investment than can be funded from saving. This is a part of life.

Householders borrow to invest in home ownership. They borrow to buy rental property and to invest in shares. Small businesses start on borrowed money and borrow more to expand. The way to wealth is to borrow and invest – not to save.

Of course it is true that there is a tax wedge (taxation/deductibility of nominal interest, concessional taxation of capital gains) supporting this but the case does not rely on that alone.

Big business also uses debt to build wealth. If a project can produce a return that is greater than the cost of borrowing, companies will borrow to invest in it. Businesses manage their balance sheets by sustaining an appropriate level of gearing. They can become takeover targets or face campaigns from shareholders if they run “lazy” balance sheets.

To return to “economising”, one element of it is deciding what level of spending is within our means. There is no economic reason at all that this important decision has to be constrained by a need to achieve a budget surplus each and every year. And if we weigh the case for surpluses against the clear needs for additional spending on infrastructure I think the answer is very plain.

We have urban rail systems that are breaking down and where timetables are providing for slower travel time because tracks are unsafe. The electricity network is unreliable. We are rationing water in almost every city. Our ports are clogged and hamper exports vital to our market credibility and balance of payments.

We know that the best way to cut the road toll is to improve the roads and that will also make business more efficient. We need more investment in hospitals and universities. I said at the start of this article that there are always more good ideas for spending than we can finance. But it is clear that in so many of these areas the returns will exceed the cost to the Commonwealth of some additional debt.

It is surely time that Australian governments took a lead from the household sector and business in terms of managing their balance sheets. It is clear they would not be blotting their copy books internationally if they did so.