4

Finance and investment

4.1 Improving regional competitive advantage depends on regional specialisation, niche market development and innovation. The Organisation for Economic Cooperation and Development (OECD) has noted the 'regional aspect to the growing global character of economic relations' and the importance of attracting investment to regions. In its view, factors that determine the attractiveness of regions for investors include:

- proximity to markets;
- quality and availability of labour;
- appropriate infrastructure (transport, telecommunications);
- quality of life; and
- cultural similarities and the presence of other companies (clusters).[1]

4.2 The Kelty report (1993) linked national and regional development and McKinsey & Company (1994) found that strong business and local level leadership were vital to economic development. In addition, McKinsey found that business investment was the main driver in terms of regional employment growth. AusCID and Australian Project Developments both supported this view:

- AusCID advised the committee that the generation of robust revenue streams is the biggest obstacle to attracting institutional investment in regional and rural projects. Lack of critical mass and ongoing demand for the goods or services provided by infrastructure are critical issues for investors. Many worthwhile project ideas go unnoticed or founder

1 B Hugonnier, *Regional Development Tendencies in OECD Countries*, paper given at the Regional Australia Summit, October 1999.

through lack of access to capital and, to date, infrastructure projects of less than $20 million in size have been unlikely to attract institutional investors unless they can be bundled into bigger projects. In order to succeed, proponents of small regional projects need to be persistent, flexible and adept at using networks and 'project champions' to progress their project.[2]

- Australian Project Developments urged governments to reduce the cost of tendering and 'better appreciate how bad policy, poor coordination and slow decision-making impacts on project costs.' It supported continued government investment in regional infrastructure where there is an identified public benefit and urged the committee to strongly consider establishment of a regional infrastructure investment fund. It urged eventual 'full devolution' to regions whereby 'senior regionally-based officials, local MPs and local leaders - would decide expenditure priorities.'[3]

4.3 In the view of the Queensland Farmers' Federation (QFF), investment in regional areas is deterred because of higher transport costs, poor availability of skilled labour and limited other support services.[4] Murrindindi Shire Council reflected the widely-held view that government resources should be directed to encouraging private investment in infrastructure that would help regions 'capitalise on their natural advantages', rather than administering government programs.[5]

4.4 At a private meeting in Burnie, Braddon Business Centre stated that the government's role in encouraging investment in regional Australia (grants towards capital costs, soft loans, accelerated capital allowances, employee subsidies etc) was crucial.

4.5 In the global environment, investment capital is highly mobile and competition for investment vigorous. Sound economic fundamentals, underpinned by reforms to the taxation system, the financial system and labour markets are Australia's advantages on which regions need to capitalise in terms of attracting investment for specific projects. However, as a result of globalisation, technological change and market development, the introduction of competition and a reduced willingness by governments to accept ownership risk in competitive and commercial markets, there is a real need for governments collectively to provide efficient 'facilitation' services to private investors. A major motivation for

2 Australian Council for Infrastructure Development, Submission no. 215, pp. 10, 16, 18.

3 Australian Project Developments Pty Ltd, Submission no. 254, p. 8.

4 Queensland Farmers' Federation, Submission no. 206, p. 4.

5 Murrindindi Shire Council, Submission no. 7, p. 1.

reform of the capital gains tax arrangements was the desire to increase the international competitiveness of Australian business and to encourage greater investment by Australians.

4.6 The Regional Development Council of Western Australia drew the committee's attention to the shortening of investment time horizons with the trend to greater private sector involvement and corporatisation of government operations. The need to generate immediate returns promotes a short term approach to investment.

> For a substantial part of [regional Western Australia's] infrastructure the returns to local, state and national economies can exceed the returns to private investment and ownership. This is particularly true of long-lived assets that may generate high income flows only after a period of time has passed.
>
> … In many cases, despite the positive net economic benefits, the risk adjusted return to private sector capital is insufficient to encourage or warrant capital expenditure. In such cases it is valid for government to step in and encourage or assist such projects.[6]

Financing infrastructure

4.7 Competition for scarce resources means that the provision of infrastructure is a major challenge for Australia. What is clear is that infrastructure provision and economic resilience are related and that our standard of living and future economic growth and employment prospects depend on our ability to provide and operate world-class infrastructure.

4.8 Many submissions pointed to the need to reverse the perception of investment in infrastructure from a community service ‘expenditure’ on government’s balance sheet, to one of an investment for future generations.[7] The submission from the Goldfields Esperance Development Commission argued that infrastructure provision must be managed like a business – ‘conceived and run as a service industry that attracts customer demand and provides an incentive for relocation and regional development.’[8]

6 Regional Development Council, Submission 286, pp. 14-16.

7 For example, Leighton Contractors Pty Limited, Submission no. 125, p. 1 and Dawson Valley Development Association Inc (DVDA), Submission no. 156, p. 6.

8 Goldfields Esperance Development Commission, Submission no. 153, p. 13.

4.9 Such an approach is justified on the grounds of the fundamental distinction between infrastructure and other investment, that is, the wider economic spinoffs or 'externalities' associated with infrastructure. Importantly, economic and social externalities may interact, triggering cluster development and private sector investment.[9] That is, investors make locational decisions on the basis of previous decisions to invest in social and physical infrastructure, leading to development of industry clusters around successful established or larger firms.

4.10 Argy *et al* set out the distinguishing characteristics of infrastructure investments relative to other investments. Infrastructure investments:

- are generally long-lived and capital intensive with long pay-back periods;
- operate in markets that have natural monopolies;
- provide services that are generally considered essential and socially desirable;
- have an impact beyond their immediate use to the wider community; and
- justify a high level of government involvement.[10]

4.11 While government has historically provided infrastructure, a focus on market forces and potential returns on investment has resulted in major changes to infrastructure provision and management. The distinction between commercial and non-commercial is fundamental to consideration of public and private sector investment in infrastructure.

- **Commercial investment is self-funding and profitable and government involvement should be limited and confined to:**
  - ⇒ **facilitating and encouraging private sector involvement in projects that would promote economic development; and**
  - ⇒ **regulation (in the planning or operational stage) to protect consumers or the environment.**
- **Non-commercial investment is economically justifiable with significant externalities, and in which government investment is not only justified but essential for the project to proceed.**

9 J Smith, *Infrastructure funding in Australia*, Research Papers, Economics, Commerce and Industrial Relations Group, Parliamentary Library, 19 October 1994, p. 1.

10 F Argy, M Lindfield, B Stimson, P Hollingsworth, *Infrastructure and Economic Development*, CEDA Information Paper no. 60, background paper for Contribution of Infrastructure in South East Queensland to the State Economy Conference, Brisbane, April 1999, p. 6.

4.12 The implementation of national competition policy has impacted in different ways on urban and non-urban Australia and between sectors. The committee considers that there needs to be a much better understanding among policy makers of the nature of public investment and the role and consequences of user charging and pricing in linking demand and supply for public goods. Identification of natural monopolies, such as ports, and understanding of investments with significant positive or negative external effects are also crucial.

4.13 Private sector involvement in infrastructure provision, while filling some gaps, is more likely where adequate returns are expected (for example, from 'user pays' projects).

4.14 The submission from the Western Australian government stated that intervention by government in providing infrastructure should occur only where adequate infrastructure will not be provided by the private sector. The submission suggested that direct provision or assistance to the private sector through 'subsidisation, indemnification against risk, or a combination of these approaches' is appropriate. The Western Australian government also referred to the obligation on the part of higher levels of government to assist lower levels of government who may have inadequate resources.

> With regard to the direct provision of infrastructure, it should be noted that a jurisdiction with principal responsibility for the provision of a particular category of infrastructure may be unable to meet a region's requirement due to funding constraints. In such circumstances it is open to a higher level of government (such as the Commonwealth government) to assist that jurisdiction by providing supplementary funding for public sector infrastructure projects.[11]

4.15 Leighton Contractors pointed out that the role of government in financing infrastructure depends on the extent to which it has adopted the principles of competition policy, corporatisation, privatisation and competitive tendering, which varies between states. It stated that:

> It is our view that, where there is no adverse impact on local employment, the private sector providing infrastructure (planning, designing, building, managing and maintaining) enables greater opportunities for government to maximise value for money through innovation and adoption of "best practice" methods and systems. We hold this view in light of the private

11 Western Australian government, Submission no. 273, p. 6.

sector being subjected to market forces which demand that, in order to survive commercially, private sector organisations must embrace innovation and best practice.[12]

4.16 The allocation of risk between the public and private sector is critical to determining the appropriate mix of investment. The submission from Australian Project Developments emphasised the need for governments to recognise the interdependence of infrastructure and regional development projects so that regional projects are not unnecessarily delayed. Risk can be of several types.

Construction risk - the risks associated with design, cost overruns and construction delays can be substantial for capital-intensive infrastructure projects.

Operating risk - these stem from shortfalls in production and/or service, and in relation to managing staff, maintenance etc. It is difficult to quantify these risks - they may only become apparent once the project is fully underway.

Revenue/Demand risk - It concerns ensuring the existence of strong revenue flows in the out-years - the long-term decline in some regions make investors distinctly uneasy. Weaknesses in demand forecasting can also be costly due to the sunk costs involved.

Regulatory (policy) risk - includes risks relating to planning and environmental requirements and competition policy (eg. aviation, water pricing).[13]

4.17 The current view is that 'private sector ownership is always better than public sector ownership, that the private sector is more capable of managing the ownership risk'.[14] This contrasts with the historical acceptance by the public sector of the role of infrastructure builder, owner and operator. Fred Argy advocated risk allocation between the public and private sector according to the ability of each to bear risk. He suggested that governments consider borrowing to finance productive investments, 'provided they have strong balance sheets to begin with', as most Australian governments do. Productive investments would bring both economic and social returns to the nation. He justified spreading the effective servicing costs across generations because infrastructure assets and the economic benefits flowing from them would be available to future

12 Leighton Contractors Pty Limited, Submission no. 125, pp. 2-3.

13 Australian Project Developments Pty Ltd, Submission no. 254, pp. 2-3.

14 Fred Argy, Transcript of Evidence, 22 September 1999, p. 144.

generations. He pointed out that Australia is on its own in running a policy of zero cash deficits; most countries run a cash deficit equal to about two to three per cent of gross domestic product over the economic cycle. He set out the disadvantages of this approach in a private meeting with the committee.

> The private sector is not always the best party to take on the ownership risks of a new infrastructure. Apart from cases of natural monopoly, the public sector may and often does have lower effective capital costs (capacity to manage risks) and can produce the best results. In this case the Government is best advised to go it alone on ownership, while allowing the private sector to manage and operate the utility …
>
> The present fiscal arrangements have an in-built presumption against public borrowing and public investment. This presumption has unfortunate consequences. It creates a bias against those infrastructure investments which have substantial "externalities" (hospitals, educational institutions, public transport and community services) relative to those which produce commercial returns. It leads to many infrastructure investments (e.g. urban roads) being financed by private sector equity and costing the community much more than if they had been financed by the public sector. In the case of long-term assets financed out of revenue it creates an inter-generational inequity. And it tends to hurt those who are relatively poor because it makes governments economize on community services such as education, health, public housing, public transport, and labour market programs.[15]

4.18 In the evidence to the committee there was strong support for:

- the fostering of partnerships between the public and private sectors;
- cooperation between all levels of government in terms of

⇒ alignment of objectives for providing assistance,

⇒ targeted investment on a multi-user regional basis,

⇒ development of uniform evaluation criteria for cost benefit analysis of projects, and

⇒ determination of the relative capacity of government to contribute towards project funding; and

- transparency and community involvement in decision making on infrastructure.

15 Fred Argy, Submission no. 292, p. 4.

4.19 The Institution of Engineers Australia 1999 report considered that there was 'no practical option but to recognise partnerships between the public and private sector as an essential feature of future infrastructure development and operation'.[16]

Venture/expansion capital

4.20 There is an ongoing need for access for regional business to finance providers for investment purposes. The Regional Australia Summit called for establishment of a more efficient and effective market for capital in regional Australia and the removal of regulatory impediments to entrepreneurship.

4.21 The Department of Industry, Science and Resources advised the committee of recent government initiatives to improve the availability of equity based finance to business, including regional business. Chief amongst these is Invest Australia, the national investment agency that manages programs to attract, promote and facilitate foreign investment in Australia and to assist Australian businesses wanting to invest.

4.22 Specific finance initiatives managed by Invest Australia include:

- Pooled Development Funds that aim to develop and demonstrate the market for patient equity capital, including venture capital, for growing small and medium-sized enterprises (SMEs) and to provide a more competitive tax regime for such investments; and
- the Innovation Investment Fund, introduced in 1997 to encourage the growth of early-stage technology-based companies, and to create a self-sustaining early stage venture capital industry.[17]

4.23 Pooled development funds that could be set up by regional development organisations for investment in particular regions were recommended by the Kelty report (1993). AusCID has advocated the development of new patient funding sources. Infrastructure banks to encourage regional based development and creation of innovative capital programs, including venture/expansion capital funds and increased access to capital markets are essential planks of recent regional development initiatives in the United States.[18]

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16 Institution of Engineers, Australia, *A Report Card on the Nation's Infrastructure: Investigating the Health of Australia's Water Systems, Roads, Railways and Bridges*, December 1999, pp. 45.

17 Department of Industry, Science and Resources, Submission no. 168, pp. 9-13.

18 D Dodd, *Regionalism for Competitive Advantage*, Morrison/Dodd Group, LLC, Shreveport, Louisiana.

4.24 At a private meeting in Toowoomba, the committee was advised of the need for a centralised financial service in rural areas. There was discussion of the much greater attractiveness of regional and agricultural portfolios in the United States. The following suggestions were made to the committee:

- establishment of cooperative, community-based businesses to act as one-stop finance shops to compete with banks, provide financial advice and address the current fragmented nature of available services;
- training for rural brokers, insurance agents and agricultural advisers to provide a broader range of advice; and
- co-location of state and federal government regional financial advisers.

4.25 During its meeting in Longford, Tasmania, the committee's attention was drawn to difficulties faced by regional and small businesses in realising the value of their assets, due to the focus of banks on urban areas. Limited understanding, lack of valuing experience in relation to new or emerging industries and lack of vision was preventing investment capital being made available to newer industries located in regional areas. While some local governments in regional Australia were interested in attracting large conglomerates (such as Woolworths) to regional towns, real benefits to regional areas would come from sustainable small business growth and the employment of larger numbers of local people.

4.26 The government's response to the recent review of business taxation (the Ralph review) provides encouragement for and facilitation of venture capital investment through several initiatives, including capital gains tax exemption for gains earned by non-resident tax exempt pension funds and by Australian widely-held superannuation funds through pooled development funds. The aim is for greater commercial flexibility to make Australia more attractive as an investment proposition and to encourage the supply of venture capital available for growing small and emerging enterprises (including in regional Australia) at all stages of their development. The committee supports initiatives to achieve these aims.

4.27 **The committee strongly urges the banking and finance sector to provide training for their staff to enable rural brokers, insurance agents and agricultural advisers to provide a broad range of advice. Training could cover taxation reform, venture capital arrangements, and broader regional development issues such as globalisation and development of competitive advantage, new developments in traditional industries and new and emerging industries.**

Centralised funds

4.28 Suggestions for establishment of a central 'regional infrastructure development fund' were put to the committee. The Local Government Association of Tasmania cited the 'shift to accrual accounting, improved asset management regimes and lifecycle costing of assets' as instrumental in revealing the inadequacies of past infrastructure renewal.

> Faced with pressures of providing infrastructure to support or encourage new investment, Councils find themselves having to come to terms with the challenges of past infrastructure decisions and a relative inability to deal with existing, let alone new, infrastructure requirements.
>
> The relative benefits of understanding the full costs of providing the infrastructure are often outweighed by the realisation that Councils will have difficulty in providing similar services at similar costs in the future. In this regard, there is a substantial argument for support for a central infrastructure fund to allow for the provision of built infrastructure to a standard and at a cost which is reasonable for regional Australians.[19]

4.29 The Outback Regional Development Council Inc advocated an 'infrastructure' fund along the lines of the previous Regional Development Program, but linked with 'Southern Regional Development Limited', to share the risks among all parties. It claimed that the IIIS project was not succeeding because of high initial costs and a lack of integrated effort involving regions, governments and the private capital markets.

Philanthropic investment

4.30 The Regional Australia Summit urged greater understanding of and respect for regional Australia. Speakers suggested that philanthropy should take a strategic role in enhancing the natural and human assets of regional Australia for community and economic development. A key outcome of the Summit was the establishment of a new rural trust fund jointly by the Sidney Myer Fund and the Commonwealth government. The fund will be known as the Federation for Rural and Regional Renewal. The Commonwealth government will provide funding of $10.7 million in 1999-2000 and up to $3.8 million over the period 2000-01 to 2008-09. This funding will be matched with contributions from the business, government and community sectors. The Sidney Myer Fund will contribute $1 million to help develop the project's concept and organisational structure. With an emphasis on economic development and

19 Local Government Association of Tasmania, Submission no. 212, p. 6.

job creation, the fund aims to support innovative approaches developing business skills, leadership, research and seed funding. These approaches will be directed to social, cultural, environmental and economic projects that will benefit rural and regional communities. The fund will also coordinate with other entities to leverage support for bigger projects.

4.31 Similar philanthropic programs operate in other countries:

- The English Partners in the Countryside program launched in the United Kingdom in April 1999 is a partnership between government, the private sector and philanthropy. The program provides resources from the national level to enable rural communities to find their own solutions. It is boosted by legislation giving tax-deductible status to gifts for regional economic development.
- The Aspen Institute's Rural Development and Community Foundations Program, funded by the Ford Foundation, supports regions in developing community foundations of their own.

4.32 The committee considers that the Federation for Rural and Regional Renewal is an example of an appropriate mechanism for Commonwealth funding of infrastructure where there is an identified public benefit, including social benefits. It believes that links should be made between bodies such as this and the proposed NIAC.

Recommendation 12

4.33 **The committee recommends that the proposed National Infrastructure Advisory Council provides information on priority regional infrastructure investment projects to bodies such as the Federation for Rural and Regional Renewal, for its consideration for funding.**

State infrastructure funds

4.34 Some states have established their own funds. For example, the Victorian government set up a regional infrastructure development fund with funding of $170 million in November 1999. The South Australian Regional Development Taskforce recommended re-introduction of an Infrastructure Development Fund (originally established to facilitate infrastructure upgrades in support of strategic business expansions in regional areas following the Economic Development Authority's 1997 review of South Australia's regional development policy and programs).[20]

State incentives/guidelines for private investment in infrastructure

4.35 States have also begun to develop incentives schemes or guidelines for private investment in infrastructure. The New South Wales government is attempting to promote efficient allocation of risk between the public and private sectors and to maximise private investment in infrastructure to the extent that this results in net benefits to the community beyond those from public provision. Guidelines for use by all departments and authorities have been developed. Although they are not binding, local councils are encouraged to use the guidelines, within the strictures of borrowing requirements and the Loan Council. The government seeks businesses that will finance and control the new infrastructure, as opposed to contracting out the task. This would normally involve design, construction, operation and maintenance with contracts awarded through an open, competitive tendering process. Although financially free-standing projects are preferred, limited government contributions that will be fully transparent will be considered where there are genuine community needs that may not otherwise be met.[21]

4.36 The Queensland Investment Incentive Scheme allows the provision of targeted government financial support (for example, payroll tax, land tax or stamp duty refunds, and establishment grants) to influence the location of important projects and the attraction of leading companies to that state. Queensland has also set up a development incentive scheme specifically to encourage investment by producers in new surface water storage for irrigation that is commercially and ecologically sustainable, involving subsidies for construction of new water infrastructure storage costing $200 000 or more.

Superannuation funds

4.37 In response to government initiatives resulting from the Ralph review,[22] superannuation funds are expected to recast their investment portfolios with investments in regional areas thereby becoming potentially more attractive.

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20 Eyre Regional Development Board, Submission no. 185, p. 7.

21 *Guidelines for Private Sector Participation in the Provision of Public Infrastructure*, New South Wales government, September 1995, p. 2.

22 That is, capital gains tax will apply to only two thirds of gains, effectively meaning a concessional tax rate of ten per cent, as announced by the Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, p. 1.

4.38 At a private meeting in Burnie, the Tasmanian Agricultural Productivity Group advised the committee that the loss of regional funds through compulsory superannuation was a major impediment to regional development. Some parties suggested reinvestment of investors' funds in regions according to their relative contribution.

> Superannuation is another concern, and most regional small businesses resent seeing local money being taken away to centrally managed superannuation funds and would like to see better access by regional small businesses to those funds. A regional superannuation fund in southern NSW is growing rapidly as local people support development of a fund that ploughs much of its resources back into the region.[23]

4.39 The committee met with Warakirri Asset Management, a company that manages investments for REST Superannuation in dryland cropping farms in Queensland, New South Wales and Victoria through the Warakirri Agricultural Trusts. Superannuation funds have a fiduciary obligation to protect members' interests and Warakirri Asset Management considered that investments including those in regional areas, which stood up on investment grounds, would be supported. It did not favour intervention either through incentives or tax-driven schemes such as infrastructure bonds because it considered they resulted in market distortion. The committee was advised of other superannuation fund investments in regional areas that covered infrastructure and operations, for example, in Mount Hotham and Falls Creek ski resorts.

4.40 The committee is aware that there is increasing international interest in investing in Australian agricultural properties because of Australia's proximity to the Pacific, its highly productive and efficient farm sector and stable government.

23 Council of Small Business Associations, Submission no. 129, p. 5.

Recommendation 13

4.41 **The committee recommends that:**

- **superannuation fund administrators be encouraged to invest in regional infrastructure; and**
- **the proposed National Infrastructure Advisory Council publish and disseminate information on proposed regional infrastructure projects.**

Taxation

4.42 The committee has taken account of taxation matters in light of continuing and ongoing reforms proposed to the Australian taxation system, including introduction of the goods and services tax (GST) and business taxation reforms flowing from the Ralph review. The inflexible, onerous nature of the taxation system particularly affects infrastructure financing and the impact is magnified in smaller projects, a matter especially relevant to regional Australia.[24]

Accelerated depreciation

4.43 Many parties to the inquiry, in particular, the mining industry, energy utilities and primary producers, opposed the removal of accelerated depreciation, a key investment concession for infrastructure and capital intensive industries. Its removal, recently included in legislation developed in response to the Ralph review of business taxation, will partly fund the lowering of the company tax rate from 36 per cent to an eventual 30 percent.

4.44 The Queensland government advised the committee of likely adverse cost impacts, particularly in relation to the water supply industry:

> The increased cost to water infrastructure providers would have an adverse impact on water costs, which would affect economic and industry growth and therefore the regional Queensland economy.

24 D O'Neill, *Infrastructure: The Challenge*, paper given at the Regional Australia Summit, October 1999.

> In general, accelerated depreciation can improve productivity and economic growth by encouraging business to update capital stock more frequently and also enables Australia to remain internationally competitive with other countries that provide similar tax concessions. While all Australian companies, particularly in the services industry, would benefit from a lower company tax rate, if this were funded by a removal of accelerated depreciation, capital intensive industries such as water supply, mining and manufacturing industries would be disadvantaged.[25]

4.45 Energy utilities (The Australian Gas Light Company (AGL) and Electricity Supply Association of Australia Limited) advocated retention of the present regime to ensure that investment in new infrastructure was not skewed leading to 'significant regional implications.'

> On AGL's calculations, the net impact of the removal of accelerated depreciation and the reduction in the company tax rate is to either increase delivery costs to consumers, resulting in increased prices, or to significantly decrease the investment attractiveness of future projects to equity investors. For new investments in long term assets, the overall effect of the proposed change is negative.
>
> Market and regulatory pressures would make it difficult for AGL to implement the necessary increase in tariffs to recover increased costs. This is likely to require a re-evaluation of the project, possibly delaying it until sufficient additional potential gas demand can be identified.[26]

4.46 The Australian Constructors Association supported the present regime for its mitigation of 'the failure of the *Income Tax Assessment Act* to permit indexation' and because it allowed 'a deduction for the imputed interest costs of equity financing'. It urged a review of the Taxation Commissioner's effective lives schedule for depreciation to ensure that asset lives reflect economic lives prior to a decision to remove accelerated depreciation provisions.[27] The committee understands that such a review has occurred as part of the consideration of changes to the provisions.

4.47 The committee is aware that consultation is still occurring in relation to removal of accelerated depreciation and other proposed business taxation reforms. Details of the 'expanded strategic investment coordination process', announced by the government in light of the potential impact on

25 Queensland government, Submission no. 257, p. 39.

26 The Australian Gas Light Company, Submission no. 179, p. 6.

27 Australian Constructors Association, Submission no. 225, p. 6.

large capital intensive projects with long lead times, have yet to be finalised. Concerns have been raised that the 'case by case' approach proposed under the expanded process is not a suitable substitute for sensible public policy in the tax area. It has been suggested that the process:

- will not address issues of small and medium sized projects;
- could discriminate in favour of a limited number of large projects at the expense of other project proponents; and
- would fail to recognise the high levels of capital injection over the life of long term, capital intensive projects.

4.48 In the existing process, the Strategic Investment Coordinator and Major Projects Facilitator provides advice to government, through the Prime Minister, on projects identified on the basis of agreed criteria. The process aims to streamline bureaucratic processes for large private sector investment projects, including consideration of provision of investment incentives (grants, tax relief, provision of infrastructure) for selected large projects, where investment would provide demonstrable net economic and employment benefits. To date, two projects have received approval for government financial assistance under this process: Visybord's pulp mill at Tumut ($40 million incentives), and Comalco's alumina plant at Gladstone ($100 million incentives).

4.49 The committee was advised that the government does not support across-the-board incentives, but acknowledges that in certain limited circumstances there may be grounds for strategic incentives, considered on a case by case basis, taking account of eligibility criteria published in *Investing for Growth (December 1997)*.[28]

4.50 Invest Australia provides assistance with Major Project Facilitation (MPF) including:

- providing proponents with relevant information;
- a whole-of-government approach to approvals which aim to ensure that efficient, timely and transparent approvals processes are followed; and
- identifying areas where government assistance may be available, such as immigration, local procurement, Customs concessions and R&D assistance.

28 Department of Industry, Science and Resources, Submission no. 168, p. 13.

4.51 The criteria for MPF status are that the project:

- involves capital investment of $50 million;
- requires Commonwealth approvals in order to proceed; and
- is commercially ready to proceed through the approval processes.

4.52 The expanded strategic investment coordination process will specifically recognise the importance of regional development to Australia's national development, 'including consideration of the option of targeted investment allowances.'[29] Criteria under which major projects would qualify for assistance and the possibility of targeted investment allowances are being reviewed. During the Senate's review of the proposed business taxation reforms, John Ralph suggested that only projects costing more than $1 billion should qualify for assistance. The likely budget impact of this measure would, however, be of the order of about a few hundred million dollars.[30]

4.53 The committee is aware of a recent change in attitude to regional investment by some financial institutions. It understands that preliminary representations have been made to the Commonwealth government concerning taxation incentives and the removal of impediments to allow greater involvement of financial institutions in regional infrastructure. For example, the committee is aware that the Macquarie Bank is investigating a number of innovative regional projects and exploring how the private sector could facilitate regional development through these projects. The committee urges the government to pursue these important initiatives with the financial institutions, in consultation with business, industry and regional communities.

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29 Treasurer, *The New Business Tax System*, Press Release no. 58, 21 September 1999, p. 1.

30 Senate Finance and Public Administration References Committee, *Inquiry into Business Taxation Reform*, 22 November 1999, Chapter 5: Section 5.9.

Recommendation 14

4.54 **The committee recommends that the Commonwealth government facilitate private investment in regional infrastructure by:**

- **publicising guidelines already developed by states;**
- **making information readily available to investors, for example, on taxation reforms;**
- **streamlining and expediting administrative processes; and**
- **providing tax relief, removing impediments and providing other incentives where the investment may otherwise not proceed.**

Sections 51 AD and Division 16D

4.55 Other taxation considerations closely bound up with the accelerated depreciation provisions include Sections 51AD and Division 16D of the *Income Tax Assessment Act 1936*. These provisions were the subject of much representation during the inquiry with the former, according to AusCID, 'the most significant hurdle which is constraining increased private investment in public infrastructure.'[31] Removal of Section 51AD was essential because it unnecessarily delayed projects, added significant costs and reduced community benefit from major private sector investment in infrastructure. Similar sentiments were expressed by other parties:

> By private sector provision, the value of depreciation and other concessions are potentially available to State Governments. In a new environment of much greater cooperation on Federal State finances the regulations prohibiting tax benefit transfer are an anachronism. The abolition of section 51AD and the reform of Division 16D should be priority outcomes from the review of business taxation.[32]

4.56 A comprehensive statement of the problems associated with these provisions was set out in AusCID's submission to the Ralph review. In brief, Section 51AD was devised to prevent government control of privately financed infrastructure in 'an era where there was no private

31 Australian Council for Infrastructure Development, Submission no. 215, p. 7.

32 Tourism Task Force, Submission no. 227, p. 5.

ownership and little private management of infrastructure in Australia.' Furthermore, 'its application was too broad and the consequences of its breach too severe'.

4.57 The submission explained that its effect was, in fact, fatal since private sector investment would not proceed in the absence of Australian Taxation Office (ATO) approval, without which all income remained assessable but all deductions were disallowed. The lengthy time taken for ATO rulings meant that finance commitments might be withdrawn and the transaction not proceed, or private consortia may decide not to bid at all because Section 51AD uncertainty made fund-raising untenable. Application of the provision depended on whether a government was considered to have retained 'control of use' of an asset, a view frequently formed by the ATO given governments' regulatory, coordination and safety functions and because the definition could extend to 'potential control'. There are many examples of projects affected by Section 51AD but AusCID explained that the wide definition of 'control of use' meant that it had 'prima facie application to virtually all private infrastructure projects' even though most did not involve tax abuse and had the support of government.[33]

4.58 The committee considers it imperative that Section 51AD be removed and Division 16D amended in order to remove impediments to the development of effective, workable public / private partnerships for the financing of infrastructure.

4.59 It is aware that the legislation tabled in response to the Ralph review proposes actions relating to capital allowances. It considers these issues are complex and worthy of a separate detailed inquiry. It also understands that, given accelerated construction times possible nowadays for large capital projects, there is greater potential for generation of income streams at an earlier stage and consequent qualification for taxation deductions.

Recommendation 15

4.60 **The committee recommends that the Commonwealth government remove Section 51AD and amend Division 16D of the *Income Tax Assessment Act 1936* as soon as possible, to allow the development of effective, workable public/private partnerships for the financing of infrastructure.**

33 Submission by The Australian Council for Infrastructure Development to the Review of Business Taxation, December 1998, Appendix B.

Shadow payments

4.61 Capital allowance provisions and investment incentives are closely related to the potential for shadow payments. As noted earlier in this chapter, mixed funding models with government funding for infrastructure that is not purely user-pays but delivers social or other benefits to regional communities may be appropriate in many circumstances. AusCID has suggested that incentives to reduce elements of risk or otherwise value and reimburse private sector for social benefits provided by projects are needed. It favours shadow payment mechanisms ‘whereby governments, not end-users, pay infrastructure providers for the service and base their payments on measured use of the service’[34] to underpin private financing initiatives and provide incentives to reduce elements of risk or ensure delivery of social benefits that would otherwise not be provided.

4.62 The Private Finance Initiative (PFI) joint funding arrangement formalised in the United Kingdom, and similar arrangements in Japan, provide models. The Department of Transport and Regional Services cast doubt on the practicality of the use of shadow payments in Australia, as discussed in chapter 7. On the other hand, the committee understands that a project developed under the PFI initiative included a payment known as an ‘availability fee’ to balance the long term public interest with short term revenue requirements. This occurred on the basis of expected road traffic use since present use was not large enough to justify investment.[35]

4.63 Fred Argy considered that, where benefit cost returns to the nation were high and considerable regulation was required, for example, in the case of the national highway, the combination of capital costs and efficiency together would point to government rather than private ownership.[36] He also drew the committee's attention to the current distortions in the risk sharing process between the government and the private sector that are partly the result of tax impediments to joint ventures and ‘an element of short-termism with a lot of our financial institutions’. He considered that the proposed business tax reforms and provision for choice of superannuation funds would intensify the trend to short-termism and not redress the need for adequate long term investment in infrastructure. In his view, removal of tax impediments to private-public joint ventures would also make certain tax avoidance measures easier.[37]

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34 Australian Council for Infrastructure Development, Submission no. 215, p. 8.

35 ‘Laing Hyder Wins A130’, *Project Finance International*, p. 44, Issue 169, 1999.

36 Fred Argy, Transcript of Evidence, 22 September 1999, pp. 146-147.

37 Fred Argy, *op cit*, pp. 142-143; 145.

4.64 According to the Australian Constructors Association, a ‘positive, predictable tax incentive program … that will transcend all levels of government’ was needed to provide certainty for investors considering infrastructure projects.[38]

4.65 AusCID considered that incentives, grants, subsidies and patient capital can support private investment in regional Australia with a high social or environmental return. Allocation of grants to projects so as to provide subsidies for delivery, rather than for the means of delivery, was required.

Recommendation 16

4.66 **The committee recommends that the Commonwealth government examine international private financing initiatives for infrastructure, including those used in the United Kingdom (Private Finance Initiative), Japan and the United States, and make the findings publicly available as soon as possible.**

Infrastructure bond schemes

4.67 A further matter related to taxation reform is that of infrastructure bonds. The IBTO scheme was introduced in 1998 to replace the Infrastructure Bonds (IB) scheme that had been subject to abuse. Under the former scheme, tax exempt interest on infrastructure bonds was intended to be passed on to borrowers through lower lending rates to encourage infrastructure investment. The purpose of the scheme was being circumvented, however, through the capturing of benefits by financiers and tax planners and generation of ‘artificial tax benefits for bondholders.’[39]

4.68 The new scheme is discretionary, requiring Ministerial approval for taxation rebates on the taxable interest of lenders’ funding approved infrastructure projects, with the maximum tax offset rate set at the company tax rate and availability up to five years from the time of first borrowing. The intention was to encourage private sector investment in projects delivering intangible benefits that may otherwise not proceed. Land transport projects and energy, water and ports development projects that had qualified under the previous scheme were eligible for

38 Australian Constructors Association, Transcript of Evidence, 23 August 1999, p. 105.

39 Regional Development Council of Western Australia, Submission no. 286, p. 18.

consideration. Under the new scheme, projects are assessed against objective criteria, including:

- commercial viability;
- the benefit to the borrower of the offset;
- the cost to revenue of the offset;
- consistency with government policy; and
- the economic and social benefits likely to flow from each project.

4.69 The land transport focus was based on the potential for sooner commencement of projects and achievement of community benefits, more efficient operation and the wider community acceptance of private sector involvement in infrastructure, including tolls. One project has been formally approved under the process, the Oakey power project located west of Toowoomba in the Darling Downs, a project that was an applicant under the original IB scheme. Projects that have received provisional approval but that are still subject to ATO scrutiny and, in some cases, environmental impact assessment, include:

- New South Wales and Victoria's eastern gas pipeline;
- Adelaide airport passenger terminal;
- Botany gas-fired cogeneration plant;
- assistance to Melbourne's City Link Road; and
- Hamilton's cruise ship terminal on the Brisbane river.

4.70 Project financing arrangements need to be finalised before formal qualification for a rebate under the IBTO scheme is possible. For ATO approval, the critical issue is whether Section 51AD was deemed to apply to the projects.

4.71 The Department of Transport and Regional Services advised the committee that it expected present IBTO funding to have been fully allocated by 2001-2002. It indicated that, although proponents focussed on employment benefits resulting from proposed projects, largely as secondary benefits, the scheme was not designed for smaller regional projects, which were being addressed through the IIIS project.[40]

4.72 The Australian Constructors Association criticised IBTO on the grounds of:

40 Department of Transport and Regional Services, Transcript of Evidence, 23 August 1999, pp. 89-90.

- limited scope;
- minimal funding (capped at $75 million per annum) and fiscal year focus when revenue implications needed to be considered over the longer term;
- restriction of rebate rate to the company tax rate rather than the marginal tax rate; and
- the lack of transparency, length and complexity of the administrative arrangements associated with the scheme.

4.73 The ACA claimed that these deficiencies meant that the scheme did nothing to encourage long-term or marginal projects because investors did not take the scheme into account when deciding on investments but rather regarded qualification for a rebate as ‘a windfall’. It suggested an alternative voucher scheme and claimed that, for an outlay of $200 million per annum, $5.56 billion in infrastructure could be generated. Benefits would include availability to all projects, including marginal projects, and claimed that, because the benefit would be provided directly to project developers with an immediate taxation impact, thereby providing a more direct link between developers and investors, infrastructure investment would be much more likely to be encouraged.[41]

4.74 The IBTO scheme is being reviewed in light of the Ralph review, and in the context of the forthcoming federal budget and Regional Forums being undertaken by the Department of Transport and Regional Services. In light of tax reforms aimed at promoting investment and competition, a tax-based scheme designed to relieve impediments to the development of a free market may be less efficient and effective than, say, a scheme focussed on the needs of individual projects, for example, non-transferable grants available to proponents.

4.75 Consideration of appropriate ways to encourage investment in regional infrastructure are closely related to calls for a national infrastructure strategy with independent oversight, for example, through the NIAC, as discussed earlier in this chapter. The IBTO scheme could be seen as a hybrid arrangement, in that:

- assessment of projects occurs against objective criteria, including consideration of social and economic benefits that might flow from the project; but
- the process is internal to government.

41 Australian Constructors Association, Transcript of Evidence, 23 August 1999, pp. 103-104.

As prioritisation and approvals occur through the Minister rather than through an independent body, decisions are not subject to pressures to respond to a 'wishlist'. AusCID cautioned against development of a 'project sponsorship group'.

> The thing that terrifies us is that we will get sidetracked on massive overdevelopment projects … to the exclusion of building a thousand bridges in New South Wales or developing and improving the Liverpool Ranges rail track. If we can do that on a rational basis, a bipartisan basis, it will be tremendous. If we end up being a big project sponsorship group and booster group, it would be very dangerous.[42]

Recommendation 17

4.76 **The committee recommends that, further to Recommendation 15, the Commonwealth government replace the Infrastructure Bonds Tax Offset scheme with other incentives and forms of assistance for projects based on their commercial viability and public benefit.**

Clustering of projects

4.77 In relation to smaller, regional projects, the committee understands that one of the difficulties in obtaining funding is that tendering costs, including legal and accounting costs, make it difficult to justify projects less than $20 million. One of the conclusions arising from the IIIS project was that small projects, termed 'orphan projects', that fall between economic and financial viability, are less likely to be developed unless new funding models, most likely involving a mix of public and private funding, become possible. Reporting these findings, AusCID advised that institutional investment would be more likely for projects valued at less than $20 million if they were 'bundled into bigger accumulations to create financial economies of scale.' The high level of interdependence between regional and rural projects, more easily appreciated by institutional investors than government agencies because of their focus on 'growing their customer base', makes project bundling or cluster development a realistic possibility for regional areas.[43]

42 Australian Council for Infrastructure Development, Transcript of Evidence, 21 June 1999, p. 7.

43 Australian Council for Infrastructure Development, Submission no. 215, pp. 15-16.

4.78 Bernard Hugonnier, Director of the OECD's Territorial Development Service, told the Regional Australia Summit that the focus now is on strengthening and enhancing locally generated competitive potential, especially networks and clusters of businesses. Programs promoting clusters and the consolidation of existing networks include 'establishment of producers' associations, facilitating contacts between cluster members and training organisations and distributing information on business groupings to business circles and employers' federations.' Clusters, both industrial districts in traditional sectors and advanced technology 'are characterised by high investment propensities, low transaction costs and levels of productivity and real wages above the sectoral average.' And 'clusters in general demonstrate a remarkable resilience and capacity for expansion when faced with new international competitors.'[44]

4.79 The value of supporting the development of an innovative cluster of industries to drive future economic development (through private/public sector partnerships focussed on sharing information, collaborating and developing ways to innovate, develop and market new products and services) was recognised by the Far North Queensland (FNQ) region in 1997. A new kind of architecture was needed based on technology, information, intellectual capital and strategic leadership that would use FNQ's 'rich endowment of resources' in a sustainable way and build new enabling infrastructure (through partnerships) to create cluster industries of future.[45]

4.80 Australian Project Developments, referred to the work of Henton (Silicon Valley) and Porter in redefining the role of governments at all levels to include:

- ensuring the supply of high-quality inputs eg. educated citizens and physical infrastructure;
- promoting cluster formation, and pursuing competitive advantage and specialisation;
- systematically upgrading public or quasi-public infrastructure that has significant impact on many linked businesses; and
- rethinking who does what in the economy, and opening up new public-private avenues for collaborative action.

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44 B Hugonnier, *Regional Development Tendencies in OECD Countries*, paper given at the Regional Australia Summit, October 1999, pp. 9-10.

45 B Roberts, *Creating a New Architecture to Rekindle the Economic Development of FNQ*, Northern Development Industry Association Conference: A vision for economic expansion, Cairns, 30 August 1997, pp. 1, 11.

4.81 It claimed that clusters embrace all of the above.

> The tendency for like-minded firms and talent to cluster in specific geographic areas has been recognised for many years. They do so to achieve synergy, facilitate business transactions and utilise hard and soft infrastructure. The seeds of a cluster can be sown by an investment in a piece of infrastructure, a government decision, a new technology, or a chance happening. Early commercial success leads to the entry of other players keen to be part of the action. This in turn feeds revenue streams to justify more infrastructure - the regional economy grows like an ice crystal.[46]

Australian Project Developments considered that cluster development could also be facilitated:

- through measurement: by ensuring information in the form of studies on linkages and economic relationships that explain the dynamics of a region or industry within a regional setting is available to investors and government at strategic times; and
- through action: by harnessing goodwill, making connections, developing aggregated demand and strategies to attract investors, and coordinating actions to drive economic and social outcomes.

4.82 Micro-economic reform (including the freeing up of capital and labour markets, export orientation, innovation and management skills) are conducive to cluster development and a number of state governments are becoming active in nurturing network alliances and cluster agendas in key industries. Australian Project Developments claimed, however, that ‘clustering concepts have not as yet become part of the mainstream debate in Australia’ and, in terms of federal agencies, there is ‘general indifference and ignorance of cluster concepts’ and the view that clustering ‘picks winners’. It urged an increased focus on a whole of government approach to program delivery in regional areas, with more effective relationships between governments and community development of regional development frameworks in partnership with state and federal governments whose policies and programs should be ‘fashioned to fit.’[47]

46 Australian Project Developments Pty Ltd, Submission no. 254, p. 6.

47 R Brown, *Strangers in the Night: Some Perspectives on Regional Australia and the Potential of Clusters*, Third National Conference Sustainable Economic Growth for Regional Australia, September 1999, pp. 12-17.

4.83 The recent Innovation Summit (February 2000) provided an opportunity to examine how clustering concepts might be brought into mainstream science and industry policy thinking.

4.84 In Fred Argy's view, the external benefits of new infrastructure are likely to be greater if:

- the investment is geographically concentrated due to clustering benefits; and
- the region is relatively backward economically, with a high incidence of structural unemployment.

> This is because of additional economic gains from a better regional spread of employment opportunities and living standards. A better regional balance has the potential to reduce structural unemployment and lift the sustainable growth rate of the economy. It also relieves congestion and pollution in the cities and promotes greater equality of opportunity amongst individuals, thus ensuring greater competitive neutrality in the labour market.
>
> But the gains are also social in that economically backward areas tend on average to have relatively low incomes.[48]

4.85 The committee considers that focussing on large infrastructure projects, at the expense of overall regional development planning and the encouragement of networking and industry clusters, will not deliver sustainable regional economic development or opportunities for ongoing employment in regional areas. This view coincides with OECD findings concerning the limited value of conventional policies aimed at reducing imbalances and economic gaps between regions. 'Direct assistance to enterprises, a technocratic approach to heavy infrastructure and support for declining activities' have been found relatively unsuccessful. For example, 'poles of growth' policies that involved large-scale infrastructure projects, enterprise zones and expensive tax incentives on a relatively small number of sites led to these sites becoming 'exporting islands' rather than contributing to wider economic development. By contrast, clusters of businesses with related activities have shown resilience and a capacity for expansion in the face of competition. Clusters characterised by high investment propensities, low transaction costs and levels of productivity and real wages above the sectoral average have been developed for:

- industrial districts in traditional sectors – northern Italy, Vendee in France, Californian wine growing districts, the Valencia region in Spain, and southern Norway; and

48 Fred Argy, Submission no. 292, p. 1.

- advanced technology clusters – Silicon Valley, the North Carolina Triangle and south western Paris.[49]

4.86 The committee supports encouragement of cluster development rather than development of assistance or subsidies for individual sectors. It considers that a focus on cluster development coupled with strategic targeted investment from the public and private sectors, including partnership-funding models, is urgently required. Government assistance could take the form of seed funding for key infrastructure projects, or assistance to ensure investment in linking infrastructure, for example, more efficient transport or advanced telecommunications.

Recommendation 18

4.87 **The committee recommends that a database of successful best practice cluster development models suitable for Australian application be developed by Commonwealth agencies, for example, for:**

- **intermodal transport;**
- **tourism; and**
- **telecommunications initiatives.**

In compiling the database, agencies should identify the critical factors underpinning the success of each cluster development.

49 B Hugonnier, *Regional Development Tendencies in OECD Countries*, paper given at the Regional Australia Summit, October 1999, pp. 6-7, 9-10.