HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON PRIMARY INDUSTRIES AND REGIONAL SERVICES: INQUIRY INTO INFRASTRUCTURE AND THE DEVELOPMENTS OF AUSTRALIA'S REGIONAL AREAS

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The term "infrastructure: will be taken to encompass not only physical infrastructure (transport, telecommunications, energy and water facilities or educational and health buildings) but also centers of excellence and research, education and training programs, financial and IT facilities for business development, collaborative frameworks etc.

Some key themes emerge from my recent work on infrastructure and economic development. They are outlined below.

1. Most types of infrastructure investment have extensive "spillover" benefits for the community which cannot be captured adequately by commercial producers e.g. secondary effects on the productivity of third parties who are not charged for the service. These positive "externalities" are hard to quantify but can be substantial.

2. 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.

3. Infrastructure is not the only way to promote regional development. It needs to be supported by a mix of other measures such as:

- greater regional sensitivity in implementing micro-economic reform and in determining government expenditure priorities;
- adjustment assistance directed at improving the viability and competitiveness of regions hurt by microeconomic reform;
- improved mobility assistance programs going beyond job search cost;
- reimbursements and embracing retraining and relocation assistance;
- support for local self-help initiatives; and
- regionally selective wage subsidies or payroll tax concessions, at least
- during a transitional phase.

The Committee may also wish to consider some of the hard-line economic liberal proposals such as cuts in award wages and welfare entitlements in regions of high unemployment and toughening the work tests to pressure to get out of bad regions and go to the cities. But from a social viewpoint such proposals deal with the regional employment imbalance but compound the regional income / wealth imbalance. [This is not to deny that an increase in structural wage flexibility may be desirable to allow some widening in regional wage-cost disparities over time.]

5. While infrastructure is only one of many instruments for promoting regional balance, it has special advantages in terms of intrinsic externalities (including better interaction between related suppliers, access to better quality support services, faster diffusion of technology, easier access to quality health and education etc.) and net social advantages.

Governments therefore have a legitimate case for pursuing an "active" infrastructure strategy (not just one which responds to needs as they arise). This needs to be linked to an active regional strategy.

6. However, careful selectivity is needed as to

- type of infrastructure as some, like transport, produce higher external returns than others like energy; and
- choice of region, which needs to have the potential to be viable in the long term.

7. In view of

- overall resource and financial constraints;
- the varying externality returns from different types of infrastructure and different regions; and
- the cost of interventions e.g. efficiency cost from higher taxes

prioritization is crucial.

This means having in place

- a broad national approach to regional development priorities; and
- a consistent national framework of cost / benefit analysis which systematically incorporates regional externalities and social benefits (as outlined earlier) in the evaluations;
- an agreed approach to the sharing of public and private ownership risk; and
- agreed financing arrangements.

There is here a crucial role here for Commonwealth-State cooperation and joint planning.

8. The present over-conservative fiscal stance of Australian governments needs a critical re-evaluation, as it is contributing to

- under-investment in infrastructure overall,
- bad financing decisions and
- distortions in the composition or allocation of infrastructure.

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 constraint here is the decision of all governments in Australia to strive for either a balance or a surplus in cash budget outcomes over the economic cycle (i.e. over a 5 or 7 year period). This means no net borrowing (and even a run-down in public debt) over that period. It also means financing all infrastructure which is not self-funding out of on-going revenue.

This is an unnecessary constraint. If a company is reasonably low-geared (i.e. with a low debt to equity ratio) and has sound investment opportunities available to it, it would be reprehensible of that company not to borrow. Government borrowing should have similar tests applied to it. That is, governments must show that the proposed investment is economically sound and that their balance sheets are strong enough to bear an increase in debt.

To meet the first test, there needs to be a proper cost-benefit evaluation, i.e. with the cost of government capital measured in terms its opportunity cost not just the bond rate, and with wider community and economic spin-offs taken fully into account. As for the balance sheet hurdle, it would be hard to argue that Australian governments are over-loaded with debt or over-geared. In fact they have a very low level of indebtedness relative to GDP compared with their counterparts overseas.

Of course governments need to be fiscally responsible in two senses. First, in general they should not borrow more than they "invest" i.e. they should aim to maintain or improve the nation's net worth over the economic cycle. Secondly, the interest rate on public debt should never exceed the growth rate of GDP so that the debt servicing burden does not increase. All this implies a zero cash deficit only on recurrent budget not an overall cash balance or surplus over the economic cycle.

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.

The above themes are developed further in

- Argy, Fred (1998), Australia at the crossroads: radical free market or a progressive liberalism?, Allen & Unwin, Sydney

- CEDA, Infrastructure and Economic Development (1999), CEDA Information Paper no. 60. Authors: F. Argy, M. Lindfield, B. Stimson, P. Hollingsworth.