AUSTRALIAN INDUSTRY
GROUP

# Ai Group

## Submission to the Senate

## Select Committee on State Government Financial Management

## March 2008

## Introduction

Ai Group welcomes this opportunity to provide our input into the deliberations of the Senate Select Committee on State Government Financial Management in its inquiry into Commonwealth and state and territory fiscal relations and state and territory government financial management.

The areas covered by the Committee's Terms of Reference are of longstanding interest to Ai Group and are areas we regard as of high importance.

The comments below are of a general nature and we would be delighted to elaborate upon them should you seek further input.

## State and Territory Borrowing, Investment and Debt Levels

Ai Group regards the current level of debt of the States and Territories to be conservative. To an extent this is reinforced by the very strong credit ratings of the States and Territories.

It is our belief that the borrowing and debt positions of the Australian States and Territories have been overly conservative for some time. This has been associated with a significant underinvestment in Australia's infrastructure. In recent years, partly we believe due to our own efforts, this overly-conservative stance has been wound back and the States and Territories have become more willing to borrow and to make inroads into the backlog of important projects that has built up over many years.

We note however that, with the economy moving towards full capacity, the increase in investment activity in infrastructure activity is occurring at a later stage than should have been the case. For much of the past decade and a half, during which we had much greater capacity, we have underinvested in infrastructure. For much of this period we were also reducing debt levels (both at the national and state and territory levels).

It is difficult to rationalise the excessive focus on reducing debt. It has little basis in good economic management but seems rather to be driven by an ideological position.
Ai Group supports strong discipline over public sector expenditure. We also see a strong role for the private sector in the provision of infrastructure. We regard these views as entirely compatible with our support for greater levels of public sector investment in infrastructure.

Private sector financing of infrastructure is often preferable to public sector provision. Ai Group supports the strong role of private sector ownership in power generation, rail and telecommunications for example. At the same time, if by financing infrastructure directly, the public sector can deliver worthwhile projects at greater social returns than if the infrastructure was privately owned, we can see no reason for this not to occur.

Such cases may include instances where there are significant spillovers that could not be captured by a private provider or where significant transaction costs are associated with aligning the interests of private providers with the public policy objectives behind the investment.

Such investment by the public sector should be very closely monitored and only projects that meet clear and firm criteria should be embarked upon. These criteria should include a rate of return sufficient to cover the additional recurrent costs associated with the investment. These include depreciation, interest, maintenance and management costs.

While we see an important role for public sector borrowing to finance worthwhile investments in infrastructure, Ai Group does not in general support borrowing to meet recurrent spending. (There may be exceptions to this when as part of a prudent macroeconomic policy borrowing is undertaken to fund counter-cyclical non-capital expenditure. Such borrowing would be expected to be repaid from surplus revenues at a stronger point in the economic cycle.)

**Dividends and Investment by Public Sector Enterprises**

We would like to note three issues in relation to the dividend policies and investment decisions of public sector enterprises.

Firstly, public ownership can give rise to sub-optimal practices. Ideally businesses would fund new investments from the most appropriate mix of sources of finance – borrowing, equity and retained earnings. Public ownership may be associated with excessive payouts of dividends when governments would prefer to derive revenue this way rather than find budget savings or raise taxes. This in turn could lead to underinvestment or less than optimal use of retained earnings on the part of the public sector enterprise.

Secondly, the commercial interest of the government in publicly owned monopolistic enterprises, can seriously compromise the public policy purposes that may be served by public ownership. The government may find itself in the position of being able to prohibit new entrants while overseeing greater than socially optimal prices. Preventing new competition would remove contestability and permit the government to tap into higher dividends funded by extracting monopoly rents from consumers.

Finally, governments may under-invest in public sector enterprises. This might occur if new injections of capital are required when there are politically more attractive alternative uses of funds. These politically attractive options may include greater spending on services, tax reductions or reductions in net public sector debt.

**Intergovernmental Finances**

In Ai Group's view there are several shortcomings with Australia's current system of intergovernmental finances. Ai Group does not offer itself as an expert in this area but some issues are listed below.

1. Australia has an elaborate system of horizontal equalisation between the States and Territories that no one seems to fully understand.

   - It is not clear how the efforts of the Grants Commission in subsidising some states and territories interact with general income redistribution arrangements under which the citizens in “poorer” states and territories on average pay less income tax and receive more income support than those in “richer” states and territories. (And how the Grants Commission adjusts its approach to changes in the progressivity of national income redistribution arrangements.)

   - The states and territories do not appear to have sufficient incentives to address the sources of their “disadvantage” that results in their being assessed as requiring subsidies financed by taxpayers in general. In fact this may create perverse incentives.

   - A simpler system would have the benefit of being more readily understood and more capable of engendering confidence.

2. Australia’s vertical fiscal imbalance appears to reduce accountability and responsibility of government. Too often and in too many areas, the states and territories point to the Commonwealth for not providing sufficient funds and the Commonwealth points at the states and territories for underspending or mismanagement. In addition as the Commonwealth’s areas of responsibility have grown into areas traditionally the responsibility of the states and territories, accountability has become more difficult. This is not conducive to responsible and responsive government.

3. The states and territories currently impose some of the most distorting taxes in the country. It is not clear that our current system of intergovernmental finances creates appropriate incentives to improve the pattern of taxation across the country.