



**Infrastructure
Australia**

Making Reform Happen

Using incentives to drive a new
era of infrastructure reform

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REFORM SERIES



Infrastructure Australia is an independent statutory body that is the key source of research and advice for governments, industry and the community on nationally significant infrastructure needs.

It leads reform on key issues including means of financing, delivering and operating infrastructure and how to better plan and utilise infrastructure networks.

Infrastructure Australia has responsibility to strategically audit Australia's nationally significant infrastructure, and develop 15 year rolling infrastructure plans that specify national and state level priorities.

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Executive Summary

There is broad agreement on the need for Australia to deliver nationally beneficial infrastructure reform. The challenge ahead for governments is to translate this consensus into action.

Australia is undergoing a period of profound change, bringing new opportunities and challenges. Our population is projected to grow to over 30 million people by 2031, our economy is in a state of transition, governments are managing fiscal constraints, new technology is changing the way we live, and the impacts of climate change are becoming more apparent.

Our economic infrastructure needs to adapt to meet these challenges and to harness opportunities. We need to ensure that Australia has infrastructure and services that strengthen our role in the global economy, enhance the liveability and productivity of our cities and regions, and support a transition to a more diversified economy. An ambitious program of infrastructure reform is required, focused on extracting the greatest value from existing infrastructure while sustainably funding new investments. If we fail to act, Australia will miss out on the full opportunities of a growing and dynamic economy. If we do act, Australia will be more prosperous, fairer and more sustainable.

There is broad agreement on the need for nationally significant reform to drive productivity

As a nation, we need to establish a new phase of microeconomic and market reform that recaptures the momentum of previous decades. During the 1980s and 1990s, Australia undertook a series of major microeconomic reforms, including floating the dollar, industry deregulation and privatisation, and introducing

a package of tax reforms, most notably the Goods and Services Tax (GST). The result was a transformation of the economy, bringing in the strongest period of productivity growth in the nation's history, and an enduring economic dividend that has delivered more than a quarter of a century of uninterrupted economic growth. On average, during the 1990s, Australia's Gross Domestic Product (GDP) increased annually by 3.5%.¹ The time is right for Australia to reinvigorate this spirit of reform.

Infrastructure Australia released the *Australian Infrastructure Plan* in February 2016, setting out a program of national infrastructure priorities and reforms. Responding to the Plan in December 2016, the Australian Government indicated support for the majority of the recommendations, including those that called for significant reform to our infrastructure markets and networks.

There is broad agreement on the need for such reform in Australia. The Plan's recommendations built on previous Competition Policy reviews (in 1993 and 2015), and research conducted by the Productivity Commission, the Reserve Bank of Australia and the Australian Competition and Consumer Commission, which linked microeconomic reform to productivity gains, particularly for infrastructure. Australian governments, industry and the community have echoed this need for reform. The challenge ahead for Australian governments is to convert policy consensus into real actions and reforms.



The Australian Government is in a unique position to drive change

While the majority of infrastructure service delivery falls under the responsibility of states and territories, there is a clear role and responsibility for the Australian Government to drive reform and continuous improvement. The structure of our federation means states and territories are responsible for the regulation and delivery of most economic and social infrastructure services, while the Australian Government retains the majority of the total revenue raising capacity – including income, consumption and corporate taxation.

This structure has led to a ‘vertical fiscal imbalance’. The scale and permanence of this imbalance means the Australian Government routinely makes substantial allocations to states and territories to support service delivery. This dynamic can be used as a mechanism to drive reforms that are important to national productivity, but challenging for jurisdictions to implement in isolation. Used intelligently, the vertical fiscal imbalance and Australian Government funding can be used as a powerful tool to deliver nationally consistent, productivity enhancing reforms.

Australian Government funding is often tied to specific projects, but not necessarily contingent on broader reform actions or policy outcomes. This means existing funding arrangements, while often essential to the delivery of projects, programs and services, do not provide an adequate platform to support infrastructure reform. This paper builds on the *Australian Infrastructure Plan*, calling on the Australian Government to implement a new incentive-based funding approach to drive nationally significant infrastructure reform: Infrastructure Reform Incentives.

Under this approach, the Australian Government would make additional investments in state and territory infrastructure – over and above existing allocations – in return for the delivery of agreed infrastructure reforms. The approach aims to embolden states and territories to carry out reform by tying funding to agreed outcomes that boost Australia’s productivity and prosperity.

Reform can deliver considerable economic benefit to all Australian governments

Independent modelling commissioned by Infrastructure Australia shows that progressing vital infrastructure reforms could help to unlock significant economic potential, and generate substantial revenue to all levels of government – particularly the Australian Government.

Infrastructure Australia undertook an analysis of the economy-wide impacts on GDP and taxation revenue of five indicative reforms that are well suited to an incentive-based funding approach. All of the modelled reforms were key features of the *Australian Infrastructure Plan*.

The illustrative reforms modelled are:

1. **introducing road user charging**
2. **reforming the urban water sector**
3. **reforming the electricity market**
4. **reforming land tax**
5. **franchising public transport services.**

This modelling suggests that instituting well-considered reforms would substantially benefit the economy and release significant fiscal capacity to fund a reform program. It shows that, if implemented in full, these

reforms alone could deliver an estimated \$66 billion increase in GDP by 2047 (\$2016), and a \$19 billion, or 4%, ongoing increase in tax revenue for the Australian Government and state and territory governments (in nominal terms) from 2016–17 levels.²

These kinds of reforms could be progressed through Infrastructure Reform Incentives. The scale of benefits that could flow from an incentive-based reform program makes this approach a win-win for all Australian governments. Using incentives to drive reform in a restrictive fiscal environment can deliver a two-fold benefit – a short-term boost from infrastructure investment, and longer-term productivity and revenue gains from beneficial reforms. Even after providing incentives to jurisdictions to undertake reforms, the Australian Government stands to see a significant and lasting improvement in its net fiscal position. Most importantly, this benefits all Australians by improving public funding efficiency and unlocking reforms that could boost productivity, employment and growth.

While the benefits can be substantial, the process of reform can have significant transitional impacts on some sectors and individuals. Decision makers should carefully consider the short- and long-term transitional costs of reform prior to the implementation of any reform program, and provide support where appropriate.

Incentive-based funding approaches have been used before, with substantial success

There are recent examples of programs that have used incentive payments from the Australian Government to drive state and territory reform, including the National Competition Policy and the Asset Recycling Initiative. While distinct in form and function, these approaches have proven effective in driving reform outcomes that may not have come about otherwise.

The National Competition Policy payments structure provided a powerful incentive for jurisdictions to enact the reform pathways set out in the 1993 *National Competition Policy Review (Hilmer Review)*. Under this policy, the financial gains from national microeconomic reforms were redistributed to contributing states and territories.

More recently, the Australian Government established the Asset Recycling Initiative, providing incentive payments to state and territory governments to sell mature, commercially viable infrastructure assets and businesses, and allocate the full proceeds and incentive funding into new infrastructure investments. Unlike the National Competition Policy approach, these payments were specifically tied to infrastructure investment.

The broad scope of the National Competition Policy payments and the targeted approach of the Asset Recycling Initiative provide a valuable precedent for

a new incentive-based funding approach to drive the infrastructure reform Australia needs now. A new approach should recognise the strengths, weaknesses and context of these past programs, and work alongside current programs, such as National Partnership Agreements and City Deals, to form an incentive hierarchy and deliver better outcomes for infrastructure users and taxpayers.

An incentive-based reform program requires clear principles

A successful incentive-based reform program requires clear, strong and straightforward principles. Jurisdictions need to have confidence that an incentive-based reform program will benefit their economies and communities, and that its processes can be trusted. This paper identifies three principles to guide the creation of such a program:

1. **Accountability** for all participants, including the Australian Government.
2. **Transparency** of governance, reform development and monitoring arrangements.
3. **Efficiency** of process.

Building an incentive-based reform program around these core principles will help to build trust in the program, and define the roles and responsibilities of each level of government. This should also help to ensure expectations are aligned between participating state and territory governments and the Australian Government, particularly regarding payments and reform outcomes.

An ambitious reform agenda should be at the centre of any incentive-based funding approach

To be effective, an incentive-based reform program needs to be underpinned by a comprehensive and ambitious reform agenda, based on an evidence-based assessment of the national significance of each reform.

This paper outlines a suggested process for identifying and prioritising a reform agenda. Broadly, reforms should be selected based on their capacity to achieve the following key outcomes:

- **Boost Australia's productivity:** Reforms should enable the Australian economy to generate more from the resources and labour we have, in turn increasing our competitiveness across domestic and international markets.
- **Deliver benefits across Australia's communities:** Reforms should deliver benefits that are shared widely across Australia's diverse communities, and enhance our already world-class standard of living.

■ **Improve the efficiency of Australia’s infrastructure:**

Reforms should look to extract more value from and better maintain the infrastructure we already have, while delivering the infrastructure renewal we need as efficiently as possible.

A reform agenda should be prioritised according to the scale of net benefits the respective reforms deliver.

Success is predicated on broad engagement and a robust governance model

The features of any incentive-based program – such as the reform agenda, funding model and governance model – will require detailed development and consultation.

An incentive-based reform program should be underpinned by comprehensive engagement with state and territory governments. Over time, individual states and territories have reformed aspects of their infrastructure markets and networks in different ways and to different levels of maturity. One of the challenges faced in designing an incentive-based reform program is determining whether jurisdictions should be paid for reforms that have already been undertaken.

The Australian Government, in collaboration with states and territories, should also carefully consider the design of a governance model. Robust institutional arrangements will ensure active participation from governments, collaboration across jurisdictions, transparent decision making and appropriate monitoring and evaluation processes.

The design of an incentive-based reform program should include an assessment of the availability of funding for incentive payments, appropriate conditions for payments linked to reform outcomes, the size of payments needed to incentivise reform actions, and a suitable schedule for payments. The funding model should be designed and implemented in a fair and transparent manner in order to maintain trust and reform momentum.

Infrastructure Australia recommends Infrastructure Reform Incentives to drive infrastructure reform for Australia. However, there are many ways to structure an incentive-based funding program. This paper aims to provide decision makers with a framework to build upon, rather than a complete model. It outlines the central considerations that should be addressed in formulating an incentive-based reform program.

This paper builds on the *Australian Infrastructure Plan*

The *Australian Infrastructure Plan*, published in February 2016, outlined an evidence-based pathway towards more efficient and productive infrastructure for Australia’s

future. It provided 78 recommendations on the reform actions required to achieve this. The Reform Series, including this paper, builds on the recommendations made in the Plan, providing further evidence and advice to all governments on the pathways and mechanisms required to deliver enduring reform.

The Plan called on the Australian Government to establish Infrastructure Reform Incentives to drive the implementation of the key reforms identified in the Plan.³ The specific recommendation reads:

Recommendation 1.1

The Australian Government should establish Infrastructure Reform Incentives, which link additional infrastructure funding to the delivery of reform outcomes. This mechanism would encourage state, territory and local governments to deliver productivity enhancing reforms to the planning, construction, operation, ownership and governance of Australia’s infrastructure. *Infrastructure Reform Incentives* should be aligned to key reforms recommended in this Plan including: improving the governance and operation of our cities and microeconomic reform across the energy, telecommunications, water and transport sectors.

The Australian Government responded to the Plan in November 2016, and supported this recommendation. This support was contingent on identification of an appropriate reform agenda and the capacity to provide the necessary funding.⁴ This paper addresses these issues and builds on this recommendation by making the case for an incentive-based approach to reform.

The paper is split into four chapters:

- 1. Making the case for an incentive-based approach:** Translating reform objectives into actions.
- 2. Establishing reform priorities:** Selecting the right reforms.
- 3. Developing an incentive-based reform program:** Creating the right structures to achieve reform outcomes.
- 4. Implementing a successful program:** Next steps for governments.

Each chapter includes recommendations, which provide advice to Australian governments on the best approach to establishing a successful incentive-based reform program that can kick-start a new era of infrastructure reform for Australia.