

Making Reform Happen

Using incentives to drive a new
era of infrastructure reform

June 2018



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.

Hardcopy

ISBN: 978-1-925352-30-6

Online

ISBN: 978-1-925352-26-9

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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.

Making the case for an incentive-based approach

Recommendations

- 1. Australia should initiate an ambitious program of infrastructure reform focused on increasing the productivity of the Australian economy.** Making our infrastructure more efficient will enable Australia to generate more from our vast natural resources and highly skilled workforce, in turn increasing our means to connect and compete across domestic and global markets.
- 2. The Australian Government should use its unique position to lead national infrastructure reform.** While key actions will be required at the state, territory and local levels of government, the benefits of reform will be shared across Australia. The Australian Government holds the appropriate funding levers to lead a national, integrated reform program and is likely to be the principal taxation beneficiary of reformed infrastructure sectors.
- 3. The Australian Government should use an incentive-based funding approach to drive reform.** This approach, which has been used successfully in the past, leverages the vertical fiscal imbalance by linking additional funding for infrastructure to the delivery of nationally significant reform outcomes.
- 4. An incentive-based reform program should be exempt from GST calculations.** GST distribution should not limit the Australian Government's ability to pursue its policy goals.

Australia is undergoing a period of sustained growth and change

Australia's population is projected to grow to over 30 million people by 2031.⁵ A growing population can be a source of economic dynamism, providing a larger domestic market for businesses and increasing the size of the labour force. Growing demand for Australia's resources and services from a vibrant Asia Pacific is also triggering substantial shifts in our economy. Rising incomes in the region present immense economic and social opportunities. Emerging technologies are stimulating innovation, changing our built environment, and providing us with the ability to build, maintain and monitor our infrastructure in new ways.

While this growth provides opportunities, it also places additional demand on Australian communities, and the infrastructure that supports them. An ageing population and growing demands on government budgets for health, education and welfare will place increasing pressure on the funding available for infrastructure at a time when demand for that infrastructure is growing.

We need infrastructure networks and services that strengthen Australia's role in the global economy, enhance the liveability and prosperity of our cities and regions, and support a transition to a more sustainable and resilient economy. This is particularly important in light of Australia's tightening fiscal environment and budgetary constraints.



Infrastructure reform can boost Australia's productivity and prosperity

In order to respond to these changes and increase our productivity, Australia needs to reform the way we plan, fund, deliver and operate our infrastructure. Productivity is the 'efficiency with which an economy transforms inputs (such as labour and capital) into outputs (such as goods and services)'.⁶ Productivity growth is an important indicator of long-term economic and income growth and competitiveness.

Microeconomic reforms across energy, telecommunications, water and transport sectors, as well as productive infrastructure projects, can deliver significant productivity gains. Making our infrastructure more efficient boosts productivity by better allocating costs and maximising benefits. This gives people and businesses more time and money for the things that matter. Reducing how much we pay for infrastructure also frees up capital for other investments that create jobs and promote sustainable growth. It enables Australians to generate more from our vast natural resources and highly skilled workforce by providing the means to connect and compete across domestic and global markets. This will help to create a more prosperous and equitable Australia.

During the 1980s and 1990s, Australia implemented a broad-ranging microeconomic reform agenda that opened up our economy, making it more competitive and productive, resulting in more jobs and trade. These reforms, supported by favourable terms of trade, contributed to the recent strength of the Australian economy and the high standard of living we enjoy today.⁷ Productivity growth is one of the ingredients required to maintain this standard.

However, our productivity growth has slowed over the past decade. The Australian economy can no longer rely on the

favourable trade and demographic conditions of the past.⁸ Without sustained productivity growth, the Australian economy will be more vulnerable to internal and external shocks.⁹ Australia needs to deliver broad economic reform to address this productivity challenge.

Infrastructure reform plays a key role within broader economic reform in boosting Australia's economic performance. The *Australian Infrastructure Plan* provides a reform and investment pathway for Australian governments to enhance the efficiency and productivity of our infrastructure. This paper builds on the reform recommendations made in the Plan.

Recommendation 1

Australia should initiate an ambitious program of infrastructure reform focused on increasing the productivity of the Australian economy.

Making our infrastructure more efficient will enable Australia to generate more from our vast natural resources and highly skilled workforce, in turn increasing our means to connect and compete across domestic and global markets.

Australian Government leadership can help states and territories implement reforms

While the majority of infrastructure service delivery and direct regulation falls under the responsibility of states and territories, there is a clear role and responsibility for the Australian Government to drive infrastructure reform. The Australian Government having a stake in state and territory level reform acknowledges that jurisdictions wear the implementation and short-term political pain of many reform actions, while the majority of the revenue flows to

the Australian Government. This revenue imbalance can be partially addressed by distributing funds from the Australian Government to reforming states and territories, to the benefit of all Australian infrastructure users and taxpayers.

Any national reform agenda should seek to enhance the capacity for states and territories to advance beneficial reform, while recognising that some states and territories already have the fiscal capacity and appetite to independently pursue reform. National leadership can support state and territory reform efforts. The Australian Government has the opportunity to use its funding position to provide strategic direction and clear incentives to state and territory governments to implement infrastructure reforms that deliver economy-wide national benefits. Funding is often used to facilitate intergovernmental cooperation and can incentivise action.¹⁰

The Australian Government already uses payments to influence state and territory outcomes

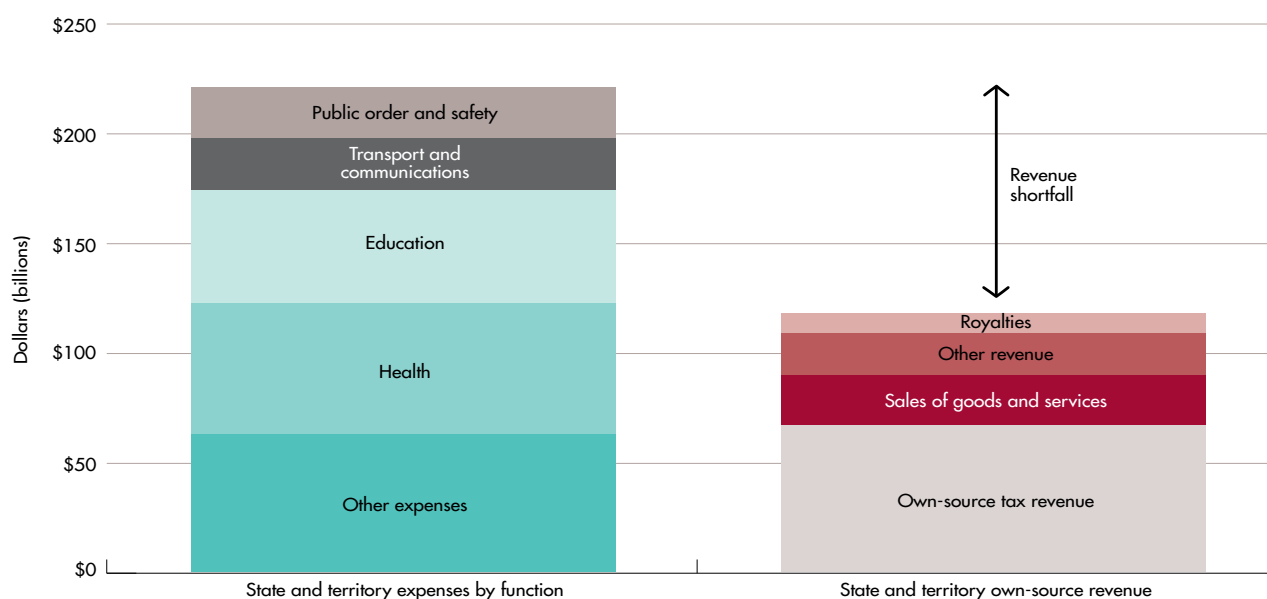
The vertical fiscal imbalance refers to the dynamic in which the Australian Government's revenue-raising capacity exceeds its direct spending responsibilities, while in contrast, states and territories do not have the powers to raise sufficient own-source revenue to meet their direct spending responsibilities. This revenue shortfall is addressed by redistributing revenue from the federal level to states and territories.

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 corporation taxes. Used intelligently, the vertical fiscal imbalance – and the flow of discretionary funding from the Australian Government to jurisdictions – can be a powerful tool to deliver nationally consistent, productivity-enhancing reforms. This means the Australian Government is in a unique position to collaborate with states and territories and drive reform.

The Australian Government uses several methods to address the vertical fiscal imbalance, including horizontal fiscal equalisation and the distribution of grants to states and territories.

Relative to other countries, Australia has a high degree of vertical fiscal imbalance. In 2015–16, the Australian Government's taxation revenue represented 80% of total taxation revenue for all levels of government.¹¹ In 2013–14, the Australian Government funded around 40% of state and territory government expenses.¹² **Figure 1** indicates the dynamic of the imbalance.

Figure 1: Australia's vertical fiscal imbalance, 2013–14



Source: National Commission of Audit (2014)¹³

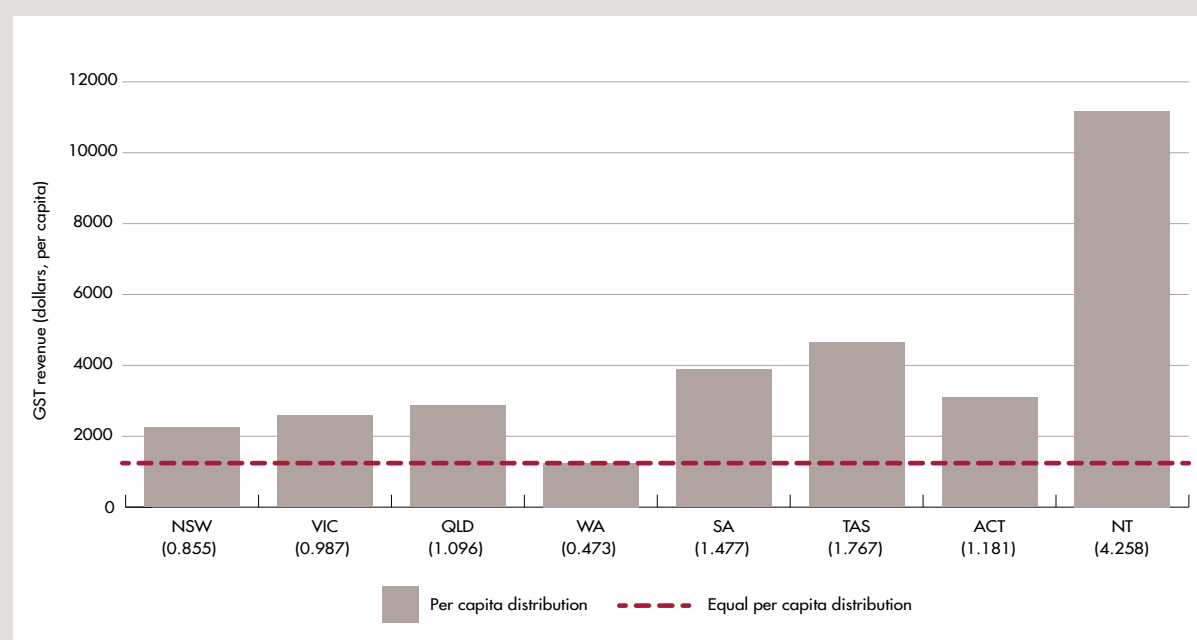
Horizontal fiscal equalisation and the Commonwealth Grants Commission

The CGC is an independent statutory body that advises the Australian Government on financial assistance to states and territories. Horizontal fiscal equalisation distributes untied grants (GST revenues) to the states and territories. Distribution is calculated based on the required state and territory expenditure for services and infrastructure, the revenue a state or territory can raise itself via other tax regimes, and how much the state or territory receives from the Australian Government in other tied funding arrangements.

The CGC aims to provide each state and territory with the equal capacity to provide the services it needs to. However, according to the Productivity Commission, the pursuit of equalisation can cause ‘extreme circumstances’, especially where states and territories have vastly different and fluctuating revenues and expenditures. Natural resources can affect equalisation, with states that increase their mineral production or royalty rates losing significant GST revenue. This has left some states to argue for a new method of equalisation.¹⁴

Under this current approach, some jurisdictions receive more support per capita than others. For example, for every dollar in GST revenue contributed to the Australian Government in 2018–19, the Northern Territory is estimated to receive over four dollars, while Western Australia will receive just under 50 cents.¹⁵ **Figure 2** compares the GST share of each state and territory to the equal per capita share, with GST relativities for each state and territory shown in parentheses.

Figure 2: GST distribution per capita, 2018–19



Source: Commonwealth Grants Commission (2018)¹⁶

A new approach could promote more opportunities for reform

Australia’s level of vertical fiscal imbalance provides the Australian Government with a powerful lever to drive national change, particularly when funding is tied to specific conditions. Current payments made from the Australian Government to states and territories are generally tied to specific projects, programs and services, but are not contingent on reform actions or policy outcomes.¹⁷

Funding arrangements for infrastructure are delivered through a number of different programs, departments, agencies and agreements, each with their own eligibility requirements and funding conditions. **Appendix A** presents a visual representation of the current Australian Government infrastructure funding architecture.

Historically, federal funding for infrastructure has been distributed primarily through grant funding. Grants can be given to states, territories and local governments with or without conditions for their use. Over time, the Australian

Government has adopted a wider variety of funding arrangements, including a number of key mechanisms:

- **Tied funding (Specific Purpose Payments (SPPs)):** Conditional grants made by the Australian Government to states and territories or local governments to assist in funding specific state and territory responsibilities, such as health and education. SPPs include National Partnership Agreements (NPAs), which generally mandate a specified outcome to receive funding.
- **Untied funding (General Purpose Grants):** Grants without conditionality used at the recipient's discretion, such as GST payments made to states and territories.
- **Incentive payments (such as payments previously made under the National Competition Policy and the Asset Recycling Initiative):** Payments made to states and territories with conditions based on predefined actions or outcomes.

Each arrangement is formulated with varying degrees of conditionality, flexibility of terms and desired outcomes.

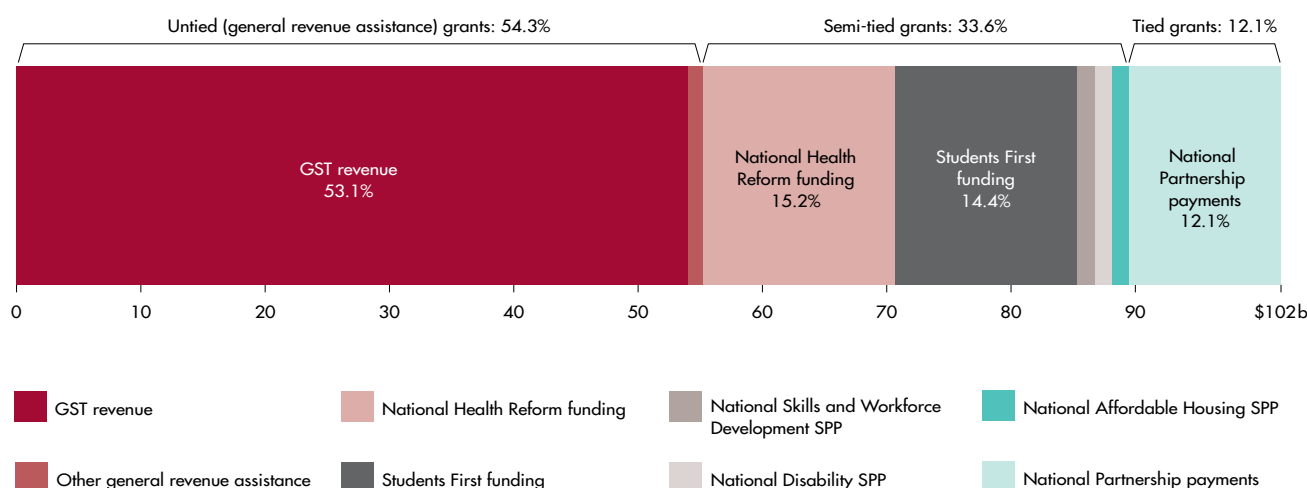
However, the range of funding mechanisms available has been described by the Productivity Commission as a 'patchwork of payments' and has the potential to reduce accountability.¹⁸ The patchwork can result in opaque definitions of responsibilities under funding arrangements, and inconsistencies between the objectives of state and territory governments and the intentions of the Australian Government.

The most recent federal infrastructure program to specifically use incentive funding, the Asset Recycling Initiative, was established in 2014 and discontinued in 2016. More recently, the Australian Government's City Deals program has been established with the aim of better aligning investment and policy at all levels of government to boost productivity and liveability in particular cities. Initial City Deals have focused on and are a mechanism in leveraging particular infrastructure investments (for example North Queensland Stadium in Townsville and Western Sydney Airport) to focus decision makers on place-based planning outcomes. As part of the wider architecture of outcome-based funding mechanisms, City Deals and broader reform incentives should be complementary. However, City Deals are unlikely to be an appropriate mechanism to deliver broader, nationally significant infrastructure network and market reforms.

States and territories rely on Australian Government tied and untied grants

Australian Government grants to the states and territories totalled \$102 billion in 2014–15, or about 25% of total Australian Government spending.¹⁹ Tied funding amounted to \$47 billion, while general revenue assistance made up the remaining \$55 billion.²⁰ Despite a recent increase in tied funding, states and territories have discretion over how they spend the majority of funding provided by the Australian Government. **Figure 3** provides a breakdown of Australian Government grants to states and territories in 2014–15.

Figure 3: Australian Government grants to states and territories, 2014–15



Source: Australian Government Treasury (2015)²¹

Infrastructure funding only makes up a small percentage of SPPs and NPAs. Health and education account for two-thirds of SPP funding. NPAs, including infrastructure NPAs, account for 26% of SPP funding.²² NPAs have been a key vehicle to facilitate reforms and support the delivery of projects and services. An incentive-based funding approach could complement these current tied-funding regimes.

Recommendation 2

The Australian Government should use its unique position to lead national infrastructure reform. While key actions will be required at the state, territory and local levels of government, the benefits of reform will be shared across Australia. The Australian Government holds the appropriate funding levers to lead a national, integrated reform program and is likely to be the principal taxation beneficiary of reformed infrastructure sectors.

There is broad agreement on the role of incentive payments to drive reform

The *Australian Infrastructure Plan* advocates for the Australian Government to commit to a structured program of incentive payments linked to reform. There is broad agreement that national infrastructure reform is necessary, and that incentive payments are an appropriate mechanism to drive reform outcomes. In the past, the Productivity Commission, the 2015 *Competition Policy Review* (*Harper Review*), the Australian Competition and Consumer Commission, the National Competition Council, the Australian Industry Group, the Australian Local Government Association, and a number of state and territory governments have supported the use of incentive payments to catalyse national reform.²³ Infrastructure Partnerships Australia, in their 2017 pre-Budget submission, suggested reinstating the Asset Recycling Initiative and committing a further \$20 billion to provide incentives to states and territories to implement national reforms.²⁴

Incentive payments have delivered change in the past

Providing incentive payments in exchange for reform is not a new approach. Past programs, including the National Competition Policy reform program and the Asset Recycling Initiative, have proven highly effective in delivering targeted reform outcomes on a national level.

From 1997–98 to 2005–06, \$5.7 billion (\$2003) worth of conditional payments were made under the National Competition Policy.²⁵ Much of the direct financial return from reforms implemented under the policy was delivered to the Australian Government through tax revenue increases. Payments worked to distribute this revenue to states and territories when they made progress against their reform commitments.

The relatively modest costs associated with incentivising nationally coordinated economic reform under the National Competition Policy were more than justified by the significant and ongoing benefits achieved across the community. National Competition Policy reforms are credited with reversing the economic stagnation of the 1970s and 1980s, decades characterised by slow growth, unemployment and inflation.

The *Harper Review* found that incentive payment approaches undertaken under the National Competition Policy positively contributed to state and territory capacity to implement difficult reforms,²⁶ while a 2005 Productivity Commission review found it had helped raise Australia's GDP by an ongoing annual increase of 2.5%.²⁷ The *Harper Review* also found that 'progress with competition policy reform waned once competition payments ceased'.²⁸

The Asset Recycling Initiative also helped to deliver reform, catalysing \$22 billion in infrastructure investment over its two-year lifecycle.²⁹ Established in 2014, the initiative provided incentive payments to state and territory governments who sold or leased infrastructure assets and reinvested the proceeds into new productive infrastructure.

Upon the sale of an asset, a state or territory would receive a financial contribution of 15% of the assessed value of the asset to be reinvested in economic infrastructure. This incentivised the recycling of capital from existing public infrastructure assets toward new productive investments.

The Australian Government ended the Asset Recycling Initiative in June 2016 with a total of \$3.3 billion worth of incentive payments distributed under the scheme. The Australian Government reallocated the \$854 million of uncommitted money to other priorities.³⁰

These examples demonstrate that, over two different periods, and using two different approaches, Australia has successfully used incentive payments to bring about nationally significant reform outcomes. The success of these approaches provides a useful guide for implementing a renewed incentive-based funding approach to reform.

An incentive-based funding approach is a useful tool for progressing reform

The Australian Government should introduce a new incentive-based approach to funding infrastructure that leverages the vertical fiscal imbalance and links federal funding for infrastructure to the delivery of nationally significant reform outcomes.

This approach to infrastructure funding, which Infrastructure Australia has titled Infrastructure Reform Incentives, would see additional Australian Government investment in state and territory infrastructure – over and above existing allocations – in return for the delivery of agreed infrastructure reforms.

An incentive-based funding approach would help drive the productivity growth Australia needs and deliver a program of nationally significant reforms. Incentive payments should be provided to states and territories, tied to specific reform outcomes, and underpinned by a transparent and fair governance and monitoring structure. Incentive payments could help build a nationally coordinated reform agenda and play a pivotal role in maintaining reform momentum.

Infrastructure Reform Incentives is a framework through which reforms could be delivered. The Australian Government should design an incentive-based funding program in line with its policy objectives, and should negotiate with state and territory governments to agree the details of this approach.

While we recommend incentive payments as a method for progressing reform, the Australian Government should also use other levers, such as regulation, governance, policy and taxation, to drive reform.

Recommendation 3

The Australian Government should use an incentive-based reform program to drive reform. This approach, which has been used successfully in the past, leverages the vertical fiscal imbalance by linking additional funding for infrastructure to the delivery of nationally significant reform outcomes.

An incentive-based reform program should be exempt from the calculation of GST shares

GST distribution should not limit the Australian Government's ability to pursue its policy goals.

It is standard practice for the CGC to include Australian Government contributions to the states and territories in its calculations of a jurisdiction's GST shares. During the 1990s and early 2000s, National Competition Policy payments were treated as entirely separate from GST revenue paid to the states and territories.³¹ Under a new incentive-based reform program, incentive payments should be fully exempt from the calculation of GST as reform benefits can accrue both within and outside of state or territory borders.

Recommendation 4

An incentive-based reform program should be exempt from GST calculations. GST distribution should not limit the Australian Government's ability to pursue its policy goals.



Establishing reform priorities

Recommendations

5. **An incentive-based reform program should be based on a robust and ambitious reform agenda that prioritises national productivity, delivers enduring and inclusive benefits and boosts economic efficiency.** Infrastructure Australia's indicative reform agenda shows that these reforms can deliver significant government revenue and economic productivity gains over time.

Reform selection and prioritisation is important

Incentive payments could catalyse a range of infrastructure reforms and deliver long-term national benefits. However, incentive payments are only worthwhile when paired with a suitable, agreed reform agenda. The rationale and value of an incentive-based reform program depends upon the nature of the reforms.³²

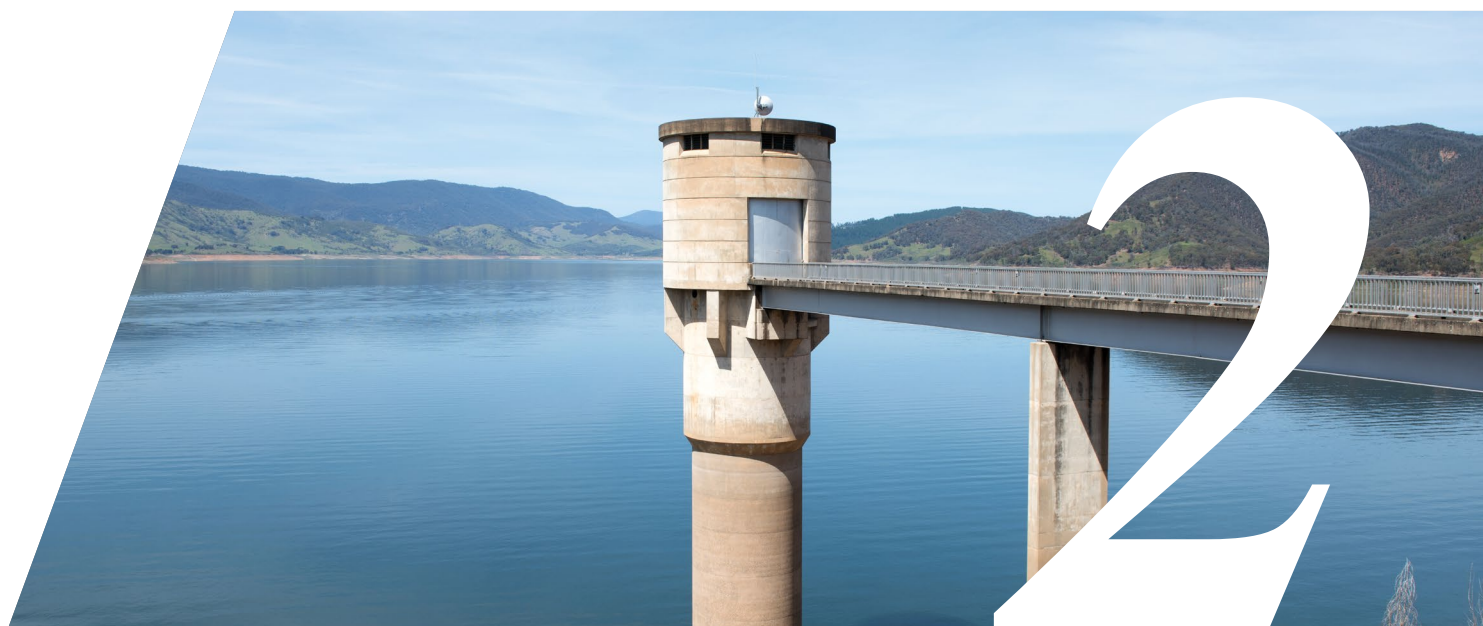
This chapter aims to outline eligibility criteria for selecting reforms to implement under an incentive-based reform program, and identify an indicative reform agenda to provide the Australian Government with a starting point for developing specific reforms. We have also selected and modelled an indicative list of reforms based on the eligibility criteria in order to demonstrate the potential gains from implementing reforms that are well suited to an incentive-based funding approach.

Reforms selected for inclusion within an agenda should aim to deliver four key outcomes:

1. **National benefits:** Reforms should be of national significance and deliver national benefits, contributing to Australia's economic productivity, social wellbeing or environmental sustainability. Such reforms may be cross-jurisdictional, or beyond the capacity of individual states and territories to carry out alone.

2. **Enhanced efficiency:** Reforms should drive the efficiency of Australia's infrastructure markets and networks, which will result in better services for users. Boosting efficiency should reduce infrastructure costs, support a more productive economy and promote sustainable growth.
3. **Long-term benefits:** Reforms should deliver lasting benefits and support long-term structural changes to Australia's economy.
4. **Inclusive benefits:** Reforms should deliver benefits for Australian communities, and enhance the efficiency, accessibility and affordability of infrastructure services for users and taxpayers across the country.

Once a reform agenda has been defined, reform delivery should be prioritised according to the benefit each reform can produce. Reforms capable of generating significant national benefits – including in productivity, efficiency or revenue gains – should be prioritised.



Several reforms are particularly suited to an incentive-based funding approach

Infrastructure Australia has assessed the reform recommendations made in the *Australian Infrastructure Plan* and our subsequent Reform Series against the listed selection criteria. This paper identifies five reforms well suited to an incentive-based funding approach:

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 is not an exhaustive list and should be considered as an illustrative starting point for the types of reforms that could be implemented using an incentive-based funding approach. States and territories, who are best placed to analyse a reform's merit, should work with the Australian Government to develop an appropriate reform agenda as part of an incentive-based program. **Appendix B** details the specific recommendations from the *Australian Infrastructure Plan* and Reform Series for each proposed reform.

Reform can deliver considerable economic benefit to all Australian governments

The potential gains available to Australian taxpayers and communities from infrastructure reforms are substantial. Infrastructure Australia undertook an analysis of the economy-wide impacts on taxation revenue and GDP of five key reforms.

If these reforms are implemented, the Australian Government is projected to receive an estimated \$9 billion permanent annual increase in tax revenue by 2031, rising to \$17.1 billion by 2047 – an estimated increase of 4.6% on 2016–17 levels.³³ Much of this increased federal tax collection comes from growth in the wider economy, such as personal incomes, company taxes and GST. The concurrent implementation of five reforms results in an estimated annual GDP increase of \$46 billion in 2031, and \$66 billion in 2047. This would account for approximately 1.9% of GDP in both 2031 and 2047.

While the Australian Government is the largest beneficiary, states and territories also stand to make substantial gains. The modelling does not show all of the significant and enduring efficiency benefits that states and territories stand to gain, such as eliminating barriers to competition and catalysing innovation – many of which will contribute additional revenue to these economies.



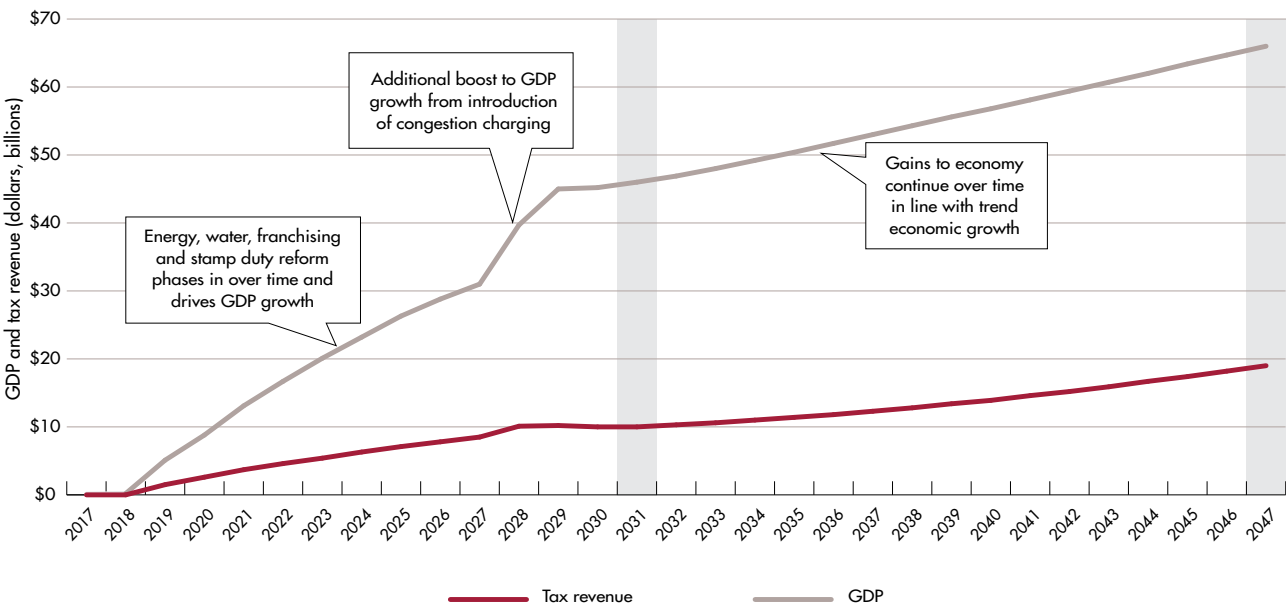
Figure 4 shows the annual change in GDP and tax revenue flowing from the reforms, relative to a baseline scenario where they were not introduced. This figure shows that implementing this concurrent package of reforms will result in steady growth in GDP and tax revenue. GDP in the concurrent reform package is 1% to 2% larger than the sum of the individual reform impacts.

Figure 5 shows the impact of individual reforms on tax revenue and the distribution of revenue gains across various levels of government. It indicates significant revenue gains above baseline estimates – particularly

to GST and state and territory revenue – can be achieved when a concurrent reform package is implemented.

Our modelling has applied assumptions, such as productivity improvements and operational savings, to each reform. The modelling is indicative and does not cover all of the broader regulatory and governance reforms that may be required. **Table 1** summarises the key assumptions applied to each reform as part of the analysis for this paper. A more comprehensive explanation of these impacts and relevant timeframes can be found in the supporting technical report.³⁴

Figure 4: Incremental change in real GDP and tax revenue (\$2016–17)



Source: PwC (2017)³⁵

Figure 5: Tax revenue impact in 2031 and 2047 by type of reform and level of government, in millions

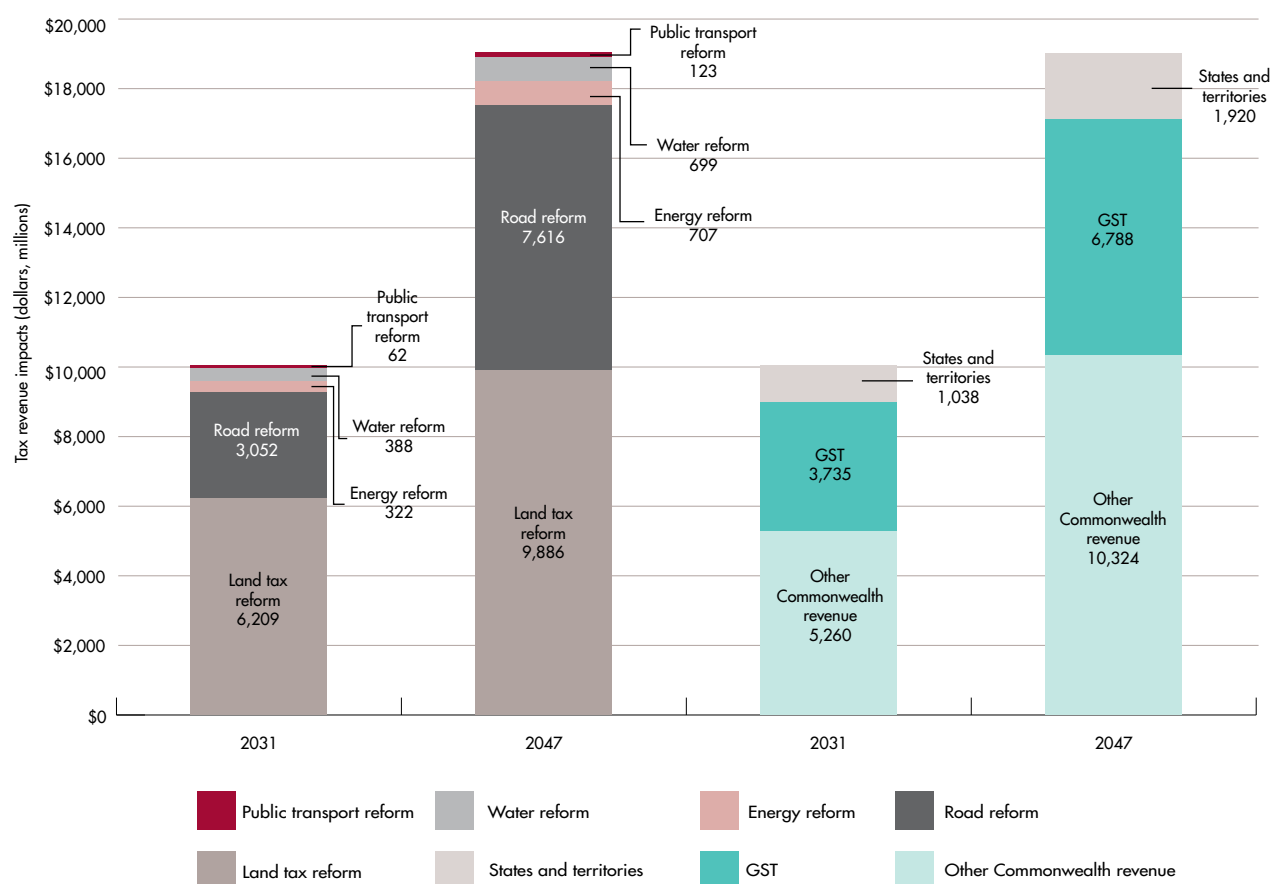
Source: PwC (2017)³⁶

Table 1: Summary of assumptions applied by sector

Reform	Assumptions
Introducing road user charging	<ul style="list-style-type: none"> Heavy vehicles user pricing: 10% productivity improvement to transport sector Rest of fleet user pricing: 15% reduction in the cost of congestion delays to various service sectors using roads
Reforming the urban water sector	<ul style="list-style-type: none"> Metropolitan water utilities privatisation: 10% productivity gain Government owners financial saving: additional 0.15% borrowing cost saving leading to a capital productivity gain for new government investments
Reforming the electricity market	<ul style="list-style-type: none"> Generation privatisation: between 1.5% and 1.8% capital productivity improvement Networks privatisation: 15% operating cost saving to the electricity supply sector Retail pricing competition: 11% reduction in New South Wales gas prices, 7% reduction in Queensland electricity prices and 13% reduction in Western Australia electricity prices Government owners financial saving: additional 0.15% borrowing cost saving leading to a capital productivity gain for new government investments
Reforming land tax	<ul style="list-style-type: none"> Stamp duty reform: average 3% total capital productivity gain across the economy (higher in ownership of dwellings and high land use industries)
Franchising public transport services	<ul style="list-style-type: none"> Rail: 5% initial operational saving scaling up to 32.5% Bus: 10% initial operational saving scaling up to 35%

Source: PwC (2017)³⁷

Introducing road user charging

Australia's road networks are extensive and heavily used. Currently, owners and users of cars and light vehicles pay fuel excise taxes and road registration fees. The revenue gathered through these sources is not directly linked to the cost of road use. There is a growing consensus that Australia needs to adopt a new approach to the way we fund, deliver and operate our roads, otherwise we can expect significant deterioration and congestion across the nation's networks over coming decades.

A reformed charging framework for roads would see all existing taxes and fees removed and replaced with direct charging that reflects each user's own consumption of the network, including the location, time and distance of travel, and the individual characteristics of their vehicle such as weight and emissions. This would also include the implementation of supporting technologies, and fundamental change to legislative and funding arrangements.

The Australian Government supported the Plan's recommendation to implement heavy vehicle road reform

in the next five years, and work is currently underway by all levels of government to progress this reform.

The modelling assumes that fuel tax and registration fees will be replaced with user charges. For both heavy and light vehicles, the modelling takes account of institutional and regulatory reforms that would enable user charging revenue to be directed towards investment in Australia's roads, instead of consolidated revenue. Those investments are likely to facilitate faster, more reliable trips and reduce wear and tear on vehicles.

The modelling also factors in labour and productivity benefits gained from enabling the greater use of heavy vehicles along the local road networks and key freight routes agreed by COAG's Transport and Infrastructure Council in 2014. It also assumes decreases in congestion.

Overall, the suite of road reforms is projected to increase GDP per annum by \$21.3 billion in 2031 and \$36.5 billion in 2047. Government tax revenue is projected to increase by \$3.4 billion per annum in 2031, and \$8.6 billion per annum in 2047. **Table 2** shows the impacts on GDP and tax revenue in 2031 and 2047 from road reforms.

Table 2: Impacts on GDP and tax revenue in 2031 and 2047 from road reforms

	GDP (\$millions, p.a.)		Tax revenue (\$millions, p.a.)	
Year	2031	2047	2031	2047
States and territories	–	–	702	1,734
Australian Government	–	–	2,718	6,862
Total Australia	21,292	36,542	3,420	8,595

Note: Totals may not sum, due to rounding

Source: PwC (2017)³⁸

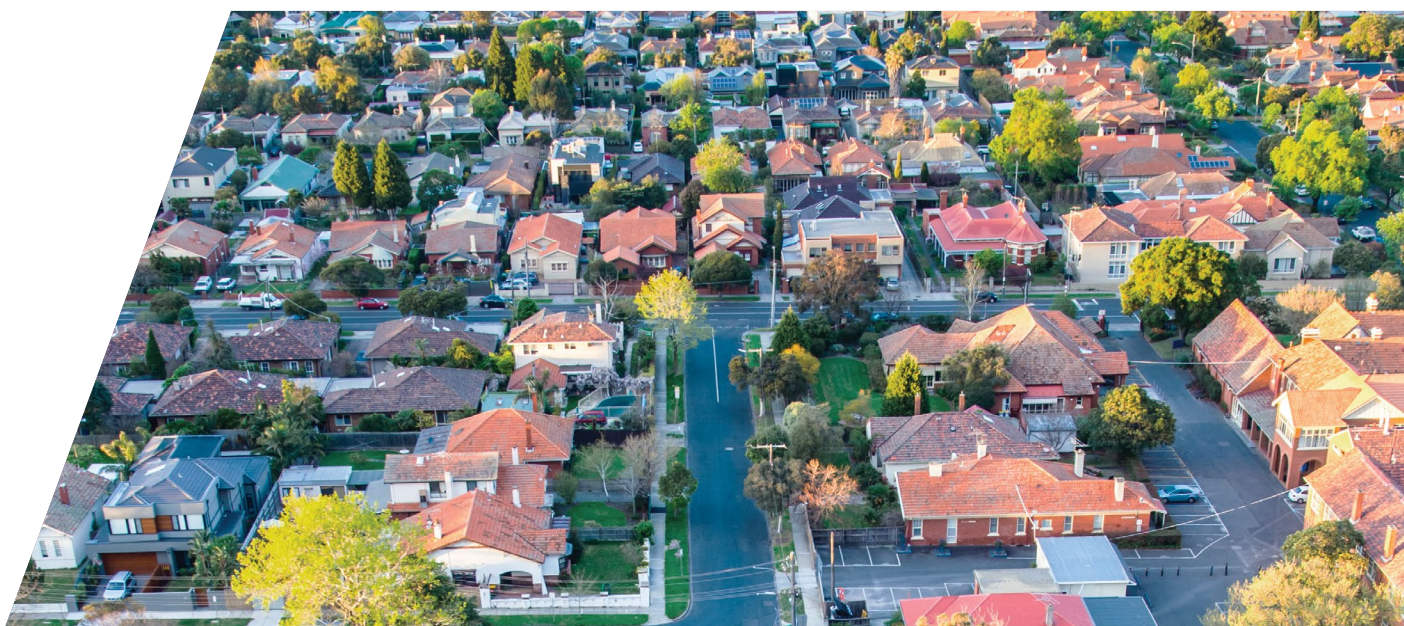
Reforming the urban water sector

Australia's urban water sector provides essential water, sewerage, flood mitigation and stormwater services to more than 20 million people and 9 million connected properties in our cities and towns. The quality, reliability and cost of water infrastructure have a critical bearing on community wellbeing and economic prosperity. A range of challenges are emerging, such as a growing population and ageing infrastructure, that could challenge Australia's water supply and demand. Governments and utilities have a distinct opportunity to plan and prepare for the challenges ahead in a way that will most effectively and efficiently meet the long-term needs of users.

As noted in our *Reforming urban water: A national pathway for change* paper, reform efforts to create an efficient, user-focused urban water sector remain incomplete.³⁹ More work is required to develop stronger market characteristics in each state and territory to meet significant challenges over coming decades. Governments

should update regulatory frameworks to ensure publicly-owned businesses are delivering services efficiently and in the long-term interest of consumers. In particular, governments should take the following actions:

- *Establish a national urban water reform pathway:* Governments should agree on the need for a new national urban water reform plan and a set of clear national objectives for reform. An independent national urban water reform body should be set up to provide the strong national leadership required to advance urban water reforms.
- *Deliver nationally consistent urban water reforms:* Governments should roll out a range of reforms, including refinements to regulation and governance in each state and territory, as well as improvements to long-term planning and pricing frameworks, and enhanced collaboration between regulators. Regional outcomes should be prioritised to ensure users outside major cities also benefit from progress in urban



water delivery, and private participation should be encouraged where there is potential for it to improve services and reduce costs.

- *Consider further reforms over time:* Following delivery of these nationally consistent reforms, governments should consider further structural changes to urban water. Moving to a national regulator and privatising urban water assets could provide substantial benefits to users if implemented in the right way – but the sector should be reformed first.

An incentive-based funding approach provides the Australian Government with the opportunity to coordinate this process, to protect against backsliding and ensure the delivery of consistent outcomes. Incentive payments could be made to states and territories at milestones, including at the establishment of well-functioning, independent regulatory and pricing frameworks, and for longer-term divestment of assets.

For the purposes of modelling, we have only considered the benefits of moving urban water utilities to private ownership. Privatisation of urban water assets remains a question for future state and territory governments, and

should only be considered after a series of no-regrets regulatory reforms that could unlock innovation and efficiency through greater private sector involvement in the short term. Privatisation should be considered in state and territory planning, but not as a short-term fix.

In terms of privatisation, the modelling focuses on efficiency improvements gained from aligning the performances of urban water utilities with the private sector. These benefits stem from outsourcing, Public-Private Partnerships (PPPs), more cost-effective digital solutions for billing and customer care, eliminating cross-subsidies, and achieving positive economic rates of return on investment.

The privatisation of the water sector would result in an estimated overall increase in GDP per annum of \$1.4 billion by 2031, and \$1.8 billion by 2047. In total, state, territory and Australian Government tax revenue is estimated to be \$435 million per annum higher by 2031 and \$789 million per annum higher by 2047 if national water reforms are prioritised. **Table 3** shows the impacts on GDP and tax revenue in 2031 and 2047 from water reforms.

Table 3: Impacts on GDP and tax revenue in 2031 and 2047 from water reforms

	GDP (\$millions, p.a.)		Tax revenue (\$millions, p.a.)	
Year	2031	2047	2031	2047
States and territories	–	–	86	158
Australian Government	–	–	349	631
Total Australia	1,444	1,839	435	789

Source: PwC (2017)⁴⁰



Reforming the electricity market

Australia's electricity sector has undergone a series of reforms over the past three decades. Public sector monopoly assets have been progressively separated into corporatised generation, retail and network components, with some assets transferred into private ownership in some states. Despite the success of these reforms, the *Australian Infrastructure Plan* found that reform of the electricity sector in Australia is incomplete. More recently, efforts have been made to formulate a national energy policy, currently entitled the National Energy Guarantee, which aims to solve the energy trilemma of security, reliability and affordability.

Many publicly-owned electricity network assets and retail and generation businesses are falling short of efficient investment and operational standards. Transitioning remaining publicly-owned electricity businesses to private ownership within a well-structured, well-regulated market is a nationally significant opportunity to improve the efficiency of the sector, deliver improved outcomes to consumers, and enhance Australia's long-term productivity.

Reform is also required to deliver a more flexible approach to how we charge for energy. The current structure of network tariffs limits the extent to which providers can signal for more efficient use, particularly in an environment with a more diverse range of generation sources and high peak demand.

The scale and scope of electricity reform required differs between states and territories. For example, Victoria and South Australia have already transitioned their full electricity businesses into private ownership, while a mix of ownership structures exist across other jurisdictions.

Our modelling takes account of the benefits stemming from the sale of electricity assets (generators and networks) that are currently in public ownership. In modelling the direct economic impacts from the privatisation of the government-owned electricity network businesses, several impacts, such as the savings in capital expenditure of networks and operating costs, indicate that privatisation is likely to result in productivity gains.

The modelling also considers the effects of price deregulation, which could create more efficient and competitive retail energy markets. The modelling assumes that increased competition would mean that less expenditure would be required to produce the same level of output. Some of these benefits could include a reduction of red tape for retailers, with flow on benefits for consumers, including lower energy bills, retailers having greater freedom to offer tailored and innovative utilities packages to customers, and retailers no longer having to offer customers regulated retail energy prices.

The modelling projects that privatisation and price deregulation in the energy sector would generate additional GDP per annum of \$1.7 billion in 2031, and \$2.1 billion in 2047.⁴¹ Tax revenue to the Australian Government and state and territory governments could be \$360 million per annum higher by 2031 and \$798 million per annum higher by 2047. **Table 4** shows the impacts on GDP and tax revenue in 2031 and 2047 from electricity reform.

Table 4: Impacts on GDP and tax revenue in 2031 and 2047 from energy reforms

	GDP (\$millions, p.a.)		Tax revenue (\$millions, p.a.)	
Year	2031	2047	2031	2047
States and territories	–	–	69	160
Australian Government	–	–	291	639
Total Australia	1,692	2,075	360	798

Source: PwC (2017)⁴²

Reforming land tax

Infrastructure Australia's paper, *Capturing Value: Advice on making value capture work in Australia*, examines a range of existing and potential options for capturing any increase in land value caused by public infrastructure investments. The paper found that, while each value capture mechanism comes with risks and rewards, broadening the land tax system while removing inefficient charges, such as stamp duties, could provide a fairer, more efficient way of capturing land value uplift and ensuring land is used most productively.⁴³

By broadening the land tax base, in addition to the removal of other inefficient charges, such as stamp duties, governments could unlock a reliable stream of funding that fairly reflects the productive value of land. The potential benefits of land tax reform are wide-reaching, with positive impacts on housing availability and affordability, transport network efficiency, infrastructure funding sustainability and long-term land use planning.

Stamp duties can have a distortionary impact on housing markets and prevent land from being used most productively. As a tax on transactions, a stamp duty can reduce housing market liquidity by increasing barriers and reducing incentives for moving to housing that best meets a household's needs. Consequently, stamp duties make it harder for those wishing to move closer to employment opportunities to find appropriate housing. For businesses, this reduces the pool of talent from which they can hire,

since it limits the eligible part of the workforce to those within commuting distance of their offices.

Reforms to land tax are already underway in the Australian Capital Territory. In 2012, the Australian Capital Territory Government commenced a 20-year period of phasing out residential property transaction taxes, while phasing in a broad-based land tax. The effect of this reform process has been to reduce the volatility of government revenues by moving from duties to a more reliable and stable land tax revenue stream.⁴⁴

Our modelling assumes that the transition from stamp duties to a broad based land tax will be revenue neutral, as is the case in the Australian Capital Territory, meaning that the new system would not be designed to increase or decrease total collections. The modelling assumes a gradual transition to reflect the reality of the time it takes property to change hands. While full implementation of this reform may take considerable time, it is likely that the efficiency and productivity benefits gained from efficient reallocation of property will be realised early on in the process.

A transition from stamp duty to a broad-based land tax could increase GDP per annum by \$20.8 billion in 2031, and \$24.3 billion in 2047. Government tax revenue is estimated to increase by \$7 billion per annum in 2031, and \$11.2 billion per annum in 2047. **Table 5** shows the impacts on GDP and tax revenue in 2031 and 2047 from stamp duty reform.

Table 5: Impacts on GDP and tax revenue in 2031 and 2047 from land tax reforms

	GDP (\$millions, p.a.)		Tax revenue (\$millions, p.a.)	
Year	2031	2047	2031	2047
States and territories	–	–	1,139	1,809
Australian Government	–	–	5,818	9,349
Total Australia	20,802	24,252	6,957	11,158

Source: PwC (2017)⁴⁵



Franchising public transport services

The franchising of public transport services across Australia's capital cities is an important opportunity to deliver service improvements and reduce costs. Franchising refers to the exposure of public transport services to contestable supply, where government transfers operational responsibilities for the delivery of services for an agreed period of time, via a competitive process. This enables governments to hold a private operator to account via an enforceable contract with clear performance targets and penalties for poor service.

Domestic and international experience shows that together, this combination of contracted requirements, financial rewards and sanctions create a powerful incentive to improve performance and efficiency. Infrastructure Australia's paper, *Improving public transport: Customer focused franchising*, found that franchising rail and bus networks in Australia's largest capital cities would deliver cost savings in the range of \$12 billion to \$16 billion (real 2016 dollars).⁴⁶

Under the proposed approach, governments would reinvest a proportion of the savings from franchising back into the public transport system. The approach borrows from the Asset Recycling Initiative model and enables governments to use the reform as a service improvement tool. **Figure 6** shows the status of Australian public transport operations, as of February 2017.

Our modelling is based on the value of exposing public transport services to contestable supply through franchising to enhance efficiency, service quality and value for money. Operating cost savings from franchising trains and buses were applied in the modelling.

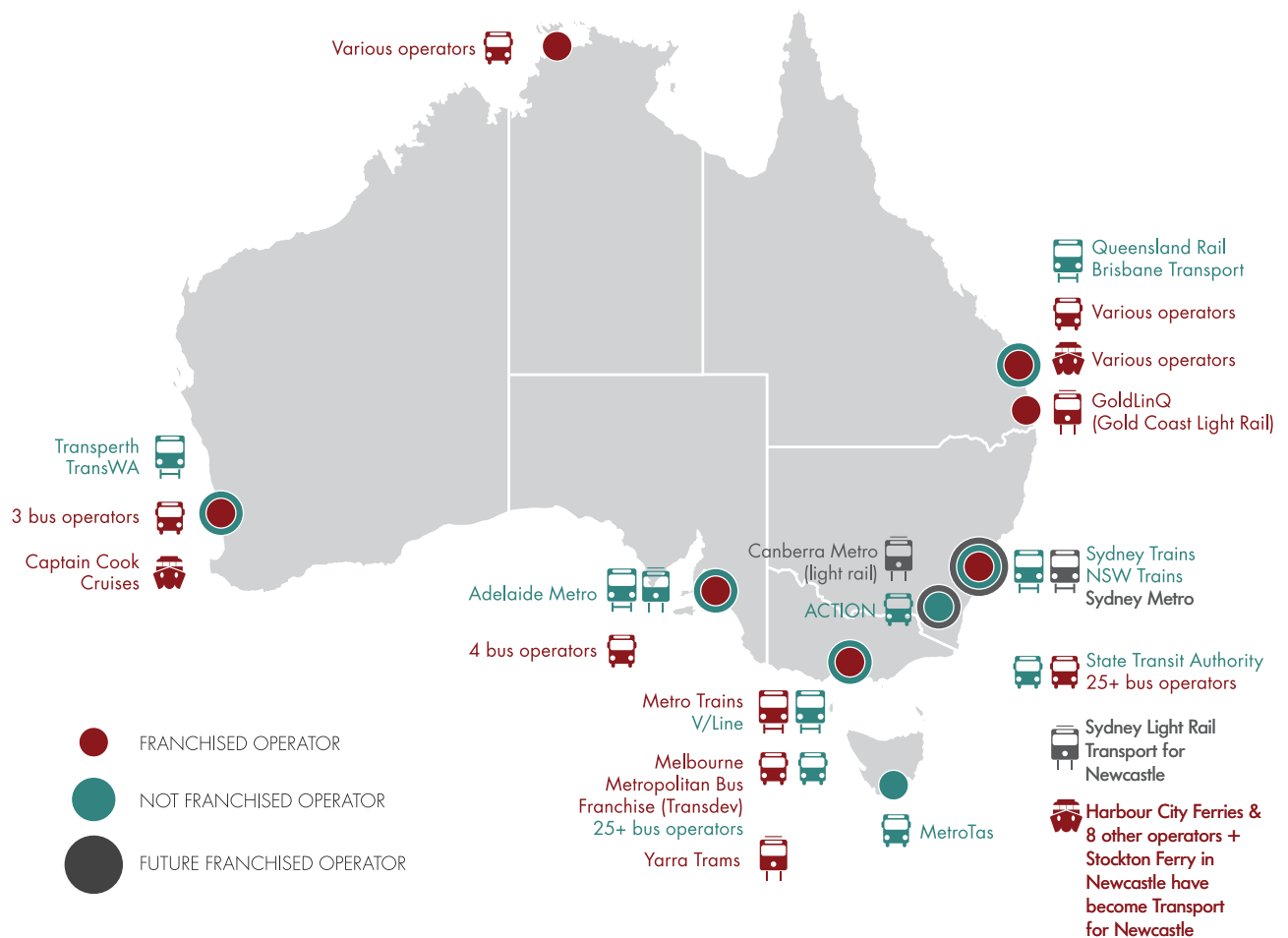
Overall, the franchising of relevant public transport businesses is projected to increase GDP per annum by \$268 million in 2031 and \$372 million in 2047. Government tax revenue is estimated to increase by \$69 million per annum in 2031, and \$139 million per annum in 2047. **Table 6** shows the impacts on GDP and tax revenue in 2031 and 2047 from public transport reforms.

Table 6: Impacts on GDP and tax revenue in 2031 and 2047 from public transport reforms

Year	GDP (\$millions, p.a.)		Tax revenue (\$millions, p.a.)	
	2031	2047	2031	2047
States and territories	–	–	18	40
Australian Government	–	–	51	99
Total Australia	268	372	69	139

Source: PwC (2017)⁴⁷

Figure 6: Status of Australian public transport operations (as at May 2018)



Source: Infrastructure Australia (2017)⁴⁸

Recommendation 5

An incentive-based reform program should be based on a robust and ambitious reform agenda that prioritises national productivity, delivers enduring and inclusive benefits and boosts economic efficiency. Infrastructure Australia's indicative reform agenda shows that these reforms can deliver significant government revenue and economic productivity gains over time.

Constrained fiscal settings should not dissuade governments from using an incentive-based funding approach to drive reform outcomes

Using incentives to drive reform can deliver a two-fold benefit – a short-term boost from investment in productive infrastructure projects, and longer-term productivity and revenue gains from beneficial reforms.

The scale of benefits that could flow from an incentive-based reform program makes this approach a win-win for the Australian Government, as well as state and territory governments. Even after providing incentives to jurisdictions to undertake reforms, the Australian Government could 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.

Developing an incentive-based reform program

Recommendations

6. **An incentive-based reform program should be based on strong and clear principles.** To build trust and create a successful incentive program, decision makers should apply the following three principles:
 - **Accountability** for all participants, including the Australian Government
 - **Transparency** of governance, reform development and monitoring arrangements
 - **Efficiency** of process.
7. **An incentive-based reform program should be underpinned by inclusive, transparent and flexible 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. The process of engagement should reflect this varied state of reform to ensure incentives are fairly distributed.
8. **The payment conditions, size and schedule under an incentive-based reform program should work together to appropriately incentivise states and territories to implement reforms.** Balancing these considerations will be critical to delivering reform and ensuring a responsible and transparent approach to funding.
9. **Robust governance and monitoring mechanisms should be implemented to ensure beneficial and long-lasting outcomes from an incentive-based reform program.** Governance structures should reduce uncertainty, monitor progress toward reform goals, and evaluate reform effectiveness.

An incentive-based reform program should be supported by strong principles

This chapter provides advice for the Australian Government on how to effectively design and implement an incentive-based reform program.

Building trust in an incentive-based reform program is key to participation and successful progression of national reforms. A successful program requires clear and robust

principles. This paper identifies three principles to guide the creation of an incentive-based reform program:

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



We can learn from past experience

An incentive-based reform program should build on and learn from past approaches, such as the National Competition Policy and Asset Recycling Initiative. While these approaches were broadly successful in driving reform and delivering positive change, they were not perfect, and the development of a new program provides the opportunity to improve on past experience.

Key lessons learnt from the National Competition Policy payments program

The use of competition payments was a key function of the National Competition Policy. Payments played a critical enabling role in encouraging jurisdictions to undertake important but difficult reforms.⁴⁹ While significant reform progress was achieved through the incentive payments process, successive reviews have identified learnings that can be applied to future incentive-based funding approaches.

Decision making regarding payments should be transparent. Decisions made regarding how and why payments and penalties were incurred could have been made more transparently under the National Competition Policy payments process. An objective and accurate assessment of reform progress should keep states and territories informed of their obligations. These payments were most successful when they accurately, consistently and transparently reflected the implementation of reforms.⁵⁰

Reforms, not competition payments, should be the primary focus for states and territories. Adherence to reform schedules and requirements is important, however this should not overshadow the primary aim of delivering real reform.⁵¹

Deductions to payments due to non-compliance can act as a powerful motivator. The Australian Government withheld some payments from states and territories for non-compliance with the National Competition Policy rules. This not only made states and territories accountable for reform actions, but also provided a different kind of incentive for them to progress reform. During 2004–05, up to 18% of competition payments were withheld.⁵² While penalty actions are effective, they must be proportionate and transparently administered.

The Australian Government should also be accountable for progressing reforms. Under the National Competition Policy, no penalties could be imposed on the Australian Government. Consequently, the Australian Government's role in progressing reforms was not formally assessed.⁵³ Feedback from states and territories indicated they were more likely to institute reforms with the knowledge that the Australian Government was also accountable for its actions in progressing the reform process.⁵⁴ The Australian Government should build trust with states and territories by subjecting itself to the same accountability and transparency in decision making as other jurisdictions under the program.

Recommendation 6

An incentive-based reform program should be based on strong and clear principles. To build trust and create a successful incentive program, decision makers should apply the following three principles:

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

Considering how states and territories will participate

The Australian Government should engage states and territories to ensure an incentive-based funding approach delivers appropriate levels of opportunity, risk and reward for all participants. There are two broad options for state and territory government participation – opt-in or comprehensive participation. Both approaches have merits but also require trade-offs specific to the reforms being enacted and jurisdictions participating.

The opt-in approach, as adopted by the Asset Recycling Initiative and the recent COAG Intergovernmental Agreement on Competition and Productivity-enhancing Reforms, allows states and territories to determine whether they should sign up to an incentive-based reform program. Under this approach, the success of a program would rely on the ability of the Australian Government to construct an attractive reform program tied to incentive payments to encourage states and territories to participate. This approach risks creating fragmented reform results if states and territories do not sign up.

Alternatively, a comprehensive participation approach would require all states and territories to sign up to the program. Uniform participation would ensure that no part of Australia is left behind in the reform process and would provide the opportunity to deliver national and cross-jurisdictional reforms with greater ease. However, requiring full participation and consensus may take more time, potentially delaying the implementation of a number of important reforms.

The state of reform differs between states and territories

Individual states and territories have reformed aspects of their infrastructure markets and networks in different ways and at different times. This means progress towards uniform, nationally significant reforms is fragmented across Australia.

Negotiation may be required between states, territories, and the Australian Government as to whether retrospective incentive payments may be appropriate when states and territories have already undertaken reforms unilaterally, or as part of previous rounds of reform. It is possible that past reform work will not attract incentive payments.

Deciding whether reforms are compulsory or optional will have significant consequences

Once states and territories have committed to an incentive-based reform program, there are several options for engagement with particular reforms within the program. There are three broad options – selective, comprehensive and split.

A selective model would allow jurisdictions to choose the reforms in which they will participate. The strength of this approach lies in states and territories' ability to engage with reforms that would deliver the greatest benefit or likelihood of success to their own jurisdiction. However, this could be at the expense of other important – and possibly more complex – reforms of national significance. This approach could also reduce the ability to nationally coordinate delivery of the program.

Alternatively, a comprehensive model would require the delivery of all reforms in the program. This approach would have to take account of the varying state of reform between jurisdictions.

The third option is a mix between the two. A split selective-comprehensive model could provide a mid-point, defining certain reforms as compulsory and others as optional. This could allow prioritisation of the most essential productivity-enhancing reforms without compelling all states or territories to agree to the full program. A combination of the benefits and risks for the selective and comprehensive models would therefore apply.

Tailoring reforms can drive better outcomes

Allowing flexibility in a jurisdiction's implementation of a reform could enable more efficient outcomes. The National Competition Policy permitted each state and territory to tailor its own reforms, so long as they were consistent with the broader reform principles articulated in the framework, such as competitive neutrality and monopolistic pricing reform. This flexibility encouraged jurisdictional autonomy and recognised differences between jurisdictions while achieving core reform outcomes.⁵⁵

A national reform agenda needs to respect the processes required in each jurisdiction to advance reforms, and the autonomy of those governments to advance reform in a way that best meets their needs. A national reform agenda should harness local expertise, rather than seeking to override it. Respecting local autonomy and giving states and territories ownership over reform implementation is key

to making them advocates for change, and establishing and maintaining the support of local communities.

State and territory buy-in to reform requires strong, long-term commitment by the Australian Government

Long-term bilateral agreements between jurisdictions and the Australian Government should form the backbone of any incentive-based funding approach. States and territories need assurance that pledges will be honoured outside of electoral cycles. Formalised agreements will give new governments confidence that the Australian Government will not walk away from their obligation to maintain incentive payments. Australian governments should commit to this institutional process to provide confidence, sustained cooperation and transparency.

The evidence base should be deepened

Where this is not already done by treasuries during the policy formulation stage, there should be extensive quantitative forecasting of any reform's economic outcomes, predicted productivity gains, recurrent expenditure as well as any other metrics that could add useful detail to the reform selection process. The benefits and impacts of reforms should be apparent. Quantification of reforms will build consistency, confidence and trust. Deepening the evidence base will guide government decisions on reform priorities.

Recommendation 7

An incentive-based reform program should be underpinned by inclusive, transparent and flexible 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. The process of engagement should reflect this varied state of reform to ensure incentives are fairly distributed.

Ensuring the right funding approach

Fiscal reward can be a catalyst for the implementation of reforms. National Competition Policy payments played a 'pivotal role in maintaining reform momentum within the states and territories'.⁵⁶ The amount of funding allocated to incentive payments will therefore play an important role in securing and maintaining state and territory participation and in achieving reform outcomes. The Australian Government should consider funding availability, payment conditions, payment size and payment schedules when designing an incentive-based reform program.

Conditions for payment should be well defined

Less prescriptive incentive payment conditions that guide rather than prescribe could provide greater flexibility. The success of the National Competition Policy hinged on allowing states freedom in their approaches to delivering reform. By making the reform process palatable, the Australian Government garnered uniform support for the payment policy. This proved to be a key feature of the National Competition Policy's success.⁵⁷ The *Australian Infrastructure Plan* also recommended that Australian Government incentive payments focus on facilitating infrastructure investments.

States and territories should be required to use their incentive payments to reinvest in productive infrastructure. Once this reinvestment is made, the jurisdiction should receive a further, additional payment from the Australian Government. Similar requirements were attached to the Asset Recycling Initiative, which provided incentive payments for states that sold assets and reinvested the sale proceeds in productive infrastructure.

The size of incentive payments should reflect reform outcomes

The size of each payment should reflect the national productivity outcomes of the reform action it is incentivising. There are a number of key factors that should be considered when determining payment sizes. Payments should be:

- of a size that incentivises real action towards reform delivery
- of a size that takes into account the complexity and cost of implementing the reform
- proportional to the national benefit achieved through the reform
- proportional to a jurisdiction's size, with per capita adjustments made accordingly.

In their assessment of the National Competition Policy, the National Competition Commission found that even when competition payments were small relative to state and territory budgets, they represented a 'significant source of incremental funds' and provided an opportunity to build community support for reform.⁵⁸ Similarly, the *Harper Review* notes that 'although the quantum of the payments was not large compared to total state and territory revenues, representatives consistently argued that the payments provided an additional argument that could be used to support reform'.⁵⁹

A clear incentive payment schedule is required

The payment schedules under an incentive-based reform program should reflect the economic impact and nature of the reform, and the resources and time required to deliver it. Making accurate, appropriately timed and transparent incentive payments adds credibility to the reform program and encourages timely reform action.

The payment schedule for an incentive-based reform program should build on the National Competition Policy experience, and could include the following features:

- **Payments linked to specific reform milestones:** This could help to enforce a timeline for delivery and maintain focus on specific actions towards delivering reforms.
- **Cumulative payment approach:** If one milestone is met, a jurisdiction would then be eligible for the next payment, conversely failure to reach one milestone locks jurisdictions out of following payments.

Recommendation 8

The payment conditions, size and schedule under an incentive-based reform program should work together to appropriately incentivise states and territories to implement reforms. Balancing these considerations will be critical to delivering reform and ensuring a responsible and transparent approach to funding.

A monitoring and evaluation framework should drive accountability

An incentive-based reform program should have a clear monitoring and evaluation framework. Such a framework would drive accountability, including at the federal level, reduce uncertainty, and allow states and territories to commit to the program with full confidence. A monitoring and evaluation framework should serve two primary functions:

1. **Assessing ongoing payment eligibility:** identifying when jurisdictions have achieved reform milestones to determine when payments are made. Incentive payments could be contingent on regular monitoring and evaluation progress reports that demonstrate payment milestones are satisfied.
2. **Evaluating the economic outcomes of reform:** evaluation of economic outcomes, disproportionate revenue flows and a reform's value for money.

The Australian Government should also be subject to appropriate monitoring and evaluation of its role within the program. Building trust with states and territories requires transparency and accountability at the national level. For instance, maintaining the integrity of the process would require discipline from all jurisdictions to adhere to the agreed program and not enter into additional side deals. There may be a role for monitoring through an organisation such as COAG, and conducting audits under the Australian National Audit Office.

Assessments and reports should be measurable and public

The performance of states, territories and the Australian Government should be clear and measurable, as reforms are more likely to be successful where commitments are well defined.⁶⁰ Recent experience, particularly from the National Competition Policy, shows that the perception of arbitrary assessments can stunt reform efforts and motivation.⁶¹

While penalty actions are effective, they must be proportionate and transparently administered. Penalties for minor matters may frustrate reform efforts if states and territories perceive them to be arbitrary or disproportionate.⁶²

Recommendation 9

Robust governance and monitoring mechanisms should be implemented to ensure beneficial and long-lasting outcomes from an incentive-based reform program. Governance structures should reduce uncertainty, monitor progress toward reform goals, and evaluate reform effectiveness.



Implementing a successful program

This paper provides a starting point for governments

This paper makes the case for an incentive-based approach to infrastructure reform, and suggests a foundation for developing an incentive-based reform program. It aims to give decision makers a framework to build on, not a comprehensive policy model. The success of any future incentive-based reform program will depend upon many variables, ranging from the amount of available funds, to the level of participation of states and territories. While this paper recommends certain foundations and principles, such a program in its final form should be carefully developed in collaboration with all Australian governments. The Australian Government, and state, territory and local governments are best placed to outline the nuances of an incentive-based payment architecture.

As outlined in **Chapter 3**, Infrastructure Australia recommends that the overarching principles of accountability, transparency and efficiency should inform the creation of an incentive-based reform program and supporting institutional frameworks. Adherence to these principles will help to clearly define roles and responsibilities, rewards for good performance and, where appropriate, the capacity to impose sanctions for poor performance. While products of their time, past experience from the National Competition Policy and the Asset Recycling Initiative provides a useful foundation for developing a new incentive-based reform program.

The Australian Government should lead the development of an incentive-based reform program

The Australian Government's response to the *Australian Infrastructure Plan* signalled support for Infrastructure Reform Incentives, subject to funding availability and other existing approaches to funding. This paper demonstrates that pursuing well-considered infrastructure reforms using incentive mechanisms can produce substantial gains to the Australian Government's net financial position, which is likely to mitigate funding constraints.

National reforms require strong collaboration between the Australian Government, and state and territory governments. While the benefits of reform will be felt across the economy, the responsibility for implementing them will lie with state and territory governments. For this reason, the Australian Government has an important leadership role in formulating, coordinating and funding an incentive-based reform program.

4



List of recommendations

1. **Australia should initiate an ambitious program of infrastructure reform focused on increasing the productivity of the Australian economy.** Making our infrastructure more efficient will enable Australia to generate more from our vast natural resources and highly skilled workforce, in turn increasing our means to connect and compete across domestic and global markets.
2. **The Australian Government should use its unique position to lead national infrastructure reform.** While key actions will be required at the state, territory and local levels of government, the benefits of reform will be shared across Australia. The Australian Government holds the appropriate funding levers to lead a national, integrated reform program and is likely to be the principal taxation beneficiary of reformed infrastructure sectors.
3. **The Australian Government should use an incentive-based funding approach to drive reform.** This approach, which has been used successfully in the past, leverages the vertical fiscal imbalance by linking additional funding for infrastructure to the delivery of nationally significant reform outcomes.
4. **An incentive-based reform program should be exempt from GST calculations.** GST distribution should not limit the Australian Government's ability to pursue its policy goals.
5. **An incentive-based reform program should be based on a robust and ambitious reform agenda that prioritises national productivity, delivers enduring and inclusive benefits and boosts economic efficiency.** Infrastructure Australia's indicative reform agenda shows that these reforms can deliver significant government revenue and economic productivity gains over time.
6. **An incentive-based reform program should be based on strong and clear principles.** To build trust and create a successful incentive program, decision makers should apply the following three principles:
 - **Accountability** for all participants, including the Australian Government
 - **Transparency** of governance, reform development and monitoring arrangements
 - **Efficiency** of process.
7. **An incentive-based reform program should be underpinned by inclusive, transparent and flexible 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. The process of engagement should reflect this varied state of reform to ensure reform incentives are fairly distributed.
8. **The payment conditions, size and schedule under an incentive-based reform program should work together to appropriately incentivise states and territories to implement reforms.** Balancing these considerations will be critical to delivering reform and ensuring a responsible and transparent approach to funding.
9. **Robust governance and monitoring mechanisms should be implemented to ensure beneficial and long-lasting outcomes from an incentive-based reform program.** Governance structures should reduce uncertainty, monitor progress toward reform goals, and evaluate reform effectiveness.



Appendix A: Australian Government infrastructure funding architecture



	Energy	Transport	Telecommunications	Water	Other	
Tied funding	Australian Renewable Energy Agency [⚡]				Regional Development Initiatives ^{^^^} [⚡]	Stronger Communities Program ^{^^^} [⚡]
	Clean Energy Innovation Fund [⚡]	Renewable Energy Venture Capital Fund [⚡]	Mobile Black Spots Program [📶]	Murray-Darling Basin Regional Economic Diversification Program [⚡]	Building Better Regions Fund [⚡]	Tasmanian Jobs & Growth Package [⚡]
	Advancing Renewables Program [⚡]	Research & Development Program [⚡]	Universal Service Obligation [📶]	South Australian River Murray Sustainability Program [💧]	National Stronger Regions Fund [⚡]	Smart Cities & Suburbs Program [⚡]
	Cooperative Research Centres Program [⚡]	Solar Towns Program ^{^^^} [🌿]		National Water Infrastructure Fund Program [💧]	Indian Ocean Territories Community Development Grants Program [⚡]	Regional Growth Fund [⚡]
	Carbon Capture & Storage Flagships Program [⚡]			Sustainable Rural Water Use & Infrastructure Program [💧]	Community Development Grants Program [⚡]	Drought Communities Program ^{^^^} [⚡]
		Infrastructure Investment Program & Infrastructure Maintenance [⚡]			Financial Assistance Grants [💵]	
Untied funding		Bridges Renewal Program [⚡]				
		Investment Road & Rail Program [⚡]				
		Black Spot Program [⚡]				
		Heavy Vehicle Safety & Productivity Program [⚡]				
		Roads to Recovery Program [⚡]				
		Northern Australia Beef Roads Program [⚡]				
		Supplementary Local Roads Funding for South Australia ^{^^} [⚡]				
		Northern Australia Roads Program [⚡]				
		Remote Airstrips Upgrade Program ^{^^^} [⚡]				
		National Highway Upgrade Program [⚡]				
Concessional Loans	Clean Energy Finance Corporation [🌿]	Clean Energy Finance Corporation Investment Mandate [🌿]	WestConnex [⚡]	Sunshine Coast Airport [⚡]	National Water Infrastructure Loan Facility ^{***} [⚡]	Northern Australia Infrastructure Facility [⚡]
						University of Sunshine Coast [⚡]
Equity	Snowy Hydro Ltd [⚡]	Moorebank [^] [⚡]	Australian Rail Track Corporation [^] [⚡]	Regional Broadband Scheme [📶]		
		Western Sydney Airport Corporation [^] [⚡]	National Broadband Network ^{**} [📶]			
Incentive Payments					Asset Recycling Initiative ^{****} [💵]	
Under these programs & initiatives, Commonwealth Government funding & financing is provided to:						
	Local Govt	Other proponents	Local Govt or other proponents			
	Government Business Enterprises	State/Territory Government or Local Govt	State/Territory Govt			
Funding provided by:			⚡ Department of Infrastructure, Regional Development & Cities			
			📶 Department of Communication & Arts			
			🌿 Department of Resources, Energy & Tourism			
			💧 Department of Environment & Energy			
			⚡ Department of Industry, Innovation & Science			
			📶 Australian Communications & Media Authority			
			💵 Department of the Treasury			
			💧 Department of Agriculture & Water Resources			

* Minister for Regional Development and Minister for Agriculture and Water Resources joint shareholder ministers

[^] Minister for Infrastructure and Minister for Finance joint shareholder ministers

** Minister for Communications and Minister for Finance joint shareholder ministers

^{^^} Funding provided to state governments who select community projects for funding

^{***} Administered by the Department of Infrastructure, Regional Development and Cities. Will be transferred to the Regional Investment Corporation, under the Department of Agriculture and Water Resources, in July 2018

^{^^^} Programs attracting less than (and including) \$40 million in funding

^{****} Discontinued in 2016. Agreement expires in 2019

Appendix B:

Indicative reform agenda

Proposed reform	Recommendations from the Australian Infrastructure Plan and the Infrastructure Australia Reform Series	Australian Government Response
Introducing road user charging	<p>Australian Infrastructure Plan, Recommendation 5.4 Federal, state and territory governments should commit to the full implementation of a heavy vehicle road charging structure in the next five years. This reform must include the removal of all existing registration and usage charges under the PayGo model and the introduction of supporting regulatory and investment frameworks.</p>	The Australian Government supports this recommendation , noting this is also a matter for consideration by state and territory governments.
	<p>Australian Infrastructure Plan, Recommendation 5.5 Federal, state and territory governments should also commit to the full implementation of a light vehicle road charging structure in the next 10 years. This reform must include the removal of all existing inefficient taxes – including fuel excise and registration charges – and the development of supporting regulatory and investment frameworks.</p>	The Australian Government notes this recommendation which is also a matter for consideration by state and territory governments.
	<p>Australian Infrastructure Plan, Recommendation 6.13 Australia should seek to transition the revenue and funding framework for roads to be consistent with other utility networks by establishing a corporatised delivery model. A regulated asset base approach provides a strong framework to achieve this outcome. As part of the broader public inquiry into road funding reform, the Australian Government should direct a body like Infrastructure Australia or the Productivity Commission to:</p> <ul style="list-style-type: none"> ■ Research the merits of a corporatised model for Australia's road network(s) to establish a reform pathway over the medium term; and ■ Evaluate and define the pathway to establish the corporatised road fund model in jurisdictions, including provisions for hypothecation of existing taxes and charges to support the delivery of transport infrastructure in advance of the introduction of user charging. This work should be delivered in tandem with heavy vehicle charging and investment reform. 	The Australian Government notes this recommendation and is undertaking further investigation.



Proposed reform	Recommendations from the <i>Australian Infrastructure Plan</i> and the <i>Infrastructure Australia Reform Series</i>	Australian Government Response
Reforming the urban water sector	<p><i>Australian Infrastructure Plan, Recommendation 6.10</i> Governments should define a pathway to transfer state-owned metropolitan water utility businesses to private ownership to deliver more cost-effective, customer-responsive services. That pathway will:</p> <ul style="list-style-type: none"> ■ Implement policy and institutional reforms to promote competitive neutrality in advance of privatisation, including full cost recovery pricing and commercial rates of return on capital; ■ Introduce independent economic regulation, with the potential for the regulatory framework to be set nationally to avoid perceived conflicts of interest; and ■ Apply uniform drinking water quality and environmental regulation. ■ These reforms should be delivered within five years. 	The Australian Government notes this recommendation , noting this is a matter for state and territory governments.
Reforming the electricity market	<p><i>Australian Infrastructure Plan, Recommendation 6.4</i> All governments should transfer their remaining publicly-owned electricity generation, network and retail businesses to private ownership. Public ownership of commercial businesses, including monopolies in well-regulated markets, distorts outcomes, stifles competition and harm consumers. Priorities include:</p> <ul style="list-style-type: none"> ■ All remaining retail and generation businesses in public ownership should be prepared for sale, including Snowy Hydro; and ■ Queensland, Western Australia, Tasmania and Northern Territory should begin the process of explaining the need for reform to the community, with a view to divesting all electricity network assets. New South Wales should articulate a pathway to a full sale as soon as practically achievable following the partial lease process currently underway. <p><i>Australian Infrastructure Plan, Recommendation 6.5</i> Governments, through the COAG Energy Council and the Australian Energy Market Commission, should introduce more flexible network tariffs in the near term. Governments should publicly renew their commitment to this reform and work with relevant bodies to communicate the consumer benefits of a more flexible tariff arrangement.</p>	<p>The Australian Government notes this recommendation, recognising that while the Australian Government has a national leadership role to play in regard to energy policy and related national security interests, ownership of publicly-owned assets is generally the responsibility of the relevant state and territory governments.</p> <p>The Australian Government supports this recommendation.</p>



Proposed reform	Recommendations from the Australian Infrastructure Plan and the Infrastructure Australia Reform Series	Australian Government Response
Reforming the electricity market (cont.)	<p>Australian Infrastructure Plan, Recommendation 6.6 The Australian Energy Market Commission, in cooperation with governments, should develop electricity metering competition to facilitate the efficient, market-led rollout of smart metering technologies, taking into account positive and negative lessons from Victoria. Smart meters will support more flexible and efficient electricity tariff arrangements.</p>	The Australian Government supports this recommendation.
	<p>Australian Infrastructure Plan, Recommendation 6.7 Australia's electricity and gas markets should move to full retail price deregulation as soon as practically possible. To support this:</p> <ul style="list-style-type: none"> Where price deregulation has not occurred in the retail electricity market, the Australian Energy Market Commission should provide advice and a pathway for removing price regulation; and The Australian Government should undertake a review to identify ways to increase competition in the retail gas market (consistent with the Harper Review). 	The Australian Government supports this recommendation.
Reforming land tax	<p>Reform Series – Capturing Value, Finding 6 A broad-based land tax – accompanied by the removal of inefficient taxes such as stamp duty – would provide an efficient, sustainable approach to value capture in Australia. While a number of mechanisms can provide individual solutions for specific projects, reform of land tax presents a clear opportunity for a more sustainable, longer term reform. The impact of this change could be streamlined by broadening existing state-based charges, and aligning payments with local property rates cycles.</p>	The Australian Government has not yet responded to this paper. This was also a key recommendation of <i>Australia's Future Tax System: Report to the Treasurer (Henry Review)</i> .
Franchising public transport services	<p>Australian Infrastructure Plan, Recommendation 6.14 Governments should adopt a default option of exposing public transport services to contestable supply through franchising. The focus of reform should be to improve customers' experience by exposing delivery to contestable supply and selecting the best operator to provide services. Private operation of public transport through time limited, exclusive franchises – where providers compete to deliver services – is a proven model both in Australia and overseas in raising service quality and value for money for customers. It should be the default option for public transport provision, with capital city bus and rail services as immediate candidates for franchising.</p>	The Australian Government supports this recommendation, noting this is primarily a matter for state and territory governments.



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Making Reform Happen
Using incentives to drive a new
era of infrastructure reform

June 2018

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