Opening statement to the Senate Economics Committee Inquiry into the Commonwealth's investment in and planning of infrastructure – by Saul Eslake, economist, 14th August 2015

Thank you for the invitation to speak to you today on the subject of the Australian Government's investment in and planning of infrastructure. I appreciate it, and regard it as an honour.

Governments have had responsibilities for providing economic and social infrastructure since Roman times, if not before. The idea that government spending on infrastructure can play a useful role in economic management, and in particular in offsetting the effects of large swings in private investment, is of more recent provenance, but it is hardly new – having been advocated by politicians such as US President Franklin D Roosevelt and here in Australia by Ted Theodore during the Great Depression, and given a formal underpinning in economic theory by Maynard Keynes in 1936.

The idea of using public infrastructure investment in this way fell out of favour towards the end of the 20th century, partly for ideological reasons, but also for the important practical reason that governments, including here in Australia, found it very difficult to get the timing right. Governments have often found it difficult to ensure that public infrastructure spending does actually ameliorate the business cycle rather than exaggerate it (or, as economists would say, operates in a counter-cyclical rather than a pro-cyclical fashion). That was particularly apparent during and after the recession of the early 1990s, when the infrastructure spending programs launched by the Keating Government under the heading of 'One Nation' didn't begin to roll out until after the recession was over, and instead by co-inciding with the subsequent upswing in private sector spending, had the unintended effect of adding to upward pressure on interest rates.

Such difficulties are to some extent inherent in the nature of infrastructure spending. Public sector infrastructure projects are usually complex; require considerable planning, especially if they entail the acquisition of land; involve a large number of tenders for work, underpinned by lengthy and complicated legal documentation; and take years to be completed. Legislative requirements – especially when more than one level of government is involved, as is often the case in Australia – add to the difficulties of matching the timing of infrastructure spending to the business cycle.

Despite these difficulties, mainstream opinion among economists has become more supportive of the idea that public infrastructure spending can have beneficial effects, both in the short term in ameliorating protracted weakness in household or business spending, especially in circumstances where the efficacy of monetary policy to that end has become limited; and over longer periods as a result of the contribution that well-chosen infrastructure projects can make to enhancing productivity growth.

This case was outlined by the International Monetary Fund, usually regarded as a bastion of economic orthodoxy, in its *World Economic Outlook* publication of October last year:

> "For economies with clearly identified infrastructure needs and efficient public investment processes and where there is economic slack and monetary accommodation, there is a strong case for increasing public infrastructure investment. Moreover, evidence from advanced economies suggests that an increase in public investment that is debt financed would have larger output effects than an increase that is budget neutral"[1].

[1] International Monetary Fund, *World Economic Outlook: Legacies, Clouds, Uncertainties*, October 2014, p. 89.

The IMF goes on to emphasize that this conclusion is "not ... a blanket recommendation for a debt-financed public investment increase across all economies", but the conditions which would prompt the IMF to counsel caution in particular cases – where debt-to-GDP ratios are already high or where returns to infrastructure investment are uncertain – do not seem to be pertinent in the Australian context.

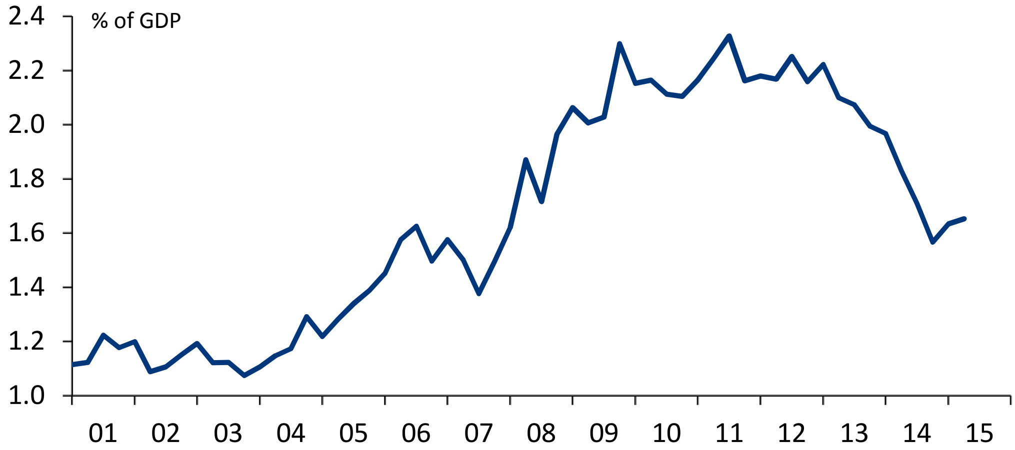
More recently, Reserve Bank Governor Glenn Stevens has observed that "it is perfectly sensible for some public debt to be used to fund infrastructure that will earn a return", noting in that context that "funding would be available, with long-term interest rates the lowest we have ever seen or are likely to"[2].

Business investment has fallen by the equivalent of 3.6 pc points of GDP since peaking at 18.5% of GDP in the December quarter of 2012, largely as a result of the decline in resources investment from the record high reached at that time. As the Reserve Bank noted in last week's *Statement on Monetary Policy*, mining investment is likely to continue to decline, as "more projects reach completion, but few new projects commence"; while outside of the mining sector "business are waiting to see a sustained increase in demand before committing to new investment projects"[3].

It is in precisely this context that Glenn Stevens suggested that "infrastructure spending has a role to play in sustaining growth and also in generating confidence …. It would be confidence-enhancing if there was an agreed story about a long-term pipeline of infrastructure projects, surrounded by appropriate governance on project selection, risk-sharing between public and private sectors at varying stages of production and ownership, and appropriate pricing for use of the finished product"[4].

It would be difficult to argue that such a 'confidence-enhancing' story can be told at present. Engineering construction work done by or for the public sector has fallen from a peak of 2.3% of GDP in the June quarter of 2011 to 1.7% of GDP in the March quarter of 2015. That's a little above the level for the two preceding quarters, in which engineering construction work done by or for the public sector were smaller as a proportion of GDP since the September quarter of 2007 (see Chart 1).

Chart 1: Engineering construction work done by or for the public sector as a pc of GDP



Source: ABS, *Engineering Construction, Australia* (catalogue no. 8762.0), and author's calculations.

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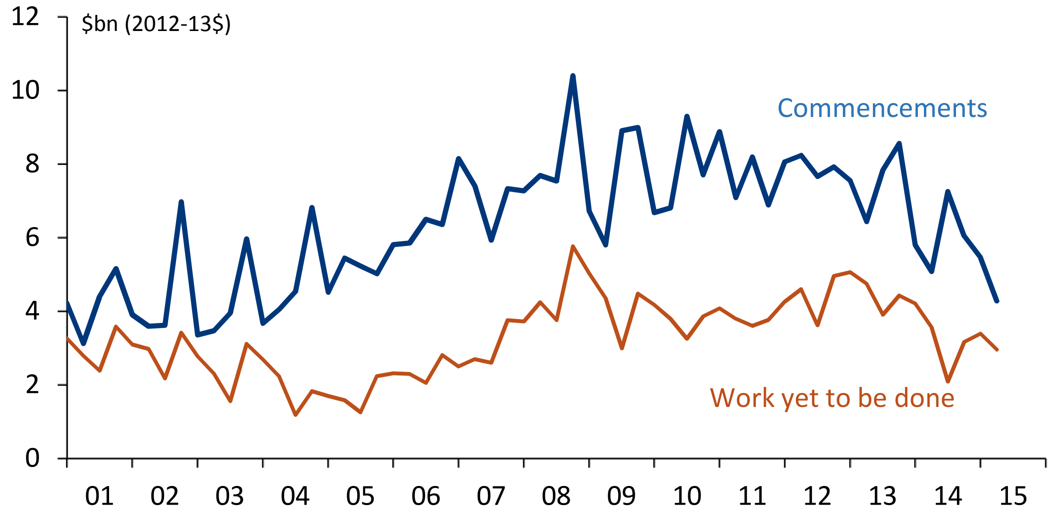
[2] Glenn Stevens, 'Economic Conditions and Prospects: Creating the Upside", Address to the Economic Society of Australia, Brisbane, 10th June 2015.

[3] Reserve Bank of Australia, *Statement on Monetary Policy*, 6th August 2015, p. 2.

[4] Glenn Stevens, *op. cit.*

The volume of engineering commencements by or for the public sector, and the 'pipeline' of work still to be done on existing projects by or for the public sector, have also been on a declining trajectory for some time (Chart 2).

Chart 2: Volume of engineering construction commencements and work yet to be done by or for the public sector



Source: As for Chart 1.

One of the principal reasons for the caution exhibited by successive governments of both political persuasions, at both the Commonwealth and State levels, regarding the funding through additional debt issuance of higher levels of infrastructure investment is the concern at the risk that this could trigger an adverse reaction from credit rating agencies, leading in turn to a downgrading of the Commonwealth's or a State's sovereign debt rating and thence to higher debt servicing costs.

There is no widely-shared consensus among mainstream economists as to how seriously such concerns should be ranked, as against other objectives and risks. The capacity to raise debt finance, when needed, or to refinance maturing debt, at advantageous interest rates is not something to be dismissed lightly: yet nor should it, in my opinion, be elevated above all other fiscal and economic policy objectives.

In the Australian federal system, the primary responsibility for public sector infrastructure spending has traditionally resided with the States and Territories, and with local governments. On average over the past decade, State and Territory Governments have accounted for 61% of total public sector gross fixed capital formation, local governments 16%, and the Commonwealth 19% (much of which is defence equipment purchases).

This is despite the fact that the Commonwealth Government has significantly greater capacity to finance infrastructure spending, both from its own recurrent revenues and via its borrowing capacity.

The Commonwealth Government has a particular additional interest in maintaining its AAA credit rating, since its credit rating underpins the AA rating of the four major Australian banks, which in turn allows them to raise wholesale finance in international capital markets at lower interest rates than would be the case if the Commonwealth's, and hence the Australian banks', credit ratings were lower.

However no such concerns apply to the credit ratings of State Governments. The only entities whose borrowing costs are affected by State Governments' credit ratings are the individual State Governments, and their wholly-owned business enterprises. And even then, the interest rates that State Governments' borrowing agencies actually pay on their borrowings are influenced more by conditions in international sovereign debt markets, and by yields on Commonwealth Government bonds, than they are by their own credit ratings. Thus, for example, Queensland has been able to borrow, in recent years, at much lower interest rates since it lost its AAA rating than it could while it had that rating – not because of the lower rating, but because of the substantial decline in 'benchmark' bond yields since the onset of the global financial crisis.

One possible way of allowing State and Territory Governments to fund a higher level of infrastructure investment through borrowing – if that were thought desirable for other reasons, such as those advanced by the Governor of the Reserve Bank – whilst also addressing these concerns, could be for the Commonwealth Government to issue debt and on-lend it to the States and Territories at a small margin (as was the practice between 1927 and the early 1990s).

There would be no increase in the Commonwealth Government's net debt – since the increase in gross debt would be exactly offset by the increase in the Commonwealth's holding of State and Territory Government debt securities. Nor would there be any increase in the Commonwealth's 'underlying' cash deficit, since under current accounting conventions these transactions would be classified as 'net investments in financial assets for public policy purposes' and thus form part of the 'wedge' between the 'underlying' and 'headline' cash balances. Indeed, all else being equal there would be a small reduction in the Commonwealth's 'underlying' deficit by the amount of the margin between what the Commonwealth paid on its additional gross debt and what it charged the States and Territories.

There would of course be an increase in State and Territory Government net debt: and it is possible that, in some cases, this could lead to a downgrading of their credit ratings. But since they would be gaining access to additional borrowings at a lower interest rate than if they borrowed in their own name, since no-one else's borrowing costs would be adversely affected, and on the (important) assumption that the additional borrowings were used to finance the construction of well-selected and efficiently managed infrastructure projects which produced returns in excess of their financing costs, it is difficult to see what the 'downside' might be.

Another reform which might assist in enhancing financial markets' understanding of the implications of any increased borrowing by the Commonwealth Government to finance additional infrastructure spending, either on its own account or through the States and Territories, would be if the Commonwealth fostered the presentation and discussion of its own Budget and financial statements in accrual accounting terms – as the States and Territories do. Indeed this was the intention when accrual accounting was introduced at the Commonwealth level in 2000 – but when the accrual accounting measure of the 'bottom line' went into deficit in 2000-01, the focus was shifted back to 'cash' measures where it has remained ever since.

A key principle of the accrual accounting presentation of budgets is the distinction which it draws between the 'operating' result – that is, the difference between revenues and 'operating' expenses which fund the ordinary recurrent services provided by governments, including depreciation, employer superannuation contributions and interest – and 'net capital investment'. By and large, State and Territory Governments focus on the net operating balance as a summary indicator of their fiscal prudence, rather than on the fiscal balance or on cash measures. This is consistent with the way in which publicly listed corporations present their financial statements.

If the Commonwealth Government were to adopt the same approach, financial markets might be more willing to draw a distinction between deficits incurred to finance operating expenses, and deficits incurred to finance infrastructure spending.

A final consideration which is important to the way that financial market participants evaluate government borrowings to finance infrastructure investment is the governance around the selection and management of infrastructure projects.

The IMF notes that "in practice, public investment decisions are frequently not guided by economic rationale … inefficient and unproductive projects are often pursued by politicians and line ministries when they should not be, and some projects (and importantly, maintenance) are foregone when they should be given priority"[5].

In the Australian context, the Productivity Commission has noted that "there are many examples in Australia of poor project selection leading to highly inefficient outcomes"[6].

Only this week, the Deputy Governor of the Reserve Bank, Dr Phil Lowe, drew attention to the importance of ensuring that "the right projects are selected, the construction costs are well controlled, and that the risk-sharing between the public and private sectors serves the public interest. Getting these 'governance issues' right is far from straightforward, but it is not impossible. Making progress on this front would help us build the infrastructure assets that would strengthen our national balance sheet and lift our productive capacity"[7].

If Australia had a more robust and transparent institutional arrangements for the evaluation, selection and management of infrastructure projects, financial markets would likely take a more benign view of borrowings incurred in order to finance at least part of them.

I appreciate the opportunity to share these thoughts with you, and welcome your questions.

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[5] International Monetary Fund, *op. cit.*, p.90.

[6] Productivity Commission, *Public Infrastructure*, Volume 1, No. 71, 27th May 2014, p. 75.

[7] Phil Lowe, 'National Wealth, Land Values and Monetary Policy', The 54th Shann Memorial Lecture, Perth,12th August 2015.