AUSTRALIAN INSTITUTE *of* COMPANY DIRECTORS

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2018 Budget Submission

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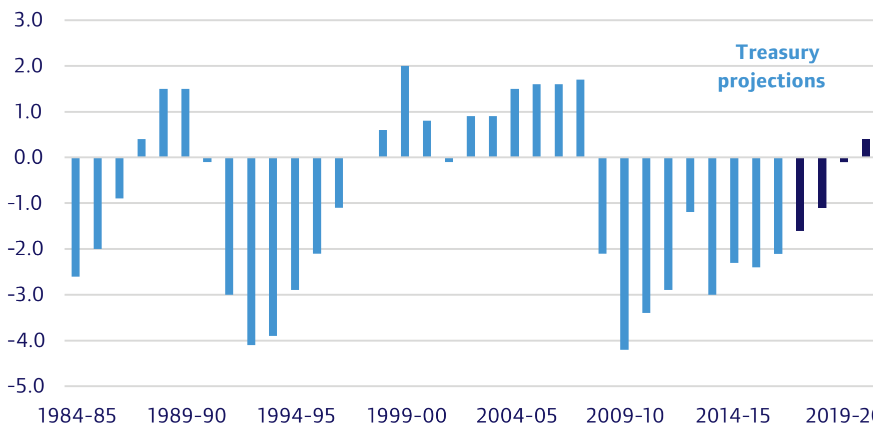
Executive summary

- **The federal Budget imbalance is unsustainable – bold policy action is needed to close the gap**
- **There is no fiscal buffer that can be deployed, as was the case during the GFC**
- **Australia has a revenue and a spending problem – spending growth should be capped**
- **AICD recommends broad-based tax reform, including a higher rate for the GST and a broader base**
- **Further personal income tax cuts should be pursued, and corporate tax reform progressed**
- **Negative gearing and the capital gains tax regime should be reformed, along with inefficient state taxes**
- **Government should borrow for essential infrastructure that brings a net benefit to productive capacity**

Every good director understands the importance of sound financial management as a cornerstone principle of good governance. It is the same for government. In fact, for the elected guardians of the nation's finances, the imperative of good fiscal governance arguably is even more important. Maintenance of our living standards depends on it.

A decade of budget deficits now has been incurred since the Budget fell back into deficit during the global financial crisis. The federal government deployed extensive fiscal stimulus back then to support the economy as the Reserve Bank (RBA) simultaneously slashed interest rates to then-record lows.

Underlying cash budget balance – % of GDP



Source: MYEFO.

This submission draws on the April 2017 Australian Institute of Company Directors' *Governance of a Nation: Blueprint for Growth* national reform document and its associated policy work and analysis.

These were the right things to do at the time, but the fiscal measures left the nation's public finances in very poor shape. The fiscal stimulus played a role in helping the economy avoid a technical recession, as did the sharp fall in AUD. With the benefit of hindsight, though, the stimulus was overdone and extended for far too long, leaving the Budget in significant *structural* deficit.

Our national finances have never recovered. Almost a decade on from the crisis, Treasury still predicts budget deficits until at least 2020/21, based on the forecasts released in the May Budget. But, even this looks optimistic, framed on upbeat macroeconomic assumptions, particularly related to wages growth, which currently is at record lows.

Insufficient incentives weighing on productivity

More fundamentally, there are insufficient incentives in the existing tax structure for firms to invest and hire. This is contributing to Australia's poor productivity outcomes. There also are financial disincentives for employees to work harder and for longer hours, and for people to make the sometimes challenging journey from welfare back to work. This needs to change.

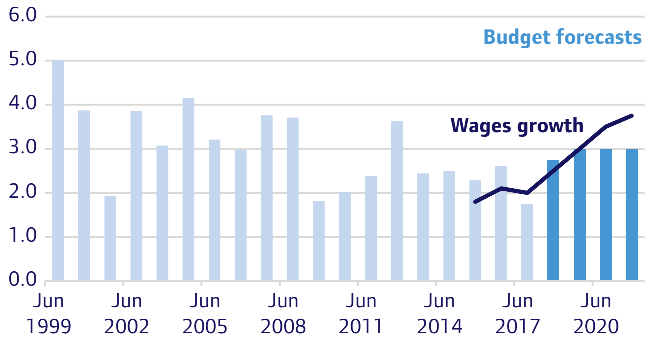
Our ageing population limits potential growth, meaning only by lifting productivity will Australia's living standards be sustained over the long term. We have been exceedingly lucky for more than two decades now in being able to ride a succession of booms, from soaring commodity prices, to housing construction, to the China boom and, most recently, an unprecedented rise in mining investment. But, we are running out of booms.

Reform is now the only option, and the 2018 Budget provides a golden opportunity to make the changes necessary to prolong Australia's unprecedented, uninterrupted period of economic growth. Failure to make the necessary decisions now will see an even heavier financial burden fall upon future generations.

Australia's current fiscal position is unsustainable

Australia's ratio of public debt to GDP still is low by global standards, but the debt ratio here is rising – comparable ratios are falling in other jurisdictions. Federal debt now is forecast to peak at nearly 20% of GDP in 2018-19[1]. Outstanding federal government debt in Australia already is above $500 billion but, with budget deficits certain in the near term, debt will continue to climb.

Real GDP growth (and wages)



Source: Budget papers.

The interest bill paid by taxpayers amounts to more than $1 billion per month, despite low levels of government bond yields. Imagine the number of schools and hospitals, or the transport infrastructure, that could be funded with an allocation of public funds this large. This interest bill will become even larger as interest rates normalise over time, which most economists expect.

Treasury's projected budget deficit for the current fiscal year remains close to 2% of the nation's GDP. Indeed, a succession of Federal Treasurers has failed to deliver on the oft-promised return to surplus.

Growth forecasts for the economy have proven to be optimistic, and unforeseen costs to the public purse have emerged. Commodity prices also have been lower than hoped.

With the demands on Australia's public purse growing over time, particularly in health and welfare as the population ages, the current fiscal position is not sustainable. We as a nation are placing too heavy a burden on future generations to pay for the current generation to live well beyond our means.

1 2017-18 Budget Papers, May 2017 www.budget.gov.au

Australian governments no longer can wait for optimistic assumptions about growth in the economy and higher commodity prices to do the heavy lifting to return the budget to surplus. Bold policy action is needed.

As things stand, without urgent remedial policy action, in order to plug the yawning Budget deficit over time, Australians face a choice between unpalatable options. The first option is that more taxpayers pay a higher marginal tax rate as a result of inevitable bracket creep, although this process has slowed somewhat thanks to record low wages growth.

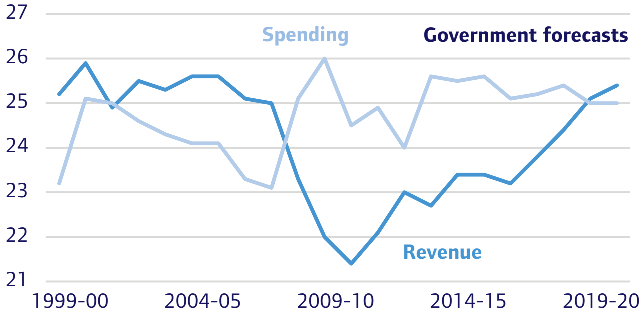
The second option is worse. Australian households will, over time, have to accept fewer and a lower standard of government services, including in health and education. Government simply will not be able to maintain the level of services we have come to expect.

No fiscal buffer should things go wrong

As things currently stand, Australia has no fiscal buffer to fall back on should economic circumstances deteriorate. No reputable economist forecasts recession here in the near term, but a serious downturn is inevitable at some point. Prior to the current period of sustained growth, recessions have tended to occur every seven years, so we are well overdue. Moreover, having avoided recession for so long, we now carry serious baggage into the next downturn, including a record high household debt ratio that is among the world's highest.

Unfortunately, the scope to repeat the experience of the GFC, when Australia boasted a Budget surplus that allowed the government of the day the flexibility to deploy fiscal resources, is not there. The government could deploy more fiscal stimulus if Australia's enviable, 26-year unbroken run without recession ends, but the scope now is very limited.

C'wealth spending and revenue – % of GDP



Source: Budget papers

The AICD is calling for political leaders to take the tough decisions needed so that Australia can afford its future aspirations, particularly on the expenditure side of the Budget. Failure to act now risks an even more abrupt economic dislocation in the future.

Protecting the AAA credit rating

Australia is one of just 10 countries in the world enjoying the highest available credit ranking from all three of the major credit ratings agencies. But, significant fiscal slippage in recent years means the rating is under threat. Without urgent action to restore fiscal sustainability, it merely is a matter of time before Australia suffers a rating downgrade.

The major ratings agencies effectively have asked the government to show that the plan to return the budget to surplus is on track. The signs so far are not encouraging, although there has been long-awaited improvement in the budget position in recent months.

The updated Budget position released by Treasury back in September revealed that the Budget position was slightly ahead of the forecasts provided in the Budget back in May, thanks in part to higher company tax collections and lower than expected outlays. Still, the deficit for 2016-17 still was 1.9% of GDP, albeit down from 2.4% in the previous fiscal year. Progress here is too slow.

Loss of the AAA credit rating would incur significant costs, including a higher cost of borrowing for governments. The loss of Australia's AAA credit rating would flow through to credit rating downgrades for affected state and territory governments and the commercial banks. The result would be higher funding costs for the banks on global markets and, therefore, higher interest rates for Australian households and businesses.

Higher interest rates may be needed to continue to attract the foreign investment necessary to fund Australia's persistent current account deficit. The ultimate outcome would be lower growth in the economy over the medium term and slower growth in national income.

Both spending and tax reform is needed

Nearly three quarters of the AICD's members[2] believe the government should aim for a return to surplus within a 10 year period. Difficult decisions must be taken now if this target is to be met. The nation's fiscal sustainability is too complex a task to be defined as a binary choice between a 'spending' or 'revenue' problem. Australia has both a revenue and a spending problem.

The AICD's membership believes that the emphasis of budget repair should fall most heavily on the expenditure side of the accounts. While comprehensive tax reform has an important role to play, its focus should be to drive growth over the longer term. An improved tax mix can create better incentives for success for Australians and boost economic growth. A more sustainable and equitable tax mix will support fiscal sustainability over the long term.

However, the heavy lifting of deficit reduction must prioritise spending reform, which has often been neglected in the debate on fiscal sustainability. Indeed, lifting taxes is not the solution to the Budget imbalance. Raising taxes merely lifts government revenue collections to match an elevated level of spending.

Business, too, has an important role to play in ensuring that governance practice and standards reflect the expectations of the community. The AICD supports measures to improve transparency in taxation and reforms to address profit shifting practices by multinational corporations.

Spending reform is overdue

Directors appreciate that challenging economic circumstances demand fiscal restraint – and apply this with a view to impacts on their companies and stakeholders. It is right to expect government to adopt the same discipline.

The current level of government spending simply is not sustainable. Previous attempts at spending restraint either have failed to pass through the Parliament, not been taken seriously, or had only limited impact.

Unfortunately, while the Commonwealth's revenue share of the economy slipped, the spending share of the economy approached the 26% of GDP previously reached during the peak spending demands during the global financial crisis.

Worryingly, Treasury projects[3] that the ratio of Commonwealth Government spending still will be 25% of GDP even in four years' time. Budget surpluses are not possible if the government's spending ratio is above 25% of the economy.

Australia's structural budget deficit represents a significant challenge to the long-term prosperity of the nation. Over the last two decades, higher levels of government spending as a share of the economy have been locked in, funded by revenue that was boosted temporarily by cyclical forces like higher commodity prices. Commodity prices have receded, but not the elevated spending they funded.

Admittedly, the GFC had a significant impact on government expenditure as the federal budget was used to smooth changes in the business cycle. But, since 2008, the federal government has not been able to reduce the level of government spending as a proportion of GDP far below GFC levels.

As the former Governor of the Reserve Bank Glenn Stevens noted, Australia needs to have a conversation about fiscal repair: as a community, we have voted for the services we want, but we have not yet voted for the means to pay for them[4].

The AICD welcomes the government's initiatives thus far in prosecuting expenditure savings measures in paring back access to family benefits, in particular, the cost of which blew out during the commodity price boom, although key measures were rejected by the federal Parliament.

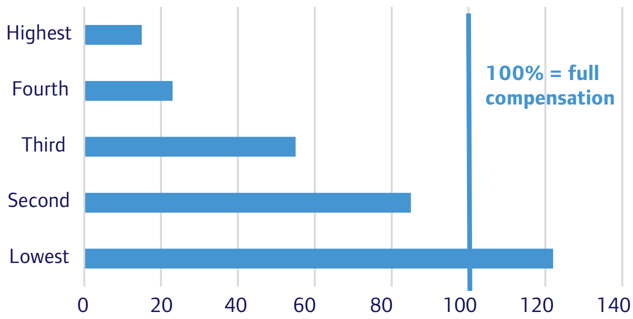
The AICD welcomes the broader savings measures that already have passed the Parliament. Yet much more needs to be done, particularly in ensuring a sustainable welfare system with appropriate targeting and incentives. This is especially the case if our comprehensive tax scenario is embraced, given the significant (targeted) compensation proposed.

2 AICD Director Sentiment Index (December 2016) www.companydirectors.com.au

3 2017-18 Budget Papers, May 2017 www.budget.gov.au

4 http://www.afr.com/news/rba-interview-series/glenn-stevens-interview-the-full-transcript-20141211-125evo

Proposed compensation by income quintiles



Source: Deloitte Access Economics.

The AICD recommends that annual growth in government spending be restricted to 1.5% in real terms, on average over the business cycle. That is, growth rates above this benchmark in any year should be offset by slower growth in subsequent periods, to maintain the targeted average growth rate. By adopting this target, the government would retain the ability to help offset fluctuations in the business cycle with fiscal stimulus, as was done during the GFC.

The Budget projects that spending growth will average just under 2% in real terms in the four years to 2020-21. Treasury expects the spending ratio to stay at 25% of GDP. A 1.5% average real spending growth cap compares to average real spending growth of 2.8% over the last three decades[5], so its maintenance will require a new level of discipline.

The AICD's preferred options for spending reform targets, to help keep Commonwealth government spending below 25% of the economy, are:

- Further paring back so-called middle class welfare, including the family tax benefits system;
- Efficiency dividends across government, targeting duplication between jurisdictions; and
- Cuts to industry assistance where funding is based on protecting inefficient industries.

None of these reforms are easy, but all offer scope for substantial savings on both budget repair and equity/fairness grounds. We note work by the Treasury in 2015[6] showing that the biggest contribution to fairness in government's impact on society and the economy comes via spending (mainly transfer payments), rather than through the tax system, despite Australia's tax system already being highly progressive.

Nearly half (46%) of all AICD members[7] advocated further reform to the welfare portfolio as a key part of expenditure restraint in a survey released in December 2016. 56% of our members advocated for smaller government, and 51% argued for concurrent general spending restraint.

While providing significant budget savings, further reforms to the welfare system also will mitigate against some of the disincentives that discourage many thousands of people from making the sometimes difficult journey from welfare back to work. These impediments contribute to Australia's low workforce participation rates, particularly among women.

More needs to be done to ensure the government's transfer payments are directed towards those most in need. The welfare system should be a safety net, not a system of entitlement that, once established, is difficult to unwind.

Tax reform – whole of system, not piecemeal changes

Federal tax revenue has dipped from a healthy level of nearly 26% of GDP a decade ago to less than 24% of the economy now. The AICD applauds the government's efforts to pare back generous tax concessions on superannuation, and for raising additional revenue from measures like the so-called backpackers' tax. These are steps in the right direction, and should help to reduce distortions embedded in the tax system. Other recent policy moves, like the proposed banks' levy, are more contentious. The levy risks being passed through to higher interest rates for borrowers.

Unfortunately, the tax measures passed so far by the current Parliament are piecemeal. The tax system has an important role to play in influencing corporate and household behaviour, including decisions about workforce participation and investment by businesses, which has been flagging for some years now. Encouraging both requires ambition and a broader scope of reforms.

5 Mid-Year Economic and Fiscal Outlook 2016-17 (19 December 2016) www.budget.gov.au

6 Re:Think Tax Discussion Paper, 2015. www.Treasury.com.au

7 AICD Director Sentiment Index (December 2016) www.companydirectors.com.au

The AICD commissioned Deloitte Access Economics to support our analysis of tax reform scenarios, presented in *Governance of the Nation: A Blueprint for Growth*. The reforms recommended here aim to shift the current burden of tax away from income towards land and consumption, and help reduce the dead weight of tax on the economy (particularly by reforming the state tax regime), while maintaining broad revenue neutrality.

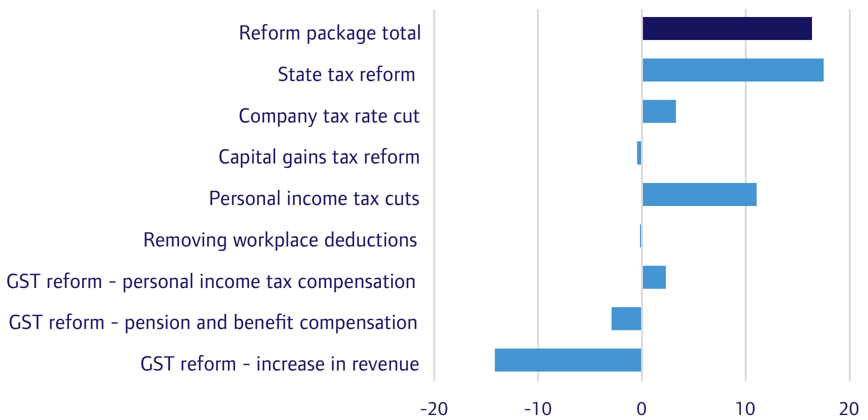
The work done by Deloitte Access Economics confirms that the mix of tax matters as much as the level of taxation in an economy. There are ways of taxing "smarter" that reduce the inefficiencies embedded in any taxation regime, to minimise the damage inevitably done to economic activity.

Cutting tax rates applied to income will help shift the tax burden in relative terms towards the taxation of capital (alongside paring back the CGT discount), which currently is lightly taxed in Australia in relative terms. This imbalance helps create distortions that encourage tax avoidance and too much investment in relatively unproductive assets like existing residential property.

The tax reforms recommended here yield an estimated "prosperity dividend" (i.e. the boost to national income) of the equivalent of 1% of GDP[8]. Most of this comes from reform of the state tax regimes, which include the most damaging, inefficient taxes in the Federation, particularly stamp duties.

Most critically, this is a tax reform scenario that should be taken as a whole – with the gains to be drawn from across the recommended reforms collectively.

Estimated prosperity dividend ($ billion)



Source: Deloitte Access Economics.

GST reform – higher rate and broader base

Australia's tax mix needs adjustment to shift the burden of taxation in the economy to more indirect and efficient sources. Comprehensive tax reform in Australia is all but impossible if discussion of the GST is excluded from the conversation.

Even the highly-regarded Henry Tax Review, released in 2010, excluded recommendations on changes to the GST. Furthermore, the federal government's recent commendable attempt to expand the tax reform conversation to include changes to the GST was shot down in the COAG process.

The AICD's *Governance of the Nation: A Blueprint for Growth* report recommends a lift in the rate of the goods and services tax (GST) from the current 10% to 15%, partly to bring it into line with the tax rates in comparable jurisdictions. The average GST rate in the developed world is above 19%[9].

8 The prosperity dividend estimates are approximate and indicative of the direction and magnitude of the selected tax reform package on the economy of Australia, measured by national income.

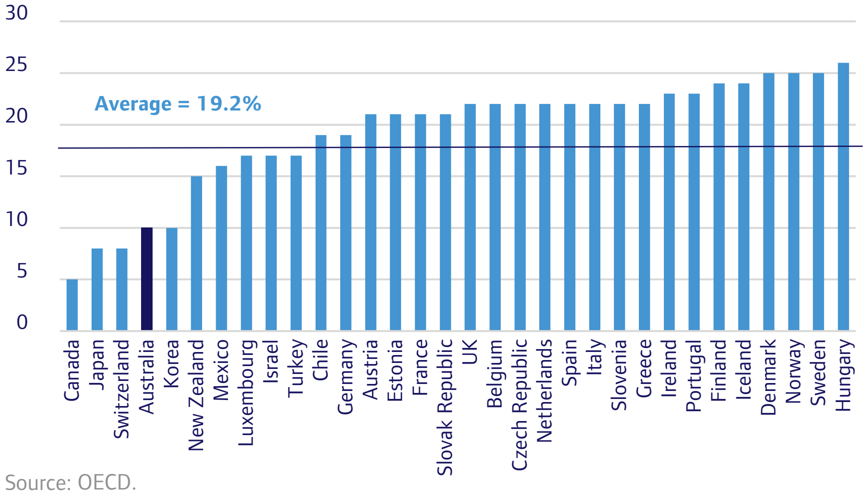
9 Indirect Tax in 2015. A review of global indirect tax developments and issues, EY, 2015.

In addition, the AICD recommends broadening the base of the GST to include spending on fresh food, education, healthcare, childcare and utilities, all of which are excluded from the tax base. The current base to which the GST in Australia applies represents less than 50% of household spending (compared to 97% in New Zealand). Worse, the tax base is shrinking in relative terms because spending that currently is untaxed is growing more quickly than spending subject to the GST.

A significant compensation package must accompany this reform to offset the increase in consumer prices, particularly to lower income households. This compensation would be in the form of a mix of tax relief and increased transfer payments. The suggested compensation package is comprehensive and well-targeted. In particular, it over-compensates lower income earners in recognition that the GST is a regressive tax.

A higher GST rate and broader GST base would raise an estimated additional $273 billion over four years. While this revenue will be partly offset by another round of personal tax cuts (including a component designed to compensate lower income earners), and compensation in the form of increased welfare payments, it will provide a more sustainable, equitable and efficient revenue base for the nation.

OECD VAT/GST rates 2015



Source: OECD.

Reductions in personal tax rates

The AICD welcomes the government's progress in lowering the personal tax burden for middle income earners via the modest tax cuts announced in the Budget and the commitment to further lower the personal tax burden for lower and middle income earners.

But, the personal tax cuts delivered so far, and those promised, do not go far enough. The AICD's proposal for GST reform would allow marginal tax rates to be reduced by 6.5% points, the cuts being funded by the broadening of the GST base.

Partly offsetting the cost of these proposed personal income tax cuts would be the removal of general workplace deductions (while preserving deductions for donations to charitable organisations). These deductions have a huge cost to the budget and are open to exploitation – they cost the Budget close to $20 billion over the four-year forward estimates period.

Removal of work-related deductions would allow the top personal tax rate to be reduced from the current 45% to 37%, bringing Australia more into line with global averages. Australia's top marginal tax rate is high by global standards, and applies at a low income threshold relative to other countries. The move also would reduce the compliance costs associated with millions of Australians submitting tax returns principally for the purpose of claiming workplace deductions.

The AICD also recommends that the tax free threshold be reduced to $15,000, but that the revenue impact be offset by a rise in the Low Income Tax Offset (LIFO), from the current $445 to $1,200. The changes will compensate for the GST changes, better target tax relief at lower income earners, and mitigate against the current disincentive for lower income earners to re-enter the workforce.

Cleaning up inefficient state taxes

The AICD continues to recommend reform of state tax regimes. Many of the taxes levied by state governments like activity-based stamp duties, are among the most inefficient taxes, damaging productivity and discouraging economic activity. The recommendations here are revenue neutral for state governments.

Under the AICD's tax reform scenario proposed in *Governance of the Nation: A Blueprint for Growth*, the states would see increased funding from an incentive payment of 10% of the increased GST revenue ($19 billion over four years). Payment would be contingent on progress in cleaning up inefficient state taxes.

The AICD recommends that state governments replace stamp duties on property with different forms of land tax. Work by the Federal Treasury in 2015[10] showed that the "dead weight" cost to the economy of stamp duties was the highest of all taxes in the federation at 72 cents in the dollar. That is, for every dollar of revenue collected, the economy shrinks by 72 cents. Land tax, by contrast, has no net cost to the economy.

Land taxes reduce the disincentive to engage in transactions. Stamp duties on residential property are a major impost on the purchase of a property and, therefore, are a powerful disincentive for the mobility of labour. Australia currently suffers shortages of skills on some regions, but surpluses elsewhere, owing to our notoriously immobile workforce. The equity issues associated with this proposal (i.e. how asset rich, income poor taxpayers could fund an annual land tax impost) can be addressed partly by structuring appropriate tax thresholds. The benefits to the economy, however, should outweigh the costs. One clear benefit would be a more equitable distribution of housing assets, improving housing affordability over time.

Reduced capital gains tax discount

The AICD recommends that the government examine the unfortunate nexus between the treatment of negative gearing of investment losses on housing and the current discounted capital gains tax arrangements. These provisions have combined to help substantially boost the after tax returns from investment in existing residential property, investment in which fails to add to the productive capacity of the nation.

The current 50% discount to capital gains tax liability far exceeds that necessary to compensate investors for the impact of inflation, which was the intention. The AICD argues that the CGT discount should be pared back from the current 50% to 40%, as was recommended in the government's Henry Tax Review back in 2010[11].

This change would further improve the balance between the current sub-optimal tax burdens carried by labour income and capital, which is lightly taxed in relative terms. The estimated boost to the Budget from this reform is material at $6.4 billion over four years.

Review negative gearing and the nexus with the CGT discount

Negative gearing is a part of many Australians investment plans. However, it has led to ineffective tax outcomes and distortions in the housing market.

The current tax arrangements encourage investment in relatively unproductive assets like existing residential property that do not boost the economy's productive capacity. These have helped fuel the housing affordability crisis, although the shortage of housing and record low interest rates have been the main drivers. Negative gearing should be reformed so that it applies only to productive assets. Government should examine all options for reform of negative gearing (e.g. the tax deductibility of losses) on housing.

As noted above, the AICD recommends that the Government examine the nexus between negative gearing and the capital gains tax discount (introduced in 1999), which the Reserve Bank believes "may have the effect of encouraging leveraged investment in property", particularly in an environment of low interest rates.

10 Re:Think Tax Discussion Paper, 2015. www.treasury.com.au

11 Australia's Future Tax System, 2010. www.taxreview.treasury.com.au

Reducing the corporate tax rate

Australia's current onerous corporate tax regime is making Australia increasingly uncompetitive. Plans by the Trump administration in the US, for example, lower the tax rate for companies to 20% are well-advanced. Similar plans are being legislated in other advanced economies, including the UK and Canada. By all but standing still, Australia is being left behind.

Worryingly, members of the Australian Parliament oppose further reductions in the corporate tax rate, and even those already legislated. Corporate taxation is very inefficient relative to other sources of government revenue – Treasury estimates[12] damage to the economy of 50 cents for every dollar in revenue collected from company tax.

Australia's 30% corporate tax rate for larger corporates stands out as one of the highest in the developed world, above the OECD average of 25%. The average corporate tax rate in countries in our major trading zones in Asia is just 22%. Only four countries in the OECD have a corporate tax rate higher than our own[13].

The AICD acknowledges the government's progress so far in lowering the tax burden for small businesses, and its plans to lower the tax burden for larger corporates progressively over the next decade[14]. The AICD's proposal outlined in *Governance of the Nation: A Blueprint for Growth* takes a similar approach.

However, we consider the best approach to adjusting the tax mix to be a comprehensive reform model, rather than piecemeal prioritisation of corporate tax over all others. More competitive corporate tax rates will make Australia a more attractive place for foreign investment and deliver a dividend in the form of job creation and higher investment.

Infrastructure priorities

Effective and efficient infrastructure is essential to support our nation's productivity and growth. Australian directors have consistently ranked infrastructure as the most important long-term issue for government over the life of the AICD's Director Sentiment Index[15]. 90% of the AICD's members consider the current level of national infrastructure investment to be too low.

Despite ongoing funding and policy commitments from state and federal governments, Australia's national infrastructure is creaking at the seams, particularly in transportation and in power generation. There are bottlenecks and costly congestion on our roads; the latter imposes significant costs, and can be a major impediment for investment.

Productivity has lagged behind long term averages in recent years, partly owing to inefficiencies and inadequacies in national infrastructure. Productivity is a fundamental element of the nation's potential growth rate – the economy's effective speed limit. Failure to address the inadequacies in the nation's infrastructure means lower economic growth in the future.

As the Australian Infrastructure Audit from 2015 highlights, without action on infrastructure, increasing congestion and bottlenecks will test Australia's productivity and quality of life[16].

12 Re:Think Tax Discussion Paper, 2015. www.treasury.com.au

13 The UK corporate tax rate currently is 19% (with plans to lower it further to 17% by 2020), and US President Trump has promised to cut the corporate tax rate in the US from the current 35% to 20%. In Europe, Germany and France also are contemplating corporate tax reform. The corporate tax rate in New Zealand is 28%.

14 The government's 10-year Enterprise Tax plan advocated staged reductions in the corporate tax rate, with all companies eventually taxed at 25%.

15 AICD Director Sentiment Index (December 2016) www.companydirectors.com.au

16 Australian Infrastructure Audit Report 2015 Infrastructure Australia www.infrastructureaustralia.gov.au. Infrastructure Australia forecasts that by 2031 road travel times in capital cities will increase by at least 20%, the national freight networking will have exceeded capacity, and regional roads and town water infrastructure will have deteriorated to service standards that the Australian community will be unlikely to accept.

A key problem is that there is inconsistent assessment of public projects across jurisdictions, many of which are guided by political rather than economic imperatives. The Productivity Commission has noted that significant questions continue to be raised about the efficiency, governance and cost-benefit methodologies applying to infrastructure planning and investment[17].

Australian governments have an established system of project assessment and prioritisation, but this process often is subsumed by the demands of partisan politics. The AICD recommends a renewed focus on national, productive infrastructure to boost growth.

A COAG commitment to a 15 year infrastructure plan

The AICD has also encouraged Australian governments to develop consistent and strong governance standards for nationally significant infrastructure projects, increase the transparency of forecasts of the costs and benefits of infrastructure investments, and develop nationally consistent measures of infrastructure performance to aid benchmarking and review.

There are important issues to be addressed in regards to governance of infrastructure in Australia, in addition to the need to address issues around the nature of government borrowing, private sector involvement, and the pressing need to boost productivity.

The AICD recommends that Infrastructure Australia's list of priority projects be adopted as the "to-do" list of infrastructure investment. There is no need for governments to reinvent the wheel – some of these projects are shovel-ready and already have been assessed for their economic and financial viability. The services of the various state infrastructure bodies also should be better utilised.

The AICD also recommends the adoption of standardised cost benefit analysis for project assessment, with oversight by the established national body Infrastructure Australia. This would help to ensure that projects selected in each jurisdiction generate sufficient national benefits when benchmarked against alternative projects. A standardised assessment approach should help to minimise political elements of project selection.

While the AICD favours adoption of the national project priority list published by Infrastructure Australia, the latest Director Sentiment Index provided an interesting snapshot of our members' priorities for government attention.

In order of priority, the top ranked areas for government investment included renewable energy sources (52% of members responding to the survey cited this as a priority), regional infrastructure (41%), roads (33%), telecommunications (27%) and urban rail (22%). Respondents' priorities for additional spending on airports and ports was relatively low, at 7% and 9%, respectively.

Good versus bad government borrowing

In principle, the AICD supports more essential public infrastructure being debt-financed, particularly given low levels of interest rates. Not all government debt is "bad", provided the additional borrowing is used to fund productive assets that ultimately boost the economy's long run productive capacity. The previously febrile debate that concludes that all government debt is "bad" is unhelpful and unproductive.

The AICD welcome's the Treasurer's commitment[18] to boost "good" borrowing to fund more infrastructure, particularly with government 10-year bond yields trading at the lowest levels in 160 years. However, we submit that addressing the infrastructure shortfall cannot wait until the "bad" borrowing to fund recurrent budget purposes has ended.

17 PC Productivity Update (July 2015) Productivity Commission www.pc.gov.au

18 Speech to the Australasian Finance and Banking Conference, 14 December 2016.

We agree in principle that the government should *not* be borrowing for recurrent purposes merely to plug the gaping hole in the government's finances. Waiting until such borrowing ends, however, would mean even more pressure is placed on infrastructure that already is under great strain.

Any new government spending, of course, should always be assessed within a framework of rigorous project assessment. Construction of long-lived assets that generate a positive economic return over time allows government to service the additional debt, and the consistent revenue stream makes the asset attractive to private sector investors.

International pension funds, for example, have a great appetite for investment in long-lived infrastructure assets, allowing government to recycle the sale proceeds into other productive assets, creating a virtuous cycle. The construction phase, for example, has clear benefits for national economic activity and employment.

The AICD recommends that government examine innovative ways of funding national infrastructure. Ongoing underinvestment by private businesses in Australia remains something of a puzzle. There is evidence that some firms maintain hurdle rates of return on investment that are too high, making it difficult to get board approval for new projects.

The AICD encourages hurdle rates to be revised downwards to reflect the new world of lower inflation so that projects can be started. The current regime encourages risk aversion.

To aid transparency, the AICD also recommends that government fine tune the list of active projects attracting government funding. There has been a tendency of late for governments to recycle lists of pre-announced (and re-announced) projects, a practice that makes it difficult to determine new funding and priorities.

Boosting private sector infrastructure investment

Australia's infrastructure needs cannot be funded by public investment alone. Expanding private sector engagement in infrastructure delivery and operation is critical if we are to avoid the forecast shortfall in capacity and service levels. Government should focus on private sector contributions enhancing public funding commitments, including via public-private partnerships, which have tended to fade from consideration.

The AICD endorses the Australian Infrastructure Plan's call[19] for greater use of well-regulated market-based solutions and increase engagement with the private sector to fund and deliver productive infrastructure. The AICD supports expansion of asset recycling as a means of maximising infrastructure use and investment.

The AICD calls on state and territory governments to significantly increase asset recycling, supported over time by nationally consistent standards on governance, benchmarking and reporting metrics.

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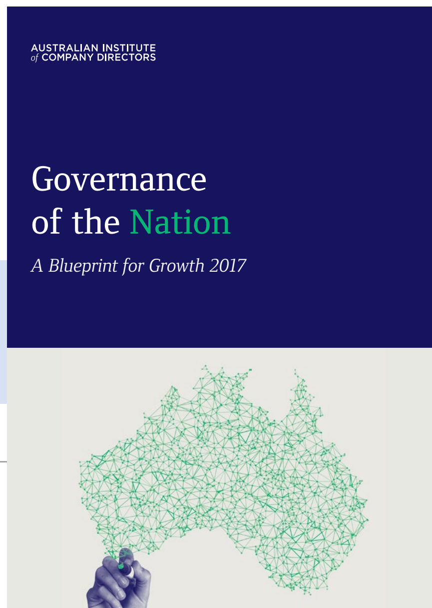
@AICD_economist

To view the AICD's national reform priorities in detail, download *Governance of the Nation: A Blueprint for Growth* at **companydirectors.com.au/blueprint**



19 Australian Infrastructure Plan, Infrastructure Australia, February 2016.

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