



AUSTRALIAN CONSTRUCTORS ASSOCIATION

**SUPPLEMENTARY SUBMISSION TO THE
HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON PRIMARY
INDUSTRIES AND REGIONAL SERVICES**

***INQUIRY INTO INFRASTRUCTURE AND
THE DEVELOPMENT OF AUSTRALIA'S
REGIONAL AREAS***

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1. INTRODUCTION

This supplementary submission is in response to the Committee's request for more detail on how an infrastructure voucher scheme might work and that advantages of a voucher scheme over the current IBTO scheme. A voucher scheme was referred to in the Australian Constructors Association (ACA) submission to the *Inquiry into Infrastructure and the Development of Australia's Regional Areas* and was discussed with the Committee at its public hearings on 23 August 1999.

The ACA believes an infrastructure voucher scheme would be a more effective program for overcoming disincentives to invest than the current Infrastructure Borrowings Tax Offset Scheme (IBTOS). The following section outlines program attributes we believe are necessary to ensure good policy outcomes for infrastructure investment in Australia. Section three provides more information on the infrastructure voucher scheme referred to in our submission. Finally section four briefly compares and contrasts the proposed voucher scheme with IBTOS.

2. ATTRIBUTES OF AN EFFICIENT INFRASTRUCTURE POLICY INITIATIVE

Australia has an infrastructure shortfall. The ACA believes that the private sector can play a significant role in reducing the gap between the current level of infrastructure service provision in regions and the level that is needed. However, there are several impediments to private sector investment in infrastructure. The largest impediment is the current business tax system. Typically, infrastructure investments involve long construction periods and generate large costs and no revenue in the early years of the project. Interest costs are an important contributor to this situation.

The Government has a number of policy options to address the disincentive for private investment in infrastructure created by current tax laws. Ideally, the ACA would prefer that this disincentive be addressed by making changes to the tax system to allow the pass through of project losses to project owners parent companies. However, there are other options which, while not ideal, are likely to represent an improvement over current arrangements. One such option is a voucher scheme.

It is important that any action to address disincentives for private investment in infrastructure efficiently and effectively overcome, or at least reduce, taxation related impediments. We believe that an efficient and effective policy response is one that displays the following 7 attributes:

- it should respond to the impediment as directly as possible;
- it should be neutral (ie non-discriminatory) across infrastructure industries;
- it should be administratively simple and transparent;
- it should have low transactions costs;
- it should represent value for money to taxpayers;
- it should provide certainty in respect of government's budgetary commitments; and
- it should be independent of the political process.

The desirability of these attributes for infrastructure policy is largely self-evident. Responding to the impediment as directly as possible helps to ensure that the impediment is overcome (or reduced) and minimises the potential for unexpected and undesirable side effects. Neutrality ensures that an infrastructure project's eligibility to participate is determined on its merits. Administrative simplicity and transparency increases certainty and reduces potential for abuse of the scheme. Low transactions costs minimise the deadweight costs associated with the administration of policy. Ensuring that taxpayers get value for money creates an important check that the benefits of the policy outweigh its costs. Providing certainty for governments budgetary commitments ensures that the revenue costs of the policy do not unexpectedly blow out and create unnecessary pressure on the budget. Independence from the political process is important to provide certainty by ensure that governments do not fall into the trap of catering to minority interests. If this happens, the program could fail to provide taxpayers with value for money and could also crowd out infrastructure investments with high benefit cost ratios that are currently discouraged by the existing tax laws.

3. THE INFRASTRUCTURE VOUCHER SCHEME

We believe that the infrastructure voucher scheme proposed in our submission would meet all of the characteristics outlined in section 2. Importantly, the proposed arrangements would provide certainty for the budget and create more favourable incentives for infrastructure

investment than IBTOS, without its disadvantages. The voucher scheme could operate as follows.

OPERATION

The government, taking into account its budgetary commitments, and ideally the level of infrastructure investment short fall, could designate a certain total value of vouchers (say \$200 million) to be issued in the first year of the scheme's operation. The allocation of \$200 million would need to be made each year until the projects initially funded become profitable, which for some projects could be around 10 years. If marginal projects had no certainty of this on-going funding they would be reluctant to proceed. There would need to be annual increases to total funding to support additional infrastructure projects. For example, assuming each project had constant interest costs in each year, all of the \$200 million in year 2 would need to be allocated to those projects which were allocated a voucher in year 1. If new projects are to receive the voucher in year 2, the cap will need to be increased. Of course as the initial projects become profitable they will drop out and their voucher funds could be allocated to new infrastructure but this would be some years down the track.

Projects in all infrastructure industries would be able to apply for an infrastructure voucher. A particular project's eligibility for a voucher would be based on its compliance with legislated criteria. An independent authority would be made responsible for assessing applications for the voucher against these criteria.¹ The authority's decisions, and its rationale for decisions, would be available to the public and subject to regular audit.

Eligible projects would be given a voucher. This voucher would be presented to the Taxation Commissioner and used to obtain a tax refund equal to its face value. The process would be repeated annually up to a predetermined date at which time the project is forecast to have become profitable. (If the project becomes profitable before this date the vouchers would no longer be redeemable.)

For example, suppose an eligible project wants to borrow \$150 million at a 10 per cent rate of interest. The annual interest cost would be \$15 million and the project is expected to become profitable in 6 years. Because the project has no income until year six this annual interest cost cannot be deducted in the year it is incurred. In the absence of the infrastructure voucher scheme, the interest cost would be carried forward as a loss and deducted from

¹ The Development Allowance Authority, with its expertise intact, would be an appropriate authority to undertake this role. The Authority, via its role as the issuer of infrastructure borrowing certificates developed substantial experience in the evaluation of infrastructure projects.

assessable income in year 6. The voucher scheme operates as though the project in year one had assessable income from which the interest costs could be deducted for tax purposes. The independent authority would issue a voucher with a face value of \$5.4 million (ie 36% company tax rate * \$15 million) to the project. The Australian Taxation Office on receipt of the voucher would issue the project a refund of this amount. This practise would continue until year six, when the project becomes profitable and will pay tax on its assessable income. Of course, the interest payments paid by the project in years one to five would not be deductible from assessable income.

The infrastructure voucher scheme would help support a substantial increase in infrastructure investment. For example, at the prevailing tax rate and assuming an interest rate of 10 per cent, an initial voucher cap of \$200 million would support \$5.56 billion of investment (ie \$5.56 initial investment * 10% interest rate * 36% company tax rate).

In the above examples, the company tax rate and the level of annual interest paid by individual project determined the face value of the voucher paid to each project. However, the actual face value of the voucher will depend on how the voucher scheme is designed. One important design issue is how the vouchers would be allocated or rationed if demand for the vouchers exceeds the capped supply.

Some possible rationing mechanisms

The government by designating a certain total value for vouchers would, in effect, ration the voucher scheme. However, it is likely that in some years the value of eligible claims on the scheme could be in excess of the cap.

In situations where the value of eligible claims for vouchers is less than or equal to the budgetary cap, the maximum face value of the vouchers will be determined by the company tax rate and the level of annual interest paid by individual projects. However, in years when demand exceeds supply, the face value of the voucher will be dependent how the vouchers are rationed within the cap. There are at least three alternative rationing options:

- First come, first served;
- Project ranking; and
- Equal shares of the pie.

Under the *'first come, first served'* option the independent authority could publicise the value of the voucher cap and call for applications for the voucher. The authority would assess applicants eligibility on a first come, first serve basis and provide the maximum voucher

value to eligible projects until the value of the cap is reached. Under this option the voucher cap and the interest payments of the first eligible applicants would determine the number of beneficiaries. Once the cap is reached all the other eligible applicants would receive no benefit from the scheme. The advantage of this option is its simplicity. A disadvantage is that late applications from marginal projects, which in the absence of the disincentives associated with the tax system would have gone ahead, could miss out on the voucher even if their cost benefit ratios are higher than the first applicants.

Under the *'project ranking'* option the independent authority would call for applications for the voucher and assess eligible projects. The independent authority would give each eligible project a score on the basis of their compliance with the eligibility criteria. This score decides their ranking and hence their position on the list of eligible projects. The highest ranking eligible project would receive a voucher with a face value determined by the company tax rate and the level of annual interest paid by the project. Additional vouchers would be given out to the next highest ranking projects until the total value of the cap is reached. Similar to the first come, first served option, the number of projects receiving vouchers would be determined by the voucher cap and the tax rate and the annual interest paid the highest ranking eligible applicants. Also like the first come, first served option, some projects will miss out on a voucher. However, if the ranking system ranks marginal projects with high cost benefit ratios highest, so that they are the ones that are most likely to receive a voucher, then the scheme will directly target projects with are worthwhile and would not otherwise go ahead. Thus, it does not simply provide a windfall gain to projects that would have gone ahead without a voucher. This means that overall, the voucher scheme is more likely to increase the level of infrastructure investment in Australia relative to the current arrangement and also relative to the first come, first serve voucher rationing option.

Under the *'equal shares of the pie'* option all infrastructure projects deemed eligible by the independent authority would receive a voucher. The voucher cap, the company tax rate and the annual interest payment of all eligible projects would determine the face value of the voucher. Advantages of this option are its simplicity and transparency and equity in the sense that all eligible marginal infrastructure projects will have access to a voucher. However, if the cap on the scheme is very low and the number of recipients is high the value of the voucher could be quite small.

COST TO GOVERNMENT

As noted above, the value of infrastructure vouchers issued each year would be capped. It is important to realise that the budgeted cap is not a tax concession, which creates a net cost to the Government. The voucher scheme, like Infrastructure Bonds and IBTOS, only changes the timing of tax payments, rather than the nominal amount of tax paid.

Of course in present value terms there will have been a transfer from Government to the project. This occurs because the voucher scheme implicitly allows a tax deduction in the year the interest is paid rather than at some future time when the project becomes profitable. However, it should also be recognised that any negative impact on tax revenues will be more than offset by the tax revenues collected as a result of the growth in national productivity and GDP which can be expected to arise from the new infrastructure investments.

4. A VOUCHER SCHEME COMPARED TO IBTOS

An infrastructure voucher scheme along the lines discussed above has all the attributes of an efficient and effective policy. Its implementation would bring benefits to government, industry and the community as a whole. By providing an implicit tax deduction for interest payments at the time they are incurred, the voucher scheme would reduce the disincentive created by the tax system to invest in private infrastructure projects. Importantly, the scheme achieves this objective directly without the need to involve third parties such as financial intermediaries. As a consequence, the scheme will not encourage aggressive tax minimisation arrangements, which were a feature of the earlier Infrastructure Bonds program. The voucher scheme is neutral in the sense that it does not pick winners. Any infrastructure project could be eligible for a voucher so long as the project complied with the legislated eligibility criteria. The scheme could be administratively simple and transparent and involve relatively low administrative costs. A cap on the total value of vouchers would ensure that the annual revenue costs incurred by the Government do not unexpectedly blow out. The transparency of the scheme, coupled with an independent authority being responsible for assessing applications, means that it would be at arms length from political influence.

IBTOS, by way of comparison, is a very poor substitute for vouchers or the Infrastructure Bonds program, which it replaced. As outlined in our previous submission, there are a number of aspects of the IBTOS that limit its effectiveness. As the following discussion and table highlights, IBTOS fails to meet the majority of the attributes of good infrastructure policy outlined in section 2. In particular:

- IBTOS does not respond to the impediment directly, but relies on financial institutions creating a discount on the interest rate. The tax offset arrangements are proving to be of limited value to many lending institutions such as domestic superannuation funds and banks. Because of this, lending institutions are reluctant to substantially reduce the pre-tax cost of infrastructure, which is the intention of the scheme. The tax offset arrangements may be of greater value to foreign banks as they are not faced with the pressure from shareholders to provide franking credits. However, the tax offset is usually not available to foreign banks as selection criteria restrict the tax offset to lenders that have been resident in Australia for a full income year;
- draft determinations by the Taxation Commissioner on the operations of the IBTOS may lead to outcomes not intended by the legislation. For example, two threaten to limit tax deductions for interest paid on funds that have been on-lent to land transport facilities at rates lower than the investor's funding cost. This will further increase uncertainty and reduce the scheme's effectiveness in addressing impediments caused by the current tax system.
- the scheme is not neutral across infrastructure investments as, in the longer term, it will be restricted to land transport infrastructure. The scheme can therefore only have a limited impact on the infrastructure shortfall because it will not address infrastructure deficiencies in sectors other than land transport.
- the complexity of the application and decision making process increases costs and uncertainty for infrastructure providers (the ACA understands that the costs may be as high as \$50,000 per application);
- doubts must be raised about the benefits to taxpayers generated by the scheme. The high degree of uncertainty associated with the scheme's decision making process means that investors tend to plan projects on the assumption that their application will not be successful. As a result, the scheme does not make marginal projects viable. Rather, it provides a windfall gain to projects that would have gone ahead in any case. It is inevitable that any scheme will assist some projects that would have gone ahead without assistance by the scheme. However, if the scheme only targets these projects, its value must be questioned;
- the annual rebate cap of \$75 million per annum creates budgetary certainty for the Government. However, the cap has been set too low given Australia's infrastructure investment short fall and the relatively small negative impact on government revenues over the longer term;

- the decision making process is not transparent and the potential for political interference cannot be discounted.

Comparison of the attributes of the infrastructure voucher scheme and IBTOS

<i>Desirable scheme attributes</i>	<i>IBTOS</i>	<i>Voucher</i>
Responds to impediment as directly as possible	x	✓
Neutral across infrastructure sectors	x	✓
Administratively simple and transparent	x	✓
Low transactions costs	x	✓
Represent value for money to taxpayers	?	✓
Certainty in respect of government's budgetary commitments	✓	✓
Independent of the political process.	?	✓