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# Infrastructure for an Ageing Australia\*

Today, I will try to cover both the big picture and a number of the specific tasks for which the Commission is better known.

The big picture is important because it is a fairly challenging outlook, if recent performance is any guide to future performance.

Of course, it may not be. But after a decade of poor productivity performance it is natural to ask what will change this trend.

And the specific area of current interest that I will cover is infrastructure, in the context of an ageing Australia.

We have a draft report out in the field on Infrastructure, quite a popular subject at present. Governments are now moving at great speed to endorse large projects that demonstrate their infrastructure credentials.

This is a little troubling – not the greater interest in infrastructure, but the speed.

There are linkages between the needs of an ageing population and infrastructure, as I hope you will see.

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I have said previously that I believe we are at the point where policy gets locked down and – for better or worse – the nature of the discourse and deliverables in Canberra is settled, by the actions of both the Government and the Opposition.

This is a pretty much commonly accepted thinking. It's nothing special to say that Governments and Oppositions try to lock down on their story about the time of the first Budget, assuming that by then the heat has gone out of the election result and the weight of good process has been shouldered.

But this time it may matter a bit more than normal.

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\*Speech to the Committee for the Economic Development of Australia conference *CEDA 2014 EPO Infrastructure series: funding and financing* in Brisbane on 9 May 2014.

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This time, we may be settling a policy paradigm where – faced with pretty clear public advice on the cost and the policy implications of an ageing population, with a terms of trade shift which must reduce national income growth and a recent history of poor productivity results – the choice is one of policy-making in anticipation of a serious slow-down in living standards growth, or not.

Last time we embarked as a nation on serious integrated structural reform, in the much celebrated reform era of the mid-eighties and well into the nineties, the standard line against change was ‘if it ain’t broke, don’t fix it’.

This played well, as I recall, on talk-back radio. It was universally applicable to any reform topic.

And it is not dissimilar to the sort of line that we are hearing today.

We know that we are facing a very significant set of cost rises in health and aged care and pensions. The ageing of the population is inevitable, irresistible.

But we hanker to put off the change.

The history of structural reform is that it takes both sides of politics to make structural change for the medium and long term.

This is not so much because of the vote or any piece of legislation, but because one government will sooner or later be replaced by another government, and effective commitment to addressing structural reform in a sustained way comes from decisions taken when not in power nearly as much as it does decisions taken when in power.

So when I talk structural reform, I am not talking of the occasional one-off improvement to a sector where crisis has suddenly induced the need for change.

As I’ve observed before in other speeches, we have often handled crisis well in Australia.

But we’re not so good at reform in advance of crisis.

And that is the sort of challenge we face today: one where the numbers stare us in the face, but the feel-good factor (maybe the feel-ok factor, to truly reflect opinion polls) is still with us from the resources boom and the benefit of the last sustained period of reform, now getting on towards twenty years ago.

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This is not a supporting speech for the coming Federal Budget. I read the newspapers like we all do – actually not so many of us do anymore – but I have no inside access.

I say it because I think we are at an inflection point, when big social or economic shifts are suddenly perceptible, through the fog of political discourse.

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Let's look at productivity, to set the context.

We have had a great start to the new century. Our incomes rose more than in the preceding decade.

Our household wealth too increased significantly.

And we survived in reasonable shape a financial crisis that brought upon Europe and the United States some exceptional economic and social shocks.

But our last ten years or so of income growth were underwritten by structural reforms of the past and commodity price increases which had not been seen in the previous one hundred and fifty years in this country.

This is all now receding.

SLIDE: productivity and national income

Some sectors – mining and energy – now have an investment base that will enable them to perform well, other factors being supportive, for many years to come.

SLIDE: productivity and national income

Agriculture has recovered from one of the worst droughts of the last one hundred years.

The finance sector and education services too are relatively healthy.

But the remainder of the economy is not as well placed.

And the reasons are many, and varied.

MFP, the measure we – and many other countries, albeit in slightly different forms – prefer to use in showing the long term trend in productivity, is a measure of what we don't know about the economy.

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I didn't just make that up. It's well-established in the literature.

You could think of MFP as measuring a surprise bonus – something above the number of units of production that we could have expected, based on past performance, beyond the simple additions an economy has made to working hours and working capital.

It's where public policy makers should be looking. It comes from innovation, competition, technology.

So when I say that what we don't know about the Australian economy – i.e. MFP – is negative and has been negative pretty consistently for a decade, you see the conundrum.

We don't know what it is, but it isn't going well.

Of course 'it' is a myriad of things.

We published last week an attempt to explain what we could about productivity trends.

We gained a bit of controversy, in attempting to explain some of the complexity that may not be effectively measured in the figures we published.

Referring to things like craft beers and artisan bread, we said there are challenges in measuring changes in quality. And consumer preferences shifting to higher quality bread or niche beers is one aspect of what is hard to measure.

On twitter, there was a bit of a riot.

SLIDES

I had hoped for a bit of attention to this graphic in that Update.

SLIDE: Conference Board

Negative numbers in MFP abound on this graphic.

International comparisons of productivity aren't necessarily helpful for policy-making. The Conference Board in the US that put this together and sought to explain some of the poor US and European figures by reference to the Global Financial Crisis and its consequences in those regions.

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The interesting thing I'd like to bring out is our performance. Australia stands out, and not for a good reason. Whereas in decades past, everyone was a winner from MFP, now just about the worst performance is here.

And doing poorly on MFP in Australia goes back quite a way before the focus of the Conference Board.

Our malaise substantially pre-dates the GFC.

Whatever causes are at work have to be home-grown, to some extent.

Structural reforms across the economy are required to reverse this trend.

Productivity improvement depends on the efforts of firms and their workforces, primarily.

But governments have a role with policies that affect the ability of firms and workforces to make adjustments.

Policies about competition, or tax or retirement or training or infrastructure or workforce management – that alter incentives and opportunities.

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Workforce management, in all its forms, is a core area for future reform.

Our total workforce participation numbers are now declining, a few years in advance of the coming tide of retirements from the baby boom generation.

Participation growth is one of the factors that might improve income growth across an economy, even in times of poor productivity growth.

So seeing both factors weakening, while knowing the impact of ageing is about to be felt across the labour market, is not a comfortable feeling.

SLIDE: re participation

Our 2103 research report *An Ageing Australia* departed from usual Productivity Commission research practice by proposing some areas of policy response to ageing.

Moreover, we gave the figures some context by converting them to future fiscal pressures.

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Subsequent to that, the Grattan Institute and other commentators added to what had been, until then, a fairly passive area of policy discussion.

The sensible conclusion to form from these reports is that we are not set up as an economy to deal with an ageing population.

The report made deep and thorough assessments of all the relevant demographic, immigration, cost, productivity and workforce participation trends, linked to the wonderful prospect that are all going to live longer than we might think.

The demographic numbers in themselves are impressive.

SLIDE: re 85 year-olds

SLIDE: re expenditure

SLIDE: re mismatch pension to life expectancy

Isn't it curious, though, that these numbers – which have been around in various forms for probably ten years now in the public debate – were rarely the subject of serious debate until this last few months?

I think the reason is the same as the reason why most reform options were quietly/probably put to one side for much of the 2000s. We were doing ok, actually in wealth generation we were doing better than ok. And then we had the GFC and we lost a few years in emergency responses and debate over their effectiveness.

A debate that they are still having in parts of the developed world.

But in Australia we can and should now move on to deal with these inexorable trends.

To act now is to avoid shifting this burden to our children. And maybe their children.

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Now many of you thought you were coming here today to hear about infrastructure. And all I've done so far is talk about productivity and ageing.

What has that got to do with infrastructure? Well, more than you might think.

One of the supporting pieces of work in the Ageing research paper addressed the changing shape of cities, as a population gets larger.

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Australia will still grow, as we age, from 23 million to 38 or so million by 2060. Our population growth rate is quite healthy by developed country standards.

Our estimates show the biggest growth being here in Brisbane, to a level in excess of 4 million people by 2060, compared to 2 million today.

Melbourne and Sydney will top 7 million by that time.

An already highly urbanised society will become more urbanised.

These figures suffer from the usual forecasting error exposures, so let's not concentrate on the individual values: let's instead recognise the immense importance of getting infrastructure decisions right.

Sydney was afraid of population growth for a while last decade – you've seen those bumper stickers 'We're full' on NSW cars – but choosing not to invest in infrastructure, which was one of the consequences, has proven to be a mistake.

Even if you don't build the roads, expand the airport (dare I say build another one), improve the rail signalling, expand the station car parks, rezone the regeneration areas, the population growth still proceeds.

It's like putting the cap on the toothpaste tube but continuing to squeeze.

That's because population expands where the jobs are, the services are, the entertainment is. People and firms just encounter increasing frustration at the failure of government if the support structure of a city is not continuously upgraded.

But here's where our Infrastructure report, due to go to the Commonwealth at the end of the month, comes in.

Which infrastructure should be upgraded?

The current answer seems to be all of the above. Projects plans are being dusted off all over Australia in the face of the new incentives for recycling capital from privatisation.

We should all hope that there is more than dust being brushed off.

But right now we can only hope.

The draft report contains a huge expanse of data and comment on issues associated with all the planning, development, financing and cost issues in the breadth of public infrastructure.

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From electricity to roads, airports and on to hospital buildings, we have tried to look across the whole swathe of development and sort out the patterns and problems. And then to propose solutions.

The final report will contain both some high level advice and some very specific recommendations for change. I can't be specific today, as the final report is not complete and in any event belongs first to the government which commissioned the work.

But if you look to the draft report as a guide you will see we identify numerous projects poorly planned and swiftly introduced in recent years.

Hastening to contract has been identified by Auditor-General reports and private sector submitters alike as one of the most important factors in poor public sector infrastructure development. However, poor planning was not solely the province of the public sector, as you know well here in Brisbane.

The evidence suggests that we do not have planning and development systems that are sufficiently valued by governments or the public.

If our infrastructure planning systems were valued, they would be regularly churning out detailed published assessments of cost and benefit in advance of announcements, and these would be given to the community to justify the immense size of some of the commitments being made.

This would be in-depth analysis in advance of press release.

Whereas the norm in major projects is that the announcement precedes the detailed planning. Then if there is time a cost:benefit assessment may be done but often won't be published due to confidentiality concerns. Following that, there is a rapid move to tender in order that the promise is not overtaken by the appearance of delay.

The deficiency is not that the data to do this better does not exist, it generally does.

Nor is it that there are insufficiently competent people to put it together.

It is that the process as just described ensures there can be no pipeline of projects for future private financiers to look over. Such a pipeline was a concept strongly supported by just about all of our submitters.

For a pipeline of projects to exist, there must be a process of continuous publication. Moreover, it must be sufficiently detailed in its analysis to allow private sector

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investors – superannuation funds or banks or operators of toll-roads or construction firms – to take the analysis down off the shelf and apply it to their business model.

The current ‘normal’ process is the opposite of what a pipeline needs.

This system can be reformed, and moreover it can be done without stopping projects in their tracks. This is a long term shift needing an equivalent long term approach.

And better planning will ultimately benefit users and taxpayers. All infrastructure is paid for by one or the other of these two parties. They should be the focus of public policy.

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Our draft Infrastructure report was published in March. Since then, we have conducted public hearings and solicited further improved advice from industry experts on both sides of each debatable point.

Our final report should offer a blueprint to governments – in this case, more for State and Territory governments than the Commonwealth – on not just what to do to improve resource allocation in infrastructure but how to do it.

If it is to be addressed by States and Territories – which are the owners of most public infrastructure – effective reforms will need to reflect local factors.

This is important.

It suggests that variation in performance between States, which may be seen as undesirable at first glance, is a necessary fact of life.

While national agreements may make good TV, the depth and quality of submissions and commentary we have received suggests that it is worth rethinking the model of reform that requires national agreements.

Infrastructure is a widely differentiated product – road, rail, air, electricity, water, possibly gas, even hospital buildings should really be viewed as infrastructure. Some States do view them this way. Others less so.

Some States have privatised much more than others.

Some States are in the midst of major investment plans while others are just embarking on them.

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These simple reflections of reality suggest that in as varied a field as infrastructure one size will not fit all.

What then for the Commonwealth? Is there no role for it?

Unsurprisingly, there will be a serious role for the Commonwealth.

The role requires some deftness – to offer flexibility in support State-based reforms that seek to apply higher quality, more public assessment processes; and to assist those jurisdictions by altering Commonwealth funding to match State pricing reforms – such as electronic road pricing – when such options emerge.

As they will.

This will be leading without imposing a template. It will be complex, but everything in infrastructure is complex. It will take time to see benefits, everything in infrastructure should take the necessary time.

What incentives then exist for States to take up these reforms?

The Commonwealth's offer of support for capital recycling will have a process to assess the nature of the projects which are meant to qualify for that assistance. It can use that process to support these reforms.

That's necessary but unlikely to be sufficient. The recycling plan will only last a short time. These are reforms for the long haul.

The larger incentive is internal to each State and Territory: the consequence of messing up what is looking like being a significant shift of resources into infrastructure at a time of budget restraint is likely to be significant. If implementation is poor, the consequences of waste will appear even greater. This could be quite important for all participating governments.

The final incentive is related primarily to roads.

Fuel excise, the Commonwealth's largest implied funding source for road investment, has since 2001 fallen by more than 30%. If we add in State-based road-related charges, the fall is less but is still below 2001 levels.

Whereas vehicle kilometres, a measure of road use, has risen about 25%.

And the cost of road building continues to rise in real terms (roughly 4% pa), even as the excise continues to fall in real terms.

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This ‘jaws’ effect – increasing use, falling funding – is the reason why we need to plan for road investment and charging to change now.

And just like our proposed age pension reforms, reforms to allow better pricing of roads will not affect today’s consumers. But they will be available some years hence. When we will really need them.

There is good support for such reforms, from surprising sources.

No less an entity than the Australian Automobile Association has offered its support for institutional and pricing reforms similar to those in our draft report.

But there is a caveat. The AAA and its members like RACQ will need to be brought in to the decision-making process on roads projects, now. This is not consumer consultation, so often honoured in the breach. It is direct user representation. We will address this in the final report.

Infrastructure Partners Australia, representing the widest cross-section of the suppliers and managers of infrastructure, was a joint supporter of this perspective with the AAA.

And private sector finance, seen by many as offering additional options to see new projects undertaken, has a similar, if less public, view.

Pricing will offer private finance and investors like superannuation funds clear mechanisms to recover their investment. Important because their future investment won’t, after all, be based on doing it for nothing.

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The sectors covered in the two reports – Ageing and Infrastructure – I have discussed today are substantial. Both comfortably exceed 10% of GDP and are growing in significance. Reforms to them have the scope to shift the dial in productivity performance, as reforms undertaken in the 1990s did.

They are two of the areas we can improve structurally. There are more, many more.

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## Conclusion

Managing these reforms will not be a short term task.

There will be an argument that implies it is not necessary to commence now. There are always alternative numbers which can show a prettier picture, if you want to look for something more comforting.

But consider this as my final comment: my contention is that productivity performance has been poor, the prospects for national income growth are also limited by things like falling participation rates and falling terms of trade, and that as a consequence we should engage now and persistently over a sustained period of years in structural reforms of the Australian economy.

If I am wrong, too gloomy, and things all line up via some natural bounce-back, what will the consequence be?

The consequence will be that we have acted to reduce waste, and improved resource allocation in the Australian economy. Dreadful, isn't it?

The consequence of reading a recent upturn in labour productivity as being all the good news we need in order not to undertake serious reform efforts is not so rosy. In this scenario, getting it wrong has much more adverse consequences.

On this basis of preferring to act in advance of crisis, I will rest my case and am happy to take questions.