

*Infrastructure Partnerships  
Australia leads the national  
infrastructure debate by  
bringing together both the  
public and private sectors  
to promote partnerships in  
infrastructure provision.*



## Infrastructure Partnerships Australia

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**Submission to Australia's  
Future Tax System Review Panel  
October 2008**

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BUILDING AUSTRALIA TOGETHER

## **INFRASTRUCTURE PARTNERSHIPS AUSTRALIA**

Infrastructure Partnerships Australia (IPA) is the nation's peak infrastructure body. Our mission is to advocate the best solutions to Australia's infrastructure challenges, equipping the nation with the assets and services we need to secure enduring and strong economic growth and importantly, to meet national social objectives.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how we do business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia seeks to ensure governments have the maximum choice of options to procure key infrastructure. We believe that the use of public or private finance should be assessed on a case-by-case basis. IPA also recognises the enhanced innovation and cost discipline that private sector project management and finance can deliver, especially with large and complex projects.

Our Membership is comprised of the most senior industry leaders across the spectrum of the infrastructure sector, including financiers, constructors, operators and advisors. Importantly, a significant portion of our Membership is comprised of government agencies.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the challenges ahead.

## EXECUTIVE SUMMARY

- Australia requires substantial and varied infrastructure to be provided over the short, medium and long term, estimated as ranging from \$455 billion to \$770 billion over the next 10 years, in order for demand to be met and our economic and social prosperity to be continued.<sup>1</sup> Economic modelling and analysis confirms that, rather than considering such spending to be a burden, it positively contributes to the economic wellbeing of society.
- IPA suggests a key factor in the ultimate success of the Federal Government's Carbon Pollution Reduction Scheme (CPRS) will be the development of new and renewed infrastructure assets in energy, freight and passenger networks to provide a foundation to achieve the national goal of giving the CPRS full effect. The CPRS has a greatly reduced chance of meeting its targets unless adequate and appropriate infrastructure is in place to support the move to a lower carbon emission economy. IPA estimates the investment required to bridge that investment alone is in the region of \$120 billion across energy, freight and passenger transport infrastructure.<sup>2</sup>
- Given the significance of Australia's forward infrastructure investment task, the existence of Government Budget constraints contributing to the attraction of public private partnerships (PPPs) as a procurement option and the uncertainties and threats posed by our carbon constrained future, IPA believes it is critical that Australia's tax system encourages private investment in infrastructure to the fullest extent. Furthermore, IPA believes it is fundamental that the tax system not be used in any manner which impedes provision of important public goods and infrastructure.
- There are no special taxation rules in Australian tax law to promote investment in infrastructure, except in very limited circumstances. Yet, taxation impacts on infrastructure in critically important ways owing to the large initial capital expenditure long life and concession arrangements involved in such projects, among other issues.
- IPA regards Australia's continued heavy reliance on income tax as the main source of tax revenue, continuing high effective marginal rates applying to income from capital and differences in the tax treatment of different forms of income impact as having a significant adverse impact on our international competitiveness and investment attractiveness.
- The deadweight cost of tax is of particular relevance to IPA owing to the negative effect of deadweight costs on the level of infrastructure investment in Australia by both residents and foreign investors and the associated reduction in the quality of investment in Australia.
- Australia's tax system impacts infrastructure in other respects which are of major concern to IPA. The first of these concerns accessing the early stage tax losses

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<sup>1</sup> ABN-AMRO Equities Australia Limited, Australia Strategy, 2 May 2008, p. 3 and Citigroup Economic & Market Analysis, Australia's Infrastructure Supercycle, 20 June 2008.

<sup>2</sup> Bilfinger Berger Australia & Infrastructure Partnerships Australia, Australia's Carbon Pollution Reduction Scheme: An Infrastructure Challenge & An Opportunity, September 2008

in infrastructure projects and, the second, the number of anti tax avoidance rules that infrastructure investment has attracted.

- Several further aspects of Australia's current tax system have the effect of distorting private investment in infrastructure, such as current tax arrangements which restrict the ability of private investors in infrastructure assets to fully utilise depreciation allowances. IPA also has significant concerns regarding the tax disincentive for trusts to invest in infrastructure owing to the inability of trusts to use the same business test as corporate entities.
- The public sector cannot deliver the infrastructure needed to support Australia's national security and prosperity, and that of future generations, without the involvement of the private sector.

IPA suggests the Henry Review of Australia's Future Tax System and ensuing deliberations of the Review Panel provide a unique opportunity to examine how Australia's taxation regime might evolve and contribute more meaningfully to, rather than create further impediments to, Australia's future infrastructure development.

## 1. INTRODUCTION

Infrastructure Partnerships Australia welcomes the opportunity to respond to the Australia's Future Tax System (AFTS) Review Panel's request for submissions as part of its broad strategy for consulting with the Australian community. IPA's Submission is framed in light of the Review Panel's guidelines, and examines the major challenges facing Australia which may be addressed through the tax-transfer system. This Paper looks at the features that the taxation system should have to respond to key challenges, issues with the current arrangements and possible reforms to address these problems.

This submission outlines core aspects of IPA's position on public-private partnerships and makes specific suggestions on how Australia's taxation system could optimise private investment in public infrastructure. We encourage the AFTS Review Panel to consider our proposals for improving taxation policy and processes to take account of the overall economic benefits to the nation as a whole from investment in productivity boosting infrastructure.

## 2. ECONOMIC AND SOCIAL BENEFITS OF INFRASTRUCTURE INVESTMENT

There is increasing recognition that Australia's existing economic infrastructure is inadequate to meet the nation's short and long-term needs. It is critical that Australia ensures timely provision of efficient and productive infrastructure to support production capability, continuing economic growth and national competitiveness. Economic modelling confirms that such spending positively contributes to the economic wellbeing of society, with the positive multiplier effects of this investment felt right across the economy.

As the Productivity Commission highlighted in its 2004 review of National Competition Policy, economic infrastructure is *"highly capital intensive, requiring major investment expenditure on long-lived assets. Poor investment decisions or under-investment could constrain Australia's growth and living standards for many years"*.

CEDA research (2005) demonstrated a strong and positive correlation between investment in infrastructure and economic growth, with a 1% increase in infrastructure spending showing an increase in economic output of between 0.17 and 0.3%.<sup>3</sup>

Modelling by the Centre for International Economics for the Property Council of Australia (2006) illustrated the contribution to economic prosperity that a portfolio-level investment in ten critical infrastructure projects in NSW could generate for that state over a 30 year period. The modelling found that an investment of \$18.5 billion in NSW's top ten unfunded projects could deliver significant economic expansion and raise prosperity including:

- a permanent increase in real Gross State Product (GSP) by around 3 per cent, equivalent to around \$8.8 billion in every year;

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<sup>3</sup> As infrastructure represents 12% of GDP, a 1% increase in its expenditure creates positive economic benefits as the associated economic output of that spend is greater than the input values (i.e.: it has a positive multiplier effect).

- an increase in employment by around 1.6 per cent, roughly adding of 50,300 jobs to NSW's workforce;
- substantial gain in NSW's competitiveness, with an increase in export volumes of around 9%; and
- benefits to each of the 12 statistical divisions in NSW from the improvements in infrastructure services, even though not every region would directly gain additional infrastructure.

Analysis performed by Econtech (2004) assessed the economic impact of overcoming infrastructure under-investment, by comparing two scenarios - 'baseline' (i.e. do nothing) and 'reform' - whereby the problem of under investment in each sector is overcome.

The Econtech modelling results showed that under the 'reform scenario', proposed investment would boost the productive capacity of five affected industries and increase GDP by 0.8 per cent. Further, in the long run, lower industry costs in the freight, road, gas, water and electricity sectors would be passed on to consumers, resulting in benefits to the broader economy through lower CPI and higher living standards.

### **3. AUSTRALIA'S FORWARD INFRASTRUCTURE TASK**

It is now broadly accepted that Australia faces a major public infrastructure rebuilding and investment task over the next five to 10 years. According to Citigroup, Australia requires up to \$770 billion of infrastructure investment over the next ten years.<sup>4</sup> ABN-AMRO forecasts that up to \$455 billion needs to be spent over the next decade with around \$14 billion worth of PPP projects reaching financial close over the next two years alone.<sup>5</sup> IPA notes that these estimates may turn out to be quite conservative since they are based on how Australia has historically met its infrastructure requirements where externalities, such as carbon emissions, have not been considered as part of the investment decision making process.

The current need for such substantial public infrastructure investment follows a long period of under-investment. Public capital formation has generally declined as a share of GDP since the 1980s, while private capital formation has increased significantly. The decline in public investment and corresponding increase in private capital formation reflects both the shift to the use of PPPs and historic under-investment by the Australian public sector in capital formation.

Recent State Budgets have all announced significant increases in infrastructure investment. The Commonwealth Government has also signalled strong policy and capital commitments to rebuilding Australia's infrastructure asset stock. The new Commonwealth commitment includes;

- Establishment of *Infrastructure Australia*, which will coordinate effective delivery of key national infrastructure projects, with the input of the private sector.

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<sup>4</sup> Citigroup Economic & Market Analysis, Australia's Infrastructure Supercycle, 20 June 2008.

<sup>5</sup> ABN-AMRO Equities Australia Limited, Australia Strategy, 2 May 2008, p. 3.

- Establishment of the Building Australia Fund to provide for Commonwealth investment in infrastructure, with an initial endowment of \$20 billion;
- Commitment to the development of a National Broadband Network (NBN) in partnership with the private sector.

The Federal Government's infrastructure policy is only one part of its broader socio-economic policies, and depends on other policies articulating the settings within which it can operate.

Given the Federal Government's commitment to the development of new and renewed infrastructure, Australia should be looking to develop a regulatory framework which encourages private infrastructure investment. The Commonwealth's commitment to PPPs and greater private investment in infrastructure should be encouraged by all levels of government, without undue impediment, subject to appropriate regulatory controls and accountability to deliver goods and services and ensure value for money.

However, the fact remains that there are no special taxation rules to promote investment in infrastructure, except in very limited circumstances. Instead, the taxation of infrastructure assets is governed by the general taxation rules that apply to all similar types of assets.

#### **4. THE ROLE OF INFRASTRUCTURE IN THE CONTEXT OF THE CARBON POLLUTION REDUCTION SCHEME (CPRS)**

The Federal Government's imminent introduction of a CPRS will have a significant impact both on the way that Australia's economy functions - and on the design of critical infrastructure assets. IPA suggests a key factor in the ultimate success of the CPRS will be the development of new and renewed infrastructure assets in energy, freight and passenger networks.

The CPRS is designed to fundamentally alter the way industries operate, and to have far-reaching and long-lasting effects on the level of greenhouse gas emissions in the atmosphere. This cannot be done without infrastructure in place to support these new methods of doing business.

IPA's submission to the Federal Government's review of the CPRS argued that the scheme will have a greatly reduced chance of achieving its purpose without developing adequate, fit for purpose infrastructure to support the transition to a carbon constrained economy.

Furthermore, IPA believes Australia's governments at all levels will need to make significant capital investments in new and renewed infrastructure to ensure that we can 'bridge the gap' between our current infrastructure asset stock and the assets required to meet the challenges of a carbon constrained world. Governments will not be able to do so without partnering with the private sector.

Australia is starting from a position of historic underinvestment in the infrastructure needed to support the demands of a growing population and economy. Moreover, Australia requires a significant and sustained period of targeted investment in infrastructure to meet the Government's goals for the CPRS and address the

challenge of climate change. IPA estimates the investment required to bridge that gap is more than \$120 billion across energy, freight and passenger transport infrastructure.<sup>6</sup>

IPA contends that the Government needs to look at a broad package of methods to remove barriers to investment in infrastructure which have contributed to current underinvestment, including improving Australia's tax system, to encourage such investment and enable private finance to fully contribute to national infrastructure development.

## **5. TAXATION, INFRASTRUCTURE INVESTMENT AND THE PPP MODEL**

Government procurement has developed significantly in the past 20 years, with new options to purchase assets and services from the private sector. An important development has been the use of public-private partnerships for the development of economic and social infrastructure.

PPPs make a significant contribution to the development of infrastructure for the benefit of the Australian public and Governments at all levels. PPPs are increasingly a key procurement method, offering Government significant benefits.

When properly scoped and executed, PPPs allow for the best share of resources, skills and risk between the public and private sectors in the delivery of critical public assets. The primary purpose of this form of procurement is to capture the benefits from combining design, construction and operation into a single PPP team that maximizes the quality of the asset over the whole of life. These partnerships enable Governments to provide key infrastructure and services (public goods) at better value for money.

Although the detail of the arrangements between public and private sector parties to a PPP can vary significantly, the essential feature of PPPs is that the public partner does not usually own the infrastructure, at least at the beginning of an agreement. In most cases, the public partner either purchases the infrastructure over time from the private partner or leases it from that partner for an agreed term.

Taxation, specifically Commonwealth levied income tax, is a primary consideration in all of these arrangements. It provides a critical opportunity for the private partner in these arrangements to reduce tax obligations and achieve a reduction in overall project costs. Utilising these arrangements, in turn, means better value for money for the public partner and, ultimately, better value for money for the wider Australian tax-paying public.

The public partner, which is usually either a State Government or an agency of State Government, is income tax exempt. However, the private partner is a taxable entity and so can potentially obtain a selection of deductions for revenue and capital expenditures in the normal course of activity.

The possibility of accessing such tax deductions is a factor in the private partner's capacity to calibrate its charges to the public partner for use of the infrastructure.

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<sup>6</sup> Bilfinger Berger Australia & Infrastructure Partnerships Australia, Australia's Carbon Pollution Reduction Scheme: An Infrastructure Challenge & An Opportunity, September 2008

In effect both these public and private partners benefit, but this benefit is inevitably involves the Commonwealth forgoing some tax revenue.

Regardless of the exact form of their arrangements, the main purpose of PPPs is to deliver public goods and services at a lower cost and risk to government. In Australia, use of the PPP model has allowed State Governments to develop significant social and economic infrastructure and deliver a range of critical services to the public in a cost-effective manner. Typical examples include roads, schools, hospitals and power stations.

## 5.1 IPA Research on PPP procurement

In December 2007, IPA launched a landmark report titled *'Performance of PPPs and Traditional Procurement in Australia'*, commissioned by IPA and undertaken by The Allen Consulting Group and Melbourne University. The study undertook comprehensive analysis of 21 PPP projects and 33 traditional projects around the nation, allowing for the first rigorous and comprehensive comparison between traditional government-delivered and privately financed and delivered projects. Its key findings were:

- PPPs demonstrate superior cost efficiency over traditional projects ranging from 30.8% (from project inception) to 11.4% (from contractual commitment to final outcome).
- In absolute terms, the PPP cost advantage was economically and statistically significant: On a contracted \$4.9 billion of PPP projects, the net cost over-run was \$58 million (not statistically significant). For \$4.5 billion of traditional procurement projects, the net cost over-run was \$673 million (statistically significant)
- With respect to time over-runs on a value-weighted basis, traditionally procured projects performed poorly. On a value weighted average traditional projects were completed 23.5% behind time. In contrast, PPPs were completed 3.4% ahead of time on average (*This is measured from contractual commitment to project completion*).
- PPPs are a proven vehicle to deliver government value for money in infrastructure procurement. As more than \$400 billion is expected to be spent on Australia's infrastructure over the next decade, with 10-15% market share, PPPs would create approximately \$6 billion in potential cost savings (vis a vis traditional procurement) over the decade.
- The study has uncovered the myth of sovereign 'risk free' borrowing rate. The report highlights the fact that the risk free borrowing rate is not actually equal to the cost of capital. An infrastructure project always has project risk associated with it, irrespective of the fact whether the public or the private sector undertakes it. Thus the cost of capital is equal to the risk free borrowing rate plus the project risk.

The benefits identified in the study are conservative. Because the study was design and construction centric, it has not captured the long term value delivered from: whole of life asset management; long term risk transfer; young assets, full risks not adequately captured; and asset quality at end of concession period.

## 6. AUSTRALIA'S TAX SYSTEM AND INFRASTRUCTURE INVESTMENT

Supporting Australia's competitiveness means removing distortions created by our tax system so as to facilitate decision-making that is driven by commercial factors, rather than by tax considerations. It also means promoting productivity by tackling "market failures" that ultimately undermine growth. In this respect, the current position of under-investment in Australia's national infrastructure should be a key focus not only for government policy, but also for taxation policy.

IPA understands that equally, competitiveness should be balanced by the aim of ensuring fairness. Individual businesses should pay their fair share of tax in relation to their commercial profits and should compete on a level playing field with others. Furthermore, if the tax system is the most appropriate policy instrument, it should be used to correct "market failures" that impose wider costs on society.

It is clear that in applying the two principles outlined above, tax policy must both consider the possible effects of tax on the level of investment as well as the distribution or redistribution of investment within the economy.

Investment in physical capital (particularly in tangible assets such as public infrastructure, consumer and government durables, land, machinery and equipment) is a key factor in economic growth. In turn, such investment can also affect economic growth through increased productivity, if the added capital raises the marginal product of the existing capital stock and labour force.

IPA considers there are a number of general features of the Australian tax system which tend to deter and distort private investment in infrastructure. These features broadly include:

- **Tax mix and tax burden:** Australia's continued heavy reliance on income tax as the main source of tax revenue, high effective marginal rates applying to income from capital and differences in the tax treatment of different forms of income impact our international competitiveness and investment attractiveness; and
- **Deadweight costs:** The deadweight cost of tax describes the extent to which the value and impact of any tax is reduced because of its side-effects and the extent to which it changes economic incentives. Deadweight costs are of particular relevance in this discussion owing to their negative effect on the level of infrastructure investment in Australia by both residents and foreign investors and their capacity to reduce the quality of investment in Australia.

### 6.1 THE EFFECT OF AUSTRALIA'S TAX MIX & TAX BURDEN ON COMPETITIVENESS

Although Australia's tax mix is comparable to other OECD countries, Australia's reliance on broadly based consumption taxation as a source of revenue is below that of the OECD average, while the proportion of total revenue raised through income tax remains high. Prior to the introduction of GST in 2000, the total proportion of Commonwealth revenue raised through income tax increased steadily from 55% in 1993-94 to over 70 % in 1998-99. However, despite the

introduction of the GST, income tax has still continued to increase as a proportion of total revenue (from 60% in 2000 to 68% today).

Although Australia's tax to GDP ratio is low by OECD standards, Australia's tax to GDP ratio is still higher than that of our Asian neighbours.

Australia's top personal income tax rate is typical of the OECD. However, the absence of a social security tax means that Australia has a high tax burden on capital income relative to comparable OECD countries (taking into account differences in capital tax segments).

Australia's corporate tax rate is the eighth highest in the OECD and above the OECD average. Corporate tax revenue as a percentage of GDP is the fourth highest in the OECD.

Australia's high tax rates are the result of two key differences between Australia's and other countries income tax regimes:

- i) Australia continues to tax income from capital (i.e. dividends, interest and rent) and income from labour at the same statutory marginal rates of personal income tax. By contrast, the international trend is shifting towards taxing income from capital at lower statutory marginal rates than income from labour, encouraging savings and investment. Other countries have introduced systems to tax dividend income at lower rates of tax or tax all income from capital at a uniform rate lower than the top personal marginal rate of tax for income from labour.
- ii) Australia has retained its full dividend imputation regime. Internationally, however, there is a trend away from such full dividend imputation regimes towards partial integration regimes which provide investors with relief from double taxation through either:
  - Provision of a credit to individual shareholders equal to a proportion of the value of the dividend (regardless of the actual amount of tax actually paid at the company level or whether that dividend income comes from domestic or foreign sources); or
  - Application of a reduced rate of personal income tax on dividend income. For instance, Austria and Belgium apply a flat personal income tax rate of 25% on dividends and Sweden a 30% rate. In 2003, Singapore replaced its dividend imputation regime with a dividend exemption regime, no personal tax on income from dividends.

Reforms such as the application of a flat personal income tax rate to dividends have helped countries reduce statutory marginal rates of tax imposed on dividend income reducing the inherent bias which imputation creates against investment in resident companies with international activities.

An inherent disincentive exists to foreign investment by Australian-owed listed companies in offshore infrastructure assets. This disincentive is a result of Australia's imputation regime and application of franking credits.

Where an Australian listed company invests in an onshore asset which generates profit, tax is paid domestically on the profit at both the corporate level through company tax, and by the shareholder when the dividend is paid through personal tax. A proportion of the tax paid on the dividend, proportional to the rate of tax paid at the corporate level, is then refunded to the shareholder in the form of a franking credit. This process is essentially designed to limit “double-dipping” in the generation of tax income.

Similar systems also exist offshore. As would be expected in most international taxation systems where a profit is derived by a company, the organisation becomes liable for company tax on that profit. In turn, where this profit is transferred to the owner (i.e. shareholder) through a dividend, the owner is liable for personal tax. In many international tax regimes, a franking credit is provided to the shareholder.

However, where an Australian-listed company operates offshore, profit on the operations of the organisation in that jurisdiction may generate a tax liability. Tax is paid to the government in that jurisdiction. However, when the profit is transferred to the Australian owners as a dividend, personal tax liability arises within Australia. In this instance, as the corporate tax is paid offshore, the Australian Government does not provide a franking credit. The effect of this is a reduced return to the shareholder on investment.

The effect of this arrangement is the creation of a bias in favour of direct investment offshore by Australian shareholders to maximise their returns. Individuals who invest directly offshore in foreign companies are eligible to receive a credit for foreign taxes levied on their income. This, in turn, has the potential to negatively affect the Australian balance of trade, artificially reducing the profitability of offshore investments.

IPA suggests that the current income tax regime has the effect of deterring investment in Australia, including investment in infrastructure, by reducing income generated by those investments. Furthermore, it reduces the quality of investment decisions by distorting the pattern of investment (owing to the different rates of tax levied on income from alternative investments), reducing the cost of debt finance against equity finance (owing to the deductibility of interest) and increasing the cost of capital by reducing investors’ returns (with the effect of increasing pre-tax market rates of interest and dividend yields).

## **6.2 THE EFFECT OF “DEADWEIGHT COSTS” OF TAXATION ON INFRASTRUCTURE INVESTMENT**

Ideally the tax system should be capable of raising and redistributing revenue in a manner which does not impose a cost on the nation as a whole: that is, it should be capable of raising revenue without altering the individuals decisions to work save consume produce invest and use resources unless, of course, the specific desire of the Government is to alter those decisions.

It has been widely recognised that taxes can never be raised costlessly. Apart from compliance and administrative costs, taxes impose ‘economic costs’ because they induce individuals to make decisions that they would not have

made in their absence. These costs (referred to as “excess burden” or ‘deadweight costs’) can be regarded as the difference between the amount individuals would be willing to pay to avoid having a tax imposed and the net amount of tax collected, after allowing for costs of compliance and administration.

In the course of raising and redistributing revenue, Australia’s current tax system inevitably imposes costs on the nation as a whole by discouraging individuals from saving, reducing the level of investment in Australia by both residents and foreign investors and reducing the quality of investment in Australia. By unintentionally distorting patterns of investment, consumption, production and resource use, the system’s overall efficiency is reduced with resultant costs to the entire community.

Whether deadweight losses are small or large depends on many factors, particularly the size of the tax. Higher rates of tax generate larger losses, and they increase exponentially as taxes rise. This is one of the arguments for a broad-base, low-rate tax system.

In general, deadweight costs of tax are larger the greater the disparities between the effective marginal rates of tax applying to different forms of income, goods and services since that is what distorts the patterns of investment, consumption, production and resource use. This is why the Australian Government needs to take steps to address the current imbalance between effective marginal tax rates applying to income generated by different types of investments (i.e. investments in physical, financial and human capital).

IPA questions the appropriateness of treating investments in long term infrastructure assets as active business income and suggests it may be more appropriate to treat such investments on a passive income basis.

Deadweight costs of taxation are also larger the greater the overall amount of tax revenue collected. Some commentators suggest the deadweight cost of taxation of capital income is likely to be higher than for labour and consumption taxation – perhaps as high as 50%.<sup>7</sup> For instance, New Zealand Treasury guidelines provide for a figure of 20% to be applied to the costs of public sector projects funded from taxation to reflect the deadweight loss.<sup>8</sup>

These deadweight costs of taxation are greater the more sensitive the taxpayer’s economic decisions are to effective marginal tax rates. Increases in the international mobility of financial, fiscal and human capital tend to increase the sensitivity of investment decisions to differences in effective marginal tax rates therefore increasing the net cost to the nation of tax income generated by investment.

## **7. SPECIFIC ASPECTS OF AUSTRALIA’S TAX SYSTEM WHICH DISTORT PRIVATE INVESTMENT IN INFRASTRUCTURE**

As indicated previously, there are no special taxation rules to promote investment in infrastructure, except in very limited circumstances. In the course of raising revenue

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<sup>7</sup> Roger Kerr , The Deadweight Costs of Taxation (First published in the Otago Daily Times, 8 September 2006)

<sup>8</sup> Ibid.

and levying charges, Australia's tax system can have a number of unintended effects on private investment in infrastructure, imposing costs on the community as a whole. Such adverse effects of the tax system are an instance of regulatory failure.

Australia's tax system directly impacts private investment in our infrastructure in two further important respects which are of major concern to IPA. The first of these involves access to early stage tax losses in infrastructure projects and, the second, the number of anti tax avoidance rules that infrastructure investment has attracted.

- **The impact of transfer charges and associated taxes and duties:** Transfer charges and other related taxes and charges, such as Stamp Duty, discourage private investment in infrastructure projects by impacting a projects long term financial profile.

A range of Federal and State and Territory taxes could be considered as impacting on the cost of infrastructure delivery, and vary in quantum and nature between jurisdictions. Despite jurisdictional variations, Stamp Duty represents a significant component of such imposts.

The removal of the suite of charges, duties and taxes affecting the cost of projects to investors would in turn encourage private investment in national infrastructure. The abolition, or as a first step towards their removal, the harmonisation of taxes and charges will assist in delivering greater investment certainty. These changes in turn will promote domestic and international investment in privately financed public infrastructure.

- **Restrictions on the use of tax losses in the infrastructure context:** The long life of infrastructure imposes considerable risk on the likely returns for new investment. The extent to which Australia's tax system restricts access to early stage tax losses in infrastructure projects is a major problem or inefficiency in the tax treatment of major public infrastructure projects.

Early stage tax losses in infrastructure projects are generated from the typically large capital allowance and interest expenses deductions involved in major infrastructure development and, also, the delay involved in these projects commencing to produce income.

In some cases, investors may wait until an infrastructure project commences to produce income in order to utilise those tax losses, but in most cases, it is more efficient to use them as soon as possible, maximising their value. For instance, interest costs incurred during the construction period are usually deductible during that period even though the project in question may have no revenue (i.e. the interest costs are treated as a loss). Such a loss can normally be carried forward and progressively offset against profits during the operational phase of a project.

The ability to use carried forward losses depends on continuity of ownership and the same business test. Should a change in majority ownership in the entity occur early in the life of the project before those losses are fully offset against profits, those losses cannot be deducted by the new owner against future project profits. Instead, in these circumstances, profits from the project are arguably taxed on an illusory basis during the operational phase because the tax treatment

of the project's profits fails to take into account the significant sunk costs incurred at the outset of the project (i.e. interest incurred during construction).

IPA contends these restrictions imposed on the ability of taxpayers to use carried forward losses is a disincentive to private investment in assets with a higher risk profile, such as infrastructure assets.

- **Unintended effects of anti avoidance provisions:** Australia's tax system has particular impact on infrastructure in terms of the anti tax avoidance rules that have grown up around some of the unique aspects of infrastructure financing.

Private infrastructure investment has been sometimes adversely affected by application of anti-avoidance provisions which were designed for other purposes. For instance, Section 51AD and Division 16D (which have now been replaced by Division 250) were designed to prevent tax avoidance by the use of leasing and similar arrangements between taxpayers and tax exempt entities at a time when there was no private ownership of public infrastructure. IPA supported reform of these two anti-avoidance provisions on the basis that these arrangements were entirely different to private infrastructure investment in a maturing market such as the presently existing market, which involves a taxpayer investment in public infrastructure and bearing the commercial risks of such investment.

At this stage, there is considerable uncertainty concerning the effect which the application of the new Division 250 may have on infrastructure investment decisions. While some government policies and guidelines in relation to private investment in public infrastructure acknowledge the now operational Division 250 reforms, it remains to be seen what its effect will be on actual tendering processes.

Finally, there are several other aspects of Australia's current tax system which have the effect of distorting private investment in infrastructure to which IPA suggests the Review panel give consideration in its Review of the AFTS, including:

- **Depreciation regime:** Current tax arrangements restrict the ability of private investors in infrastructure assets to fully utilise depreciation allowances (that is, the tax benefit associated with depreciation/amortisation/write-off of capital investments) with the result that an additional cost is built into the financing of the infrastructure. Furthermore, IPA notes the impact of Division 58 which prevents private investors in infrastructure from claiming depreciation on the full market value of infrastructure assets acquired from government; and
- **Tax treatment of trusts:** Current tax arrangements provide a considerable disincentive for trusts to invest in infrastructure due mainly to the harshness of the trust loss rule and the inability of trusts to use the same business test as corporate entities.

## 7. CONCLUSION

The core issue for IPA is that private sector investment and participation in the provision of public infrastructure is not only a necessity but a desirable goal for governments. As such, it should be encouraged, rather than discouraged, by Commonwealth and State taxation legislation. Furthermore, the productivity gains

from such investment have positive flow-on effects in terms of increases in overall tax revenue.

If Governments at all levels across Australia are to deliver for their voting constituencies, they must be cognisant of the potential impediments new policy initiatives can create to efficient provision of infrastructure (including private investment in infrastructure and PPPs).

Given the considerable uncertainties posed by climate change, the global credit crisis and constraints on government budgets, the public sector cannot deliver the infrastructure needed to support our national security and prosperity, and that of future generations, without the involvement of the private sector. This means that governments must have regard for the need of the private sector to derive a return on their investments in public infrastructure.

IPA suggests the Henry Review of Australia's Future Tax System and ensuing deliberations of the Review Panel provide an opportunity for the Commonwealth Government, at a challenging point in our country's history and economic development, to participate in a whole of Government examination of how Australia's taxation regime might evolve and contribute more meaningfully to, rather than create further impediments to, Australia's future infrastructure development.

If you would like to discuss the IPA submission, please don't hesitate to contact Brendan Lyon, Executive Director IPA on (02) 9240 2054.



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