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We Need a Clearer Debate About Infrastructure

Much discussion about infrastructure is confused. What is infrastructure and how is it best provided?

Infrastructure is a loose term covering a collection of industries and assets. The government does not have a major role to play in many of them.

Typically, infrastructure industries are taken to include roads, railways, water, sewerage and stormwater systems, gas, telecommunications, ports and airports. Most of them can be run as commercial operations in the private sector and each has different characteristics.

Thus is it not possible to talk sensibly about any general infrastructure problem in New Zealand. There is very little concern about gas distribution and transmission, for example. The industry is 100 percent commercial and not subject to problematic capacity constraints.

Nor does it make sense to talk about a general infrastructure 'deficit'. A serious problem in the ports industry, which is largely local government-owned, is actually over-investment. It is well known that many port companies are achieving poor rates of return on equity due to parochial decisions to expand capacity beyond levels supported by demand.

The only meaningful sense in which we can talk about deficits is if profitable investment opportunities are not being taken up. The high benefit to cost ratios of many roading projects in recent years is a clear indication – assuming the calculations are reliable – that New Zealand has been under-investing in viable roading projects. (Some 30 years ago New Zealand had the opposite problem and there was over-investment in roading.)

The main barriers to efficient investment in infrastructure are typically regulation and ownership.

Electricity is one example. Electricity is overwhelmingly a private sector industry in most OECD countries. Typically mismatches between supply and demand are not an issue.

In New Zealand, electricity is a government-dominated industry and actual or threatened winter shortages have become routine. The problem has been compounded by regulatory interventions by both National and Labour-led governments.

Government interventions which distort markets discourage private sector investment and typically invoke further government responses.

Thus in electricity we have seen the government underwriting Genesis's E3P project and running Whirinaki as a baseload station for much of this year at prices below the actual cost of its diesel feedstock. The incentives for efficient private sector investment in electricity have been blunted.

Similarly, the government's forced unbundling and separation of Telecom, the only telco capable of large-scale investment in broadband in New Zealand in the medium term, has damaged investment incentives in that industry. Predictably, we now have both main political parties saying rates of investment in broadband are inadequate and planning to invest taxpayer funds in it.

Arguably this problem is entirely caused by government actions that were not supported by any cost-benefit analysis. At a recent conference, major industry players indicated that government spending on broadband was not needed.

Confusion about infrastructure and the government's role in it leads to confusion about funding.

Spending on infrastructure is capital spending, not operating spending. Sound capital expenditure is not constrained by a shortage of funds. As with any commercial entity, it should be funded by a proper combination of current revenues, borrowing and equity raising. Profitable investments will pay for themselves over time.

The state of the government's accounts – whether it is running operating surplus or deficits and its level of debt – is irrelevant for investment decisions. SOEs do not depend on the core Crown balance sheet.

The important policy issues are how infrastructure industries should be owned and regulated and whether investments in them are profitable.

Under private ownership (in competitive and well-regulated markets) we can be confident that investments in infrastructure industries will be expected to meet their cost of capital since investors will demand normal returns, adjusted for risk. While some investments will not work out, investors will not continue to throw good money after bad.

In contrast, with government ownership political imperatives dominate over time and returns on capital and hence economic growth will be sacrificed. Government ownership of rail is expected to result in losses, which will reduce GDP. Distortions will be created with sea, air and land transport. Political imperatives also impede industry rationalisation, as is obvious in the port industry.

As to regulation, it is clear that regulation of electricity and telecommunications is dysfunctional, and that the operation of the Commerce Act and Electricity Act (which governs the Electricity Commission) is discouraging investment and dynamic efficiency.

If National forms a government after this year's election, a priority should be to review this raft of problems. Putting infrastructure industries like water and roading into government-owned commercial structures (while not excluding private sector involvement), removing heavy-handed regulations and disincentives to invest (including barriers to overseas investment), making the case for shifting central and local government-owned businesses into the private sector, and exploring public-private partnerships should be the first order of business.

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