

6 Cabinet Notes

Not Relevant

613 ECONOMIC DEVELOPMENT BOARD - STATUS REPORT DISCUSSION PAPERS ON KEY ISSUES

Not Relevant

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MINUTES forming ENCLOSURE to

165/011/002TC06

TO: PREMIER FOR CABINET TO NOTE

RE: ECONOMIC DEVELOPMENT BOARD – STATUS REPORT DISCUSSION PAPERS ON KEY ISSUES

1. PROPOSAL

- 1.1. Cabinet to note the final two Economic Development Board (EDB) 'key issues' discussion papers. The papers, Higher education and Finance are scheduled for public release on 23 November 2002. Confidential copies for Minister's eyes only are attached.

2. BACKGROUND

- 2.1. The EDB's status report "*The State of the State: A Status Report on the South Australian Economy*", was presented to Cabinet for noting on 14 October 2002 and released on 6 November 2002.
- 2.2. As previously advised, the EDB has also prepared discussion papers on five key issues that it considers fundamental to the fabric of a strong and prosperous economy and in critical need of action by government, industry and the broader community. These papers cover: Population; Export capability; Government efficiency, effectiveness and leadership; Higher education; and Finance.
- 2.3. The Population and Export capability papers were released on 9 November 2002 and Government efficiency, effectiveness and leadership on 14 November 2002.

3. DISCUSSION

The following provides an overview of the main recommendations contained in the Higher education and Finance discussion papers.

Higher Education

- 3.1. This discussion paper highlights that a skilled and adaptable workforce, supported by high standards of higher education and training, has become very important as a source of competitive advantage and as means of attracting investment and providing high wage employment. South Australia has some unique strengths in its educational and research infrastructure, but also faces enormous pressures brought about by demographic trends, reduced Commonwealth funding and rising global competition. The EDB believes that major reforms are urgently needed to meet these challenges and to establish a strong, competitive university system in the State.
- 3.2. The EDB recommends that the State Government lead the implementation of a centralised coordinating structure to improve communication, collaboration and resource sharing, based upon greater specialisation, between the State's

three universities. The use of incentives, maximising the use of Commonwealth funds, is recommended by the EDB to encourage university support for the proposed systems approach. Bi-partisan and Commonwealth support will be vital to the success of university reform.

- 3.3. In the short term, greater synergies between the universities could be promoted through the establishment of a Higher Education Council.

Finance

- 3.4. This discussion paper argues that business access to finance on reasonable terms is a pre-requisite for viable industry and broader economic growth. An inadequate flow of venture capital is limiting high risk and early stage business expansions in South Australia, which are needed to revitalise the State's industries. South Australia's low deal flow limits its attractiveness as a base for investment fund managers. The EDB believes that the State needs a number of locally based venture capital firms, offering both capital and experienced management, and will explore options to achieve this. It is likely that the State Government will need to be a catalyst for change in this area.
- 3.5. Upgrades to public infrastructure, particularly in some non-metropolitan areas, are needed to maintain community living standards and support industry and population growth. The EDB notes that South Australia's public debt and interest rates are at historically low levels. The EDB recommends that the Government develop a prudential capital management policy that utilises both traditional and more innovative options for funding public investment expenditure. This policy would recognise the need for both prudent financial management and to facilitate economic growth.
- 3.6. In the face of substantial infrastructure demands, the EDB believes that best practice PPP arrangements, that lower costs to government, offer significant funding opportunities. The EDB also recommends that the State Government be more proactive in pursuing avenues for increased Commonwealth funding of infrastructure and that the Commonwealth Government should be encouraged to reintroduce some form of infrastructure bond.

4. RECOMMENDATION

- 4.1 That Cabinet note the attached EDB discussion papers: Higher education and Finance.


Kevin Foley MP
DEPUTY PREMIER
TREASURER
MINISTER FOR INDUSTRY, INVESTMENT AND TRADE

8/11/2002

HIGHER EDUCATION¹

Unquestionably, education, training, and research and development are central to the future development of the South Australian economy and community. In an era of globalisation, South Australia can only compete in international markets by being flexible and innovative, and by maximising the ability of South Australians themselves to contribute to economic development.

South Australia faces a multitude of challenges across the entire education spectrum.

The State has seen a major fall in retention rates for full-time students in years 10 to 12, and a lower proportion of South Australians complete school compared with the national average. In addition, the proportion of South Australian early-years students achieving benchmark standards of literacy and numeracy is below the national average.

These trends are disturbing, not least because of the relationship between education outcomes and economic performance and competitiveness.

Initiatives are already under way to address issues in primary and secondary education. Therefore, the Economic Development Board (EDB) has decided to focus its initial efforts on higher education, where the challenges are both urgent and unaddressed.

The EDB's recommendations on higher education may or may not lead to this State having the "best university" in Australia. That may be the ultimate result, and would be a laudatory one.

The immediate objective, however, is to ensure that South Australia has a competitive university system – one that can produce world-class graduates, generate research (and commercialise research outcomes) and stop the "brain drain" from the State.

Pressures on South Australia's Universities

Within the higher education sector, there are two important issues to tackle:

¹ The Chairman of the Economic Development Board, Mr Robert Champion de Crespigny, declared his interest as Chancellor of The University of Adelaide and had no involvement in the preparation of this section of the report. Mr Andrew Fletcher declared his interest as a member of the Council of Flinders University and also had no involvement in the preparation of this section.

- the relationships and interactions between the three State universities (The University of Adelaide, Flinders University and the University of South Australia)
- the role of the State Government in promoting coordination and collaboration among the various stakeholders in higher education, i.e. universities, technical and further education (TAFE) colleges, Government and industry.

South Australia's universities face enormous pressures, with no sign of relief on the horizon. These pressures include substantially reduced Commonwealth funding, unfavourable demographic trends, and impending Commonwealth initiatives, which, along with reform, may present threats.

Added to these pressures is the desire for the universities to be more integrated in the overall economic development strategies of the State.

In recognition of this challenging environment, the three South Australian universities have been developing their strategic and educational models so that they can compete and cooperate more effectively. Although structurally and operationally they are three separate entities, progress has been made in deriving synergies between the three institutions. In particular, there has been success in collaborative research and in resource sharing.

However, the EDB considers that the challenges facing higher education in South Australia are so great that the current rate of reform is inadequate to meet impending threats. The EDB therefore believes that the pace and intensity of reform must be accelerated.

Central Coordination

The EDB believes the current extent of collaboration between higher education institutions is insufficient to meet the challenges ahead. There are significant opportunities to further strengthen communication links both between the universities and between the universities, TAFE colleges, government and industry. Stronger communication links would better position the State's universities to:

- deepen their centres of excellence through increased collaboration
- raise overall quality through greater focus and specialisation
- control costs through effective resource sharing

- help strengthen existing industry clusters through tighter coordination and collaboration between education and industry.

The EDB believes that a central coordinating structure needs to be implemented to promote stronger communication links between the universities, and between the universities and the other higher education stakeholders. The EDB also believes that the State Government must directly engage in this process and provide stronger leadership across the entire higher education sector.

The EDB recognises that the issue of stronger collaboration across higher education has been canvassed many times in the past. Yet no government has yet been willing to take on the difficult challenge of introducing the necessary reforms. Given the increasing pressures on the university sector, this may be the last opportunity for government to intervene and put in place the appropriate structure for long-term effectiveness.

The EDB believes that rather than three well-rounded universities, what South Australia needs is one well-rounded *system* of universities. This statement reflects a desire not so much for amalgamation, but more for creating deeper centres of excellence at each institution through greater specialisation.

The EDB proposes adopting a "system model" of higher education. This is a hybrid structure that provides centralised coordination while at the same time allowing a reasonable degree of autonomy at the institution level. Each of South Australia's three universities would maintain its identity, culture and mission, but they would all be part of a coherent and cohesive system that provides a structure for coordination, collaboration, resource optimisation and specialisation. The university systems in California and Texas are successful examples of this model.

In arriving at the system model, the EDB did assess the option of amalgamating the three universities. However, it concluded that the organisational and implementation barriers to such an option would in all likelihood outweigh the potential benefits. Importantly, the system model could deliver many of the benefits of amalgamation without its associated trauma and therefore have greater prospects for success.

The EDB recommends that the State Government implement a centralised coordinating structure for strengthening communication links between the universities. In the longer term, a "systems" approach should be analysed, adapted to South Australian conditions and implemented.

The Government should focus on developing positive resource incentives to encourage the universities to engage with and support the proposed central coordinating structure. The EDB realises that resources are extraordinarily scarce. As such, the "carrot" rather than the "stick" offers the best chance for success in a highly constrained funding environment. Commonwealth sources of revenue need to be leveraged for this purpose. The EDB would prefer to see incremental sources of revenue developed for the universities, rather than portions of existing revenue channelled through the system structure or the proposed Higher Education Council (see below).

The EDB recommends that the Government adopt an incentive-based structure to encourage the universities to engage with and support change, maximising use of Commonwealth funds for this purpose.

Higher Education Council

Assuming a system model is deemed appropriate for the universities, the EDB recommends that the appropriate Parliamentary Acts be implemented. However, given that implementation could take 12 to 18 months, the EDB believes that the Government needs a short-term strategy to identify and implement opportunities for synergies across the higher education sector. This strategy could be accomplished through the establishment of a South Australian Higher Education Council.

The Higher Education Council would include the university vice-chancellors and the head of TAFE SA, and be led by the Government. It would also include other people vitally interested in education who understand the unique opportunity South Australia has in higher education. The Council would work to ensure collaboration and cooperation across the universities and other higher education institutions. It would also promote tighter coordination with industry and with the Government's overall economic development strategy.

The EDB recommends establishing a Higher Education Council to promote synergies across the universities and other higher education institutions.

Commonwealth and State Support

The State's universities are facing enormous pressures and immediate action must be taken to strengthen them. Moreover, as the Commonwealth Government is committed

to education reform, the State will have to take action soon if the changes proposed for South Australia are to be synchronised with federal actions.

The State Government and the EDB must make representations to South Australian federal legislators and the Commonwealth Education Minister to support university reform. South Australia's federal parliamentary delegation is an under-utilised resource (in education as well as the other key policy areas with which the EDB is concerned).

Support from the Commonwealth Government could come in the form of legislative support or resource support. It is perhaps more likely to be forthcoming if the State's reform agenda were viewed as consistent with Commonwealth objectives. (This probably helped secure the Commonwealth's support in retaining Mitsubishi in South Australia.)

Importantly, it is early enough in the election cycle for there to be a reasonable prospect of obtaining bipartisan State support for reform. Given that significant reform of the universities will require an Act of Parliament, bipartisan support is an important condition for achieving implementation success.

The EDB recommends that the Government act without delay and seek both Commonwealth and bipartisan support for reform in South Australia.

FINANCE

Access to finance and to debt and equity capital is a key issue affecting South Australian business and the development of the State's economy.

Businesses of all types and sizes need finance when they develop new products, acquire new facilities, purchase new equipment and enter new markets. The South Australian Government, too, needs funds for the roads, schools, hospitals and other services and infrastructure needed by the community.

Venture Capital

For a large publicly listed corporation, funds may be provided by shareholders or by debt finance raised directly through capital markets or from banks. For a small business, finance may be derived through the private savings of its owners or a bank loan.

South Australian businesses seem to be able to attract venture capital for the mid to late expansion phases of business development and for management buy-outs. However, start-up or early-stage businesses are high risk and have greater difficulty accessing both equity and debt finance. Although South Australia accounts for 6.5% of national output and 7.8% of the population, the State had just 2.7% of the firms receiving venture capital from Australian sources in 2000-01.¹

The difficulty in accessing venture capital can be explained by:

- small to medium-sized enterprises (SMEs) lacking the "bricks and mortar" and other collateral needed to back loan applications
- a lack of "investor-readiness" on the part of South Australian small businesses
- the fact that most Australian capital providers are based on the eastern seaboard – it is easier and cheaper for them to service local clients.

Lack of investor-readiness indicates a mismatch between the needs and expectations of finance seekers and those of finance providers. Seekers of finance often lack suitable business plans, have poor management/ownership structures, lack entrepreneurship, have unrealistic expectations and are unwilling to cede control of

¹ Australian Bureau of Statistics, *Venture Capital*, Cat. no. 5678.0. Official statistics on South Australia's utilisation of venture capital may be unreliable because some of the larger transactions have been incorrectly attributed to other States and not all venture capital transactions are captured.

their venture to an outsider. For their part, providers of finance are often unwilling to accept the terms offered or refer to a lack of suitable investment opportunities.

It is indicated that only 3% of SMEs aspire to growth, and are willing to take external equity and dilute their ownership and control.²

Very few venture capital funds are based in South Australia. Moreover, those that do operate in this State typically have a low maximum limit on any single investment and hence cannot "lead" a round of venture capital raising other than for small seed or early-stage projects.

A number of interstate venture capital firms have become more active locally in recent years.³ Nevertheless, South Australia does not have the level of activity or the volume of deals that national and global venture capital providers are familiar with or that would minimise their perception of risk. The low level of local deals also means that South Australia lacks investment professionals who are experienced in managing start-up businesses.

Private equity "business angels" and local small equity investors currently operate in South Australia, but are reluctant to supply venture capital due to the greater risk and the higher cost of deal appraisal (compared with providing development capital to established businesses). The business angel network in Adelaide does not appear to be as well organised as in other cities.

Attracting Private Investment

The Economic Development Board (EDB) believes the emphasis should be on facilitating and leveraging funding from the private sector, rather than on the Government directly taking positions in inherently risky early-stage investments.

The EDB considers that South Australia will be better served by having more locally based venture capital providers. The State needs at least two venture capital firms with a minimum of \$25 million in capital and experienced management. Achieving this would provide improved access to, and a greater volume of, venture capital as well as provide a "lead" investor for local companies. It would also expand the pool of local know-how and capability with regard to finance for industry development.

² National Investment Council (1995).

³ These include Gresham Rabo, Nanyang Ventures, Coates Myer, Foundation Management, Development Australia Fund and Colonial First State in the early expansion/expansion area, and Castle Harlan Mezzanine Partners (CHAMP) in the larger/MBO transactions.

The success of these ventures depends on attracting experienced venture capital managers who are able to raise the required funds through reduced perceptions of risk and to provide the critical management expertise that turns innovative ideas into profitable, growing companies.

The **EDB** recommends that the Government play a role as catalyst in this area. The **EDB** will, as a matter of priority, explore and report on practical options for achieving these goals.

Public debt

Traditionally, governments have borrowed to finance investment in public infrastructure by issuing government or semi-government bonds. The nature and level of public infrastructure investment can have significant impact on economic growth. Governments are able to borrow at lower interest rates than many private enterprises can because they are regarded as a more secure risk.

Over the past two decades, views on the appropriate form and level of public debt have been significantly influenced by the failure of a number of public enterprises and by the excessive levels of debt reached by some governments in the 1980s and 1990s. Similarly, community confidence has been affected by corporate governance issues and the disappointing outcomes of some privatisations.

The **EDB** believes it is essential that the Government maintain a firm and responsible fiscal stance. It recognises that the Government is seeking to stabilise the financial position of the State over the next four years, initially through achievement of cash surpluses. It also recognises that unless this balanced budget position is achieved, the State's financial position will be unsustainable.

However, ongoing fiscal constraint poses a challenge for the State, which continually requires new or upgraded infrastructure. A policy goal of negligible or zero net public debt can constrain the State's economic growth and delay improvements in community living standards. The **EDB** believes that over the medium term the Government needs to consider all available methods for funding appropriate infrastructure (including debt funding and public-private partnerships). As regards debt, the key consideration is the capacity to service the debt. This depends, on the one hand, on the amount of debt held and the level of interest rates, and on the other hand, on Government recurrent revenues and expenditures.

The **EDB** believes that prudent borrowing by governments remains a legitimate means of financing investment in public infrastructure and may ultimately raise a government's revenue base or reduce operating costs.

South Australia's net debt currently stands at \$3.4 billion. The level of public debt has been reduced from \$8.2 billion in 1993 (following the State Bank failure) through the sale of government assets. At 7.5% of Gross State Product (GSP), the State's net debt is low by historical standards.⁴ However, these lower debt levels were achieved through sales of income-earning assets and the State's revenue base is now narrower as a result. The sale of assets has not resulted in greater budget flexibility for the State.

As South Australian public debt and interest rates are at historically low levels, the **EDB** recommends that the Government review its capacity for servicing the funding of infrastructure projects that can lower business costs. Any funding must be consistent with prudent balance sheet management.

There are clearly limits on the Government's capital investment program, so selection of the projects to be funded must be based on a robust priority-setting process. The Fahey Report identified a number of areas in the capital budget process, from project selection to approval, that are in urgent need of improvement.⁵ Public investment projects must be based upon the Government's strategic vision and all-of-government priorities. This must, of course, involve adequate prudential oversight and an important facilitative role for Treasury.

The **EDB** recommends, as a matter of urgency, overhauling Government capital works processes to provide a more streamlined and rigorous process for selecting and implementing public investment projects.

Role of Treasury and the SAFA

The Government's budgetary strategy must address the complementary goals of prudent financial management and longer-term economic growth. The South Australian Government Financing Authority (SAFA) is tasked with developing and implementing borrowing and investment programs for the South Australian

⁴ If unfunded superannuation liabilities are included the State's net debt is \$7.2 billion which is equivalent to 15.8% of GSP.

⁵ John Fahey, Greg Crafter & Rod Payze 2002, *Public Sector Responsiveness in the 21st Century – A Review of South Australian Processes*, Adelaide.

Government. It also undertakes other financial activities determined by the Treasurer of South Australia to be in the interests of the State.

The EDB recommends, as a matter of urgency, the development of an all-of-government policy on prudential capital management. This policy should be under the auspices of the Treasurer, and embrace both traditional and more innovative options for funding public sector investment.

Public-Private Partnerships

Public-private partnerships (PPPs) are an option for financing the delivery of government services and infrastructure developments. In essence, the private sector provides the service, which is paid for by user fees or through budget appropriations.

The EDB believes that in the present environment of financial constraint accompanied by substantial infrastructure demands, PPPs should be explored along with other forms of financing. This exploration should encompass the lessons learned from both successes and failures with PPPs elsewhere (e.g. where large one-off capital expenditures have been replaced with long-term recurrent expenditures by government).

The benefits of a PPP include:

- value for money, achieved through the efficient allocation of risk between the public and private sectors
- potentially substantial savings in time and cost compared with traditional government delivery mechanisms
- operational savings arising out of innovative capital build solutions – a benefit derived from combining the operational and capital phases of the project.

Projects that have commercial or non-commercial value but which the Government itself is not necessarily able to deliver in a timely manner should be considered for PPP rather than rejected outright. The South Australian Government recently endorsed guidelines for PPPs, appropriately vesting in the Cabinet the authority to approve any particular PPP proposal.

PPP projects need to be of sufficient size to overcome the fixed costs associated with the PPP process, such as the costs of carrying out due diligence, bidding for the project and raising funds. In comparison with the eastern States, South Australia has

had little experience with PPP, mainly because of the comparatively small size of projects available in this State. One way around this problem would be to "bundle" similar projects together so as to bulk up the value of projects and allow the fixed costs to be spread.

The EDB considers that opportunities may exist to initiate new major infrastructure projects in the State. These should be pursued with reference to best-practice PPP arrangements in Australia and around the world, and to other forms of structured funding, taking into account risk and total project costs.

The EDB recommends that all public investment projects be prioritised and approved in principle by the Government, subject to funding, and then opened up to competitive funding proposals. This would substantially reduce the potential for bias in comparisons between public and private funding options.

The EDB believes that PPPs should meet the criterion of lowering the cost to Government and the community in both the medium and long term.

Other Financing Options

Infrastructure bonds were introduced by the Commonwealth Government five years ago to facilitate infrastructure development, but lasted less than two years because they were used for aggressive tax planning purposes. Their open-ended nature exposed the Commonwealth financially and they arguably failed to facilitate new infrastructure projects because developments had to be up and running before the scheme could be accessed.

Another initiative was the Commonwealth Infrastructure Borrowings Tax Offset Scheme, which operated in the late 1990s. Under this scheme, infrastructure financiers received a tax rebate on interest received from infrastructure providers. The infrastructure provider enjoyed a reduced borrowing cost but was not entitled to a tax deduction on interest payments. This scheme was targeted at selected infrastructure projects that passed a public benefit test, and was administered in close consultation with State Governments. Although successful, the scheme was not extended when its original funding was exhausted.

The EDB considers that the State Government should press the Commonwealth Government to introduce innovative incentives to promote private-sector investment in selected public infrastructure and regional development projects.

Commonwealth grants are a major potential source of funding for infrastructure. Such grants could be targeted at specific regions or types of infrastructure, and used to assist enterprise zones or regions in need. The **EDB** believes that South Australia must be more proactive in pursuing strategies to gain its fair share of grant funding from the Commonwealth.

Finally, local government in South Australia is the custodian of about \$8 billion of public assets. Historically, councils have worked collaboratively with the State Government in developing infrastructure for economic development. The further development of partnership arrangements between the State Government and local governments would provide an opportunity to establish clear and consistent priorities for infrastructure provision across the whole of the State.