



LEGISLATIVE ASSEMBLY
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STANDING COMMITTEE ON PUBLIC ACCOUNTS

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Submission Cover Sheet

Inquiry into Auditor-General Report 8/2021
- Canberra Light Rail Stage 2A:
Economic Analysis

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Submission to ACT Standing Committee on Public Accounts' inquiry into Auditor-General's report 8/2021 – Canberra Light Rail Stage 2A: Economic Analysis.

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Thank you for inviting me to comment on the economic analysis of Stage 2a of the Canberra tram project.

Discount rates

The report uses a 7 per cent discount rate. This seems unduly high for the purpose.

The yield on Australian government 10-year bonds is 3.1 per cent and that on 30-year bonds is 3.5 per cent. (The ACT government has the same AAA rating as the Australian government.)

Companies use higher discount rates but this reflects the short-term view of many CEOs. The median tenure for a CEO is around five years. Furthermore, Reserve Bank research has shown that the 'hurdle rates' set by companies remained high even while interest rates dropped; Edwards and Lane (2021) and Lowe (2019, pp 11-12).

Behavioural science studies have shown that many people overly discount future returns. In the jargon this is called 'hyperbolic discounting'; in everyday language it is 'impatience'.

Governments, who should be taking into account the interests of future generations, should be taking a much longer term view on issues than do individuals and companies.

I note the report itself comments that 'Douglas Economics advised that the discount rate was "high by international standards".' (para 2.12).

Having an excessively high discount rate means that the benefits of long-term projects are understated. As the costs are concentrated in the early years this means that worthwhile projects may be erroneously rejected as benefit-cost ratios will be underestimated.

Using a lower discount rate would also mean that benefits accruing after 30 years would be more important in the calculations. Most of the capital works for the project will last much longer than 30 years (even if the rolling stock does not). Much of the infrastructure for the London underground was built in the 19th century and is still in use today, for example. So ideally benefits beyond 30 years should be included. (para 3.3).

¹ Views expressed are those of the author and not necessarily shared by the University of Canberra.

Other aspects of modelling

In principle 'wider economic benefits' or 'positive externalities' should be included in the calculations, but they are harder to measure. Accordingly, some sensitivity analysis to alternative assumptions about their magnitudes should be undertaken and presented.

Disruption costs are also reasonable to include but if disruption just diverts business from firms in the construction area to other businesses there may be no net cost involved. (para 2.48)

The suggestion to revise the patronage forecasts in light of experience with Stage 1 (para 3.22) seems sensible.

I agree with Douglas Economics that the 'blended result', a BCR for Stages 1 and 2 combined, has no relevance to the decision as to whether to proceed with Stage 2 or Stage 2a as Stage 1 costs are 'sunk'. (para 3.65)

Stage 2a may not be worth doing on its own ($BCR < 1$) but still be worth doing as a necessary component of taking the light rail to Woden (if the total stage 2 $BCR > 1$).

Disclosure

I own a residence in Yarralumla and an investment property in State Circle, Deakin, whose value may be influenced by Stage 2b.

References

Edwards, H and Lane, K 2021 'Why are investment hurdle rates so sticky?', *Reserve Bank Bulletin*, December, pp 12-20.

Lowe, P 2019 'Some echoes of Melville', Sir Leslie Melville lecture, Canberra, 29 October.