



SMALL BUSINESS WHITE PAPER

Small Business: Big Vision



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The IPA, formed in 1923, is one of Australia's three legally recognised professional accounting bodies with more than 36,000 members and students in over 80 countries. The IPA is a member of the International Federation of Accountants, the Accounting Professional and Ethical Standards Board and the Confederation of Asian and Pacific Accountants.

On 1 January 2015, the IPA acquired the Institute of Financial Accountants in the United Kingdom and in doing so formed the IPA Group which is now the largest small to medium enterprise focussed accounting organisation in the world. The IPA Group is an entity concept and refers to the shared infrastructure. The IPA Board is the governing body of the IPA Group.

The IPA-Deakin SME Research Centre

The IPA-Deakin SME Research Centre undertakes multidisciplinary research on small-and-medium-sized private businesses and not-for-profit enterprises. Focusing on bringing together practitioner insights with world-class research, we provide informed comment for substantive policy development.

The evolution of the Centre began when the Institute of Public Accountants (IPA) and the former School of Accounting, Economics and Finance commenced the IPA-Deakin SME Research Partnership in June 2013, signing a highly-successful three-year research and consultancy agreement.

In 2016, the partnership expanded by bringing together researchers from the Deakin Business School and Deakin Law School to become the multidisciplinary IPA-Deakin SME Research Centre.

The Centre aims to build on its existing portfolio of research and consultancy for small-and-medium-sized private enterprises (SMEs) and not-for-profit enterprises (NFPs). It is also affiliated with leading international SME researchers and research centres, such as the Small Business Research Centre at Kingston University (United Kingdom).

The Centre's scope of activities includes providing submissions, reports, original research, thought leadership papers and its flagship Small Business White Paper in areas such as (but not limited to) taxation, retirement incomes policy, regulation, corporations law, financial services, competition policy, trade and investment policy, access to finance, access to justice, workplace relations, cyber security, sustainability and corporate governance.

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Foreword

Prof Andrew Conway FIPA FFA

In a crowded, saturated public arena, there has never been a more important time for thoughtful policy that builds on the best available academic research informed by practice. The methodology applied in this *Australian Small Business White Paper* combines a range of inputs to provide a voice to Australia's small business owners, advisers and researchers.

The publication of the second *Australian Small Business White Paper* represents a significant milestone for the IPA Deakin SME Research Centre and the policy dialogue for small business in Australia. The IPA prides itself on its long, strong association with small business – through more than 36,000 members and students we see and hear accounts of small business issues every day. We felt it was vital to bring these insights together with academic research to provide a series of policy options to policy makers, at all levels of government, to provide the framework for enhanced future prosperity which, unfortunately and alarmingly, is at significant risk.

This publication, which I have had the privilege of co-directing and editing, builds on the original Small Business White Paper, which was extremely well-received by policy makers around Australia and in markets like China and the United Kingdom. The first white paper was used by the Australian Government and many state governments to guide significant reforms. We anticipate that the recommendations in this second white paper will take the advocacy of small business to a new level.

Never before has there been such an assembly of informed academic research, together with practitioner insights. Perhaps today, more than ever, our economy needs to think bigger than ever before. Small business does not equate with small opportunity or narrow vision. Small businesses and our economy require policy solutions that promote small businesses with bold ideas. We therefore focus the recommendations on the theme of 'small business: big vision'.

This means we must encourage, at every junction, policy makers to have the courage to develop policies that deliver a

seismic shift. There is one compelling reason for this: Australia's declining productivity.

We know, through our research, that Australia's multi-factor productivity (or our quality of life) is in decline. We face the disgraceful dilemma of potentially willing to future generations a quality of life that is worse than the one we currently enjoy. This would be the first time in our history that we are faced with such a prospect. The *Australian Small Business White Paper* seeks to jolt policy makers into action, to realise that unleashing the productive capacity of small business will boost our economy in ways we can only imagine. To do this requires policy makers to adopt the mindset of an entrepreneur – almost a 'nothing ventured, nothing gained' approach.

In other words, stop talking and start doing. Politics is the art of doing and we have an opportunity, informed by evidence and practice, to deliver real change. We recognise that small business will not be the panacea for the productivity crisis befalling Australia. However, it is a key part of the cure. We make recommendations in this paper for Australia to re-engage with the 'One Belt, One Road' initiative to ensure the maintenance of trade markets and ongoing competitiveness.

This document has been prepared with numerous inputs. I acknowledge the hundreds of small businesses who shared their insights at our consultations sessions which I was delighted to personally facilitate around Australia, from Darwin to Geelong. We gathered evidence from UK-based academics to inform the way we structured our recommendations. We also looked far afield to places like the OECD for insights.

The primary recommendation in this paper is a message to policy makers: think big, get out of the way of entrepreneurs, and watch small business truly drive productivity.

This *Australian Small Business White Paper* covers 12 topics which are, to an extent, interrelated:

- Productivity
- Regulation
- Taxation
- SME financial markets
- Workplace relations
- Job creation and job destruction
- Innovation
- Competition policy
- Family firms
- Internationalisation
- Mental health
- Digitisation and cybersecurity

The purpose of the document is, through the detailed findings, to make specific, targeted recommendations for policy reform here and now, while at the same time creating a platform for discussion on providing a clearer, bolder vision for the future of small business in this country.

We need to tell policy makers that it is acceptable to be bold in thinking and to generate a new wave of reform. We should begin with the 'big three' issues as key productivity enablers: tax, finance and competitiveness. The passage of the tax reforms in the United States on 22 December 2017 should give all stakeholders confidence that major reform is possible. What is required is mature, bi-partisan debate and a focus on productivity and boosting Australia's competitiveness.

In relation to tax, the three key recommendations are:

- 1. Broaden the base and lift the rate of GST (subject to appropriate equity measures)**
- 2. Cut direct taxes**
- 3. Undertake a zero-base design of a thoroughly modern taxation system.**

We must, for the sake of Australia's competitiveness, initiate a conversation and deliver on the principles of a tax system that is simpler, fairer and more competitive.

What would it look like, for example, if Australia's GST rate rose to 15% and personal income taxes were slashed or removed for a new entrepreneur's first five years in business? What does a tax system look like that rewards rather than punishes people under the age of 50 for saving for their retirement? Why do we have excess contributions taxes for those wanting to remove the burden from the state in their retirement? What impact would a policy recommendation have that said: if you're on the minimum wage, you pay minimum tax? What about a tax rate that applied a tax-free threshold at \$30,000 per annum and 15% for minimum wage earners? Or a tax system that rewarded entrepreneurialism, investment in health, education and supporting charities?

As a consequence of increasing the rate of GST, state and territory governments would have greater capacity to substantially reduce or eliminate key stamp duties and charges on transactions such as property transfers, vehicle registration and insurances.

What if our personal tax rates looked like this?

Income	Tax rate
\$0-\$30,000	0%
\$30,001 - \$60,000	15%
\$60,000 - \$100,000	25%
\$100,000+	35%

By increasing the disposable income of Australians on incomes under \$100,000 per annum, the system could facilitate the removal (or substantial restructuring and simplification) of complex family tax benefits.

Deductions could be simplified to five broad categories: charitable, educational, entrepreneurial, health and investment.

For companies, the tax rate should be standardised to 25% across the board.

In such a streamlined regime, banks would be levied to fund an Australian growth fund to generate a pool of funds to initiate a surge in start-up businesses that may not ordinarily meet the requirements for traditional bank finance. This would complement a loan guarantee scheme that would support development in a particular industry or geographic location, to reduce reliance on already strained infrastructure.

Foreign investment in critical infrastructure may be matched by a dollar-for-dollar investment to reduce sovereign risk.

States and territories could be incentivised to reduce stamp duties, payroll tax and other charges that were committed to be reduced or abolished following the introduction of the GST, as documented in the Intergovernmental Agreement on Tax Reform.

Such charges and levies which serve to stifle entrepreneurship should be quarantined and directed to special state and territory Infrastructure funds to grow regions and the capacity of the economy. If you like, they could form localised 'future funds', with a critical focus on growing the size of the segmented economies within the Commonwealth.

These are all topics for consideration – suggestions for deliberate measures to put on the table for discussion. They will no doubt attract widespread views. However, without a clear, bold direction for tax in Australia, we risk simply missing an opportunity to secure future sustainability due to the fiscal pressure applied by, among other things, our significantly aging population. Australia's tax mix is simply unsustainable and we hope, through this white paper, to put real concepts forward

that provide quick wins and maintain our focus on the future.

To round out our calls for greater leadership at all levels of government, we believe the Commonwealth should play a key facilitation role. It is vital that we re-think our approach to small business policy with a view to the following:

- 1. An incoming government should commit to holding a small business summit within the first six months of assuming office. It is vital that we curate the brightest minds in research, innovation, regulation, practice and policy to turn Australia into the world's best place to start and run a small business.**
- 2. The Prime Minister should form and chair a small business advisory council that would provide direct policy options to government to inform the COAG agenda, with productivity at its core. This critical platform should follow the model set by many other jurisdictions in our region, with an eye towards the regulatory burden.**
- 3. The Small Business Minister should remain in Cabinet, within the Treasury portfolio. This is critical to ensure the principal economic driver of the economy is central to the administration of government within a 'whole of government' agency.**
- 4. An incoming government should conduct a zero-base design of Australia's tax system. From our understanding, such an activity has never been undertaken. This should be in partnership with the profession and researchers to develop an applied model for tax reform.**

Finally, and perhaps most importantly, we seek to generate a new-level dialogue in relation to the importance of mental health and the wellbeing of small business owners and their advisers. We spend a great deal of time educating accountants and other advisers about the technical elements of small business ownership – however, we have not prepared advisers to look for the signs of mental ill-health or to promote a greater sense of personal wellbeing. One of the most staggering changes in the dialogue we have had with small businesses across Australia, compared to 2015, was how frequently we heard the issue of mental health raised. The prevalence of mental ill-health among small business owners and operators, particularly in regional areas, has prompted an urgent review of the body of evidence in this space. We have commissioned a separate, dedicated research focus on these issues, with a view to developing a

Small Business: Big Vision recommendations

- 1.** Broaden the base and lift the rate of GST (subject to the appropriate equity measures).
- 2.** Cut direct taxes.
- 3.** Undertake a zero-base design of a thoroughly modern taxation system.
- 4.** Reform and simplify the personal income tax scale.
- 5.** Standardise a company tax rate at 25%.
- 6.** States and territories should be held accountable to the Intergovernmental Agreement on Tax Reform to eliminate payroll tax and stamp duties. These revenues should be channelled into a state infrastructure fund to grow the economies.
- 7.** Commit an incoming federal government to hold a small business summit within the first six months of assuming office.
- 8.** The Prime Minister should form and chair a small business advisory council to provide direct policy input and options to the government to inform the COAG agenda with a core focus on productivity.
- 9.** The federal Small Business Minister should remain a permanent position in Cabinet, preferably with its own department.
- 10.** The Australian Government should facilitate small businesses joining global value chains to remain competitive and access global markets.

suite of resources for accountants who, so often, are seen by small business owners as their first, most trusted advisers.

I would like to thank the co-contributors and authors of this white paper; namely the IPA's Vicki Stylianou and Tony Greco, Dr Nick Mroczkowski (Deakin University), Professor George Tanewski (Deakin University), Peter Carey (Deakin University), Robert Blackburn (Kingston University UK) and Marc Cowling (Brighton Business School UK), Ms Rachel Burgess (Deakin University), Mr Wayne Debernardi (IPA Media and Communications team), and the many hundreds of small businesses and advisers who came to our consultation sessions across Australia and the UK.

In addition, I would like to thank and commend the IPA Deakin SME Research Centre Advisory Board – comprising The Hon Bruce Billson (Chair), Dr Michael Schaper, Ms Su McCluskey, Mr Arthur Anastasiou, Dr Nick Mroczkowski, Prof George Tanewski, Prof Barry Cooper and Ms Vicki Stylianou – for the Research Centre's guidance and leadership.

We welcome feedback and discussion, and encourage you to engage with us as we release the second edition of the *Australian Small Business White Paper – Small Business: Big Vision*.



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Executive summary

The focus of this second *Australian Small Business White Paper* – researched, written and published by the IPA-Deakin SME Research Centre – is on Australia's small business sector and how it can contribute to lifting our national productivity.

Productivity matters because, simply put, productivity growth is the primary determinant of income growth. As long as productivity remains stagnant, Australia faces a significant challenge in maintaining the nation's living standards.

The small business sector (as a huge component of the economy) has the potential to positively influence productivity growth. However, Australian small businesses now operate in an increasingly complex global environment of increased interconnectedness, interdependence, uncertainty and change. For this reason, and others, the sector requires support to become more innovative and efficient, to employ more people and to export more.

At the IPA-Deakin SME Research Centre, we believe government has an important role to play in positively influencing productivity growth, especially through supporting the small business sector with measures such as:

- Enabling and promoting access to affordable finance to improve the longevity of small businesses
- Implementing the Harper competition reforms to enhance the competitiveness of small business
- Facilitating education and skills development for small business owner-managers
- Updating regulatory settings over time, so as not to impede private sector investment
- Resisting protectionism and facilitating increased access for small businesses to international markets
- Fine-tuning innovation policy to reward collaborative research, support innovation diffusion and expedite the commercialisation of innovative ideas, especially in the technology space

- Reforming the taxation system to increase incentives and decrease disincentives to the establishment and growth of innovative small businesses
- Undertaking workplace relations reform to ensure the framework delivers consistency and stability to small business owner-managers
- Supporting small businesses in developing effective cybersecurity processes and systems, with the aim of preventing or mitigating potential security exposures to their operations.

Non-state actors (such as multinational companies, civil society groups, private interests and individuals) also have a role to play, as they are increasingly able to influence the agenda and outcomes, often through the expert use of social media.

This paper contains a number of key policy recommendations, focusing particularly on assisting the small business sector in the areas of productivity and efficiency; regulatory overload; taxation; finance principles; workplace relations; employment dynamics; innovation; competition policy; family firm financing; internationalisation; SME owners' mental health; and cybersecurity.

1. Recommendations related to productivity and efficiency

To support the small business sector's ability to contribute to Australia's national productivity growth, the federal government should:

- Introduce initiatives to improve managerial capabilities in SMEs
- Review capital market efficiency to address the problem of 'zombie companies' (those businesses that require bailouts to survive), where too much capital is currently held
- Review the regulatory framework to reduce insolvency resolution times
- Encourage business start-ups to stimulate efficient, dynamic resource reallocation
- Conduct a sector review of the mining industry
- Conduct a competition review of the 'mining', 'manufacturing' and 'electricity, gas, water, and waste' industries
- Introduce initiatives to enhance technological absorption rates in 'older' firms
- Speed up the roll-out and increase the coverage of high-speed broadband
- Introduce supply-chain efficiency initiatives
- Introduce initiatives to enhance firms' marketing capabilities



- Ensure the education system produces enough STEM (science, technology, engineering and maths) graduates, and that the business sector can absorb them at an efficient rate.

2. Recommendations related to regulatory overload

With an increasing number of small businesses concerned about the impact of laws and regulations on their ability to operate and innovate, we recommend that the federal government should:

- Continue emphasising the need for 'risk-based' regulation, so entities at a 'low risk' of non-compliance are not subjected to inappropriate, unnecessary regulatory scrutiny
- Continue contributing to the work of the OECD in enhancing global awareness of good regulatory practice
- Continue periodic reviews of regulatory agencies/bodies and statutory boards to ensure the public interest is well served
- Continue using the Office of Best Practice Regulation (OBPR) to ensure laws and regulations take account of small business needs
- Strengthen the use of small business regulation impact statements
- Ensure company extracts and financial statements lodged with the regulator are made freely available
- Facilitate the application of technology ('regtech') solutions, especially by small business, as a means of easing the regulatory burden
- Consolidate corporate and other registers, so small business owners can deal with one portal for all their compliance needs
- Pursue necessary measures to implement one regime for registration and regulation of charities and not-for-profits.

We recommend that the Australian Accounting Standards Board (AASB) should continue reviewing existing accounting frameworks to ensure they reflect community needs and maintain the integrity of the measurement and recognition requirements in international financial reporting standards.

We also recommend that preparers of special purpose financial statements should review the format of such statements (following changes made by international accounting standard setters to the conceptual framework).

3. Recommendations related to taxation

Taxation reform – to encourage entrepreneurs to start, run and keep their businesses in Australia – is an essential ingredient in ensuring a stable economic future for Australia.

We therefore recommend that the federal government should:

- Renew its commitment to a comprehensive tax reform process
- Realign our tax system to reduce its heavy reliance on individual and corporate income taxes
- Explore changes to the GST
- Explore the use of a parliamentary forum (such as a committee) to seek further stakeholder views on tax reform
- Investigate the potential implications of adopting tax incentives for new businesses, such as those operating in countries such as Singapore
- Explore options with the states and territories to either remove payroll taxes or ensure the laws and the way they apply are consistent across the country
- Ensure the smooth implementation of the single touch payroll regime
- Establish clear policy objectives for small business tax concessions
- Reform the tax system so that it provides targeted assistance towards stress points in a business life cycle, such as the start-up phase or during a temporary setback
- Remove incentives to complex business structures and consider the creation of a simplified small business entity.

In addition, we recommend a holistic review of small business tax concessions to ensure they are consistent and work collectively to support small businesses through all stages of a business life cycle.

We recommend that professional advisers should constantly promote the in-house facilitation process as a potentially effective, cost-efficient means of resolving tax disputes.

We also recommend a whole-of-government approach for small business assistance programs (accountants are well placed to deliver such programs, as they already act as advisers to small businesses).

4. Recommendations related to finance principles and alternative financing

Given the importance of SMEs as significant contributors to (and drivers of) GDP, we recommend that the federal government should:

- Review its current policy settings for SME finance to ensure it follows world's best practice (as specified by the G20 and OECD)
- Provide appropriate incentives that encourage financial institutions to urgently re-examine their finance offerings for SMEs
- Initiate loan guarantee schemes
- Allocate priority funding to vocational education courses to enhance SME owners' financial literacy, business strategy and management skills
- Provide incentives (such as tax deductibility for education costs) to SME owners for financial literacy and business management education
- Fund research initiatives to support the work of the OECD in developing a generally-accepted definition of SMEs
- Support initiatives for the introduction of a new bank that services the specific financing needs of the SME sector
- Pass legislation allowing proprietary companies to take advantage of equity crowdfunding.

There is a need for clarity relating to the operations and legal aspects of crowdfunding in Australia.

Governments and financial institutions can address the finance gap through alternative finance models such as more asset-backed loans (including the recognition of intangible assets as collateral), project financing and leasing.

Governments, financial institutions and industry groups should also encourage SMEs to use alternative sources of finance as a means of bridging the SME finance gap.

5. Recommendations related to workplace relations

Small businesses owner-managers benefit from a workable workplace relations framework that delivers consistency and stability. They need to know how to operate optimally within the workplace relations system, but the system itself will not provide competitive advantage.

However, how human resources (HR) are managed within the owner-managers' firms will be an important driver of (sustainable) competitive advantage.

We therefore recommend that:

- Continued effort is required to ensure small business owner-managers understand their legal rights and responsibilities with regard to workplace relations, for the purposes of managing their workforce in a fair, equitable manner and in a way that is conducive to a sustainable, productive work environment. To achieve this:
 - Easy-to-understand regulatory material needs to be readily available.
 - Small business owner-managers should be given the opportunity to make anonymous enquiries regarding workplace relations matters (to encourage more accurate, timely information flow).
- Regulators, at all levels of government, should continue to address and remain vigilant to compliance burdens. Regulatory requirements need to be simplified and associated cost-burdens minimised where they are unable to be removed.

6. Recommendations related to net employment dynamics of Australian SMEs

Our analyses demonstrate that start-ups and young firms are important drivers of net employment in Australia and, when considering the effects of age and innovation together, we find that these factors significantly contribute to job creation and are important sales growth and performance differentiators.

Our results show compelling evidence that the innovation capability of start-ups and young firms underpins the observed firm-employment dynamics, significantly influencing employment outcomes in the Australian economy.

We therefore recommend that:

- An important policy objective is to identify start-ups and young firms that have innovation capabilities early, as these firms contribute significantly to net job creation.

7. Recommendations related to innovation

Given that innovative firms (particularly start-ups) are known to create more jobs than other business categories, governments in Australia should do everything they can to assist businesses



to understand the value of innovation and, where appropriate, provide financial and other incentives to encourage innovative thinking within the small business community.

We recommend that federal, state, territory and local governments should:

- Provide more support for research and development by small and medium-sized firms
- Promote better linkages between research universities and industry
- Provide more support for firms to adapt existing technologies and innovation
- Develop and implement measures to help the spread of existing innovations to a broader range of firms
- Encourage firms to adopt 'continuous improvement' methods to embed incremental innovation.

The federal government, in particular, should:

- Provide tax breaks for companies acquiring new technologies not developed in-house
- Develop a 'matching' service to promote collaborative relationships between multinational corporations and Australian businesses, both domestically and abroad
- Provide a tax allowance for companies that invest in intellectual property protection (through patents, copyright, trademarks, design rights etc) in-house
- Provide tax allowances for companies that generate licensing income for in-house new technologies
- Rigorously continue with its 'patent box' initiatives, as outlined in its current reform agenda
- Further develop government procurement initiatives to ensure small business procurement targets are met and exceeded by 2022
- Allocate funds for further research into youth entrepreneurship in Australia.

8. Recommendations related to competition policy

To fully give effect to the new competition law provisions for the benefit of small business, we recommend that the ACCC should:

- a. **Bring cases on the new provisions as quickly as possible to provide clarity on how they will apply in practice**
- b. **Apply the amended misuse of market power provision to exploitative practices as well as exclusionary practices**

c. **Produce tailored guidance for small businesses on the new concerted practices provision**

d. **Produce separate guidance on concerted practices for industry associations and their members.**

The small business community should also consider lobbying the ACCC for a class exemption in relation to identified common commercial transactions that are technically at risk of breaching competition law but are unlikely to do so in practice.

In addition, the benefit of the Harper Reforms (and competition policy generally) could be enhanced for small businesses through an improvement in access to justice for small business. We therefore recommend that:

- a. **Changes are made to facilitate representative private damages actions**
- b. **Procedural changes are made to encourage private actions for damages, as the market would be less reliant on the ACCC to bring action**
- c. **Higher penalties be imposed on firms that break competition law, creating a greater deterrence effect**
- d. **Encouragement is given to compensation schemes for those who have suffered as a result of a breach of competition law**
- e. **Online tools and materials be made available to assist in the early resolution of competition law disputes**
- f. **The introduction of online court processes be considered, particularly for simpler cases.**

Many of these recommendations are applicable to broader access to justice issues in Australia.

9. Recommendations related to family firms

Family firms are a major component of the SME community and contribute significantly to GDP. To address financing needs, some larger family firms list on the Australian Stock Exchange (despite the ASX tightening the listing criteria to discourage small-cap businesses from applying to go public).

We recommend that:

- State and federal governments should encourage more research on family firms and their role in contributing to the wealth of the economy

- The ASX should consider removing the recent barriers caused by changes to the listing rules, thus encouraging family firms to take up the option of listing (an alternative may be to consider resurrecting the former 'Second Board', allowing smaller-cap companies to list and thus have another financing option).

10. Recommendations related to internationalisation

There is much to be done to help Australian SMEs raise their game in the international marketplace. Evidence shows a weak international performance by SMEs, but also grounds for optimism.

In terms of government policy interventions, we recommend:

- A targeted approach, aimed at those SMEs that seek to internationalise but have not yet done so, and those that are already exporting and seek to expand their international reach into new markets
- A higher priority on facilitating SME exports in the six most internationally active industries, including 'mining', 'agriculture', 'manufacturing', 'wholesale', 'information media', and 'professional'
- Greater emphasis on encouraging small and self-employed firms to participate in foreign markets by providing targeted export incentives, support for network and international collaboration, business matching opportunities, and facilitating access to finance
- Increased support for growth and innovation to boost the number of exporters and accelerate their international activities
- More support for SMEs in terms of detailed information provision, such as tailored advice and a mentoring program for firms internationalising in different geographical markets, in-depth discussion forums and network events.

11. Recommendations related to SME owners' mental health and performance

As research on this issue is ongoing and still in progress, the IPA-Deakin SME Research Centre is unable to provide details on findings or recommendations at the time of writing.

The Centre is of the view, however, that mental health and wellness is a significant area of concern for all businesses, not just SMEs. In this sense, we feel a sense

of responsibility to inform readers of the extent of mental health issues impacting SMEs and their advisers.

We also believe it is important to articulate the current work undertaken by the Centre to identify the real mental health issues impacting IPA members and their clients, and the potential mechanisms that can be utilised to assist businesses, their owners and advisers in their struggle to cope with day-to-day mental health challenges.

12. Recommendations related to cybersecurity

To avoid or defend against the high risk of cyberattacks, we recommended that SMEs should:

- Increase their awareness of the need to apply adequate checks and balances to prevent or mitigate potential security exposures to their operations
- Increase their awareness of the significant risk they face from cybercrime, including the risk of their systems being used as a 'stepping stone' into connected systems in the supply chain.

Governments and technology companies also have a role to play in simplifying techniques for 'hardening and shielding' websites from cybercrime, so that such techniques are accessible to SMEs (and particularly small businesses).

A range of online 'cloud-based' host sites should also be established, so that SMEs can migrate their IT systems into a secure cloud environment.



Introduction

Vicki Stylianou: Executive General Manager,
Advocacy and Technical, IPA

Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.

(Paul Krugman 1994, The Age of Diminishing Expectations)

Revitalising the Australian economy: navigating the headwinds

This is the second Australian Small Business White Paper produced by the IPA-Deakin SME Research Centre. When the first Small Business White Paper was released in 2015, we stated that its principal purpose was to present policy options for Australia to deal with the emerging economic challenges that were confronting the Australian economy. We posed the fundamental proposition that, while the Government grapples with ways to address Australia's budgetary problems, a much more profound and urgent challenge was emerging – a productivity crisis. In the three years since we made that statement, developments have accentuated this challenge, creating a greater imperative for urgent government action.

These challenges have been compounded by a global environment that has seen the election of Donald Trump as US President, the uncertainty in Europe and possible contagion effects attributable to Brexit, rising protectionism, the implications from the rise of China as a super power (including geopolitical issues and the so-called 'trade war'), ongoing technological advances with the advent of the Fourth Industrial Revolution, continuing demographic shifts, transnational cybercrime, the impacts of climate change and continuing refugee crises. At the same time, our world has continued to become increasingly interconnected and interdependent with scientific, technological and logistical advances in countless countries simultaneously driving economic growth globally.

These events have all combined to create an environment of even further uncertainty and change. What we need to consider is the impact of these events

on the Australian economy and the need to develop appropriate domestic policy responses.

Being a small, open economy, Australia is particularly susceptible to the rise in global protectionism. This could damage future economic growth and undermine the global rules that underpin our trade and investment status. Moreover, at a time when productivity remains stagnant, Australians should be concerned about the potential serious consequences of stagnant productivity on the Australian economy and future living standards.

These economic 'headwinds' continue to strengthen and present potential challenges for the Australian economy going forward.

Successfully navigating these headwinds will be essential to maintain, if not boost, Australian productivity growth, improve national income and raise living standards. The challenges for Australian policymakers are increasing, making the need for action immediate.

Small business continues to be the engine room of economic growth. The latest ABS Business Counts data for 30 June 2017 indicates that, of the 2.24 million businesses in Australia, there were 2.18 million (97.3%) micro and small businesses (those with less than 20 employees) (**Figure 1a**). Of these, there were 1.4 million (64.2%) micro businesses that did not employ any staff. Small business contributes one-third of GDP, employs 44% of all workers and generates 40% of new jobs. The annual turnover for 60% of these small businesses is less than \$200,000 (**Figure 1b**).

However, if small business is to prosper, some things need to change. Innovation processes are less common in small businesses, with 60% engaged in innovative activity compared to 67% for medium-sized businesses and 80% for large businesses. Small businesses also report slower rates of productivity improvements compared to large firms (28% compared to 36%). While small businesses represent 44% of all businesses that export goods, they only account for 0.5% of exports by value⁰¹. Despite increases in the number of small businesses that are 'born global', significant scope exists for them to become more dynamic, innovative and efficient.

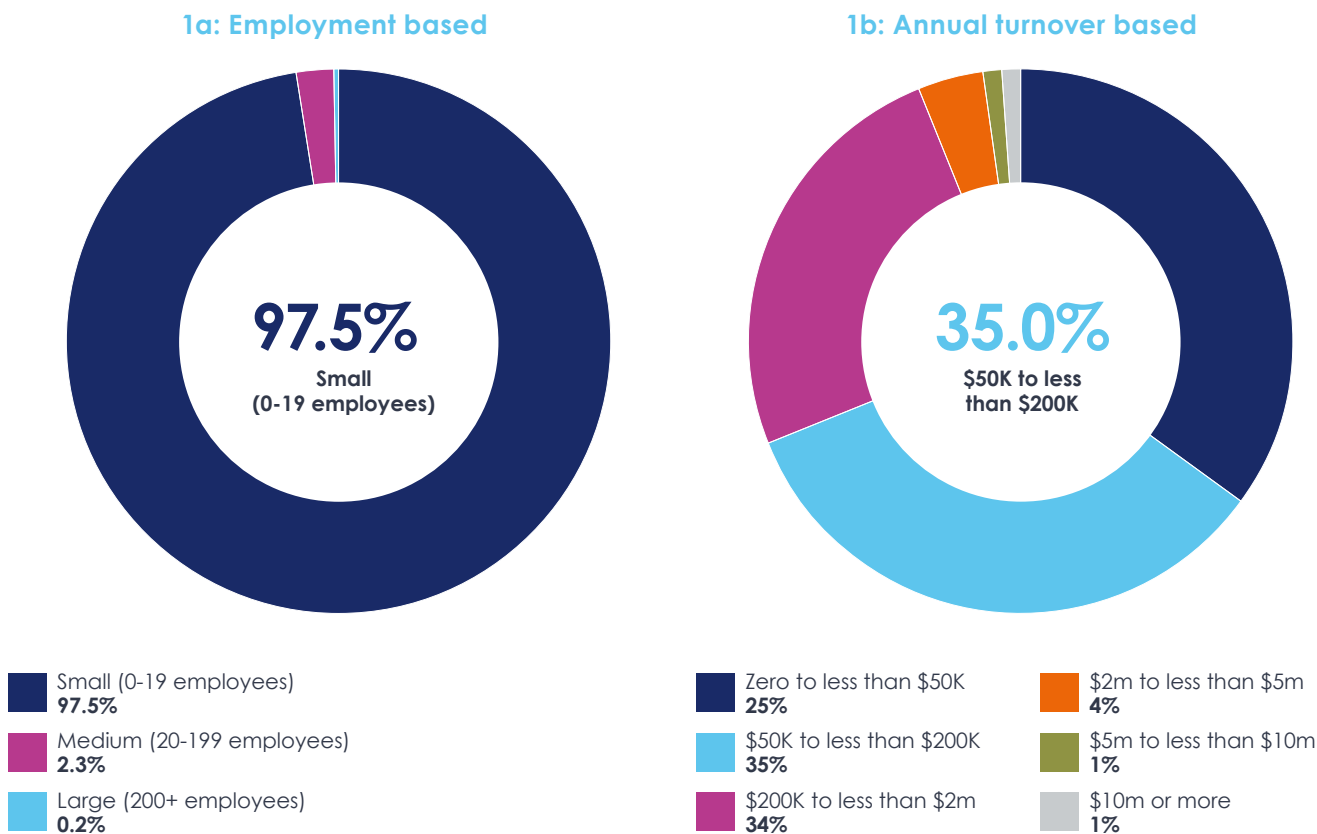
Recent research by the OECD and others⁰² indicates that small business can play an important role in lifting national productivity growth and, more importantly, national living standards

01 Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2016).

02 Andrews et al (2015, 2017).



Figure 1:
Australian business counts by size, as at 30 June 2017



Source: ABS 2018, Counts of Australian Businesses, including Entries and Exits, Jun 2013 to Jun 2017, Cat. no. 8165.0, Table 13 and 17.

through a variety of ways, including improved diffusion of knowledge, products, processes and technologies across businesses.

It is for these various reasons that, as noted in the Foreword to this white paper by Andrew Conway, we look to *Small Business: Big Vision* to frame our 'reform agenda' to tackle these strengthening headwinds confronting the Australian economy.

After all, more prosperous small businesses are good for the Australian economy.

Given the breadth of issues affecting small business in Australia, the white paper selectively focuses on high priority issues. These include:

- Understanding productivity in the Australian economy (chapter 1)
- Regulatory overload (chapter 2)
- Taxation (chapter 3)
- Finance principles and alternative financing (chapter 4A)
- The case for crowdfunding in Australia (chapter 4B)
- Workplace relations (chapter 5)
- Net employment dynamics of Australian SMEs (chapter 6)
- Innovation (chapter 7)
- Competition policy: will the new laws benefit small business? (chapter 8)
- Family firms (chapter 9)
- Internationalisation (chapter 10)
- SME owners' mental health and performance (chapter 11)
- Cybersecurity and Australian SMEs (chapter 12)

The respective chapters in this second important white paper make the case for reform and include policy recommendations to tackle existing and emerging headwinds.

Productivity – is critical for improving Australian living standards

Productivity growth is vital to improving per capita incomes and living standards, especially over the longer term. Indeed, as stated by Nobel Laureate Paul Krugman:

Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.⁰³

As stated in the first Small Business White Paper, productivity is about how well businesses, industries or countries combine resources to produce goods and services. This includes resources such as raw materials, labour, skills, capital equipment, land, intellectual property, managerial capability, technology, financial capital, knowledge and ideas.

Productivity growth not only leads to higher living standards, but also enables society to choose from a wider range of options for improving living standards and wellbeing.

Simply put, growth in productivity is vital for growth in national income and living standards into the future.

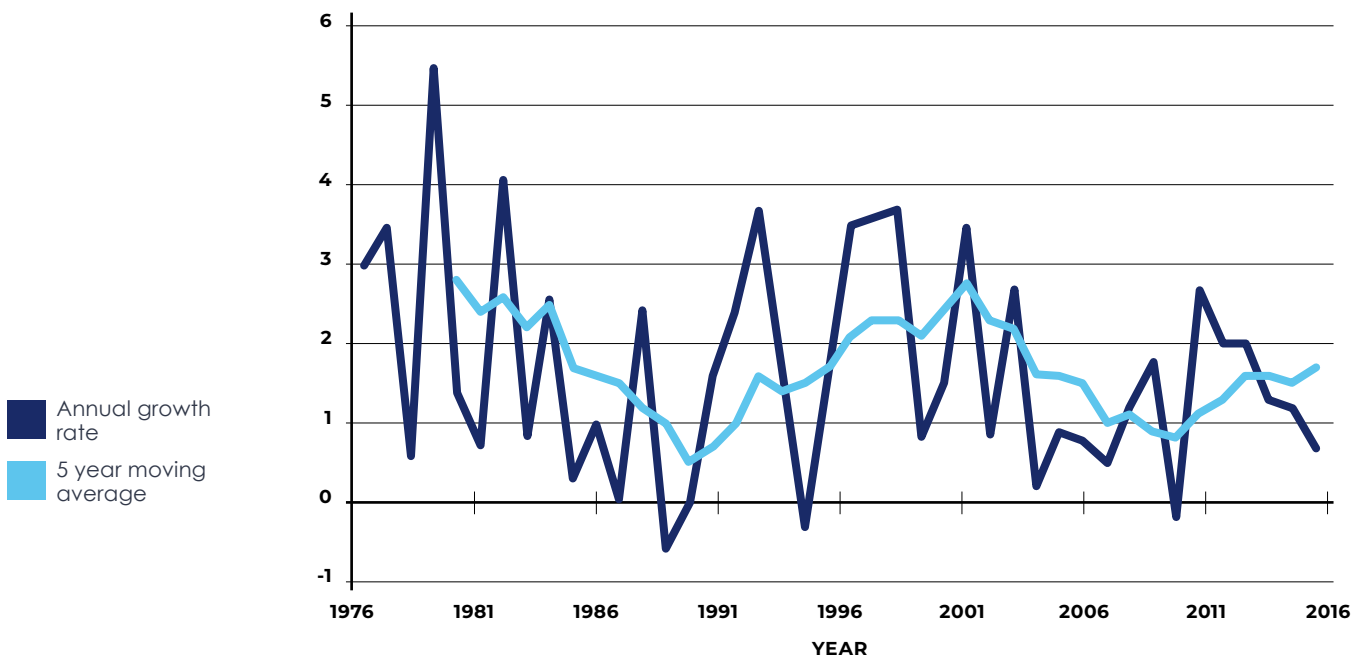
Productivity growth in Australia is measured by the ABS and others using one or two interrelated measures. The first is labour productivity, which is defined as output per unit of labour input (typically measured in terms of hours worked). The second is multifactor productivity (MFP), which is a residual measure after taking out the contribution made by the increased use of capital inputs per unit of labour input in production (termed 'capital deepening'). MFP is generally interpreted as a measure of the efficiency with which labour and capital inputs combined are used in productivity. Most analyses typically assess changes in productivity growth rates over time rather than focusing on the underlying level of productivity.

Productivity – headwinds are gathering

As shown in **Figure 2**, the long term trend in Australian labour productivity growth has been steadily declining over the last half-century.

Figure 2:
Australian labour productivity* growth, 1976 to 2017

*Labour productivity is defined as GDP per hour worked.



⁰³ Krugman, P (1990).

Source: ABS 2017, Australian System of National Accounts, 2016-17, Cat. No. 5204.0, Table 1.



The declining trend is more clearly indicated by the downward revisions to the 30-year average growth rate made by the Commonwealth Treasury in its successive intergenerational reports, falling from 1.75% in its 2002-03 report to 1.5% in the 2015 report⁰⁴.

More recently, as noted by the Productivity Commission (PC) in its report *Shifting the Dial, 5 Year Productivity Review*⁰⁵ released in August 2017, annual productivity growth has been 'flat' for over a decade.

However, sluggish productivity growth in the Australian economy is not unprecedented, nor is weak national income growth. The recent strong growth in Australia's terms of trade boosted growth in Australian national income to the envy of most other developed countries and gave rise to the mining boom. Unfortunately, the mining investment boom is now behind us. Looking ahead, it is growth in the non-mining sector that will largely determine the prospects for Australian incomes and living standards.

The declines in productivity growth partially reflect the effects of longer-term structural changes in the Australian economy that have seen a decrease in the relative importance of many traditional 'goods-producing' industries such as manufacturing and agriculture, and an increase in many service sector industries. The lower rates of measured growth in labour productivity in many of the service sector industries compared to the generally higher rates in the traditional goods producing industries has contributed to the decline in national labour productivity growth identified in the intergenerational reports⁰⁶. This trend is expected to continue, as stated by the PC in its *Shifting the Dial* report⁰⁷. In other words, this long-term trend in labour productivity is expected to continue unless significant productivity-enhancing reform is undertaken and undertaken now.

The use of capital in production (capital deepening) has been the main source of longer-term labour productivity growth in the Australian economy over the last century, accounting for roughly 60%. This means that each use of Australian output tends to be produced using less labour than it did 50 years ago. MFP growth accounted for the remaining 40% of historical labour productivity growth.

More recently, MFP has underpinned labour productivity growth in most industries, with 9 of the 16 industries for which MFP is reliably measured

experiencing positive average MFP over the current productivity cycle (i.e. 2007-08 to 2016-17). This contrasts with the previous productivity slowdowns that have been generally broad-based⁰⁸.

Yet productivity headwinds are strengthening and have the potential to make it harder for Australia to maintain, let alone improve, living standards into the future. Governments have an essential role to play in addressing these headwinds.

Productivity – governments have a vital role to play in boosting productivity and living standards

Governments play a significant role, directly and indirectly, in the effective operation of the Australian economy. Governments set the rules by which markets operate. They regulate and enforce the rules, levy taxes, and provide or fund significant services and infrastructure for the community. These rules, taxes and expenditures affect business profitability and may create artificial incentives for them to alter their behaviour in search of higher returns which can result in unintended consequences or excessive compliance costs.

Governments also exert significant influence on wider productivity in the private sector. The PC notes that governments can exert influence on both MFP performance and capital deepening over time, both of which are desirable sources of productivity growth.

Given the myriad of ways and mechanisms that governments, directly and indirectly, impact productivity growth, it is essential that their initiatives and actions are selected, funded and managed as efficiently and effectively as possible to ensure the significant potential benefits are realised.

New and improved policies are also important. For example, significant scope exists to improve productivity growth in the delivery of education and skills development, as would updating regulatory settings to reflect the current economic realities.

The first white paper contained an extensive chapter on ways to develop human capital, and both white papers contain chapters on ways to improve the regulatory environment and Australia's productivity performance.

As noted in this white paper and elsewhere, technology simultaneously creates and destroys jobs. To the extent that technological shifts require more advanced or new skills from workers,

⁰⁴ The Treasury (2015).

⁰⁵ Productivity Commission (2017b).

⁰⁶ The Treasury (2015).

⁰⁷ Productivity Commission (2017b).

⁰⁸ Productivity Commission (2017b).

there is a role for government to ensure education and labour market policy settings enable upskilling and retraining. The first white paper makes a significant case for government to support vocational training, which has an important role to play in this process.

Government also has a role to play in enabling research and providing access to data. We note that recent improvements in data collection and research, such as the development of the BLADE (Business Longitudinal Analysis Data Environment) framework, which was boosted by funding in the 2017-18 Budget, offers great potential for improving productivity growth through better targeting of government policy and the effectiveness of government programs at the firm level.

Australia should follow the lead of New Zealand in promoting more collaboration between the public sector, private sector and academia to improve the contribution of policy to increasing productivity growth 'by connecting people, shaping research agendas and sharing research'. This will improve the evidence base needed for robust policy development.

Productivity – investment will also need to play an essential role going forward

Given that past investment has fuelled the capital deepening that has been an important source of historical productivity growth, investment needs to play an essential role going forward to underpin productivity growth and maintain living standards.

Prospects for two of the key main industries that contributed to this historical capital deepening – manufacturing and mining – are likely to be more subdued going forward than has been the case historically. If this occurs, future Australian productivity growth will be harder to sustain without capital deepening in other areas of the economy or through improvements in MFP (requiring a significant and sustained reform effort).

Furthermore, as noted in the Federal Budget 2017-18, non-mining business investment remains a key uncertainty for growth since the end of the mining boom. Despite lower official interest rates and surveys indicating above-average business confidence, investment remains muted. This implies that businesses are likely to be waiting for improved business conditions and greater certainty before making significant new investments.

The longer-term structural change towards service sector industries that are more reliant on labour have reduced measured labour productivity growth. These industries also tend to rely more on investment in intangible capital, such as research and development (R&D), information and communications technology, brand equity and organisational capital, all of which affect productivity and are harder to quantify. However, studies cited by the PC suggest that investment in intangibles is significant but 55% (2012-13 study) of such investment is not treated as investment in the national accounts; and that average annual growth in intangible investment was about 130% that of tangibles since 1974-75. The difference in investment between tangibles and intangibles could also contribute to the differences in productivity observed across firms. The productivity chapter in this white paper discusses the productivity of firms in greater detail.

The IPA-Deakin SME Research Centre suggests that research is needed on how best to improve the measurement of investment in intangibles, especially in the services sector, in the national accounts.

The weak outlook for investment, as discussed above, is supported by the International Monetary Fund (IMF), which observed in 2017 that the prolonged periods of uncertainty and sluggish private investment after the Global Financial Crisis have further held back productivity growth, especially in the advanced economies, and that this slow growth is likely to make challenges such as the aging population harder to address.

The OECD, in its 2018 policy paper *The Long View: Scenarios for the world economy to 2060*⁰⁹, also referred to slowing global growth, limited income convergence and rising fiscal pressures as being the long-term baseline projection. However, structural policy reforms can brighten the outlook substantially in all countries (including Australia). For instance, reforms through 2030 to make product market regulation in OECD countries as friendly to competition as in the five leading countries can raise living standards by over 8% in aggregate (and up to 20% in some countries). For this reason, it is imperative that Australia ensures that the benefits of the recent Harper reforms (which came into operation in November 2017) flow through to small business. This topic is discussed in detail in the competition policy chapter in this white paper.

⁰⁹ Guillemette and Turner (2018).



Globalisation – presents significant opportunities for Australian businesses

Globalisation is, for better or worse, a fact of modern life.

Technological changes have made the world a smaller place. Given our relatively small size, globalisation offers great potential to Australian businesses and for improving Australian living standards.

Globalisation, according to the United Nations, is a multi-dimensional process characterised by the acceptance of a set of economic rules for the entire world designed to maximise profits and productivity by universalising markets and production, and by obtaining the support of the 'state' with a view to making the national economy more productive and competitive. A simpler definition is that globalisation refers to all those processes by which people of the world are incorporated into a single world society, global society¹⁰. It can also be seen as the worldwide movement toward economic, financial, trade and communications integration.

One in five Australian jobs are trade-related and one in seven rely on exports. Over 50,000 Australian businesses export, contributing \$337 billion in export income in 2016. Exporting firms, on average, employ more people and pay higher wages than firms focused on the domestic market alone. Trade liberalisation delivers \$8,448 extra income per year for the average family¹¹.

While these figures sound impressive, have we made the most of the opportunities presented by internationalisation?

According to the Bertelsmann Stiftung *2018 Globalisation Report, Who Benefits Most from Globalisation?*¹², Australia's internationalisation has developed similarly to the median for all 42 countries assessed in the report. Low commodity prices have reversed some of the structural changes since 2012 that arose from the mining boom, which has resulted in a decrease in trade. This report notes further that Australia is in the middle in terms of per capita income gains from internationalisation.

Australia has very low tariff rates by international standards. This has helped to increase the competitiveness and flexibility of domestic Australian markets. Despite this, Australia is ranked 95th for ease of trading across borders in the 2018 World Bank's *Doing Business* survey¹³. This indicates that further significant improvements are possible.

Australia needs to improve its performance against these and other measures if it is

to seize the opportunities presented by international developments.

These opportunities exist by exploiting the 'complementarity' of our economy with those of our rapidly developing regional neighbours. That is, Asian economic growth relies on what Australia produces. China and India together make up more than 60% of Asia's economic activity. By 2030, Asia will produce more than half of the world's economic output and consume more than half of the world's food and 40% of its energy. By then, over 600 million more people will live in Asian cities. These countries will not only need Australian minerals and energy but also the services we provide to fuel this growth.

At the same time, Australia is looking beyond Asia to find new opportunities in South America, Africa and the Middle East¹⁴.

The Australian government will need to maximise economic growth in the region by facilitating the ability of Australian businesses to tap into global value chains; and to increase our relatively low investment in Asia, which may be hindering our ability to tap into these global value chains. This includes manufacturing businesses. Manufacturing makes up \$44 billion or 13% of our exports. More than four out of five of all manufacturing businesses are SMEs. They rank fifth among advanced economies for business innovation. This should be applauded, encouraged and improved through government policy settings. Services make up a growing share of our exports, \$75 billion or one-fifth of exports in 2016. For instance, Australia is the third largest provider of education to international students¹⁵.

Technological progress, urbanisation and rising incomes are leading to an increase in the share of services in economic activity across the globe. Australia has an opportunity to capitalise on the growing demand for tradable services, particularly from Asia. Our comparative advantage in services is in financial services and personal and recreational services. The aging population is another opportunity. There are already more people over 65 years of age in Asia than the whole population of the United States. Aged care services, health services, nursing, asset management and insurance services could all represent opportunities from this demographic change. However, in these industries there are often high domestic barriers to entry, which our trade agreements will need to overcome if these opportunities are to be realised.

¹⁰ Albrow and King (1990).

¹¹ Department of Foreign Affairs and Trade (2017).

¹² Weiß, Sachs and Weinelt (2018).

¹³ World Bank (2013).

¹⁴ Department of Foreign Affairs and Trade (2017).

¹⁵ Department of Foreign Affairs and Trade (2017).

The Trans-Pacific Partnership (TPP), which was a major free trade agreement between 12 countries, was being negotiated at the time of the last white paper. Since then, the United States withdrew after the election of Donald Trump as President. However, due to efforts by Australia and Japan, the TPP has been reinvented as the TPP-11 which was signed by all 11 countries in March 2018, with tabling in the Australian Parliament in the same month. The agreement will operate as a platform which others can join if they meet the high standards. Australia is committed to expanding the TPP membership over time. The TPP has been promoted as the 'gold standard' in free trade agreements in terms of its extensive coverage (including for the first time, a chapter devoted to SMEs) and the standards to which member countries must adhere. Australia needs to ensure substantial market access covering goods and services market openings and regulations on foreign investment.

China's One Belt One Road (OBOR) initiative presents further opportunities for Australian businesses. It is the Silk Road of the 21st century. 'Belt and Road', which was proposed by China and unveiled by Chinese leader Xi Jinping in 2013, is a development strategy and framework, that focuses on connectivity and cooperation between countries, primarily in Eurasia. It comprises two main components: the land-based 'Silk Road Economic Belt'; and the ocean-going 'Maritime Silk Road'. The strategy underlines China's push to play a much bigger role in global affairs, and to export spare production capacity in areas such as steel manufacturing. There are numerous opportunities for Australian businesses to take advantage of the OBOR.

More recently in 2018, Australia has joined the United States and Japan to establish an alternative to OBOR, which also seeks to build infrastructure in emerging economies. The United States has announced plans for a new development finance institution to bring together its response to OBOR.

Australia has expertise in infrastructure development, funding and management. As a result, it could benefit from both projects. SMEs play a vital role as part of the global value chains which undertake these projects. We must ensure that they are supported to enable them to realise these opportunities.

Government needs to seek out ways to further increase the recognition of Australian qualifications and licensing in

overseas markets, thereby creating new opportunities for Australian businesses to export professional and other services and to increase the value of Australian qualifications to international students. Government also needs to broaden services exports beyond education and tourism and look at factors other than cost that influence the ability of Australian service providers to compete internationally. This has been extensively considered in the literature on barriers to export and was discussed in the first *Small Business White Paper*.

In terms of international collaboration, the United Nations 2030 Agenda for Sustainable Development presents further opportunities. Its 17 Sustainable Development Goals (SDGs) seek to reduce poverty, protect the environment, and promote gender equality, responsible consumption and production, decent work and economic growth, quality education, peace, justice and strong institutions, industry, innovation and infrastructure and partnerships to achieve these goals. In addition to opportunities for Australian SMEs, the SDGs provide a useful, consistent and aspirational framework to inform policy development in Australia and other countries across the world. 'Humane Entrepreneurship' has emerged as a useful tool for achieving the SDGs.

It is built on the premise that countries and organisations should extend their priorities beyond the profit margin; and shift their focus onto their people, the environment and society. Human-oriented businesses are deemed to perform better, produce better products and satisfy their customers.

While Asian economies are largely growing, we note that, in the developed world, the headwinds are gathering as productivity gains associated with past technological advances have largely been exhausted, while the benefits for productivity from current and future technological advances have not yet been realised. Real wage growth is not expected to improve in developed economies unless productivity increases. Other constraints on global growth include aging populations, especially in Japan, China and the European Union; high public debt and low official interest rates; and China's slowing economy as it matures (which the OECD estimates will peak at 27% in the 2030s and then slowly decline).

Overall, international developments present further opportunities for Australian business, including SMEs.



Global trade – can benefit the Australian economy across the board

The Australian domestic market is small compared to many international markets. Future economic and population growth in the region will only further increase the size of these markets. For example, it is estimated that Asia's total infrastructure investment needs will exceed \$26.2 trillion by 2030, which is roughly 15 times the current size of the Australian economy.

Australian businesses and the Australian economy have long gained benefits from accessing these markets through trade, investment and other strategic partnerships.

Yet there remains significant untapped potential for Australian businesses to improve engagement in these potentially lucrative markets.

To do this, Australian businesses need to be internationally innovative and competitive as well as having management that can identify and exploit these opportunities.

Domestic policies can help or hinder the international competitiveness of Australian businesses. Excessive or poorly-targeted regulation can reduce the competitiveness of Australian business or result in unintended collateral damage.

International policies can also indirectly present opportunities for Australian businesses and the Australian economy. For instance, by encouraging APEC countries to improve their productivity growth — whether by supporting education and training, competition, good governance and market openness, including in services, through helping to improve investment settings, regulatory frameworks, taxation systems, management of natural resources, workforce participation by women or the design and management of national budgets — the ensuing economic growth would increase demand for the goods and services that Australia produces¹⁶.

Australian domestic and international policies need to support or reinforce each other to strengthen the resilience and competitiveness of Australian businesses through innovation, science and technology and an environment that facilitates improvements in productivity and a desire to drive exports. SMEs can play a vital role in this process.

Domestic policy must reflect this global reality.

It is pleasing, therefore, that the federal government has reinforced its initiative to

assist Australian businesses, including over 50,000 SMEs, to access international markets, through Austrade and EFIC ('Finance for Australian Exporters'). It has stated that it will also partner with the private sector through Asialink Business, chambers of commerce and other programs. In the first *Small Business White Paper*, we noted the need to increase the utilisation of free trade agreements (FTAs), otherwise there would be no point in having them. It is, therefore, pleasing to see that the government has responded with a new FTA portal and other online resources to enable small businesses and others to more readily access the benefits of our trade agreements.

Despite the potentially significant benefits to the Australian economy from increasing internationalisation, we cannot ignore adverse impacts on certain parts of society, thereby potentially further exacerbating the already uneven distribution of income in Australia. In its 2018 report *Rising inequality? A stocktake of the evidence*¹⁷, the PC states that inequality has risen (slightly) in Australia over the last three decades. It suggests that governments need to ensure regional resilience, adequate training and education, greater labour mobility, greater diffusion of knowledge and innovation, if we are to continue to reap the benefits and address the challenges.

Other global challenges abound, including increasing urbanisation, environmental degradation and the rising demand for sustainable food sources, water and energy. It is not inconceivable that these could become political, economic and security disruptors over the longer term. For Australia, and for any of our trading partners, these issues have the potential to undermine regional stability, contribute to conflict and affect economic interests. For instance, the OECD estimates that 60% more food will be needed by 2050 with growing demand by middle classes for more resource-intensive food like meat; and the United Nations estimates that, if no changes are made to the way water is used, demand will outstrip supply by over 40% by 2030. In addition, the United Nations estimates that the world needs to create around 40 million new jobs every year, just to keep pace with the growth of the global working age population.

The situation becomes more complex when given the increasing influence of non-state actors on global issues, including multinational companies, private interests, civil society groups, celebrities and others, who can influence large numbers of people through the forces of social media.

¹⁶ A Department of Foreign Affairs and Trade (2017).

¹⁷ Productivity Commission (2018).

Despite not being able to challenge these global trends, we nonetheless need to position and prepare ourselves to take advantage of the tremendous opportunities that these trends present, particularly in ways that benefit all Australians and not just a lucky few. A failure to do so will be to the detriment of us all.

Navigating these headwinds, while taking advantage of global trends and regional opportunities, will define Australia in the coming decades.

Global trade – Australia needs to resist the growing international protectionist sentiment

Global economic growth has generally been relatively slow since the Global Financial Crisis.

After decades of falling levels of international protectionism, recent developments have moved in the opposite direction. Protectionism is rising in G20 countries, as indicated by the World Trade Organisation (WTO) register of the annual incidence of application of protectionist measures.

There is also debate about whether Brexit will create increased protectionism. The Committee for Economic Development of Australia (CEDA) believes it will result in more open markets in the United Kingdom. There are numerous countries, including Australia, lining up to do a trade deal with the United Kingdom.

This recent trend back towards global protectionism brings significant risks for world economic growth and, with it, for the Australian economy.

Australia is not immune from this trend towards increasing protectionism. The increasing role played by the Australian Anti-Dumping Commission is a case in point, a move which has bipartisan political support. CEDA, in its November 2017 report *Australia's Place in the World*¹⁸, correctly refers to this as 'creeping protectionism'.

A return to protectionism in Australia is neither inevitable nor desirable. While Australia may not be in a strong position to alter the policies of other countries, it can influence its own policies. Just because other countries resort to increased protectionism, Australia does not have to follow.

An apparent US 'trade war' with China could mean a significant reorganisation of world trade, although the PC, in its 2017 Research Paper, *Rising Protectionism: Challenges, Threats and Opportunities for Australia*¹⁹, indicates that economic activity in Australia is unlikely to be significantly

affected in the longer term. However, transitional costs for Australia could be material, especially to established value chains involving US firms. The worst-case scenario considered is that Australian GDP would decrease by 1% cent annually, with the loss of 100,000 jobs, and the average household would be \$1,500 per year worse off. In addition, uncertainty is likely already affecting global trade and investment and in ways that cannot be readily captured.

The uneven distribution of impacts across households explains why the broad support of the community to open markets cannot be taken for granted. Australia should resist any political pressure towards protectionism and work with like-minded countries to keep markets open²⁰.

The OECD, in its 2018 policy paper *The Long View: Scenarios for the world economy to 2060*²¹, estimates that slipping back on trade liberalisation and returning to 1990 average tariff rates would depress the long-run living standards by 14% for the world as a whole and as much as 15-25% in the most affected countries.

To help prevent Australia progressing down this protectionist path, and to ensure that domestic policies and the international agreements that we sign are in the national interest, government needs to be more open and honest with Australians about the policies being developed and their likely impact, and as well as dealing with any significant adjustment costs. The PC recommended that Australia should adopt better consultation processes in negotiating preferential trade agreements, including widening stakeholder groups' access to draft treaty text on a confidential basis during negotiations. It also recommended that governments should pursue broader policies to strengthen economic resilience and workforce adaptability to changes underway in the global economy, many of which are driven by new technologies. There is a need to build community confidence in trade and foreign investment policies and structural adjustment policies to respond to the human costs of technological change. These recommendations are a continuation of those made in our first white paper.

Other recent reports have made recommendations on how Australia can succeed in a changing global economy. Their recommendations fall under three broad categories relating to:

- continuing open international engagement
- broader domestic policy
- community engagement.

¹⁸ Committee for Economic Development of Australia (CEDA) (2017).

¹⁹ Productivity Commission (2017a).

²⁰ Productivity Commission (2017a).

²¹ Guillemette and Turner (2018).



Resisting protectionism and continuing to work towards freer markets, while making trade work for all by minimising adjustment costs and ensuring the benefits are widely shared, is the best path for Australia. Higher living standards depend on it.

Global governance – reform is imperative

The WTO is no longer playing the role it once did in advancing a 'rules-based' world trading order. With 164 members, all with divergent interests and levels of development, getting consensus has become very difficult. Countries that were once keen supporters of free trade and the WTO, such as the United States, are no longer as enthusiastic as they once were.

No matter how desirable, the current global political realities mean that a multinational approach to international trade reform is effectively defunct.

Given this scenario, the best prospect for maintaining and improving Australia's competitive position and to open new markets and help grow our economy lies in bilateral and regional trade agreements. New agreements need to be as broad and comprehensive as possible, covering competition policy, investment and intellectual property rights as well as non-tariff barriers and other behind-the-border measures that prevent Australian firms from accessing foreign markets.

Broad preferential trade agreements such as the TPP-11 are preferable to individual bilateral agreements with specific countries. These broader agreements provide greater scope for ultimately improving the international trading architecture and institutions such as the WTO, G20 and IMF.

However, these broad agreements need to be flexible and adaptable enough to enable other countries to easily join.

The best way for Australia to proceed in these challenging times is to lead by example and continue its international leadership role. For example, Australia played an influential role in leading to the WTO's Trade Facilitation Agreement, which will reduce red tape and compliance costs for exporters, potentially boosting global trade by up to \$1 trillion per year. Historically, Australia has been known for 'stepping up' – we played a key role in the formation of the United Nations, APEC and the G20.

Opportunities for trade and commerce rely on a stable global system based on mutually agreed rules. Stable global conditions at home and abroad provide the best platform for Australia and the world to prosper.

Innovation – is critical to improving Australian productivity growth

Successful innovation is critical to improving productivity and living standards.

Firms that develop new knowledge, processes or goods and services can gain a competitive and financial advantage from doing so.

However, these innovations can also indirectly produce wider economic benefits when new knowledge, processes or goods and services are spread across other parts of the economy (and indeed internationally). The broader 'spillover effects' can produce significant economic and social benefits in their own right, including in ways unrelated to the original innovation.

A case in point is the development of Wi-Fi which was originally developed by the Commonwealth Scientific and Industrial Research Organisation (CSIRO) to remotely control telescopes.

Innovation is a risky, iterative process that involves research, development and commercialisation.

Government policy needs to address all aspects of the innovation process. It should not be just aimed at fostering new innovation. It should also be about encouraging the broadest dissemination and uptake of new knowledge, processes and goods and services by other parts of the economy to ensure the widest possible economic benefits. Robust competition and intellectual property frameworks established by government are, for example, crucial for facilitating knowledge spillovers between firms.

Governments undertake and fund significant innovation in Australia. Public sector institutions such as the CSIRO, Australian universities and co-operative research centres undertake significant R&D in Australia. They also provide significant assistance to private business in their research, development and commercialisation activities.

Innovation policy can play an important role in addressing the decline in Australian MFP that has been linked to declining knowledge-based capital investment over the past two decades²².

Australian government expenditure on innovation policy, through an array of different programs, is significant. In 2015-16, the Australian Government alone spent almost \$10 billion on innovation. The Australian Government has a large number of small innovation programs, with 74 programs collectively accounting for less than 2% of its \$10 billion in expenditure in 2015-16.

²² Productivity Commission (2017b).

It is essential that innovation policies encourage socially worthwhile innovations, while getting the maximum value for Australian taxpayers; as well as working together in a harmonised fashion.

The small size of many of the innovation programs arguably reduces their effectiveness and increases the cost to taxpayers of their administration. There is significant merit in adopting the OECD's 2017 recommendation that the Australian Government consolidate its 150 innovation programs to make them more effective and to give taxpayers better value for money.

One of the flagship innovation policies of the Australian Government is the 'R&D Tax Incentive', which accounted for almost one-third of all Australian Government spending on innovation policy in 2015-16.

The 2016 Ferris, Finkel and Fraser review²³ found that the R&D tax incentive, as part of a mix of innovation policies that sought to improve the quality and quantity of R&D investments in Australia, played a key role in improving productivity and economic growth.

However, the report went on to find that the incentive fell short of meeting its stated objective of encouraging additional R&D and producing spillovers. To this end, the report made six recommendations, including rewarding collaborative research and having a better focus to support innovative investments by limiting cash refunds and imposing an intensity threshold. The OECD supports this in its 2018 policy report, *The Long View: Scenarios for the world economy to 2060*²⁴, where it estimates that boosting R&D intensity in all OECD countries to the level of the five leading countries raises aggregate living standards by over 4% by 2060. These measures could be adopted to make this important policy more efficient and effective.

Other government innovation policies would also benefit from tighter focusing and being made more efficient and effective. The Australian National Audit Office (ANAO) 2017 report *Design and Monitoring of the National Innovation and Science Agenda* (NISA)²⁵, evaluated the process leading to the December 2015 NISA package of 24 measures, costing \$1.1 billion over four years. The government announced that "innovation and science are critical for Australia to deliver new sources of growth, maintain high-wage jobs and seize the next wave of economic prosperity". This statement was based on four main pillars being: culture

and capital; collaboration; talent and skills; and government as an exemplar. Even though the ANAO found that much of the advice on which the agenda was based was general in nature and did not present quantitative or in-depth analysis of problems, or how expected impacts or outcomes would be measured, it also found that monitoring and reporting arrangements for the agenda have, in most respects, been effective.

It is imperative that NISA (or its equivalent) be implemented and that government and all relevant stakeholders play a role in Australia's innovation agenda. The innovation chapter in this white paper goes further with recommendations.

Significant technological changes are occurring that present ample opportunities for Australian firms to innovate. The Internet of Things, big data, robotics and the combination of artificial intelligence with genomics and biotechnology, will drive further innovation in medical treatments, smarter cities, low emissions energy, the creation of new industries and new jobs. Our 'net employment dynamics' chapter discusses job creation and job destruction, including these themes in the context of start-ups. Australia must not miss the opportunities that new technologies present.

While Australia has a solid reputation, by international standards, for both high-calibre researchers across multiple disciplines, as well as research institutions, a perceived weakness of the Australian innovation system lies in the inability to successfully commercialise world-class research outcomes. Arguably also, information regarding research outcomes and innovations generally is not well disseminated across the wider Australian economy.

Yet countries such as Singapore and Israel which face similar barriers to Australia, such as small domestic markets, do well by these measures.

Small and medium businesses play a critical role in this diffusion process and in ensuring that markets are competitive. Government should encourage the wider uptake of new ideas and products. Accordingly, government policy should recognise and support the vital role played by SMEs.

Australian businesses also need to develop more of an innovative mindset that encourages upskilling and the learning of new skills and overcoming an excessive risk-aversion outlook. Our domestic market,

²³ Ferris, Finkel and Fraser (2016).

²⁴ Guillemette and Turner (2018).

²⁵ Australian National Audit Office (ANAO) (2017).



while small, offers high margins relative to many international businesses. Australian firms that rely solely on the domestic market might be overtaken by more innovative and competitive rivals from overseas.

Offering world-class products and services will help to ensure that Australian businesses are internationally competitive. Studies show that distance imposes enormous costs on the export of goods, so trading with our closer markets in Asia makes good economic and business sense.

Another key failure of the Australian innovation system – one that goes to the core of the effectiveness of the Australian innovation ecosystem – is the lack of strong, effective connections between the government-funded research institutions and the private sector. Australia has among the lowest proportion of firms that collaborate with Universities and other non-commercial research organisations in the OECD. Addressing this issue will require, as stated in *Industry Insights Globalising Australia 2018* by the Office of the Chief Economist from the Department of Industry, Innovation and Science²⁶, CEOs and government leaders to reflect deeply on the values, purpose and principles that influence their choices of technology, the design of new systems and the resulting impact on organisations and individuals, and not just rely on better consultation, incentives for partnership or more lobbying.

The effectiveness and sustainability of the Australian innovation ecosystems could be further improved by developing sufficient critical mass to underpin current (and increased) investment in incubators and accelerators to ensure existing success occurs on a larger scale.

There is hope – Australia has a strong foundation for a successful innovation policy. We are a G20 economy. We have six universities in the world's top 100 (exceeded only by the United States and United Kingdom). We have world-class scientific and research institutions. We produce more than 7% of the world's most highly-cited research publications, despite having less than half a per cent of the world's population.

Improving the effectiveness of innovation in Australia, however, is not just about government lifting its game. The private sector also has an essential role to play.

All of this can contribute to addressing the decline in Australian MFP growth that has been linked to declining knowledge-based capital investment over the past two decades²⁷.

Taxation – the tax system needs to be sustainable

As noted in the first white paper, major taxation reform remains significant unfinished business.

The IPA has repeatedly advocated for the need for major and bold tax reform by moving from transaction taxes on property to broad-based land tax and addressing the internationally uncompetitive company tax rate (the OECD average is 24% and the average in Asia is 21%) and for reform of the GST. The tax chapter in this white paper continues the case for reform.

Fiscal sustainability — governments are currently living beyond their means

Australia has performed well on various indicators of inequality, thanks to our tax and transfer system.

However, this tax and transfer system needs to be sustainable in the long term. The growth in government services has outpaced the growth in average incomes (e.g. the National Disability Insurance Scheme (NDIS), school funding, the aging population putting pressure on health services etc). Total government payments to households and individuals from 1995 to 2014 grew roughly at 121% of the rate of income growth (as measured by GDP). This excludes transfers relating to active labour market programs and unemployment benefits²⁸.

This situation is clearly unsustainable. Escalating public expectations do not help. Improvements in the efficiency with which services are delivered will help deliver fiscal sustainability, but tough decisions will need to be made. Either taxes have to grow or expenditure growth will need to be reined in, or both.

Workplace relations – tough love is needed

Workplace relations reform remains untackled by government.

Previous governments from both sides of politics – Keating with the *Industrial Relations Act 1993* and Howard with the *Workplace Relations Act 1996* – moved the responsibility for determining matters affecting the employment relationship to the employer and employees at the workplace or enterprise level.

Since then the Rudd Government's *Fair Work Act 2009* unwound some of these reforms.

²⁶ Office of the Chief Economist (2018).

²⁷ Productivity Commission (2017b).

²⁸ Productivity Commission (2017b).

Subsequent reviews, including by the 2012 Fair Work Act Review Panel and the 2015 PC inquiry report, *Workplace Relations Framework*²⁹, have identified areas where the current system could improve, including rectifying the procedure over substance process.

The OECD, in its 2018 policy paper, *The Long View: Scenarios for the world economy to 2060*³⁰, states that a reform package to improve labour market policy settings in OECD countries up to those of leading countries raises the aggregate employment rate by 6.5% by 2040, mostly via higher youth and female employment. The package raises living standards by 10% by 2060 and helps alleviate future fiscal pressures related to aging.

In the meantime, there is constant discussion and debate about the 'gig economy' and disruptive technology and what these mean for the 'future of work', including the potential need to introduce a 'universal wage'. These topics are widely debated by numerous commentators.

The workplace relations chapter in this white paper tackles some of the tough issues.

Cybercrime – not a footnote

Technology has helped to make the world a smaller, more interconnected place.

This interconnectedness provides great benefits to Australia and to Australians. However, it also provides great risks that need to be effectively managed.

The launch of the National Cyber Security Strategy in 2016 and the establishment of the Home Affairs portfolio are moves in the right direction.

However, Australia is not immune to such attacks. These attacks could come from state and non-state actors. In fact, CEDA goes so far as to talk about the 'military uses of cyber space' and that Australia is currently under-prepared for cyber war.

The Australian Cyber Security Centre's October 2017 threat report noted that networks in Australia have been compromised by rudimentary techniques exploiting known vulnerabilities. The cybersecurity industry offers huge potential for Australia to become a leading provider.

These themes are discussed further in the cybersecurity chapter, which was prepared by the Cyber Security Centre at Deakin University, where cutting-edge research is being undertaken.

Political will is needed – other countries have had the courage to act

The reform ideas developed in this white paper to tackle the strengthening headwinds confronting the Australian economy are outlined and developed in the following chapters.

Tacking these emerging headwinds requires sustained ongoing action from Australian governments.

We must ensure that resulting policies have broad public acceptance as well. Otherwise we are faced with sound policies being considered politically unpalatable and a lack of political willingness to tackle big reforms will continue to the detriment of all Australians.

Even though we acknowledge the impact of minority governments and lack of power in the Senate, there appears to be a lack of political will to even make the case for reform.

If New Zealand and other countries can undertake significant worthwhile reforms to improve the competitiveness of their economies, to improve their productivity growth and to raise future living standards, surely Australia can too.

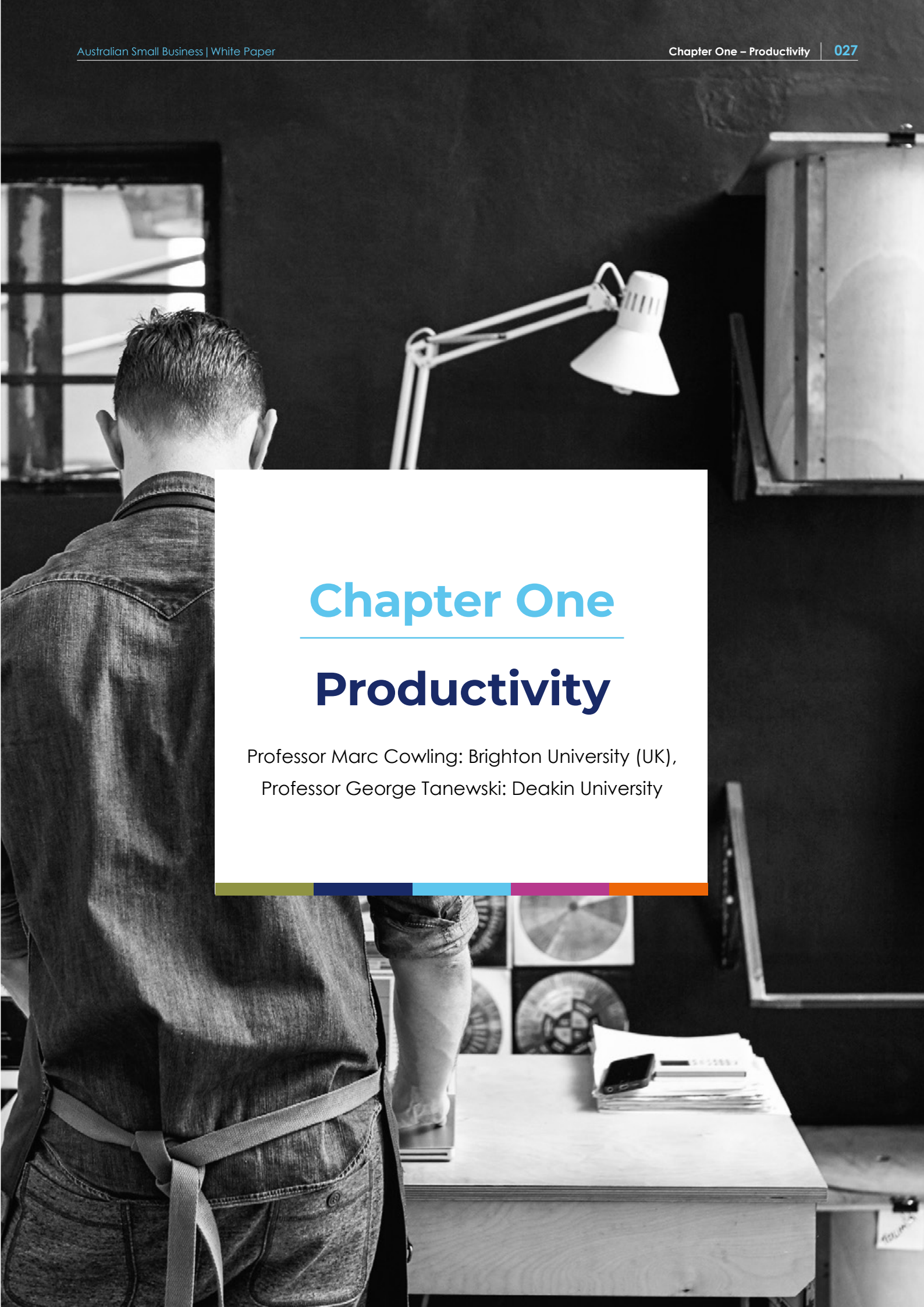
²⁹ Productivity Commission (2015).

³⁰ Guillemette and Turner (2018).

Chapter One

Productivity

Professor Marc Cowling: Brighton University (UK),
Professor George Tanewski: Deakin University



Understanding productivity in the Australian economy

It is widely accepted that growth in productivity is a major determinant of the incomes and wealth of the population. This holds at the firm and industry level, and also in a spatial context, fundamentally shaping the economic well-being of localities, cities, regions and countries. While the estimation of productivity and technical efficiency requires complex mathematical and statistical models, the underlying concepts can be illustrated and explained fairly clearly.

We can think of a woodworker who buys in some raw timber. These are the materials that will be used to create some furniture. The woodworker has a lathe which is typical of the types of lathes that anyone can buy from a local woodworking machinery manufacturer. This we call the 'state of technology'. The woodworker has hired a carpenter to help produce the furniture.

The carpenter's wage reflects the skills that the carpenter is expected to have as required in that specific line of trade. This is the labour input to the process. The woodworker has invested in tools, equipment (saws, hammers etc.) and a small workshop. This is the capital input to the process of converting raw timber into polished furniture.

So, we have timber, a workshop with tools and a lathe, and a carpenter. The value-added created in this simple scenario relates to how good the carpenter is, along with the tools and machinery at their disposal (i.e., in turning that chunk of raw timber into a beautiful table and set of chairs). Of course, the relative contributions that our carpenter (the labour input), the machinery, the workshop and the tools the carpenter uses (the capital input) make, in processing the raw timber (the materials input) and creating a beautiful new table and chairs, might be very different.

³¹ Cowling and Tanewski (2018).

Further, it may also be the case that there are economies of scale associated with higher levels of capacity utilisation of the machinery or if the process can be conducted at a more efficient rate with the input of two carpenters.

Equally, after dealing with this value-creating process, it is likely that other softer and less tangible factors play a significant role in how much value is created. For example, technical efficiency may be affected by the entrepreneurs' organisational skills and the strategies adopted for ensuring that enough timber arrives on time and the finished goods are shipped out to customers. It may also be the case that the entrepreneur cannot hire workers with the appropriate skill levels or raise enough external capital to buy the best machinery or tools. All these factors can potentially enable us to understand more about differences between businesses that, from the outside, look fairly similar.

The formal technical and statistical work that underpins this chapter is drawn from a paper co-authored by Professors Marc Cowling and George Tanewski³¹. The main body of this chapter is organised in three parts, as follows:

- 1. We consider the basic production relationships between labour, capital and the creation of value-added. We also consider differences in the 'state of technology' available. All these issues are explored in aggregate, and at a more disaggregated level, by classes of firm size, by industry sector, and across firm age classes, as well as across the value-added distribution.**
- 2. We consider differences in the technical efficiency levels, again in aggregate, and also at a more disaggregated level by firm classes of firm size, industry sector, and across firm age classes.**
- 3. We consider differences in technical efficiency arising from softer strategic, managerial and operational factors.**

We conclude with a summary of our key findings and draw out the potential implications for the Australian economy. We also identify areas and issues that require further consideration by public policy-makers, as well as among the business community itself.

We now turn to providing an overview of productivity in the Australian economy and highlight the important role that SMEs play in adding value to the overall economy.

Headline findings: Productivity and efficiency

Productivity findings

- Many parts of the Australian economy are characterised by firms with decreasing (or, at best, constant) returns-to-scale. This means scaling up may not impact productivity in any meaningful way, or indeed may reduce productivity. In turn, this would imply that typical businesses need to focus on being smarter at their current levels of operation rather than seeking to expand.
- Loss-making businesses account for around one-third of the total business stock and these firms may benefit from growth due to their under-utilisation of current resources. Alternatively, the wider economy may benefit from reallocating the unproductive resources held in these businesses.
- There are large differences in the way businesses organise their production to yield the same level of output, which may indicate that specific classes of firms suffer from capital or labour constraints.
- Labour-intensive classes of firms include: those in the bottom 25th percentile of value-added creating businesses, loss-making businesses, medium-sized firms, and younger firms below 6 years in age.
- Capital-intensive classes of firms include: those in the top 25th percentile of value-added creating businesses, profitable businesses, large firms, and firms over the age of 5 years.
- The 'state of technology' available to different classes of firms varies considerably across the economy.
- High 'state of technology' classes of business include: new firms and younger firms more generally, small firms, profitable firms, and those creating average levels of value-added.
- Low 'state of technology' classes of firms include: old firms, medium-sized businesses, and loss-making businesses.
- Financial services appears to be the most productive industry in the economy and mining the least productive.
- Other relatively productive industry sectors include: agriculture, forestry, fishing, rental, hiring, real estate, transport, postal, warehousing, and construction.
- Other relatively unproductive industry sectors include: administrative and support services, manufacturing, public administration and safety, and other services.

Efficiency findings

- The average level of efficiency in the Australian business sector is 0.81% and the median level is 0.85%. This implies that value-added in the business sector could potentially be increased by 15% to 19% using the same amount of capital and labour inputs and state of technology.
- Businesses in the lowest single class of firms (administrative and support services, 3-5 years old, A\$1 million – \$2 million) are operating, on average, at 14.5% efficiency and businesses in the highest single class (financial and insurance services, 0-2 Years old, A\$5 million - \$10 million), on average, are operating at 96.5% of their efficient level given inputs.
- Of the 62 classes of business operating above 90% efficiency, new firms are represented in 25 of these classes.
- Of the 62 classes of business operating above 90% efficiency, two industry sectors account for 29 of these classes. These are: financial and insurance services (11 classes); transport, postal and warehousing (11 classes).
- Of the five classes of business operating below 30% efficiency, four are in mining, with sales of A\$1 million - \$2 million.
- Of the 12 classes of business operating below 40% efficiency, ten are in mining.
- Overall, the three industry sectors with the highest average efficiency rates are (highest first): financial and insurance services; transport, postal and warehousing; construction.
- Overall, the three industry sectors with the lowest average efficiency rates are (lowest first): mining; manufacturing; electricity, gas, water and waste.
- The 'state of technology' in common usage within the business sector is highest among: younger firms (0-5 Years old), small firms, and profitable firms.
- The 'state of technology' in common usage within the business sector is lowest among: old firms (10 years plus), medium-sized firms, and loss-making firms.

Factors associated with efficiency gains and losses

Efficiency gains

- Sourcing and establishing a supply chain with foreign firms
- Creating a monopolistic position in a tightly defined market
- Focusing on core activities and on a small set of key customers
- Access to high-speed broadband
- Introducing new modes of logistics
- Introducing new marketing strategies

Efficiency losses

- Excessive product or service differentiation
- Introducing new products, services and processes that cause short-term disruption
- Internal (within firm) and external (labour market) skills constraints, particularly around innovation capabilities
- Skill levels (or skills deficit) of the current workforce around their ability to support innovation (considered as the dominant constraint)
- Government regulatory constraints

of the health of an economy and an important determinant of living standards. Productivity is also a complex phenomenon, with its growth or decline having multiple micro- and macro-economic causes. For example, production output, impact of government policies, capital investment, changes in technology, capital and labour, management effectiveness and labour behaviour are some of the important factors that have an impact on productivity.

Cross-country modelling of OECD countries indicates that, while labour-market regulation shows mixed effects on productivity growth (i.e. depending on the country/region and tightness of the regulation), higher taxes are shown to have a negative impact on productivity growth, whereas innovation shows to have a positive effect on productivity growth³⁴. Furthermore, productivity levels have been linked to technology, demand and market structure³⁵, while human capital, incentive pay, various human resource practices and managerial talent have been shown to be associated with productivity differences³⁶.

Productivity growth is usually examined by analysing how efficiently capital and labour resources are utilised in terms of its outputs and inputs, such that when we obtain greater outputs over inputs, we achieve positive growth. In other words, when we are able to create more outputs by using less inputs, our society's living standards improve, precisely because we make more efficient and sustainable use of our overall resources.

Economists measure productivity growth in a number of ways, usually from the perspective of labour or a combination of labour and capital or a combination of labour and capital and other resource inputs. Specifically, labour productivity is a measure of how efficiently real economic outputs are produced by labour inputs, while multi-factor productivity measures the efficiency of real economic outputs via a combination of labour and capital inputs. Similar to multi-factor productivity, total productivity measures the efficiency of real economic outputs by measuring not only labour and capital inputs but, in addition to these two inputs, accounting for other resource inputs such as the amount of energy or water used.

While Australia's labour productivity has more than doubled since the late 1980s, resulting in higher wages and income growth³⁷, multi-factor and total-factor productivity have both shown lacklustre

An economy-wide perspective on productivity

Australia has had uninterrupted GDP growth for the past 28 years, making it one of the few countries in the OECD not to experience a recession, technically³², in nearly three decades. Australia's sustained growth over this period can be primarily attributed to the mining (resources) boom in the 2000s, which provided the country with strong terms of trade growth up to around 2012. This, coupled with strong population growth, has resulted in unprecedented prosperity.

However, while the economy's productivity has more than doubled in the past 30 years, Australia's productivity over the last decade has remained on average stagnant, threatening living standards. With productivity growth showing no signs of improvement in the near future³³, there are signs that Australia's prosperity is in significant danger of faltering or even declining. Once dubbed the 'lucky country' by historian Donald Home in the 1960s, Australia is in danger of becoming a 'banana republic' (to use former Prime Minister Paul Keating's infamous 1986 warning about how Australians should face up to the ever-changing economic realities or become a third world economy).

Productivity is an important goal for achieving national, business and personal prosperity, as it is an indicator

³² A recession is generally identified by negative growth in GDP in two successive quarters.

³³ Productivity Commission (2017).

³⁴ Eichler, Grass, Blöchliger and Ott (2006).

³⁵ Syverson (2011).

³⁶ See, for example, Fox and Smeets (2011); Ichniowski and Shaw (2003); Lazear (2000).

³⁷ Productivity Commission (2017).



and declining trends in recent years, with Australia falling well behind other countries in terms of productivity³⁸.

Numerous reasons can be attributed to Australia's declining productivity, such as the end of the mining (resources) boom, lower rates of mining and non-mining capital investment³⁹, significant technological changes that are not adequately reflected in productivity measures, resulting in an understatement of productivity growth⁴⁰, the effectiveness of firms in adopting new technologies⁴¹, the slowing pace of technology and innovation diffusion throughout the economy resulting in a widening gap between high-productivity firms and other firms, and a growing number of relatively poorly-performing firms⁴².

The Productivity Commission⁴³ highlights that due to the end of the mining boom in the late 2000s and the effects of the global financial crisis (GFC) still being played out internationally, the Australian economy has experienced a pronounced structural change in recent years. Specifically, there has been a compositional change away from goods-production towards more labour-intensive services-oriented sectors (Heath, 2017) that are, on average, less capital-intensive compared to non-service sectors such as mining and manufacturing.

As SMEs are prevalent in all sectors of the Australian economy, making up around 99.8% of all counts of businesses (ABS, 2018) and accounting for 33% of Australia's GDP⁴⁴, this chapter examines the productivity and technical efficiency levels of firms across different size, industry-sector and firm-age classes. Given that business activity among SMEs contributes to around 55% of the total value-added of the Australian economy, an examination of productivity and technical efficiency by firm-size, industry and age-class factors will allow us to better identify and inform policy-makers and the business community where potential productivity growth differences exist among SMEs in the Australian economy.

As the Productivity Commission report⁴⁵ provides evidence that Australian multi-factor productivity has recently shown signs of lacklustre growth, an analysis of productivity and technical efficiency among SMEs is worthy of consideration, as identification of how value-added is created from labour and capital across different classes of firms and industries is important to developing a more appropriate picture of why the Australian economy may have reached a productivity-growth turning point.

Data

To explore these productivity and efficiency issues, we use two sources of data.

Firstly, we use the tax return data from the Australian Tax Office (ATO) covering all business entities in the Australian economy, including those that ceased trading in the tax year and those that began trading in the tax year.

This is our core data set for the productivity estimation, as it contains all the core elements of a production function (output, materials inputs, labour and capital investment). We use the most recent data extracted from the ATO tax return data, which is for the tax year 2014-2015.

In total, the Australian business sector in 2014-15 contains 954,367 businesses that file annual accounts to the Australian Taxation Office (ATO). The ATO Company Tax Return collects the following information for each company:

- Company details and tax registration code
- Status defined by legal form, with additional categories for (a) ceased business (code E2) and (b) commenced business (code E3)
- Calculation of total profit or loss, including income and expenses statements
- Reconciliation to taxable income and loss
- Financial statement
- Capital allowances
- Calculation statement of tax

For confidentiality purpose, the ATO data is grouped into 380 classes of private business in Australia. Our classes are defined by 19 industry sectors, four age classes of firm, and five size classes of firm. The data is grouped by these 380 classes of firm. In its totality, it covers 954,367 private businesses in Australia for the tax year 2014-15. In a sense, we are considering the 'average' firm within each of our 380 classes. We derive our key variables of interest at the firm level, by dividing the total class figures by the number of firms within that class of firms.

The second data set is used to understand more about technical efficiency. We augment this tax-based data set with a set of strategy, markets and competition variables derived from the annual Australian Bureau of Statistics panel survey of SMEs, which is accessed via the Business Longitudinal Database (BLD) Confidentialised Unit Record File (CURF) covering an eight-year period for the financial years 2006-07 to 2013-14.

³⁸ Productivity Commission (2017); Bergeaud, Clette and Lecat (2016); Carmody (2013).

³⁹ Elias and Evans (2014).

⁴⁰ Productivity Commission (2017).

⁴¹ Andrews, Criscuolo and Gal (2015).

⁴² Productivity Commission (2017), p 31.

⁴³ Productivity Commission (2017).

⁴⁴ ASBFEO (2016).

⁴⁵ Productivity Commission (2017).

The BLD has over 170 variables containing numeric data on a wide range of topics such as employment, years of operation, financial characteristics, main sources of income, debt and equity finance topics, respondent self-reported comparisons to the previous year on various matters such as revenue, profitability, productivity, expenditures, etc, and questions related to skills and innovation in undertaking core business activities. The BLD also includes some financial data matched from the Australian Taxation Office (ATO) and the Australian Customs and Border Protection Service sources.

The BLD survey is extensive in its depth and breadth and covers issues relating to:

- Firm demographics (age, size, industry sector, ownership)
- Technology (broadband, websites, internet purchasing and sales)
- Business focus (finance, costs, operations, quality, innovation, HR and environmental)
- Changes over time (sales, products and services, profit, productivity, jobs, export markets, outsourcing, training, IT and government assistance)
- Geographic markets (local, state, national and overseas)
- Markets and competition (number of competitors)
- New inputs (operational processes, logistics, customer services, management processes and marketing)
- Product and service offerings (new products and services)
- Investments (product and service development, process development and marketing development)
- Constraints on innovation (finance, costs, business skills and labour market skills)
- General constraints (government regulations and market demand)

To use these survey-based variables in our second-stage estimation, we calculated the average for businesses in each age and industry class, as used in the tax data in the first stage estimation for the representative firm within each of the 380 formal age, size, and industry classes. We were unable to reconcile the two data sets for business size as the tax data uses total income as its size delineator and the ABS longitudinal business survey uses an employment-size class definition.

In this respect, we have averaged the survey data for the 76 age-industry classes.

Creating value-added and the contributions of technology, capital and labour

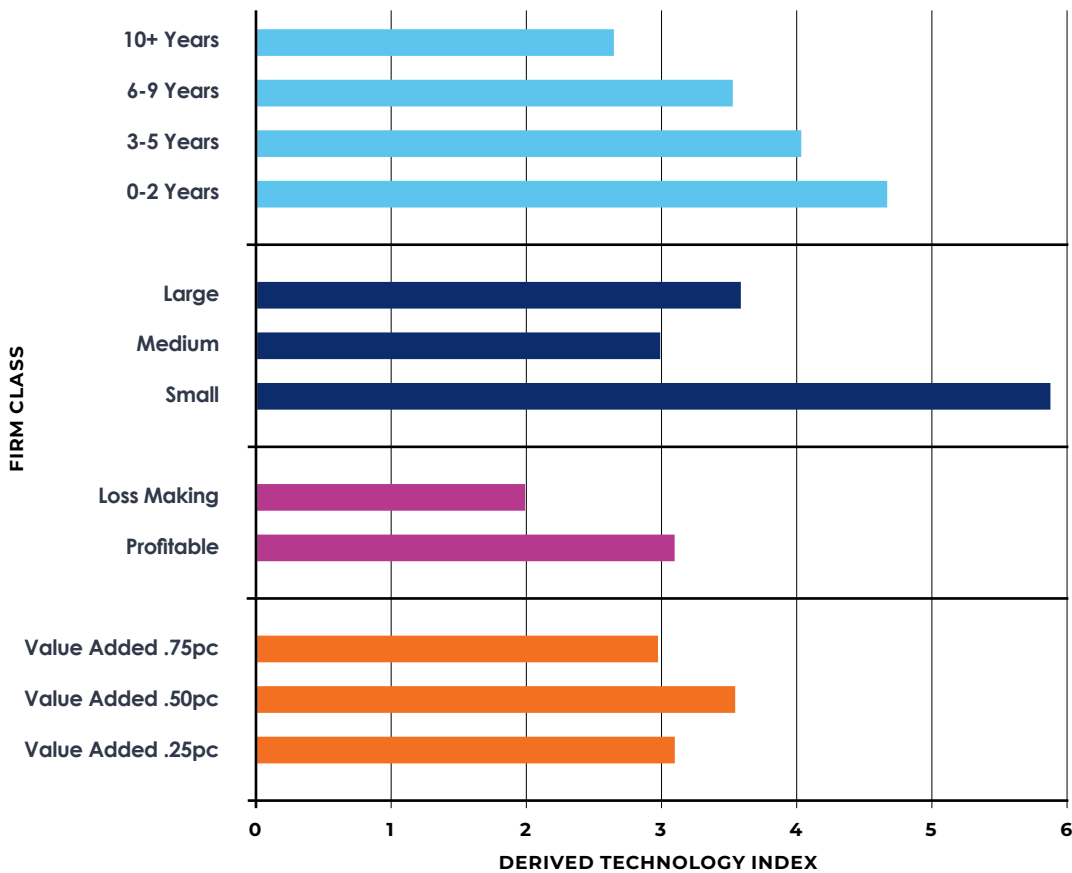
Here we initially consider what is referred to as the 'state of technology'. This is effectively the knowledge that exists about a method of production. It helps determine the maximum potential output for a given set of inputs. Put another way, the 'state of technology' captures the technological constraints that each firm, class of firms, industry or geographic area has to contend with. It follows that the larger this number, derived directly from the production function, the higher the prevailing 'state of technology' that a firm, or class of firms, has in respect of turning inputs into outputs. Here we consider how much variation in technology exists between firms of (a) different age classes, (b) different size classes, (c) profitable versus loss-making firms and (d) across the value-added distribution. These estimates are presented in **Figure 1**.

There are several interesting features of the estimates of the state of technology.

In respect of firm age classes, we find that there is a negative relationship between firm age class and the state of technology. In short, the younger a firm is, the fewer technological constraints, on average, it faces. This means that the very oldest firms in the economy, on average, have the most significant constraints in terms of the technology they use, or their understanding of the prevailing state of technology. We also observe that there are differences apparent across firm size classes. Here, small firms face the lowest technological constraints, medium-sized firms the highest, and large firms lie above medium-sized firms, but significantly below small firms. There is also a difference between loss-making and profitable classes of firms, with loss-making classes of firms suffering much higher technology constraints than their profitable peers. Finally, we note that technology constraints across the value-added distribution approximates an inverted 'U' shape, with firms around the median point in terms of value-added being the least constrained by technology.

Taken overall, we suggest that there is a potential issue around either technology adoption or understanding among older firms, medium-sized firms and loss-making firms. In contrast, technology constraints do not appear to be an issue for younger and smaller firms.

Figure 1:
Differences in the 'state of technology' by classes of business
The State of Technology



Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

Organising labour and capital to create value-added

Establishing the way firms choose their combination of the two core factor inputs – labour (people) and capital (investment in plant, machinery, buildings etc) – is fundamental to understanding how value is created in the production process.

In general, economists would predict that higher capital intensity (relatively more capital to labour inputs) would be associated with higher productivity growth. This process reflects the time dynamic of firms investing in new capital assets and, increasingly, firms seeking to automate their production processes with a view to being more productive in the future. But not all firms have equal access to capital markets or, indeed, primary

labour markets. For example, if small firms were disproportionately constrained in terms of their access to external capital, they would then make smaller investments in new assets and technologies and tend toward a labour-intensive production process. However, due to the relatively low remuneration and benefits packages that smaller firms offer compared to their larger counterparts, as well as the fixed costs of hiring workers in the primary labour market, they may largely draw their labour from secondary (lower human capital end) local labour markets.

Here, we present our derived estimates from the production functions regarding labour and capital intensity across different classes of firm including: across the value-added distribution, between

profitable and loss-making classes of firm, by firm size classes, and by firm age classes. These estimates are presented in **Figure 2** through to **Figure 5**.

The estimates refer to a notional 100 units of value-added in each case, the labour cost input is measured in AU\$000s, and the capital assets are measured in AU\$000s. To give an example from the 75th percentile of the value-added distribution, to create 100 units of value-added requires a wage bill of AU\$333,000 paid to workers, and an investment in capital assets of AU\$133,000.

The notable feature of our estimates is that, as we move from the high to low end of the value-added distribution, firms increasingly shift to less (more) capital (labour) intensive modes of production. This means that, on average, a firm in the lowest quartile of the value-added distribution has a total wage bill of more than 5 times that of a similar firm in the top quartile of the value-added distribution. At the same time, however, their investment in capital assets diminishes by 20.5%.

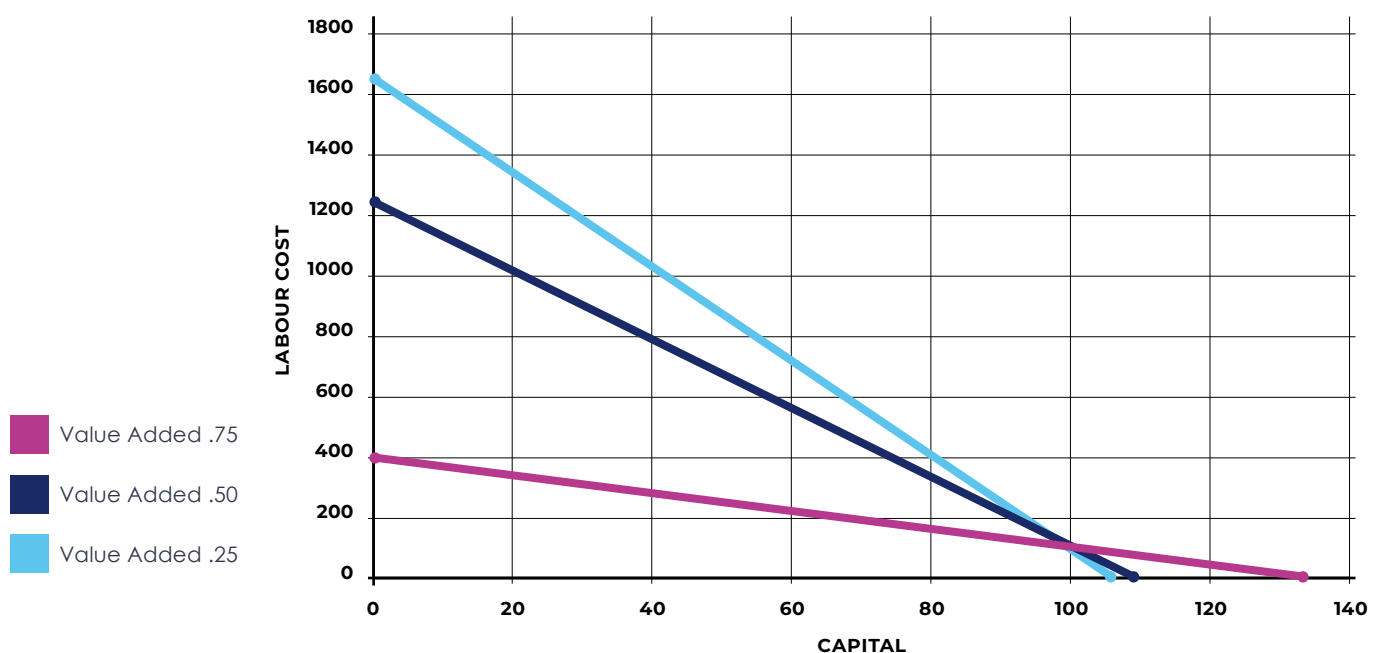
Figure 3 shows the relative capital and labour mix for profitable and loss-making firm classes. Here the findings are intriguing in that loss-making firms tend to adopt more capital-intensive modes of production than

their profitable counterparts. This suggests that there is more to understanding differences in productivity and production that are not captured by a simple dichotomy between profit and loss.

It follows that being productively efficient is better for the economy per se, but this may not always translate into profit. What this does suggest is that loss-making firms do not appear to be capital-constrained, at least not in the short run.

In respect of firm size classes, we again observe a distinct 'U' shaped pattern here in relation to the capital and labour mix in the production process. We find that capital intensity is highest in large firms and lowest in medium-sized firms, with small firms somewhere between the two groups. In fact, medium-sized firms' labour input is 2.2 times that of small firms, with a corresponding reduction in the respective capital asset base of only 4.6%. From **Figure 5**, we note there is a clear distinction between younger firm classes (up to 5 years old) and older firm classes in relative capital (labour) intensity. Here we find that younger firms typically use labour-intensive production techniques and older firms use more capital-intensive production techniques.

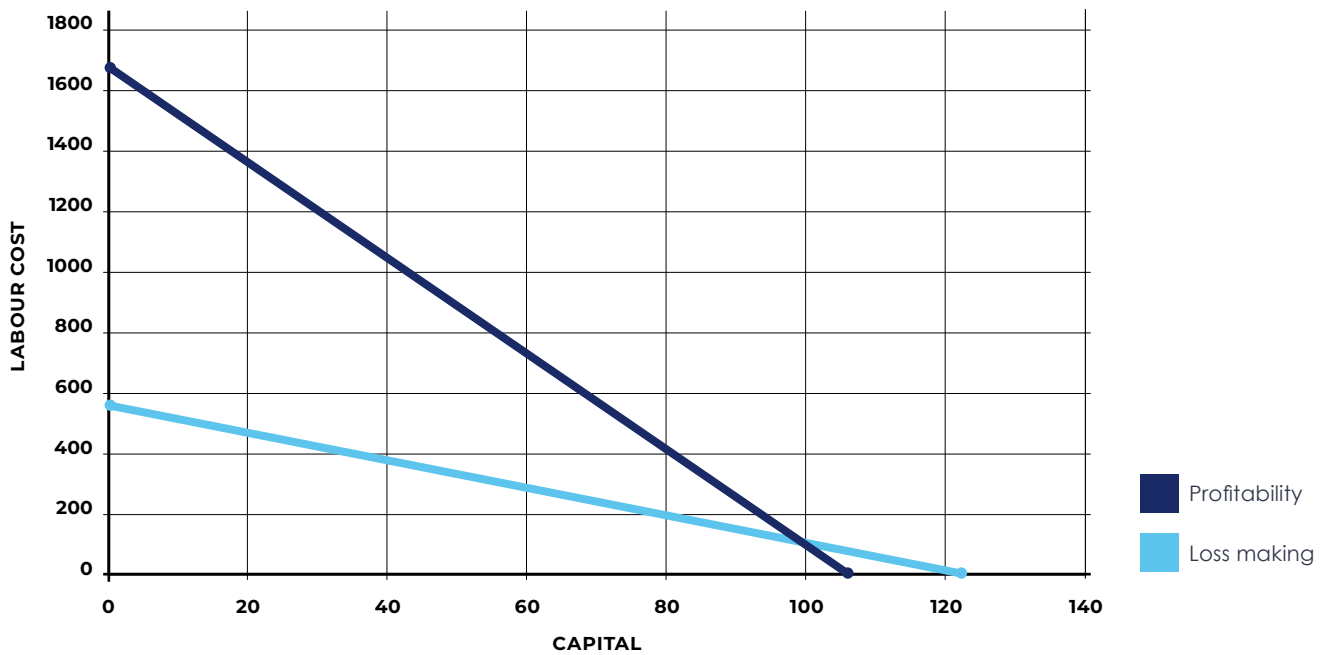
Figure 2:
Labour and capital intensity across the value-added distribution



Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

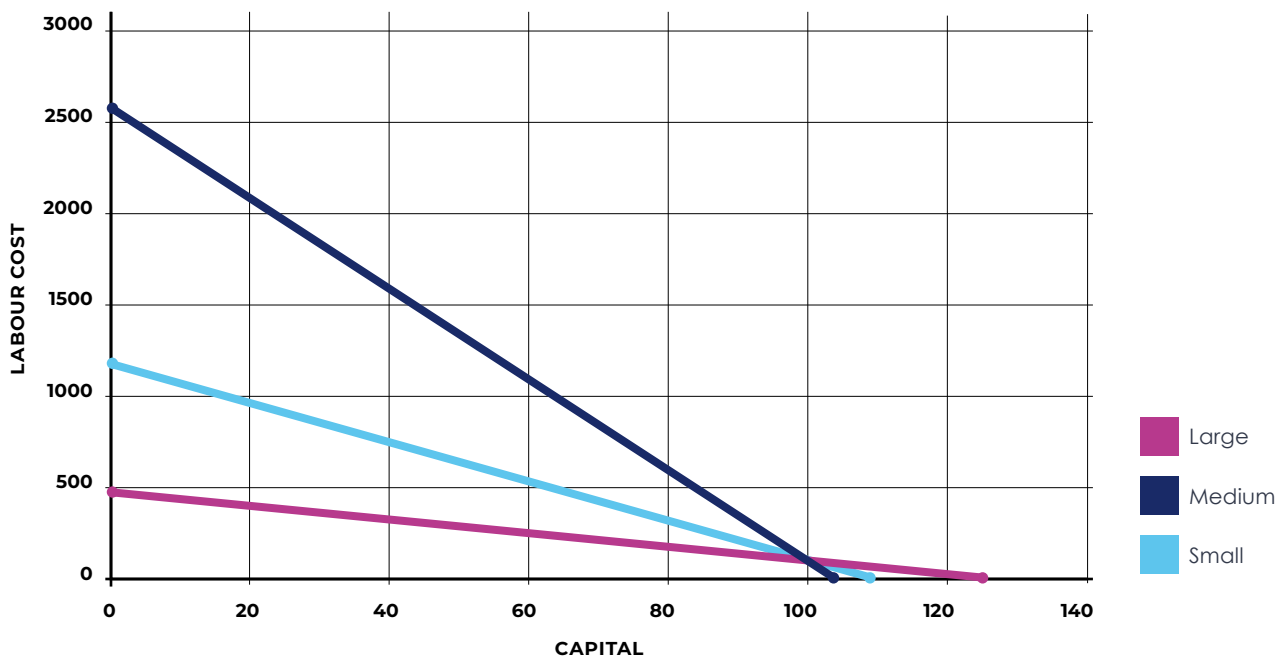


Figure 3:
Labour and capital intensity across profitable and loss-making business classes



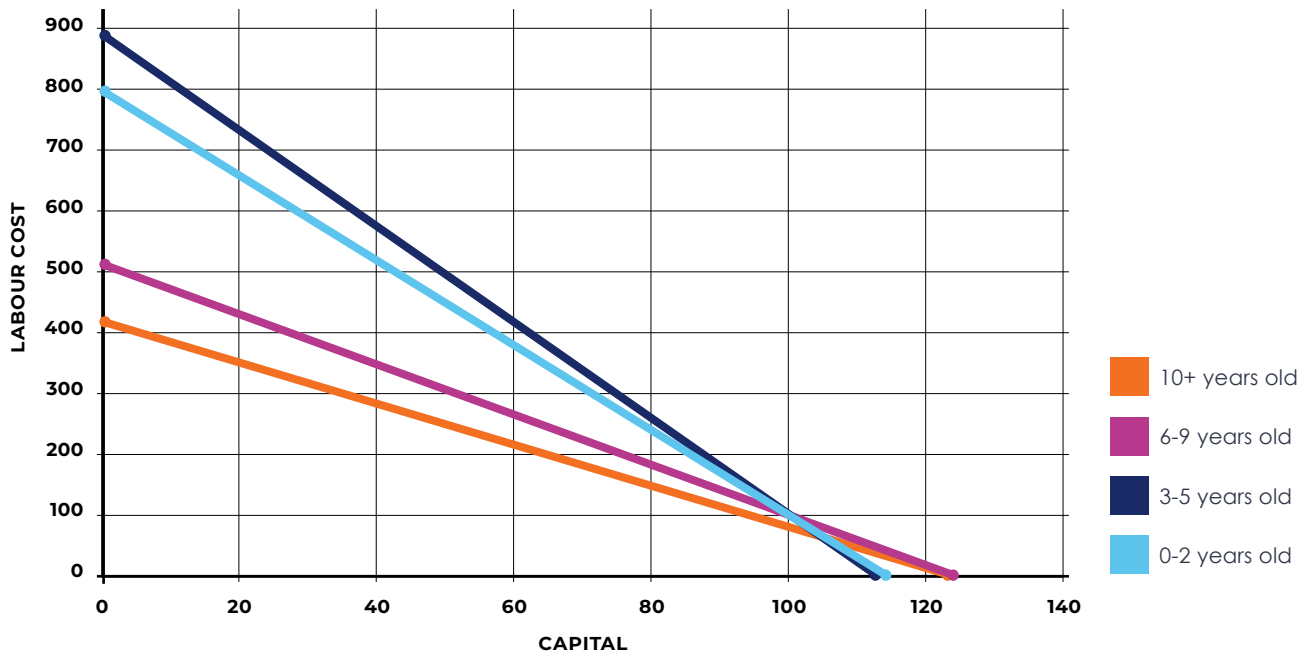
Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

Figure 4:
Labour and capital intensity across firm size classes



Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

Figure 5:
Labour and capital intensity across firm age classes



Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

These findings may imply that younger firms may be more constrained in external capital markets in respect of raising capital for investment in productive assets. For example, compared to the most established group of firms (trading for a minimum of ten years), labour costs are 60-80% higher on average for the same output. On the capital side, younger firms use around 5% less capital inputs to create the same amount of value added.

Returns-to-scale: is growing bigger a good idea?

Here we question whether particular classes of business would benefit from growing larger to take advantage of economies of scale. **Figure 6** depicts a 'typical' textbook long-run average cost curve. It has three main parts. To the left side is the region where, as output expands, the average cost of producing each unit of output falls. In the central region, increasing (or, indeed, reducing) output has no effect on the average cost of producing each unit of output. The right-hand-side area, which relates to high levels of output, exhibits decreasing returns-to-scale in that the average cost of producing each unit of output actually increases.

From this, we might expect that smaller (and indeed younger) firms would tend to be concentrated towards the left of the curve in the region where increasing output reduces the per-unit cost of producing it.

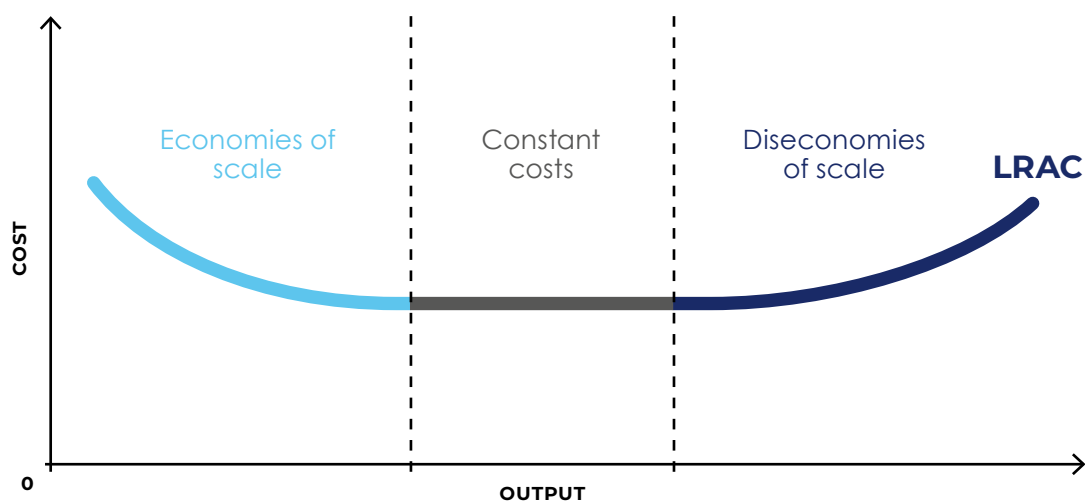
Table 1 shows the estimated returns-to-scale for different classes of firm. It is important to remember that these estimates are for the 'typical' or representative firm in each class. It is certainly the case that, within each class of firm, there are subsets of firms that face increasing, constant, and decreasing returns-to-scale.

In general, the majority of firm classes exhibit decreasing returns-to-scale. That is to say, at current output levels, the average cost of producing output is not as low as it could be if those classes of firm produced less. In this sense, there are many classes of firms operating at output levels above their maximum efficiency level and this is reflected in higher costs per unit of output.

While, at first glance, the obvious solution would appear to be to reduce size, thus moving back towards the constant returns-to-scale area, it is probable that other solutions are more appropriate. For example, for firm classes that either have high barriers to technology adoption or



Figure 6:
Average costs and the effects of scale
A typical long-run average cost curve



Source: IPA-Deakin SME Research Centre (2018).

Table 1:
Returns-to-scale by classes of business

Firm class	Estimated returns-to-scale
Value added	
.25 percentile	Slightly decreasing
.50 percentile	Decreasing
.75 percentile	Slightly decreasing
Profitability	
Profit-making	Decreasing
Loss-making	Constant
Firm size class	
Small	Decreasing
Medium	Constant
Large	Decreasing
Firm age class	
'0-2 years	Decreasing
'3-5 years	Constant
'6-9 years	Constant
'10 plus years	Decreasing

Source: IPA-Deakin SME Research Centre (2018).

don't understand how to efficiently utilise the technology available to them (both aspects of what we called 'the state of technology') one part of the solution to this technology problem would be to increase the dissemination of state-of-the-art technologies (technological diffusion). Another would be to increase the abilities of firms to either use their existing technologies efficiently or adopt new technologies. This would lower production costs without the need to reduce absolute scale. But it is absolutely the case that, for many classes of business, growth per se will lead to a decrease in productivity.

We explore other, potentially interesting, explanations relating to firm-specific capabilities and strategic choices later in this chapter to identify any specific managerial and strategic issues that are driving this observed lower productivity and technical inefficiency across many classes of firm.

There are some notable exceptions to this decreasing returns-to-scale pattern observed. For example, medium-sized classes of firms face, on average, constant returns-to-scale. That is to say, within a feasible range of outputs, the average cost of producing more (or less) units of output will stay the same. This was also the case for certain firm age classes including 3-9 year old firms. The intriguing finding was that loss-making firms were, on average, operating in the constant returns region, suggesting that, in a cost sense, growth or decline will not solve their profit problem through changes in the cost base.

However, there may be a more obvious explanation for the prevalence of this finding in the Australian economy.

The first explanation relates to the lack of competition, which means that inefficient firms can survive in the market as there are not enough competitors to force them to drive down costs. This may also be a characteristic of the Australian economy – an economy that currently holds the world record for the longest sustained period of positive economic growth. Simply put, with growing consumer demand, firms have over-expanded and allowed costs to rise just to meet this increased demand for their goods and services.

The second explanation may relate to the case that many classes of firms have too much organisational slack, in that they employ more resources, labour, capital and materials than they need to produce a given quantity of output. Excess capacity leads to what is commonly termed X-inefficiency.

Are different industry sectors able to contribute more to value-added?

Here we explore industry-level variations in productivity. Based on our production function estimates, which requires that we use one industry sector as a base or reference category (here we reference our 18 industry sectors against 'A. agriculture, forestry and fishing'), **Figure 7** shows the relative productivity of each industry sector against our reference industry sector. The results show quite clearly that, in order of productivity, the top five industry sectors are: 'K. financial and insurance services', 'A. agriculture, forestry and fishing', 'L. rental, hiring and real estate services', 'I. transport, postal and warehousing', and 'E. construction'. The five lowest productivity industry sectors, ranked from the bottom, are: 'B. mining', 'N. administrative and support services', 'C. manufacturing', 'O. public administration and safety' and 'S. other services'.

It is apparent that the highly-productive industry sectors have a strong representation of service industries, but it was also the case that more traditional industries, like agriculture and construction, were still capable of sustaining high productivity levels. Of concern, particularly in the context of exporting and international trading activities, is that mining and manufacturing were identified as low-productivity industry sectors. Both are industries with relatively high exposure to international competition in domestic and export markets.

Technical efficiency

Here we consider the relative technical efficiency of the business population. In a simple sense, we are seeking to establish how efficient classes of firms are in turning factor inputs (labour, capital and materials) into outputs and value-added.

The procedure we use allows us to estimate how far different classes of firms are from their maximum efficiency level given the resources at their disposal. This maximum efficiency level is termed the *production frontier*, where a firm is 100% efficient at turning its inputs into outputs. We note that, in reality, very few firms are capable of achieving perfect technical efficiency, but deviating too far from this frontier means that finite resources within the economy are not being used in a way that delivers rising incomes and economic well-being over the long run.

The estimated technical efficiency (TE) scores imply that the economy-wide average efficiency is 80.9% and the median efficiency level is 85.0%. This highlights the simple fact that value-



Figure 7:
Industry sector value-added coefficients

(reference group = A. agriculture, forestry and fishing)

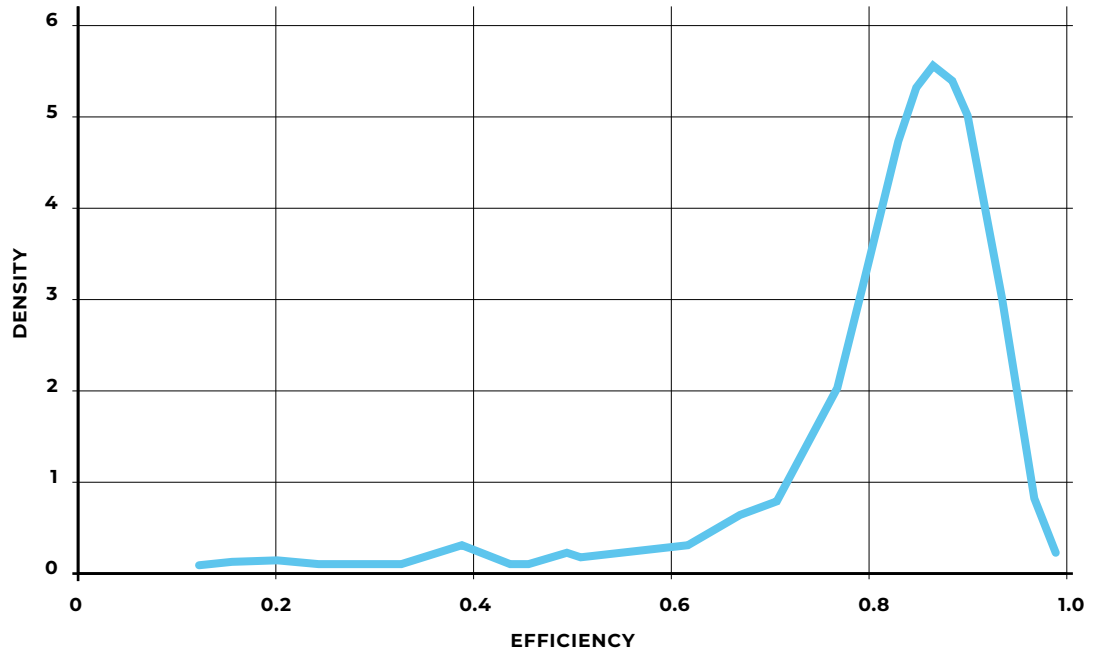


Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

Figure 8:
The efficiency distribution

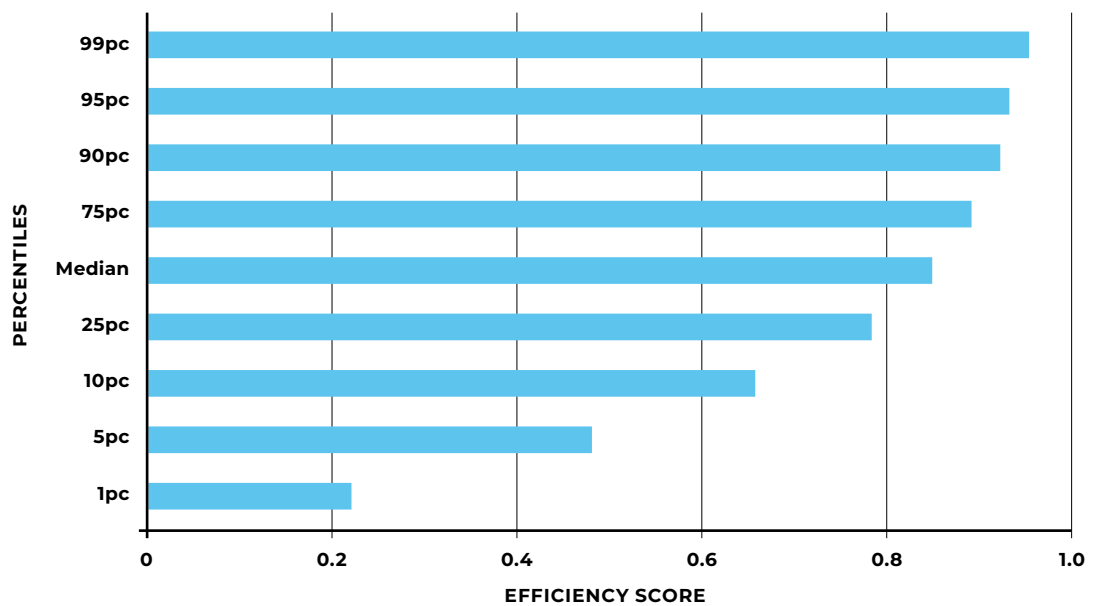
Kernel = epanechnikov, bandwidth = 0.0225

Kernel density estimate



Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

Figure 9:
Efficiency across percentiles of the firm class distribution



Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.



added in the business sector could be increased by 15% to 19% using the same amounts of capital and labour inputs in the production process. Figure 8 shows the entire distribution of efficiency scores. From this we can identify a long, but important, tail of inefficient firms. Firms in the lowest class operate, on average, at 14.5% efficiency (85.5% away from their production frontier given their resources) and firms in the highest efficiency class, on average, operate at 96.5% of their efficient level given their resources.

Figure 9 implies that an estimated 9,544 firms in the economy operate at an efficiency level below 25% of their potential, given the resources available to them. Further, a total of 47,718 firms operate at an efficiency level below 50% of their potential. However, once we shift upwards to the 10 percentile in the efficiency distribution, the typical firm manages to raise its efficiency levels to around two thirds of its potential.

At the 25th percentile, this increases to 78.5% efficiency. It is also the case that the top 75% of firms operating in the business sector are generally efficient, with the top 25% exhibiting very high levels of technical efficiency. This means there is a large number of extremely efficient firms (estimated to be around 238,500 businesses).

This poses an interesting policy dilemma. Should policy act to help tackle the inefficient 9,500 or so businesses operating below the 25% efficiency level? Or should policy makers refrain from intervention and let market forces play out? Alternatively, should policy support the supremely efficient 238,000-plus businesses to expand and extend their activities? Or both, but possibly in different ways?

The highs and lows of efficiency

Here we consider what classes of firms in the economy are the most and least efficient. We consider 19 industry sectors, by age classes of firm and by size classes of firm. This analysis generates 380 classes of firm. **Table 2** shows the top 10 most efficient classes of firm, by age and size.

The striking feature is that four of the top five most efficient classes of firm are operating in K. financial and insurance services. Further, three of the top 10 most efficient classes of firms are in I. transport, postal and warehousing, with an additional two of the top 10 in O. public administration and safety, and one from R. arts and recreation services.

All these classes of firm are extremely efficient by any benchmark. Another equally striking feature is that new and very young classes of firm dominate the top 10, with 0-2-year-old firms accounting

Table 2:
Top 10 most efficient classes of firm

Broad industry	Age band	Business size class (by revenue)	Efficiency
K. Financial and insurance services	a. 0 - 2 years	d. \$5 million to \$10 million	0.965171
K. Financial and insurance services	a. 0 - 2 years	c. \$2 million to \$5 million	0.962526
O. Public administration and safety	a. 0 - 2 years	d. \$5 million to \$10 million	0.955662
K. Financial and insurance services	a. 0 - 2 years	b. \$1 to \$2 million	0.951713
K. Financial and insurance services	a. 0 - 2 years	e. \$10 million to \$100 million	0.948078
O. Public administration and safety	b. 3 - 5 years	d. \$5 million to \$10 million	0.945470
I. Transport, postal and warehousing	b. 3 - 5 years	b. \$1 to \$2 million	0.943781
I. Transport, postal and warehousing	a. 0 - 2 years	b. \$1 to \$2 million	0.940804
R. Arts and recreation services	a. 0 - 2 years	d. \$5 million to \$10 million	0.940633
I. Transport, postal and warehousing	c. 6 - 9 years	b. \$1 to \$2 million	0.938308

Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

for seven of the top 10 efficiency classes, and 3-5-year-old firms accounting for a further two classes. In relation to size classes, four of the top 10 most efficient classes have sales between AU\$1 million and AU\$2 million, and an additional four classes have sales between AU\$5 million and AU\$10 million.

Based on these efficiency estimates, young and smaller-size classes of firm, particularly those operating in financial and insurance services and transport, postal and warehousing, are the top efficiency-performing classes in Australia.

Table 3 reports on the 10 most inefficient classes of firm. It is immediately apparent that the mining industry dominates the list, with eight out of 10 of the least-efficient classes of firm. There is also a distinct pattern relating to the age class of businesses, with five of the 10 being in the 3-5-year-old range and a further three out of 10 being in the 6-9-year-old age range. The evidence on business-size class is equally striking, with the smallest firm classes (AU\$1 million – AU\$2 million) accounting for the five least efficient classes of firm. To summarise, there appears to be a significant issue with technical efficiency in the mining industry and this is apparent across the age bands, but more concentrated in the very smallest classes of mining firms.

46 ABS Business Longitudinal Data 2006-07 to 2010-11 and 2009-10 to 2013-14

How do the internal workings of a firm impact efficiency?

We were also able to test for *efficiency effects* using a rich source of data⁴⁶ from a business-level survey covering many aspects of strategy and operations. This provided the IPA-Deakin SME Research Centre with a detailed, nuanced picture of what types of strategy and organisational features were associated with high (lower) levels of efficiency. Our results show that goods exporters were, on average, less efficient than services exporters. Efficiency is also associated with the availability and use of broadband, but developing an internet presence was found to have no effect on efficiency.

One particularly interesting finding was that incorporating foreign firms into the firm's supply chain enhanced efficiency. This suggests a coordinated national strategy to support Australian firms to find and match with appropriate foreign suppliers may well enhance the efficiency of Australian firms. Further, enhancing marketing and logistics efforts at the firm level improved technical efficiency, suggesting that engaging with customers and ensuring that raw materials in and final goods out are organised and shipped in an orderly and synchronised manner can result in added value.

Table 3:
The bottom 10 most efficient classes of firm

Broad industry	Age band	Business size class (by revenue)	Efficiency
C. Manufacturing	b. 3 - 5 years	e. \$10 million to \$100 million	0.375253
B. Mining	c. 6 - 9 years	c. \$2 million to \$5 million	0.365282
B. Mining	c. 6 - 9 years	e. \$10 million to \$100 million	0.361855
B. Mining	b. 3 - 5 years	c. \$2 million to \$5 million	0.304272
B. Mining	b. 3 - 5 years	e. \$10 million to \$100 million	0.303058
B. Mining	b. 3 - 5 years	b. \$1 to \$2 million	0.240396
B. Mining	a. 0 - 2 years	b. \$1 to \$2 million	0.223324
B. Mining	c. 6 - 9 years	b. \$1 to \$2 million	0.193223
B. Mining	d. 10+ years	b. \$1 to \$2 million	0.17632
N. Administrative and support services	b. 3 - 5 years	b. \$1 to \$2 million	0.145356

Source: IPA-Deakin SME Research Centre (2018), estimates derived from ATO data.

Inefficiency is associated with skills constraints, both within the firm and in the wider labour market. This is a particular constraint on innovation-driven efficiency gains. It suggests that the wider labour market is not functioning well in terms of matching skilled workers to firms. In part, this may relate to the fixed costs of hiring new workers or the costs of searching for appropriately skilled workers. The particularly notable feature of this skills issue is that internal skills constraints have a greater effect on inefficiency than external skills constraints. The obvious solution here relates to firm-specific training activities, or lack of these activities.

Focusing on the wider economy, lack of demand exerts the expected negative effect on efficiency, suggesting that, where demand is lower than firm capability to produce goods and services, firms have under-utilised capacity, which is driving costs upwards. Government regulations were also associated with efficiency problems, as they tend to add to the cost base of firms with no corresponding increase in output sales. For smaller firms, it is arguably the case that regulations often impose greater proportional costs to the firm due to limited managerial capacity.

Conclusions

We explored three interconnected strands of research which covered:

- (a) how firms combine technology, labour and capital to create value-added**
- (b) how efficient different classes of business are within the economy**
- (c) how the strategic choices firms make impact the efficiency levels they are able to achieve.**

In terms of created value-added, we find that most classes of firm face decreasing returns-to-scale, which implies that firms need to work smarter rather than focusing on growth. The level of technology adoption and the understanding of how to use technology also appear deficient among older firms. At a wider level, there may be a strong case for a more efficient process of reallocating productive resources away from unproductive classes of firms to more productive classes.

This, of course, may imply what Schumpeter (1942) would call creative destruction, with inefficient firms exiting the market and their resources being

Recommendations

Productivity

- Introduce initiatives to improve managerial capabilities in SMEs
- Review capital market efficiency to address the problem of 'zombie companies' (those businesses that require bailouts to survive), where too much capital is currently held
- Review the regulatory framework around insolvency resolution (Australia has the fourth-longest insolvency resolution time in the OECD) as this creates resource misallocation and reduces growth opportunities for efficient firms.
- Conduct a competition review of the mining, manufacturing, and electricity, gas, water, and waste industries
- Introduce initiatives to enhance the technological absorption rates in 'older' firms
- Speed up the roll-out and increase the coverage of high-speed broadband and enable SMEs to connect their premises all the way with fibre-optic cables
- Introduce supply-chain efficiency initiatives
- Introduce initiatives to enhance firms' marketing capabilities

Efficiency

- Encourage business start-ups to stimulate efficient, dynamic resource reallocation
- Conduct a sector review of the mining industry
- Ensure the education system produces enough STEM (science, technology, engineering and maths) graduates, and that the business sector is capable of absorbing them at an efficient rate.

channelled to more productive businesses. But, as our skills constraints evidence suggests, the external and internal labour market does not appear to be functioning efficiently. Further, given the use of labour-intensive production techniques adopted in younger and smaller-size classes of business, this might also suggest that capital markets are not functioning in a way that meets the needs of smaller and younger classes of firm.

However, the picture in relation to efficiency shows that there are many parts of the business sector that are operating at very high productivity and efficiency levels. The stand out industry is financial and insurance services. In particular, younger firms operating in this sector perform exceptionally well in these respects. The mining industry is a concern and appears to be very inefficient, particularly with smaller-size classes of mining firms.

Overall, the business sector is performing at 81%-85% of its potential, which is actually a very strong performance given that evidence from other countries often

reports figures of 60%-80% efficiency. But there is a long tail of inefficient firms which we estimate to number around 47,000 businesses that represent a drag on the economy. At the level of the business, our evidence suggests that improvements in efficiency can be brought about by developing new customer engagement strategies and improving logistics.

Given that most classes of firms in Australia face decreasing returns-to-scale, we provide the following key recommendations on productivity. As our chapter reports international evidence demonstrating that managerial talent is associated with improved productivity growth⁴⁷, this managerial talent is one key factor that could assist in improving the general productivity of the Australian economy. Hence we recommend that both federal and state governments introduce initiatives to improve the managerial capabilities of the SME sector.

Government should also address the high proportion of 'zombie'-class firms that are tying up significant amounts of unproductive resources in the Australian economy. These firms are highly unproductive, but remain in the market, despite creative destruction and economic growth theories predicting that such firms should exit the market. Accordingly, the federal government should review the regulatory framework around insolvency resolution – Australia has the fourth-longest insolvency resolution time in the OECD – as this creates resource misallocation and reduces growth opportunities for efficient firms.

With respect to efficiency, business start-ups should be encouraged to stimulate efficient, dynamic resource reallocation as a way of improving their technical efficiencies. As we report that the SME mining sector is one of least efficient classes of firms, the federal government should conduct a sector-wide review of the mining industry and a competition review of the mining, manufacturing, electricity, gas, water and waste industries. Government should also encourage initiatives for 'older' firms to enhance their technological absorption rates and should speed up the roll-out and increase the coverage of high-speed broadband throughout Australia, particularly by enabling SMEs to connect their premises all the way with fibre-optic

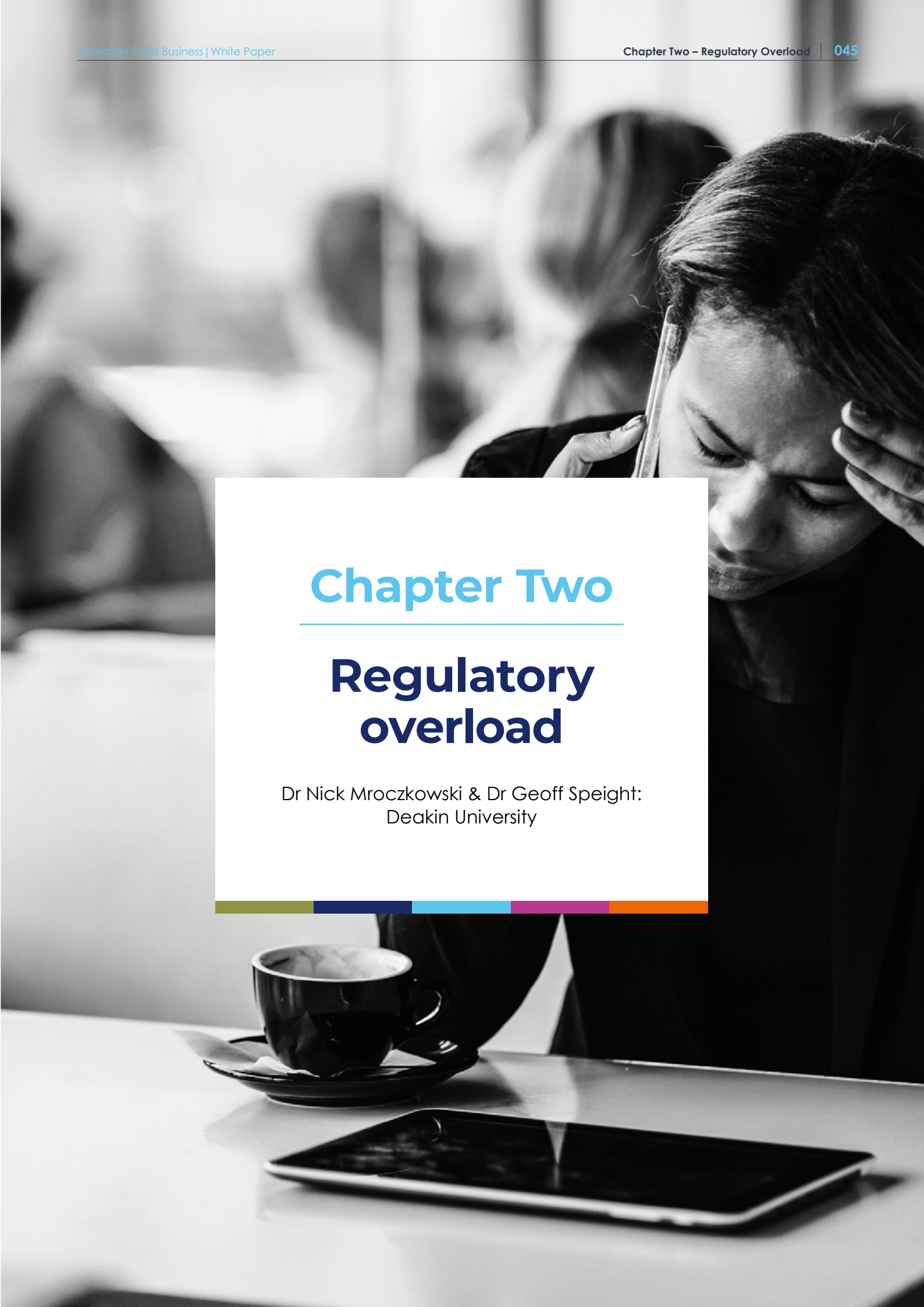
cables rather than using existing copper wires to connect premises to a local hub or node. This will result in significantly faster internet access and boost digital productivity. More importantly, government should ensure that the education system not only produces enough STEM (science, technology, engineering and maths) graduates, but that the business sector of the economy is capable of absorbing them at an efficient rate.

⁴⁷ See Fox and Smeets (2011); Ichniowski and Shaw (2003); Lazear (2000).

Chapter Two

Regulatory overload

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Regulatory overload

The IPA-Deakin SME Research Centre continues to be concerned about the impact of regulations developed by lawmakers in Australia, and in offshore jurisdictions, which can impair the ability of small business owners to focus on growing their businesses.

Headline findings:

- Surveys undertaken by industry, financing and professional bodies show an increasing number of small businesses continue to be concerned with the impact of laws and regulations on their ability to run their business and innovate.
- Recent studies show that Australia has a complex regulatory structure for charities and the not-for-profit sectors that needs urgent attention.
- The federal government has been attempting to consolidate regulatory bodies to achieve efficiencies and reduce the cost of regulation. This process has impacted accounting and audit standard-setting.
- Risk-based regulation should be considered as a preferred approach for dealing with regulatory challenges.
- Concerns about the compliance with accounting standards by charities and not-for-profits have led to proposals for 'proforma' reporting.
- Accounting standard-setters are currently reviewing accounting frameworks to determine whether the way in which accounting standards currently apply to a range of small entities ought to change.
- The use of special purpose financial reports for regulatory lodgements is also being reviewed, with the possibility of removal and replacement with a third tier of reporting.

Reducing regulatory burdens will relieve small business owners of onerous compliance tasks. Regulatory imposts remain one of the key problems cited by small business (i.e. as time-consuming and unnecessary requirements that impair their ability to spend more time on innovation and on growing their respective enterprises).

This negative sentiment is corroborated by research conducted by the Australian Bureau of Statistics (ABS), which shows that an increasing number of small business owners are concerned about the way regulators do not appear to consider the impact of new regulations on business owners' ability to build their businesses.

Further corroboration of the impact of regulatory imposts on small-to-medium enterprises is supported by recent research undertaken by the Centre, using an extensive ABS data set covering the period 2006-2014. The results of the research are explained in the following section.

SMEs believe government regulations and/or regulatory compliance significantly hampers them

This *Small Business White Paper* draws upon multiple data sources to document Australian small businesses' perceptions regarding government regulations on compliance imposts over the period 2006 to 2014. Central to our sources are two unique datasets obtained from the Australian Bureau of Statistics – the 'Business Longitudinal Database (BLD) Confidentialised Unit Record File (CURF)'.

The two separate BLD datasets we analysed are for the financial years 2006-07 to 2010-11 and 2009-10 to 2013-14. They contain the most recent information available on small businesses. The sample design in the BLD datasets involves the use of panel cohorts that represent the Australian business population, stratified by industry division and business size at the point in time that each panel is initiated. In this case, the two separate panel cohorts analysed were initiated in 2005 and 2009.

Tables 1 and 2 show that a small proportion of SMEs (over 13% in the 2006-10 sample period and approximately 15% in the 2010-14 sample period) perceive that government regulations or compliance significantly hampers their innovation. This perception is mapped out over nine years in **Figure 1**, which shows that, while this negative perception significantly increased over the financial years 2006-07 to 2010-11 ($\chi^2(4) = 30.2428, p = 0.000$),



Table 1:
Government regulations and/or compliance significantly hamper SMEs 2006-2014

Government regulations or compliance	2006-2010		2010-2014	
	Freq	%	Freq	%
No	9,832	86.68	6,564	85.27
Yes	1,511	13.32	1,134	14.73
Total	11,343	100	7,698	100.00

Table 2:
Perception that government regulations or compliance significantly hamper innovation 2006-2014

Government regulations or compliance	2006	2007	2008	2009	2010	2010	2011	2012	2013	2014
No	2,334	2,123	1,932	1,768	1,675	1,503	1,417	1,324	1,202	1,118
% No	23.74	21.59	19.65	17.98	17.04	22.9	21.59	20.17	18.31	17.03
Yes	285	299	305	310	312	254	230	242	226	182
% Yes	18.86	19.79	20.19	20.52	20.65	22.4	20.28	21.34	19.93	16.05
Total	2,619	2,422	2,237	2,078	1,987	1,757	1,647	1,566	1,428	1,300
% Total	23.09	21.35	19.72	18.32	17.52	22.82	21.4	20.34	18.55	16.89

it decreased slightly over the five-year time period between 2009-10 to 2013-14.

This decrease in negative perception in the latter years is not statistically significant ($\chi^2 (4) = 3.427, p = 0.489$). However, an analysis by size of business depicts a different picture. Figure 2 shows that small (5-19 employees) and medium-size (20-199 employees) businesses are more likely to agree with the perception that government regulations or compliance significantly hamper their innovation, particularly increasing in the financial year period 2009-10 to 2013-14, and these differences are statistically significant ($\chi^2 (3) = 25.932, p = 0.000$ and $\chi^2 (3) = 36.4117, p = 0.000$) in both sample periods, respectively. Such sentiments were not noted for sole-traders (non-employer) and micro (1-4 employees) businesses.

A similar picture emerges for perceptions regarding government regulations or compliance significantly hampering other business activities or performance.

Figure 3 shows that, while agreement in

the perception regarding government regulations or compliance hampering other business activities or performance significantly increased over the financial years 2006-07 to 2010-11 ($\chi^2 (4) = 35.461, p = 0.000$), these perceptions decreased slightly over the five-year time period between 2009-10 to 2013-14, although this decrease is not statistically significant ($\chi^2 (4) = 6.595, p = 0.159$).

However, an analysis by size of business (see Figure 4) shows that small (5-19 employees) and medium-size (20-199 employees) businesses are more likely to agree that government regulations or compliance significantly hampers their other business activities or performance, particularly increasing in the financial year period 2009-10 to 2013-14, and these differences are statistically significant ($\chi^2 (3) = 35.461, p = 0.000$ and $\chi^2 (3) = 25.575, p = 0.000$) in both sample periods respectively. In contrast, sole-traders (non-employer) and micro (1-4 employees) businesses do not share these perceptions.

Figure 1:
Government regulations or compliance significantly hampering innovation 2006-2014

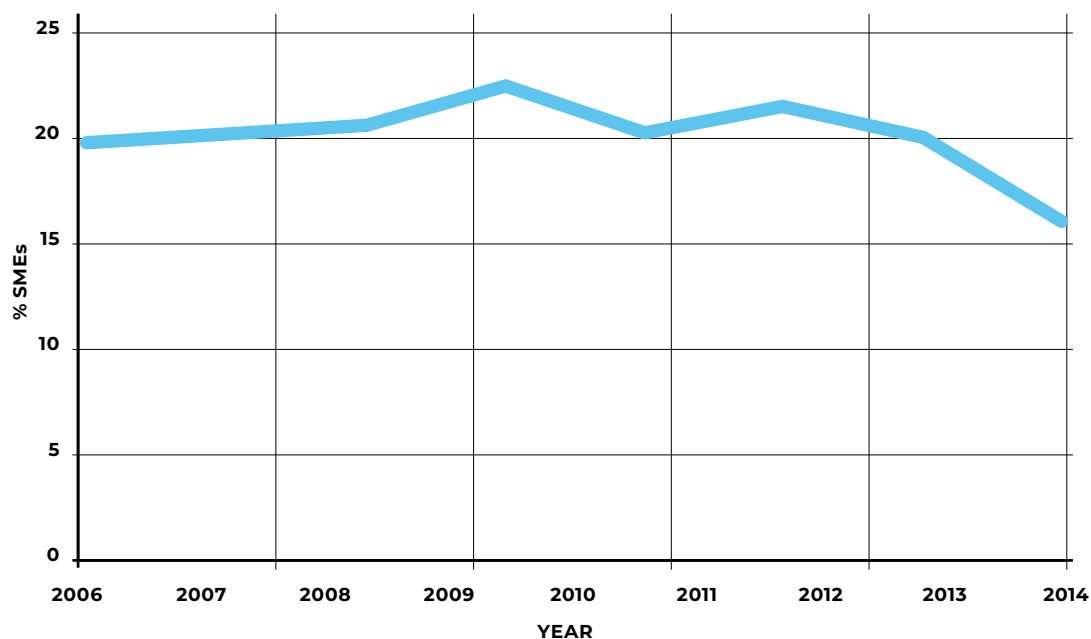


Table 3:
Government regulations or compliance significantly hampering innovation by size of business 2006-2014

Size of Business	Number of employees			
	Non-employer	1-4	5-19	20-199
Government regulations or compliance 2006-2010				
No	2,666	2,603	2,331	2,232
% No	27.12	26.47	23.71	22.7
Yes	333	389	430	359
% Yes	22.04	25.74	28.46	23.76
Total	2,999	2,992	2,761	2,591
% Total	26.44	26.38	24.34	22.84
Government regulations or compliance 2010-2014				
No	731	2,090	1,886	1,857
% No	11.14	31.84	28.73	28.29
Yes	99	281	378	376
% Yes	8.73	24.78	33.33	33.16
Total	830	2,371	2,264	2,233
% Total	10.78	30.8	29.41	29.01

Figure 2:
Government regulations or compliance significantly hampering innovation by size of business 2006-2014

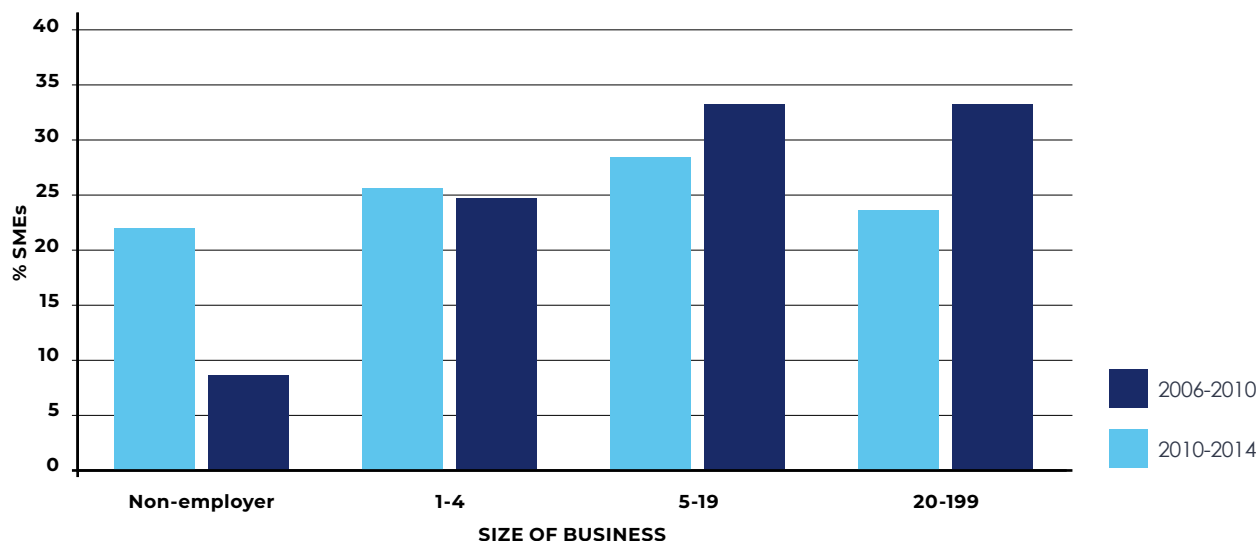


Table 4:
Government regulations or compliance significantly hampering other business activities or performance: 2006-2014

Government regulations or compliance	2006-2010		2010-2014	
	Freq	%	Freq	%
No	9,837	87.05	6,479	84.24
Yes	1,463	12.95	1,212	15.76
Total	11,300	100	7,691	100

Table 5:
Government regulations or compliance significantly hampering other business activities or performance: 2006-2014

Government regulations or compliance	2006	2007	2008	2009	2010	2010	2011	2012	2013	2014
No	2,340	2,121	1,917	1,771	1,688	1,478	1,420	1,298	1,189	1,094
% No	23.79	21.56	19.49	18	17.16	22.81	21.92	20.03	18.35	16.89
Yes	239	301	315	306	302	275	232	270	232	203
% Yes	16.34	20.57	21.53	20.92	20.64	22.69	19.14	22.28	19.14	16.75
Total	2,579	2,422	2,232	2,077	1,990	1,753	1,652	1,568	1,421	1,297
% Total	22.82	21.43	19.75	18.38	17.61	22.79	21.48	20.39	18.48	16.86

Figure 3:
Government regulations or compliance significantly hampering other business activities or performance: 2006-2014

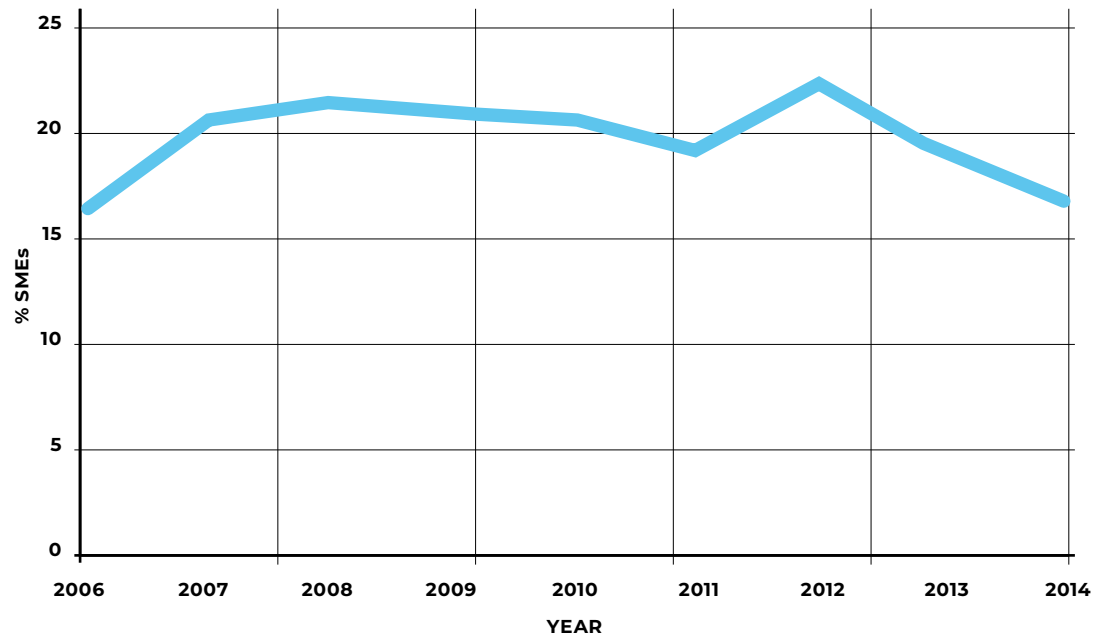
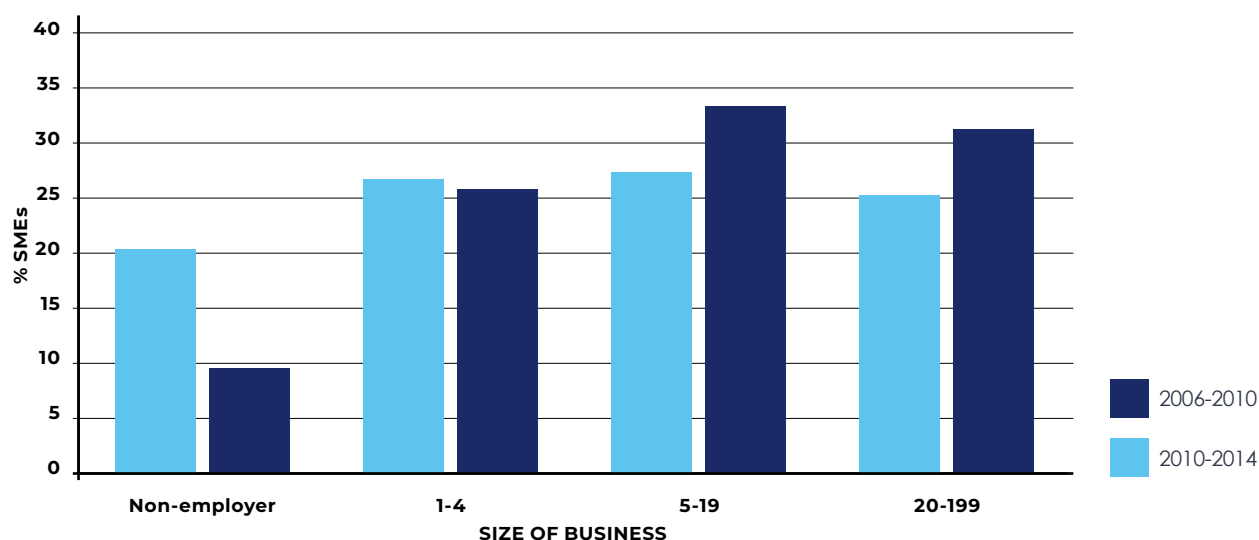


Table 6:
Government regulations or compliance significantly hampering other business activities or performance by size of business: 2006-2014

Size of Business	Number of employees			
	Non-employer	1-4	5-19	20-199
Government regulations or compliance 2006-2010				
No	2,688	2,595	2,343	2,211
% No	27.33	26.38	23.82	22.48
Yes	299	393	401	370
% Yes	20.44	26.86	27.41	25.29
Total	2,987	2,988	2,744	2,581
% Total	26.43	26.44	24.28	22.84
Government regulations or compliance 2010-2014				
No	719	2,053	1,855	1,852
% No	11.1	31.69	28.63	28.58
Yes	114	312	405	381
% Yes	9.41	25.74	33.42	31.44
Total	833	2,365	2,260	2,233
% Total	10.83	30.75	29.38	29.03



Figure 4:
Government regulations or compliance significantly hampering other business activities or performance by size of business: 2006-2014



The Centre contends that part of the increase in negative sentiment from the small business sector is due to regulatory overload in a range of areas, especially legislative requirements and reporting compliance that divert the small business owner’s attention from business-building activities to regulatory compliance. There is also a need to reinforce a risk-based approach to regulation and enforcement, so that regulators focus on sectors that are more likely to be at risk of contravening laws and regulations.

The purpose of regulation

Before exploring how best to approach regulatory issues that impact small business, it is necessary to understand the purpose of regulating business. Adam Smith (cited in Bosch (1990)⁴⁸), a moral philosopher, believed that regulation of a country’s citizens falls to government in order to create a civilised environment. He thus outlined three core responsibilities for governments in his seminal book, *The Wealth of Nations*.

The first responsibility of government, wrote Smith, is to ensure citizens are protected from outside forces – that is, other countries wishing to do them harm. This is essentially protection from invasion by outsiders. A second responsibility

of governments is to prevent people from harming each other, while a third responsibility is the development of infrastructure and public services for which private investment is unlikely to occur.

Both the first and second of these obligations are relevant to the examination of laws designed to draw bright lines on the pitch on which the game of business is played. The sporting analogy was used by former corporate regulator Henry Bosch (1990)⁴⁹ when he observed that rules are needed “for the game to be played efficiently and competitively and those rules must be fair and must sustain confidence in the market; that is, they must protect each of the players from the ‘injustice or oppression’ of the others.” Bosch’s definition provides key principles for the regulation of the conduct of business: efficiency, competitiveness and confidence that must be present within the regulatory environment.

The OECD’s view on regulation

Guiding principles for regulatory quality and performance reflecting Bosch’s perspective on regulation have been at the centre of the work by the OECD, with that organisation issuing a range of documents dealing with regulatory architecture from 1995 through to 2014.

⁴⁸ Bosch (1990).

⁴⁹ Bosch (1990).

The work of the OECD (1997)⁵⁰ on regulation has classified regulation as covering three core areas:

- **Economic regulations:** These are direct interventions in market conditions such as pricing, competition and barriers to both entry and exit in a particular market. Deregulation at this level is a means by which governments seek to boost economic activity by reducing or removing barriers to competition and business innovation. A regulatory framework could also be revised or overhauled to improve the functioning of a market or prudential oversight such as the regulation of the banking sector.
- **Social regulations:** This classification covers public interest issues such as health, safety, the environment and regulation dealing with social cohesion. The OECD notes that substantial economic impacts of social regulations may arise. Reform proposals in this area may deal with making the provision of assistance and services more flexible, simpler and less costly.
- **Administrative regulations:** This is the area that is often of greatest concern to small businesses, because it deals with the administrative burden that comes with 'red tape' compliance. The OECD observes that onerous administrative tasks related to compliance can affect private sector performance and that changes to such regulations tend to be aimed at removing redundant rules, streamlining procedures and, thus, simplifying compliance.

The OECD published recommendations of its Council on Improving the Quality of Government Regulation (OECD 1995)⁵¹ that comprised 10 questions for governments to ask themselves when designing or reviewing their regulatory regimes.

The questions were designed to provide prompts for the development of regulation. They included whether the regulatory problem was properly defined and if government regulation was the best form of action.

The 10-question checklist was followed two years later by an OECD *Report on Regulatory Reform* (OECD 1997), in which the global body observes that there are advantages to an economy and to business owners if regulatory reform takes place. The OECD observes that regulatory change "that reduces business burdens and increases the transparency of regulatory regimes supports entrepreneurship, market entry, and economic growth that, in turn,

should produce high-paying, high-quality jobs". It further notes that the reduction of paperwork burdens on 'ordinary citizens' frees up time that would otherwise be taken up by compliance.

The OECD defines regulatory reform as any change that improves the quality of regulation. Indicators of improvement in the quality of regulation, according to the OECD, include an enhancement of performance, "cost effectiveness or legal quality of regulations and related government formalities"⁵². The same report also defines deregulation as the repeal or partial removal of regulations to improve economic performance.

A further and not insignificant point noted by the report is that it is "difficult to measure the precise cost of failure to reform, but it can be substantial". While the OECD states precise measurement is difficult, it observes that there are hidden costs of a failure to reform that can lead to advocacy for subsidisation or "costly supports" and protectionism in sectors vulnerable to rapid technological change.

The OECD published an updated version of the *OECD Guiding Principles for Regulatory Quality and Performance in 2005*⁵³. It noted there was change in the concept of regulatory reform since they issued their OECD report to Ministers. Reducing the scale of government was a major focus in the 1990s and the OECD observes that this was typically carried out in a piecemeal fashion. Isolated or single initiatives, the OECD notes, are no substitute for a holistic review and reform process that aims to create a regulatory environment that is "favourable to the creation and growth of firms, productivity gains, competition, investment and international trade"⁵⁴.

The principles updated at that stage, which acknowledge the importance to an economy of regulatory reform in any individual jurisdiction, are:

1. **Adopt at the political level broad programs of regulatory reform that establish clear objectives and frameworks for implementation**
2. **Assess impacts and review regulations systematically to ensure that they meet their intended objectives efficiently and effectively in a changing and complex economic and social environment**
3. **Ensure that regulations, regulatory institutions charged with implementation, and regulatory processes are transparent and non-discriminatory**

50 Organisation for Economic Development and Co-operation (OECD) (1997).

51 Organisation for Economic Development and Co-operation (OECD) (1995).

52 Organisation for Economic Development and Co-operation (OECD) (1997).

53 <https://www.oecd.org/regreform/sectors/37318586.pdf>. Accessed 15th April 2018.

54 Organisation for Economic Development and Co-operation (OECD) (2005).



4. Review and strengthen where necessary the scope, effectiveness and enforcement of competition policy

5. Design economic regulations in all sectors to stimulate competition and efficiency, and eliminate regulations except where clear evidence demonstrates that they are the best way to serve broad public interests

6. Eliminate unnecessary regulatory barriers to trade and investment through continued liberalisation and enhance the consideration and better integration of market openness throughout the regulatory process, thus strengthening economic efficiency and competitiveness

7. Identify important linkages with other policy objectives and develop policies to achieve those objectives in ways that support reform.

These 2005 principles were also a part of an integrated checklist released that same year in conjunction with APEC⁵⁵ and these principles have been developed and expanded further in the OECD's (2012) Recommendation of the Council on Regulatory Policy and Governance. The 2012 publication also places an emphasis on regulatory impact analysis and the need to conduct a regular stocktake, review, revision or repeal of laws or regulations that are deemed to be redundant at a point in time.

Australian efforts to improve regulation

The Centre believes it is necessary for the federal government to ensure that all laws and regulations are subject to a rigorous review framework that maintains the requirement for a regulatory impact analysis and accompanying statements on the way in which new rules affect individuals or entities.

A research paper by the Australian Productivity Commission⁵⁶ outlined various costs that are imposed on small businesses as a result of regulations, including the following:

- The additional costs of paperwork, management and record-keeping systems associated with compliance with government regulations and taxes
- Government costs of administering the regulation, including the process of regulatory formulation, administrative systems, monitoring, enforcement, and reporting

- Additional output costs stemming from regulations (such as the additional costs of pollution abatement or energy efficiency investment, changed work practices, higher prices for inputs, and restrictions on activities)
- Reduced incentives for efficiency, entrepreneurship and innovation that feed into lower productivity levels and growth rates
- Indirect effects on economic efficiency. These include resources dissipated by rent-seeking and systemic problems in the market system that interact to impede efficiency.

The Commission's report acknowledges that a compliance burden for businesses exists. One quantitative measure the Commission uses as evidence to draw attention to the compliance burden is the increase in the number of laws in Australia's statute book. The report observes that "from 1992-93 to 1995-96, the Commonwealth Parliament passed 664 Acts, of which approximately 200 are thought to have a substantial effect on business ... An average of nearly 5000 pages of new primary legislation were enacted per year from 1990 to 1994." The report notes that businesses also must comply with relevant state or territory laws as well as local council regulations and by-laws, and these requirements add to the compliance burden.

Arguably, companies are able to afford and allocate the necessary human and technological resources to manage complex regulation and paperwork. However, small businesses are by their nature resource-constrained and will attempt to do more with fewer resources. While various technological solutions such as accounting software and online portals for compliance provide some processing and lodgement relief, the task of complying with the rules impacting a small business still exists.

Lignier and Evans⁵⁷ highlight resource-consuming compliance costs within the tax regime for small businesses in Australia. The authors noted that there was a significant increase in the costs of compliance with tax laws in the 2009-10 income tax years, with small businesses paying an average of \$28,000 a year when compared with the costs highlighted in earlier and similar studies conducted in the 1990s.

Small businesses surveyed by Lignier and Evans observed that, while tax compliance

⁵⁵ Organisation for Economic Development and Co-operation (OECD) (2005).

⁵⁶ Lattimore, Madge, Martin and Mills (1998).

⁵⁷ Lignier and Evans (2012).

resulted in a need for computerised accounting records, the information captured could also be used for internal purposes. Technology provides a means by which a small businesses can automate compliance tasks, but the capacity to automate should not lead to unnecessary and more complex regulation. It remains critical for governments and their respective departments to continue to review the relevance and impact of regulations on the owners of small businesses.

Any protocols for considering the development of laws and regulations should always be transparent and criteria for dealing with the needs of small businesses consistently applied. This requires an underlying framework that provides key principles for evaluating existing laws and proposed legislation in the context of the impact on small business.

A Productivity Commission review of regulations in 2006⁵⁸ established six broad principles that remain relevant today. The principles set down in the review titled *Rethinking Regulation*, prepared by the Taskforce on Reducing Regulatory Burdens on Business (2006)⁵⁹, provide a strong foundation for the development of sound regulations.

The six principles described in the taskforce's report include the following:

- Governments should not act to address 'problems' through regulation unless a case for action has been clearly established. This should include evaluating and explaining why existing measures are not sufficient to deal with relevant issues.
- A range of feasible policy options — including self-regulatory and co-regulatory approaches — need to be assessed within a cost-benefit framework (including analysis of compliance costs and, where relevant, risk).
- Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted.
- Effective guidance should be provided to regulators and regulated parties to ensure that the policy intent of the particular regulation is clear, as well as what is needed to be compliant.
- Mechanisms such as sunset and transition clauses or periodic reviews need to be built into legislation to ensure that regulation remains relevant and effective over time.
- There needs to be effective consultation with regulated parties at the key stages of regulation-making and administration.

The report also observed that the taskforce received submissions that noted compliance can consume up to 25% of the time that company officers, such as senior managers and members of a board of directors, may need to be engaged. Small business owners, the report acknowledged, were likely to spend more time on compliance because smaller entities lack the "in-house capacity to deal with and keep abreast of the regulatory morass".

As documented in the OECD's publications on reform of regulation, the Productivity Commission's taskforce report notes that regulation can stifle innovation and "crowd out productive activity in the 'economic engine room' of Australia". Increases in the amount of regulation, it further observed, involved greater allocation of government resources, which also increases the burden to administer and enforce. Various reviews of regulation and the regulatory impost in subsequent years have pointed consistently to the challenges faced by small businesses when they are burdened with compliance work arising from undertaking an enterprise.

The Australian Institute of Company Directors⁶⁰ has stated, for example, that there is an expectation gap between what directors are expected to do by various stakeholders and what the law actually requires. An observation made by the AICD is that regulation and red tape are seen by directors as a diversion from the core role directors should be playing: the provision of strategic guidance to an entity.

The federal government, irrespective of the changes of political hue from time to time, has acknowledged that small businesses have particular characteristics that need to be considered in any regulatory design and via the OBPR endeavours to ensure that small business issues are considered as a part of any regulatory design. This is particularly relevant in the case of preparing regulatory impact statements that must demonstrate an evaluation of the impact of regulatory changes on smaller entities.

A guidance note issued by the OBPR⁶¹ states that government departments must reflect specifically on the impact any regulatory changes have on small businesses. Some of the factors in the guidance note point to options that must be considered, including the following:

- flexible compliance options
- differentiated regulatory requirements and ways of administering them, based on turnover or number of employees

⁵⁸ Taskforce on Reducing Regulatory Burdens on Business (2006).

⁵⁹ Taskforce on Reducing Regulatory Burdens on Business (2006).

⁶⁰ Cole (2012).

⁶¹ Office of Best Practice Regulation (2017).

⁶² Productivity Commission (2013).



- leveraging, modifying or streamlining existing regulatory frameworks and/or compliance mechanisms
- simpler, lighter-touch compliance options for small businesses or risk-based enforcement
- principle-based approaches augmented with minimum compliance standards
- use of existing data sources and coordination among regulators to minimise reporting requirements.

The Centre believes these principles are useful in evaluating appropriate policy responses to an issue and encourages their continued use as a way of determining and applying regulations to smaller entities. It is important, however, to acknowledge that a policy articulated in a law or regulation must also be subject to implementation by regulators that enforce the spirit of the law while also demonstrating a degree of sensitivity to the impact of regulations on the administration of small businesses.

Regulator behaviour and enforcement

The Centre has long argued that regulators should ensure they apply a risk-based approach to regulation. It is an approach that was also highlighted by the Productivity Commission⁶² in its report on *Regulator Engagement with Small Business* as a way of ensuring that the enforcement of rules is undertaken proportionately. The Institute of Public Accountants (2013) submission to the inquiry on regulator engagement reinforced advocacy for enforcement of regulations.

Risk-based regulation means that individuals or businesses considered more likely to transgress, or businesses with potential transgressions, are likely to cause the highest costs to society, and are supervised more closely than others. Such an approach would ensure an efficient allocation of regulator resources and avoidance of unnecessary burdens on businesses that are perceived to be less risky from a regulatory perspective.

It should also be acknowledged, however, that a risk-based approach to regulation may result in some minor offences not being pursued because it would be considered an inappropriate use of resources. This is a point made by Sparrow⁶³, who refers to the tension between two regulatory philosophies: the legal model of regulation and the expert model of regulation.

The legal model of regulation is defined by Sparrow⁶⁴ as one in which regulators focus on compliance with the law. Harm reduction and the creation of alternative methods for shaping societal behavior is the focus of the expert model of regulation. He observes that the regulatory world is looking more closely at the expert model, partly because of the various terrorist acts such as the September 11⁶⁵ attacks and financial challenges such as the Global Financial Crisis that have taken place over the past two decades. Sparrow argues that the focus on risk control has promoted regulators to identify and suppress harm rather than seek to use powers available under the law as a matter of first resort.

The Centre agrees with the expert approach and has encouraged the adoption of this approach in submissions to government bodies. Risk-based regulation helps focus regulatory efforts on individuals and companies that are deemed to be at high risk of non-compliance. Arguably, there is little value in conducting surveillance or monitoring of individuals or companies where, based on research conducted by the regulator, there is low risk of non-compliance and where only compliance is likely to be observed.

Five-yearly productivity reviews by the Productivity Commission

The Australian Productivity Commission conducts productivity reviews every five years, with the most recent review published in August 2017⁶⁶. Periodic reviews are a part of the Commission's workflow and are designed to ensure the Commission (2017)⁶⁷ focuses on the following matters:

- Investigating Australia's productivity performance in both the market and non-market sectors, including an assessment of the settings for productive investment in human and physical capital and how they can be improved to lift productivity
- Examining the factors that may have affected productivity growth, including an assessment of the impact of major policy changes, if relevant
- Prioritising potential policy changes to improve Australian economic performance and the wellbeing of Australians by supporting greater productivity growth.

Of particular interest is the focus placed by the Commission on regulatory stock-takes (i.e. to ensure that laws and regulations do not restrict activities beyond

⁶² Productivity Commission (2013).

⁶³ Sparrow (2012), pp 34Ref.

⁶⁴ Sparrow (2012), p 34.

⁶⁵ Sparrow, M (2012) pp.34f.

⁶⁶ Productivity Commission (2017).

⁶⁷ Productivity Commission (2017).

what is needed to achieve a regulatory objective). The Commission observes that regulators and policy departments need to be able to identify areas where regulations are outdated because “technologies and tastes have moved on and so the restrictions are no longer necessary”, while noting that some regulations could have been too stringent in the first instance.

The Commission highlights that one way in which the regulatory objectives of regulations can be reviewed is through the use of regulatory stock-takes. These stock-takes can provide the opportunity to assess regulations and determine whether they remain relevant in their present form or require revision to modify their impact on the community. Regulations can be removed when they have outlived their usefulness, because the matter or behaviour subject to regulation has become less significant.

An example of a legislative amendment that would lessen the stringency of a specific law is for the federal Parliament to make it clear that it is not a copyright infringement to circumvent or by-pass geo-blocking technology. Geo-blocking technology detects the location of a computer user and restricts the user's ability to access digital products online. In a marketing context, this technology is usually implemented for the purposes of price discrimination between markets. The five-yearly review noted⁶⁸ that the imposition of geo-blocking on Australian consumers has meant higher prices and a lower or more limited level of digital service. The Commission's recommendation (2017)⁶⁹ was that copyright laws be amended to ensure that by-passing geo-blocking technology is not regarded as a breach of copyright laws and for Australia to avoid entering into any international agreement that involve the imposition of geo-blocking technologies.

The Productivity Commission's (2017) most recent five-yearly review observed that there was a need for governments at all levels to ensure regulatory impact analysis was included in the development of regulations, rather than what is effectively seen as a post-implementation review.

The process of analysing regulatory impacts is meant to ensure that regulation is both effective and less costly. A study conducted by the Productivity Commission⁷⁰ found “factors such as commitment to [the implementation of regulatory impact assessment] in time challenged environments and an apparent culture of

risk aversion in some public services, which defaults to regulation as a policy lever”. The Commission points to the need for cultural change within the public service and regulators for impact analysis to be effective.

A further matter highlighted by the Commission is the concern expressed by businesses regarding the volume of regulation with which each enterprise needs to comply. This is addressed, in part, by the creation of single portal access to information and regulatory approvals that the Productivity Commission observes has progressed (at federal and state government levels). A recommendation in the five-yearly review states that single portal access be accelerated so it is easier for businesses to deal with regulatory burdens.

The Centre commends the Productivity Commission for undertaking five-yearly reviews and supports the use of stock-takes of regulations to ensure the objectives of regulation are met at the least possible cost to business. It is also important that government agencies ensure they embed regulatory impact analysis at the regulation development phase.

In focus: regulatory overload and accounting standards

The problem of regulatory overload is more pronounced for small businesses, because they are less likely to have the staff and the systems to deal with what may at times be complex regulations^{71, 72}.

One such example of overload is arguably in the area of accounting standards compliance in the 1980s. It was an accounting standard-setting regime that appeared to have no sound basis upon which entities could properly assess whether or not they should prepare financial statements than comply with all accounting standards. A critical question at that point in the history of accounting regulation in Australia was how best to reduce the compliance burden and costs related to financial reporting for entities in which there was no demonstrable community interest. Studies in the area of regulatory overload are prominent in the accounting literature and they include the questions of accounting standards overload as explored by McCahey⁷³, and McCahey and Ramsay⁷⁴.

These studies contributed to advancing the development of the conceptual framework that embedded the reporting entity concept. The reporting entity concept helped create a situation where fewer entities needed to comply with the

⁶⁸ Productivity Commission (2017).

⁶⁹ Productivity Commission (2017).

⁷⁰ Productivity Commission (2012).

⁷¹ Productivity Commission (2013).

⁷² Taskforce on Reducing Regulatory Burdens on Business (2006).

⁷³ McCahey (1986).

⁷⁴ McCahey and Ramsay (1989).



complete suite of accounting standards, as these entities were not deemed to be reporting entities. The reporting entity concept is defined in the conceptual framework adopted by Australia in 1990 as an “entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources”⁷⁵ (AASB 1990).

Accounting standards experienced a further change in the context of the adoption of International Financial Reporting Standards (IFRS). Moreover, the Reduced Disclosure Regime (RDR) was an attempt to provide relief for smaller entities⁷⁶. This was an initiative that permitted entities to publish financial statements with fewer disclosures if they were deemed to be not publicly accountable by the financial reporting framework. Shaded boxes were placed around disclosure requirements in standards and used to help non-publicly accountable entities identify what disclosures were unnecessary for their purposes. It should be noted that the RDR was introduced as a way of ensuring that entities were able to reduce the size and depth of their financial statements while maintaining the integrity of the preparation of the accounts.

An option considered at the time and supported by some commentators was the introduction of IFRS for SMEs, which was a standalone standard that contained simplified measurement and recognition requirements. This approach was rejected on the basis that it would result in an absence of comparability and also require an entity to transition from IFRS for SMEs to the full suite of standards once they became publicly accountable. Amendments to the RDR regime were proposed in early 2017 and in 2018 the AASB has continued to further its review of the accounting framework. The Centre supports a continuous review of accounting guidance to ensure it evolves over time without diverging from IFRS compliance in substance.

Rationalising regulatory bodies

The federal government should, on a regular basis, consider the rationalisation of regulatory bodies where the functions of those organisations overlap. A periodic audit or review of regulatory agencies is needed to ensure that the functions they perform continue to be relevant and are performed efficiently.

Any mergers or rationalisation of regulatory agencies will always be accompanied by sensitive change management initiatives given that altering regulatory arrangements will, by necessity, mean change to the working lives of public servants involved in the business of regulation. This is an impact that must be anticipated and plans for transitions from one regime to another must be created in advance, so all of the individuals and organisations involved can own aspects of the change process.

There is a need for organisations occupying a regulatory space, as discussed by Artiach et al⁷⁷, to become legitimised through a series of consultation processes and then legislative implementation. A regulatory space is an environment where individuals and regulators interact and from time to time a regulatory space may morph as a result of government policy initiatives. This naturally leads to tensions, because any institutional change requires people to adapt to something different.

One recent case of this kind of phenomenon is the proposed merger of three external dispute-resolution schemes in the financial services sector into a single complaints authority. The federal government established a consultation process using a review panel to evaluate whether there was an alternative way to deal with customer complaints that arise from dealings with financial services organisations. Three schemes dealing with essentially the same issue – consumer complaints regarding the conduct of financial services professionals or institutions – appears to be overkill. The Centre supported the merger of the three schemes to streamline the structure in place for consumer disputes with financial services providers.

A core recommendation of an Interim Report⁷⁸ was for the Financial Ombudsman Service (FOS) and the Credit and Investment Ombudsman (CIO) to be merged into one. The report notes that the existing schemes are a result of continuous improvement processes in dispute resolution, given that the FOS in particular was the result of merging several other schemes. A further consolidation of these bodies is an extension of the continuous improvement trend in an endeavour to focus on the function of these bodies instead of on the individual products and/or services that have been sold to consumers.

⁷⁵ Australian Accounting Standards Board (1990).

⁷⁶ Potter, Wright and Ravlic (2013).

⁷⁷ Artiach, Irvine, Mack and Ryan (2016).

⁷⁸ The Treasury (2016).

This is consistent with trends examining the role and function that a professional is expected to perform under law, rather than the requirements and obligations of the professional body of which the professional person is a member.

An accountant specialising in audit intending to audit private or public companies incorporated under the *Corporations Act 2001* must be a registered company auditor. The professional accounting body of which the accountant is a member is immaterial. The most critical issue is the registration of the practitioner with the corporate regulator as a company auditor. The same is true of liquidators and practitioners that are engaged in the provision of tax advice. Laws have increasingly focused on the function performed by an individual rather than the professional designation they hold.

The same regime applies to financial advisers. There are laws that deal with the provision of financial advice that apply equally to those individuals who are members of financial planning member bodies as they do to members of accounting organisations.

The proposed merging of two external dispute-resolution regimes in the financial services sector is an indication that the federal government is keen to rationalise regulatory structures. A final report by the same government review panel further proposed the merging of the above-mentioned external dispute resolution regimes as well as the Superannuation Complaints Tribunal.

Any opportunity to rationalise a complaints-handling and resolution process should be taken to streamline the services offered. The federal government will need to be mindful of the fact that any merger of complaints schemes will need to ensure that sufficient staff with the necessary expertise across the specific product ranges are retained so that complaints using the external processes experience are appropriately resolved.

The recommendation for the creation of one financial services body is also consistent with the federal government's approach to merging or removing various bodies as recommended in the National Commission of Audit commissioned following the election of the Abbott Government in 2013. The Phase Two Report from the National Commission of Audit's⁷⁹ report published in March 2014 stated that 696 non-principal bodies needed to be rationalised, with 482 of those bodies

singled out for abolition, amalgamation, transformation or assessment. The approach taken in relation to merging the three schemes fits the policy approach recommended by the National Commission of Audit.

The accounting profession experienced this rationalisation first-hand with the merger of standard-setting experts at the Australian Accounting Research Foundation and the Australian Accounting Standards (AASB), with a new statutory board known as the Financial Reporting Council (FRC) that was legislated by the federal Parliament as a part of the Corporate Law Economic Reform Program (CLERP)⁸⁰ in 1999, and made effective from January 2000. That move brought together the AASB, which was the standard setter recognised under law as having the delegated power to develop and issue accounting standards, and the professional staff that were housed within the auspices of the private sector technical organisation.

These institutional changes had the effect of ensuring the government standard-setting body had its own staff from which to draw rather than the previous situation where support staffing for the board was outsourced to the AARF. The audit standard-setting function followed suit within the space of four years and became similarly accountable to government, following reputational damage against the audit profession generally, propelled by the collapse of global corporate giants such as Enron and WorldCom and the now defunct Australian general insurer, HIH. Both the accounting and auditing standard-setting boards report to the Financial Reporting Council (FRC). The FRC reports back to the Treasurer.

Further rationalisation of internal staffing and *back office* arrangements of auditing and accounting standard-setting agencies has occurred over the past two years, which reflects a recommendation of the National Commission of Audit (2014b)⁸¹. The accounting and auditing profession effectively now only retains control of one standard-setting body, the Accountants Professional and Ethical Standards Board (APESB), which develops and issues professional and ethical standards.

A further example of the rationalisation of regulatory or dispute-settling bodies occurred when the Federal Government dissolved the accounting arbitration body known as the Financial Reporting Panel (FRP). The FRP⁸² was established in 2009 and

⁷⁹ National Audit of Commission (2014b).

⁸⁰ Corporate Law Economic Reform Program Act (CLERP) (1999).

⁸¹ National Commission of Audit (2014b).

⁸² A brief history of the Financial Reporting Panel can be found at <https://treasury.gov.au/programs-and-initiatives-banking-and-finance/financial-reporting-panel/>.



its panel comprised company directors, accounting experts and shareholder representatives. The panel's primary role was to hear disputes related to appropriate accounting treatments that emerged between the corporate regulator (ASIC) and companies in an environment where individuals familiar with accounting and its conventions could rule on a specific situation. While the panel was deemed to be a worthwhile concept at the time, in practice few matters were actually referred to the FRP. As a consequence, the panel was decommissioned in 2012. This is a classic example of a concept that was trialled and was later found to be underutilised.

As discussed above, it is important that a review of regulatory structures takes place periodically to ensure that structures and processes used by the government for the regulation of businesses are relevant, efficient and cost-conscious, and continue to serve the public interest. While changes of this order may be disruptive on a number of levels, the IPA-Deakin SME Research Centre recommends that initiatives that create a more efficient, responsive and risk-based regulatory environment should be at the forefront of government policy.

Adopting international best practice

Company law in Australia requires the lodgement of various company details on the corporate registry maintained by ASIC and the registers of other regulators such as the Australian Taxation Office. Limited registry details are freely accessible. Small business owners seeking to evaluate potential suppliers or clients are unable to access further details without paying a fee for basic current and historical extracts. These charges might have been justified in an era when technology used to archive these records relied on manual conversion of paper records. There is now, more than ever, a need to review the methods of capturing and archiving company data, as well as the costs of accessing that data by interested parties such as small business owners and others.

The Centre is of the view that, consistent with other leading nations (the United States and the United Kingdom in particular) relevant company information on the public record (with some exceptions relating to private information) should be made freely available. This will, inter alia, enable small business owners to further understand the companies with which they are engaging. It would seem incongruous to collect information about companies for

the protection of the public and then to deny free access to the public.

Financial reporting is not just a mere tool to assist management in keeping track of its own performance – it exists in its present form because there is a public interest in understanding the financial affairs of entities that are permitted to use the corporate veil. The filing of information with the corporate regulator is part of an obligation the company has, in return for the privileges of incorporation.

A further relevant consideration in this context is that the financial reporting frameworks assume a general-purpose financial report user exists and that a company's financial position and performance should be presented and prepared in accordance with accounting standards for this user.

We note that financial and other relevant information is produced for users of financial statements – a notion that has been in financial reporting for many decades without question. Indeed, this notion was hardwired in a definition of the purpose of financial reporting by Paton and Littleton⁸³ in their seminal monograph, *An Introduction to Corporate Accounting Standards*. For these two prominent accounting theorists, accounting had the purpose of furnishing “financial data concerning a business enterprise, compiled and presented to meet the needs of management, investors and the public”.

A more contemporary definition of financial reporting and the relevance it has to users is tied to the concept of general-purpose financial reporting embodied in Statements of Accounting Concepts SAC2, which deals with the *Objectives of General Purpose Financial Reports* (GPFR), published by AARF in 1990⁸⁴. A GPFR is defined in SAC2 as a “financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs”⁸⁵. An Appendix in the *Framework for The Preparation and Presentation of Financial Statements* (AASB 2014a, AASB 2014b)^{86, 87} defines the objectives of GPFRs to be the provision of “financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors, in making decisions about providing resources to the entity”.^{88, 89} These definitions, taken from different periods of the development of financial reporting standards, cement the notion of satisfying users' needs in the accounting framework.

⁸³ Paton and Littleton (1940).

⁸⁴ Australian Accounting Research Foundation (1990).

⁸⁵ Australian Accounting Research Foundation (1990).

⁸⁶ Australian Accounting Standards Board (2014a).

⁸⁷ Australian Accounting Standards Board (2014b).

⁸⁸ Australian Accounting Standards Board (2014a).

⁸⁹ Ball (1988).

It should be noted that the *conceptual framework* was developed to provide a principles-based framework that preparers of financial statements could read, understand and apply, depending on the classification the entity⁹⁰ has adopted for the purposes of preparing and presenting their financial statements^{91, 92, 93}. However, researchers have recently observed that special purpose financial statements were inappropriately used for financial statements lodged on the public record and, as such, it has become difficult for users such as media representatives to understand and compare accounts between entities^{94, 95, 96}.

The Centre notes that, at the time of writing, the AASB issued a consultation document⁹⁷ that deals with notion of special purpose financial reporting in the context of a revised conceptual framework. Any initiative that brings a greater level of compliance to the preparation and presentation of financial reports lodged with public regulators is to be welcomed. To comment further on access to company information in the context of financial report usefulness, the inability of potential users of a set of financial statements filed with a regulator to access these freely, given cost constraints, makes it impossible to fulfil the full vision of the designers of the financial reporting framework on which the accounting standards specifying the preparation and presentation of financial statements are based.

An example of a free database is that offered by the Securities and Exchange Commission (SEC), the capital markets regulator in the United States. The SEC provides free access to all financial statements of SEC registrants, and such a system is consistent with the general philosophy of regulators ensuring that corporate lodgements are made available to the public on a timely basis. Investors, creditors, suppliers, academics, researchers and journalists can access these documents without paying a fee. The SEC model should be further explored by the federal government as a way of improving the accessibility of financial reports prepared and lodged by entities required to comply with the relevant legislation. This is one approach to keeping markets fully informed, which is one of the primary roles of the regulator (i.e. "to promote confident and **informed** participation by investors and consumers in the financial system"⁹⁸).

Using the SEC model would need to be considered in line with the government's review of business registers. The Centre supports the notion of company registers and encourages the government to merge registers wherever practicable to make it easier for small business owners and others to use online services.

The Productivity Commission⁹⁹ has previously noted that small business owners find supplying information to a regulator as one of the more onerous aspects of regulatory compliance. The Commission argued that requests for information from small businesses should be the minimum required to ensure monitoring and enforcement tasks can be undertaken efficiently. Data requests, the Commission argued, should also be based, as much as possible, on material already kept by a small business rather than asking for new information to be generated. The Centre supports this principle and encourages state and federal governments to continue to be mindful of administrative requirements impacting small businesses.

Strengthening register integrity

Regulation needs to be implemented using appropriate mechanisms. One example of this is reflected in one of the strengths of Australia's regulatory environment, which is how easy it is to set up a company online with the corporate regulator. Advances in information and communication technology have greatly assisted individuals in registering a company with ease and have provided all necessary details required via an online register. These online facilities can be accessed by company officers providing they use the Australian Company Number, a Corporate Key and a unique password to protect their individual access.

While the objective of ensuring small businesses can operate without unnecessary regulatory obstacles in Australia is commendable, there are some areas of regulation that need remedial action.

One of those areas is the ability of company officers to add or remove directors without individuals knowing that they have been appointed to a board of directors, or indeed removed from a board. The current registry mechanisms, which might fulfil the objective of making business compliance easier by lowering the complexity of business registration can, however, be used by a company officer to appoint individuals as directors without their knowledge. An individual may find that they are a director of an entity without their consent when an entity has failed to pay its creditors

⁹⁰ Ball (1988).

⁹¹ Potter, Wright and Ravlic (2013)

⁹² Carey, Potter and Tanewski (2014)

⁹³ Walker (2007)

⁹⁴ West (2015a)

⁹⁵ West (2015b)

⁹⁶ West (2015c)

⁹⁷ Australian Accounting Standards Board (2018d).

⁹⁸ Australian Securities and Investments Commission (ASIC) Act 2001

⁹⁹ Productivity Commission (2013)



or is found to be trading while insolvent. Understandably, this can be a perilous scenario for a director who is not aware of the unauthorised director appointment.

The *Corporations Act 2001* does not distinguish between actions taken by a person who has properly consented to being a director or by someone who has been added to a register online without their consent. An individual may be held liable for decisions made during their term as a director, even though they had never given their formal consent. This also includes de facto or shadow directors, whether or not formally recorded on any register^{100, 101}.

These apparent irregularities in the law need to be at the forefront of the minds of the government as it contemplates amendments to legislation dealing with phoenix operators. The federal government should ensure there is a mechanism such as mandatory consent forms filed by the individual appointed as a company officer built into the registration process to protect innocent individuals from being liable in a situation where an unethical individual uses their access to a company register to compromise another person by making them a company officer.

The existence of de facto and shadow directors requires different consideration as, in both situations, their consent appears to be apparent (i.e. someone acting, for all intents and purpose, as a director (de facto), or someone not able to be formally appointed as a director (normally due to some legal impediment, such as insolvency), but is accustomed to directing the directors (shadow)).

Standard-setting frameworks for for-profit and not-for-profit entities

The AASB has recently reviewed Australia's standard-setting frameworks for for-profit¹⁰² and not-for-profit¹⁰³ entities. These frameworks provide an overview of how the standard-setter will evaluate the standards issued by the International Accounting Standards Board (IASB) in the Australian context. It is important to note that International Financial Reporting Standards (AASB 2018a) are used as the basis for both standard-setting frameworks (i.e. AASB standards and IASB (International Financial reporting Standards - IFRS) standards), because:

- they are developed by an expert standard-setting board, the International Accounting Standards Board (IASB), and the views of the IASB represent international consensus on best practice for publicly accountable for-profit entities;

- they are developed following a stringent due process which encourages parties interested in financial reporting to express their views
- The AASB is able to participate in the development of the IASB's proposals to the extent it considers appropriate.

The revised standard-setting frameworks were released at the same time of the release of research reports^{104, 105} that detail the financial reporting requirements for for-profit and public sector entities. These research reports provide background information to assist the AASB and stakeholders when analysing proposals for change to the frameworks for both the private and public sectors. The AASB is also reviewing the role played by special purpose financial reports in the Australian regulatory framework.

The Centre acknowledges that the underlying approach of the AASB to developing standards for the two sectors in Australia is sound. However, it is critical to ensure that the underlying basis of continued standard-setting development is that the full suite of international accounting standards be adopted and modified only to reflect specific Australian exclusions. Consistency with recognition and measurement criteria of the full suite of financial reporting standards, as issued by the IASB, should be a core principle of standard-setting in Australia. Users of financial statements should be assured that the financial statements are prepared on the same basis, even through the presentation of those financial statements may differ depending on whether an entity is considered publicly accountable.

Reporting for smaller entities and businesses

The AASB has spent much of the past decade considering whether there is a need to increase the number of tiers of reporting. There are currently two tiers for which the AASB currently develops pronouncements and ultimately accounting standards – Tier 1 applies to publicly accountable entities and Tier 2 applies to those entities that have no public accountability. The standard-setter is evaluating whether there is merit in introducing additional tiers, given that recent changes in the international financial reporting conceptual framework could result in some entities that prepare special purpose financial statements having to prepare a full set of financial

¹⁰⁰ Gidley (2000)

¹⁰¹ Flaye E (2009)

¹⁰² Australian Accounting Standards Board (2018a).

¹⁰³ Australian Accounting Standards Board (2018b).

¹⁰⁴ Australian Accounting Standards Board (2018f).

¹⁰⁵ Australian Accounting Standards Board (2018e).

statements that must comply with all the preparation, presentation and disclosure requirements of accounting standards. The new IASB conceptual framework has added a chapter dealing with the notion of an entity that is required, or chooses, to prepare financial statements. Inconsistencies in financial statements lodged with regulators have been observed in research¹⁰⁶ and the application of the new conceptual framework could result in greater consistency and compliance. Entities that lodged special purpose financial statements previously may now face additional compliance costs if they are forced to move to compliance with the full suite of accounting standards.

A recent AASB staff paper¹⁰⁷ exploring possible options for tiers of reporting has evaluated accounting standards in Australia, New Zealand, the United Kingdom and the International Accounting Standards. The paper observes that an additional tier may be necessary as a result of consultation on the establishment of a 'single reporting regime' for charities and not-for-profit entities. The IPA-Deakin SME Research Centre supports any initiative that enables comparative analysis of regimes to determine whether there is merit in changing the current regulatory environment.

A single reporting regime for charities and not-for-profit entities

Accountants that work with small businesses also work frequently with charities and associations to assist them with compliance issues. Charity and not-for-profit reporting requirements across Australia are varied and complex, with a recent research report published by the AASB¹⁰⁸ observing that Australia's regime for charity reporting is the most complex out of the seven jurisdictions surveyed. The other countries examined as a part of this exercise were New Zealand, United Kingdom, Hong Kong, Singapore, South Africa and Canada.

The report from the standard-setter states that the jurisdictions reviewed by the research project team had a 'clearer, less onerous financial reporting framework' than Australia. One of the pre-eminent features noted in the report was that the regulators in the other six jurisdictions reviewed by the AASB prescribed the form of the reports to be lodged rather than the entities themselves being forced to self-assess.

A risk in the Australian regime is that self-assessment will result in a lack of uniformity

and an absence of comparability in the sector. There may also be a risk of non-compliance, given that small charities may choose to not engage an accounting firm or an expert to help compile financial information and to not present that material in accordance with accounting standards.

The AASB research report observes that the following factors create a more complex compliance environment for charities in Australia:

- **Multiple regulators:** The report notes there are state-based regulators and also the Australian Charities and Not-for-Profits Commission (ACNC) that oversee charities, which numbers around ten, when Australia's near neighbour, New Zealand, has only one regulator for the sector. There are also areas of duplication between regulators and charities find it difficult to determine what they should be reporting to which authority.
- **Variations in requirements between jurisdictions:** There are differences between state and territory reporting thresholds that result in confusion. The ACNC, for example, uses revenue and the Northern Territory uses annual gross receipts, gross assets and "whether an entity holds a gaming machine licence as proxies for the significance of incorporated associations"¹⁰⁹. Similar measurement criteria might exist across some jurisdictions, but minimum thresholds may differ. There are also different consequences of exceeding thresholds in different jurisdictions.
- **Financial report formats are open to significant judgement:** Charities are often required to use judgement to determine whether special-purpose or general-purpose financial reports are required.
- **Rationale for the rules is unclear:** The report notes that there is no apparent reason for certain requirements embedded in the law of various jurisdictions.
- **Audit requirements vary depending on jurisdictions:** There are differences between when an audit or review may be required and also the qualifications of an individual deemed to be appropriate to conduct an audit of a charity. This creates additional confusion for both charities and accounting professionals when seeking to comply with the rules of federal, state or territory governments as they relate to charities.

¹⁰⁶ Carey, Potter and Tanewski (2014).

¹⁰⁷ Australian Accounting Standards Board (2018c).

¹⁰⁸ Australian Accounting Standards Board (2017b).

¹⁰⁹ Australian Accounting Standards Board (2017).

Recommendations

- The federal government should continue to emphasise the need for 'risk-based' regulation, so individuals and entities that are at a 'low risk' of non-compliance are not subjected to inappropriate and unnecessary regulatory scrutiny.
- The federal government should continue to contribute to the work of the OECD in enhancing global awareness of good regulatory practice.
- The federal government should continue to conduct periodic reviews of regulatory agencies/bodies and statutory boards to ensure that public interest is well served.
- The federal government should continue to use the Office of Best Practice Regulation (OBPR) to ensure that laws and regulations take account of the needs of small business. The government should also strengthen the use of small business regulation impact statements.
- The federal government should ensure that company extracts and financial statements lodged with the regulator are made freely available. We refer to our recent consultation on this proposal.
- The federal government should take all necessary steps to consolidate corporate and other registers so that small business owners are able to deal with one portal for all their compliance needs. We refer to our recent consultation on this proposal.
- The federal government should pursue all necessary measures to implement one regime for registration and regulation of charities and not-for-profits. We refer to our recent consultation on this proposal.
- The federal government should consider the role of regtech (technology-based solutions applied to regulatory compliance) and facilitate the introduction, development and application of regtech solutions (especially by small business) as a means of easing the regulatory burden.
- The Australian Accounting Standards Board (AASB) should continue to review existing accounting frameworks to ensure they reflect the needs of the community and maintain the integrity of the measurement and recognition requirements contained in international financial reporting standards.
- Preparers of special purpose financial statements will need to review the format of their financial statements following changes made by international accounting standard-setters to the conceptual framework.

These factors are an indication that there is a need for further work to be done by the federal, state and territory governments to ensure that powers are referred where necessary to the federal government to ensure all charities are subject to consistent requirements across the country.

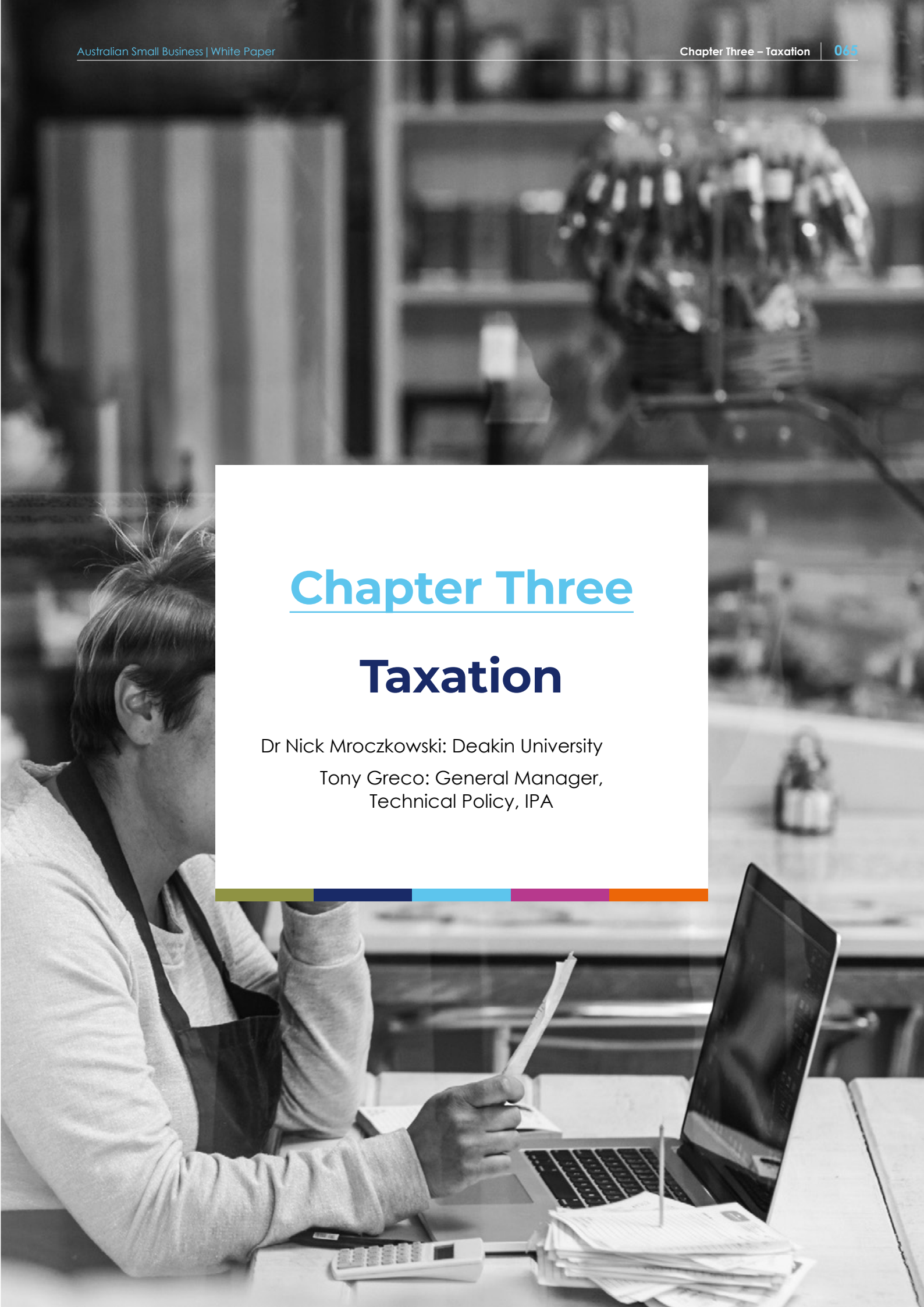
A move to prescribe a format for charity reporting and to eliminate differences across jurisdictions in laws and regulations in Australia would not only simplify and clarify the compliance requirements for charities, but it will also ensure that practitioners providing services such as financial report preparation or audit, for example, have a less complex task in explaining requirements to a client and fulfilling engagement-related obligations. The AASB should ensure, however, that any accounting guidance produced for a prescriptive regime remains faithful to recognition and measurement requirements of the accounting standards.

Chapter Three

Taxation

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Taxation

The passage of tax reforms through the United States Congress under the Trump administration has created an opportunity to again raise questions about the status of tax reform in Australia. Wholesale reform is possible, with the aim of re-designing a tax system that is no longer fit for purpose.

Headline findings:

- Federal Treasury has stated that the impact of the US tax law changes will become evident over time. As capital markets have become increasingly global and business locations increasingly mobile, governments are using the lowering of corporate tax rates as a means of driving economic growth. The US reforms have the potential to accelerate tax competition, making Australia's current corporate tax rate increasingly uncompetitive internationally.
- Australia is yet to get closure on a comprehensive taxation debate.
- The federal government and the federal opposition remain reluctant to address the goods and services tax (GST) as a part of reform.
- Singapore offers an example for corporate tax reform designed to encourage the establishment and growth of new businesses.
- Incompatibilities remain to be addressed between payroll tax and land taxes.
- Australian schools do not appear to place sufficient emphasis on developing an understanding of the tax system.
- There is a need for a holistic review of policy objectives in relation to small business tax concessions (given the multitude of such concessions).

Reform has stalled in Australia, in part because most tax discussions have been the subject of political trench warfare. Partisan arguments over reforms will usually result in no change unless a government has the necessary numbers in the both houses of the Commonwealth parliament to successfully shepherd through reform.

Some Australian companies or individuals may choose to base their corporate operations overseas while this domestic policy skirmish continues. Policy debates create uncertainty and this needs to be borne in mind by all sides of politics.

A report published by the Treasury on the tax reforms in the United States in November 2017¹¹⁰ provides support for this analysis. It suggests that tax changes in the one of the world's largest capital markets could result in countries such as Australia experiencing a permanent reduction in the level of gross domestic product (GDP) and real wages. The US reforms have the potential to accelerate tax competition, making Australia's current corporate tax rate increasingly uncompetitive internationally. A competitive company tax rate needs to be part of a package of fundamental changes to the tax base.

Reforming the tax regime may assist in keeping businesses in Australia. Encouraging entrepreneurs to start, run and keep their businesses in Australia by dealing expeditiously with taxation reform is an essential ingredient when contemplating how best to ensure a stable economic future for the country. Achieving the necessary reform requires Australia's political leaders to set aside a piecemeal approach to tax policy.

Reviews, reviews, reviews

As a general observation, tax reform initiatives have been divided into discrete reviews, requiring each to be considered in isolation, with an overall revenue-neutral outcome. Tax reform in this manner misses the synergistic benefits available from holistic tax reform opportunities.

A focus on revenue neutrality in reform processes can also be a brake on innovative policy solutions. It seeks to eliminate risk to the revenue from policy analysis. While risk aversion is an understandable trait in a political environment (where the country has no surplus as a cushion for a major tax policy shift), the use of a revenue-neutral benchmark places a limitation on what any individual or group may be prepared to recommend to government.

¹¹⁰ Henty, Yi and Davis (2017)



It gives rise to institutional timidity, with any legislative innovation likely to be minimal when such a constraint is applied to a discussion of broad-based tax system reform.

The Henry Review¹¹¹ is one example of such a critical reform process. It was initiated by the Rudd Government and sought to address fundamental imbalances within the current system.

The existing tax mix will struggle to achieve revenue adequacy in the long term, in the face of rising expenditures as the population ages and workforce participation declines. Consumption taxes, being the most efficient and sustainable of taxes, are widely regarded by tax policy experts and others as integral to reshaping Australia's future tax reform agenda¹¹².

The Henry Review recommended the removal of nuisance taxes and a decrease in the reliance on income tax – with a shift towards greater reliance on consumption taxes that will encourage savings and investment and provide a more sustainable source of revenue.

Most nuisance taxes – which are inefficient¹¹³, distortive and inequitable – are levied by state governments. Reform in these areas will require an examination of the adequacy of state and territory revenues.

The Henry Review, however, was limited in its scope, because it was unable to address the issue of a change in policy regarding the GST. That limitation of scope meant a fundamental area of tax reform was not properly explored.

It is critical that the federal government, the federal opposition and the cross-bench minor parties consider all options as a part of any review process. Failure to do so means that any review of the tax system will, by its nature, be flawed.

The need for fundamental tax reform will not go away and is needed to achieve more sustainable revenue streams. Piecemeal changes to the tax system go nowhere near the big-picture reforms Australia requires to build a sustainable tax base.

What needs to happen with the GST?

The base and rate of GST must be included in any discussion of tax reform. Consumption taxes (such as the GST) represent one of the most efficient and sustainable tax bases available¹¹⁴.

The IPA- Deakin Research Centre is not alone in articulating concerns about establishing a greater focus on indirect taxation as a way of reorienting the Australian tax system to a different direction. The OECD,^{115, 116, 117} in its country specific economic survey, has repeatedly urged Australia for much of the past decade to change its tax system so that it reduces reliance on income taxes and other state-based taxes.

Figure 1 shows that the GST rate in Australia is relatively low, compared to the OECD unweighted average of 19.2% (the 10% base rate in Australia is almost 100% less than the OECD GST/VAT rate).

111 Evans (2012).

112 Institute of Public Accountants (2018).

113 Henry, Harmer, Piggott, Ridout and Smith (2009).

114 Henry, Harmer, Piggott, Ridout and Smith (2009).

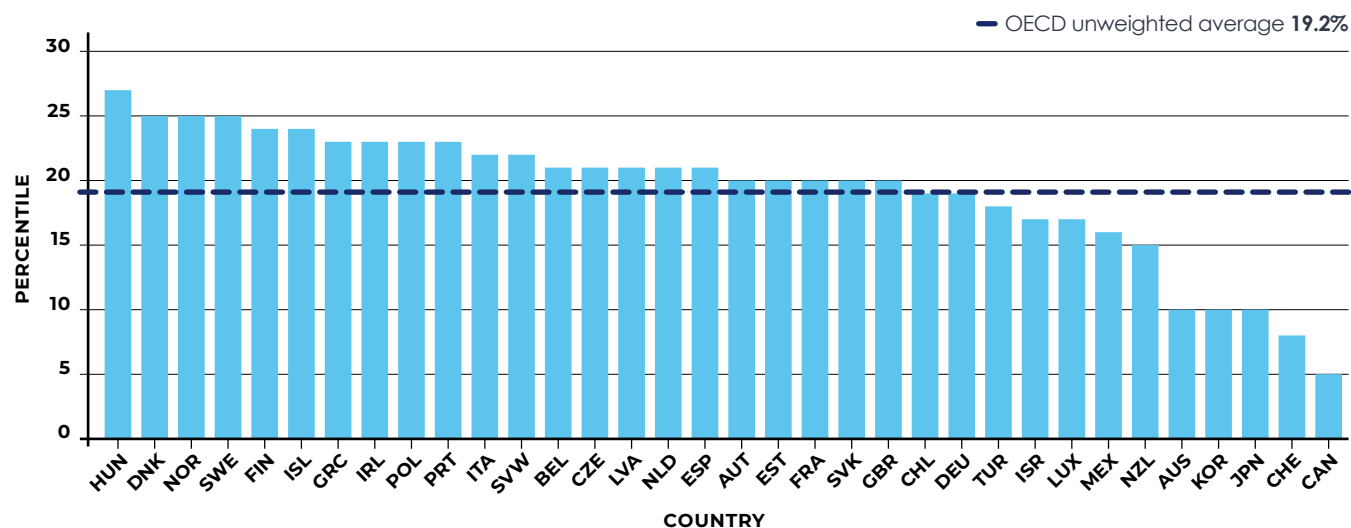
115 Organisation for Economic Co-operation and Development (OECD) (2012).

116 Organisation for Economic Co-operation and Development (OECD) (2014).

117 Organisation for Economic Co-operation and Development (OECD) (2017).

118 Organisation for Economic Co-operation and Development (OECD) (2016).

Figure 1:
¹¹⁸Comparative tax rates for OECD countries



Source: OCED Tax Data Base 1st January 2016

Table 1:
Tax Structure for the Year 2015 (% of Total Tax Revenue)

	Australia	France	Germany	Japan	Korea	UK	USA
Taxes on personal income, profits and capital gains	41%	19%	27%	19%	17%	28%	41%
Taxes on corporate income, profits and capital gains	15%	5%	5%	12%	13%	8%	9%
Taxes on goods and services (excluding VAT/ GST)	15%	9%	9%	39%	13%	12%	17%
Value added taxes/ goods and services tax	13%	15%	19%	7%	15%	21%	0%
Property taxes	11%	9%	3%	14%	12%	13%	10%
Payroll taxes	5%	3%	0%	8%	0%	0%	0%
Social security contributions	0%	37%	38%	0%	27%	19%	24%
Others	0%	2%	0%	0%	2%	0%	0%
Total tax revenue	100%	100%	100%	100%	100%	100%	100

Source: Developed from OECD.Stat, revenue statistics – OECD countries: comparative tables at <https://stats.oecd.org>, accessed 20 January 2018.

Table 1 shows that tax on personal income, profits and capital gains (basically considered as tax on wealth creation) continues to be the highest in Australia compared with most other countries, including France, Germany, Japan, Korea and the United Kingdom. Tax on personal income, profits and capital gains, as a proportion of total tax revenue, amounted to 41% in 2015, on par with the US, which was also 41% in the same period.

As discussed above, a review of the tax mix is long overdue and increases in consumption-based taxes such as GST are inevitable if Australia is to be in line with other modern economies.

A review of the base and rate of GST in the context of the total tax base mix must be considered as a valid reform option for addressing the fiscal imbalance between federal and state governments, with a view to achieving a close correlation between states/territories' expenditures and their revenue-raising capabilities. GST revenues have grown over time and represent a more robust and stable source of revenue than income taxes – the latter of which are more vulnerable to changing economic conditions.

The regressive nature of GST means that appropriate compensatory measures for low-income households will be required if rates are increased. Any increase in the base or rate will need to be accompanied by increased welfare payments to mitigate the effects on those who are worst off. It is far better to have targeted policies to address the regressive impacts of any changes to the GST, such as making transfers to low-income households and thereby removing the regressive nature of the tax for those in need.

The IPA-Deakin SME Research Centre encourages an open, constructive debate on this issue, which must take place well before any laws are passed and are due for implementation. There must also be a shift of the tax burden to less mobile and less growth-damaging bases to support economic growth and meet spending needs.

All taxes represent a drag on economic growth, but indirect taxes do not discourage earnings or investment nearly as much as income and corporate taxes. It should be noted that the 2015 White Paper process, which commenced with the *Re:Think* discussion paper¹¹⁹, was a possible means of initiating appropriate reform of tax law

¹¹⁹ Australian Government (2015). *The Re:think tax discussion paper and the submissions responding to it* may be found at <http://bettertax.gov.au/>. Accessed 30 May 2018.



in Australia. The process was started by former federal Treasurer Joe Hockey and received more than 870 submissions from organisations and individuals. While that paper and constituent submissions remain publicly available for reference, the abandonment of that reform process, without a replacement reform agenda to provide some closure for constituents, is regrettable.

There may be merit in considering whether the area of tax reform should be subject to a review or inquiry by a Senate parliamentary committee charged with exploring viable options for tax reform. An advantage of this process would be that such a committee would comprise members from all the parties in parliament necessary to assess the appropriateness of tax measures. It would also assess the likely community response.

Such a committee could have a two-phase review process. The first phase could explore stakeholder views and reflect those in an interim report. The Parliamentary Budget Office could be engaged in the second phase of the inquiry, to model the various solutions and see the cumulative impact of measures suggested by stakeholders. A final report should be completed within 12 months of the inquiry's commencement, and new reform proposals should ideally be put before the electorate at the next possible federal election. The political climate, however, does not help the government commit to wholesale re-weighting of its tax base away from personal taxes and towards GST.

Learning from the Singaporean template

Australia can learn from approaches to corporate taxation reform in the Asian region as a way of stimulating economic growth (including growth in the numbers of Australians employed).

Australia can learn from approaches to corporate taxation reform in the Asian region a way of stimulating economic growth (including growth in numbers of Australians employed).

Singapore, for example, has a corporate tax regime worth evaluating from the perspective of redesigning Australia's tax system. The approach taken in Singapore reflects the government's policy decision to grow domestic businesses and attract overseas entities to establish enterprises in the country. This is partly because Singapore has no natural resources¹²⁰ and, according to the Ministry of Finance of Singapore, it has recognised it must grow its economy in other ways. This is somewhat different to Australia,

where we have a massive natural resources base and need a tax system that recognises that contribution (e.g. royalties etc).

Singapore has a 17% corporate income tax rate^{121, 122}. The first S\$10,000 of income is partly exempt. Of that amount only 25% is taxed at the 17% rate. Singapore also grants a 50% exemption from tax for the next S\$290,000 an entity earns. A 50% corporate income tax rebate capped at S\$20,000 per year of assessment was in place during the 2016 and 2017 financial years.

The Singaporean regime also has a specific tax regime for new businesses that applies for a qualifying entity's first three years of assessment. It is possible for new companies to receive a full tax exemption on the first S\$100,000 of chargeable income and a further 50% exemption on the next S\$200,000 of chargeable income. The scheme does not apply to new businesses involved in property development or investment holdings.

This is a tax regime worth considering as a part of both a revamp of the tax system in Australia and providing incentives to small businesses in their early years of operation. The IPA-Deakin SME Research Centre recommends that the Singaporean 'start-up' tax exemption regime be considered as a reform measure to assist small businesses in their growth phase.

Payroll tax

One example of taxes regarded as a nuisance by owners of small businesses and other entities is payroll tax. Payroll tax is an imposition transposed on top of other compliance issues that are a burden for small businesses. It is an area the IPA-Deakin SME Research Centre believes ought to be the subject of review, because business owners generally (and small business owners in particular) are frustrated, as shown by the Board of Taxation¹²³ stakeholder survey, which highlights payroll tax as an area where change must occur to make handling compliance in this area easier.

Respondents to the survey said they would like:

- consistent payroll tax payment dates across the states
- alignment of payroll tax rates between states
- alignment of disclosure requirements
- similar treatment of taxable fringe benefits, dividends, trust distributions, loans and attributed personal services income across different areas such as payroll tax and workers compensation rules.

¹²⁰ See Ministry of Finance, Singapore, website at <http://www.mof.gov.sg/Policies/Tax-Policies/Corporate-Income-Tax>. Accessed 15 January 2018.

¹²¹ Ernst & Young (2015).

¹²² Ernst & Young (2017).

¹²³ Board of Taxation (2017).

The Board of Taxation¹²⁴ published these concerns from respondents. It also noted, in its report, that state and federal cooperation has taken place to deal with a range of payroll tax-related matters, such as:

- timing of lodgement of returns
- motor vehicle allowances
- accommodation allowances
- a range of taxable fringe benefits;
- work performed outside a jurisdiction
- employee-share acquisition schemes
- superannuation contributions for non-working directors
- grouping of businesses.

While acknowledging that jurisdictions have worked closely together to reduce compliance costs and eliminate differences, the IPA-Deakin SME Research Centre agrees with the observation from the Board of Taxation that further work is needed to simplify the payroll tax regime.

While respondents to the Board of Taxation survey argued for changes to the actual payroll tax regime, it may be worth considering what reform measures (at both a Commonwealth and state level) would persuade state governments to repeal the payroll tax regime. It is important to encourage businesses to employ more people, and removing payroll tax may be a factor in making it more attractive for employers (especially those in small businesses) to hire more talent.

Land tax and stamp duty

The 2017 Board of Taxation report on inconsistencies also focused its attention on land taxes and stamp duty. Laws in states and territories have changed and have different common law definitions of the term 'fixture'. The definition has been altered in some states, linking it to the meaning of 'land'. This results in differences in policy choices that impact taxpayers. Stakeholders have told the Board of Taxation they are concerned about the inconsistent practices between states.

The IPA-Deakin SME Research Centre believes these differences should be eliminated to simplify the tax rules across states and territories as they relate to land tax and stamp duty. Additional issues include the need for clearer guidelines on land tax exemptions and annual valuations for real property.

The report states that consideration was also given to the concepts of 'taxable Australian property' and 'indirect

Australian real property interest' in relation to the GST and foreign residents rules under the *Income Tax Assessment Act 1997 (ITAA 1997)*. The IPA-Deakin SME Research Centre agrees with the view of the Board of Taxation that the current law is appropriate given that it ties in with various international obligations and agreements.

Single touch payroll

The IPA has made a submission to the federal government supporting the implementation of single touch payroll (STP). Single touch payroll, the Institute observes, will bring major improvements to system integrity and transparency (especially for the super guarantee) while also creating a building block to enable further government reporting (IPA, 2018).

The benefits to employers lie in improvements to the employee commencement and reporting, and the compliance benefits which will flow from a more level playing field for employers. Employees will gain new transparency over their pay as you go (PAYG) withholding tax position and super contributions, as reported by employers each payday.

The government has already legislated STP for employers with 20 or more employees. They transition to STP from 1 July 2018. The government intends to apply single touch payroll for smaller employers coming on board from 1 July 2019 (IPA, 2018)¹²⁵.

A pilot program with a series of small businesses that have fewer than 19 employees was conducted and it found:

- 1. small businesses would see limited benefits in the initial implementation of the system**
- 2. potential barriers to implementation, such as ongoing costs, trust and convenience issues**
- 3. barriers were significant for employers that did not have compatible software.**

The IPA observes that the pilot found a small but significant minority of small employers will struggle with the implementation if support is not provided.

"Depending on the solution pathway a business takes, they are likely to find the change effort and potential cost significant," the IPA notes¹²⁶. Possible solutions to the information technology challenges faced by small businesses may include the development of a range of strategies and tools, in concert with stakeholders, to bridge the capability and confidence gap these employers face.

¹²⁴ Board of Taxation (2017).

¹²⁵ Institute of Public Accountants (2018).

¹²⁶ Institute of Public Accountants (2018).



Tax education

The IPA remains concerned that tax education in schools is not taking place early enough. This subsequently impacts on young people's understanding – especially the understanding of those young people who start small businesses online, in respect of their obligations under tax legislation.

Increasing use of platforms such as Air Tasker, Airbnb and Uber, by people who might otherwise not work for themselves, is further evidence of the need for tax to be a part of primary and secondary school education. It is critical that students are taught from a young age that a social contract requires people who earn income to pay tax in accordance with the law, so the government can provide services needed by the community.

Understanding the tax system and how it operates is important generally as it increases understanding of the legal system in Australia. It is even more critical for people who work for themselves, either as sole traders or company directors.

Small businesses have a range of tax obligations and getting a general understanding of the tax system through primary and secondary school years would prepare prospective entrepreneurs with the tax knowledge they require. Tax education in primary, secondary and tertiary institutions may also encourage students to consider a career as a tax professional. There will be a need to ensure enough accounting graduates are able to replace the aging tax agent demographic. This requires a conscious effort by secondary and tertiary institutions to encourage candidates to consider the appropriate studies to become a registered tax agent.

A broader focus on tax education is important to promote a mature public debate on tax reform and tax compliance. Discussions on tax reform should be conducted in an environment in which taxpayers understand the different elements of the tax system and how they operate. For example, the ATO issues data on the entities that do not pay tax each year, but not all taxpayers understand that non-payment of taxation can mean a company is using tax losses or that an entity has not made a profit in a particular year. A better understanding of the taxation system would at least provide some knowledge that alerts taxpayers to the concept that there may be greater, more rational reasons for the tax non-payment in a specific reporting period.

A better understanding of tax system fundamentals will also alert people entering into business about the tax issues they should ask more questions about. In the case of the shared economy application sector (e.g. Airbnb, Uber, Air tasker, Fiverr) people need to properly understand the general notion of assessable income and the expenses they can legitimately claim. There is a difference in the way ride-sharing enterprises are treated for taxation purposes, compared with other, similar services where a vendor uses an online platform to connect with a customer. The latter concept is one that we cannot readily expect the average taxpayer to comprehend without specific knowledge. Yet understanding the notion of assessable income is critical.

A further benefit of such a regime may be to minimise the number of people who are taken in by fraudulent tax schemes.

In-house facilitation (IHF) – a workable alternative to costly litigation?

The IPA-Deakin SME Research Centre is currently undertaking a tax research project, the focus of which is effective dispute resolution mechanisms for tax-related matters in the Australian context. The research objective, inter alia, is to examine the efficacy and effectiveness of current systems and procedures for resolving tax disputes. Moreover, as the focus of the research will centre on SMEs in particular, the scope of the research will be restricted to smaller, less complex disputes between taxpayers and the ATO.

The IPA-Deakin SME Research Centre expects to finalise results/outcomes of the research later in this current year. These, in turn, will form the basis of an article in the IPA's Public Accountant publication.

In the meantime, the centre is delighted to see the take-up of in-house facilitation (IHF) as a viable, economical alternative to litigation-based solutions in resolving ATO disputes. In the following paragraphs we briefly outlined the major features of the IHF mechanism, including the intent of the mechanism and some 'how it works' dialogue (i.e. processes and participants, relevant timeframes, outcomes and documented experiences since the program's inception).

We hope that taxpayers involved in less complicated cases will seriously consider whether IHF is appropriate in settling their disputes with the ATO. From our preliminary assessment, IHF would appear to be far

less costly for both parties to the dispute (i.e. the taxpayer and the ATO) compared with more formal litigation. Moreover, the dispute resolution time would be considerably reduced in most cases.

The facilitation process – an SME perspective

The process of self-assessing and filing a return by SME taxpayers is a well-established procedure in Australia. Thus, for most taxpayers and their advisers, it needs no further explanation.

Perhaps less known, however, is the process of dispute resolution, where a range of matters relating to a tax assessment, or other obligations required by tax legislation, is challenged by the ATO. This can often be a daunting experience for taxpayers and, indeed, a perilous journey if the matter under dispute needs resolution through the courts. Needless to say, it is a potentially very costly exercise in the legal system, particularly if the court does not rule in the favour of the taxpayer.

In 2014, the ATO established a form of alternative dispute resolution via an In-house facilitation (IHF) process. The ATO describes IHF as follows;

... a mediation process where an impartial ATO facilitator meets with you (... the taxpayer) and the ATO case officers to:

- identify the issues in dispute
- develop options
- consider alternatives
- attempt to reach a resolution.

The IHF service is ideal for less complex disputes, is conducted on a 'without prejudice' basis, and can be used at any stage, from the audit up to and including the litigation stage.¹²⁷

Timing of the IHF

Either the taxpayer or the ATO can initiate the IHF process although, in most cases, the taxpayer is expected to. We note, also, that the IHF process is not compulsory for the taxpayer, who may wish to use the more formal litigation route or some other mechanism for resolving the dispute.

The appropriate time to initiate an IHF can be at any of the following stages:¹²⁸

1. **after an audit is initiated, but prior to a position paper being issued**
2. **after a position paper is issued, but before the amended assessment is issued**

3. **after the amended assessment is issued, but before any objection is lodged**
4. **after any objection is lodged, but before the objection decision is made**
5. **after the objection decision is made, and before any application is lodged with the tribunal or appeal is lodged with the court**
6. **after any application is lodged with the tribunal or an appeal is lodged with the court.**

Arguably, the most optimal timing to commence the IHF process would be after the issues are identified by the ATO in their position paper.

Participants in the IHF process

The IHF process entails the involvement of and discussion between various parties, including:

- an ATO-appointed independent facilitator
- the taxpayer, perhaps supported by a professional advisor (tax counsel or accountant)
- the ATO case officers.

Generally, there should be a minimum of four persons attending the facilitation. The ATO facilitator is a specially-trained senior ATO officer who has not been involved in the dispute and, in this respect, is impartial and independent. The role of the facilitator is not to adjudicate in the dispute, but to facilitate negotiations between the taxpayer and the ATO case officers as they attempt to craft a resolution.

When attending the facilitation session, each side to the dispute must include persons who are empowered to negotiate decisions. Moreover, to make the process effective, negotiators should be familiar with the facts and issues in the dispute and be thoroughly prepared. This is an area that has been the subject of some critical comment (see below for more detail).

Outcomes of the IHF process

There are generally two possible (main) outcomes to a dispute:

- Resolution of the dispute and the recording of the resolution by the ATO as a *Deed of Settlement*.
- Non-resolution of the dispute, which may then proceed to the Administrative Appeals Tribunal (AAT) or the Federal Court. Alternatively, the facilitation session may result in agreement between

¹²⁷ See Australian Taxation Office (ATO) website page on in-house facilitation (IHF). <<https://www.ato.gov.au/General/Dispute-or-object-to-an-ATO-decision/Options-for-resolving-disputes/In-House-Facilitation/?=redirected#Statementsofexpectations>>. Accessed 12 April 2018.

¹²⁸ See ATO website page on IHF.



the parties on certain issues which then do not need to be considered by the AAT or the Federal Court. This, in effect, simplifies the dispute resolution within the legal system. The issues in agreement would also be documented in an ATO *Deed of Settlement*.

As there are two main outcomes, with some latitude for partial resolution (i.e. some issues, but not all, can be agreed to by the parties) IHF is often considered to be a 'binary system'.

In addition to the IHF process the ATO will, from 1 July 2018, run a 12-month pilot to extend its independent review service to certain small business taxpayers.

An independent review is where an independent technical officer from outside the ATO's audit area reviews the merits of the audit position before the assessment or amended assessment is issued. The pilot is limited to small business disputes involving income tax audits in Victoria and South Australia.

Disputes relating to the following topics are excluded: GST, superannuation, fringe benefits tax, fraud and evasion findings, and penalties and interest. We applaud this initiative and hope the pilot becomes permanent feature for small business to resolve disputes.

Small business tax concessions

Small businesses account for approximately 96% of all businesses in Australia by number and employ 5.6 million Australians. A strong, vibrant small business sector is crucial to achieving sustained, healthy growth of the Australian economy. The importance of the role of entrepreneurs in this regard cannot be overstated.

Well-designed small business tax concessions can play an important role in helping small businesses at all stages of their business lifecycle, from the crucial start-up phase through to maturity and the retirement of business taxpayers.

The current small business tax concessions have been developed over time and generally have been implemented independently of each other. Some tax concessions, such as CGT small business concessions, have evolved over a period of more than three decades from their first incarnation, starting life as a 20% exemption on gains arising from internally-generated goodwill. Over the years, this concession has expanded into a suite of four concessions,

providing eligible taxpayers with the ability to eliminate up to 100% of the capital gain from the realisation of business assets.

A holistic review to identify ways to improve the current suite of small business tax concessions (to ensure they remain effective, easily accessible and well-targeted) is overdue. This will involve identifying new concessions for small businesses and ways to improve existing concessions. Identifying areas in which concessions that are less effective, or not well targeted, could be removed or scaled back to generate savings that can be redeployed in areas where they may have a greater impact such as during the critical start-up phase.

The small business CGT concessions, for example, are skewed to the end of the small business lifecycle. The cost associated with these concessions accounts for a substantial portion of the overall tax concession outlay for all the small business tax measures. This raises the question of whether the cost of this measure, which rewards success rather than encouraging or facilitating businesses at an earlier stage of the life cycle, is still appropriate policy setting.

There is a broad range of small business concessions, with various eligibility requirements and benefits.

The current suite of tax concessions can be summarised as follows:

1. Lower company tax rate.

In the 2015-16 income year, the company tax rate was reduced to 28.5% for companies with aggregated annual turnover of less than \$2 million. For the 2016-17 income year, the company tax rate was lowered to 27.5% for companies with a turnover of less than \$10 million. The reduced rate is available to companies with a turnover of less than \$25 million in the 2017-18 income year and \$50 million in the year thereafter.

2. Unincorporated small business tax discount.

Individual taxpayers with business income from an unincorporated small business (sole traders, partnerships, trusts) that have aggregated annual turnover of less than \$5 million are eligible for an 8% tax discount on the income tax payable on that business income in the 2016-17 income year. This discount rate will then be increased over time until it reaches 16% in 2026-27. The discount is capped at \$1,000 per individual for each income year and is delivered as a tax offset.

Increasing the discount rate over time will cause more taxpayers to reach the \$1,000 cap, which puts non-incorporated entities at a disadvantage when compared to corporate entities, which have access to lower tax rate without any ceiling. If this concession is to incentivise entrepreneurship, the cap needs to keep pace with the benefit achieved by business owners using a corporate structure.

Note: The IPA was instrumental in advocating for this measure to assist small businesses that face disproportionate cost of compliance pressures. This concession goes some way towards compensating small operators for the regressive nature of tax compliance, while rewarding entrepreneurial activity and freeing up more after-tax income for businesses to re-invest and expand.

3. Capital gains tax concessions.

Small business owners with net assets of no more than \$6 million or annual turnover of less than \$2 million are eligible for one or more of four small business capital gains, as follows:

- a CGT exemption on active small business assets that have been held continuously for 15 years, where the taxpayer is permanently incapacitated or reaches the age of 55 and retires
- a 50% reduction of capital gains that arises from the sale of active small business assets (in addition to the general CGT discount)
- an exemption, up to a lifetime cap of \$500,000, on capital gains arising from the sale of active small business assets, where the proceeds of the sale are used for retirement
- a CGT roll-over for capital gains arising from the disposal of active small business assets, if the proceeds of the sale are used to purchase other active small business assets.

The hard cut-off test for eligibility have been cited as encouraging some taxpayers to limit the growth of their enterprise to ensure they do not forfeit these generous concessions, which may work against the policy direction of the small business tax concession. There is no tapering when thresholds are exceeded. It is an all-or-nothing concession.

The provisions are so complex that it is difficult for a small business to confirm

that they qualify for a concession under the rules. As such, this area should be a focus for reform. Also, there is no cap on the gain that receives concessional tax treatment once eligibility criteria is satisfied. While it is important to reward small business operators for the greater risk they undertake, the uncapped nature of some of the concessions may over-reward small business taxpayers. The SBCGT tax concessions offer considerable scope to better target this concession to eliminate disincentives and unfairness.

Some of the savings can be re-directed towards the start-up and growth phase of a business life cycle to improve the chances of survival. Providing windfall gains to successful businesses focused on the end point of the business life cycle may need to be re-visited. The Henry Review also recommended (Recommendation 17) the removal of two of the four small business CGT concessions, namely the 50% reduction and the 15-year exemption.

4. Instant asset write-off and simplified depreciation rules.

Small business entities with an aggregated annual turnover of less than \$10 million are able to access concessional depreciation arrangements for business assets. Under the concessions, small business entities can immediately deduct assets that cost less than a threshold amount. From 12 May 2015 until 30 June 2018, the threshold was \$20,000. The government announced it would extend the concession for a further year until 30 June 2019 as part of the 2018-19 Budget. The threshold is scheduled to return to \$1,000 from 1 July 2019.

The uncertainty around the actual amount caused by the constant temporary nature of this concession is not ideal. There needs to be more clarity around its future, including the threshold amount. As part of the US tax reform package, a much higher allowance for capital assets write-offs supports calls for the threshold to be much higher than the temporary \$20,000 limit.

In addition to the immediate write-off, assets above the threshold are depreciated through simplified pooling arrangements at a rate of 30% per year (15% in the first year). The general small business pool can also be immediately deducted at the end of the income year if its value is less than the immediate write-off threshold (before deducting depreciation for the year).

**5. Refundable R&D tax.**

In the 2018-19 Budget, the government announced that, for companies with aggregated annual turnover below \$20 million, the refundable R&D offset will be a premium of 13.5 percentage points above a claimant's company tax rate. Cash refunds from the refundable R&D tax offset will be capped at \$4 million per annum. R&D tax offsets that cannot be refunded will be carried forward as non-refundable tax offsets to future income years. This concession is limited to corporate entities only. Most small businesses with turnover up to \$2 million are generally unincorporated entities.

6. Restructure roll-over relief.

Owners of small business active assets are eligible for CGT and income tax roll-over relief for a 'genuine restructure' of their business, provided the underlying economic ownership of the assets is unchanged. The roll-over is available for businesses with an aggregated annual turnover of less than \$10 million. This measure has been a welcome addition to the concessionary small business tax environment, removing income tax impediments from business restructuring decisions.

7. Immediate deduction for professional expenses.

Small business entities with an aggregated annual turnover of less than \$10 million can immediately deduct a range of professional expenses associated with starting a new business, such as professional, legal and accounting advice. Previously, these professional costs were able to be deducted over a five-year period.

8. Simplified trading stock rules.

Small business entities with an aggregated annual turnover of less than \$10 million may choose to use a simplified trading stock regime. Under this regime, small businesses may choose not to account for the changes in the value of stock for an income year if the difference between the opening value of stock on hand and a reasonable estimate of stock on hand at the end of the year does not exceed \$5,000.

9. Prepayments - tax shelter prepayments for certain passive investments.

Small businesses may immediately deduct prepaid expenditure subject to certain rules.

10. Small business carve-out for debt and equity rules.

If a company has a turnover of less than \$20 million, there is a carve-out which means related-party 'at call' loans will be treated as debt interests rather than equity interests.

11. PAYG: instalments based on GDP-adjusted notional tax.

Small businesses can elect to have their pay as you go instalments calculated for them by the ATO by applying an adjustment to previously-reported information.

12. Two-year amendment period.

A small business entity will generally be eligible for a two-year amendment period for tax assessments instead of the standard four years.

13. Fringe benefits tax: employee car parking exemption.

Car parking benefits provided to employees of small businesses are exempt from fringe benefits tax if the parking is not provided in a commercial car park. The employer must not be a government body, listed public company or subsidiary of a listed public company, and the employer's total income must be less than \$10 million.

14. Fringe benefits tax: multiple portable electronic devices.

From 1 April 2016, an FBT exemption applies to multiple work-related portable electronic devices provided by a small business to its employees – even if the devices have substantially identical functions. This exemption applies to portable electronic devices mainly for use in the taxpayer's employment.

15. GST concessions.

Small businesses are entitled to a range of GST concessions, including the option to:

- account for GST on a cash basis
- pay GST by quarterly instalments and lodge an annual return
- lodge a simplified business activity statement to report GST
- apportion GST input tax credits on an annual basis for acquisitions and importations that are partly creditable.

In addition, businesses (other than providers of taxi or limousine services) do not have to register for GST if their turnover is less than \$75,000.

16. Small business superannuation clearing house. A free superannuation clearing house service is available to businesses with aggregated turnover of less than \$10 million or where the business has 19 or fewer employees.

17. Early-stage investor tax offset and employee share schemes. In addition to the concessions listed above, the tax system also delivers favourable outcomes to the small business sector by providing incentives to attract investors. For example, investors in 'early-stage' innovation companies are granted a tax offset of 20% of the investment up to \$200,000 and are entitled to a CGT exemption where the shares are held for more than 12 months. Furthermore, to incentivise employees of start-up companies, concessional tax treatment is afforded to shares provided under an 'employee share scheme' to an employee of an unlisted start-up company with a turnover of less than \$50m. This enables employees to share in, and benefit from, the future growth of the business and allows small business owners to invest more of the company's cash in growing the business, which is extremely important for start-ups.

Objectives of small business tax concessions

The principal aim is to strive for a tax system that:

- best allows business owners to get on with doing business
- is responsive to the unique challenges faced by small businesses
- takes into account their needs and requirements.

One issue that has evolved has been the distortions and complexities that tax concessions may have themselves contributed to.

Again, the aim is to avoid, as far as possible, the creation of distortions or complexities in the tax system, so that business decisions are motivated by commercial, rather than primarily tax, considerations. The current concessions also have hard cut-off eligibility thresholds criteria which can create disincentives to growth.

The suite of tax concessions currently available has been introduced over many years. The tax concessions have not been reviewed collectively to ensure they remain effective and well-targeted and are consistent with the policy objectives they were developed to achieve.




Recommendations

- The federal government should renew its commitment to a comprehensive tax reform process – a new process to draw on all the work already undertaken (including the Henry Tax Review and Tax Forum) in formulating a blueprint to prepare our economy for the challenges ahead. The government should realign our tax system to reduce its heavy reliance on individual and corporate income tax.
- The federal government and federal opposition should explore changes to the GST.
- The federal government should explore the use of a parliamentary forum (such as a committee) to seek further stakeholder views on tax reform. Such an inquiry should also use the Parliamentary Budget Office to model various scenarios.
- The federal government should investigate the potential implications of adopting tax incentives for new businesses, such as those operating in countries such as Singapore.
- The federal government should explore options with the states and territories to either remove payroll taxes or, at the very least, to ensure the laws and the way they apply are consistent across the country.
- The federal government should ensure the smooth implementation of the single touch payroll regime.
- The in-house facilitation process for resolving taxation disputes should be constantly promoted and recommended by professional advisers as a potentially effective and cost-efficient means to resolving tax disputes.
- The federal government should establish clear policy objectives for small business tax concessions. (What is it that we want to achieve?) Clearly-defined policy objectives would assist in ensuring that tax concessions are appropriately targeted to achieve the desired outcomes.
- Small business tax concessions need to be consistent, with the policy objectives as defined. A holistic review of all the current concessions needs to be undertaken to ensure the suite of tax concessions work collectively to support small businesses through all stages of a business life cycle. Small business tax concessions must be benchmarked against the policy objectives to ensure they are well-targeted and remain so. The IPA-Deakin SME Research Centre supports the independent self-initiated review of small business tax concessions conducted by the Board of Taxation. The consultation guidelines which set out the principles for evaluating and improving the current suite of tax concessions for small business is an appropriate basis for undertaking a holistic analysis.
- A whole-of-government approach is required for small business assistance programs. Accountants are well placed to deliver such programs, as they already act as advisers to small businesses.
- The tax system should provide targeted assistance towards stress points in a business life cycle, such as the start-up phase or during a temporary setback. Most tax concessions (excluding the Small Business Capital Gains Tax concession and refundable R&D concession) are merely timing benefits that bring forward tax deductions to reduce the amount of tax payable, which is only useful if the taxpayer is in a tax paying position. If a small business is in the start-up stage or undergoing a temporary downturn, the bringing forward of deductions may not provide essential cash flow benefits other than more carried-forward losses. Loss-carry-back for corporate entities is one way the tax system can assist taxpayers deal with a temporary setback. Non-corporate entities, while problematic, may also require similar relief to assist with the survival of viable businesses.
- To avoid incentives towards complex business structures, consideration should be given to the creation of a simplified small business entity. Our current tax rules provide an incentive for small businesses to use complex structures. Tax outcomes depend on business structures, and multiple structures are needed to achieve tax outcomes that would be otherwise unavailable through a single entity.

Chapter Four A

SME financial markets: finance principles and alternative financing

Dr Nick Mroczkowski and
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Finance principles and alternative financing

Headline findings:

- OECD reports (supported by the G20) explore innovation in SME finance.
- There is a need to broaden the terms of traditional lending to SMEs.
- Alternative options for SME finance, such as asset-based lending, are growing in popularity.
- There is an urgent need for governments to revisit loan guarantee schemes for SMEs.
- Financial literacy: training in finance and related disciplines helps achieve better financing outcomes for SMEs.
- There is an urgent need to develop a generally-accepted definition of an SME.

In the first *Small Business White Paper*¹²⁹ (hereafter WP1), the IPA-Deakin SME Research Centre (then known as the IPA Deakin University SME Research Partnership) provided theoretical and practical support to a government-backed loan scheme for SMEs, and highlighted various forms of equity-based finance for SMEs, including venture capital, for which we also recommended a publicly-supported venture capital fund. In the current paper, we note that credit conditions and access to debt capital continue to play out as major constraints for SMEs¹³⁰ in Australia and, with the exception of some state-based financing initiatives, Australia is still counted among the few developed countries that do not have a government-backed loan scheme for small businesses.

Table 1:
Financing SMEs - Australia, 2007-2016

Indicator		Unit	2007	2008	2009
Debt	Outstanding business loans, SMEs	AUD million	188,709	203,880	203,598
	Outstanding business loans, total	AUD million	710,887	771,942	721,345
	Share of SME outstanding loans (% of total outstanding business loans)	Percentage	26.55	26.41	28.22
	New business lending, SMEs	AUD million	77,517	79,914	69,562
	New business loans, total	AUD million	374,997	336,145	265,484
	Share of new SME lending (% of total new lending)	Percentage	20.67	23.77	26.20
	Interest rate, SMEs	Percentage	8.56	7.99	7.56
	Interest rate, large firms	Percentage	7.6	6.16	5.85
	Interest rate spread (% points)	Percentage	0.96	1.83	1.71
Non-bank finance	Growth capital and venture capital	AUD million	6,939	8,315	7,903
	Growth capital and venture capital (% year-on-year growth rate)	Percentage	...	19.83	-4.95
	Leasing and hire purchases	AUD million	9,546	9,342	6,904
	Factoring and invoicing	AUD million	54,757	64,991	63,101
Other indicators	Bankruptcies, SMEs (total)	Per 10,000 businesses	45	47	47
	Bankruptcies, SMEs (% year-on-year growth rate)	Percentage	...	4.44	0.00

The significance of SMEs in contributing to economic growth and prosperity is well documented in countless private surveys, in an almost endless list of contributions from investigatory journalists, and in a plethora of scholarly articles¹³¹. While governments around the world have long recognised that the SME sector is the *engine room* that drives their respective economies¹³², more intervention by governments is needed in some countries (including Australia), to mitigate or remove significant constraints impacting small-to-medium enterprises. Counted among the more prominent constraints identified by Australian business owners are the lack of access to debt financing, high taxes and ongoing regulatory imposts.¹³³

The Australian government, to its credit, has introduced significant policy and legislative reforms as part of its comprehensive SME agenda, including changes to the financial system to accommodate greater access to debt finance for SMEs, and the introduction of a range of tax incentives targeting small businesses and particularly innovative start-ups.

Table 1 shows that there has been continued growth in new lending to SMEs since 2007 – in particular, an increase of

5.13% in 2014 followed by an increase of 7.32% in 2015. However, new loans to SMEs declined by 4.9% during 2016. Moreover, while total outstanding loans to SMEs increased during 2015 by 4.05%, there was a 3.9% decrease in total outstanding loans during 2016. This is consistent with the decrease in the number of SME bankruptcies, which declined to a new low of 36 per 10,000 in 2016. Similarly, venture and 'late stage' capital investments, combined, grew by 4.7% during 2016, whereas leasing and hire-purchase volumes decreased by 8.62%.

In the Australian context, whether these increases in various forms of finance intended to assist the SME sector can be attributed to the government's SME financing reform agenda, or are attributable to moderate improvements in the Australian economy following the global financial crisis and the end of the decade-long mining boom, remains unclear. The IPA-Deakin SME Research Centre supports government initiatives from which it is hoped SMEs will benefit, particularly those initiatives that bring positive changes to SME financing, such as Australian-based crowdsourced funding, applicable to public companies from 1 September 2017.

129 IPA Deakin University SME Research Partnership (2015).

130 Scottish Pacific Business Finance (2017), p13.

131 An excellent review of the SME finance literature is provided in Kersten et al (2017)

132 Scottish Pacific Business Finance (2017).

133 Scottish Pacific Business Finance (2017).

Source: OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. http://dx.doi.org/10.1787/fin_sme_ent-2018-en. Accessed 29 May 2018.

2010	2011	2012	2013	2014	2015	2016	% change 2014/15	% change 2015/16
223,624	234,271	238,267	241,220	249,855	260,282	270,408	4.17	3.89
705,885	714,619	737,796	749,726	784,781	835,077	881,298	6.41	5.53
31.68	32.78	32.29	32.17	31.84	31.17	30.68		
82,506	81,561	73,674	79,130	85,373	91,126	86,658	6.74	-4.90
265,820	310,696	273,774	292,430	360,436	391,641	341,766	8.66	-12.73
31.04	26.25	26.91	27.06	23.69	23.27	25.36		
8.29	7.94	7.07	6.44	6.18	5.58	5.29		
6.67	6.37	5.29	4.29	4.15	3.59	3.20		
1.62	1.57	1.78	2.15	2.03	1.99	2.09		
8,912	8,700	7,652	8,348	7,907	8,802	9,213	11.32	4.67
12.77	-2.38	-12.05	9.1	-5.28	11.32	4.67		
7,140	7,579	8,691	7,549	8,690	10,368	9,474	19.31	-8.62
58,661	61,422	63,361	63,272	62,391	64,400	...	3.22	
50	51	53	49	39	41	36	5.13	-12.20
6.38	2.00	3.92%	-7.55	-20.41	5.13	-12.20		

Moreover, the IPA-Deakin SME Research Centre commends the federal government's proposed changes to corporate law that allow proprietary companies to engage in crowdsourced funding activities and, despite not having been passed as law (at the time of writing), crowdsourced equity funding as a new form of finance for SMEs. This is a promising initiative that will be particularly beneficial to the SME community.

With respect to the government's suite of tax incentives for small business announced in 2015 as part of the National Innovation and Science Agenda¹³⁴, the IPA-Deakin SME Research Centre has undertaken significant research on the role of tax incentives for small business. The relevant findings and potential implications for government policy are discussed in other sections of this paper.

Financing the SME sector

The IPA-Deakin SME Research Centre maintains that the financing issues confronting SMEs, as observed in WP1 (and briefly reiterated here), still continue to be problematic for SMEs, on both the demand side and the supply side. This suggests that sub-optimal lending continues to persist in the SME sector in Australia. On the demand

side, SMEs continue to compete with their larger counterparts in highly-competitive debt markets. Notwithstanding their ability and willingness to pay¹³⁵, **Figure 1** shows that there remains a considerable gap between lending to SMEs and total business loans.

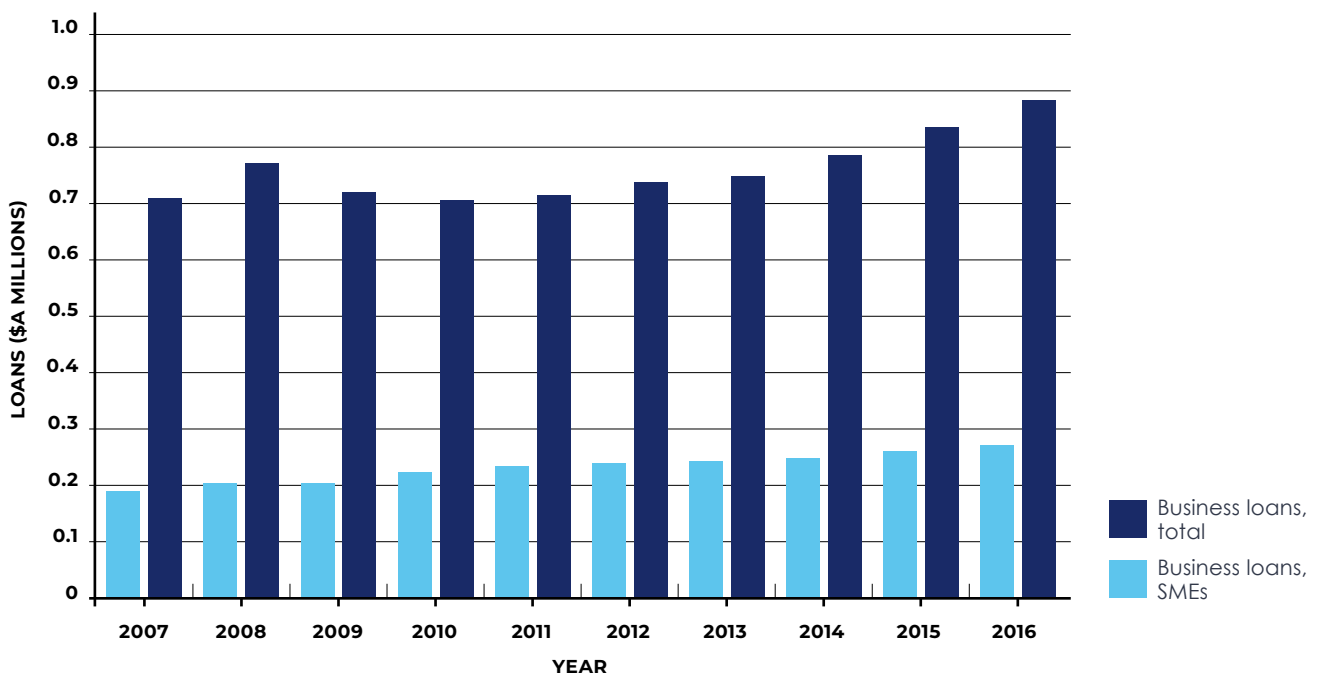
Financial literacy issues also appear to be at the heart of demand constraints, with entrepreneurs new to the market often lacking knowledge about finance, strategic management and the extensive range of financial products available to start and sustain their businesses. Against this background, the ability to formulate and articulate a sound business strategy (sufficient to convince and woo potential lenders and investors) can be a major impediment in accessing much-needed funds.

The IPA-Deakin SME Research Centre further notes that the spread in Australian interest rates between large enterprises and small-to-medium enterprises continues to persist. Although the average interest rate on loans to the SME sector in Australia is decreasing, as shown in **Figure 2**, interest rates generally in Australia remain relatively high compared to those in other developed countries. This phenomenon has a flow-on effect on SME loans.

¹³⁴ For more information, see National Innovation and Science Agenda (2015).

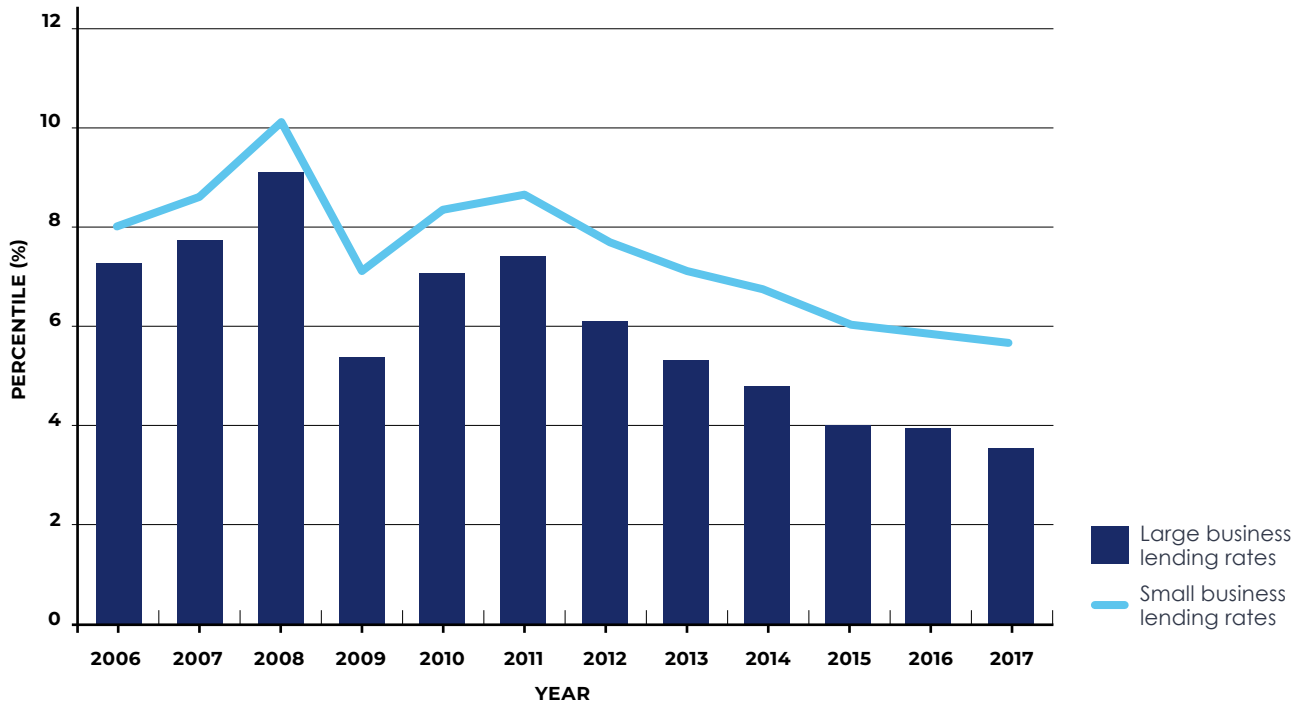
¹³⁵ IPA Deakin University SME Research Partnership (2015), pp 23-27.

Figure 1:
SME and total business loans, Australia (2007-16) (\$A millions)



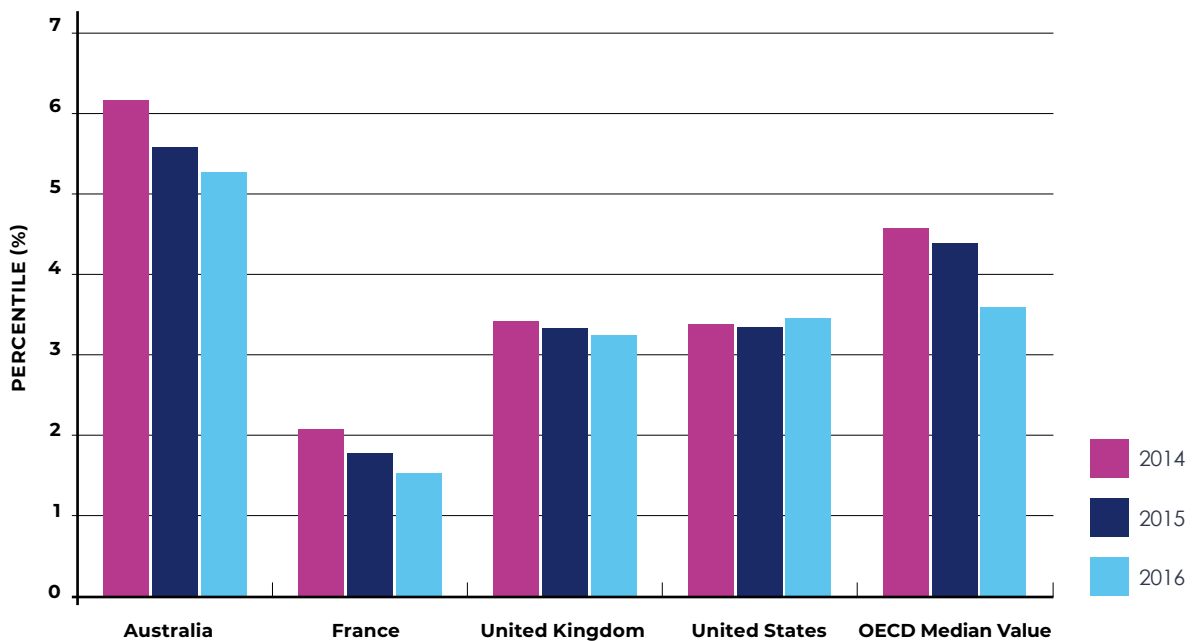
Source: OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. http://dx.doi.org/10.1787/fin_sme_ent-2018-en. Accessed 4 June 2018.

Figure 2:
Interest rates charged on small business loans, Australia (2006-17)



Source: Data compiled from Reserve Bank of Australia (RBA).

Figure 3:
SME interest rates (2014-16)



Source: Data compiled from OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. http://dx.doi.org/10.1787/fin_sme_ent-2018-en. Accessed 26 May 2018.

On the supply side, banking institutions continue to be cautious, post-financial crisis, in lending to SMEs, and particularly to small emerging and innovative enterprises. This is primarily due to the lack of a credible trading history and thus the higher risk profiles of SMEs compared with larger, more established firms. There is a persistent 'information asymmetric' phenomenon that is well documented in the finance literature. Given these circumstances, it is not unreasonable to expect the presence of a 'spill-over effect' at play in the market for debt, whereby lenders fail to recognise the positive externalities generated by SMEs, such as more jobs, new and innovative products, and ultimately more economic growth.¹³⁶

Many of the above issues were covered in some depth in WP1. Rather than reiterating the same arguments here, in this paper the IPA-Deakin SME Research Centre explores new forms of funding currently trending within the SME and entrepreneurship space. Among the more interesting of these include crowdsourced funding (hereafter 'crowdfunding'), a new funding source that has recently become available in Australia for public companies due to changes in corporate law. Crowdfunding will also potentially soon be available for proprietary companies and, following the closing of submissions to Treasury commenting on the proposed legislation (July 2017), we trust that the preparation of a bill supporting further changes to corporate law will be high on the agenda for the legislature over the coming months.

The IPA-Deakin SME Research Centre further notes that the public flotation route for SMEs at the upper end of the size scale and, in particular, family businesses, is gathering momentum in Australia and in offshore jurisdictions as a potential longer-term alternative to debt finance.¹³⁷ To this end, the IPA-Deakin SME Research Centre examines the pros and cons of larger SME firms taking the public float route to expedite growth and profile. The IPA-Deakin SME Research Centre, however, is concerned that the Australian Securities Exchange (ASX) is considering changing minimum spread and other changes to the listing rules which will limit the ability of small-cap companies to follow the public flotation route. The IPA-Deakin SME Research Centre does not believe that this is an appropriate initiative without first undertaking extensive studies that provide sufficient evidence of thin trading inter alia, attributable to small cap firms, and the potential impact on the Australian equity market.

A new bank for SMEs to challenge the 'four pillar' policy?

The IPA-Deakin SME Research Centre was heartened by an article in *The Age*¹³⁸ reporting on the launch of a new bank, Judo Capital, in March 2018. Judo Capital will primarily operate within the SME finance sector and thus is destined to fill the \$60 billion shortfall in lending to SMEs. Even more encouraging are the sentiments expressed by Kate Carnell, Ombudsman for Small Business and Family Enterprise, which acknowledged that there is "no competition" in the banking system, and that "The big 4 banks have 80% plus of the SME lending market and they mostly don't lend except if it [the loan] is secured against property and that means access to capital is very difficult for many SMEs".

In the same article, Cara Waters quotes Joseph Healey, co-founder of the new bank, who explains that "We saw a new opportunity to go back to relationship-centric banking as it used to be and banking as it should be". This is an interesting observation, as the IPA-Deakin Research Centre (through its joint partner the IPA and its membership) has noted that one of the most common complaints from SME owners is the lack of relationship with their bankers.

While the IPA-Deakin Research Centre strongly supports the initiative to establish a new bank which focuses on SMEs and their financing needs, it will be interesting to observe how this new initiative will play out in the future, i.e. as the potential saviour for SMEs. Indeed, given the comments by Waters¹³⁹ that the bank will focus on the four 'C's of banking – character (i.e. the SME's history and risk appetite), future cash flows, current capital base, and collateral – how will this bank be any different to the existing banks? If collateral is the focus then, in reality, the new bank might adopt similar strategies and practices as the big four and thus add to the existing oligopolistic banking architecture in Australia.

Alternative forms of finance for SMEs

A good starting point for examining alternative forms of finance for SMEs is to firstly recognise the work of well-respected international bodies that support the drive for alternative sources of finance for SMEs, micro-enterprises and entrepreneurs generally. In this respect, it is important to acknowledge two notable bodies working together toward the development and endorsement of 'High-level Principles

¹³⁶ IPA Deakin University SME Research Partnership (2015), pp 23-27.

¹³⁷ Deloitte (2017).

¹³⁸ Waters (2018).

¹³⁹ Waters (2018).

on SME Financing' – the Organisation of Economic Cooperation and Development (OECD) and the Group of Twenty (G20), of which Australia is an active member.

In April 2015, G20 finance ministers and central bank governors requested the development of a set of high-level principles on SME financing by the OECD. The rationale for this request stemmed from the need for G20 and OECD members "to support their efforts to enhance access to a diverse range of financing instruments by SMEs, including micro-enterprises, and entrepreneurs".¹⁴⁰

Further, "Cross-cutting policies to enhance SME access to finance are needed to provide a coherent framework for government actions in this area, within the broader policy ecosystem for SMEs. Such strategies are instrumental to define specific policy objectives; design, coordinate and implement policy measures; and to provide a framework for monitoring and evaluation".¹⁴¹

In September 2015, an 'in-progress' draft of the high-level principles on SME financing was tabled at a meeting of G20 finance ministers and central bank governors. In July 2016, the OECD published their report titled *Progress Report on the Development of Effective Approaches to Support the Implementation of the G20/OECD High-level Principles on SME Financing*.¹⁴² Given their importance in guiding and setting government policies that will ultimately support greater access to finance by SMEs, we have listed the 11 principles here.

Interpreting the high-level principles of SME financing

From extensive discussions with IPA members and their clients during roundtable meetings, various IPA events, seminars, forums and congress, the IPA-Deakin SME Research Centre is constantly reminded that the ability of entrepreneurs and/or SME owners to achieve their desired business goals is only in-part facilitated by a particular set of skills, or a unique idea, concept, product or business model. What is also critical is access to reliable, affordable and sustainable funding sources, many of which are often overlooked or simply not fully understood by those SME owners who critically depend on these sources. With new forms of financing emerging and becoming more and more available and accessible to SMEs and entrepreneurs, it is timely for governments and other professional bodies to fully articulate the benefits of these new products to the SME community.

Table 2: High-level principles on SME financing

1. Identify SME financing needs and gaps and improve the evidence base.
2. Strengthen SME access to traditional bank financing.
3. Enable SMEs to access diverse non-traditional bank financing instruments and channels.
4. Promote financial inclusion for SMEs and ease access to formal financial services, including for informal firms.
5. Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection.
6. Improve transparency in SME finance markets.
7. Enhance SME financing skills and strategic visions.
8. Adopt principles of risk sharing for publicly supported SME finance instruments.
9. Encourage timely payments in commercial transactions and public procurement.
10. Design public programs for SME finance which ensure additionality, cost-effectiveness and user-friendliness.
11. Monitor and evaluate public programs to enhance SME finance.

Source: OECD (2016), *G20/OECD Progress Report on the Development of Effective Approaches to Support the Implementation of the G20/ OECD High-level Principles on SME Financing*, July 2016, OECD Publishing, Paris.

Some of the alternative and emerging financing options have been thoroughly analysed by global organisations such as the G20 and the OECD. These two organisations have expended significant resources and time over the past decade focusing on mechanisms that encourage both developed and less-developed countries to adopt, as a central policy objective, the development of their financial system to provide those entrepreneurs operating SMEs with a range of financing options. These new options support appropriate funding mechanisms for SMEs to facilitate business success.

In particular, the underlying purpose of the work undertaken by the G20 and the OECD in recent years is to establish the key areas that governments, government departments, central banks and other banking institutions and private sector organisations should consider when designing policies that aim to improve SMEs' access to finance. While the high-level principles were initially prepared in the context of a body of work by the G20 and OECD on improving SME financing in the developing world, the IPA-Deakin SME Research Centre believes they provide a useful framework for evaluating

¹⁴⁰ OECD (2015b), p 5.

¹⁴¹ OECD (2015b), p 5.

¹⁴² OECD (2016).

policy initiatives aimed at improving financing opportunities for the owners of SMEs in Australia.

The IPA-Deakin SME Research Centre further believes that the principles outlined below are eminently suitable for setting government policy related to SME finance. Moreover, the principles are also a way that Australia can assist its trading partners – particularly those with underdeveloped financial systems – to support employment growth of their own SME sectors.

In the section that follows, the IPA-Deakin SME Research Centre reviews and discusses each of the principles in more depth, with particular emphasis added on their relevance to Australian SMEs and the Australian economy generally. We note that our discussion does not follow the sequence of principles outlined by the OECD and thus, for ease of understanding, we have provided below the OECD principles both in the order presented by the OECD and the order presented in the white paper. We have also provided an additional section (**Principle 12**) which discusses in detail the importance of credit guarantee schemes, which we believe will greatly support OECD principles 2, 3, 4, 8, and 10.

Considering each G20/OECD high-level principle on SME financing in turn

Principle 1 (OECD 1) – Identify SME financing needs and gaps and improve the evidence base

The IPA-Deakin SME Research Centre's interpretation of this principle is that policy decisions must be driven by an evidentiary base (i.e. the availability of accurate financial and non-financial data relating to SMEs), as well as an understanding of the marketplace served by any proposed or existing initiative. It is important that policy decisions in the area of SME financing are based on research that is credible and able to be used as a foundation for discussions on new policy settings or the revision of existing policy settings.

Some stakeholder groups that would be a part of such a dialogue would include key government agencies such as central banks and other financial regulatory agencies, small business industry/professional groups and other relevant bodies operating in the finance sector. The G20 and OECD have constantly emphasised the importance of the

Table 3:
OECD principles and equivalent white paper financing principles

Principle	OECD no.	White paper equivalent no.
Identify SME financing needs and gaps and improve the evidence base.	1	1
Strengthen SME access to traditional bank financing.	2	7
Enable SMEs to access diverse non-traditional bank financing instruments and channels.	3	8
Promote financial inclusion for SMEs and ease access to formal financial services, including for informal firms.	4	3
Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection.	5	4
Improve transparency in SME finance markets.	6	2
Enhance SME financing skills and strategic visions.	7	6
Adopt principles of risk sharing for publicly supported SME finance instruments.	8	9
Encourage timely payments in commercial transactions and public procurement.	9	5
Design public programs for SME finance which ensure additionality, cost effectiveness and user-friendliness.	10	10
Monitor and evaluate public programs to enhance SME finance.	11	11
Develop and promote government-backed credit guarantee schemes	No Equivalent	12



availability of accurate statistical and non-statistical information from which prudent policy directions can be developed. This is an observation which is fully endorsed by the IPA-Deakin SME Research Centre.

Indeed, given the IPA-Deakin SME Research Centre's concerns regarding the availability and reliability of research data applicable to the SME sector, the IPA and Deakin University jointly established the IPA-Deakin SME Research Centre in 2014. The Centre has the primary task of undertaking high-level technical research relating to SMEs. It was established to meet the growing demand for quality research on SMEs and related topics. This demand has emerged as a direct consequence of the phenomenal growth of the SME sector in most economies around the world and the recognition by governments of the significant role the SME sector plays in contributing to employment growth and increasing GDP.

A further element of concern by the G20/OECD relates to data analysis and research – in particular, the manner in which data on SMEs is collected, recorded and translated within domestic markets, and whether the data in its final form is able to be used for international comparability. In this regard, member countries need to adopt a data collection/processing framework which ensures that similar procedures and processes are consistent, thus enhancing the reliability and comparability of data relating to SMEs.

Quantitative measures, however, tell only one side of the story. Every country adds its own cultural aspects to the institutional/regulatory environment in which business is conducted. Any quantitative analysis will need to be tempered with an acknowledgement of those cultural and institutional peculiarities that impact results observed by the researchers.

There are further, and perhaps more serious, challenges for those attempting to create a comparable database for SMEs. A primary, important consideration would be the need to adopt a consistent definition of an SME across jurisdictions, and preferably a definition which could have global application. While it is appealing, conceptually, to derive a consistent and perhaps generally-accepted definition of an SME, research has shown that definitional consensus has been problematic, even within a jurisdiction covering a defined group of related countries, let alone a global definition. For example, one study has shown that there are no less than 10 definitions of SMEs within the countries of the ASEAN community¹⁴³ and, as well, there are sub-

definitions within the primary definition for some countries (See Appendix A). This is an interesting finding, particularly given that many of the countries within the ASEAN group have similar cultural and institutional settings.

Australia is also not without SME definitional diversity that potentially could impact the interpretation of research data. For example, three key government agencies define an SME differently (viz, the ATO, the ABS and ASIC). At this point, we believe it is important to draw on the findings in the literature to help our understanding of the extent of SME definitional diversity and whether it is possible to derive a generally-accepted definition of an SME which can be operationalised. Consideration needs to be given to the benefits derived from establishing a generally-accepted definition of an SME.

The extant SME literature maintains that, while SMEs account for more than 95% of all firms in many countries – playing a major role not only in ASEAN countries such as, for example, Indonesia, Malaysia, Thailand, Vietnam, but also in developed countries such as Japan, Canada, US, the UK and Australia¹⁴⁴ – there is nonetheless considerable diversity in the definitions of SMEs among different jurisdictions¹⁴⁵. This diversity of definitions, which primarily relates to a lack of consensus on common size thresholds of the SME sector across countries, has created problems of comparability and consistency, which in turn can create significant validity issues.¹⁴⁶

Furthermore, while different jurisdictions adopt differing criteria based on employment, sales, total net assets or investment to determine an SME, even within a specific criterion such as employment, there is no uniformity across different countries.¹⁴⁷ For example, the Philippines uses three employment levels (i.e. micro = 1 to 9, small = 10 to 99, medium = 100 to 199 employees) to define SMEs across all industries, while both Thailand and Vietnam use differing employment levels for different industry sector groupings (e.g. 'manufacturing', 'retail', 'wholesale', 'services and other' in Thailand; 'agriculture, forestry and fishery', 'industry and construction', 'trade and services' in Vietnam).

Of greater concern are the numerous studies reported in the extant literature that "... employ different, often ad hoc, approaches to the definition and measurement of key [SME] concepts"¹⁴⁸, casting doubt on the validity of these studies showing substantial growth within the SME sector¹⁴⁹.

¹⁴³ Mroczkowski, Tanewski and Kiaterittinun (2017).

¹⁴⁴ Allee and Yohn (2009); Chiao, Yang and Yu (2006).

¹⁴⁵ For example, Ayyagari, Beck and Demircuc-Kunt (2007).

¹⁴⁶ Ayyagari, Beck and Demircuc-Kunt (2007); Luger and Koo (2005).

¹⁴⁷ Ayyagari, Beck and Demircuc-Kunt (2007).

¹⁴⁸ Luger and Koo (2005), p 17

¹⁴⁹ For example, Joshi, Yapa and Kraal (2016).

Consequently, inconsistencies between these studies create a generalisability problem and weaken their external validity, diminishing the impact of the message on policy makers.¹⁵⁰ While this evidence relates mainly to start-up enterprises, their findings nonetheless have relevance to the current WP11 and can equally apply to the SME sector.

Accordingly, there is an urgent need to provide an omnibus definition of SMEs, not only for the ASEAN region but also for other jurisdictions, and possibly a global definition. While it is acknowledged that no single definition of SME will suit all the needs of government or the private sector, the IPA-Deakin SME Research Centre argues that it is possible, by examining the four most common attributes relating to the definitions of an SME in the literature (annual turnover/sales, number of employees, total net assets or total investment, or a combination of the four criteria) it may be feasible to develop a generally acceptable (and operational) definition of SMEs. Doing so would enhance measurement and comparability between countries within the G20 and between other external jurisdictions, and will assist in addressing some of the validity issues related to data and statistical analysis.

We are cognisant of the importance of developing a robust definition of SMEs that is theoretically appealing and generally accepted within both academic and professional circles. It is reported in the extant literature that SMEs have some fundamentally different characteristics from large organisations – these are that SMEs are generally resource-constrained, they utilise informal strategies, create flexible structures, and they are reactive to their market environments.¹⁵¹ As a consequence, SMEs tend to have higher failure rates compared to larger organisations. For example, the literature reports that 24% of all new businesses in the United States fail within two years and that 63% fail within six years¹⁵², with similar failure rates observed in Australia, the United Kingdom, Japan, Taiwan and Hong Kong¹⁵³.

Due to SMEs' differing characteristics, the IPA-Deakin SME Research Centre argues that the resource-based view (RBV) of the firm is one of a number of theoretical frameworks that can be used to develop a robust definition of SMEs that will assist in explaining the manner in which SMEs develop competitive advantage. The RBV focuses on sustainable and unique costly-to-copy attributes of the firm as the sources of economic rents – as the

fundamental drivers of the performance and sustainable competitive advantage needed for firm survival and success.

Given the heterogeneity of small firms and their operating environments, there are fundamental difficulties in seeking to identify and define the critical resources needed for survival and success.

By focusing on the attributes and resources that an SME should possess to sustain a long-term competitive advantage, the literature proposes that resources must be valuable, rare, not readily imitated and not substitutable¹⁵⁴, while other researchers argue that resources must capture durability, transparency, transferability, and replicability¹⁵⁵. Resources in general can be considered stocks of available tangible or intangible factors that are owned or controlled by the firm and converted into products or services, using a variety of other resources and bonding mechanisms.

The RBV approach is useful for definitional purposes as it focuses on identifying observable characteristics that explain the source of a firm's competitive advantage as the basis for business success, and how the firm can maximise its value by combining and using all available resources to improve its processes.¹⁵⁶ In addition, the definition must also be able to be operationalised; that is, be sufficiently functional with criteria that can be readily applied in practice, particularly in a measurement context.

From studies undertaken by the IPA-Deakin SME Research Centre thus far¹⁵⁷, it would seem that functionality and application of criteria in defining an SME does not appear to be a major issue. Rather, the problem seems to be the significant diversity in the definitions of SMEs, making it difficult for relevant measurement and comparability across jurisdictions. As previously mentioned, there are nonetheless many common elements in the definitions used in different countries around the world.

There is also commonality with definitions applied by authoritative bodies such as the World Bank Group (WBG), the Organisation for Economic Cooperation and Development (OECD), the Asian Development Bank (ADB), the International Monetary Fund (IMF), and the International Federation of Accountants (IFAC). From our research, what appears to be emerging is that three criteria are common across most definitions, namely:

- 1. the number of employees**
- 2. the total amount of revenue**
- 3. the total amount of assets (both current and non-current).**

¹⁵⁰ Luger and Koo (2005).

¹⁵¹ Terziovski (2010); Qian and Le (2003); Hudson, Lean and Smart (2001); Hudson, Smart and Bourne (2001).

¹⁵² Wheelen and Hunger (1999).

¹⁵³ Lu and Beamish (2001).

¹⁵⁴ Barney (1991).

¹⁵⁵ Grant (1991).

¹⁵⁶ Teece, Pisano and Shuen (1997).

¹⁵⁷ IPA-Deakin SME Research Centre (2017).



While further research still needs to be undertaken, we envisage that the substance of an omnibus definition will be based on the three criteria mentioned above.

Given the themes and theories briefly discussed above, we should pose the obvious question here – Would an operational definition of SMEs that is theoretically appealing and generally accepted within both academic and professional circles provide positive, meaningful benefits to interested stakeholders? The IPA-Deakin SME Research Centre argues that deriving a generally-accepted definition of an SME will result in a significant reduction in definitional diversity which, in turn, should allow for ‘better’ and more accurate measurement in future research. Just as it is critical in the natural sciences to clearly delineate species for the purposes of accurate and meaningful research relating to individual species, so too is the case with enterprises within economies. For example, researchers may discover that there are more entrepreneurs working within the SME sector than there are in large listed companies.

Given the global pressures for national economies to innovate and remain competitive in world markets, it might be socially prudent and economically desirable to offer incentives (such as tax breaks) to SMEs. This type of thinking is currently in place in countries such as the United States and the United Kingdom, inter alia via a ‘Patent Box’ initiative where tax incentives are offered to certain business groups to stimulate innovation.

In this sense, having an SME definition which is consistent among the various parties involved with incentive schemes (such as government departments, regulatory bodies such as the tax office and corporate regulators etc) ensures that the right parties are the beneficiaries of such incentive schemes. Having a common definition will also be vital to organisations that collect statistical data for the purposes of analysis which might impact government policy.

Recognising that SMEs are significant contributors to world economies on so many levels (such as for example, employment, innovation, growth, income and so on), governments may wish to encourage the SME sector with incentives, thus preserving an important engine of business.

Principle 2 (OECD 6) – Improve transparency in SME finance markets

Information collected by government in relation to trends in SME financing will form one component of a more transparent approach to the collection of information related to all aspects of financing smaller entities. It is also important that the so called ‘information asymmetric’ phenomenon relating to SMEs is identified within financial markets and is constantly monitored to better understand the implications on public policy development for SME finance.

This would be greatly assisted by a review and revision of the legal and regulatory frameworks for credit reporting systems so that they are more relevant to the SME market. Moreover, a review of the way small businesses have their credit risk assessed may be warranted, particularly if the outcomes establish a need to improve techniques for credit risk assessment for SMEs. For any review of this nature, critical information (such as standardised credit risk methodologies) must be accessible to policy makers, financial institutions and SME stakeholders in Australia and overseas.

Principle 3 (OECD 4) – Promote financial inclusion for SMEs and ease of access to formal financial services, including for informal firms

Most governments are in a strong position to set the tone for fairness and equity within societies, including initiating utilitarian concepts of ‘inclusion’ which ensure that access to goods and services is made available to the broadest possible group of stakeholders. This is particularly relevant to the role of financial institutions such as banks, which arguably will always have captive audiences (i.e. in a modern developed society there would be few people or firms that don’t use and rely on banks). Given the important role of government in maintaining the well-being of society, it would make sense that governments should also have an active role in matters impacting members of society, including the financial systems which affects not only individuals but businesses as well.

Given the discussion above, in the context of Australia, there is increasing evidence that the larger banks are large-firm-centric in their lending practices, and the lending gap between large and small firms appears to be a persistent regularity in Australia and many other countries as noted by

the OECD. The OECD has suggested that this gap could be considerably lessened if governments played a greater role in setting the tone and providing the foundation for mechanisms that offer SMEs easier access to finance. This could be achieved in many ways, depending on the institutional settings of respective countries. For example, the Australian government could take a lead role in shaping policies or programs through various government agencies, through ongoing monitoring and liaison with the banking sector, or even acting as a facilitator between the various banking sectors. The IPA-Deakin SME Research Centre supports the views of the OECD that governments should use their leadership position to create the playing field on which SMEs can thrive, and should encourage banks and similar institutions to continue to focus on the market for emerging and developing businesses.

The principle of 'inclusion', however, extends far beyond SME financing. The G20 and OECD also recognise that financial inclusion also extends to ensuring that there are no barriers to accessing finance in the banking sector with respect to particular groups. The two bodies have noted that there is a need to focus on ensuring that there are measures in place so access to finance is made easier for:

- women
- young entrepreneurs
- minorities
- migrants, and
- senior entrepreneurs.

This needs to be balanced by the experience of financial institutions that have made finance readily available to a wide variety of customers only to find that they subsequently get into financial difficulties, attracting criticism of the financial institutions for providing easy access to finance to customers that have little or no capacity to repay. In this sense, access to finance needs to be tempered by risk of default.

The IPA-Deakin SME Research Centre believes that the focus on equality of opportunity in accessing finance is appropriate and consistent with recommendations by the OECD. The federal government should also consider monitoring the performance of banks in their lending practices according to the OECD groupings. This could be achieved via consultative forums or online discussions boards and feedback surveys.

As a final note in this section, the IPA-Deakin SME Research Centre notes with great interest that there are several international organisations promoting positive initiatives to support financial inclusion, particularly in relation to women and low-income persons in emerging markets. One such initiative is the raising of \$300m by the International Financial Corporation (IFC, a member of the World Bank) through the issue of 'Kangaroo' social bonds, to support women entrepreneurs.¹⁵⁸ The five-year Kangaroo bond was purchased by more than 15 institutional investors across the world, including the ANZ Bank and Deutsche Bank. As Symons writes, "the issuance helps deepen the market for the growing category of environment, social, and governance-themes bonds in Australia".¹⁵⁹ The proceeds will also be used to help lending to women-owned enterprises and refugee women fleeing conflict.

The IFC's Vice President and Treasurer stated: "Our social bond creates an attractive alternative for investors seeking triple-A rated investment products. The IFC is very happy to include Australian dollars in the social landscape. We will continue to bring innovation and transparency to the environment, social, and governance, unlocking additional funding development".¹⁶⁰

Goldman Sachs, via the IFC social bond programs, was among the first to create a unique loan facility for woman-owned small-to-medium enterprises in 2014 and, within two years, "catalysed new investments from both the public and private sectors and reached more than 30,000 women in 17 countries".¹⁶¹

Principle 4 (OECD 10) – Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection

History has shown that legal and regulatory systems cannot afford to be static in respect of both financial markets and product innovation, which are constantly evolving and, as a result, have led to an explosion of new laws, regulations, guidelines, pronouncements and so on. Unfortunately, many of these changes have taken a broad brush approach which often manages to unnecessarily capture even the smallest of enterprises, entangling them into a web of legislative compliance costs; which some may call unintended consequences.

¹⁵⁸ Symons (2018).

¹⁵⁹ Symons (2018).

¹⁶⁰ Cited in Symons (2018).

¹⁶¹ Goldman Sachs (nd).



It is against this background that the G20 and OECD are recommending a review of all legal, tax, prudential and other levels of regulation to assess whether they are able to be amended to create an environment where SME finance is easier to obtain. The IPA-Deakin SME Research Centre wholeheartedly supports this initiative as over-regulation continues to trend as one of the most common complaints from the IPA membership and their clientele.

The IPA-Deakin SME Research Centre considers that the notion of 'risk-based regulation', discussed elsewhere in this paper, needs to be at the heart of developing policies, laws and regulations that:

- reduce red tape wherever possible for SME finance applications
- encourage best-practice corporate governance for SMEs
- enhance international coordination on matters of international regulation, and
- participate in knowledge-sharing in relation to the shaping and drafting of laws and regulations that deal with new sources of finance.

The IPA-Deakin SME Research Centre acknowledges that the federal government has already taken legislative initiatives that will greatly assist many entrepreneurs and start-up businesses that may fail at least once before becoming successful. In its *National Innovation and Science Agenda Report*¹⁶², the government announced that it would reform insolvency laws "which currently put too much focus on penalising and stigmatising business failure". The government also recognises that some entrepreneurs may fail several times before they succeed, but they "will usually learn more from the failure than from the success". For these reasons, the government proposed reforms to insolvency laws that would:

- introduce a safe harbour for directors from personal liability from insolvent trading in certain circumstances (i.e. when a professional adviser is appointed to turn the business around)
- ban the use of *ipso facto* clauses in contracts, such that an agreement cannot be terminated purely on the basis of an insolvency event during a restructure
- reduce the *bankruptcy default* period from three years to one year, thus allowing entrepreneurs to return to their business activities much quicker.

It is pleasing to see that, on 11 September 2017, the *Treasuries Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017* passed through the Senate, bringing at least two of the above reforms closer to becoming law. The safe harbour exception for insolvent trading will commence when the bill receives royal assent, whereas the reforms for the *ipso facto* rights are expected to apply from July 2018. It is interesting to note that the safe harbour provisions will only apply where directors develop (or are in the process of developing) one or more courses of action that "are reasonably likely to provide a better outcome for the company" than would be the case if a liquidation or administration is immediately effected.

Two further points warrant attention. Firstly, directors will enter the safe harbour, and thus have an *exception* (i.e. not a *defence*) from insolvent trading liability, only when developing courses of action that are likely to provide **better outcomes for the company** – i.e. not the directors themselves. Secondly, what constitutes a **better outcome** for the company, versus outcomes from an insolvency/ administration, will be a matter of much professional judgement, and will no doubt be tested in practice when the bill becomes operative.

As a final note, while the IPA-Deakin SME Research Centre continues to support legal reforms which can assist entrepreneurs and owners of start-ups, we also need to be cognisant that SMEs will often deal with third parties that may qualify for protection under the safe harbour provisions.

Accordingly, given that the new laws do not apply retrospectively, contracts and arrangements after the *Treasuries Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* becomes law will need to be carefully considered such that adequate protection provisions are in place and are not likely to be unenforceable due to the *ipso facto* reforms.

Principle 5 (OECD 9) – Encourage timely payments in commercial transactions and public procurement

As simple as it may seem, one of the most critical issues for any SME is cash flow, and cash from operating activities needs to be vibrant – i.e. cash flow needs to continue to flow into the business on a day-to-day basis for the firm to survive and, of course, to meet its obligations to lenders, trade creditors, employees, government agencies etc. Yet, our feedback from members and their clients is that one of the

¹⁶² Department of Industry, Innovation and Science (2015).

most frustrating aspects of their businesses continues to be the lack of cash inflows on a timely basis, particularly from the larger customers as well as government agencies who appear not to be mindful of the critical cash flow needs of SMEs.

To their credit however, the Australian government is ahead of the recommendations in the various OECD reports, and has recently acknowledged the call from the SME community and representatives of other enterprise groups for the development of a payment system that will help expedite the cash-to-cash cycle for all businesses. The New Payments Platform (NPP) was launched in February 2018. It is open-access infrastructure for fast payments in Australia to enable households, businesses and government agencies to make simply-addressed payments, with near real-time funds availability to the recipient, on a 24/7 basis.¹⁶³ The IPA fully endorses the proposed new payment system, the introduction of which, we believe, is imminent and which will greatly strengthen the operating and solvency status of many SMEs. Further commentary relating to payment times for government procurement contracts is included in the IPA's pre-budget submission paper discussed in later sections of this chapter (see Government 'cash flow' initiatives).

Principle 6 (OECD 7) – Enhance SME financial skills and strategic vision

The causes of small business failure are well documented in an extensive body of literature that has gained considerable coverage in academic and non-academic publications over several decades. It is outside the scope of this publication to explore those causes in any depth. However, apart from the major identified cause being the lack of business planning, there is merit in discussing another contributing factor – the lack of financial literacy, which is one of the major findings of OECD financing research.¹⁶⁴

The OECD has reported that a lack of understanding of finance, as well as poor skills in strategic management, will often lead to difficulties for SME owners, particularly in raising finance and keeping the business operational and solvent. Australia is no stranger to quality education and, over many years, courses and materials have been readily available through universities and other registered training organisation (RTOs) to educate new business owners.

Notwithstanding Australia's track record of educational excellence, the IPA-Deakin SME Research Centre concurs with the OECD and the G20 that there is great merit in further expanding educational offerings specific to the SME community. We envisage that this would include educational materials tailored for SMEs, including a host of course offerings via seminars, webinars and medium-term training programs.

The IPA is already engaging in training initiatives specific to members and the smaller business community, and offers an extensive range of practical professional programs aimed at extending the knowledge and skills base of members and their clients. For SMEs, it offers programs with which to build an understanding of accounting, finance, business planning, internal controls, business ethics and the management of business risks. Businesses are exposed to a range of risks that include but are not limited to risks related to liquidity, credit, foreign exchange, interest rates, commodity prices and movements in the general economy.

Many of the education and training initiatives are presented by TAFEs and other RTOs. These courses are directly linked to improving the competencies of owners seeking to start and operate a small business. The following courses are examples of relevant offerings targeting the SME community.

- Certificate II in Small Business (Operations/Innovations)
- Certificate III in Micro Business Operations
- Certificate IV in Franchising
- Certificate IV in New Small Business
- Certificate IV in Small Business Management
- Diploma of Franchising.

Each course comprises a number of units of competency and some specifically aim to provide financial literacy skills to small business owners, irrespective of whether they are sole traders or conduct their businesses through a trust or a company. These courses can provide a solid foundation for the continuity of small-to-medium businesses and, given the importance of the SME community to the economy, courses that ensure a greater survival rate should be incentivised. Tax incentives are one way of directly encouraging owners to undertake courses

¹⁶³ Reserve Bank of Australia (n.d.).

¹⁶⁴ OECD (2015a).



likely to increase their chances of trading successfully and surviving.

In turn, an increase in demand for such courses will ensure that there is a vibrant vocational education and training sector underpinning and fulfilling the training needs of the SME community.

Vocational education and training offered to small business owners in Australia may also serve another purpose. Australia may be able to export this knowledge and understanding, with relevant modifications for overseas regulatory regimes. This would assist in ensuring Australia plays its part in facilitating SME business owners' greater understanding of financial management.

Principle 7 (OECD 2) – Strengthen SME access to traditional bank financing

We mentioned earlier that, despite problems in obtaining finance from banks, bank lending is still the most common form of financing for start-ups as well as established SMEs. However, bank lending practices appear to be changing globally and moving more toward asset-based financing for SMEs. While this may be good news for many SMEs, for businesses at the smaller end of the size scale there may be insufficient assets, or the appraisal of such assets might yield low values that are insufficient for collateral purposes.

One of the ways global finance think tanks suggest this problem can be overcome is to extend lending conditions to permit a broader range of assets for use as security for the loan. The focus on assets against which a loan may be obtained should be broadened so that 'movable' assets can become collateral for the loan.

One other area that may merit further consideration (although some may view it as contentious) is the use of intangibles assets as collateral. This may be relevant in the context of knowledge-based companies that have few 'bricks and mortar' assets to put up in exchange for access to funds.

The IPA-Deakin SME Research Centre, in principle, endorses the concept of including intangibles as a part of the asset mix for security purposes, as many firms now disclose intangible assets in their balance sheets as a significant component of total assets. This is not unreasonable as the world moves closer to all businesses becoming IT-dominated entities. Moreover, the valuation of intangibles using sophisticated finance

techniques is gaining traction and has created an atmosphere of less uncertainty and greater reliability among lenders and regulators, although banking institutions continue to exercise caution and rely on prudential lending practices as well as comprehensive risk assessments.

There may also be scope for the review of other aspects of traditional banking. This might include, among other things, a review of credit guarantees and the provision of credit insurance where relevant (discussed in more depth below).

Principle 8 (OECD 3) – Enable SMEs to access diverse non-traditional bank financing instruments and channels innovation

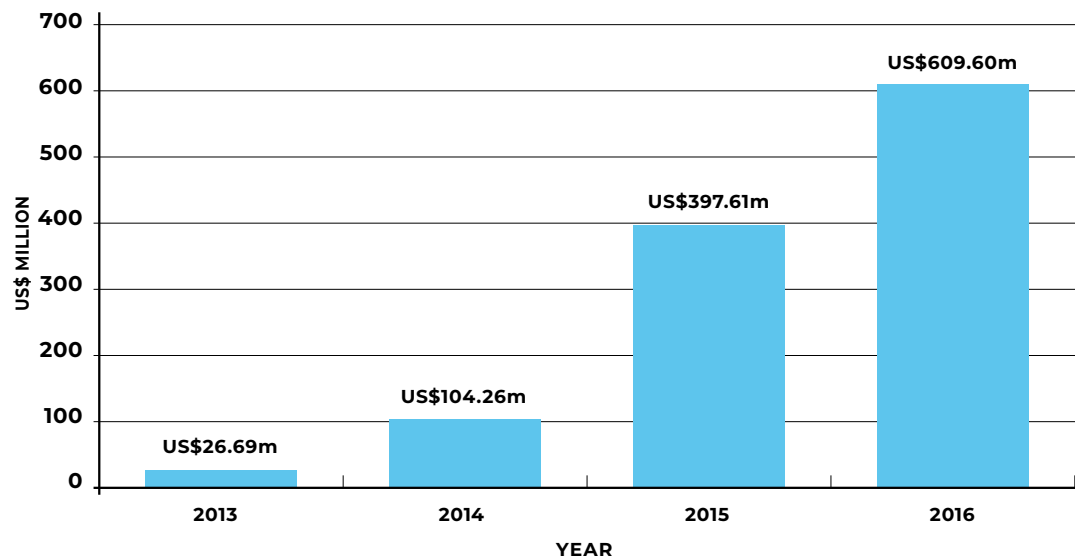
One policy area needing the attention of governments and other actors in the policy-making process is to support initiatives to further develop non-traditional financing options. While traditional lenders will still be critical, there is a need to consider the potential role of a broader group of investors in businesses.

The G20 and OECD have noted that small business owners have, for decades, relied heavily on traditional sources of finance such as bank loans, overdrafts, credit lines and credit cards to enable them to start up and/or meet operating cash flow and investment needs. Some forms of finance, however, may not be suitable for those businesses that operate in newer and faster-growing industries. There may also be circumstances where substantial funds are required for specific projects, but finance might be difficult to obtain if there is an inability for a small business owner or their adviser to provide reliable revenue and profit forecasts for potential lenders. Given these inherent difficulties, new financing models have, perhaps by default, emerged to address the finance gap.

Figure 4 and **Figure 5** show an increasing reliance on alternative funding sources in Australia and neighbouring regions from 2013 to 2016.

As the old adage goes, 'it takes two to tango' when considering financing options: i.e. lenders and applicants both need to assess the risks and payoffs. Small business owners need to decide what level of risk and accountability they are prepared to entertain. Low-risk financing options might appeal to some entrepreneurs, but banks and similar institutions may find it difficult to justify lending to business owners that are unable to provide an indication of

Figure 4:
Australia – total alternative finance market size 2013-2016
(\$US Million)



Source: Cultivating Growth: The 2nd Asia Pacific Region Alternative Finance Industry Report, September 2017, University of Cambridge: Judge Business School, Monash University, and Tsinghua University in Collaboration with KPMG, CME Group Foundation, and HNA Capital.

profitability or provide sustainable income streams as evidence of their ability to service a loan. At the other extreme, there are high-risk options where an individual or entity chooses to buy a share of a business or provide personal funds as a way of establishing a new business.

International organisations such as the G20 and the OECD, among others, have expended significant resources in considering the impact of possible sources of finance on the SME sector globally. The OECD provides a useful list of alternative sources of financing for small-to-medium enterprises (as shown in **Table 4** on page 96) and the broad category of possible sources of finance and their relative risk profiles (according to the OECD), as shown below:

- Asset-based finance (low risk/return)
- Alternative debt (low risk/return)
- 'Hybrid' instruments (medium risk/return)
- Equity instruments (high risk/return).

Alternative financing instruments

To provide readers with a better understanding of some of the above financing approaches for SMEs, we have briefly outlined their major features below.

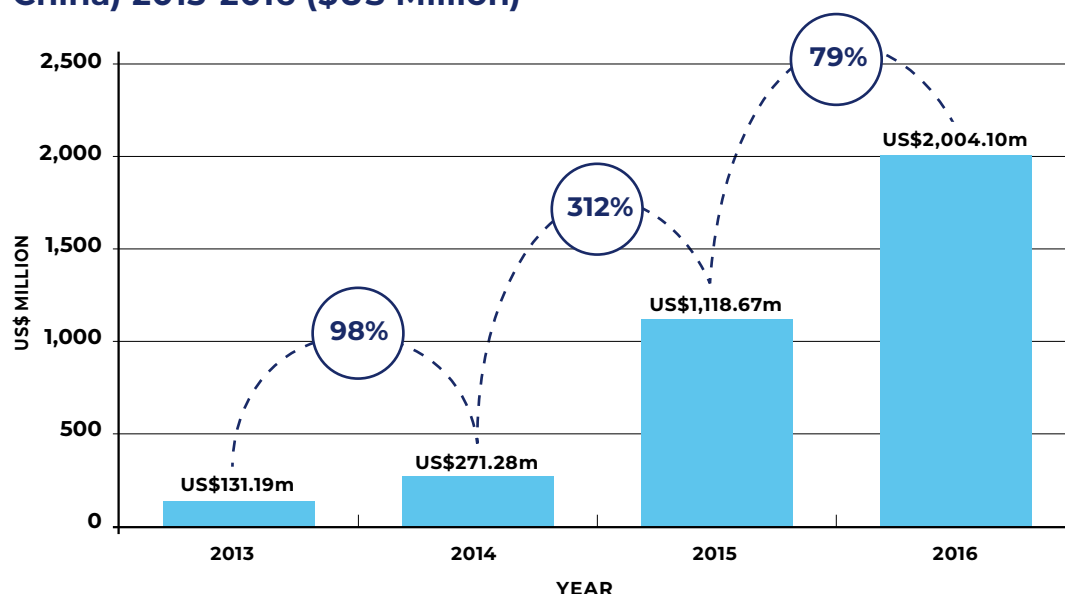
Asset-based finance

Asset-based finance, which encompasses asset-based lending, factoring and leasing, is not based on the credit standing of a small business, but relates to the value of assets owned by the business or the personal assets of the owner.

The owner of a small business would be able to access cash more readily and under terms that are more generous than the traditional bank loan. For example, on the strength of the valuation appraisal of the assets, a small business owner may be able to access finance to meet working capital needs even though the business does not have a credit or trading history.

An advantage in an asset-based financing arrangement can be the ability to access additional funds as advances that are repaid back to the lender. The small business owner may be able to secure additional funds that could be borrowed against other assets owned by the business. A disadvantage in using this kind of financing is that there may be higher costs and complex procedures, as well as serious limits to the actual size of the loan.

Figure 5:
Total Asia Pacific – alternative finance volume (excluding China) 2013-2016 (\$US Million)



Source: Cultivating Growth: The 2nd Asia Pacific Region Alternative Finance Industry Report, September 2017, University of Cambridge: Judge Business School, Monash University, and Tsinghua University in Collaboration with KPMG, CME Group Foundation, and HNA Capital.

Crowdfunding

Crowdfunding (discussed in more detail in Chapter 2B) is a method increasingly used by small business owners to obtain seed funding for their business or funding for a specific project. It is common for artists and small businesses to offer goods or services to funders. A musician, for example, may seek funding for a new album and may offer various benefits in exchange for funds. They might offer a digital copy of their new album for a minimal donation and also provide a live performance at a venue for a funding provider that injects significantly more funds.¹⁶⁵

Targeted *project finance* is only one form of crowdfunding. Other forms of crowdfunding are offered in various jurisdictions. For example, one form involves attracting investors that may wish to hold shares in the entity via an online platform. It is expected that crowdfunding based on lending or selling equity to interested investors will play an increasing role in the way small business obtains finance. Australia has already set up a regulatory structure, with amendments to the Corporations Act 2001 that permit

unlisted public companies that meet certain criteria to use the option of crowdfunding to obtain further funds for the business. The changes in the corporate law related to fundraising with this kind of arrangement are able to be accessed from September 2017.¹⁶⁶

Hybrid instruments

One area of finance that has been developing more slowly in OECD countries is the use of hybrid instruments. These instruments have the characteristics of debt and equity and might be considered as a potential financing method, but are regarded as fairly complicated for owners of smaller businesses and may not be available given that a major requirement is strong evidence of stable earnings over a reasonable time period, as well as a stable market position.

These instruments also require a more sophisticated understanding of finance. As such, they are often used only by larger businesses with the resources and expertise to fully understand and evaluate the pros and cons of the hybrid financial product.

¹⁶⁵ Australian Taxation Office (nd a).

¹⁶⁶ Australian Taxation Office (nd a).

Table 4:
Alternative financing instruments

Alternative financing instruments			
Low risk/return		Medium risk/return	High risk/return
Asset-based finance	Alternative debt	'Hybrid' instruments	Equity instruments
Asset-based lending	Corporate bonds	Subordinated loans/bonds	Private equity
Factoring	Securitised debt	Silent participations	Venture capital
Purchase order finance	Covered bonds	Participating loans	Business angels
Warehouse receipts	Private placements	Profit participation rights	Specialised platforms for public listing of SMEs
Leasing	Crowdfunding (debt)	Convertible bonds	Crowdfunding (equity)
		Bonds with warrants	
		Mezzanine finance	

Source: OECD (2015a), *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, OECD Publishing: Paris.

Private equity and business angels

Private equity and business angels are a source of finance for small business owners that has been front of mind in recent times, because of the presence on television of 'Shark Tank', a program that features high-worth investors who have a proven record of success in evaluating pitches for equity funding from small businesses wanting to get their ideas to the market. A central feature of both private equity and business angels is the intense personal interest that investors show in the enterprise and business expertise they might give to the initial owner of the business or creator of the idea.

These are collectively recognised as being a part of the venture capital (VC) industry. The role of venture capitalists and business angels has been growing in recent years and often in relation to providing finance to new high-growth start-up enterprises that were largely – although not exclusively – in the technology sector. In 2017, in the United States, VC funds flowed mostly into healthcare and business products and services.¹⁶⁷ The global financial crisis, however, saw a decline in the investment by venture capitalists in new and emerging entities. The G20 and OECD observe that, in 2013, the levels of investment in start-ups by venture capitalists were below the levels that existed prior to the global financial crisis.¹⁶⁸ In the US, there was a massive peak in VC investment in 2000, a low point in 2009, and recovery within 2 years.

There is merit in evaluating what measures a government can put in place to encourage greater investment in SMEs. An example that could be considered is a suitable tax incentive that would encourage a venture capitalist or business angel to consider investing in a start-up or the provision of funding for associations or other groups that have a role in facilitating a meeting between business angels and small business owners seeking finance.

The Australian government has put in place tax concessions for investors in start-up ventures. For example, investors in early-stage innovation companies (ESICs) can, in certain circumstances, disregard a capital gain made from a CGT event impacting qualifying shares if the shares have been held continuously for 12 months or more but less than 10 years.¹⁶⁹

Alternative securities exchanges for SMEs

One possibility flagged by the G20 and the OECD in thought leadership papers¹⁷⁰ is for the development of securities exchanges that deal solely with SMEs. Capital gains can be realised by SME owners and a securities exchange provides the owner of a business with the opportunity to attract both retail and sophisticated investors.

There are equity markets in various countries that provide a trading platform for smaller enterprises. One of the key characteristics of the second-tier or smaller entity exchange is the effort made by the

¹⁶⁷ Statista (nd b).

¹⁶⁸ Statista (nd a).

¹⁶⁹ For more detail, see The Australian Taxation Office (nd b).

¹⁷⁰ OECD (2015a).



various exchanges to limit the degree of red tape that typically surrounds the listing processes for much larger exchanges. This does not mean that exchanges for SME offerings lack necessary checks and balances for the protection of investors. Use of these exchanges raises the issue of disclosure and, as discussed previously, SMEs have to be larger in size to have resources to provide disclosure documents.

The full potential of SME listings is yet to be reached, the G20 and the OECD observe, because there is a range of obstacles for a more general use of the financing method. Factors such as cost, red tape, reporting requirements, cultural issues and practices of small business management have created owner reluctance to use SME equity markets. Investors may also find the notion of investing in a listed SME problematic because of the low liquidity in the listed SME market place. There is a need for the listed market to be allowed to mature and grow over time so that it becomes a more acceptable basis of financing smaller entities.

Principle 9 (OECD 8) – Adopt principles of risk sharing for publicly supported SME finance instruments

The IPA-Deakin SME Research Centre agrees with the OECD's position that all public programs for SME finance should enable the use of private resources in risk capital or equity markets. Public schemes can be effective in kick-starting the offer of financing tools for SMEs, the OECD observes, but securing the involvement of private resources is critical to ensuring the availability of SME financing options in a rapidly changing economic and regulatory environment. Measures such as the implementation of crowdsourced funding in Australia are one way this objective is currently being achieved within the domestic jurisdiction. It allows for private sector investment without putting public or taxpayer resources greatly at risk.

The OECD suggests that multilateral development banks (MDBs), national development banks (NDBs) and similar sources of public funds should encourage the involvement of private interests in SME finance. Similar points in relation to venture and other forms of risk capital were made some years earlier in a 2004 position paper entitled the UEAPME Position Paper on the Future of SME Finance published by the European Association of Craft, Small and Medium-sized Enterprises (UEAPME). The association argued that equity financing was important as a financing method for

start-up companies and, in particular, entities that are growing quickly. It proposed that the following 'three pillars' be adopted as a way of encouraging the further development of venture and other risk capital markets:

1. Availability of venture capital.

Member countries of the European Union should review tax systems and provide further incentives encouraging private investors to invest funds in venture capital. Member countries should also seek to develop guarantee instruments such as credit guarantee schemes (a topic given greater coverage later in this chapter).

2. Improve the conditions for investing venture capital into SMEs.

European Union states should support the development of secondary markets for venture capital investments. Accounting standards for SMEs should be revised (cost and expertise required for this to happen) to ease transparent exchange of information between investors and owner-managers.

3. Owner-managers must become more aware of the need for transparency towards investors.

Access to external finance will depend heavily on transparency between the lender or investor and the owner of a small business. SMEs will need to use different information and management instruments to fulfil the requirements for transparency and openness to investors and lenders. Business plans and financial statements are examples of the kinds of information instruments that SMEs must be prepared to provide to access finance of this kind.

The European Association of Craft, Small and Medium-sized Enterprises acknowledges in its recommendations that governments and SMEs must act to create an environment in which investors are encouraged to invest in small enterprises.¹⁷¹

Principle 10 (OECD 10) – Design public programs for SME finance which ensure additionality, cost-effectiveness and user-friendliness.

The IPA-Deakin SME Research Centre supports the OECD's observation that programs for accessing SME finance should be cost-effective and be developed with the involvement of all relevant stakeholders so there is a coherent policy across all levels of government. The OECD states that SME financing programs must also

¹⁷¹ See European Association of Craft, Small and Medium-sized Enterprises (2004).

incorporate what it refers to as financial/credit and economic additionality.

Financial or credit additionality occurs when more loans are made possible via a guarantee scheme and SMEs are able to access additional finance more readily (i.e. than otherwise would have been likely). Moreover, due to the scheme, loans are made on more equitable terms and more reasonable interest rates, thus reducing the usual high financing costs to the business owner. Without a guarantee scheme, high financing costs will normally be borne by SMEs that mostly present with higher risk profiles, from a lender's perspective, and higher risk can lead to higher failure rates. As lenders are not prepared to engage in high risk lending (i.e. without adequate collateral), higher interest rates are levied or other measures are undertaken to compensate for risk, the end result being the emergence of a *lending differential* (often described as a financing gap).

Arguably, therefore, one of the most attractive ways to provide affordable finance and thus support the SME community with an attractive alternative to standard banking finance, is for governments to underwrite the risk. This can be achieved in several ways, but most commonly directly via a credit/loan guarantee scheme, which has the effect of diminishing the significant collateral requirements demanded by lenders, and can also result in more equitable interest rates being levied. Alternatively, lending costs can be offset indirectly via tax breaks. Either way, both forms of assistance will still require public monies.¹⁷²

The benefits that accrue from *Financial/credit additionality* refers to all the benefits derived from all the additional loans made possible through loan guarantee schemes. For example, by allowing SMEs to have greater access to finance, business ventures (that otherwise might have been denied the opportunity) can proceed and create a trading history from which they can be assessed, particularly their repayment performance. Further, as posited by the OECD, lenders can 'gain valuable experience' and develop a deeper knowledge along with greater skills relating to loans facilities and the smaller enterprise. The net effect could result in further market development for the loan guarantee type of product, which might in turn increase the borrowing pool without compromising the quality of the pool.

It should be noted, though, that the evidence in the literature explaining the

benefits of financial or credit additionality appears to be inconclusive, mainly attributable to the apparent difficulty in measuring additionality. However, Levitsky (1997) has clearly shown that a *well-planned* credit guarantee scheme can create, on average, 30-35% financial additionality.

Economic additionality is the benefit that flows to the broader economy as a result of an SME or SMEs having access to finance. A good example of the impact of economic additionality (albeit in the area of unemployment but still capturing the issue here) is the micro-business model, 'The power of one in three' initiated by the Association for Enterprise Opportunity (AEO). In its report, "The Power of One in Three: - Creating Opportunities for all Americans to Bounce Back" the AEO claims that "*if one in three main street microbusinesses hired a single employee, the United States would be at full employment*".¹⁷³ The OECD has also briefly explained the potential for credit guarantee schemes contributing to "technology and knowledge spill-over, both of which can lead to increases in profits, employment and productivity".¹⁷⁴

Principle 11 (OECD 11) – Monitor and evaluate public programs to enhance SME finance

All stakeholders involved in financing SMEs should ensure that monitoring and evaluation occurs on a regular basis so the effectiveness of a scheme is tested. This is necessary to ensure decisions made about continuing, revising or discontinuing an SME financing program are made with appropriate evidence. The OECD observes that *ex ante* and *ex post* evaluation must be performed in accordance with "clearly defined, rigorous and measurable policy objectives and impacts". It says that such research into programs must be conducted with the assistance of financial institutions, small business representatives and any other stakeholders that may be relevant to the program under review.

Evidence from research conducted into SME financing programs and their impact may be used to shape government policies. Australian government bodies such as the Productivity Commission¹⁷⁵, for example, will review marketplace conditions to determine whether there are any barriers that make it difficult for SMEs to access finance. A September 2015 report into the set-up, transfer and closure of businesses found that there were challenges for SMEs seeking access to finance. The Australian

¹⁷² Cusmano (2018).

¹⁷³ Association for Enterprise Opportunity (2013).

¹⁷⁴ OECD (2009), p 6.

¹⁷⁵ Productivity Commission (2015).



Small Business Commissioner¹⁷⁶ observed that access to finance still rated as a concern for many small businesses because non-bank financing streams such as finance companies had exited the market place as a result of the Global Financial Crisis (GFC) and the immaturity of alternative financing options such as crowdfunding and venture capital.

It should be noted that since the Productivity Commission report was tabled, the federal government has introduced the option of crowdsourced funding for public and proprietary companies as a way for entities to access finance. The 2015 report noted that the number-one barrier to innovation is access to finance and that access to finance was the third largest barrier to general business activity. Reports such as this will be used to assist in reviewing laws and regulations to determine whether the federal or state parliaments can remove legal barriers limiting the variety of ways small businesses can obtain finance for their enterprise while still maintaining appropriate restraints to protect the investing public.

Knowledge obtained from research or inquiries into the finance needs of small businesses may also be used internationally as a part of information sharing that is encouraged by the OECD. The G20 and the OECD are two forums through which knowledge about small business finance trends and methods is able to be disseminated. Australian representatives to the OECD are able to share the research done by agencies such as the Australian Bureau of Statistics or the Productivity Commission to enhance the understanding of the experience of small businesses in a specific jurisdiction. This may encourage the government in a country with an underdeveloped economy to adopt similar measures to create greater financing opportunities for small businesses in their own economies.

There are other non-government channels for sharing results from research and inquiries. The professional accounting bodies across the globe are able to share the experience they have in operating within a particular financial market. That sharing of knowledge can occur in many different ways, such as through publications and online training that is accessible to practitioners in other countries. The sharing of ways in which finance systems could be improved can also be done through the various peak bodies for the accounting profession such as the International Federation of Accountants (IFAC)

and the Confederation of Asian and Pacific Accountants (CAPA). Each of these organisations has committees that deal with a variety of issues facing small businesses.

The critical issues include methods of financing small businesses. Accounting bodies from countries with less sophisticated financial markets may be able to leverage this knowledge to advocate for change in the laws of their country, with the ultimate goal of improving the access to finance for small business owners.

The IPA-Deakin SME Research Centre notes that the federal government already has an extensive consultation process with various stakeholders where SME matters are concerned. The Centre encourages the federal government to continue maintaining this high level of engagement with the SME sector through the following mechanisms:

- The federal government should periodically review laws and regulations that impact SME financing to ensure they meet or exceed the benchmark set by the OECD in its SME financing principles
- The federal government should continue (and enhance wherever possible) its outreach to the SME sector on matters relating to access to finance and onerous regulations
- Financial institutions should be encouraged to review their financial products periodically to ensure they are providing a variety of financing solutions to SMEs for whom the traditional bank loan may be ineffective
- Tax deductions for undertaking courses in small business management provided by reputable registered training organisations should be considered to encourage SME operators to improve their knowledge in business management and finance

Government initiatives supporting SMEs¹⁷⁷

A number of government initiatives specific to SMEs and entrepreneurs are currently available and worthy of a brief mention here. The IPA-Deakin SME Research Centre supports these initiatives, which we believe provide great support for the SME community. As a means of providing further coverage and support for the SME community, a brief dialogue of the initiatives relevant to SMEs is provided below.

¹⁷⁶ Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2016).

¹⁷⁷ For more information, see Department of Industry, Innovation and Science (2017).

Information and advice

AusIndustry, a division of the Department of Industry, Innovation and Science, puts the needs of Australian businesses first by simplifying and streamlining access to information and advice. Businesses can now access vital information and help through one website, one contact centre and the AusIndustry national network to:

- get a business up and running
- develop and commercialise ideas and products
- improve, innovate and grow a business
- reach new markets.

The Australian government has provided the website, <https://www.business.gov.au/>, as an online resource for the general Australian business community. It offers simple, convenient access to government information, forms and services. It is a *whole-of-government* service that provides essential information on planning, starting and growing a business.

Entrepreneurs Program

Another important support program for SMEs, the Entrepreneurs' Program¹⁷⁸ is the Australian Government's flagship initiative for business competitiveness and productivity. It forms part of the Australian Government's National Innovation and Science Agenda.

The program offers support to businesses through four elements:

1. Accelerating commercialisation – helping small and medium businesses, entrepreneurs and researchers to commercialise novel products, services and processes.

2. Business management – with experienced business advisers and facilitators reviewing business operations, including business direction, strategy, growth opportunities and supply chain. They provide a report with strategies for business improvement and work with SME managers to make them happen.

3. Incubator support – assisting new and existing incubators to improve the prospects of Australian start-ups achieving commercial success in international markets, through helping them to develop their business capabilities.

4. Innovation connections – with experienced innovation facilitators working with SMEs to identify knowledge gaps that are preventing business growth. The outcome is an innovation facilitation report, providing practical support for businesses, including:

- advice from people with relevant private sector experience
- co-funded grants to commercialise new products, processes and services
- funding to take advantage of growth opportunities
- connection and collaboration opportunities.

Procurement initiatives

Another form of significant government support for SMEs is via government procurement policies. The United States federal government allocates 23% of all federal contracts to American SMEs. Also, it has *set-asides* for SMEs owned by women, veterans and native Americans. These preferential access policies provide support for a dynamic American SME market while supporting key social goals. US state governments also have procurement schemes for local SMEs which vary from those of the federal government. The total government procurement market in the US (federal and state) is massive, as is the SME share of that total.¹⁷⁹ In Australia, the general target for SME government procurement contracts is a minimum 10%, but the actual achievement is far greater than 20% and even higher than the US target of 23%.¹⁸⁰

Table 5a shows that, in 2016-15, the percentage value of total government contracts attributable to SMEs was almost 26%, increasing moderately from the previous period percentage of 24% (2015-16). Moreover, the percentage value of the total contract value attributable to small businesses (a subset of SMEs), increased from 9.77% in 2013-14 to 12.27% in 2016-2017. Furthermore, **Table 5b** shows that the percentage number of contracts for SMEs moderately increased from 59.4% of the value of all procurement contracts during 2013-14, to 60.4% during 2016-17.

***Note:** An SME is defined as a business which has less than 200 employees and operates independently of any parent organisation for taxation arrangements. A small business is defined as a business with fewer than 20 employees. Small Business is a subset of SME. Note that the government's target for SME participation by contract value is 10% and has been consistently well above 20%. SME participation in 2016-17 was 26%. It was 24% in 2015-16, 28% in 2014-15, 34% in 2013-14 and 32% in 2012-13.

¹⁷⁸ For more information, see Department of Industry, Innovation and Science (2018).

¹⁷⁹ Bell and Tayler (2016).

¹⁸⁰ Department of Finance (nd a).



Table 5a:
SME and small business participation trends (value of contracts)*

Financial year	SME including small business		SME excluding small business		Small business		Other		Total	
	Value \$m		Value \$m		Value \$m		Value \$m		Value \$m	
2016-17	12,309	25.99%	6,500	13.73%	5,809	12.27%	35,046	74.01%	47,355	100%
2015-16	13,680	24.04%	8,134	14.29%	5,546	9.74%	43,232	75.96%	56,912	100%
2014-15	16,716	28.12%	10,910	18.35%	5,806	9.77%	42,731	71.88%	59,447	100%

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <<https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>>. Accessed 20 February 2018.

Table 5b:
SME and small business participation trends (quantity of contracts)*

Financial year	SME including small business		SME excluding small business		Small business		Others		Total	
	Number of contracts		Number of contracts		Number of contracts		Number of contracts		Number of contracts	
2016-17	38,649	60.30%	17,338	27.05%	21,311	33.25%	25,443	39.70%	64,092	100%
2015-16	42,737	60.76%	19,854	28.23%	22,883	32.53%	27,601	39.24%	70,338	100%
2014-15	41,151	59.44%	17,611	25.44%	23,540	34.00%	28,085	40.56%	69,236	100%

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <<https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>>. Accessed 20 February 2018.

Individual businesses and contracts

In terms of the number of individual businesses, **Table 6** shows that 89% of the total number of companies involved in government procurement contracts were SMEs. This is a significant result and demonstrates that the government does, indeed, have a strong commitment to awarding procurement contracts to SMEs. Further support, however, is needed to enable SMEs to grow and continue with their efforts in servicing an extensive range of procurement contracts across a broad spectrum of industry sectors.

Ratio of goods to services

Table 7 shows the value of goods and services procured between 2013 and 2017, and the percentage value attributable to goods and services separately. For example, in 2016-17, the value of procurement goods was \$20,417 billion (i.e. 43% of the total value of both

goods and services), whereas the value of procurement services was \$26,937 billion (57% of the total value of both goods and services).

We note also that the ratio of goods to services has been reasonably steady for years 2013-14 through to 2014-2015. During 2015-16 and 2016-17, the good to services ratio changed considerably for the quantity of contracts – i.e. increasing to 43% goods and decreasing to 57% services for both the 2015-16 and 2016-17 periods.

Procurement trends by top 20 sectors

Table 8 shows that, in terms of contract value, the top 20 sectors accounted for \$46,082 billion of procurement value during 2016-17, which represents more than 97% of the total value of all procurement contracts for 2016-17. **Table 8** also shows high levels of SME participation across several sectors, including the following:

Table 6:
Procurement contracts: individual business* participation

	Total uniquely identified businesses	% of total businesses
SME	9,196	89%
Other	1,166	11%
Total	10,362	100%

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <<https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>>. Accessed 20 February 2018.

- Management and business professionals and administrative services
- Information technology, broadcasting and telecommunications
- Engineering and research and technology-based services.
- Public utilities and public sector related services
- Politics and civic affairs services
- Transportation and storage and mail services
- Financial and insurance services
- Laboratory and measuring and observing and testing equipment
- National defence and public order and security and safety services
- Environmental services.

Table 7:
Procurement contracts: ratio of goods to services

		TOTAL	Goods	Services
2016-17	Value \$m	47,354.7	20,417.8	26,936.9
	%	100%	43%	57%
	Number	64,092	22,593	41,499
	%	100%	35%	65%
2015-16	Value \$m	56,912.3	24,460.2	32,452.2
	%	100%	43%	57%
	Number	70,338	26,520	43,818
	%	100%	38%	62%
2014-15	Value \$m	59,447	20,097.8	39,349.2
	%	100%	34%	66%
	Number	69,236	26,444	42,792
	%	100%	38%	62%
2013-14	Value \$m	48,921.1	18,886.4	30,034.7
	%	100%	39%	61%
	Number	66,047	24,822	41,225
	%	100%	38%	62%

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <<https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>>. Accessed 20 February 2018.

***Note:** The United Nations Standard Products and Services Code (UNSPSC) is used by agencies to categorise their contracts to a specific industry sector. Please refer to AusTender at www.tenders.gov.au for detailed sectoral information.

Government 'cash flow' initiatives

Given the enormous procurement engagement in government contracts by SMEs, as articulated in the previous section, the importance of constant cash flow to keep SME firms cash-stable and free from liquidity tension cannot be over-emphasised. In this respect, there have been concerns in the past that governments, and other large corporations subcontracted to government, were not paying creditors quickly enough, thus in some instances jeopardising SMEs' liquidity and the continuity of their operations.

Given the real possibility of these circumstances occurring for many SMEs, the IPA in its 2017 pre-budget submission recommended that governments should act to adopt a 20-day payment period to improve cash-flow and enhance SME financial stability. This recommendation was in line with offshore jurisdictions and is also consistent with OECD initiatives. The IPA-Deakin SME Research Centre is pleased to note that, commencing from 1 July 2019, the Australian government has committed to paying SMEs within 20 days.

We note that this change is a considerable reduction from the 30-day policy currently in place. We also understand that, if payments are not made within the 20-prescribed-day period, interest charges will apply.¹⁸¹



Table 8:
2016-17 procurement contracts: top 20 categories for goods and services*

Category title	Value \$m	% of total value	% of SME participation
Commercial and military and private vehicles and their accessories and components	12,473.1	26.3	7
Management and business professionals and administrative services	9,164.3	19.4	44
Building and construction and maintenance services	5,487.9	11.6	12
Information technology broadcasting and telecommunications	3,304.2	7.0	44
Engineering and research and technology-based services	3,196.7	6.7	45
Defence and law enforcement and security and safety equipment and supplies	2,767.1	5.8	27
Travel and food and lodging and entertainment services	2,619.0	5.5	1
Education and training services	1,705.8	3.6	24
Healthcare services	1,338.4	2.8	15
Public utilities and public sector related services	861.3	1.8	37
Politics and civic affairs services	690.3	1.5	53
Transportation and storage and mail services	650.3	1.4	47
Financial and insurance services	381.1	0.8	35
Laboratory and measuring and observing and testing equipment	267.3	0.6	75
National defence and public order and security and safety services	266.7	0.6	42
Environmental services	248.2	0.5	60
Structures and building and construction and manufacturing components and supplies	179.4	0.4	22
Electronic components and supplies	163.7	0.3	64
Chemicals including bio chemicals and gas materials	162.6	0.3	1
Drugs and pharmaceutical products	155.0	0.3	7
Total of top 20	46,082.4		

Source: The Australian Government: Department of Finance, Statistics on Australian Government Procurement Contracts (nd), <<https://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>>. Accessed 20 February 2018.

Principle 12 – Develop and promote government-backed credit guarantee schemes

The IPA-Deakin SME Research Centre articulated, in WP1, the need to have a government-backed credit (loan) guarantee scheme (CGS) and the IPA, as joint partner of the IPA-Deakin Research Centre, has in its capacity as a peak professional body continued to pursue this initiative through advocacy, publicity in its journals and, more recently, with detailed commentary in their 2018-19 pre-budget submission.

Given the potentially significant boost to the economy, particularly through economic additionality via a government-backed source of funding for SMEs, we reiterate, below, the major points raised in the IPA 2018 pre-budget submission.

IPA 2018-19 pre-budget submission: credit (loan) guarantee schemes

The rationale for public intervention to improve SMEs' ability to access private financing is twofold. First, as argued in previous sections of this paper, the spill-over hypothesis posits that SMEs are able to

182 Recall from our previous discussion, generally, that there is less public information available for small-to-medium enterprises as compared with larger, more established businesses. This is particularly the case for start-ups and younger enterprises with either no or little trading history. Lack of credible information increases uncertainty for prospective lenders, resulting in a perception of a higher risk profile. In turn, this could mean that a loan will be declined or, if granted, the lender will compensate for the risk through higher interest rates, greater collateral requirements, a requirement for loan protection insurance and/or a combination of all three measures.

generate positive externalities by creating new jobs, new ideas and new abilities that other industries and the economy as a whole may enjoy. The second argument for government intervention is the existence of market failures, such as the presence of asymmetric information in terms of adverse selection and moral hazard.¹⁸²

A few key points are worthy of mention here:

- The focus of investment in Australia has shifted from investments in new productive capacity and efficiency to a more basic survival and liquidity dynamic, necessitating greater expenditures for continuity and going concern.
- By comparable international standards, the cost of debt in Australia is high.
- Australian lending banks, in complying with the Basel III obligations, are cautious in their general lending policies (compared with offshore jurisdictions) and risk-adjusted lending is not the norm.
- The IPA in its capacity as a peak professional body, the members of which deal with SMEs on a daily basis, recommends that a credit guarantee scheme is justified, albeit on a modest scale, for a trial period.
- External equity is of particular relevance for those high-growth/high-potential, young businesses, where the current revenue capability cannot sustain a guaranteed payment of loan interest, thereby possibly ruling out debt finance.
- There is a real danger that equity market pump-priming by the state translates into a permanent arrangement, with private investors happy to leave the onus and challenge of early-stage investing to the government. Legal (statutory) rules to prevent the government from becoming a cornerstone investor partly address this concern.
- Governments with a strong commitment to economic growth via R&D investment, facilitating greater enterprise and innovation activity, are faced with a direct choice. They must find a means to ensure that early-stage venture capital (VC) finance remains available to high-potential, young firms or risk a reduction in the new commercialisation opportunities stemming from national investments in science and technology.

The important public policy question is whether or not constrained businesses are of poor quality, and hence too risky to invest

in, or whether they are constrained for non-quality-based reasons such as lack of assets to place as security or lack of a sufficiently long track record. The former implies no role for public policy and is simply an indicator of the market operating efficiently and sorting out the 'good' from 'bad' propositions. The latter implies unfair rationing and a case can be made for public policy intervention to correct for a market failure.

The most widely used, and long-standing, public policy mechanism worldwide for supporting small firms is the (partial) credit guarantee scheme. Well-established examples of these schemes include the SBA 7(a) loan program in the United States (discussed further below) founded in 1953, the Canadian core guarantee program (CSBFP) founded in 1961, and the United Kingdom's Small Firm Loan Guarantee program, founded in 1981. A World Bank guarantee scheme survey by Beck, Klapper and Mendoza¹⁸³ identified loan guarantee programs in a total of 46 different countries across the world, including France, Germany, Sweden, India, Korea, Indonesia and Macedonia. In this regard, we note with interest that Australia is unique in the developed world in that it has no credit guarantee scheme in place.

Critical indicators of the need for credit guarantee programs

Having considered why credit may be rationed among smaller firms, and which firms are most likely to face severe problems in accessing debt finance from conventional sources, we now outline the critical indicators that policy-makers in Australia might consider when assessing the specific need for policy intervention in the form of credit guarantee type programs. These include:

- a highly concentrated banking sector (few large banks)¹⁸⁴
- fewer dense local branch networks and a general lack of relationship banking
- low levels of housing or general (tangible) asset ownership
- most commercial loans require assets to be placed as security
- falling or stable asset values
- a diverse entrepreneurial and latent entrepreneur population (poor as well as rich potential entrepreneurs)
- access to loans is conditional on criteria not related to the quality of the entrepreneur or their investment proposal (e.g. collateral availability)

- the spread of interest rates on bank loans between large companies and SMEs is broad (around 2% in Australia, compared with a world median of 0.96%)¹⁸⁵ indicating rationing is favoured over risk-adjusted lending
- there is substantial diversity in the relative quality of lending institutions.

The case for an Australian credit guarantee scheme

The evidence is broadly supportive of the use of financial engineering instruments to correct for (the lack of) collateral issues in debt markets and, to a lesser degree, lack of a track record. Credit guarantee schemes have the advantage of being simple to design and administer, and typically require that investment appraisal is conducted on a commercial basis, thus minimising deadweight. Instruments of this type are most effective when the entrepreneurial population is more widely distributed than wealth throughout the general population. This gives credit guarantee schemes the potential to have disproportionately high and positive effects in countries and regions where:

- (a) collateral-based lending is the norm
- (b) a significant proportion of the entrepreneurial population is not asset-rich.

As a tool for promoting local economic development, credit guarantee schemes have been shown to be relatively successful as a means of public policy intervention.¹⁸⁶

To a degree, the evidence in the academic literature reports that the high costs of debt, low interest margins and cautious lending are all consistent with credit rationing theories limiting the flow of loans to entrepreneurs. That is, margins imply relatively low-risk lending and a backward-bending loan supply curve, while riskier loans are choked off as they would attract a higher interest rate margin and raise the default rate above the banks' expected profit maximising level.

Models of credit guarantee schemes

The OECD discussion paper cited above also identifies four types of CGS¹⁸⁷:

- 1. Public guarantee schemes:** where governments bodies assume part of the risk. Due to the involvement of public funds, this is the safest scheme for commercial lenders.
- 2. Corporate guarantee schemes:** where, typically, banks create guarantee schemes which charge borrowers a premium of 1-2%

of loan value to provide the guarantee. The banks creating the schemes have experience in credit provision and these schemes tend to be successful.

- 3. International schemes:** created and managed by bilateral or multilateral government or NGO initiatives (e.g. the ILO, UNIDO or the European Investment Fund). One benefit of these schemes is that, as well as providing the guarantee, they also provide technical expertise.
- 4. Mutual guarantee schemes:** where borrowers from an association, typically based on similar types of firms, fund guarantees by pooling membership subscriptions with or without government support. Members provide support to each other and use peer pressure to minimise the number of defaults.

Examples of how some of the above four models have been applied in offshore jurisdictions

United States

Many of the more prominent loan assistance schemes for small business are administered by the US Small Business Administration (SBA). Loans are made available to small businesses that are not able to readily secure finance through normal lending channels such as banks, building societies and other mutuals (e.g. credit unions and other customer-owned institutions).

The SBA, as an institution, has no funds of its own and thus does not actually lend any money, but instead provides guarantees to private lender providers, such as banks, for a portion of the loan. For instance, the 7(a) Loan Guaranty (Guarantee) Program can offer loans of up to US\$2 million accompanied by an SBA guarantee of up to 50% of the loan. In effect, the "SBA reduces risk for lenders and makes it easier for them to access capital. That makes it easier for small businesses to get loans"¹⁸⁸.

The SBA also sponsors Certified Development Company (CDC) 504 Code loans of up to US\$5.5 million, tailored specifically for the capital needs of growth businesses. The loans are primarily for the purchase of non-current assets (fixed assets such as real estate, building and machinery) with long-term fixed rates of interest which are lower than market rates.

As would be expected, a host of strict criteria applies to these loans, particularly in terms of the timing and use of funds. For example, assuming a business first qualifies within the definition of a small business,

¹⁸³ Beck, Klapper and Mendoza (2008).

¹⁸⁴ Institute of Public Accountants (2018).

¹⁸⁵ OECD (2018).

¹⁸⁶ OECD (2009); Cowling (2007); Arping, Morrison and Lóránth (2008); Boocock and Shariff (2005); Bennett, Doran and Billington (2005); Levitsky (1997a); Levitsky (1997b); Roper (2009); Wilcox and Yasuda (2008).

¹⁸⁷ OECD (2009); Cowling (2007); Arping, Morrison and Lóránth (2008); Boocock and Shariff (2005); Bennett, Doran and Billington (2005); Levitsky (1997a); Levitsky (1997b); Roper (2009); Wilcox and Yasuda (2008).

¹⁸⁸ US Small Business Administration (nd).

the owner needs to use at least 51% of the property acquired for its own business operations within one year of the receipt of loan monies.¹⁸⁹

The way these loans operate is normally to have three parties to the loan – i.e. the small business owner, a private lender, and a CDC company set up under the US504 Code as a not-for-profit entity for the purpose of promoting economic growth in local areas. The small business owner is required to contribute at least 10% of the loan value, the private lender (usually a qualifying bank or regulated lender) will typically provide 50%, with the 40% balance to be provided by the CDC. The funds provided by the private lender are made available through the issue of monthly bonds which are 100% guaranteed by the US Government. The private provider is also protected via a primary lien over the assets and has priority in an insolvency distribution should there be a default on the loan. The CDC has a secondary lien over the assets.

Many other 'government-backed' loan schemes are offered via the SBA as well as other government measures used to promote small business. Some examples are briefly discussed below:

- **The Microloan Program** – loans of up to US\$35,000 offered to qualifying start-up, newly-created and growing business. The loans are provided by non-for-profit community-based lenders.
- **Disaster Recovery Loans to Small Business Owners** – available to business owners who have experienced loss and are victims of a disaster. These loans can relate to a specific disaster event (such as a hurricane, flooding, fire, earthquake etc) or a specific local area impacted by the disaster.
- **Set-aside programs** – Government contracting initiatives for small business.

Similar to Australian government initiatives, the US federal government sets aside a certain percentage of government contracts to be awarded to small business and, for some years, has maintained a target of 23% of all government contracts. These initiatives are not only working to support small business but, on a wider level, promote contractual fairness in government procurement.¹⁹⁰

The way the program generally works is that the government sets aside a percentage of contracts within certain bands (by contract value) and awards

contracts to special and small business groups within each of the bands. In essence, a set-aside is based on the value of goods and services procured by government during any particular year, and the US federal government purchases around US\$400 billion in goods and services from the private sector.¹⁹¹

The following are typical of current offerings:

- **Contracts between US\$3,500 and US\$150,000**
 - Providing that at least two companies are able to undertake the work (note there are eligibility criteria based on performance capacity and definition of micro/small business), these contracts must be exclusively set aside for small business.
- **Contracts above US\$150,000 and up to US\$700,000**
 - The same rules apply as for contracts between US\$3,500 and US\$150,000, providing there is a sufficient number of responsible small business enterprises capable of undertaking the work (i.e. more than two companies) and that the businesses are competitive in terms of market price, quality and delivery.
- **Contracts above US\$700,000 or construction contracts in excess of US\$1.5m**
 - Contracts that are awarded to companies other than small business, must include sub-contracting plans specifically for small businesses and for special groups as listed within the 'prime contract goals' requirements (discussed below).
- **'Prime contract' goals for special groups**
 - As part of the US government's initiatives to support small business in procurement contracts, there are also specifically-targeted sub-groups that form part of the overall policy:
 - Small disadvantaged businesses – controlled by African Americans, Hispanic Americans, Asian-Pacific Americans, Subcontinent Asian Americans and Native (5% target)
 - Women-owned small businesses (5% target)
 - Service-disabled veteran-owned small businesses (3% target)
 - HUBZone program – small start-ups in designated high-unemployment/low-income areas (3% target).

¹⁸⁹ US Small Business Administration (nd).

¹⁹⁰ US Small Business Administration (nd).

¹⁹¹ US Small Business Administration (nd).



Other countries

We note that, while recent data is not always available on the application of credit guarantee schemes in some countries or, indeed, the success (or otherwise) of such schemes in promoting the SME community and growth in GDP generally, it is nonetheless useful to track their history and the manner in which they have been adopted in specific countries.

Korea

The Korean Technology Credit Guarantee Fund (KOTEC), a not-for-profit institution established in 1989, has provided a total US\$99.7 billion in guarantees to technology-based SMEs with strong growth potential. Apart from credit guarantees, KOTEC also provides a number of support functions to SMEs, including technology appraisals, product advisory services and range of support services (e.g. assistance with company restructuring and technology transfer, financial and legal advice, and business/strategic planning).¹⁹² Roper (2009) and Kang and Heshmati (2008), as cited in OECD, report that KOTEC has had a positive effect on growth for SMEs, and has contributed to "a high survival probability of loans"¹⁹³. Despite this success, however, more recent studies have shown that the 4% default rate applicable to KOTEC credit guarantee loans is relatively high by international standards.

In 2002, the KOTEC fund changed its name to Korea Technology Finance Corporation (KIBO) following the revision of the fund's original founding Act, which was fully revised and newly titled "Korea Technology Finance Corporation Act".¹⁹⁴ KIBO is responsible for operating the loan guarantee scheme specifically for high-risk and high-tech SMEs which are often too risky for normal bank loans.¹⁹⁵ The fund is mainly funded by fees paid by financial institutions for the guarantee service and from guarantee fees paid by companies seeking loans.

The outstanding government-guaranteed loans have increased from KRW 60.9 trillion in 2015 to KRW 62.6 trillion in 2016. These loans were backed by two nationwide funds. Direct loans were used to remedy market failures and enhance the competitiveness of SMEs and these loans have increased from KRW 3.9 trillion in 2015 to KRW 4.5 trillion in 2016. The Korean government has recently looked for alternative cost-effective ways to support SME lending and has planned on improving the policy-based financial system to facilitate innovative SMEs (OECD 2018).

Canada

The Canadian Small Business Financing Program (CSBF) – essentially a credit guarantee scheme – was established in 1961 and (as at 2009) guaranteed around 10,000 CSBF loans each year estimated to be worth more than C\$1 billion. All loans are provided by private lenders (mainly banks). Past research has shown that 66,000 additional jobs were created in 1995 as a direct result of the CSBF scheme.¹⁹⁶

Nitani and Riding investigated the loans guaranteed under the CSBF disbursed between 1 April 1989 and 31 March 2011.¹⁹⁷ They found that small firms are more likely to default than larger firms and young firms are more likely to default than older firms. They also reported that the costs to taxpayers of honouring defaults is more than compensated from incremental tax revenues and the fees paid by borrowers. The program also supported substantial job creation.

Chile

The state-backed Partial Credit Guarantee Scheme for SMEs in Chile is provided by two institutions – Banco Estado, the state-owned bank, and CORFO (Corporación del Fomento de la Producción), a governmental institution bank.

Banco Estado runs the Small Business Guarantee Fund (FOGAPE or Fondo de Garantía para Pequeños Empresarios), which provides guarantee rights to financial intermediaries through an auction process. The rights are assigned to the bid with the lowest coverage rate. The number of FOGAPE-guaranteed loans increased from 24,374 in 2007 to 78,869 in 2010. However, the number has continually dropped every year since 2010 to 44,504 in 2015. The amount of coverage also peaked in 2010, with approximately CLP 896 billion, and decreased to CLP 523 billion in 2015, then slightly increased to CLP 536 billion in 2016.¹⁹⁸

CORFO also operates various credit guarantee programs, including FOGAIN, COBEX Pro-Inversión. These schemes provide funding for working capital and investments as well as credit coverage for foreign trade credit operations and operations relating to credit, factoring or leasing. CORFU also runs the Mutual Guarantee Societies Schemes (IGR) program, which provides funding to the reciprocal guarantee societies, which in turn provide guarantees to SMEs. During 2015, CORFO provided US\$2 billion worth of credit for 66,038 credit guarantee coverage, of which over 85% were granted to SMEs.¹⁹⁹ In 2016, it provided 67,429

¹⁹² Roper (2009); Kang and Heshmati (2008).

¹⁹³ Kang and Heshmati (2008).

¹⁹⁴ Cusmano (2018).

¹⁹⁵ Ha (2016).

¹⁹⁶ Riding and Haines (2001).

¹⁹⁷ Nitani and Riding (2014).

¹⁹⁸ OECD (2018).

¹⁹⁹ OECD (2017).

government-backed guarantees with a 2.3% rise from 2015 to 2016²⁰⁰. The evolution of government-backed guarantees in Chile is presented in **Figure 6**.

Larrain and Quiroz investigated the impact of the fund by examining 700 borrowers who received a FOGAPE guarantee.²⁰¹ They reported that the scheme appeared to have contributed to an increase in the credit amount by 40% and FOGAPE's clients are 14% more likely to obtain a loan than non-clients. Although Alvarez, Belmar and Opazo also found that the credit guarantees improved access to banking debt for SMEs, no evidence showed that this access to a loan improved investment, sales and employment.²⁰²

Slovenia

The number of small businesses in Slovenia had increased by more than 500% over the period between 1990 and 1996.²⁰³ The rapid development of the small business sector in 1990s prompted the government of Slovenia to establish the Small Business Development Fund (SBDF) in 1992 to promote the establishment and development of small business units. The fund guarantees both long-term and short-term loans, in collaboration with banks.

All forms of support were provided on the basis of a public invitation to tender,

in which the board of directors, consisting of both chambers and government representatives, made the decisions on the applications that were pre-approved by a bank. The priority criteria of appraisal included increasing employment, encouraging small business competitiveness, promoting the establishment and development of advanced technologies, innovation and environment-friendly practices in small businesses.

Initially, the SBDF was funded by the state budget with very limited funding. However, due to a number of failing small businesses, the funding began to run out by 1995 and the government stepped in to provide additional funds.²⁰⁴ After 1995, the SBDF's financial support was no longer provided directly to the businesses but in collaboration with the banks. While the fund issued guarantees for the loans, the banks took over the credit assessment responsibility and assumed all the risk.²⁰⁵ This practice allowed good credit-standing businesses to access soft loans while start-ups were excluded due to their riskiness.

As the SBDF's and the banks' objectives were not aligned, the SBDF in 1998 began to offer 'soft loans', aiming specifically at start-up businesses. Initially, only a small fraction of the offered loan amount was taken up by the businesses because the targeted

200 OECD (2018).

201 Larrain and Quiroz (2006).

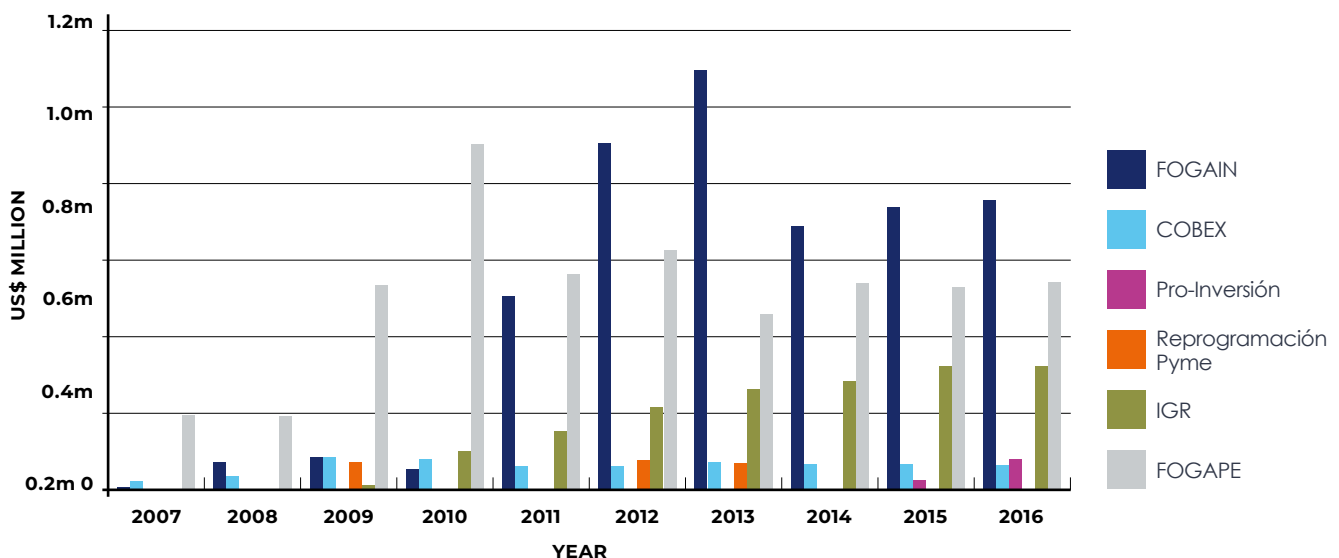
202 Alvarez, Belmar and Opazo (2015)

203 Krec (1995).

204 Glas and Drnovsek (2000).

205 Bartlett, Bateman and Vehovec (2002).

Figure 6: Evolution of government-backed guarantees in Chile, amount of coverage, CLP million (Stock)



Source: OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris. <http://dx.doi.org/10.1787/fin_sme_ent-2018-en>. Accessed 26 May 2018.

group (start-ups and craftsmen) were unable to fulfil the banks' requirement of securing the loans with matched collateral values.²⁰⁶ In 2000, the SBDF introduced a new tender procedure directly to the target businesses, with the guarantees provided by the municipalities.²⁰⁷

Slovenia's government also provided Regional Guarantee Funds (RGF) that operated through regional business centres. These funds pooled local resources from municipalities, state and private funds (through admission and membership fees) and set the guarantee portfolio regionally.²⁰⁸ Half of the guarantee (80% for start-ups) was usually provided by the guarantee fund and the rest is worked out with the bank.²⁰⁹ At the end of the 1990s, the fund provided a 50% guarantee of credit for amounts between US\$6,000 to US\$60,000 with interest rates of around 6%.²¹⁰

As can be seen in **Figure 7**, during the period 2007-2016, government loan guarantees in Slovenia fluctuated considerably. The available amount was €3 million in 2007 and increased to around €1 billion in 2013, before decreasing to €552 million in 2014, down to zero in 2015 and bounced back to €520 million in 2016.²¹¹

Italy

Modern mutual guarantee institutions (MGIs) or schemes (MGSs) appeared in Europe in the 1940s and have since grown in both size and number.²¹² The first Italian collective guarantee of credit, Confidi, was founded in Rome in late 1950s. During those years, the central bank enforced the monetary restrictions, with credit selection based on a high-collateral security in proportion to the loan size. These restrictions hence encouraged the multiplication of collective loan-guarantee schemes.²¹³ Confidi has gradually spread from central Italy to northern Italy and now exists throughout the country.

The membership structure is based on the principle of equality, in which each member has one vote, regardless of its size,²¹⁴ and the credit risk is based on sharing the business risk between various members of the Confidi who constitute its guaranteed funds. As the loan is arranged through the bank, the overall business risk is thus redistributed among business owners, the collective guarantee fund and the bank, depending on their agreements.²¹⁵

The success of Confidi depended on not only good relationships and partnerships between the collective-guarantee organisations and the banking system, but

also the structure of the Confidi, which had high-quality technical management, focusing on risk sharing and strengthening of SMEs.²¹⁶ The establishment of mutualistic guarantee funds and the greater contractual power generated by the joint liability of small entrepreneurs also helped bridge the gap between SMEs and credit institutions in the credit-granting process.²¹⁷

The government has continued to facilitate SME financing via the Central Guarantee Fund (CGF). The 'counter guarantee' and 'joint guarantee' can be requested by banks, financial institutions, Confidi and other guarantee funds.²¹⁸ In 2016, the CGF provided €11.6 billion in guarantees for just under €17 billion worth of loans.²¹⁹

Portugal

The two main guarantee mechanisms in Portugal are mutual guarantee and counter-guarantee schemes. Mutual guarantee systems first emerged in Portugal in 1992, due to a public initiative by the 'Institute to Support Small and Medium Enterprises and Innovation' (IAPMEI).²²⁰ The mutual scheme is presented under the private Mutual Guarantee Societies (MGS), which are financial institutions supervised by the central bank, operating under specific regulations and laws, including Basel II and III regulations on capital and provisions requirements.²²¹

The MGS issue the guarantees and have the following characteristics²²²:

- The MGS share capital is majority-held by the beneficiary SME (>50%), banks, SME organisations and SPGM. Thus, they are mutual and private credit institutions.
- Their scope is to support access to finance by micro businesses and SMEs. The MGS provide, on first demand, financial guarantees aimed at helping SMEs to access credit on reasonable price and other terms and conditions.
- The MGS get a partial counter guarantee from the national Counter Guarantee Fund (FCGM).
- They assume their own risk analysis activities and credit decisions.
- The price of the guarantees is set according to the risk appraisal results (internal rating model), inside the global boundaries defined at MGS board level (currently minimum fee of 0.5% and maximum of 4.5% per annum on the outstanding amounts).
- They are subject to internal and external auditors.

²⁰⁶ Bartlett, Bateman and Vehovec (2002).

²⁰⁷ Podvršnik, L. (2000), Financial support of Small Business Development Fund of Slovenia, paper presented at the International Conference on 'Financing of small and medium enterprises', Bled, Slovenia, October 10-13, 2000, p 60, cited in Bartlett, Bateman and Vehovec (2002).

²⁰⁸ OECD (2000).

²⁰⁹ Bartlett, Bateman and Vehovec (2002).

²¹⁰ OECD (2009).

²¹¹ OECD (2018).

²¹² De Gobbi (2002).

²¹³ OECD (2014).

²¹⁴ De Gobbi (2002).

²¹⁵ OECD (2014).

²¹⁶ De Gobbi (2002).

²¹⁷ Leone and Vento (2012).

²¹⁸ OECD (2012).

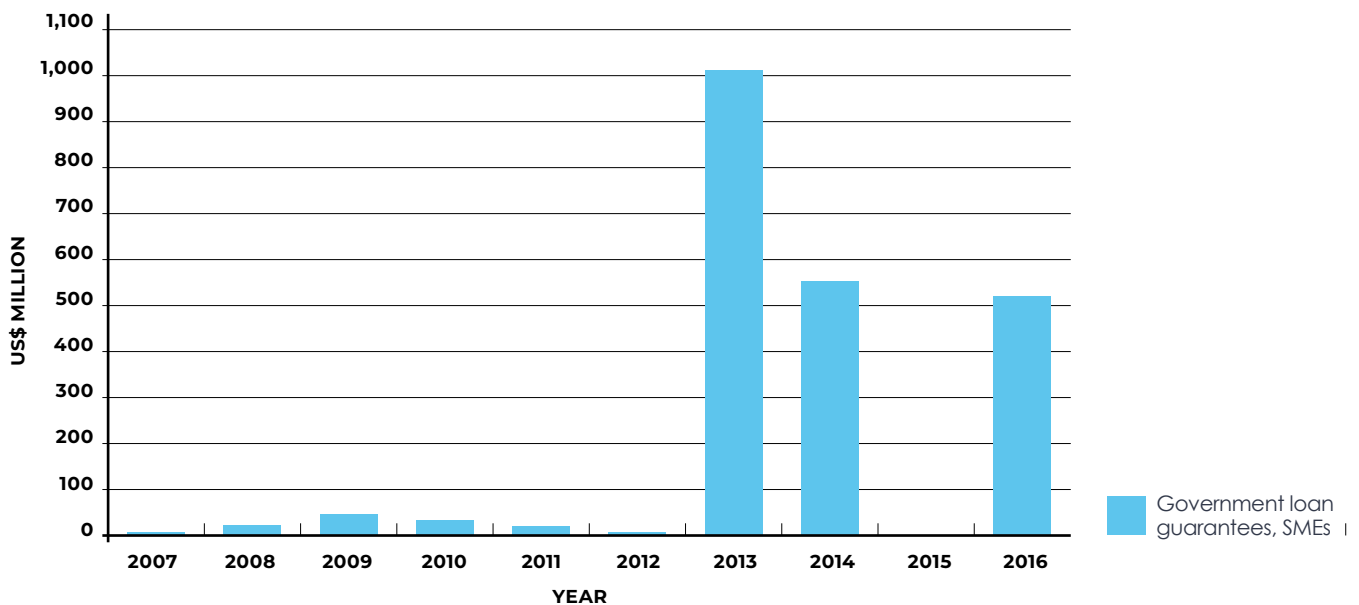
²¹⁹ OECD (2018).

²²⁰ Gama and Duarte (2017).

²²¹ Karafolas and Woźniak (2014).

²²² This list is quoted from Branca (2013).

Figure 7:
Government loan guarantees to SMEs, 2007-16 (annual, in € million)



Source: OECD (2018), *Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/fin_sme_ent-2018-en>. Accessed 26 May 2018.

The counter-guarantee mechanism is presented by the Fundo de Contragarantia Mútuo (FCGM) and was created in association with the European Investment Fund (EIF) in 1998.²²³ This fund is managed by SPGM (Portuguese Society of Mutual Guarantees) and provides automatic coverage from 50% to 90% to all guarantees issued by the private MGS.²²⁴ “By law, the fund must reinsure all guarantees provided by mutual guarantee companies and the fund itself benefits from risk coverage provided by the European Investment Fund (EIF) on guarantees of bank loans lasting over three years granted to companies with less than 100 employees”.²²⁵

The Counter-guarantee Fund (FCGM) automatically covers a part of the risk assumed by the MGS and has the following characteristics²²⁶:

- It has no direct contact with either SME or banks
- Its own funds are fully owned by the government
- It doesn't carry any kind of risk analysis on individual files as counter-guarantees are, by law, automatic and compulsory
- The counter-guarantee levels go from 50% to 80% of the guarantees issued by the MGS, depending on the type of product

- The fund is managed by SPGM
- The fund is audited by an internal auditor, which is actually the external audit body of the central bank. It is submitted to specific auditing by tax authorities and the Court of Auditors, namely in specific programs supported by EU structural funds and/or national budget endowments and/or under a third-level partial coverage of the EIF/EU programs.

The Portuguese Society of Mutual Guarantees (SPGM), established in 1994, is the oldest entity within the Portuguese Mutual Guarantee Scheme. Initially, SPGM's role was to operate as an MGS aiming to create and develop a mutual guarantee scheme to facilitate and improve SME access to finance. Nowadays, its main role is the management of the Counter Guarantee Fund, a financial entity which covers part of the risk taken by the Mutual Guarantee Societies.²²⁷

SPGM also acts as a 'holding' entity of the Portuguese Guarantee Scheme and has the following characteristics:²²⁸

- It manages the Counter Guarantee Fund
- It acts as shared services centre for both the fund and all MGS

²²³ OECD (2009).

²²⁴ Karafolas and Woźniak (2014).

²²⁵ OECD (2009).

²²⁶ This list is quoted from Branca (2013).

²²⁷ European Investment Fund (2013).

²²⁸ This list is quoted from Branca (2013).



- It represents the public interests while designing and negotiating new credit lines or other guarantee facilities;
- It negotiates with national agencies (such as IAPMEI, Tourism Agency, Ministry of Higher Education) and international organisations (EIF and EIB) about new credit facilities to Portuguese SMEs
- It institutionally represents the guarantee scheme at internal organisations
- It represents the Portuguese Guarantee Scheme internationally, namely at international organisations, such as the European Association of Guarantee Societies (AECM) and the Ibero-American Guarantee Network (REGAR).

Gama and Duarte investigated the Portuguese mutual guarantee schemes (MGS) in response to the recent financial crisis and the impact of MGS in loan pricing and on the ex post performance of borrowers.²²⁹ They reported that the MGS improved loan activity and privileged less risky borrowers (with mutual guarantees and collateral) by reducing the costs of borrowing and improving the ex post default rate. They further stated that, although credit guarantee systems are important for providing additional funds to support SMEs, they had less relevance for credit assessment and collateral remained virtually compulsory for SMEs in obtaining a loan.

Malaysia

The World Bank²³⁰ has heralded Malaysia as an ideal model of a successful credit guarantee scheme, having experienced what works and what doesn't work over a 45-year period, particularly in terms of defaults and the impact on the banking system, as well impact in terms of both financial additionality and economic additionality.

Notwithstanding, an in-depth study of this scheme in its earlier years by Boocock and Shariff²³¹ showed that, while there were a number of positive outcomes in respect to economic additionality "baseline financial additionality is below average, there have been high rates of default and the lenders have borne a substantial portion of the losses incurred". Moreover, the authors argued that "the lenders would surely support Meyer and Nagarajan (1997) in their contention that: '... the burden of proof that this type of intervention into financial markets is cost effective and sustainable clearly rests on the shoulders

of its advocates. So far, they have not made the case'."²³²

Despite these perhaps somewhat harsh findings, particularly in the context of the study's limitations, the authors have rightly suggested that their results would greatly assist policy makers, especially in the design of future credit guarantee schemes. Indeed, the lessons that have been learned have seen the Malaysian Credit Guarantee Scheme move from strength to strength, so much so that the scheme has now been showcased by the OECD as a model for other developing countries (such as, for example, South Africa, which is using the Malaysian model to address some of the issues with its existing credit guarantee schemes.

Designing a credit guarantee scheme

One of the key success factors of credit guarantee programs throughout the world is the simplicity of their basic parameters and the general level of flexibility that these parameters allow policy-makers to reshape or refocus programs. The fact that commercial banks conduct due diligence (in most but not all cases) effectively transfers some of the downside risk back to banks, although the government clearly bears most of the default risk. Important in the Australian context is that banks might become more willing to expand the supply of loans significantly when a large share of the outstanding loan is guaranteed and the pool of loans still does not suffer from excessively high default rates.

The core parameters of a loan guarantee program are:

- the level of guarantee (the percentage share of the outstanding debt that is covered by government in the event of default)
- the interest rate premium (the margin that the government receives for guaranteeing the loan)
- the maximum (and in some cases minimum) loan amount available
- the maximum (and in some cases minimum) loan term available
- the arrangement fee.

Importantly, these parameters are easily understood by most people who have ever taken out a personal or business loan and/or insurance. So credit guarantee schemes benefit from being simple to

²²⁹ Gama and Duarte (2017).

²³⁰ Bell, Mawadza and Mavundla (2017).

²³¹ Boocock and Shariff (2005).

²³² Meyer and Nagarajan (1997).

create and operationalise and also from being widely understood by all actors in the debt market. This helps avoid the problem of many complex government programs which are only understood and accessed by those with a high level of awareness, skills, knowledge and resources to clear all the necessary hurdles and deal with the complexities of application. This is generally why smaller firms do not bid for government contracts and why, in many cases, 'scheme deadweight' (i.e. lack of additionality or further spinoffs for the economy) can often be high.

As a guideline, the typical range across these core parameters for established credit guarantee schemes are as follows:

- **Guarantee:** 65% to 85%
- **Interest rate premium:** 0.5% to 2.5%
- **Loan size:** minimum A\$8,000, maximum A\$500,000
- **Loan term:** 1 to 10 years
- **Arrangement fee:** 0.25% to 3.0% of the total loan value.

We conclude that there is a case for the design and implementation of a credit guarantee program in Australia to correct for the specific problems of smaller firms being unable to finance new investment opportunities through normal commercial bank channels on affordable and 'reasonable' terms. But the specific scale of potential program demand needs to be established in a detailed feasibility study, as this determines the scale of the initial and ongoing demands on the government.

Further, more detail is required on (a) the specific characteristics of credit-rationed smaller firms in Australia, (b) the specific characteristics of smaller firms capable of generating the highest value-added when unconstrained by debt markets, and (c) the scale of unmet loan demand. This would then help determine the actual values of the key program parameters (level of guarantee, interest rate premium, loan term, and loan size).

IPA-Deakin SME Research Centre recommendation

To help increase the availability of much-needed, affordable loan finance to the small business sector, the federal government should introduce a state-backed credit guarantee scheme as a matter of urgency.

Australia is one of the only countries in the developed world without such a scheme.

Such a scheme would provide a limited state-backed guarantee to encourage banks and other commercial lenders to increase loan finance availability to small businesses. For further detail, we refer to WP1, which identifies a number of specific problems that smaller firms have in accessing finance from commercial banks, particularly smaller and younger start-up firms. Our evidence suggests that, by international standards, the cost of debt for Australian small businesses is high and risk-adjusted lending is not the norm in Australia. There is hence, a strong case for designing and implementing a credit guarantee program in Australia to help remedy the specific problems of smaller and younger start-up firms being unable to finance new investment opportunities through normal commercial channels.

When appropriately designed and administered, credit guarantee programs can deliver value for taxpayers through their support of employment growth, productivity, innovation and exporting.

Recommendations

- The federal government must review its current policy settings for SME finance to ensure it is following world's best practice, as specified by the G20 and OECD.
- Given the importance of SMEs as significant contributors to (and drivers) of GDP, the federal government should provide appropriate incentives that encourage financial institutions to urgently re-examine their finance offerings for SMEs. These should include the provision of varying options allowing SMEs access to funding for starting up a business and for working capital. While the primary role of financial institutions is to generate returns for shareholders, given that there is significant industry concentration in the banking industry in Australia, banks have a dominant role in financial markets impacting all businesses. Accordingly, the IPA-Deakin SME Research Centre is of the view that banks and similar institutions have wider obligations towards ensuring the financial health of the business community.
- Loan guarantee schemes must urgently be initiated for Australia to be in step with similar initiatives in offshore jurisdictions.
- Vocational education courses must receive priority funding from the federal government to enhance SME owners' financial literacy. The IPA-Deakin SME Research Centre also supports practical education in areas encompassing business strategy and management, which should also form part of the educational offerings.
- Incentives for further financial literacy and SME business management education, such as tax deductibility for educational costs, should be offered to SME owners via the tax system. Registered Training Organisations (RTOs) could partake in government incentives and play a more active role in encouraging SME operators to improve their knowledge in business management and finance.
- The federal government should seek to fund research initiatives to support the work of the OECD in developing a generally-accepted definition of SMEs.
- The federal government should support initiatives for the introduction of a new bank that services the specific financing needs of the SME sector.

Case study: Quickstep and the NSW and federal governments

Quickstep Holdings Limited ('Quickstep') is an Australian publicly-listed company at the forefront of advanced composites manufacturing and technology development.

Quickstep is currently the largest independent aerospace-grade advanced composite manufacturer in Australia, partnering with some of the world's largest defence and aerospace companies, including Lockheed Martin (USA), Northrop Grumman (USA), Boeing Defense (USA) and BAE Systems (UK), as well as Victorian-based Marand Precision Engineering.

Quickstep's advanced manufacturing headquarters are in Bankstown NSW. The company also has a global Research & Development (R&D) centre and a demonstrator-manufacturing facility within Deakin University's Waurin Ponds campus in Victoria. It currently employs 230 people, with 210 working at the Bankstown site. The majority of Quickstep's revenue is attributable to defence export sales, with its Bankstown operation 100%-export focused.

Quickstep is a major supplier to the global Joint Strike Fighter (JSF) F-35 program, manufacturing and supplying a range of centre fuselage and vertical tail composite parts for the F-35 aircraft. The company is also the global supplier of composite wing flaps for the C-130J transport aircraft program. It has long-term contracts in place for both major programs, which have required a significant investment in 'state of the art' capital and equipment to manufacture high-precision parts.

Quickstep recently completed a planned \$10 million capital expansion of the Bankstown facilities, taking the total investment made at the Bankstown site to over \$30 million since it officially opened in 2012.

Funding for this substantial investment in plant, equipment and people was achieved through a number of mechanisms involving capital raising via shareholders and new investors, and with the strong support of the NSW and federal governments and Quickstep's key customers.

Funding support

Quickstep was originally established as a R&D business in 2001 to develop advanced composite manufacturing process technologies. The company was, at the time, based in Western Australia (WA). It publicly listed on the Australian Stock Exchange in 2005.

Quickstep commenced its journey from WA to NSW in 2009, when it secured its first manufacturing contract for the supply of composite components to the JSF program.

The move from Coogee WA to Bankstown NSW was undertaken with assistance from the NSW Government, through funding support for the establishment of Quickstep's aerospace manufacturing facility in Bankstown. This funding helped Quickstep to move into vacant buildings that were previously the home of Boeing Australia, before that company consolidated all of its manufacturing in Port Melbourne, Victoria. The government funding supported Quickstep in the refurbishment of the vacated site, the purchase and commissioning of new manufacturing equipment and the recruitment and training of a new workforce.

This was a win-win situation for Quickstep and the NSW Government. Quickstep established a new advanced manufacturing facility to support its recently-secured export contracts and meaningful employment was founded for a number of ex-Boeing staff.

Quickstep now has a long, enduring relationship with the NSW Government and sees it as a key partner in the company's success and ongoing growth. The NSW government has also been a strong advocate for Quickstep within government circles and with existing and new customers, both domestically and internationally.

Getting established was, however, not the only issue for Quickstep. It was now a participant in the world's largest defence program, and thus needed to be able to fund the operational expenses related to supplying export parts for the JSF and



C-130J programs as well as needing to add further capital to support the future ramp-up of JSF volumes.

This is where the Australian Government came in with support, in the form of a multi-option finance facility through the Export Finance and Insurance Corporation (Efic). This included a performance bond facility for technology export contracts and an export working capital guarantee to support growth in the existing aerospace contracts.

The combined funding packages from the NSW and federal governments were instrumental in ensuring Quickstep's participation in both of the two defence export projects, allowing the company's transformation from an R&D organisation into one that can manufacture advanced composite parts and sell its technical capabilities to the world.

The package of work carried out by Quickstep within these two projects will sustain the 200+ new jobs created, and will enhance the company's reputation as an international manufacturer and distributor of advanced composites.

Lessons for SMEs

Collaborating and partnering with government can provide substantial benefits for SMEs in Australia, both from a funding perspective and in advocacy for your company across government and within industry. Both the state and federal governments have a number of initiatives and support programs designed to assist and grow Australian businesses. SMEs are well advised to seek these out.

Government initiatives available include support for:

- **business start-ups**
- **R&D**
- **commercialisation and growth**
- **international market access**
- **business improvement**
- **staff recruitment and training**
- **export market sales**

Government support and partnering come with obligations for SMEs, mainly centred on creating and sustaining meaningful jobs for Australians and delivering economic value to the community, both of which are good things for SMEs and Australia as a whole.

Chapter Four B

SME financial markets: the case for crowdfunding in Australia

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Tanewski: Deakin University

Professor Marc Cowling: Brighton University (UK)

The case for crowdfunding in Australia

In WP1, we provided a brief account of an emerging form of finance for SMEs now commonly known as crowdfunding. Government initiatives for the introduction of crowdfunding as a legal, permissible form of financing in Australia commenced in 2014/15 (public companies) and 2017 (proprietary companies). In response to these initiatives, the Institute of Public Accountants prepared and lodged two detailed submissions to government proposals issued in 2015 and 2017 respectively.²³³

Headline findings:

- Equity crowdfunding is one of the fastest-growing types of crowdfunding in many countries (particularly European countries, the United States and China).
- Australia has recently paved the way for equity crowdfunding by passing legislation for public companies, and by inviting comments for proposed legislation for private companies to be permitted to partake in equity crowdfunding activities. These measures put Australia in step with other jurisdictions that have, for some time, relied on crowdfunding as a primary source of SME financing.
- If experiences in the United Kingdom and the Americas can be taken as a guide, equity crowdfunding will rapidly develop into a major source of funding for the SME community in Australia.
- Crowdfunding has been acknowledged by many economies as a finance mechanism that circumvents traditional bank lending and, thus, has become instrumental in bridging the SME financing gap.
- There are still legal and practical issues to be addressed before legislation for proprietary companies is passed.
- Crowdfunding, as an industry, is emergent and remains hugely immature in many countries. There is, as yet, little consolidation of platforms and, while a number of crowdfunds will quickly develop, the industry is still characterised by a growth of new entrants, high levels of innovation and several experimental formats in offerings to investors.
- Trends relating to venture capital (VC) as a source of funding suggest a shift from funding seed capital to funding 'later stage' financing needs.

Given that equity-sourced funding has now officially commenced in Australia, as of 1 September 2017 for public companies, and that legislation is currently being drafted for proprietary companies, the IPA-Deakin SME Research Centre believes it is important to revisit this source of funding, which the IPA-Deakin SME Research Centre maintains will be an important measure for bridging the so-called financing gap for SMEs. Indeed it was pleasing to see that the new crowdfunding legislation got off to a good start, given that, at the time of writing, "Australia's first equity crowdfunding deal closed successfully".²³⁴

Revvies Energy Strips Limited, an SME at growth stage, was successful in raising almost \$300,000 via 239 investors. The capital raising was undertaken through OnMarket, one of the first equity crowdfunding intermediaries to be licenced in Australia. Co-founder of OnMarket, Ben Bucknell, commented: "We anticipate that there will significant interest in this space going forward, from both companies looking for capital, and investors looking for access to innovative, growing companies, just like Revvies".²³⁵

We start first by raising one caveat relating to the Centre's joint partner, the IPA and its initial submissions on crowdfunding prepared by the Centre. That is, with new legislation only just commencing, there is no substantive history of raising finance from these sources within the Australian jurisdiction (other than the example briefly cited above). Much of the research, therefore, has relied on crowdfunding mechanisms in offshore jurisdictions, particularly the United Kingdom, which in many respects has a broadly similar institutional environment to Australia.

We note also that we have extracted and expanded the more relevant components from both of the IPA submissions on crowdfunding and have included this work within this section, along with a number of recommendations to further expedite the passing of laws relating to proprietary company crowdfunding, which is perhaps more relevant to SMEs.

Background

The purpose of this chapter is to address contemporary issues related to the creation and maintenance of an efficient, effective regulatory environment for the promotion of a form of early-stage entrepreneurial finance termed 'crowdfunding' (CF). We will focus exclusively on equity crowdfunding (ECF, also termed 'crowd investing').

Investment-based crowdfunding is defined by the UK’s Financial Conduct Authority (FCA) as “people who invest directly or indirectly in new or established businesses by buying shares, debt securities or units in an unregulated investment scheme”²³⁶. Of the five main types of crowdfunding²³⁷, only equity and loan-based forms fall within the FCA’s regulatory remit. In a legislative sense, ECF, which exhibits a number of different structures and activities, is acknowledged to be legislatively more complex than other variants of CF²³⁸.

Equity crowdfunding is one of the fastest growing types of CF. In Europe, ECF had a compound annual growth rate of 50% between 2010 and 2012²³⁹. In the United Kingdom, ECF was the fastest growing category of CF with an average growth rate of 410% between 2012 and 2014 and a total £84 million raised for investment by ECF platforms in 2014. However, business debt (£749 million) and consumer debt crowdfunding (£547 million) in the UK currently dominate profit-based CF.²⁴⁰

It is important to government, legislators and policy makers worldwide that CF may augment and materially expand the financial resources available to start-ups and younger businesses,

thereby contributing to a supportive, proactive ‘entrepreneurial environment’. Crowdfunding is also seen as highly relevant for supporting the developing world²⁴¹.

Since the Global Financial Crisis in 2008, banks have increasingly restricted their supply of loans for small-and-medium enterprises (SMEs), although this has been in parallel with a reduction in the demand for loans. While this situation is improving in Europe, researchers believe that the supply of bank debt to SMEs will continue to remain constrained²⁴².

Equity and debt variants of CF are both seen as a means of improving the supply side of finance to smaller and younger businesses (the so-called ‘finance gap’). The Economist noted the present ‘treasure hunt’ by SMEs for new sources of finance while bank lending remains subdued. However, the article expressed a necessary note of realism when it observed that the total raised by CF in Europe in 2014 was €1.5 billion compared to new external funding to European SMEs of €926 billion in the same year²⁴³. Most of this latter sum is provided by banks. Nonetheless, ECF is seen as particularly relevant to innovative, technology-focused new enterprises²⁴⁴ which have greater problems in supporting loan servicing in their earlier years and thus

²³³ Institute of Public Accountants (2015); Institute of Public Accountants (2017).

²³⁴ Australian Fintech (2018).

²³⁵ Australian Fintech (2018).

²³⁶ Financial Conduct Authority (2014).

²³⁷ Donation-based; prepayment or rewards-based; exempt (Enterprise schemes or industrial and provident societies).

²³⁸ European Commission DG Communications Networks, Content and Technology (2014).

²³⁹ Wilson and Testoni (2014).

²⁴⁰ Zhang, Baeck, Ziegler, Bond and Garvey (2016).

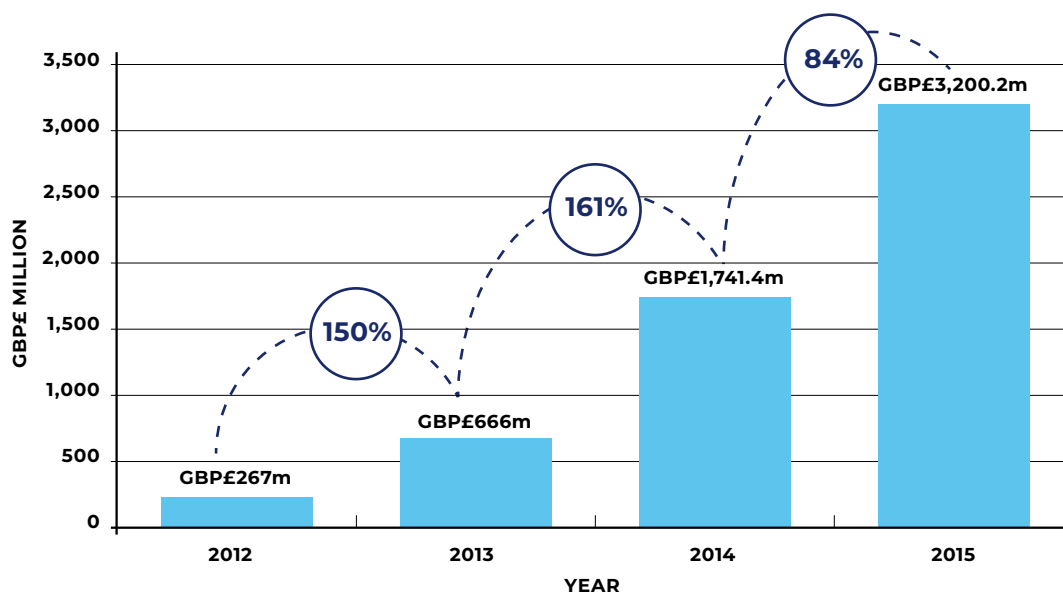
²⁴¹ World Bank (2013).

²⁴² Kraemer-Eis, Lang, and Gvetadze, (2015).

²⁴³ The Economist (2015).

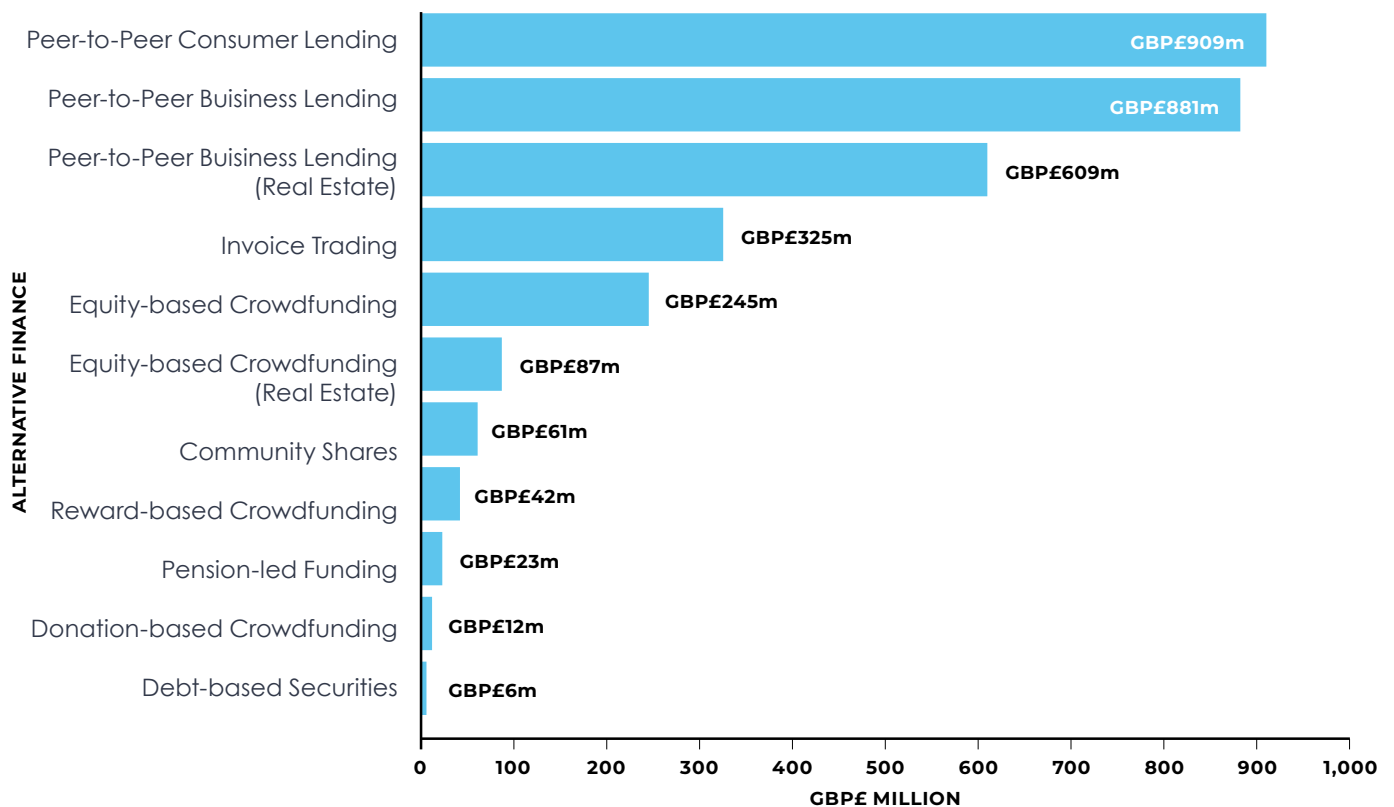
²⁴⁴ European Commission DG Communications Networks, Content and Technology (2014).

Figure 8:
Size of alternative finance in the United Kingdom



Source: Data sourced from Baeck, P, Collins, L and Zhang, B (2014), Understanding Alternative Finance: The UK Alternative Finance Report 2014, November 2014, NESTA, London, and Zhang, B, Baeck, P, Ziegler T, Bond J, and Garvey K (2016), Pushing Boundaries: The 2015 UK Alternative Finance Industry Report, February 2016, Cambridge Centre for Alternative Finance, NESTA, London.

Figure 9:
2015 market volume by alternative finance model in the United Kingdom



Source: Zhang, B, Baeck, P, Ziegler T, Bond J, and Garvey K (2016), Pushing Boundaries: The 2015 UK Alternative Finance Industry Report, February 2016, Cambridge Centre for Alternative Finance, NESTA, London.

usually need access to external sources of equity or risk capital to grow rapidly²⁴⁵.

Another caveat is necessary here.

Crowdfunding, as an industry, is emergent and remains hugely immature²⁴⁶. There is, as yet, little consolidation of platforms and, while a number of CF platforms have exited, the industry is still characterised by a growth of new entrants, high levels of innovation and several experimental formats in their offerings to investors. The fact that the 'platform' market is still in its infancy is a particular issue as many will exit the market and new entrants will arise. This creates uncertainty in the market for both investors and investees. Similarly the regulatory environment has been described as 'a patchwork of legal frameworks' with, as yet, little pan-European commonality or integration²⁴⁷.

Accordingly, industry and academic analyses remain tentative in an often 'over-hyped' environment fuelled by statistics of frequently dubious provenance and

authenticity. Industry data are best viewed as exploratory and speculative contributions, and should be treated with due caution.

Industry immaturity is also a compelling argument for tentative intervention by policy makers and regulatory authorities in this early period of high uncertainty as to the industry's future structure, conduct and performance.

Finance in the entrepreneurial ecosystem – the 'financial escalator'

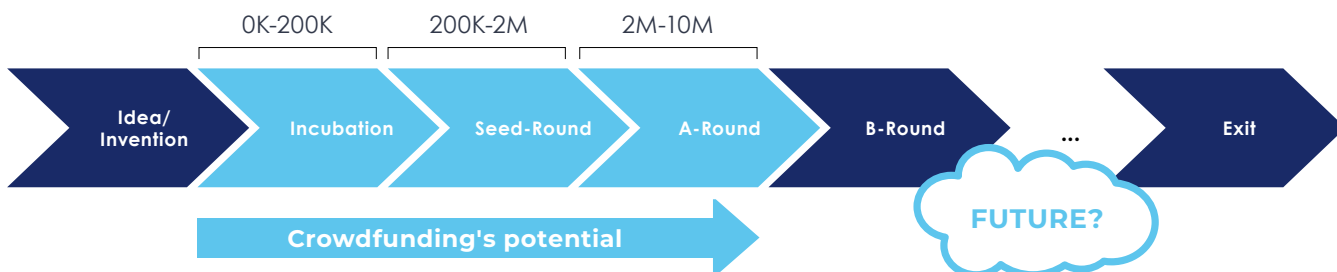
A considerable interest of government, in both its enterprise and innovation policy frameworks, is to create a series of complementary, interlinked sources of external finance available to young, potentially-attractive, growth-oriented firms after the founders have committed and exhausted their own funds (aka 'family and friends' finance). Such finance may include debt provision and will, at the earliest stages, concentrate on the equity or risk capital needed by the young firm.

²⁴⁵ Hall and Lerner (2009).

²⁴⁶ Crowdcube organised the first successful equity crowdfunding in the UK in 2011.

²⁴⁷ European Commission DG Communications Networks, Content and Technology (2014); European Securities and Markets Authority (2014).

Figure 10:
ECF's positioning in the financial escalator



Source: European Commission DG Communications Networks, Content and Technology (2014), Crowdfunding innovative ventures in Europe: The financial ecosystem and regulatory landscape. DG Communication Networks, Brussels, Content and Technology, p 6

Figure 11:
Inter-related funding activities of ECF actors



Source: European Commission DG Communications Networks, Content and Technology (2014), Crowdfunding innovative ventures in Europe: The financial ecosystem and regulatory landscape. DG Communication Networks, Brussels, Content and Technology, p 7.

This early-stage equity environment will include business angels (BA) and some venture capitalist (VC) providers. In an ideal world, such an environment will enable seamless 'follow-on' finance from a range of successive types of provider as the young firm grows, authenticates its commercial value, and requires more finance to realise its growth options. ECF providers, if classified by their ability to provide significant amounts of risk capital, are likely to sit between family and friends and BA individuals or syndicates, and well before the introduction of most VC finance.

Indeed, one of the key policy issues is exactly how and where CF fits into the wider enterprise finance ecosystem. In clarifying this question, it is important that

all parties interested in ECF also understand and learn from the relevant histories of VC and BA finance emergence in Western economies, particularly the USA and the UK.

Industry actors and their interests

There are three key interest groups in ECF, excluding government:

1. **The entrepreneurial enterprises or 'issuers' seeking external finance through issuing equity-type instruments to support both start-up and growth phases**
2. **Investors, including both private individuals and, increasingly, professional BA and VC entities**
3. **The intermediary ECF platforms facilitating the financial transaction.**

Each party is subject to a range of regulatory constraints (or exemptions), depending on the degree of sophistication of individual country legislative regimes. Freedom of action is also influenced by pan-European legislation in the European Union as well as state-based legislation in the USA. The activities of the three key actors and their relations to other risk capital providers have been summarised in two useful diagrams²⁴⁸ (Figure 10 and Figure 11).

For entrepreneurs, the attraction of ECF can stem from investors' improved access to appropriate information, allowing better matches, which can result in an improvement in supply and possibly a lowered cost of capital.

Entrepreneurs can also gain from more information or signals provided by interested investors, which may enable them to make better forecasts of present and future market demand, product improvements etc. These advantages come at the cost of the greater levels of firm disclosure. Applicants for ECF have to communicate publicly and make detailed disclosures, with little ability to control who receives this private intelligence. Such disclosure may encourage emulation from competitors and/or may imperil the security of the enterprise's key 'intellectual property rights'.

For investors, likewise, the widespread availability of information via digital communications can improve decision-making and can also reduce the advantage of geographic proximity to the new venture.²⁴⁹ Investors, particularly 'early adopters', may gain greater access to innovative product and service offerings mediated through specialist network communities. There is also evidence that there are further non-economic benefits of the preferential and voluntary participation of the crowd, as both users and co-owners, in an innovative and entrepreneurial community. However, these advantages each assume that the information is accurate, not overly optimistic, and that the entrepreneurs seeking external finance are competent, honest and not fraudulent. On occasions, each or all of these assumptions will not be met and investors will bear the ultimate cost.

Indeed, ECF in its early development produces a double information asymmetry. Traditional models of financial markets focus on the relative information asymmetry between the firm (investee) and the financier (investor). Generally, these models predict that the firm knows more about the distribution of potential outcomes (the

quality of the project) than the financier. But both equity and loan CF may give rise to a different type of market where asymmetric information exists but the asymmetry is apparent on both sides. The firm cannot make an accurate judgement on the quality of the investor (i.e. ability to provide further rounds of finance, sector skills or networks, commercial expertise etc). Likewise, the investor cannot make a good judgement on the quality and future prospects of the firm. The potential for 'mismatches' increases exponentially in this situation. That is, the investor is poorly informed as to the quality and prospects of the issuing company. By the same token, the issuer knows very little about the true worth of the investor beyond the initial payment received via the platform.

For platform managers, their income is primarily calculated as a percentage of the total value of successful fund raisings. Attracting more successful entrepreneurs and raising successively larger sums both contribute to their reputation as an intermediary, and to the potential for further business. In an emerging market with low barriers to entry, user recognition, media attention and market share are likely to be of far greater long-term value to platform managers than immediate profitability – as Amazon has powerfully demonstrated. Platforms seek, over time, to widen the coverage and, critically, to enhance their reputation among advisers, funders and entrepreneurs in their selected market(s). Specialisation of platforms beyond the basic classification of CF activity is still rudimentary but is starting to occur. Platform managers' greater experience and ability to abort slow and unsuccessful fund raisings early helps address problems of adverse selection.

However, the dominant performance metrics presently communicated by the CF industry is the number, value (and speed) of successful fund raisings. While these measures are also of direct interest to the entrepreneurs, for the investors they are merely a means to the final goal of the realisation of an attractive, risk-adjusted return on capital. By focusing only on 'money in', the success of ECF platforms is problematically measured on half of the 'objective function'. As the international VC industry learned painfully post 2000, total funds raised or 'funds under management' held by a VC's general partnership is not ultimately a credible, ex post investment performance measure²⁵⁰.

²⁴⁸ Wilson and Testoni (2014).

²⁴⁹ Agrawal, Catalini and Goldfarb (2011); Wiltbank (2009).

²⁵⁰ Fund raising by the VC industry collapsed worldwide after the technology bubble burst in Q1, 2000.



Table 9:
Characteristics of risk capital providers relevant to high-potential/high-growth enterprises

	Equity crowd funders	Business angels	Venture capitalists
Background	Many different backgrounds, many have no investment experience	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Seed and early stage	Range of seed, early-stage and later-stage but increasingly later-stage
Investment instruments	Common shares	Common shares (often due regulatory restrictions)	Preferred shares
Deal flow	Through web platform	Through social networks and/or angel groups/networks	Through social networks as well as proactive outreach
Due diligence	Conducted by individual, if at all, and sometimes by the platform	Conducted by angel investors based on their own experience	Conducted by stage in VC firm sometimes with the assistance of outside firms (law firms, etc.)
Geographic proximity of investments	Investments made online: most investors are quite distant from the venture	Most investments are local (within a few hours' drive)	Invest nationally and increasingly internationally with local partners
Post investment role	Depends on the individual investor, but most remain passive. Some platforms represent the interests of the crowd	Active, hands-on	Board seat, strategic
Return on investment and motivations for investment	Financial return important but not the only reason for investing	Financial return important but not the main reason for angel investing	Financial return critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

Source: Cited in The Institute of Public Accountants (2015), Crowd Funding – A policy response submission on crowd funding, July 2015, p 7.

Information and the regulator's central dilemma

Government regulators have to address one central question that presently dominates the many debates as to the influence and role of CF. This dilemma, while also affecting 'peer to peer lending' as the other and larger category of profit-related CF activity, is most starkly observed in the choice as to how and to what degree ECF is to be regulated. Not surprisingly US observers, with their frequent ambivalence to government intervention, articulate the two choices most emphatically:

'Government should recognise that CF is a game changing and disruptive positive phenomenon in the critical area of enterprise formation, financing and support. It should, accordingly, seek to ensure that artificial and bureaucratic barriers are not erected to impede the activities of CF actors. Investors are informed and can – and should – make their own commercial decisions without hindrance. Market evolution and innovation will eventually sort out inefficiencies at acceptable costs.'

The diametric view is that:

'CF and particularly ECF is an open license to abuse, cheat and defraud the investing public outside those few persons with appropriate professional/business skills and/or access to expert advice. In these circumstances, regulatory constraints have to be applied in order to protect all parties (particularly non-professional investors) and to ensure that the emerging CF industry remains honest and fit for purpose.'²⁵¹

The former position is most frequently espoused by interested commercial parties and particularly platform managers. It conforms to a strongly ideological view held by many entrepreneurs that the best course of action is to let markets discriminate and buyers should therefore beware. Government is seen as having little direct role given that intervention is seen to invariably produce excessive costs, restrictions in trade and other negative externalities. This essentially Darwinian view conflicts with a more interventionist regulatory view that public money-raising schemes operating without clear legal definitions and transparent practices are likely to be abused. Uninformed and gullible retail investors will be particularly vulnerable and the state has a responsibility to pre-empt such threats.

Of course, each position is essentially a parody and represents the pole opposites on a continuum. Such ideal types, if taken to extremes, would each incur costs that would endanger the future of the industry, be they from malfeasance or from the suffocating costs to a new industry of excessive regulatory burdens. The pragmatic question for regulators and policymakers is: where, along the continuum, regulation should engage to ensure optimal outcomes of ECF activity and investor protection.

Central to this ongoing debate is the role of information in the transaction. That is, the degree to which information asymmetries exist, the ability of actors to access and use (i.e. comprehend) the information needed, and how these market imperfections affect efficient industry behaviour. These questions essentially point to a key issue of what is the appropriate value of ECF as a financial component of the entrepreneurial ecosystem and how this value may be best realised.²⁵²

By its very nature, the financing of new or young, growing enterprises – particularly if they are addressing novel markets with innovative products and services – is fraught with Knightian²⁵³ risk and uncertainty.

Regardless of the nature of enterprise funding employed, the transaction will typically involve high levels of market risk, technology risk and/or managerial risk. Eurostat data shows that, by 2010, only 46% of business started five years before have survived. ECF is focused on early-stage enterprise – one of the most challenging marketplaces for finance. It is therefore sensible to use a meaningful benchmark of selection and governance to assess a platform's actions.

Here, observers most readily reference ECF to its more established peers of business angels and, perhaps most rigorously, venture capital finance. Such comparisons of the modes of investment selection and subsequent portfolio management tend to show ECF in a poor light compared to BA and VC investment activity. However, perhaps this comparison, while highly relevant, is as yet too early to make. Nonetheless, there is no question that ECF platforms can learn from these more established financiers of enterprise.

It is important to note that ECF platforms are rarely able to offer their investors advice on investee firm selection to retain their regulatory exemptions (see below). Rather, the platform recruits applicant firms against its own selection criteria and then makes the existence of such firms known to its investors. It is the latter who are responsible for their own decision about whether or not to invest in a particular firm. Detailed information on the investment offering is typically rudimentary, and is at a level that would be unacceptable to experienced BA and VC investors. BAs, particularly those operating in syndicates and VC general partnerships, invariably undertake considerable due diligence on all aspects of any proposed investment. Professional investors are very aware of the information asymmetries existing between the owner of a young business and those that are approached as investors, and of the probability of adverse selection. This information discrepancy may also create a moral hazard which may adversely influence the behaviour of the funded entrepreneur with a now reduced ownership share.²⁵⁴

Commentators have frequently expressed concern over the poor level of scrutiny of applicant enterprises conducted by investors in ECF platforms and the organisation and structures of the deals offered.²⁵⁵ Platforms have also been criticised for:

²⁵¹ These two statements have been written by the author and represent a composite summary of the views of each camp as expressed in the media.

²⁵² Moritz and Block (2014).

²⁵³ https://en.wikipedia.org/wiki/Knightian_uncertainty

²⁵⁴ Hyttinen and Vaananen (2006).

²⁵⁵ For a particularly critical and informed analysis of the value of ECF to BA syndicates in the UK, see Gray (2014).



- bias over reporting their activity levels
- the quality of enterprises selected
- the ambiguity and inflexibility of the legal and shareholding structures used
- the negative influence of ECF funding models on future fund raising (particularly from BA or VC investors)
- their inattention to investment realisation via profitable exit channels.

Governments have similarly been criticised for their often uncritical support of ECF, including both directing public financial support via platforms and making attractive tax breaks to investors available for eligible ECF activity.²⁵⁶ Critics argue that the *imprimatur* of such public, official support to ECF activities gives an overly positive signal to non-professional investors, which is not warranted by ECF performance to date. This criticism is justified and many politicians and policy makers do currently appear uncritically enamoured by CF and its potential to support new enterprise financing.

It is interesting that, while several of the observers' concerns about ECF are well-founded, the same set of criticisms could be levelled at the BA community until very recently. Through the agency of Business Angel Networks (BANs) and latterly National BA Associations, often financially supported by government, BA financing has matured over the last decade into a more disciplined and collectively-managed vehicle for enterprise finance.²⁵⁷ One key indication of this greater professionalism is seen in the increasingly complementary co-investment and syndication between BAs and early-stage VCs. ECF platforms are already engaging with BAs^{258, 259} and it is likely that these relationships (along with greater clarity of regulatory requirements on CF actors) will encourage rapid industry learning.

Regulatory oversight of ECF

We have noted the patchwork diversity of regulation affecting CF that presently exists. In this section, we will look exclusively at ECF, which is acknowledged to be the most complex area of CF activity in terms of legislation and regulation. We will look at the demands as they affect different actors. This will be referenced against individual country examples, albeit the USA and the UK will predominantly feature as the two biggest and most sophisticated markets for ECF. Given the importance of international activity in Europe and the influence of the European Union, we will also look briefly at

both European regulation and the growing international dimension of ECF. (Note. In all cases, we are only introducing elements of relevant legislation and this summary is not intended to be read as any form of legal comment or opinion.)

It is important to recognise that crowdfunding regulation embraces all three major actors in ECF:

- 1. investors seeking to purchase equity, debentures or similar convertible instruments**
- 2. the company or enterprise seeking to raise finance by selling such securities to investors**
- 3. the intermediary or ECF platform that links all parties to complete a finance raising.**

Essentially, investors are seekers of appropriate information on new opportunities and the entrepreneurs seeking finance are the providers of information. The platform acts as an intermediary mandated by its two users to provide (ideally) full, unrestricted interchange of information between buyer and seller.

Regulators are interested in ensuring that investors are appropriately protected. They need to decide if investors are consumers (and need protecting) or rational operators in the financial market and thus subject to the full requirements of the UK's FCA. In ECF, the regulators have clearly seen retail investors as customers. Hence, there has been a bias towards imposing restrictions on investors' ability to access ECF platforms unless they can demonstrate that they are 'professional' investors or that they are 'retail' clients who can vouchsafe appropriate skill sets that will enable them to analyse the investment offering, including the full range of risks that the proposed financing may incur.

In the UK, eligible retail investors include those that receive regulated investment advice or are (self) certified as 'sophisticated investors'²⁶⁰ or 'high-net-worth individuals'²⁶¹. These statements must be provided in writing and signed by the investor.²⁶² Individual retail investors who cannot demonstrate sufficient (high) net worth or annual income and do not conform with the requirements of a sophisticated investor are frequently proscribed from investing as a condition of platform acceptance. That is, conditions of accreditation under the relevant financial acts are relaxed by the regulatory authority to allow ECF platforms to trade.

A number of countries also require a 'cap' to be placed on the level or

256 The highly-attractive Enterprise Investment Scheme and Seed Enterprise Investment Scheme are available to investors in ECFs in the UK. Belgium is also implementing tax breaks of relevance to ECF.

257 LINC Scotland is an example of a highly-professional national BA association. See <http://www.lincscot.co.uk/>, accessed 26 May 2018.

258 In January 2014, Crowdcube Ventures announced a collaboration with Braveheart Investment Group (a BA network) that would enable Crowdcube's ECF investors to build a portfolio of investments by co-investing in ventures which have been screened by a professional fund manager.

259 Syndicate Room is a site which encourages ECF investors to invest in ventures assessed by experienced Bas.

260 In the UK, a sophisticated investor must meet at least one of the following criteria: Has been a member of a network or syndicate of business angels for at least the six months preceding the date of the certificate; Has made more than one investment in an unlisted company in the two years preceding that date; Has worked, in the two years preceding that date, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises; Has been, in the two years preceding that date, a director of a company with an annual turnover of at least £1 million.

261 A 'high net worth individual' is one who had, during the financial year immediately preceding the date of the certificate, an annual income of £100,000 or more; and held, throughout the same year, net assets of £250,000 or more.

percentage of a retail investor's income or wealth that may be invested annually or by each project or platform. In the case of the USA, this cap changes depending on the annual income or net worth of the investor. The question of how much license should be given by regulators to retail investors not using an accredited financial adviser (and without specialist skills or the diversification advantages of high income or wealth) appears to be one of the largest areas of debate. If ECF activity continues its rapid growth, unskilled and inexperienced retail investors may well become the numerical majority of retail investors.

For the entrepreneurial business or 'issuer' of equity-type instruments to a retail public, the obligation is for the owners to be able to provide such information about the business, its financial condition and requirements, and its plans that will allow an experienced investor to make an informed decision on the information provided. The question of the validation of such information provided (and the platform's responsibilities for the quality and quantity of information available to investors) frequently remains unclear.

For the generic ECF platform, the arranging of deals and the financial promotions of securities, including equity and debt instruments, are regulated activities in most developed countries. Accordingly, the platform must be authorised, unless an exemption is available. See below for a summary of national regulation.

Brief illustrations of national ECF regulation

United States

An industry report launched on 31 March 2015 estimated the total crowdfunding market in the USA in 2014 to be \$9.46 billion, with an annual growth rate of 145%.²⁶³ The central catalyst for this phenomenon occurred three years earlier. On 5 April 2012, the JOBS Act was approved by Congress and signed by President Obama into law. It gave private companies greater access to capital and made it easier for certain companies to go public on US exchanges. The Act created a new category of issuer called an emerging growth company (EGC) and provided regulatory relief to EGCs to encourage initial public offerings (IPOs).

While passed by Congress and hailed by a myriad of entrepreneurial groups, lawyers and particularly the Securities and Exchange Commission held

several concerns as to the unregulated advertising of ECF fundraisings to the public. Accordingly, Title II of the JOBS Act, while allowing public advertising of fund raising, restricted ECF access to accredited investors (high-net-worth investors). Title III allowed companies to raise a maximum of \$1 million a year from the crowd without having to register these securities with the Securities and Exchange Commission. Under the proposed rules, unaccredited investors are capped at a maximum investment of \$2,000 per deal or 5% of their income if their annual income is less than \$100k, or 10% of their income if their income is greater than \$100k. However, finance raising campaigns had to go through a website hosted by an intermediary and disclosures, including audited financial statements, were required for campaigns of over \$0.5 million. Title III has not yet been passed into law by the US authorities.

Three years later in the USA, in 2015, the Title IV rules / Regulation A+ will allow for the first time non-accredited investors to invest in ECFs. In Regulation A+, there are two tiers of fund raisings and by implications two tiers of company issuers:

- Tier 1 allows companies to raise funds up to \$20 million from both accredited and non-accredited investors. Tier I will not have state pre-emption (as under Title II 506(c)) offerings. While subject to formal review by state regulators, Tier I companies will not be required to perform formal audits and annual reporting as required from Tier II offerings.
- Companies raising funds under this latter Tier II category can raise up to \$50 million. While the fund raising does not need to be registered in every state (a pre-emption on 'blue skies laws'), offerings will require audited accounts and annual reporting requirements.

Accredited investors are defined as individuals who earn over \$200K per year or have a net worth of over \$1 million, or entities with over \$5 million in assets. Under Tier I there is no restriction on individual investor limits. However, in Tier II, non-accredited investors are restricted to investing in ECF a maximum of 10% of the greater of their (self-reported) income or net worth per year.

Security regulators in December 2012 found 8,800 domains with crowdfunding in their name, of which 6,800 had materialised after the JOBS Act was signed into law. Crowdfunding intermediaries can charge

a commission to their investment-seeking retail clients, but they cannot offer investment advice. They can set criteria for the transactions their portal will list, but they must allow every company that meets these standards to sign up if they so wish.

This legislative process is facilitating an internet-mediated equity investment market that will develop both in parallel with and alongside existing venture capital and business angel infrastructures. As with current European efforts, while the USA remains the largest market for crowdfunding in all its variants at the present time, it is too early to say exactly how this rapidly developing market will react to current and recent legislation, and particularly the additional freedom of access to retail investors not classified as high-net-worth or as sophisticated investors. It is also too early to say at which stage of a company's lifecycle or which sectors will benefit most from ECF.

Several observers have noted that CF generically is significantly influenced by emotion and empathetic reaction from investors strongly linked to new social networking practices.²⁶⁴ Whether such criteria will discriminate, for example, against supporting longer-term and more technically complex projects remains to be seen.

The United Kingdom²⁶⁵

The United Kingdom has the largest and most developed crowdfunding environment in Europe and is currently²⁶⁶ second only to the USA in terms of the rapid evolution of this emergent industry. **Figure 12** shows the significant growth in loan-based crowdfunding from 2012 through to 2015. **Figure 13** shows a similar growth pattern in investment-based crowdfunding during the same period. The annual growth in loan crowdfunding grew almost three times to nearly £1.3 billion in 2014. ECF demonstrated the same level of growth moving from £28 million to £84 million in the same period.²⁶⁷

Regulation in the UK falls under the aegis of the Financial Conduct Authority (FCA). However, the FCA's responsibilities for CF regulation are limited only to loan-based²⁶⁸ and investment-based crowdfunding activities. The UK regime is essentially restrictive and requires that a financial promotion to the public should be approved by a licensed authority. Similar to the USA, control is reduced for platforms that promote exclusively to professionally-advised clients, high-net-worth individuals or self-certified professional investors.

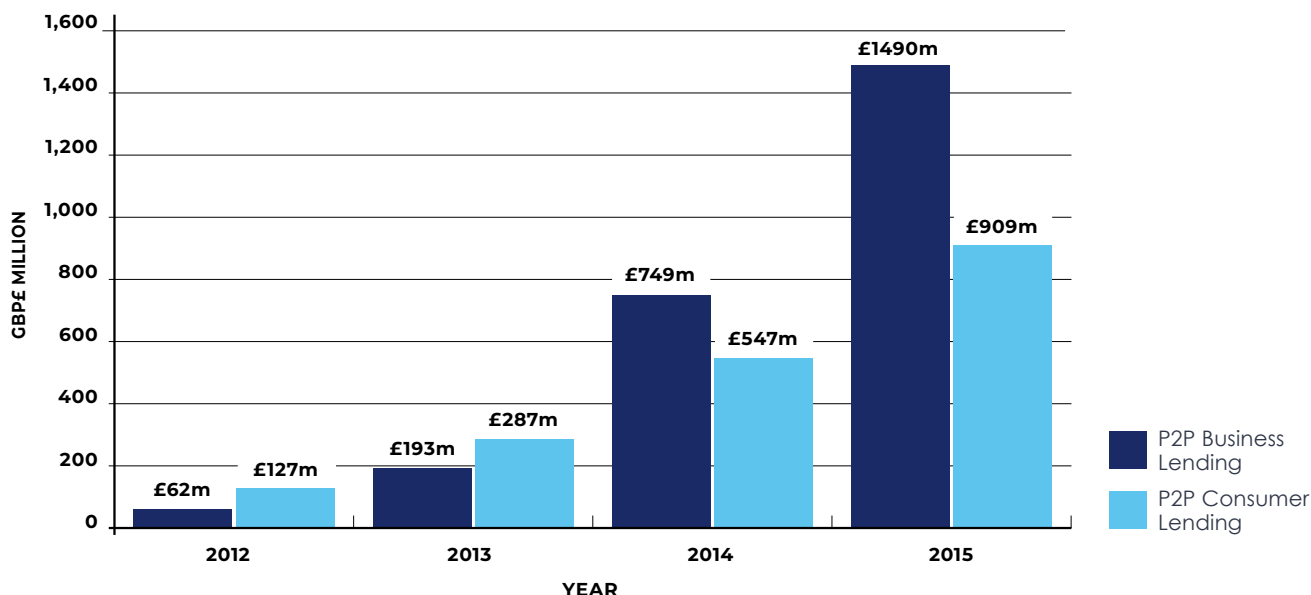
262 It is important to note that, by signing such documents, the investor waives important legal rights of consumer protection and compensation.

263 Massolution (2015).

264 Agrawal, Catalini and Goldfarb (2011); Belleflamme, Lambert and Schwienbacher (2014).

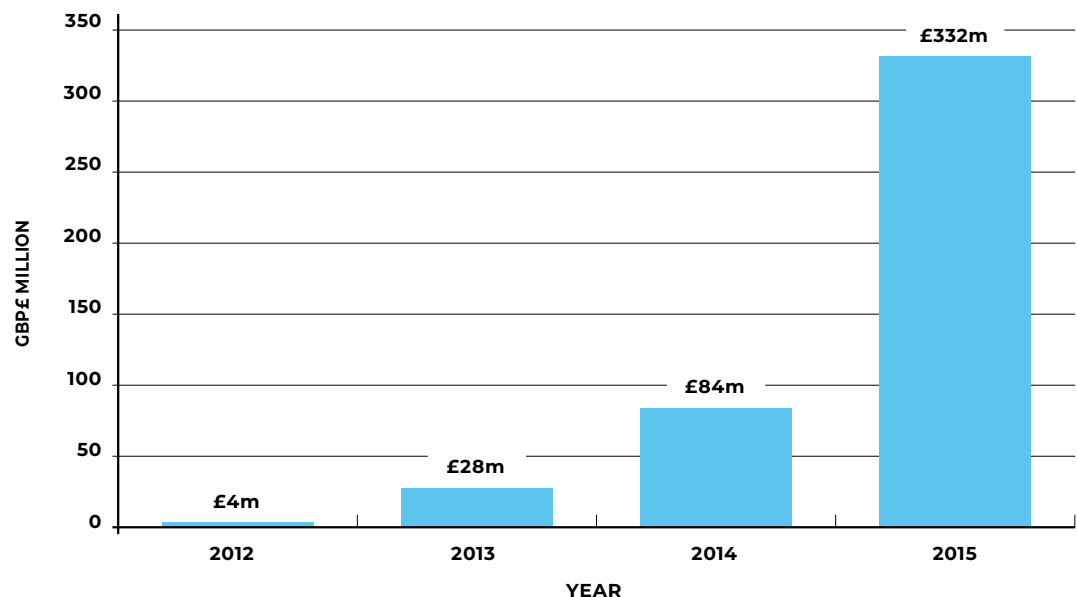
265 I am indebted to Sandy Finlayson, David Grahame and Nelson Gray for their expertise and wise counsel in alternative financing.

Figure 12:
Loan-based crowdfunding market size



Source: Data compiled from Baeck, P, Collins, L and Zhang, B (2014), Understanding Alternative Finance: The UK Alternative Finance Report 2014, November 2014, NESTA, London, and Zhang, B, Baeck, P, Ziegler T, Bond J, and Garvey K (2016), Pushing Boundaries: The 2015 UK Alternative Finance Industry Report, February 2016, Cambridge Centre for Alternative Finance, NESTA, London.

Figure 13:
Investment-based crowdfunding market size



Source: Data compiled from Baeck, P, Collins, L and Zhang, B (2014), Understanding Alternative Finance: The UK Alternative Finance Report 2014, November 2014, NESTA, London, and Zhang, B, Baeck, P, Ziegler T, Bond J, and Garvey K (2016), Pushing Boundaries: The 2015 UK Alternative Finance Industry Report, February 2016, Cambridge Centre for Alternative Finance, NESTA, London.

266 Massolution (2015) notes the very rapid rise in Asia of for-profit crowdfunding (i.e. equity and loan CF).

267 Zhang, Baeck, Ziegler, Bond and Garvey (2016).

268 On 1 April 2014, regulation of the consumer credit market transferred to the FCA, including the regulation of loan-based crowdfunding platforms.

269 Baeck, Collins and Zhang (2014).

270 Financial Conduct Authority (2015).

The average amount raised through ECFs in the UK in 2014 was £199, 095. Almost 95% of funded deals were eligible for the Enterprise Investment Scheme (EIS), potentially reducing the net investment cost to eligible tax payers by 50%. According to the NESTA 2014 study²⁶⁹, 38% of their respondents classified themselves as sophisticated or high-net-worth investors. The average portfolio size for these investors was £8000. For the remaining 65% of retail investors, their average portfolio was less than £4000. The FCA noted that, by April 2014, there were 14 portals authorised to conduct ECF, 10 sites in the process of application and a further 11 firms that act as appointed representatives and conduct regulated activities in ECF.²⁷⁰

In 2014, the FCA introduced new consumer protection rules for the sale of what was now to be collectively termed 'non-readily realised securities'. The rules came into force for all ECF firms on 1 October 2014. These marketing rules on the direct promotion of securities to the public restricted retail communications by ECF platforms to those who:

- take regulated advice

- qualify as high-net-worth or sophisticated investors
- confirm that they will invest less than 10% of their net assets in this type of security.

ECF firms are required to check whether customers understand the risk if they do not take regulated advice. Most sites apply a self-certification process via their on-line portal, which requires new applicants to the site to undertake a short questionnaire on the basis of which the person may be deemed an eligible investor under the above criteria. The FCA conducted a post-implementation review of the impact of the new rules in 2016.

In its February 2015 review, the FCA also noted that, in its supervisory role, it investigated the practices and communications of ECF sites. It expressed concerns with "most of the websites" in the review, particularly with regard to:

- a lack of balance as to benefits and risks
- insufficient, omitted or 'cherry-picking' of information
- the downplaying of important information, especially on the risks of an investment.

The CFA approached all the ECF providers, who quickly amended their communications to meet the CFA's requirements of being fair, clear and not misleading. This regulatory watchdog role is likely to gain in importance as regional, national and international ECF and loan CF activities increase in size and frequency.

Other European examples

Belgium²⁷¹

Recent amendments in Belgium have included exemptions to CF sites issuing certain investment instruments under the public offering. For ECF sites, exemption is achieved if the fund-raising is <€300,000 and includes a cap of €1000 per investor. Belgian CF platforms operating under these ceilings do not need to test the experience, knowledge or expertise of their retail investor clients.

ECF platforms would like to see this cap raised to €5,000 to encourage activity. The Belgian Federal High Council for Entrepreneurs and SMEs argues, as an interest group, for the complete removal of this cap. Government is currently looking at the logic of a 'light' investment services regulation including the introduction of appropriateness tests for retail investors in line with French regulation (discussed below).

At the same time, the government authorities are currently approving tax incentives for ECF. These include capital investments up to €7,500 via licensed platforms leading to a reduction in personal income tax for investors. The tax shelter proposed includes a reduction of 45% in personal income tax for new shares in an EU-defined micro-firm SME and, secondly, a tax reduction of 30% on new shares to be issued by newly-formed SMEs if held for four years.

Germany

The German government adopted the *Small Investor Protection Act (SIPA)* on 23 April 2015. For the first time, Germany now has specific legislation on the regulation of the German crowdfunding market. Before this initiative, ECF was subsumed within legislation governing banking, capital markets and trade/consumer trading. As in several other markets, the proposed legislation has engendered a debate among various interest groups including government policy makers and the academic community.

At present, there are approximately 80 CF sites in Germany operating across the full spectrum of activities, including real estate and social investing.²⁷² Excluding real estate and film financing, some 174

financing projects via crowdfunding had been accomplished in Germany, with a cumulative volume of approximately €41 million since its 2011 start.

German practice and the new investment Act closely follow the precedent set by the JOBS Act, given that the new German legislation establishes an exemption from the prospectus requirement. The conditions for exemption include²⁷³:

- The offering must be for investments within the meaning of the Investment Act as amended by the SIPA. That is, of profit-participating loans, subordinated loans or other similar financing forms and investments which are subject to a prospectus requirement for the first time because of the revisions in the SIPA.
- The investment must be offered exclusively by means of an investment consulting or investment brokerage via an internet platform.
- The ECF platform has a legal obligation to monitor the agreed subscription limit imposed by the Act on ECF investors of a single issuer limit of the following:
 - €10,000 maximum in an issuer, provided the investor has freely available assets of €100,000
 - Investors not having available assets of €100,000 can invest up to twice the investor's monthly net income, but are constrained to a limit of €10,000.
 - In all other cases, particularly if the investor does not provide a statement of assets and income, the investment cap is €1,000.
- Importantly, the investment limit is regulated by law to the amount the investor can invest in a single issuer. It does not make any comment on the amount the investor may invest in the entire CF market.
- Further, the legislation does not define or discriminate between types of investor, and the limits apply only to investors who are not 'corporate entities'.

Klohn, Hornuf and Schilling²⁷⁴ note that, apart from observing the limits imposed on the investors, the CF portals remain almost entirely unregulated. The authors also note the potential for confusion in distinguishing the status in CF of profit-participating loans from the (popular) German 'silent partnership' arrangement,²⁷⁵ which has extra investor protection and knowledge-access rights via the German Commercial Code. These instruments are treated as a brokerage activity and trading CF platforms do not require a license.

271 I am indebted to Xavier Walthoff-Born and Professor Sophie Manigart for their guidance on Belgian activity.

272 Klohn, Hornuf and Schilling (2015).

273 Klohn, Hornuf and Schilling (2015).

274 Klohn, Hornuf and Schilling (2015).

275 Silent partnerships are economically similar to equity, but legally meet the definition of a contractual instrument and not a security or equity instrument under company law.

Finland

The Finnish Ministry of Finance recently circulated a draft for a Crowdfunding Act (i.e. investment and business lending activities only). The consultation period ended on 12 June 2015 and the feedback is currently being appraised.

In 2014, the Finnish Financial Supervisory Authority ruled that ECF is an investment service for which the provider must be authorised according to the Investment Services Act when the service includes the sale of financial instruments to the public. The activity may require authorisation and other regulations concerning investment activity need to be taken into account, including the obligation to draw up a prospectus under the Securities Markets Act and any relevant disclosures relating to the offer of securities.

The current draft regulation includes raising the issuing threshold to €3.5 million. It currently stands at €1.5 million. The proposed legislation is also looking at how Finnish platforms can be more simply regulated under Markets in Financial Instruments Directive (MiFiD I) article 3, while conforming to the investor protection and disclosure aims of this European legislation. For example, the draft also looks at how non-transferable securities, such as silent partnerships and promissory notes (mainly used by loan CF platforms) which are non-transferable, can be used in the Finnish context without the platform requiring a full Markets in Financial Instruments Directive (MiFiD) license.

Given the current period of consultation and likely change, comments about future regulation concerning retail investors is no more than speculation. However, in communication with Finnish policy makers²⁷⁶, the following points were made:

- The sophisticated/unsophisticated classification may well feature in future legislation.
- The classification between high-net-worth investors and other parties is not currently in the draft legislation.
- Similarly, professionally-advised retail investors are also not currently in the proposed legislation.
- There are currently no controls (caps) put on the individual retail investor regarding either a fixed limit or a maximum percentage of net income or assets. Concern has been expressed as to how such caps are efficiently and cost-effectively policed.

²⁷⁶ I am indebted to the detailed information and very helpful comments provided by Mr Aki Kallio of the Ministry of Finance, Helsinki.

France

France had about €66 million invested in CF in 2014, with more than 60 platforms administering 55,000 projects. The importance of France as a source of CF finance is likely to grow, given a clear commitment from the French president to promote all forms of CF. On 30 May 2014, France adopted new legislation (Ordinance n2014-559) enabling an exception to securities public offering rules and banking monopolies. It created two specific regulatory statuses for CF platforms:

- Conseil en investissement participative, or crowdfunding investment advisers (CIP)
- Intermediaries en financement participative, or crowdfunding intermediaries (IFP).

The first status allows ECF investment up to €1 million per company (previously €100,000) and gives an exemption from MiFiD. The second status allows loan crowdfunding projects beyond €1 million, and the investment can be promoted to investors across Europe using the MiFiD Passport system. The offering by the CIP of equity via an ECF platform is not construed as a public offering, and is therefore not subject to a prospectus. This is conditional on the sum being raised being less than €1 million over a 12 month period.

CIPs cannot receive funds from investors (other than platform fees) and are not authorised to receive securities from issuing companies. The limit on investors is <€1000 per project but only relates to loans and the IFP status. The French government believes that this limited, light regulation will enable France to become a European centre of CF activity in both equity and loans provisions to entrepreneurial businesses. However, the regulation also seeks to encourage disclosure, given a recognition that most retail investors are likely to be unsophisticated.

Australia

Background to existing and proposed legislation

After many years of discussion and debate, as well as several 'false' starts, Australia has finally passed legislation allowing public companies to access crowd-sourced funding (CSF), effective from September 2017. As well, the government proposes, via

the *Corporations Amendment (Crowd-Sourced Funding) for proprietary Companies) Bill 2017*, to extend the crowd-sourced funding regime to proprietary companies, which will be of particular interest to IPA members and their clients; particularly because the proposed changes are expected to allow many eligible SMEs (existing and new) to have greater access to a relatively new form of finance.

Start-ups that are often desperate for funds to survive the harsh infancy period of between one and two years will be the largest benefactors in our view.

Indeed, we predict that the proposed amendments will change the landscape for financing small businesses and, in the words of one commentator, 'will democratise the funding of start-ups'²⁷⁷.

The passing of the new laws for public companies, along with the proposed changes for proprietary companies, is a quantum leap forward for this form of funding and will position Australia alongside several other countries that have already adopted and embraced similar laws and financing regimes. Examples of other jurisdictions that have successfully implementing crowdfunding include the United States, the United Kingdom, Canada and New Zealand, along with a host of European countries.

To meet the eligibility criteria, a public company must earn less than \$25 million in annual revenue and have less than \$25 million in gross assets. Some of the other features of the changes, which the IPA fully endorses and would be of interest to members and their clients, are briefly listed below:

- An eligible company can raise up to a maximum of \$5 million in any 12-month period.
- An eligible company can accept offers from retail investors (with a maximum holding of \$10,000 per company for each investor in any 12-month period). A retail investor could be any member of the public, and typically could well include the so-called 'mum and dad' investors.
- Any offers to invest in a CSF offer must be made via a CSF intermediary. The intermediary must hold a current Australian Financial Services Licence, along with authorisation to conduct CSF offers.
- Investor protections, for example;
- Cooling-off period of 5 days

- Prohibition of financial assistance for investment in a CSF
- Accepting risk-acknowledgement prior to lodgement of application for shares
- Civil and criminal liability for defective offer documents.
- Concessions for unlisted public companies, including:
 - No holding of an AGM
 - Ability to provide required reports online
 - No need to appoint an auditor if CSF offer is less than \$1 million

Extending CSF legislation to proprietary companies

The recently-enacted CSF legislation for public companies, in its current form, will have the consequential effect of restraining a more predominant corporate form, and perhaps a form more representative of new entrepreneurs and start-ups in Australia, i.e. the proprietary company. Current parliamentary endeavours to extend the CSF legislation to proprietary companies will address one of the major criticisms of the new laws, which prevented private companies from participating and enjoying the benefits of engaging in CSF offers.

Without the proposed amendments (i.e. as the law currently stands) due to the well embedded '50-member' legal restriction, the only mechanism that would allow existing proprietary companies to partake in CSF activities is for a company firstly to morph from a proprietary company to a public company and then be eligible to engage in CSF activities (assuming of course, that all the other eligibility criteria set out in the legislation are met – e.g. revenue and asset monetary thresholds). Moreover, any new start-ups that wish to reap the benefits of the new CSF regime would first need to register as a public company, a decision on structural form which, in many cases, will be expensive and may not be appropriate in the early stages of developing a new business.

As with the new CSF laws relating to public companies, the IPA also fully endorses the proposed measures for proprietary companies, with some minor exceptions detailed in our commentary below. It is also important for IPA members to understand the major features of the proposed laws in the current bill and the accompanying explanatory memorandum. We start by explaining what the changes mean (i.e. what will change once the legislation is passed).

What the changes will mean for proprietary companies

As briefly mentioned above, the CSF Bill will extend the current CSF funding regime (applicable to public companies) to proprietary companies that meet the eligibility criteria. They are basically the same as those for a public company making a CSF offer (except that, in the case of a proprietary company, the company must have at least two directors).

Eligibility criteria – revenue and asset thresholds

We note that, to be eligible to make a CSF offer, a company must satisfy a number of criteria, including having less than \$25 million in gross consolidated assets, or less than \$25 million in consolidated annual revenue at the 'test time'. We assume that test time means the time that the offer is made. This being the case, we ask whether the criteria are ongoing (i.e. will they need to continue to be met after the offer?) For example, will there be consequences, in terms of continued eligibility, if the thresholds are exceeded after the CSF offer? Perhaps this issue requires further clarification in the legislation.

Funding

The amendments will bring significant benefits that will flow from bridging the 'capital gap' faced by countless young, emerging start-ups in the Australian economy. As explained by one author: "Australia's success rate in funding and commercialising innovation lags behind most other advanced economies" and "addressing the lack of funding for start-ups is critical because it is these firms that drive the economic transformation needed to respond to new challenges and requirements of a dynamic global economy"²⁷⁸.

Through the work undertaken by the IPA-Deakin SME Research Centre, we have found that technology-based start-ups are the greatest contributors to net job growth in Australia²⁷⁹, thus confirming the findings of Zein²⁸⁰. Accordingly, extending the current CSF regime to proprietary companies is an important and much-needed government initiative which will boost economic growth.

Indeed, since the decommissioning of the Australian Secondary Board Stock Market several decades ago, which

specifically catered for young, emerging firms, it appears that start-ups in Australia have had very few avenues for adequate long-term funding. In this respect, they have relied on funding sources that may not have been the right choice in their particular circumstances and stage of development. Many have turned to going public only to find the route requires considerable expense and is often fraught with significant regulatory burdens, as well as a lack of investor interest.²⁸¹

The considerable discounting (underpricing) that occurs for SME firms that engage in an initial public offering (IPO), particularly those with a short trading history, is also documented in the study.²⁸² Considerable underpricing is often at the expense of the entrepreneurial firm founders, as the academic literature shows that the share price for promising IPOs will climb well above initial price in the first 20 days post listing (see, for example, Rock 1986), at which time there is a sell-off period in which initial buyers reap considerable gains. The other avenue of funding that has some appeal is venture capital, but often this form of financing, means agreeing to significant covenants and constraints for entrepreneurs, and perhaps rightly so, as some evidence suggests that up to 75% of venture-backed start-ups fail.²⁸³

It has been the experience of IPA members and their clients that a significant source of funding for SMEs has traditionally been an over-reliance on funding from private sources, such as family members and friends. For many firms, this is a wise choice where these funds are available and there are no overwhelming restrictions. For most SMEs, however, private funding is not readily accessible.²⁸⁴

Directorships

It is proposed that proprietary companies wishing to raise funds via the crowdfunding option must have a minimum of two directors.

Residency of directors

The proposed new laws require the majority of the directors of a company engaging in a crowdfunding activity to be resident in Australia. This requirement may be difficult to enforce in circumstances where there are only two directors (i.e. determining what constitutes a majority would be difficult, if not impossible).

²⁷⁸ Zein (2013).

²⁷⁹ Tanewski, Cowling and Mroczkowski (2017).

²⁸⁰ Zein (2013).

²⁸¹ See particularly Mroczkowski and Tanewski (2007).

²⁸² Mroczkowski (2003).

²⁸³ See Ghosh (2012).

²⁸⁴ Mroczkowski and Tanewski (2007).



Cap of 50 non-employee shareholders – default trigger to public company form?

From our understanding of the proposed amendments, the existing cap of 50 non-employee shareholders for proprietary companies will not include shareholdings that arise from a CSF offer, in which case first-time acquirers of CSF shares will not trigger the current default provisions in the law requiring a proprietary company to convert to a public company.

Ordinarily, there should not generally be an issue with these amendments, as they relate to initial buyers of CSF shares. However, there may be concerns with the proposed amendments as they relate to secondary buyers who evidently lose their CSF status and are, thus, counted among the existing shareholding subject to the 50 non-employee shareholders cap. Our concerns relate to IPA members and their clients, many of whom (either directly or through various inter-posed entities) have already reached the cap of 50 members or are close to it. Consider for example, instances where family firms with several families and their generations of offspring are shareholders and who are already looming toward a membership of 50.

A sudden sell-off or transfer of shares by initial purchasers to secondary buyers might result in a breach of the cap, thus resulting in a mandatory conversion to a public company. This, in itself, might bring with it unintended and undesirable circumstances for the original 'private' group of shareholders.

We believe this area of the proposed legislation needs further examination and consideration, particularly in terms of whether it would be plausible, for at least the first 5-year period, to consider all acquirers, including secondary acquirers, as qualifying CSF shareholders, and thus not forming part of the cap.

Composition of shareholding

In addition to our earlier comments, we note the commentary in the explanatory memorandum that the proposed new CSF regime for proprietary companies will, in effect, create two classes of shareholders and possibly another class of secondary buyers. The IPA-Deakin SME Research Centre acknowledges that the class or classes of shareholders not forming part of the original (closely held) holdings will not have the same access to information as those in the closely-

held group (i.e. information upon which to make informed judgement as to the status of their investment *inter alia*). Accordingly, the typical situation articulated in the literature as a separation of ownership and control will occur and therefore the need for protection for these groups of shareholders is warranted.

The IPA-Deakin SME Research Centre has no issue with these additional protections and measures, particularly the additional reporting and governance regulations as discussed further below. Our concerns are more with the rights of the new shareholder group(s). Nothing has come to our attention within the bill or the explanatory memorandum for us to assume that the normal provisions of the law relating to all companies will not equally apply to CSF shareholders. Accordingly, we would expect their rights and entitlements to be the same as a result of being in a separate class of shareholding. For example:

- The right to expect the full application of the law with respect to the fiduciary duties of directors as they currently apply to all shareholders
- The rights to dividends, assuming the criteria within the act are satisfied
- The right to attend meetings, if and when called
- The right to receive financial reports, and so on.

As is customary with all legislation, proposed amendments make reference to additional requirements that may be specified in the regulations and accompanying schedules from time to time, and often without providing additional information. For example, within the *Corporations Amendment (Crowd-Sourced Funding) Act 2017*, No 17, 2017, applicable to public companies, s738F(3), s738G(f) and s738ZJ are typical examples of citations relating to regulations dealing with further detail. While we understand that regulations and schedules are required to bring effect to the operational and more perfunctory aspects of the law, the Centre is of the view that more detailed explanations within the explanatory memorandum on specific practical issues (such as, for example, CSF shareholder rights and processes that may impact those rights [for example, the basis upon which an intermediary allocates shares to particular offerees]), would help readers better understand the rationale for the various measures proposed, as well as their potential impact.

Moreover, we maintain that more information is better than less and adhering to this principle sets the platform for meaningful debate and the enactment of good laws.

While we commend the government's efforts in providing a valuable, much-needed avenue of funding for SMEs and the like, without further information of how the proposed legislation will play out in practice, we fear that the new laws could provide fertile ground for potential disputes between the closely-held group of shareholders and the CSF shareholders. At the extreme, it would be almost be akin to the majority versus the minority dilemma that has plagued corporate law, it would seem, for centuries.

\$10,000 cap per investor per company in any one year

The Centre confirms their support for an excellent mechanism to mitigate/cap risk exposure for retail investors, particularly 'mum and dad' investors.

5-day cooling-off period

While we understand the concept of a cooling-off period as another form of added protection for retail investors, we are not convinced of the need for such protection, particularly given that Australia almost stands alone as a country that has adopted this form of protection.

Unlike the sale of expensive motor vehicles and real estate, where a cooling-off period or similar regime is arguably warranted – e.g. where an acquirer gets 'cold feet' for whatever reason (such as not having enough time to properly assess the purchase and/or feeling a little pressure from sales hype) – an investment in a CSF offer has already significant protections in place, not only in terms of the \$10,000 cap per investor, but also the significant checks and balances placed on intermediaries. Moreover, one would expect that a person intending to invest in a CSF offer would take advantage of the significant time period (up to three months) to undertake appropriate due diligence measures to ensure the appropriateness of the investment in terms of the investor's personal circumstances (often described as the 'cliente effect' in the finance literature).

The Centre also has concerns that the five-day window where an investor can withdraw from an offer (after the offer closes) could potentially lead to market manipulation. A good example is the situation where a group of investors known to each other (and who

have made significant investments in the offer via different vehicles and associates) can band together and withdraw from an investment, thus possibly changing the outcome of the offer. While this would be highly unlikely, it is possible and, as such, could have a significant negative impact.²⁸⁵

Offer platform

The IPA-Deakin SME Research Centre has no major issues with the detailed provisions relating to the offer platform via licensed intermediaries. Our only concerns relate to our earlier comments regarding the need for more information on the practical aspects of the legislation relating to offers. Moreover, we eagerly await the release of the forthcoming details in the regulations relating to the minimum information required to be included in a CSF offer document.

Additional reporting obligations

Financial

The requirement to comply with international accounting standards when preparing a financial report is an important governance measure which the IPA fully supports. We note, however, that the proposed compliance requirements will be a major gear-shift for some companies not currently required to comply with accounting standards. In this respect, perhaps some form of reduced disclosure regime may warrant further consideration.

Related parties

The requirement to comply with Chapter 2E of the Corporations Act, which applies to related parties, is an important governance measure which the IPA-Deakin SME Research Centre fully supports. We note, however, that the proposed compliance requirement will be a major burden for companies not currently required to comply with related-party restrictions and disclosures. This is particularly so for proprietary companies, many of which are fraught with complex structures often involving an intricate web of personal and business relationships.

Audits – CSF offers greater than \$1 million

Except to confirm our support for an excellent mechanism of corporate governance which will provide credibility to the financial statements, we have limited further commentary on the proposed amendments. Our only concern is the significant cost burden that a financial audit will place on proprietary companies.



Public company governance concessions

Unlisted companies choosing to adopt the CSF public company model will have concessions for a period of five years that relate to the holding of an AGM, an option to post reports online, and the removal of the requirement to appoint an auditor unless the company engages in a CSF offer of greater than \$1 million. The IPA is concerned that, after the initial five-year period, the concession will presumably be removed, in which case the remaining structure, along with all the compliance burdens, may not be what was initially planned or desired.

Further funding pressure on the regulator

Our final comment relates to the enormous work that will no doubt be required by ASIC to continue monitoring the activities of companies that undertake the crowd-sourced funding route, along with the activities of their intermediaries and their respective offer platforms. We fear that ASIC's already under-resourced monitoring and surveillance/compliance activities will be further stretched, requiring even more funding from the public purse.

European Union legislation in crowdfunding

It is impracticable to detail European legislation in a short briefing note. The reader is advised to look at two recent, comprehensive reports on crowdfunding from:

1. **the European Securities and Markets Authority ESMA**²⁸⁶
2. **DG Communications Networks, Content and Technology**²⁸⁷

What is clear from these reports is that the creation and functioning of a pan-European crowdfunding legal and regulatory environment will be an extremely challenging, complex and time-consuming task, given the large number of national and European legislative rulings that will need to be revised, agreed and implemented across the full spectrum of financial services, from money laundering to consumer protection.

Positively, some European legislation already offers several elements of a workable framework; for example, the Alternative Investment Fund Managers Directive (AIFMD) and Markets in Financial Instruments Directive (MiFiD), which have already been subject to extensive refinements by both national governmental and industry interests.

Nonetheless, the nascent status of the ECF industry, and its rapid growth and evolution, suggest that the regulatory changes need to be light and experimental at this emergent, volatile stage of industry development. However, while profit-related CF does not currently represent a system risk to financial markets²⁸⁸, there will likely remain a need to review its potential impact over time.

Regulatory constraints on ECF investor actions in the EU

As we show in **Table 10** on page 136 (Summary of ECF regulation by country) and the accompanying text describes, governments have placed a number of restrictions on both platforms and retail investors to ensure the general public (i.e. retail investors, excluding professional, sophisticated and high-net-worth individuals) are protected from undertaking volumes of excessively risky investments that could imperil their livelihoods.

The balancing act that all regulators are seeking to achieve is a level of protection that is meaningful while not excessively hobbling the crowdfunding platforms in their raising of new funds for worthwhile and growing enterprises. Essentially, both parties are asked to moderate their actions in the light of self-reported information. Retail investors are asked to self-certify their discretionary income, wealth and/or their status as a sophisticated investor. Investors who wish to register with ECF websites are also frequently asked to undertake a questionnaire which will allow the platform to make a judgement on whether they should be treated as sophisticated investors. In both cases, the onus on reporting accurately is primarily the responsibility of the retail applicant.

As part of a robust regulatory structure, this is highly problematic. The details of quantifying income and assets are complicated, especially for those who might need most protection. Likewise, the short questionnaires requiring completion prior to being treated as a sophisticated investor, available on a number of ECF platforms, do little to test the analytical or judgmental skills of the applicant. For the naïve investor anxious to seize 'a part of the action', self-certification presents a danger of being, on occasion, little more than an online box-ticking exercise.

As ever, caveat emptor still rules. This may not present as an issue if the majority of crowdfunding investors remain one-off exercises involving the family and friends of the would-be entrepreneurs.²⁸⁹

²⁸⁶ European Securities and Markets Authority (2014).

²⁸⁷ European Commission DG Communications Networks, Content and Technology (2014).

²⁸⁸ Kirby and Womer (2014).

²⁸⁹ Gray (2014).

Figure 10:
Summary of ECF regulation by country

	Country	Prospectus Limited	Requirements for Licence of Financial Authorities	Limits for Investors	Other
EUROPEAN REGION	FR	EUR 1 Million	AMF (Regulation: Ordonnance n° 2014-559)	≤EUR 1 K (for crowdlending only)	
	DE	EUR 1 Million (under new proposed regulation), but information document required	BaFin	≤EUR 10 K (under new proposed regulation)	Staff needs to demonstrate relevant skills; platforms need to produce an information document if they accept contributions more than EUR 250 (under new proposed regulation)
	UK	EUR 5 Million per issuer within 12 months	FCA	≤10% of net assets per year	
	ES	EUR 5 Million per issuer within 12 months	No	≤EUR 3 K per project ≤EUR 10 K in a platform (During a 12-month period)	Legal initiative propose: stricter regime should apply including accounting and auditing
	IT	EUR 5 Million per issuer within 12 months	Only for professional online portal manager; if the portal manager is a financial intermediary no licence is required and the enrolment in the Consob register is automatic	5% of the equity offer should be taken by professional investors before offer completion	Under a Italian specific "crowdfunding law" Payment requires to be licensed by Bank of Italy
	SE	EUR 1.5 Million within months	S-FSA or cooperation with licensed firm	Possible to offer investments in limited liability companies formed as "private", with limitations on the number of investors	Require a license when securities or investment products are sold; payment requires to be licensed by S-FSA
	FI	EUR 1.5 Million per 12 months	No	No	Finnish Credit Institutions Act and Investment Services Act
	SK	EUR 100 K in EU within 12 months	NBS	No	Financial Instruments Market Act; Payment Services and Systems Act
	BG	EUR 100 K within 12 months	Bulgarian National Bank	No	Law on Credit Institutions and Law on Payment Services and Payment Systems
	PL	EUR 5 Million per issuer within 12 months	No	No	National Law
NON-EUROPEAN REGIONS	US	Securities USD 1 Million (EUR 750 K) per 12 months	SEC, register as a broker or crowdfunding platform	USD 2 K (EUR 1.5 K) or 5 % of annual income for net worth less than USD 100K(EUR 75 K) per year; 10 % of annual income for net worth more than USD 100K(EUR 75 K) per year	
	AU	AUD 5 Million (EUR 3.5 Million) per year	No	AUD 2.5 K (EUR 1.8 K) per issuer; AUD 10 K (EUR 7 K) in total per year	Corporations and Market Advisory Committee legal regulation
	JP	JPY 100 Million (EUR 730K) per campaign	No	JPY 500K (EUR 3.7 K) per investor	Under new proposed regulation, will come into effect in May 2015
	SG	SGD 5 Million (EUR 3 Million) in a year	No	No	Singaporean Securities and Futures Act
	KR	USD 500 K per year	No	USD 10 K per issuer for start-up; USD 10 K per issuer for Individual issuer	Capital Market Act Start-up Companies Support Act

Source: European Commission DG Communications Networks, Content and Technology (2014). Crowdfunding innovative ventures in Europe: The financial ecosystem and regulatory landscape. DG Communication Networks, Brussels, Content and Technology, pp 74-5.



But the potential that several other credible observers see in CF would suggest that this modest impact might not remain the case. In the short-run at least, crowdfunding platforms are likely to know very little about the majority of their potential investors and vice versa.

This is what we have termed the 'double information asymmetry' problem. As ECF expands, this knowledge disparity between issuers and investors is likely to become greater unless credible, and legally formalised, investor certification becomes a strict condition of engagement with the platform as an investor. Accordingly, beyond the earliest stages of a new industry, self-reported certification is not likely to offer sufficient investor protection. Similarly, there will likely be pressures to formalise the amount, type and quality of the information that potential firm applications provide to platforms and investors. Any well-publicised incident where 'innocent' retail investors lose money in an ECF-mediated deal, because of either incompetence or corruption, is likely to hasten public and government calls for greater regulation.

A 'modest proposal'

It is more likely that the CFE platform itself is in a better position of regulating or rationing the amount that individual investors are allowed to invest in a new issue. It is a relatively simple matter to cap the maximum individual investment for either a single fund-raising or for a period across the total offerings of the CFE platform. Several country CF legislations impose such a cap (see **Table 10**)

A default position of the ability only to receive 'modest' individual commitments until at such times as the investor is satisfactorily appraised by the platform would offer protection, but at a greater initial onus (and cost) on the platform rather than the retail investor. We suggest that the maximum retail investment should be around A\$10,000 per investor per year, regardless of the number of platforms or firms invested in. If both the investor and platform wished to increase the investment per named individual, then an independent certification of the status of the investor (i.e. professionally-advised, sophisticated, and/or high-net-worth) would have to be made. At or before that juncture, further generalised agreements as to industry investment limits and conditions would sensibly have to be made by regulators in consultation with all interested parties.

This simple, pragmatic, two-stage arrangement is proposed at this stage of the industry's evolution to give some clarity and protection. It is believed that the regulation imposed should be relatively light until the ECF industry's growth and characteristics have evolved and are more easily understood.

This simple, two-stage arrangement would not protect the retail investor who was committed to joining and investing in several ECFs, regardless of his/her competencies or wealth, unless platforms could share investor identities. But a regulatory system has to determine at what stage the retail investor must accept the consequences (good or bad) of his/her own actions. Policy makers would do well to study the evolution of the BA and VC industries in the gradual refinement and professionalisation of the investment process and its governance.

And the near future ...?²⁹⁰

Over time, it is likely that ECF platforms will wish to professionalise in the same manner as BA and VC firms. This will be important to attract quality deal flows in a competitive environment. In these circumstances, the attraction of a large number of amateur investors will rapidly decline as credibility is sought with established, well-financed, professional co-investors. That minority of CF investors who will wish to participate in this transition are likely to wish to be seen – and act – as professional, sophisticated investors. In reality, this condition of investor selection will be imposed on ECF platforms by their co-investors. Small retail investors will regroup primarily around donation and reward-based funding categories.

In these circumstances, there is likely to be opportunity for platforms that can either assess ECF (as well as P2P) opportunities on behalf of interested but inexperienced investors. There are also likely to be opportunities for putting high-net-worth ECF investors in co-investment syndicates with BAs (see, for example, the 'syndicate room' model). In each case, the retail ECF investor is escorted by more experienced early-stage investors in traversing a steep learning curve. Such 'investor-readiness' activities, recommended by Gray²⁹¹, may also help attenuate the very likely over-pricing, which several BA industry participants believe will invariably occur, when optimism and inexperience meet in the disruptive industry that profit-related crowdfunding most certainly is.

²⁹⁰ It should be noted that this brief report has focused exclusively on ECF. It has been observed that loan-based CF (aka peer-to-peer lending or P2P) is currently a considerably larger activity in profit-related CF than equity trading. Several observers see P2P as a more valuable innovation for enterprise finance than ECF. This author is rather sympathetic to this viewpoint.

²⁹¹ Gray (2014).

Recommendations

- There is a need for clarity relating to the operations and legal aspects of crowdfunding in Australia, particularly around the rights and obligations of existing shareholders and the new categories of 'first time' and secondary crowdfunding shareholders.
- Changes in financing via the VC route provide opportunities for governments and financial institutions to address the finance gap through alternative finance models such as, for example, more 'asset backed' loans (including the recognition of intangible assets as collateral), project financing and leasing.
- Governments and other bodies, such as financial institutions and industry groups, should encourage SMEs to use alternative sources of finance as a means of bridging the SME finance gap.
- The federal government should endeavour to pass legislation, as a matter of urgency, allowing proprietary companies to take advantage of equity crowdfunding.

Chapter Five

Workplace relations

Dr Vince Giuca: Partners-In-Business Institute,
Professor George Tanewski: Deakin University

Workplace relations

The small business sector is an important employer of labour and contributes significantly to the Australian economy. However, the sector is not one homogenous group. It is diverse, and its impact is widespread across the economy, including the government sector. While not all small private-sector businesses employ people, 798,000 (or almost 38.0%) are employers of labour, employing 4,731,000 (or over 44.0% of all employees).

Many changes are impacting the workplace. Principally associated with changing demographics and technology, they are altering the way work is viewed. Small businesses are not immune from these trends, as will be shown in this chapter.

Small business owner-managers who employ labour face many challenges in managing their human resources (HR), especially if they want to grow their businesses. An important distinction to make relates to whether an owner-manager is growth-oriented. This will significantly impact how the business is likely to be managed in a sustainable way, noting that small businesses have a higher failure rate than their larger counterparts.

While the workplace relations system is sometimes seen as imposing unnecessary compliance costs on small businesses, the system provides for flexible work arrangements that are not necessarily accessed by small business owner-managers. It also provides owner-managers with key standards or benchmarks, so they can readily determine what to offer their people in terms of pay and other terms and conditions of employment. These are readily available and easier to understand than was the case in the past.

Businesses that rely on paying their people (minimum) award terms and conditions are less likely to succeed. HR are an important source of superior productivity and competitive advantage. Business owner-managers who do not demonstrate that they value their people are less likely to achieve such results²⁹².

The changing workplace landscape

The world of work is changing rapidly due to advances in information and communication technologies, community expectations and cost pressures, among other things²⁹³. Many long-held assumptions by employees about regular working hours, including limited weekend work, spending time with family, loyalty to one or just a few lifetime employers and working in one location are being challenged²⁹⁴.

Also challenged are the assumptions taken for granted by employers regarding “the idea that hierarchy is the best way to manage information flows; that most people will work with team members in the same office; or that the majority of talent will be held within the boundaries of the company”²⁹⁵. These changes have implications for the way work is designed and accomplished, and for the way managers control and monitor their workers, and they impact workers’ terms and conditions of employment (i.e. whether a worker is hired as an employee, a casual or a contractor, or hired through a labour hire firm).

Technology is now making it possible for work to be undertaken remotely (i.e. outside the traditional workplace). This is referred to as virtual work, whereby working times become blurred. A worker can interact with his or her manager and other work colleagues at almost any time of the day or night and any day of the week, including weekends. While this raises concerns about proper work-life balance, from an employer’s perspective it also raises issues about online distractions from such things as social media and how productive workers are when ‘working’. These issues can then give rise to how workers activities and outputs are monitored, and what individual privacy issues these may generate. This picture brings into focus dynamic, complex issues from both sides of the worker-employer divide that are not easily addressed²⁹⁶.

Small businesses can now access technologies that were once used only by larger businesses. For example, Enterprise Resource Planning (ERP) systems are now available ‘in the cloud’ at affordable prices to small businesses where they can operate most, if not, all of the back office functions (e.g. accounting, customer relationship management and payroll). In the context of workplace relations, there are now various human resource management (HRM) offerings that enable workforce information to

²⁹² Fox and Smeets (2011); Ichniowski and Shaw (2003); Lazear (2000).

²⁹³ Holland, Sheehan, Donohue, Pyman and Allen (2015).

²⁹⁴ Gratton (2011).

²⁹⁵ Gratton (2011).

²⁹⁶ Holland, Sheehan, Donohue, Pyman and Allen (2015).

Headline findings and recommendations

- The small business sector is often perceived in the business and political media as a homogeneous group. It is, however, very diverse and a critical distinction needs to be made between growth (entrepreneurial) and non-growth-oriented owner-managers. While the latter group is numerically significant, growth-oriented entrepreneurs, in the main, do the heavy lifting when it comes to new job creation. New and small businesses are subject to vulnerabilities – that is why the survival rates are relatively low for such businesses. The longer they survive and the more they grow, the more sustainable they become. Growth-oriented businesses have the opportunity to contribute more significantly to employment growth.
- In broad terms, the workplace relations system appears to work reasonably well. Some will undoubtedly be critical, often on political or ideological grounds, while others will see merits in the current arrangements, perhaps with some changes. This is inevitable for an area that is highly contested and has seen many significant changes since its inception nationally following federation. Whenever fundamental changes have ensued, the impact has been felt at the coal-face, by employers and employees who have had to turn to third parties for assistance in interpreting and operationalise system changes. Whether the changes are worth the resulting confusion and instability (and money) is often not known for some time. Even then, it often turns on political and ideological considerations.
- Owner-managers of small businesses, including entrepreneurs, will benefit from a workable workplace relations framework that delivers consistency and stability. Such owner-managers are time-poor and lack resources to deal with too many ongoing changes, particularly of a significant nature. Such owner-managers, especially the entrepreneurial types, are looking for (sustainable) advantages to outdo their competition. These players will need to know how to operate optimally within the workplace relations system, but the system itself will not provide competitive advantage. However, how HR are managed within the owner-managers' firms will be an important driver of (sustainable) competitive advantage.
- Continued effort is required to ensure small business owner-managers understand their legal rights and responsibilities with regard to workplace relations, not necessarily at an expert level, but for the purposes of managing their workforce in a fair, equitable manner and in a way that is conducive to a sustainable, productive work environment. To achieve this:
 - Easy-to-understand regulatory material needs to be readily available. For example, the continued effort of the Fair Work Ombudsman (FWO) to work collaboratively with agencies such as the Australian Small Business and Family Enterprise Ombudsman and other small business and associated bodies is very important to ensuring the relevance of information for small business owner-managers.
 - Small business owner-managers should be given the opportunity to make enquiries regarding workplace relations matters anonymously (to encourage a more accurate, timely information flow).
 - Penalty rates are a highly contested area of the workplace relations landscape. They were introduced as a deterrence against the use of longer, unsociable working hours by employers, as well as to compensate employees for working such hours. Over time, consumer preferences have changed to longer trading hours in the retail and hospitality sectors. The Fair Work Commission (FWC) has addressed this issue recently and, through transitional arrangements, is aligning Sunday penalty rates with existing Saturday rates. This seems to be a sensible approach as it removes inconsistencies for undertaking any weekend work. However, it is unlikely to present businesses (including small businesses) with any distinctive competitive advantage, as all businesses across these sectors would be similarly impacted.
 - The main direction and operation of federal unfair dismissal provisions appear to be fulfilling important fairness and justice standards and need to remain. We note that the Productivity Commission, in its recent review of the workplace relations framework, did not see any evidence to justify removing such provisions. Importantly, it concluded that unfair dismissal provisions are not playing any significant role in employers' hiring and firing decisions.
 - Due to resource constraints experienced by small business owner-managers, it is important that regulators, at all levels of government, continue to address and remain vigilant to compliance burdens. Regulatory requirements need to be simplified and associated cost-burdens minimised where they are unable to be removed (such as with the wording and administration of awards and the inspectorate role of the FWO).
 - While improvements to the workplace relations systems will continue to be important in addressing any anomalies and modernising outdated provisions, substantive and sustainable improvements to business productivity and competitiveness are more likely to arise from changes made at the firm level. Major differences in productivity and competitive advantage will be shaped, to a large extent, by what happens in specific workplaces and not so much by legislative or governmental changes at the national level.

297 Holland, Sheehan, Donohue, Pyman and Allen (2015).

298 Bloom, Canning and Lubet, 2015; Patrickson (2016).

299 It is unlawful for an employer to discriminate against a person who is an employee or a prospective employee because of the following attributes of the person: race, colour, sex, sexual orientation, age, physical or mental disability, marital status, family or carer's responsibilities, pregnancy, religion, political opinion, national extraction or social origin.

300 Holland, Sheehan, Donohue, Pyman and Allen (2015).

301 Holland, Sheehan, Donohue, Pyman and Allen (2015), pp 256-260.

302 Bloom, Canning and Lubet (2015).

303 Patrickson (2016).

304 Patrickson (2016), p 191.

305 Berkman, Boersch-Supan and Avendano (2015).

be managed from recruitment and selection to performance management and, ultimately, termination. Today, small businesses have access to robust systems and processes that will (at least potentially) allow them to manage their workforces in more sophisticated, cost-effective ways than in the past.

Changing demographics, talent management and social norms

Researchers and policy makers have raised concerns about impending skills shortages and the management of talent in the Australian workforce²⁹⁷. Furthermore, younger workforce participants will need to support an increasing number of retirees, placing a bigger strain on future government budgets²⁹⁸.

With an aging population, employers will need to be more open to the employment of older workers and can ill-afford to succumb to discriminatory practices²⁹⁹ based on outdated myths. For instance, Holland et al³⁰⁰ refer to research by the Australian Human Rights Commission that suggests one in ten business respondents would not hire individuals above a certain age (averaging 50 years old). They also cite other research indicating that more than one in three Australians aged 55 or more had experienced aged-related discrimination, usually about not being accepted for a job.

Holland et al³⁰¹ outline nine myths:

1. **Aging brings ill-health and disease.**
2. **Older workers have more injuries.**
3. **Older workers have reduced functional capacity and are therefore less able to work.**
4. **Older workers lack the capacity for training and retraining, particularly in relation to the use of new technology.**
5. **Older workers represent a lower return on the training investment.**
6. **Older workers are less able to adapt to change.**
7. **Older workers are less productive.**
8. **Older workers are less committed to the job and their organisation.**
9. **Older workers are more expensive to employ.**

The stereotyping of older workers in this way is fallacious and, obviously, not applicable to all in the same way that stereotyping of young or female workers is also problematic. As a

society, acknowledging that older workers have a lifetime of knowledge, experience and know-how is critical if issues concerning labour shortages, productivity and competitiveness are to be adequately addressed³⁰².

With increasing longevity, older workers have much to offer for the benefit of society and individual businesses who take advantage of what they have to offer. A growing number of older workers are now looking at their work preferences, about when to leave their employment, whether they continue to work full-time or part-time or whether they work on a project-by-project basis³⁰³. However, in practice, the opportunities may not be there as many such workers face various contextual barriers "within the recruitment industry or within existing workplace cultures" whereby "most Australian employers only play lip service to the benefits of providing employment to older job seekers"³⁰⁴. For small businesses who often struggle to attract and retain suitably skilled and experienced workers, this often untapped talent pool is an obvious place to start.

In addition, Berkman, Boersch-Supan and Avendano³⁰⁵ point out that employing older workers does not reduce the employment opportunities of younger workers (citing research work by Gruber and Wise). In fact, these can be complementary, as older workers tend to fill skill shortages and can be used as workplace facilitators and mentors to assist younger workers with skills and knowledge development.

However, HR strategies need to address discriminatory practices to help and retain older workers. One important means is to increase the availability of flexible work options. Others "include developing a supportive work environment; the recognition of skills and abilities; training opportunities leading to career progression; and being able to pass on knowledge to younger staff"³⁰⁶.

Within an environment of increasing skills shortages, it does not make sense for owner-managers to dismiss significant segments of the workforce that can be used to plug skills gaps and that provide them with competitive advantages. Older workers are one example where, with the use of specific strategies, commercial benefits may accrue to the firm. Others include attraction and retention of women and young workers³⁰⁷.

Discriminatory practices may be difficult to eradicate with the use of legal means



Table 1:
Number of actively trading businesses (market sector, June 2016)

Business size		Number of businesses	
Small non-employing		1,318,579	60.7%
Small Micro	1-4 employees	599,408	27.6%
Small other	5-19 employees	198,721	9.2%
Medium	20-199 employees	51,024	2.3%
Large	200 or more employees	3,812	0.2%
Total		2,171,544	100.0%

Source: ABS (2017b).

Table 2:
Employment (market sector, June 2016)

Business size		Employment	
Small	0-19 employees	4,731,000	44.3%
Medium	20-199 employees	2,489,000	23.3%
Large	200 or more employees	3,458,000	32.4%
Total		10,678,000	100.0%

Source: ABS (2017b).

alone. However, increasing social pressures coupled with commercial imperatives means that employing and retaining individuals based on merit is a sensible approach that small business owner-managers can utilise without incurring added expenses.

Small business employment

The small business sector is an important component of the Australian economy. Small businesses are defined by the Australian Bureau of Statistics³⁰⁸ as business entities employing fewer than 20 people.³⁰⁹

The small business sector, incorporating non-employing and micro-businesses, makes a substantial contribution to the Australian economy. In June 2016, there were over 2.1 million small businesses in Australia (Table 1) employing more than 4.7 million people (including working

proprietors), representing over 44.0% of private sector employment.

This sector is also a significant generator of new jobs for the Australian economy. In their research, Hendrickson, Bucifal, Balaguer and Hansell³¹⁰ found that a disproportionately high number of new jobs (i.e. 50.0%) came from small to medium-sized enterprises (SMEs), with start-ups contributing approximately half of this employment growth.

As this chapter relates to workplace relations, the focus will be mainly on small businesses that employ more than 5 but less than 20 employees.³¹¹ In June 2016, 198,721 small businesses were in this category, employing approximately 2.6 million people³¹² and representing a quarter of the private sector workforce. Overall employment numbers, by business size, are shown in **Table 2**.

³⁰⁶ Mountford (2013), p 272.

³⁰⁷ Metz (2011); McCracken, Currie and Harrison (2016).

³⁰⁸ Australian Bureau of Statistics (2002).

³⁰⁹ In contrast, the Australian Taxation Office defines a small business as one that has a turnover of less than \$20 million. Unless otherwise stated, the ABS definition will be used.

³¹⁰ Hendrickson, Bucifal, Balaguer and Hansell (2015).

³¹¹ Business entities employing less than five people comprise micro businesses and non-employing businesses (i.e. sole proprietorships and partnerships without employees).

³¹² The employment figure is extrapolated from ABS (2002) data.

Table 3:
Key elements of the national workplace relations system

- A safety net of minimum terms and conditions of employment.
- A system of enterprise-level collective bargaining underpinned by bargaining obligations and rules governing industrial action.
- Provision for individual flexibility arrangements, as a way of allowing an individual worker and an employer to make flexible work arrangements that meet their genuine needs,
- provided the employee is better off overall.
- Protections against unfair or unlawful termination of employment.
- Protection of the freedom of both employers and employees to choose whether or not to be represented by a third party in workplace matters and the provision of rules governing the rights and responsibilities of employer and employee representatives.

Source: Department of Jobs and Small Business (2018).

Workplace relations framework

The rights and wrongs of the workplace relations system are frequently contested in the political sphere. As a consequence, the system has been subject to persistent changes since the Federal Parliament passed the original regulatory framework, the Commonwealth Conciliation and Arbitration Act, in 1904. Arguably, continuing changes to this framework creates a sense of uncertainty for participants³¹³. This can be particularly confusing and unsettling for small business owner-managers, who have minimal resources to understand and implement changing regulatory requirements.

Since federation, the national workplace relations system has increased in importance over state-based systems and now covers an overwhelming proportion of the Australian workforce³¹⁴. The existing national system operates predominantly under the *Fair Work Act 2009*, which includes the FWC, the FWO, Fair Work Building and Construction and the Fair Work divisions of the Federal Court of Australia and the Federal Circuit Court of Australia. Key elements of this system are listed in **Table 3**.

In particular, the role of the FWC includes providing a safety net of minimum conditions, including minimum wages in awards, facilitating good-faith bargaining and enterprise agreement making, dealing with applications in relation to unfair

dismissal, administering the regulation of industrial action, and resolving a range of collective and individual workplace disputes through conciliation, mediation and in some cases public tribunal hearings (FWC website). The role of FWO includes promoting harmonious, productive and cooperative workplace relations, and ensuring compliance with Australian workplace laws (FWO website).

In 2015, the Productivity Commission conducted an extensive inquiry into the workplace relations system and attempted to set a balanced tone in stating that:

The premise of any WR [Workplace Relations] system is that, absent [sic] specific workplace legislation and oversight, many employees would suffer from unequal bargaining power. Most stakeholders recognised this. Of course, bargaining power is not always in the hands of employers. Aspects of the Fair Work Act 2009 (Cth) ('the Fair Work Act') and the Competition and Consumer Act 2010 (Cth) seek to address excessive use of bargaining power by unions. Once a system is in place to regulate bargaining power, there will always be questions about the efficiency and effectiveness of the system, and whether the system has over or under shot in remedying any prior imbalances.³¹⁵

While recognising that further improvements could be made to the system, the Productivity Commission emphasised that the system and, in particular, the National Employment Standards (NES) that underpin core minimum standards of employment, “have attracted little controversy — mainly because their prime aspects (like annual leave) have a long and accepted role by all stakeholders and accord with community norms”³¹⁶. It went on to state that scope for flexibility in the system is considerable:

Notwithstanding complaints from some employers, there is considerable scope for flexibility through independent contracting and employers' capacity to negotiate individual and firm-specific outcomes. In fact, award wages are less important now than at any other time in the last 100 years.³¹⁷

The national system has evolved and is, arguably, now more flexible than in the past, with more simplified and streamlined awards and standards of employment, thus making the system more easily understood by non-experts.

³¹³ Productivity Commission (2015b).

³¹⁴ Productivity Commission (2015b).

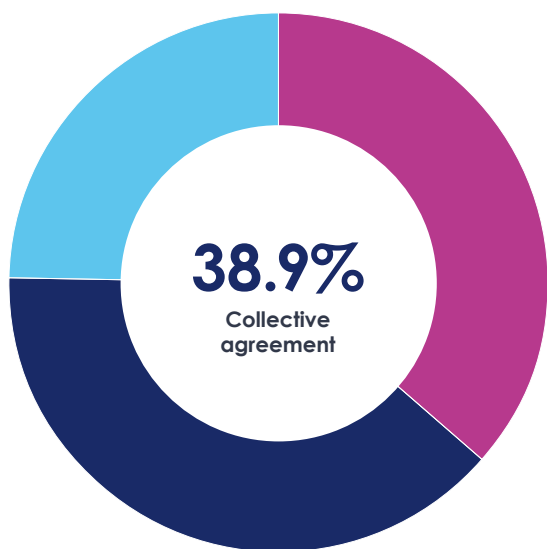
³¹⁵ Productivity Commission (2015a), p 5.

³¹⁶ Productivity Commission (2015a), p 20.

³¹⁷ Productivity Commission (2015a), p 6.

Figure 1:
Employees by pay-setting method
(all employees)

Employees by Pay Setting Method
Non-managerial employees working for small businesses, May 2016

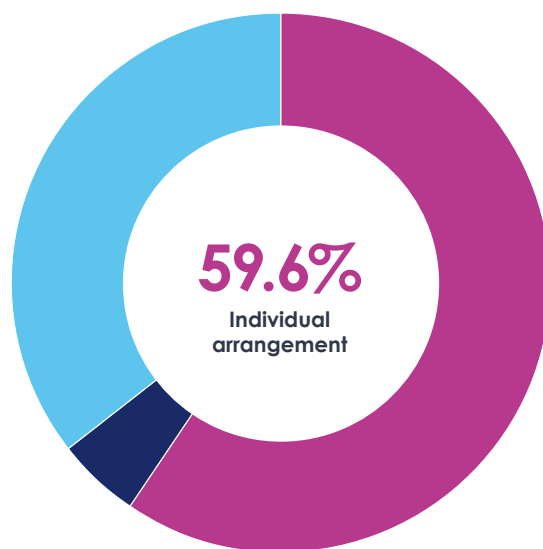


- Individual arrangement
36.6%
- Collective agreement
38.9%
- Award only
24.5%

Source: ABS (2017c).

Figure 2:
Employees by pay-setting method
(employees working for small businesses)

Employees by Pay Setting Method
Non-managerial employees working for small businesses, May 2016



- Individual arrangement
59.6%
- Collective agreement
5.1%
- Award only
35.4%

Source: ABS (2017c).

In the Commission’s view, while the regulatory framework in Australia is broad and elaborate, market forces continue to play a significant role in wage outcomes and conditions of employment. Job security, for instance, could not be and is not guaranteed under the workplace relations system. Nevertheless, the Productivity Commission found some aspects of the system to be ‘clunky’ and expressed “concerns about the complexity of forming enterprise agreements, inconsistencies and lack of clarity in awards, barriers to forming individual flexibility arrangements, and the unpredictability of FWC decisions on a range of matters deters firms from using some of the available avenues.”³¹⁸

This chapter will address these points insofar as they impact on the small business sector.

Award and non-award pay setting

As a method of pay setting, awards were used for 24.5% of all non-managerial employees in 2016 (Figure 1) in contrast to 35.4% for non-managerial employees working for small businesses (Figure 2). The ABS uses ‘award only’ where employees are paid as specified in the award and more than that rate of pay. While small employing entities are more likely to use award rates to set pay than their medium and larger counterparts, the use of individual arrangements is significantly higher in the small business sector compared to other sectors (i.e. 59.6% and 36.6%, respectively).

This would suggest that, while the workplace relations system sets minimum pay and conditions of employment, a large component of the small business sector is not necessarily constrained by these minima.

318 Productivity Commission (2015a), p 6.

Table 4:
National employment standards

1. Maximum weekly hours	6. Public holidays
2. Community service leave	7. Annual leave
3. Requests for flexible working arrangements	8. Notice of termination and redundancy pay
4. Long service leave	9. Personal carers leave and compassionate leave
5. Parental leave & related entitlements	10. Fair Work Information Statement

Source: FWO (2018).

Arguably, these minima are helpful to small business owners-managers in assisting with the setting of pay and conditions of employment for their workers for both award and over-award rates of pay.

Interestingly, Farmakis-Gamboni, Rozenbes and Yuen³¹⁹, in their research on small businesses, found that “small award-reliant only businesses were less likely to have experienced increased productivity and profitability” and “small award-reliant only businesses exhibited lower survival rates relative to small businesses that used non-award arrangements and businesses that utilised a combination of both”.

This may suggest that business owner-managers that rely on paying their employees minimum pay are likely to have less successful outcomes than those who pay above award. This latter group, perhaps, is also better able to motivate their employees and therefore achieve higher productivity and profitability than the former, who may be more cost-driven and not as successful at retaining, attracting and motivating employees. Additional research is needed to explore this in more detail.

Complexity of the workplace relations system

A familiar view often expressed about the workplace relations system is that it is too complex, and that small business owner-managers need to have expert knowledge to navigate this area (e.g. Council of Small Business Australia, 2015). The system is undoubtedly complex, but this also reflects contemporary community standards, some of which have been developed over long periods of time. Anti-discrimination and anti-bullying laws are in

place because, as a community, we have particular expectations. While there would appear to be general acceptance about these standards, there will be arguments about the best way to achieve these.

Improvements have been made to address the previous entangled web of the awards set-up. In January 2010, the FWC introduced 122 modern (and simplified) awards with more flexibility, replacing 1,500 federal awards³²⁰. The *Fair Work Act 2009* also requires the FWC to review awards every four years. Furthermore, the FWC is committed to applying plain-language drafting principles to new award provisions to make modern awards more accessible, particularly for small businesses and individuals.

In addition, the *Fair Work Act 2009* details 10 minimum employment standards (see **Table 4**), thus removing many areas of ambiguity that once existed. All employees covered by the national workplace relations system – regardless of award, registered agreement or employment contract – are covered by the NES. As a result, modern awards, together with the NES, provide a minimum safety net of terms and conditions for employees in the national workplace relations system, making it much easier than in the past to understand its core components.

Flexible work arrangements

Survey data from the ABS³²¹ over a nine-year period tracks seven types of working arrangements offered by private sector businesses. The following figures provide the percentage of businesses within the respective employment size ranges that offer their employees the specified working arrangements.

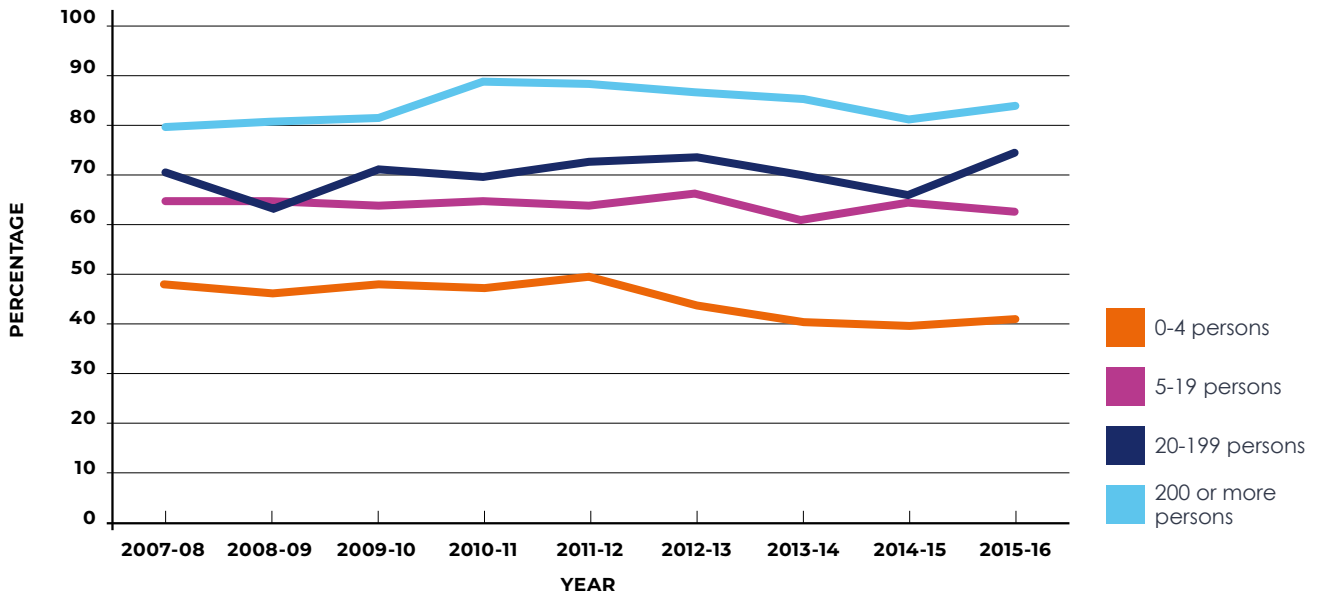
Figure 3 shows the percentage of businesses offering flexible working hours. Overall, employees working for larger employing entities were more likely to be offered flexible working hours. Over the nine-year period for which data is available, businesses employing 0-4 persons and 5-19 persons provided flexible working hours on average in 44.9% and 64.0% of cases, respectively, while the 20-199 and 200-or-more categories allowed for these arrangements in 70.2% and 83.9% of cases, respectively. The diagram also shows that businesses employing 0-4 persons had a 7.0% reduction over the period, while businesses in the 5-19 person category displayed very marginal changes over the same time period.

³¹⁹ Farmakis-Gamboni, Rozenbes and Yuen (2012) p 36.

³²⁰ FWC website; Productivity Commission (2015b).

³²¹ Australian Bureau of Statistics (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

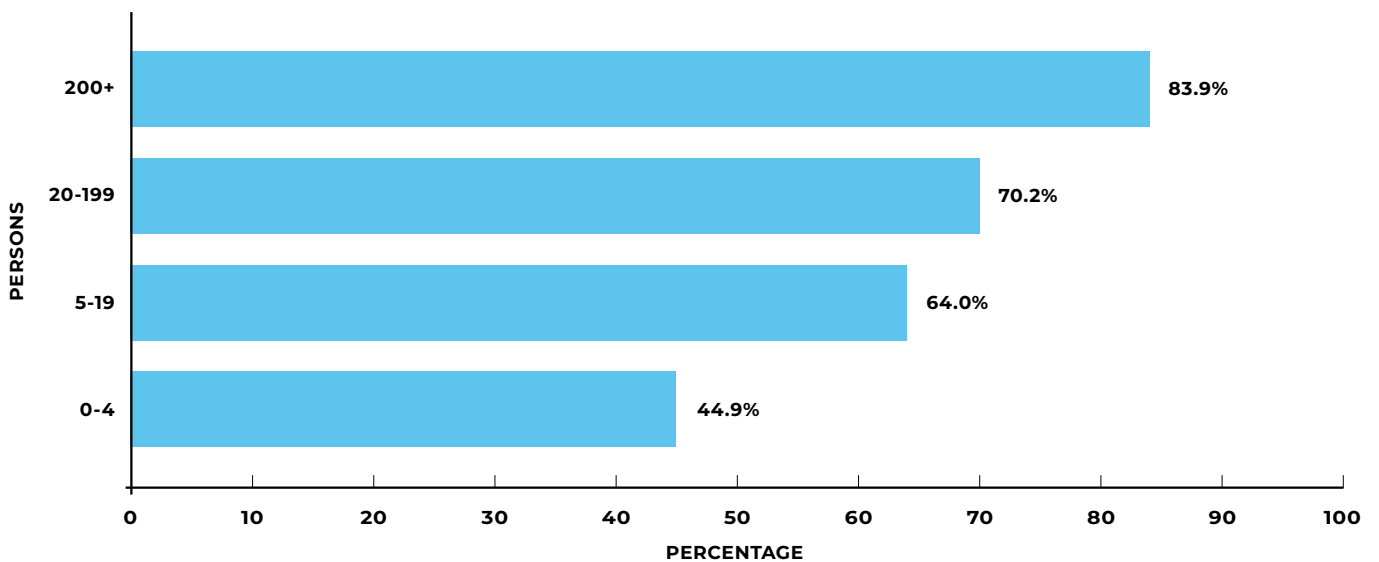
Figure 3a:
Flexible working hours by business size: 2007-08 to 2015-16



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	47.8	46.3	47.4	47.5	48.9	43.8	41.2	39.8	41.1
5-19	64.5	64.7	64.0	64.7	63.5	65.9	61.0	64.7	63.3
20-199	70.2	63.5	71.1	69.6	72.9	73.9	70.0	66.1	74.1
200+	79.4	80.9	81.8	88.1	88.4	86.4	85.2	81.2	84.0

Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 3b:
Average flexible working hours by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

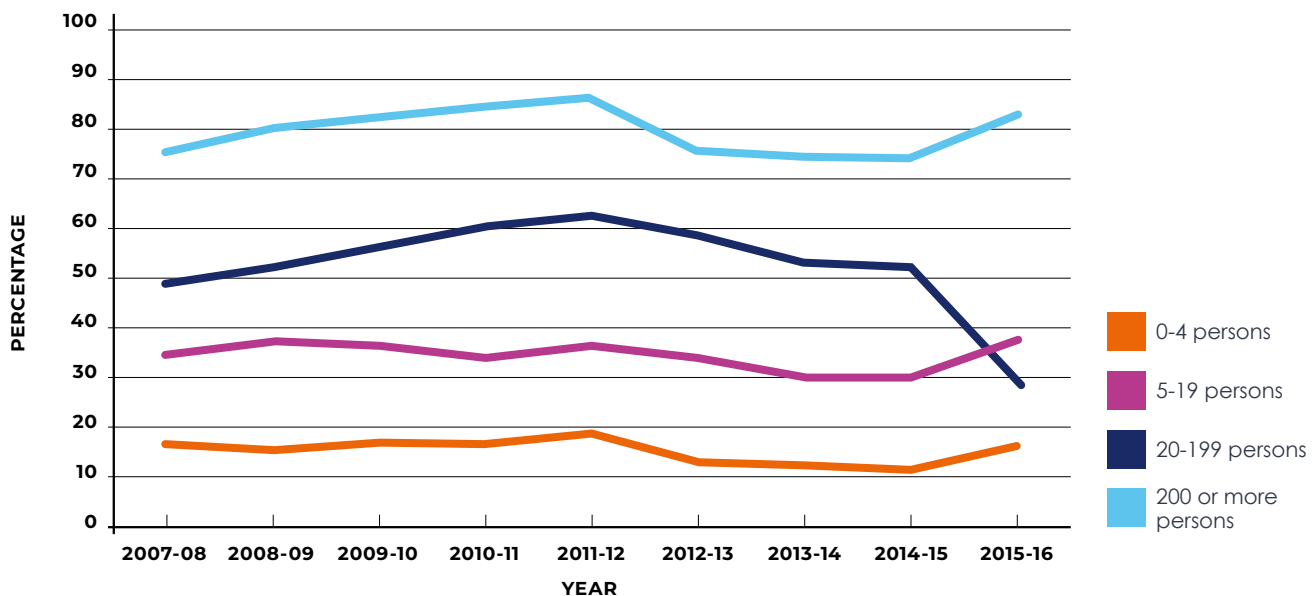
Businesses offering flexible use of personal, sick, unpaid or compassionate leave is displayed in **Figure 4a**. Except for 2015-16, larger-sized businesses provided more flexibility with regard to these types of leave. On average, over the nine-year period, businesses in the categories of 0-4 employees and 5-19 employees had rates of 15.0% and 34.4%, respectively. These rates were significantly less than the other two categories of businesses (20-199 employees had 52.2% and 200 or more employees had 79.4%). For businesses within the 0-4 and 5-19 employment ranges, the figures are fairly stable, albeit with some fluctuations during the nine-year period.

Figure 5 shows businesses offering their employees the ability to buy extra annual leave, cash out annual leave or take leave without pay. Again, there is a clear pattern of the prevalence of these types of arrangements being associated with employment size. While there was a noticeable decline over time in the

use of these arrangements for the 0-4 employment category, there was an increase in 2015-16, but not to the levels of the first five years. For the 5-19 employment category, there has been a consistent decline since 2010-11 and the latest reading stands at 21.3% (a decline of almost 7.0% on the 2010-11 figure).

Businesses offering their employees a selection of their own roster or shifts is displayed in **Figure 7**. As with other working arrangements reviewed, generally the larger the business, the greater the likelihood of being offered choices; although there are some overlapping instances, particularly between businesses with 5-19 employees and those with 20-199 employees. For businesses with 0-4 employees, the trend shows a 6.2% decline from 2010-11 to 2014-15 with a substantial increase of 8.5% from 2014-15 to 2015-16. Whether this last blip is a trend or not will need to await new data for the forthcoming years.

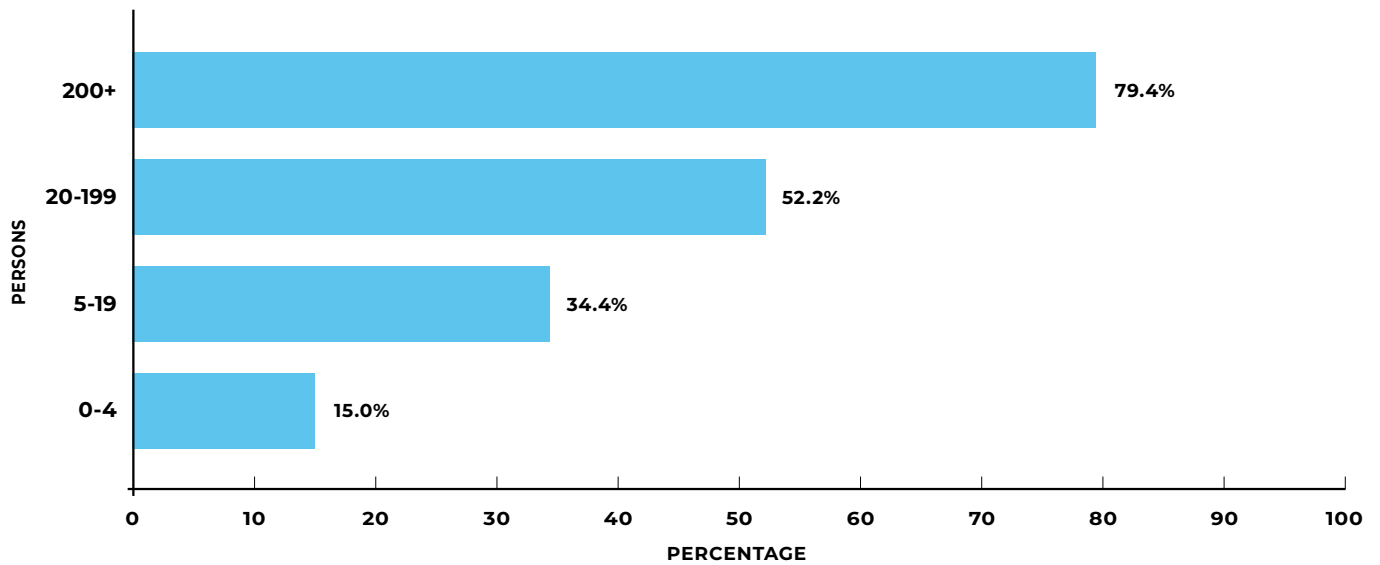
Figure 4a:
Flexible use of leave by business size: 2007-08 to 2015-16



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	15.8	15.0	17.0	17.0	17.7	13.2	11.7	11.6	16.1
5-19	34.7	37.2	36.1	34.2	36.6	34.3	29.7	29.8	37.0
20-199	48.3	52.1	55.8	60.0	61.5	58.7	52.8	52.1	28.3
200+	75.3	79.5	82.0	84.7	85.8	75.9	74.3	73.7	83.0

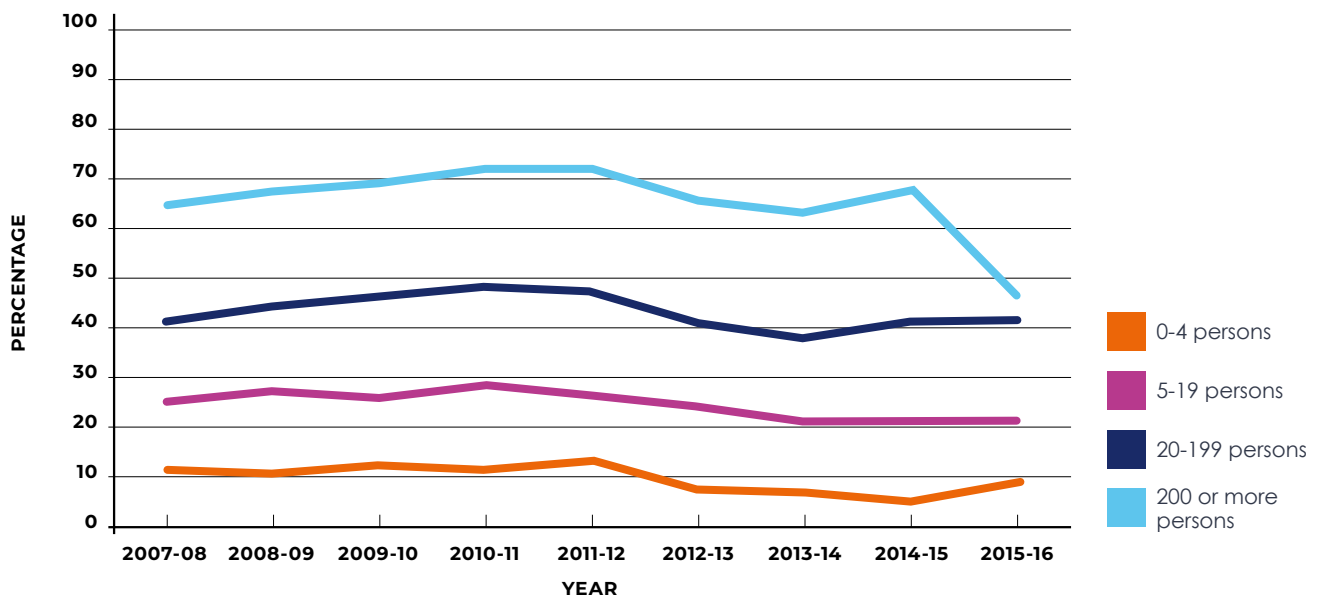
Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 4b:
Average flexible use of leave by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

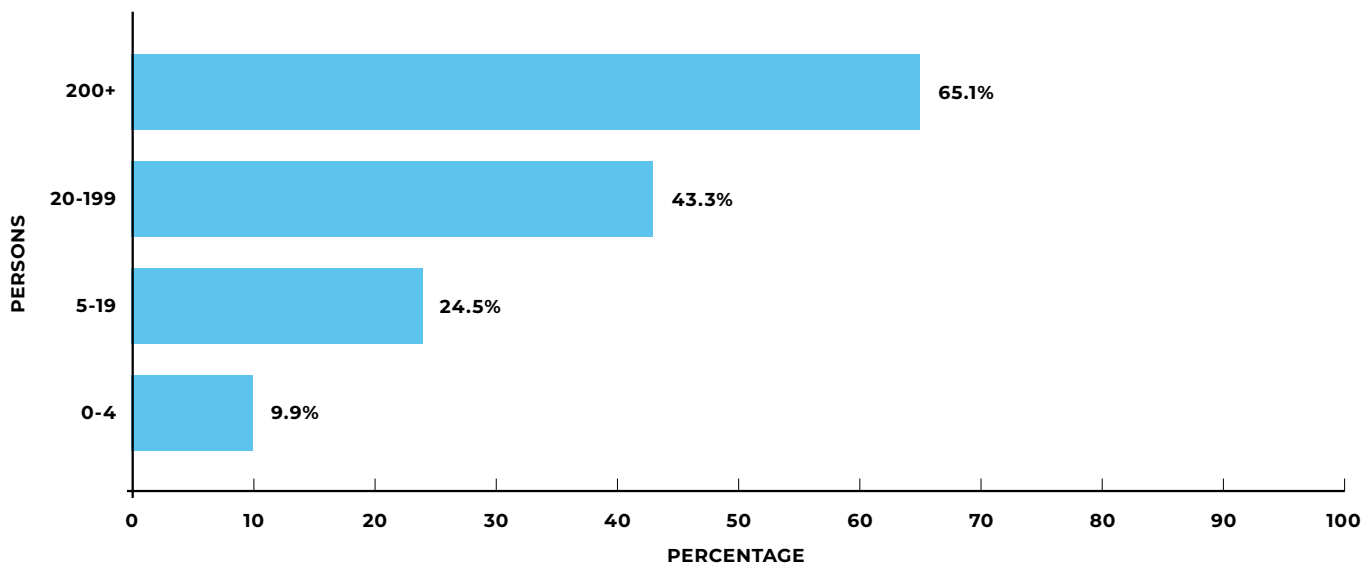
Figure 5:
Leave-type arrangement by business size: 2007-08 to 2015-16



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	11.4	10.7	12.2	11.6	13.2	7.5	7.4	5.4	9.3
5-19	25.6	26.8	25.9	28.2	26.1	23.8	21.2	21.3	21.3
20-199	42.0	44.1	46.3	48.1	47.3	40.8	38.4	41.0	41.7
200+	64.7	66.8	68.8	71.5	71.3	65.5	63.5	68.2	45.8

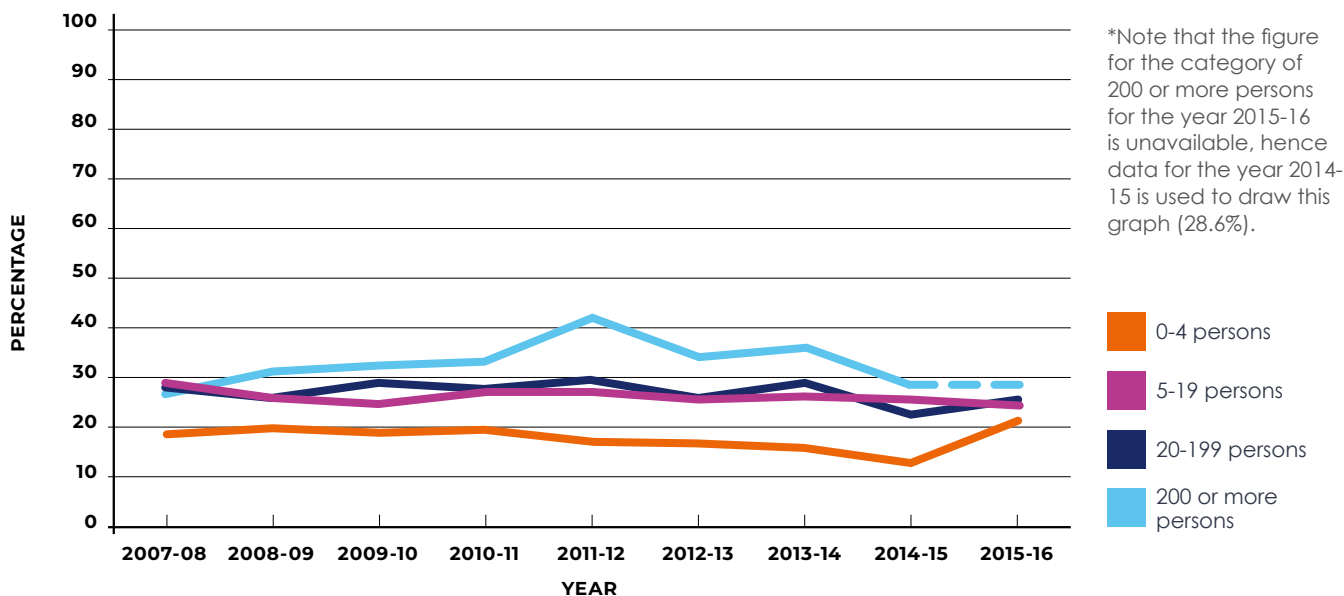
Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 6:
Average leave-type arrangement by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

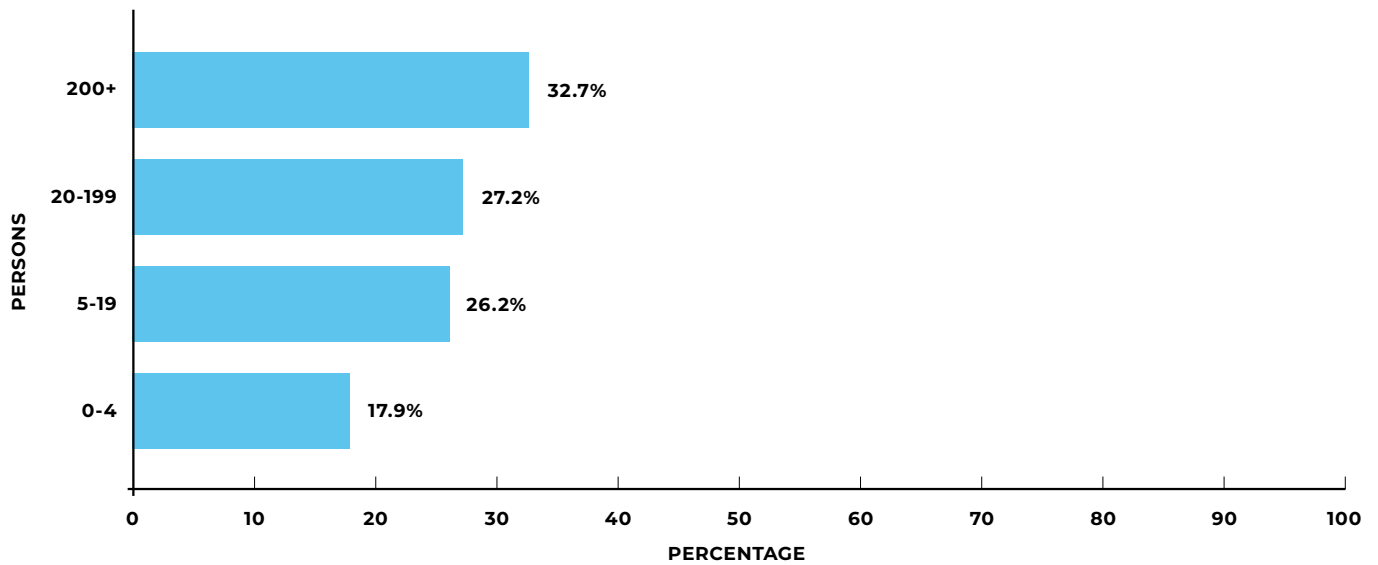
Figure 7:
Selection of own roster or shifts by business size: 2007-08 to 2015-16*



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	19.0	19.9	19.4	19.1	17.2	16.5	15.8	12.9	21.4
5-19	28.2	26.1	25.1	27.5	27.1	25.5	26.2	25.7	24.5
20-199	27.9	25.9	29.4	28.3	29.7	26.4	28.9	22.5	25.9
200+	27.0	31.0	32.8	33.2	42.3	34.3	36.1	28.6	28.6*

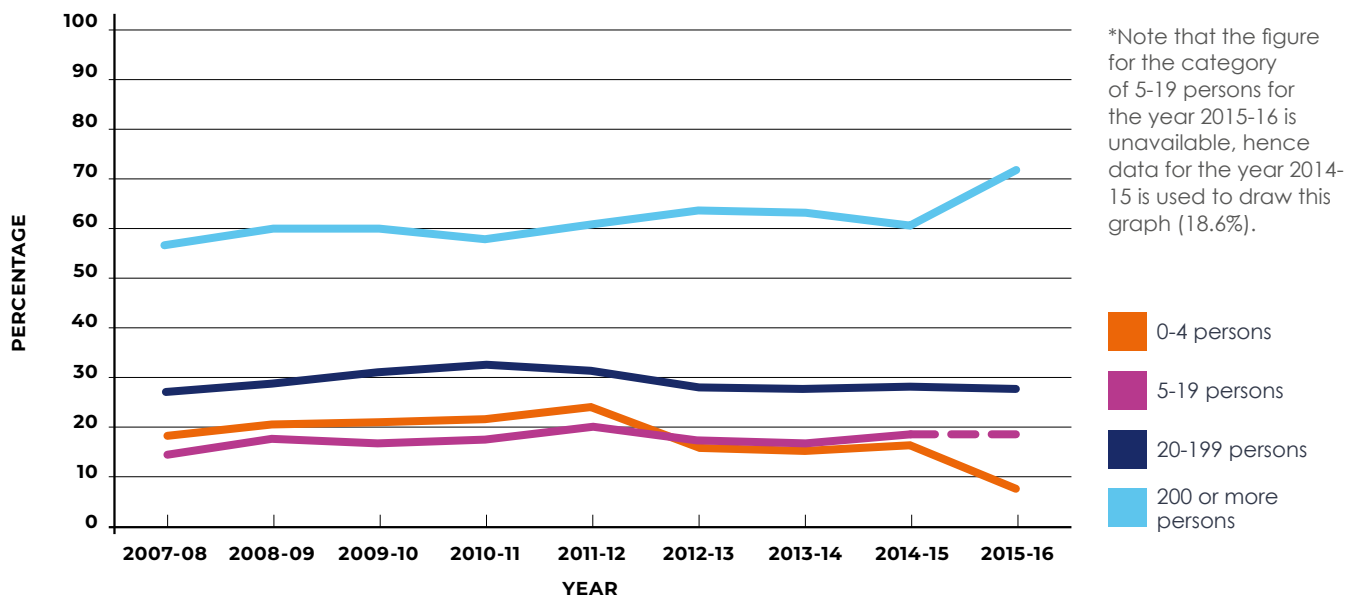
Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 8:
Average selection of own roster or shifts by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 9:
Work from home by business size: 2007-08 To 2015-16



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	18.9	21.5	21.4	21.8	23.8	16.6	15.4	16.1	8.6
5-19	15.0	18.0	16.7	17.7	19.7	17.8	17.1	18.6*	18.6*
20-199	27.5	29.2	31.5	32.6	31.7	27.9	27.7	28.4	28.0
200+	56.6	59.7	60.0	57.9	61.4	63.3	63.4	61.0	71.3

Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Data for businesses offering staff the ability to work from home is shown in Figure 9. Unlike previous business offerings, the figure shows a consistently higher percentage for businesses with 0-4 employees compared to businesses with 5-19 employees during the initial five-year period. This trend is reversed in subsequent years, but only marginally. On average, over the nine-year period, there is little difference between the two categories within the small business sector (i.e. around 18.0%). In comparison, businesses employing 20-199 persons and those employing 200 or more persons averaged higher rates (29.4% and 61.6% respectively).

Figure 11 provides data about businesses offering job sharing, where the overall trend is consistent with most of the other working arrangement offerings (i.e. the larger the employment size of the business, the higher the likelihood of having more flexible working arrangements). Data for 2015-16 is unavailable for businesses with 20-199 employees and there is a sharp (unaccounted for) drop for businesses with 200 or more employees.³²²

The percentage of businesses by employment range providing paid parental leave is shown in **Figure 13**. The figure for the final year for businesses with 0-4 employees is unavailable. For this group, on average over the eight-year period, 2.2% offered paid parental leave,

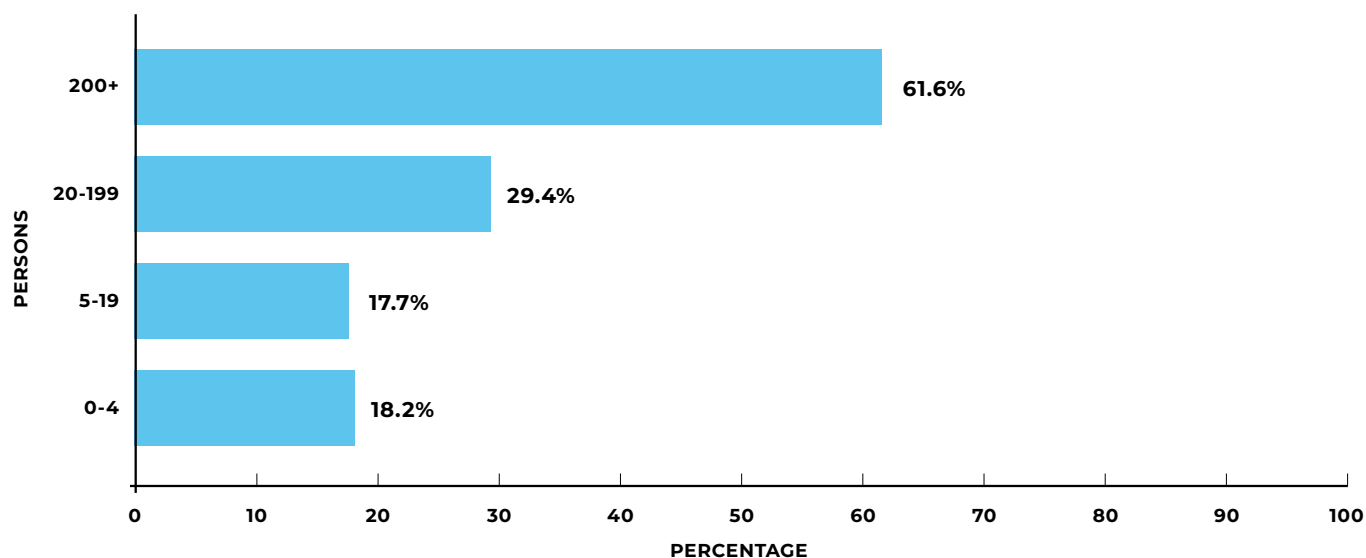
decreasing from 2.4% in 2012-13 to 0.9% in 2013-14 and sitting at 1.4% in 2014-15. Businesses in the 5-19 employee range provided noticeably more paid leave than their smaller counterparts, averaging 7.2% over the nine-year period. However, this rate is much lower than for businesses with 20-199 employees (averaging 19.3%) and businesses with 200 or more employees (averaging 53.9%).

Notwithstanding a few exceptions, the data on working arrangements indicates that employment size matters. The smaller the business in terms of employment range, the lower the rate of different (and arguably more flexible) working arrangements offered by businesses to their employees.

This could be explained in two ways. First, the more limited resource base of small businesses makes it much more difficult for such businesses to offer more opportunities to their employees. In general, small businesses are more constrained financially and have fewer human resources to meet operational needs. The second explanation for smaller businesses providing lower rates of the selected working arrangements may reflect the less sophisticated and more rigid HR policies and practices that may be in place. The use of innovative measures such as allowing employees to buy extra leave, cash out annual leave or take leave

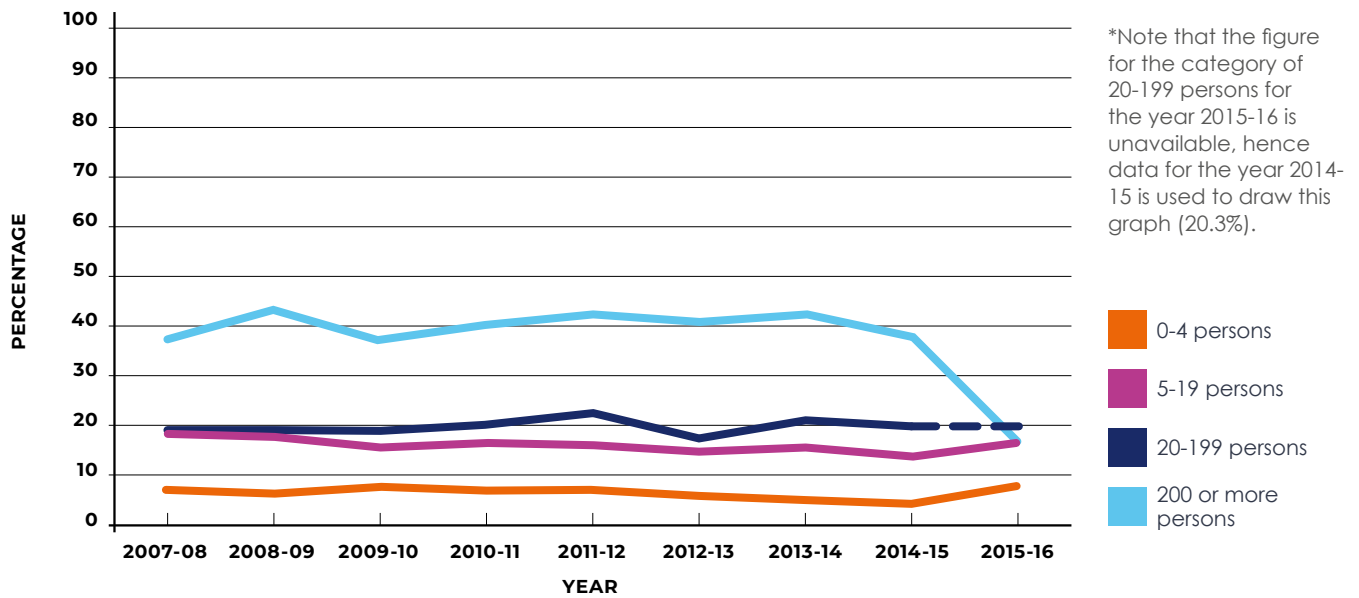
322 It seems unusual that the rate of job sharing is more than halved in 2015-16 compared to 2014-15 for businesses with 200 or more employees. Data in subsequent periods will demonstrate if there is a downward trend.

Figure 10:
Average work from home by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

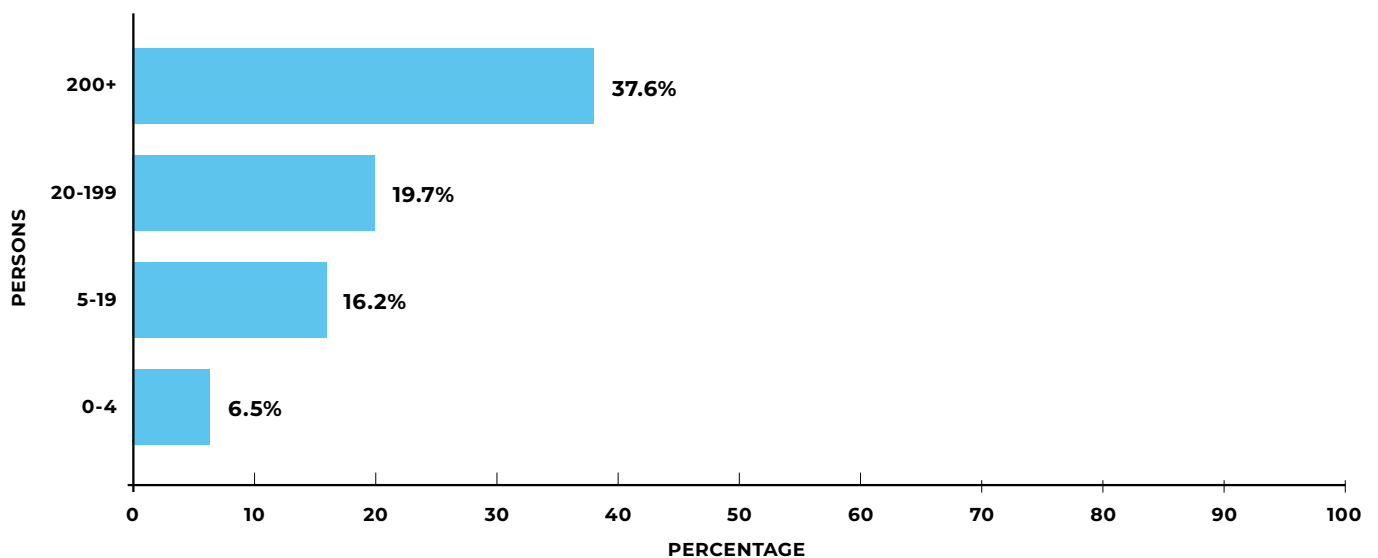
Figure 11:
Job sharing by business size: 2007-08 to 2015-16*



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	7.2	6.6	7.8	7.1	7.3	5.7	5.1	4.3	7.5
5-19	19.0	17.8	15.5	16.5	15.8	14.5	15.6	14.2	16.5
20-199	19.1	19.2	18.7	20.0	22.5	17.1	20.5	20.3	20.3*
200+	37.6	43.1	37.6	40.2	41.9	41.1	42.3	37.8	17.0

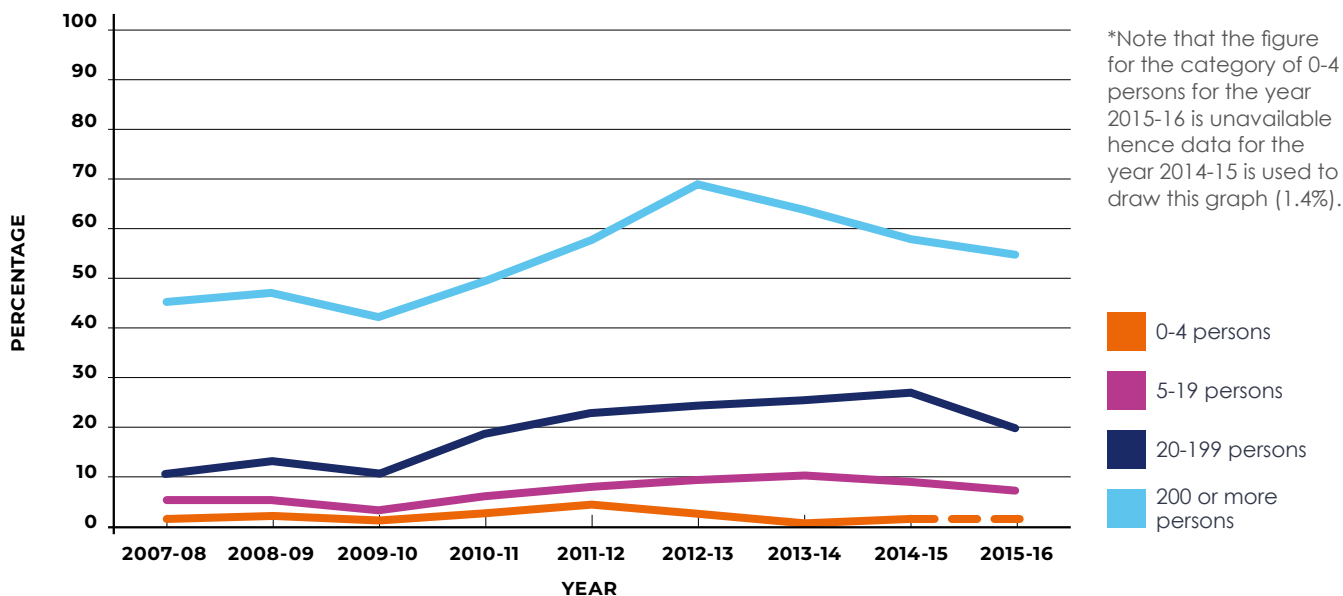
Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 12:
Average job sharing by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

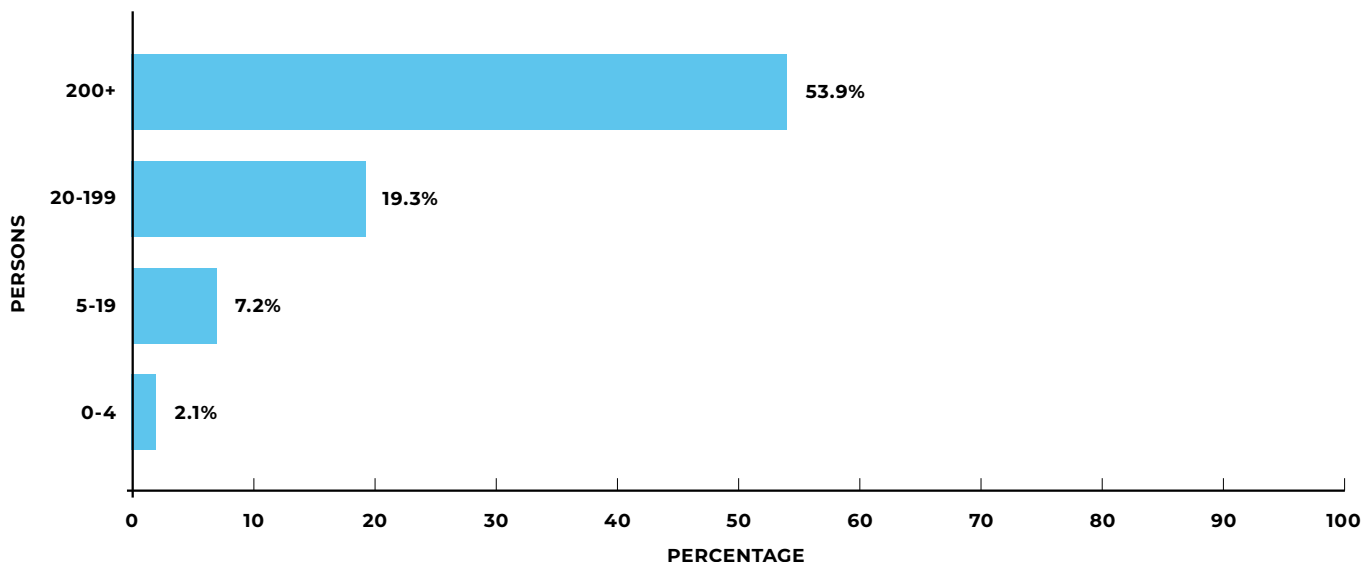
Figure 13:
Paid Parental Leave by Business Size: 2007-08 to 2015-16*



Persons	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
0-4	2.1	2.4	2.0	2.3	4.4	2.4	0.9	1.4	1.4*
5-19	5.3	5.0	4.0	6.0	8.1	9.4	10.2	8.9	7.8
20-199	11.1	13.0	11.2	18.4	22.4	24.1	25.0	27.2	20.9
200+	45.3	47.2	42.0	48.5	57.4	68.5	63.9	57.8	54.3

Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Figure 14:
Average paid parental leave by business size: 2007-08 to 2015-16



Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).



Table 5:
Working arrangements offered by SMEs to employees, 2010-11 to 2013-14

	Non-employing	1 to < 5 employees	5 to < 20 employees	20 to < 200 employees
Flexible work hours	3.2	23.6	36.4	36.8
Ability to buy or cash out extra	3.2	23.6	36.4	36.8
Select own roster or shift	3.2	23.6	36.4	36.8
Job sharing	3.2	23.6	36.4	36.8
Ability to work from home	4.8	23.3	30.4	41.5
Paid parental leave	0.7	7.1	30.3	61.9
Flexible use of sick leave	0.7	7.1	30.3	61.9

Source: ABS (2017b).

without pay is significantly less in small businesses compared to medium and larger businesses. Measures such as these may be a factor in helping to attract and retain valuable workers.

However, it needs to be acknowledged that it is difficult to generalise in this area as each business will have different reasons for and against offering more flexible work arrangements to their employees. Nevertheless, what are the implications for small businesses where significant discrepancies exist with their larger business counterparts? How do these discrepancies affect small businesses' ability to attract and retain employees?

As indicated by the ABS data (see Table 5), sizable numbers of small businesses provide a range of working arrangement choices to their employees. Therefore, if some small businesses can provide such working arrangements, what prevents a greater number of these businesses from doing the same? Do resource constraints account for most of this or are there other factors (such as the application of human resource policies and practices, whether formal or informal)?

Educative or enforcement approach

The role of the FWO, as prescribed under the Fair Work Act 2009, includes an educative component (i.e. promoting harmonious, productive and cooperative workplace relations) and an enforcement component (i.e. ensuring compliance with Australian workplace laws).

Some have argued that the emphasis has been too much on the latter and that this can be costly, especially for small businesses that have limited resources. In striking a balance between these two components, the then Australian Small Business Commissioner had the following to say:

In regard to behaviour, the easy approach for a regulator is to concentrate effort on enforcement, rather than educating businesses to comply. However, the majority of businesses want to comply with the laws that regulate their industry. Non-compliance, especially among small business, is often associated with inexperience, lack of understanding or poor management practices.

In our experience, small business is more responsive to a facilitative approach to regulation, one that is underpinned by understanding and education. For example, dealing with non-compliance by explaining the breach and providing an opportunity to rectify the situation, rather than immediately issuing fines or prosecuting the business.³²³

In its latest annual report, the FWO acknowledged that most employers want to do the right thing and problems arise from misunderstanding of legal rights³²⁴. Accordingly, the FWO states that it promotes harmonious, productive and cooperative workplace relations by providing advice and education that is "primarily delivered through engagement with people on our Fair Work Infoline

³²³ Australian Small Business Commissioner (2015a), p 5.

³²⁴ FWO Annual Report (2016).

325 Stewart, Bray, Macneil and Oxenbridge (2014).

326 Productivity Commission (2015b).

327 Owner-managers of unincorporated enterprises is used as a proxy for independent contractors.

328 All employed covers all employees plus owner-managers of incorporated and unincorporated enterprises.

329 The ATO treats contractors who are paid mainly for their labour as employees for SGC purposes even if they have an Australian business number (ABN). These contractors are defined as employees by the ATO where (i) more than half the dollar value of the contract (whether verbally or written) is for their labour, (ii) they are paid for their physical, mental or artistic effort and not for achieving results, and (iii) they perform the work personally and is not delegated. (ATO website)

(including the specialist Small Business Helpline), and via the online learning portal and the tools and resources on our website" (FWO submission to Productivity Commission).

However, as pointed out by Stewart, Bray, Macneil and Oxenbridge³²⁵:

This suggests that the government of the day saw the promotion of workplace cooperation primarily in terms of providing general information or training, rather than taking more proactive steps to work with organisations to improve consultation, communication or decision-making.

These authors are critical of the FWO's narrow approach in this area and see it as a lost opportunity to be more proactive. They suggest that more substantial initiatives, such as those in the United Kingdom and New Zealand, could be examined. Nevertheless, based on the views expressed to the Productivity Commission³²⁶ during its inquiry into the Workplace Relations Framework, the Commission summed up its findings about the FWO in a positive light and suggested there was no need for any change to its function.

Employees or independent contractors?

The ongoing debate about whether some independent contractors are, in fact, contractors or employees is an important one. However, before considering this issue, it is useful to understand how many independent contractors there are and what proportion of the national workforce they represent.

Table 6 provides ABS data for the number of independent contractors (or owner-managers of unincorporated enterprises) for the period 2008 to 2013. During this period, the total number of independent contractors decreased from 1.22 million in 2008 to 1.15 million in 2013. In addition, as a percentage

of all employed persons, independent contractors have also decreased from the mid-11% range to high 9% range.

Figure 15 depicts ATO data showing a breakdown of selected expenses related to salaries and wages, contractors, payments made to associated persons, and superannuation expenses for SMEs with a company structure for the six-year period 2010 to 2015. Contractors make up, on average, around 19% of the SME companies' expenses over the period 2010 to 2015, whereas superannuation payments appear to constitute the largest proportion of the SME company's expenses, averaging around 40% over the six-year period.

The issue about whether some workers should be classified as employees or independent contractors is one that originates from English law and is based on common rather than statute law. The issue is contentious because employees have many entitlements not available to independent contractors (e.g. stable ongoing employment, various forms of paid leave and termination notice/redundancy pay). Some types of independent contractors³²⁹, however, do have entitlements to the Superannuation Guarantee Contribution (SGC).

Whether a contract is one 'of service' (employee) or 'for services' (contractor) is determinable by the courts based on a range of factors. Courts will look at the totality of the situation in arriving at their decision, rather than a single factor. Typical factors or indicators that the courts will consider are listed in **Table 7**.

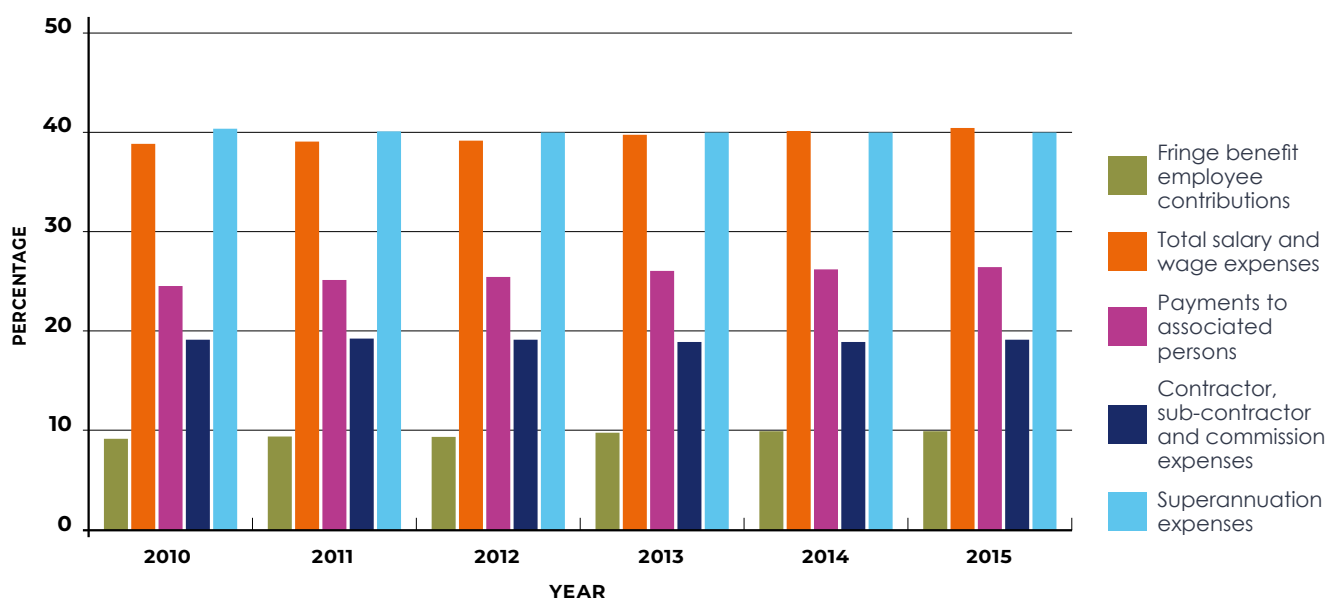
Some groups (e.g. ACTU and Legal Aid NSW)³³⁰ have argued that this is too confusing and creates uncertainty where working relationships sit at the margin of the employee / independent contractor divide. Consequently, they argue that common law, in this respect, should be codified into statute law. However, others (e.g. Professionals Australia, the Australian Mines and Metals Association, and the

Table 6:
Forms of employment, 2008 to 2013

	2008	2009	2010	2011	2012	2013
Independent contractors³²⁷ ('000)	1,223.0	1,242.1	1,288.4	1,215.8	1,130.8	1,156.2
As % of all employed³²⁸	11.48	11.65	11.38	10.71	9.86	9.99

Source: ABS (2017a).

Figure 15:
Selected expenses by SME companies, 2010-2015



	2010	2011	2012	2013	2014	2015
Fringe benefit employee contributions	9.26%	9.45%	9.50%	9.85%	9.93%	9.88%
Total salary and wage expenses	38.91%	39.01%	39.26%	39.78%	40.16%	40.54%
Payments to associated persons	24.66%	25.10%	25.56%	25.98%	26.21%	26.35%
Contractor, sub-contractor and commission expenses	19.07%	19.23%	19.19%	18.98%	18.94%	19.06%
Superannuation expenses	40.28%	40.18%	39.91%	39.94%	40.02%	40.22%

Source: ABS (2009; 2010; 2011; 2012; 2013b; 2014; 2015; 2016; 2017d).

Australian Industry Group)³³¹ have argued that this will not eliminate the problems.

While acknowledging these difficulties, Stewart, Gahan, McCrystal and Chapman³³² stated that, even with a statutory definition, an independent body (i.e. a court or tribunal) would still be necessary to adjudicate on the issue in particular cases. Similarly, Norton Rose Fulbright³³³ argued that a statutory definition would come full circle back to the common law test currently applied by the courts. In addition, it would create another basis for subjective interpretations and it may end up being too prescriptive and legislative provisions may not keep up with changing workplace developments.

In its 2015 report, the Productivity Commission³³⁴ considered this issue in some detail and concluded that “the existing common law definition of a subcontractor may not always be easy to

apply, but alternatives such as a legislative definition or test have their own problems”. As a result of “considerable difficulties and risks associated with a policy shift involving the rigid adherence of such a definition”, it concluded that it was best to remain with the status quo.³³⁵

Other inquiries have also examined this issue, but no legislative changes have been forthcoming. In 2005, the House of Representatives Standing Committee on Employment, Workplace Relations and Workforce Participation recommended the adoption of a hybrid approach where some aspects of the *Income Tax Assessment Act 1997* would be specified in legislation and that the common law approach would continue to be applied. In their post-implementation of the *Fair Work Act 2009*, McCallum, Moore and Edwards³³⁶ considered the issue but made no recommendations.

³³⁰ See submissions to the Productivity Commission’s 2015 Workplace Relations Framework Inquiry; also Productivity Commission (2015c).

³³¹ As per the previous footnote.

³³² Submission 118 (page 2) to the Productivity Commission.

³³³ Submission 61 (page 2) to the Productivity Commission.

Table 7:
Forms of employment, 2008 to 2013

Indicator	Employee	Independent contractor
Degree of control over how work is performed	Performs work under the direction and control of their employer on an ongoing basis.	Has a high level of control in how the work is done.
Hours of work	Generally works standard or set hours (note: a casual employee's hours may vary from week to week).	Under agreement, decides what hours to work to complete the specific task.
Expectation of work	Usually has an ongoing expectation of work (note: some employees may be engaged for a specific task or specific period).	Usually engaged for a specific task.
Risk	Bears no financial risk (this is the responsibility of their employer).	Bears the risk for making a profit or loss on each task. Usually bears responsibility and liability for poor work or injury sustained while performing the task. As such, contractors generally have their own insurance policy.
Superannuation	Entitled to have superannuation contributions paid into a nominated superannuation fund by their employer.	Pays their own superannuation (note: in some circumstances independent contractors may be entitled to be paid superannuation contributions).
Tools and equipment	Tools and equipment are generally provided by the employer, or a tool allowance is provided.	Uses their own tools and equipment (note: alternative arrangements may be made within a contract for services).
Tax	Has income tax deducted by their employer.	Pays their own tax and GST to the Australian Taxation Office.
Method of payment	Paid regularly (for example, weekly/ fortnightly/monthly).	Has obtained an ABN and submits an invoice for work completed or is paid at the end of the contract or project.
Leave	Entitled to receive paid leave (for example, annual leave, personal/carers' leave, long service leave) or receive a loading in lieu of leave entitlements in the case of casual employees.	Does not receive paid leave.

Source: FWO website.

334 Productivity Commission (2015c), p 797.

335 Productivity Commission (2015c), p 813.

336 McCallum, Moore and Edwards (2012).

This matter should be addressed by the federal government, because it continues to be an issue within the business community and makes the management of workplace relations more difficult and time consuming, especially for small businesses. If the government can define particular forms of independent contractors as employees for superannuation purposes in the *Income Tax Assessment Act 1997*, why can it not make this applicable more broadly in other workplace matters? Removing at least some of the ambiguity would be helpful for all concerned.

What is most concerning about independent contracting is the issue of 'sham contracting', where there is intentional misclassifying of employees as independent contractors. This type of contracting is unlawful but, some would argue, the burden of proof to prosecute a case is too high. Under existing law, it is not sufficient to establish simply that an unlawful contracting arrangement is in place. In addition, the prosecutor must establish that 'recklessness' is involved.

Both the Australian Building and Construction Commission (ABCC) in its

inquiry into sham contracting in the building industry and McCallum, Moore and Edwards³³⁷ in their post-implementation review of the *Fair Work Act 2009* recommended that the test of 'recklessness' should be replaced with 'reasonableness'. This is also the position that the Productivity Commission³³⁸ decided to take and recommend in its final report. No legislative changes have been forthcoming.

Penalty rates

Another issue that has drawn much controversy is that of penalty rates. In the federal jurisdiction, they were first introduced in 1909 and became a prominent feature of the workplace relations system in 1947.³³⁹ Provision was made for inclusion of penalty rates under awards as a deterrent against the use of longer, unsociable working hours by employers and to compensate employees for working such hours.

Since the middle of the last century, not only has the composition of the workforce and working arrangements of many workers changed, but there are widespread community expectations about the availability of various consumer services on weekends and late nights, in particular retail and hospitality. However, penalty rates have largely remained unchanged until recently.

In its 2015 review of the workplace relations framework, the Productivity Commission³⁴⁰ argued that, as a means of compensating employees for working long and unsociable hours, "penalty rates have a legitimate role". However, it went on to state that weekend penalty rates for hospitality, entertainment, retailing, restaurants and cafes should align with those prescribed for Saturdays (i.e. Sunday rates to be reduced to those of Saturday) because they "are inconsistent across similar work, anachronistic in the context of changing consumer preferences, and frustrate the job aspirations of the unemployed and those who are only available for work on Sunday".³⁴¹

In February 2017, a landmark decision on penalty rates was handed down by the FWC³⁴². The decision affects penalty rates for permanent and casual employees working on Sundays, public holidays, evenings and after midnight who are covered by the hospitality, restaurant, fast food, retail and pharmacy awards. Consequently, rates will be brought into alignment with Saturday penalty rates (typically, a reduction of 25.0%) and

transition arrangements are now being applied (commencing in July 2017 with a 5.0% reduction and ending in 2020 when the full reduction takes effect). This suggests that the FWC listens to economic argument, but is also cognisant of community expectations.

While the purpose of penalty rates is generally considered to have both compensatory (to employees) and deterrence (for employers) elements³⁴³, the Institute of Public Affairs' Lane and Rozner³⁴⁴ contest this view. They argue that penalty rates were introduced only as a means of deterring employers from using employees to work longer hours, particularly on weekends. Accordingly, penalty rates "distort the labour market and limit economic opportunities of both businesses (which would otherwise employ more staff for weekend work) and workers (who would otherwise have more work opportunities available)".³⁴⁵

They contend that penalty rates should no longer be mandatory due to the changing habits of workers and consumers, with weekend work now more prevalent³⁴⁶. Rather, they recommend that employees and employers should negotiate directly on matters like these, without any involvement of third-parties (such as the FWC). With regard to small businesses, Lane and Rozner³⁴⁷ state that penalty rates in awards place small businesses at a disadvantage relative to their larger counterparts, which have superior resources to negotiate favourable agreements.

As suggested by Farmakis-Gamboni et al³⁴⁸, small businesses paying their employees award rates (i.e. minimum rates) are less likely than those paying over-award rates to have higher productivity and profitability levels. It is also interesting that one of the examples highlighted by the Productivity Commission³⁴⁹, in their examination of penalty rates, was the case of Toyota and its successful appeal before a Full Bench of the Federal Court of Australia in 2014 to have Sunday penalty rates reduced. Toyota's manufacturing operations in Australia closed in October 2017.

In contrast to the report by Lane and Rozner³⁵⁰, Rajadurai and Cavanough³⁵¹ found, in their research for the McKell Institute, that there was a drop in employment in the accommodation and food sector between May and August 2017. This coincided with the first tranche of penalty rate cuts following the FWC's

337 McCallum, Moore and Edwards (2012).

338 Productivity Commission (2015c).

339 Jones (1981). The first federal penalty rates test case took place in 1947 - the same year that standard weekly hours of work were reduced to 40 - where the then Commission of Conciliation and Arbitration ruled in favour of including penalty rates across relevant national awards.

340 Productivity Commission (2015a), p 3.

341 Productivity Commission (2015a), p 3.

342 Fair Work Commission (2017a and 2017b).

343 e.g. Jones 1981; Productivity Commission (2015b).

344 Lane and Rozner (2017).

345 Lane and Rozner (2017), p 2.

346 Productivity Commission (2015c).

347 Lane and Rozner (2017).

348 Farmakis-Gamboni, Rozenbes and Yuen (2012).

349 Productivity Commission (2015c), p 661.

- 350 Lane and Rozner (2017).
- 351 Rajadurai and Cavanough (2017b).
- 352 Rajadurai and Cavanough (2017b).
- 353 Rajadurai and Cavanough (2017ba), p 6.
- 354 This is the most common avenue. Alternatively, but not simultaneously, disputants may elect to use the 'general protections' provisions (section 395) that differs from the 'harsh, unjust or unreasonable' provisions (section 394) of the Fair Work Act 2009 in that: (a) compensation is uncapped, (b) there is no high-income threshold, (c) relief is available to certain employees outside the national workplace relations system, and (d) the dismissal must constitute 'adverse action' or otherwise contravene Part 3-1 of the Fair Work Act 2009. In addition, disputant employees, where relevant, may have access to State unfair dismissal laws (not applicable for Victoria and the Territories). Finally, a much higher bar is set for disputants who wish to pursue 'wrongful dismissal' under the common law where proof is required that the employment contract has been breached.

February 2017 decision. While Rajadurai and Cavanough are not attributing causation between the penalty rate reductions in this sector and job losses, they point out that "there is no evidence suggesting the penalty rate cuts have been overtly beneficial for job creation in the sector" (**finding 4**).

Furthermore, through economic modelling, Rajadurai and Cavanough found that "workers across [rural and regional] communities collectively stand to lose \$667 million in disposable income, with the regional and rural economies themselves subject to lose approximately \$289.5 million as businesses shift money previously allocated to labour costs within these regions into other jurisdictions". This raises the issue of whether employers will in fact reallocate expenses saved from penalty rates to other parts of their businesses. Human resource management (HRM) strategic theory (particularly, the resource-based view of the firm (RBV)) would suggest that employers will do so if there is a competitive advantage.

The FWC's February 2017 decision seems sensible, as it removes inconsistencies for undertaking any weekend work. However, it is unlikely to present businesses (including small businesses) with any distinctive competitive advantage, as all businesses across these sectors would be similarly impacted. Given the contentious nature of the penalty rates debate, the FWC's decision should be allowed to take its course and its full effects can be reviewed after the transition arrangements are completed in 2020. However, it is unlikely that adjustments to penalty rates will be an important driver of competitive advantage for small businesses.

Unfair dismissals

Remedies for employees who are dismissed in a 'harsh, unjust or unreasonable' manner are provided for under the *Fair Work Act 2009* (section 394),³⁵⁴ as was the case under the previous *Workplace Relations Act 1996*.

The term 'dismissed' is defined in the *Fair Work Act 2009* (section 386) as a situation where either:

- (a) **the person's employment with his or her employer has been terminated on the employer's initiative; or**
- (b) **the person has resigned from his or her employment, but was forced to do so because of conduct, or a course of conduct, engaged in by his or her employer**

The FWC may order that the unfairly dismissed employee be compensated or reinstated, if appropriate.

Employees of small businesses are not eligible to lodge unfair dismissal claims if they have been employed for less than 12 months, unlike employees working for larger employers where the comparable period is 6 months. Under the *Fair Work Act 2009* (section 23), a small business employer is one that has fewer than 15 employees (based on a headcount of all employees, including regular casual employees and the dismissed employee(s)). This is a more restricted definition than the one used by the ABS.

Small businesses are subject to the *Small Business Fair Dismissal Code* (**Table 8**) which came into operation in 2009. This code helps minimise unfair dismissal claims against small business employers. If an employee engaged in a small business is dismissed after the 12-month period and the employer has followed the *Small Business Fair Dismissal Code*, the dismissal will be deemed to be fair.

The *Small Business Fair Dismissal Code* should remain as it streamlines the requirements for this sector, although the definition of a small business should be increased and aligned with that used by the ABS (i.e. less than 20 employees). This would seem to be a more appropriate criterion, allowing for better analysis through available data sets.

It is evident that the regulatory framework acknowledges "that small businesses are genuinely different in nature both organisationally and operationally".³⁵⁵ Nevertheless, the FWC will still want to ensure that basic rules of procedural fairness are present in any dismissal decision. Issues of workplace fairness and justice are integral elements of good management practices, irrespective of organisational size³⁵⁶ and are likely to be aligned with contemporary community standards.

Unfair dismissal laws may not be perfect, but their purpose is to minimise unscrupulous behaviour by employers, among other things. The *Productivity Commission*³⁵⁷ identified four broad justifications for unfair dismissal laws:

- protecting vulnerable workers
- balancing (albeit limited) the relative bargaining power of the parties
- avoiding less-efficient mechanisms for addressing conflict of this nature (e.g. use of common law and industrial action)
- empowering employees to follow a legal process without enlisting union support.

In summary, the Productivity Commission³⁵⁸ saw the removal of legal unfair dismissal provisions as “not justified on the evidence”. Furthermore, it concluded that such laws “are not playing a major role in hiring and firing decisions, a further crucial test”.³⁵⁹

One study conducted by Ji and Wei³⁶⁰ shows that compliance with labour protection laws, such as unfair dismissal, can induce the reallocation of resources from less-efficient to more-efficient firms, thus improving an economy’s productivity performance. Businesses that are poorly managed, therefore, are more likely to be penalised, while those using appropriate HRM policies and practices will, more likely than not, have few, if any, formal unfair dismissal actions brought against them.

Exploring this point further would be a useful research project. For small business owner-managers, who are typically time-poor and have few resources at their disposal, access to publicly-available educational material and easy-to-understand information regarding their legal requirements and good management practices is a vital element in assisting them to better manage their businesses. To this end, the FWC and FWO websites contain easily accessible, useful material regarding unfair dismissal laws and processes. The FWC’s *Benchbook: Unfair Dismissals*³⁶¹ is also a useful, detailed guide.

The provision of reinstatement has been contested³⁶² and, while it is the primary remedy for unfair dismissals in the legislation, in practice it is used in only a small percentage of cases. Table 9 shows that, of the 8,880 conciliation matters before the FWC in 2016-17, only 0.9% resulted in reinstatement. The comparable figure for arbitrated matters is 8.1% (from a much lower base on 307 cases) for 2016-17. The figures are relatively stable across the four-year period to 2016-17. Figures are not available for the small business sector.

Nevertheless, even from the small number of formal reinstatement cases, this remedy is not appropriate for small businesses where people normally work in close proximity to one another. Once a conflict of this nature has arisen, any reinstatement would seem unhelpful and a recipe for ongoing tensions in the workplace. The FWC should make it very clear – if it has not already done so – that reinstatement will not be entertained as an appropriate remedy in the small business sector.

Table 8: Small Business Fair Dismissal Code

Summary dismissal

It is fair for an employer to dismiss an employee without notice or warning when the employer believes on reasonable grounds that the employee's conduct is sufficiently serious to justify immediate dismissal. Serious misconduct includes theft, fraud, violence and serious breaches of occupational health and safety procedures. For a dismissal to be deemed fair it is sufficient, though not essential, that an allegation of theft, fraud or violence be reported to the police. Of course, the employer must have reasonable grounds for making the report.

Other dismissal

In other cases, the small business employer must give the employee a reason why he or she is at risk of being dismissed. The reason must be a valid reason based on the employee's conduct or capacity to do the job. The employee must be warned verbally or preferably in writing, that he or she risks being dismissed if there is no improvement. The small business employer must provide the employee with an opportunity to respond to the warning and give the employee a reasonable chance to rectify the problem, having regard to the employee's response. Rectifying the problem might involve the employer providing additional training and ensuring the employee knows the employer's job expectations.

Procedural matters

In discussions with an employee in circumstances where dismissal is possible, the employee can have another person present to assist. However, the other person cannot be a lawyer acting in a professional capacity. A small business employer will be required to provide evidence of compliance with the Code if the employee makes a claim for unfair dismissal to Fair Work Australia, including evidence that a warning has been given (except in cases of summary dismissal). Evidence may include a completed checklist, copies of written warning(s), a statement of termination or signed witness statements.

Source: FWC (2014).

355 Fair Work Commission (2017).

356 Holland, Sheehan, Donohue, Pyman and Allen (2015).

357 Productivity Commission (2015c), pp 572-573.

358 Productivity Commission (2015c), p 557.

359 Productivity Commission (2015c), p 557.

360 Ji and Wei (2013).

361 Fair Work Commission (2017d).

362 Productivity Commission (2015c).

Table 9:
Unfair dismissals – conciliation and arbitration cases

Settlement Type	2013-14	2014-15	2015-16	2016-17
Conciliation				
Reinstatement	65	71	71	82
	0.8%	0.8%	0.8%	0.9%
All	8,659	8,788	8,529	8,880
Arbitration				
Reinstatement	34	27	30	25
	9.3%	7.7%	9.2%	8.1%
Remedy to be determined	n/a	10	24	16
All	367	349	326	307

Source: FWC (2017c).

Table 10:
Unfair dismissals – arbitration case with compensation

Compensation range ³⁶³	2013-14		2014-15		2015-16		2016-17	
	< \$6,000	54	36.0%	56	39.7%	49	36.3%	61
\$6000 - \$9,999	29	19.3%	25	17.7%	25	18.5%	21	15.6%
\$10,000 - \$19,999	26	17.3%	34	24.1%	34	25.2%	31	2.0%
> \$20,000	31	10.7%	22	15.6%	25	18.5%	20	14.8
No loss of wage	4	2.7%	1	0.7%	0	0.0%	0	0.0%
Unknown	6	4.0%	3	2.1%	2	1.5%	2	1.5%
All	150	100%	141	100%	135	100%	135	100%

Source: FWC (2017c).

³⁶³ This includes wages and payments owed to employees for such things as accrued annual leave.

With regard to arbitrated compensation cases, the actual amounts paid out are often not high, as shown in Table 10. More than 50% of compensation payments from 2013-14 to 2016-17 were for amounts of less than \$10,000. In 2016-17, the figure was over 60%.

The unfair dismissal regulation outlined above demonstrates it is operating relatively well and that unfair dismissal provisions are not playing a major role in small businesses' hiring and firing decisions. More importantly, the Small

Business Fair Dismissal Code introduced in 2009 has reduced unfair dismissal claims against small business employers. However, while reinstatement provisions in the Fair Work Act have been used in only a small percentage of cases, the FWC nonetheless should make it very clear that reinstatement will not be entertained as an appropriate remedy in the small business sector (as such remedies are not appropriate in workplaces where people work in close proximity to one another).



The vulnerabilities of new and small businesses

Unlike their larger counterparts, small businesses tend to be independently owned and managed, and the owner-manager is the primary decision-maker. In addition, the owner-manager typically provides most, if not all, of the operating capital.³⁶⁴ Consequently, workplace relations in these businesses tend to be qualitatively different than those found in larger businesses, where 'professional' managers act on behalf of the business owners (or shareholders). For example, because the manager and owner are one and the same, decisions about spending are more directly related to the bottom line and, consequently, the cost and short-term implications of decisions are likely to have a disproportionately higher focus.

Small businesses are not homogeneous. They cover a very wide range of activities and industry sectors³⁶⁵, with owner-managers differing in their aspirations for their businesses. In broad terms, there are two categories of aspirations held by small business owner-managers.³⁶⁶ There are those who choose to keep their businesses small, with little or no growth prospects. These owner-managers may see their businesses as job substitutes and/or as related to lifestyle choices. Alternatively, there are those owner-managers who have a more entrepreneurial orientation and seek to grow their businesses. It is widely recognised that most new jobs are created by a small proportion of small-and-medium-sized enterprises (SMEs) that fall into the latter category.³⁶⁷

This brings into question the relationship between size and age which is often confounded in the literature. Issues and challenges faced by small businesses are not necessarily the same as those faced by new entities.³⁶⁸ This is considered within the academic literature in terms of *liabilities of smallness*³⁶⁹ and *liabilities of newness/adolescence*.³⁷⁰ Businesses that are small or new are more vulnerable than their respective larger or older counterparts. Thus, businesses that are both small and new face these liabilities as combined sets of challenges.

Small businesses are vulnerable mainly because they lack resources (particularly financial and HR) and managerial capacity (such as knowledge, expertise, time and decision-making capabilities). New businesses lack sustainability because they often have not established their legitimacy in the marketplace and have

not demonstrated their capability to compete with established firms. These newer firms are challenged on issues of reliability, availability and accountability.

As businesses grow in size and age over time, they tend to become more sustainable entities. This has been supported by research and is consistent with recent data from the ABS. Connolly, Norman and West³⁷¹ found it "unsurprising that only around 60% of small companies (using the ATO definition of revenue under \$2 million) and three-quarters of unincorporated business were profitable in 2009/10". They concluded that the "likelihood of a business being profitable increases with size".

In its count of Australian businesses in 2012-13 to 2015-16, the ABS³⁷² found that the "higher the turnover of a business in June 2012, the more likely it was to survive" and "the more employees an ongoing business had in June 2012 the more likely it was to survive to June 2016". This supports the case that businesses with higher turnover and employment growth are more likely to survive over longer periods of time.

As shown in **Figure 16**, a business's survival rate will increase as its workforce increases. The data shows that 56.5% of non-employing businesses were still in existence after four years, compared to 67.6% and 77.0% for businesses with 1-4 and 5-19 employees respectively. Medium and larger businesses had survival rates above 80.0%.

Similarly, survival rate increases with annual turnover from 48.0% for businesses with less than \$50,000 turnover to 82.5% for businesses with turnover of \$2 million or more (**Figure 17**).

The ABS data also shows that, for 2015-16, the highest rates of business entries and exits were for businesses with no employees, while the lowest of these rates were for businesses with 20-199 employees.³⁷³ The evidence clearly shows that the size of a business is linked to its sustainability. However, it is important to take into account that not all owner-managers want to grow their businesses or are capable of growing them.³⁷⁴

Competitive advantage and workplace relations

The management of human resources in the workplace is a vital ingredient in a firm's ability to survive and attain competitive advantage.³⁷⁵ While human resources comprise a substantial amount of a firm's expenses, they are also very important in shaping how the firm competes and whether it grows and is profitable.

³⁶⁴ Australian Bureau of Statistics (2002).

³⁶⁵ Australian Small Business and Family Enterprise Ombudsman (2016).

³⁶⁶ Cardon and Stevens (2004); Dwyer and Kotey (2017).

³⁶⁷ Dwyer and Kotey (2017). In accordance with the ABS's definition, SMEs in the Australian context have less than 200 employees (ABS, 2002).

³⁶⁸ Cardon and Stevens (2004).

³⁶⁹ Freeman, Carroll and Hannan (1983); Aldrich and Auster (1986).

³⁷⁰ Stinchcombe (1965); Hannan and Carroll (1995).

³⁷¹ Connolly, Norman and West (2012), p 9.

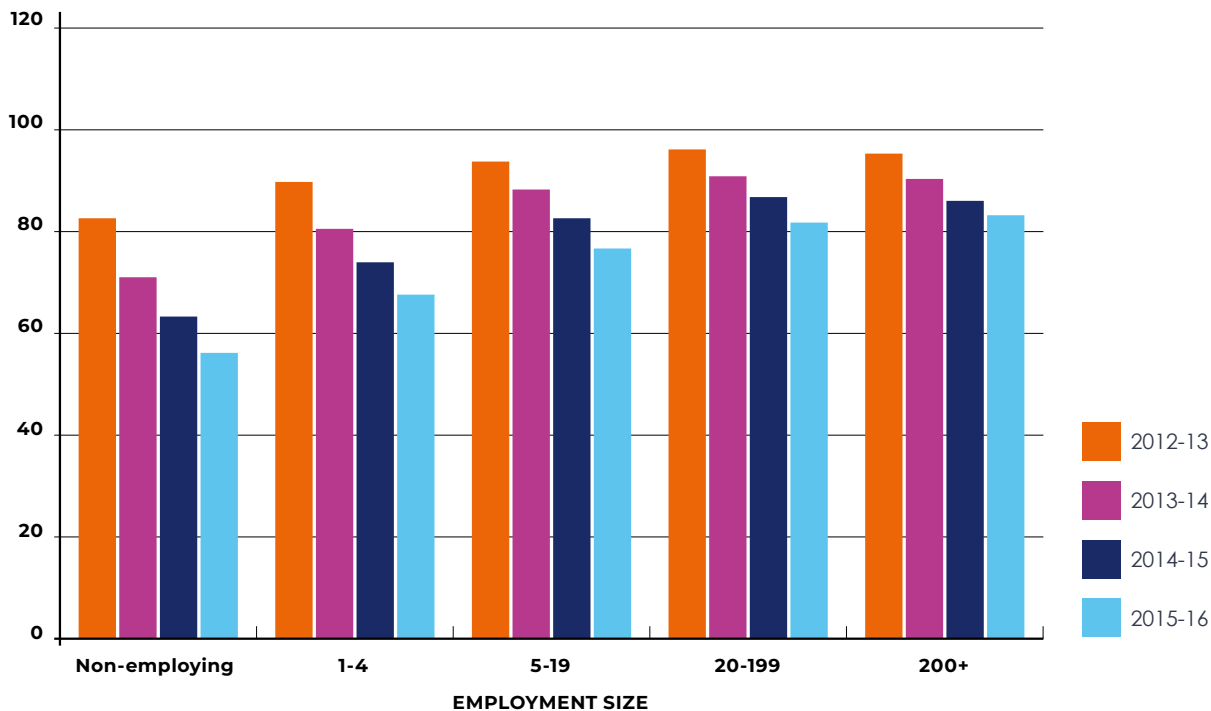
³⁷² Australian Bureau of Statistics (2017).

³⁷³ Australian Bureau of Statistics (2017b).

³⁷⁴ Carland, Hoy, Boulton and Carland (1984).

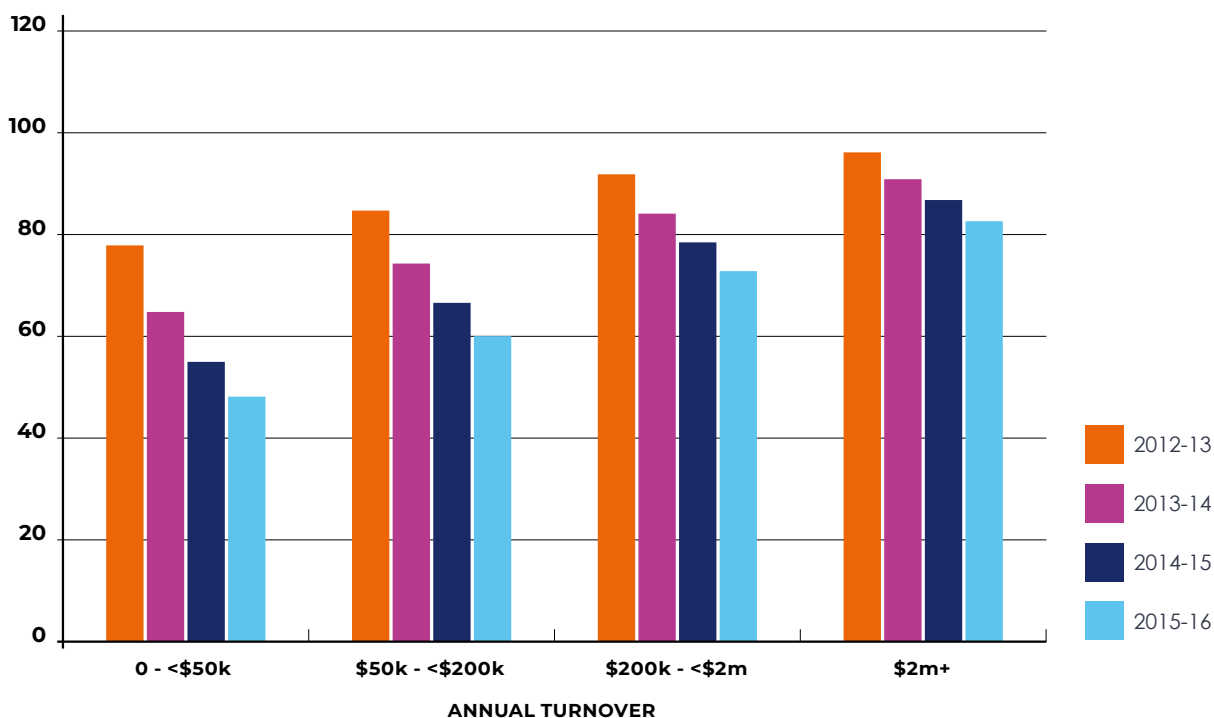
³⁷⁵ Barney and Wright (1998); Boxall and Purcell (2011).

Figure 16:
Business survival by employment size range, 2012-13 to 2015-16



Source: ABS (2017b).

Figure 17:
Business survival by annual turnover size range, 2012-13 to 2015-16



Source: ABS (2017b).



Unlike other resource inputs, human resources require ongoing management – employees need to be motivated, developed, provided with feedback, replaced (where appropriate) and rewarded. Based on organisational practices and routines, they interact with one another or in groups in a way that creates and sustains an organisational culture – the underlying assumptions about the way work is performed in the organisation. These are critical elements that, when combined into a whole, establish productive, as well as unproductive or undesirable, work habits. Therefore, how owner-managers of small businesses manage their HR is of critical importance.³⁷⁶

Despite common pronouncements that “people are our greatest asset”, management practices in many businesses suggest otherwise. The cost perspective of HR is often given primacy over the intrinsic value that comes from valuing people for the potential contribution they can make to a business’s competitive advantage.

In their seminal paper on the resource-based view of the firm (RBV), Barney and Wright³⁷⁷ outlined the economics that underpin HR in a firm’s productivity and competitive advantage. This view is consistent with human capital theory, another broadly-accepted perspective relating the strategic importance of developing key HR assets.³⁷⁸ Thus, a narrow cost-based perspective can inhibit increased productivity and competitiveness because of its short-term focus and its inability to recognise the value of intangible resources and capabilities.

Resource-based view of the firm (RBV)

According to Barney and Wright³⁷⁹, competitive advantage arises from resources that are valuable, rare and difficult to imitate. In addition, these resources need to be well organised and executed. Resources that can be developed to meet all these criteria – referred to as the VRIO³⁸⁰ framework – are likely to provide a business with competitive advantage. According to this framework, resources that are of value, but not rare, can be sources of competitive parity.

A generic quality recruitment process may be valuable but may not produce competitive advantage for a firm. However, without it, the firm may be at a disadvantage. If a resource is valuable

and rare but easily replicated by competitors, it may provide temporary competitive advantage, while a resource that has all the four elements of the VRIO framework will be a source of sustained competitive advantage. Boxall and Purcell³⁸¹, similarly, differentiate between firm viability and sustained competitive advantage – the former is required to meet certain baseline conditions so that they remain in business, while the latter is required to seize opportunities for sustained competitiveness.

In their article, Barney and Wright³⁸² focused on HR, given the potential for these assets to provide competitive advantage. HR include “the knowledge, experience, skill, and commitment of a firm’s employees and their relationships with each other and with those outside the firm”.³⁸³ Various aspects of HR are intangible, heterogeneous and, depending on how they are configured and allowed to operate (through work design and organisational culture, for instance), are difficult to imitate by competitor firms. They are thus an important source of competitive advantage.

Using the VRIO framework, competitive advantage can be seen to arise from:

- firm-specific rather than general skills
- team rather than individual work
- HR systems rather than individual human resource practices.

General skills refer to skills possessed by individuals that are easily transferable from one firm to another (e.g. spreadsheet skills). While these are often necessary, they will not provide the firm with competitive advantage. In contrast, firm-specific skills are those that are valuable to a particular firm only and are not readily transferable (e.g. the use of a unique, firm-specific technology).

Similarly, competitive advantage may arise from teams that provide value to the firm rather than from individuals who are more likely to exploit the situation and claim most of the value-added via higher remuneration.

Finally, single, standalone HR practices will not yield competitive advantage. HR practices need to be integrated and implemented as a consistent whole. For instance, there is not much point in hiring a senior manager with a high salary package and not providing the proper level of delegation and authority to make decisions.

376 Kotey and Sharma (2016).

377 Barney and Wright (1998).

378 Holland, Sheehan, Donohue, Pyman and Allen (2015).

379 Barney and Wright (1998).

380 That is, resources that are valuable, rare, inimitable and organised.

381 Boxall and Purcell (2011).

382 Barney and Wright (1998).

383 Barney and Wright (1998), p 32.

Growth and non-growth oriented small businesses

RBV and the VRIO framework is typically applied to larger firms and not small businesses. Nevertheless, these concepts can be adapted to the small businesses. The categorisation of growth-oriented and non-growth-oriented small businesses can be usefully married to the ideas of sustainable competitive advantage and viability.³⁸⁴ Growth-oriented entrepreneurs often seek innovative opportunities that will make a difference in their respective markets. They seek competitive advantage, if not sustainable competitive advantage. On the other hand, non-growth-oriented owner-managers typically try to stay in business by protecting their existing customer base or, perhaps, by looking for marginal growth opportunities. These non-growth owner-managers seek competitive parity rather than competitive advantage. They typically seek stability and, wherever possible, cost-minimisation. Growth-oriented entrepreneurs, on the other hand, seek opportunities to expand their markets in cost-effective, innovative ways.

With regard to HR practices in small businesses, Barrett and Mayson³⁸⁵ found that growth-oriented businesses were more likely than their non-growth-oriented counterparts to use more formalised practices. Non-growth small businesses in Australia are likely to use ad hoc and informal HR practices that “do not necessarily recognize the value of employees”.³⁸⁶

While this informality may provide flexibility, it may run counter to a firm's strategic focus in the longer term. Formalising practices in small businesses is directly related to the owner-manager's recognition of its importance and on his or her ability to implement such practices. However, the authors recognise that, for small businesses where resource constraints are significant, developing and implementing formalised practices can result in considerable costs.

HR practices within these businesses “reflect operational needs and pragmatic concerns: record keeping; staffing activities, such as recruiting and selecting staff; and, to a lesser extent, motivation and retention activities such as compensation and reward practices”.³⁸⁷ Nevertheless, ad hoc, informal approaches in HR practices present barriers to business growth.³⁸⁸ Non-growth-oriented owner-managers, therefore, are more likely to choose short-term, cost-driven outcomes.

Attracting and retaining employees

Research demonstrates that small businesses experience difficulties in hiring and retaining employees, particularly more skilled and qualified employees (Barber, 2006). Often small businesses struggle to attract suitable employees because their employer brands are inconspicuous and their employment offerings are not as attractive as those offered by other employers (in terms of salary and other tangible benefits, career prospects and flexible work arrangements).

As a result of attempting to recruit from a small pool of candidates, small businesses are more likely to select a compromise candidate – one who is not currently suitable but has the potential – to fill a position. Filling vacancies from within, especially for specialised roles, is also more problematic for small businesses. Furthermore, where small businesses do manage to hire a suitable candidate, there is always the added risk that the employee will move to a larger firm as soon as the opportunity is presented.

Given that human resources are a very important, if not the most important, source of improved, sustained productivity and competitive advantage, attracting and retaining suitable employees should be given much more prominence by researchers and by small business practitioners, including owner-managers and advisers.

Beyond survival

Not all businesses need to grow to survive and their contribution to the economy is significant in terms of overall employment and other key indicators. Many of these businesses have found niche market segments to service and have overcome issues associated with liabilities of newness. In other words, they have demonstrated their capability to deliver services and products to their customers in a reliable and acceptable manner.

Nevertheless, their small scale of operations continues to make them subject to liabilities of smallness, where lack of resources and constraints on managerial capacity can be a major limitation and a significant vulnerability. Owner-managers in this segment are likely to be focused on managing their operations in a hands-on way, using well-established routines with minimum or no delegation of key responsibilities.

³⁸⁴ Boxall and Purcell (2011).

³⁸⁵ Barrett and Mayson (2007).

³⁸⁶ Mayson and Barrett (2006b).

³⁸⁷ Barrett and Mayson (2007), p 308.

³⁸⁸ Mayson and Barrett (2006b).



Table 11:
Differences between small business owners and entrepreneurs

Business	Owner-manager
<p>Small business venture: A small business venture is any business that is independently owned and operated, not dominant in its field, and does not engage in any new marketing or innovative practices.</p>	<p>Small business owner: A small business owner is an individual who establishes and manages a business for the principal purpose of furthering personal goals. The business must be the primary source of income and will consume most of their time and resources. The owner perceives the business as an extension of his or her personality, intricately bound with family needs and desires.</p>
<p>Entrepreneurial venture: An entrepreneurial venture is one that engages in at least one of Schumpeter's four categories of behaviour – that is, the principal goals of an entrepreneurial venture are profitability and growth and the business is characterized by innovative strategic practices.</p>	<p>Entrepreneur: An entrepreneur is an individual who establishes and manages a business for the principal purposes of profit and growth. The entrepreneur is characterized principally by innovative behaviour and will employ strategic management practices in the business.</p>

Source: Carland, Hoy, Boulton and Carland (1984).

In contrast, owner-managers within the entrepreneurial segment, with their focus on growth and innovation, will make many experiential changes – some successful and some not.

Table 11 provides definitions to differentiate the two categories of businesses and their owner-managers.

How these entrepreneurs delegate their responsibilities and manage their human resources will be critical in the development of their businesses. Mazzarol³⁸⁹ argues that, for small business owner-managers to transition their firms into larger entities, they require commitment and a set of management skills “to put in place structures, policies and practices that enable employees to take on greater responsibilities and participate in dynamic innovative teams. Learning to delegate authority and responsibility through application of coaching and HR practice will be essential to success.”

From their recent review of the literature on SMEs, Dwyer and Kotey³⁹⁰ developed a set of markers of high growth firms (HGFs).³⁹¹ Research findings show that, while these firms represent a small proportion of all SMEs, they create most new jobs. So, what makes these firms so special?

According to Dwyer and Kotey³⁹², the markers that single out these firms from others include a range of psychological and demographic factors of the entrepreneur (or owner-manager), the firm's strategic orientation and other

organisational characteristics (see **Table 12** for a list of the most important specific markers identified by the authors).

For small businesses, it is often difficult to separate the owner-manager from the business itself. The owner-manager and the business are very much intertwined.³⁹³ Consequently, the psychology and demographics of the owner-managers become disproportionately important.

Improving the workplace relations framework or management practices

While improvements can be made to the workplace relations system, any consequential productivity and other performance improvements for the Australian economy are likely to be small, unclear and subject to ongoing debate.³⁹⁴ Furthermore, any substantial changes are likely to result in a period of uncertainty with, perhaps, added complexity. This is not necessarily conducive to business confidence.

More substantive, sustainable improvements are likely to emanate from a more concerted focus on developing managerial skills, knowledge and know-how, and decision-making capabilities among Australia's small business owner-managers. Furthermore, there needs to be an acknowledgement of the sizeable gulf between growth-oriented and non-growth-oriented small business owner-managers in their respective aspirations for their businesses.

³⁸⁹ Mazzarol (2003), p 47.

³⁹⁰ Dwyer and Kotey (2015).

³⁹¹ These are firms defined by the Organization for Economic Co-operation and Development (OECD) as having 10 or more employees with employment growth of 20% or more over three consecutive years.

³⁹² Dwyer and Kotey (2015).

³⁹³ Bhide (2000).

³⁹⁴ Peetz (2012).

Table 12:
Markers of high growth firms

Broad marker	Specific marker
Psychology and demographics of entrepreneur	Portfolio of knowledge and skills acquired
	Experience
Strategic orientation	Entrepreneurial orientation
	Customer, market and export orientation
	Learning orientation
Organisational characteristics	Management structure and human capital
	Ownership structure
	Access to finance

Source: Dwyer and Kotey (2015).

³⁹⁵ Holland, Sheehan, Donohue, Pyman and Allen (2015); Peetz (2012).

³⁹⁶ Australian Revenue Offices for the States and Territories of Australia (2017).

³⁹⁷ Commonwealth Grants Commission (nd).

³⁹⁸ Australian Bureau of Statistics (2017e).

³⁹⁹ Productivity Commission (2015b), p 299.

⁴⁰⁰ The above thresholds may be reduced where the company is part of a group and/or pays interstate wages.

⁴⁰¹ The lower 3.65% rate applies to business where at least 85.0% of their payroll goes to regional employees.

⁴⁰² This threshold reduces by \$1 for every \$4 of Australian wages over \$1,100,000. Businesses with annual taxable wages of \$5.5 million or more will be subject to payroll tax of 4.75% on their entire taxable wages.

The differing needs of these two cohorts of owner-managers needs to be taken into account when structuring any assistance and developmental programs. Major differences in productivity and competitive advantage will be shaped, to a large extent, by what happens in specific workplaces and not so much by legislative or governmental changes at the national level.³⁹⁵

State and territory payroll taxes

Payroll taxes levied by the states and territories are based on wages and salaries paid to employees, and other employer payments such as superannuation. In all cases, annual individual employer payrolls below the threshold amounts are exempt. However, once the payroll threshold is exceeded, all the payroll is taxed at the applicable rate. As shown in **Table 13**, the threshold amounts vary between jurisdictions, as do tax rates.

Key issues with this arrangement for small businesses are that there is no consistency in the way these taxes are applied across state and territory boundaries and the threshold amounts are a disincentive to hiring more employees where a business's annual payroll may potentially exceed that threshold, thus creating 'growth traps'.

Despite all state and territory governments signing a protocol for payroll harmonisation between jurisdictions on 28 July 2010³⁹⁶, little or no progress appears to be in the offing.

Substantial amounts of revenue are collected from this stream. The Commonwealth Grants Commission³⁹⁷ states that this is the largest single source of tax levied by the states and this, at least in part, explains why there has been little to no progress on this matter recently. In 2015-16, states raised \$22.7 billion in payroll tax or 28% of total taxation revenue for the states.³⁹⁸

While recognising that payroll taxes create "an incentive for smaller employers to curb wages and/or employment growth", the Productivity Commission³⁹⁹ argued:

In the short run, business are unlikely to be able to change existing wages and prices and so bear any costs associated with increased payroll taxes. However, in the long run, the cost of the tax is likely to be passed onto employees (through lower wages) and consumers (through higher prices). Cutting payroll tax is seen by some as a way of reducing wage costs and achieving stronger employment outcomes and has been raised as an alternative to an EITC [earned income tax credit]. However, the employment effects of a reduction in payroll tax has been the subject of debate among economists for some time. An analysis of the original five economists plan suggests that the employment effects of an EITC were larger than those associated with a cut in payroll tax (Dixon and Rimmer 2001). Moreover, current exemptions



Table 13:
Payroll Tax Rates and Thresholds

State/territory	Rate (%)	Annual threshold ⁴⁰⁰
NSW	5.45	\$750,000
ACT	6.85	\$2,000,000
VIC	4.85 / 3.65 ⁴⁰¹	\$625,000
QLD	4.75	\$1,100,000 ⁴⁰²
TAS	6.1	\$1,250,000
SA	4.95 ⁴⁰³	\$600,000
WA	5.5	\$850,000 ⁴⁰⁴
NT	5.5	\$1,500,000 ⁴⁰⁵

The facts and figures outlined in this tax summary are current as at 1 July 2017.
Source: PwC Australia (2017).

and thresholds mean that a significant proportion of the payroll base is not subject to tax. The Business Council of Australia has estimated that close to half of the potential payroll tax is exempt.

In Australia, payroll tax is levied by the states and territories against the total sum of remuneration (i.e. wages, salaries and superannuation) of employees within a firm for each dollar above a threshold. The application of this tax is highly contentious, with some commentators expressing the view that payroll taxes hinder employment.⁴⁰⁶

Furthermore, as businesses with total remuneration below these payroll tax thresholds are not liable to pay payroll tax, it has been suggested that smaller firms might have a cost advantage over larger firms, thereby encouraging firms to stay small to avoid payroll tax which could result in an economic distortion.⁴⁰⁷

However, recent Australian Treasury modelling shows there is no bunching at the payroll tax thresholds, with only some instances of bunching recorded for Victoria and Western Australia, suggesting there is little change in the behaviour of firms around payroll tax thresholds.⁴⁰⁸ Notwithstanding these results, much more research is required around payroll taxes and their effect on small business.

⁴⁰³ A small business rate of 2.5% is proposed to apply to firms with payrolls between \$600,000 and \$1 million, then phase up to the general rate of 4.95% for payrolls above \$1.5 million.

⁴⁰⁴ This threshold reduces gradually for employers with annual taxable wages between \$850,000 and \$7.5 million. Businesses with annual taxable wages of \$7.5 million or more will be subject to payroll tax at 5.5% on their entire taxable wages.

⁴⁰⁵ This threshold reduces by \$1 for every \$4 of wages over \$1,500,000. Businesses with annual taxable wages of \$7.5 million or more will be subject to payroll tax of 5.5% on their entire taxable wages.

⁴⁰⁶ Adonis (2015).

⁴⁰⁷ KPMG Econtech (2010); Ralston (2018).

⁴⁰⁸ Ralston (2018).

Case study 1:

ABC Hairworkshop

The issue: difficulty in obtaining good staff.

ABC Hairworkshop is a hairdressing business that was based in a large city in New South Wales, has recently closed its doors. Both principals of the business decided that finding, hiring and retaining young committed employees with passion for the industry is a serious obstacle.

Nyugen Ha⁴⁰⁹, a young highly trained stylist and one of the two owners, argues the biggest reason for exiting the business is that “it’s been really difficult to find and retain competent and committed staff”. As the business is located in quite a large city, she suggests that it is easier for people to get work in firms that have standard regular hours. She has also found it hard to find apprentices and believes that a three year apprenticeship has become a major obstacle.

The business was first opened in July 1996 by John Tory*, and at the time, there were two other employees. From being a silent investor in the business, Nyugen joined in a full-time role in 2007. By 2012, in addition to the two owners, the business had grown to 12 employees. This level of employment was maintained for the next four years. Just before ceasing, the business employed one full-time employee, an apprentice, and two casuals.

Nyugen does not see penalty rates as an obstacle and points out that ABC Hairworkshop pays well above the award rate. According to her:

I don’t see that [penalty rates] as the heart of the issue, that is just a political thing. All of that is political and is of no consequence to the actual businesses or employees, because if you are good at what you do you will be paid what you’re worth.

... Most successful hairdressers, in our industry, they pay people above the award wage and penalty rates don’t come into that, but it is finding the right people, firstly, that is the biggest struggle we have.

However, from Nyugen’s point of view, flexible working hours impose a burden on small businesses such as hers because there is often a mismatch between the hours casuals want to work and what is necessary to retain clients, especially around working during the peak, busy times, which includes Saturdays.

As with many small business owners, lack of resources and time is a constant theme that emerges and ABC Hairworkshop is no different. Nyugen expresses the frustration in obtaining clarity regarding workplace relations regulations. She gives an example where one of her full-time staff wanted to go part-time but this would have a hugely negative impact on her business as she really needed a full-time person in that particular senior role.

Nyugen contacted Fair Work Australia, the Fair Work Ombudsman and Worksafe but was unable to obtain a definitive answer about what she should do. ABC Hairworkshop was not a member of an industry association. Fortunately, and after some time and effort, the matter was resolved amicably with a mutually satisfactory arrangement.

However, according to Nyugen, the unfair dismissal laws are “far too loose and for private enterprise they can’t cope with the cost of it and small business can’t cope with the cost.” She argues that while ABC Hairworkshop was never subject to unfair dismissal claims, it was the possibility of this happening that provided the biggest concern for both business owners. Nyugen explains:

Unfair dismissal is hard ... if you have an under-performer, you have to manage that with required time ... that costs you money, that costs you time, but you can’t get rid of them if they are ineffective. You have to go through the process, you have to manage them and make sure they’re complying and then it comes down to the he said, she said, but then the writing is on the wall and then they make a decision if they get a job somewhere else and then they go.

Nyugen finishes on a rather pessimistic note, saying that “the conclusion we have come to is having more staff or having a bigger business is no longer viable today. Basically, work for yourself and that is it, and have no employees.”

⁴⁰⁹ Names have been changed at the request of contributors.

Case study 2: Hancock Creative

The issue: the power of stories to differentiate.

Alecia Hancock started her business on her own with the help of a virtual assistant in October 2010 and shifted the business' focus to exclusively target the cause sector (not-for-profit and social enterprises) in 2015. Hancock Creative now specialises in helping these enterprises become more sustainable by learning how to market themselves in today's world. According to Alecia, many do not realise that solutions to their funding problems can often be addressed through social media.

Hancock Creative now employs eight people under a mix of full-time and part-time employment arrangements. Alecia points out that she normally has contractors as well, but at the moment everyone is employed on a permanent basis, stating that:

Most of my team fall into the category of permanent part-time, because we offer flexibility around families. A lot of our team have kids, some of them might work five days [a week] but work 9 to 3, for example.

While the business is based in Perth, it has a presence in Sydney and Brisbane. Alecia expects to double the size of the business over the next 12 months in a sustainable way.

Having limited resources and taking account of the difficulties of managing a fledgling growth oriented business, Alecia explains that she considered merging with another similar business but decided against that move. Instead, she assembled an advisory board that she is very happy with.

What I have learnt ... I am better off having an advisory board. So we have that now for the business, where we have experts and people that I can have those conversations with. Now that I have an operations manager as well, we can have high-level conversations internally. For a long time I felt that way that I may have needed a partner, but now I don't really feel that any more, because I have plenty of people to bounce ideas off.

In addition, Alecia has a small legal firm on a retainer so that she can readily obtain answers to legal questions and stay up-to-date with regulatory issues relevant to her business. As a result, Alecia is not fazed by unfair dismissal laws in Australia, partly because she has ready access to legal advice and, secondly, because the culture at Hancock Creative is focused on trust and transparency coupled with the active use of performance management. She explains that:

I have had situations in business where things haven't been working out. I am a fan of performance management, where you have a lot of conversations before you let someone go, where you kind of go 'Hey, this is what is required' ... I usually have metrics – this is what good looks like, this is what less than good looks like, this is what really good looks like – where are we sitting right now? And then they can usually go 'Right, I'm below the curve on a few of these', and we have weekly meetings for a while and it either resolves itself ...

She continues by arguing that her business is about creating the right work environment where work purpose and job design feature prominently in order to make work attractive. Alecia does not compete on salary because she knows she can't. Creating an attractive workplace culture is more important for attracting and retaining quality employees, so finding the right employees is not an issue at Hancock Creative.

On a positive note, Alecia concludes that perceptions of small business owners and the stories they tell about their businesses can be very powerful.

Sometimes, as small business owners, we find the problems and look for the excuses and go 'We can't do this, we can't do that'. Instead I think shift that story and go 'What can we offer that no one else can that makes us more attractive?' Every business has that story and if you can lead with the story and get people to follow you, it's amazing what you can achieve.

Chapter Six

Job creation and job destruction

Professor Marc Cowling: Brighton University (UK)

Professor George Tanewski: Deakin University



Net employment dynamics of Australian SMEs

Since its inception in 2013, the IPA-Deakin SME Research Centre has been tracking the economic behaviours of small-to-medium-sized enterprises (SMEs) in Australia, analysing and highlighting in its 2015 Small Business White Paper (SBWP) the performance of these businesses in relation to financing, innovation, skills and human capital, competition and regulation. This chapter extends the 2015 SBWP analysis further by focusing on the net employment of Australian SMEs and its relationship to size, age and innovation.

While there is evidence in the literature suggesting that employment growth is generated by a few rapidly-growing firms in a number of developed economies⁴¹⁰, these high growth firms are not necessarily small and young. More importantly, to date, there is limited evidence on better understanding employment growth in Australia in relation to firm characteristics such as size, age, innovation and other firm factors. This chapter addresses the gap in the literature by focusing on these specific SME firm characteristics and their contribution to Australia's net employment between 2006-07 and 2013-14, by using the Australian Bureau of Statistics' (ABS) Business longitudinal data.

Before providing a more detailed analysis of employment among SMEs, it is notable to highlight the importance of SMEs and their employment capabilities in the Australian economy. While large public corporations and businesses have a significant impact on the Australian economy, SMEs play a critical role in determining the strength of the economy. SMEs are prevalent in all sectors of the Australian economy, covering a wide diversity of different types of business activities from agriculture and manufacturing to a range of different services such as accounting and other professional services. According to the counts of businesses compiled by the ABS in February 2018, there were 2,234,384 SME firms in Australia at the end of the 2016-17 financial period, making up 99.8% of all counts of businesses. The composition of Australian businesses is characterised by a high number of non-employing businesses – 1,370,051 – comprising around 61% of all businesses.

In terms of employment counts in the population, small businesses engage a large proportion of the Australian workforce, that is, 44% of total employment is due to small businesses employing approximately 4.7 million people. According to the Office of the Chief Economist at the Department of Innovation, Industry and Science, small businesses generated around 40% of new jobs in the Australian economy in 2013-14.⁴¹¹

While non-employing firms (i.e. firms run by a sole proprietor) make up a significant proportion (61%) of businesses in Australia, they account for a very small percentage of total employment in the economy (0.4% and 0.9% of manufacturing and services, respectively). This is due to the fact that most employees work for medium and large firms in Australia, whereas 40% of employment occurs among a relatively small number (0.3%) of large firms.⁴¹²

Headline findings:

- This chapter shows that both business size and age are significant determinants of net employment, particularly among start-ups and young firms.
- As firms become older, they contribute significantly less to net employment, whereas younger firms (i.e. less than 5 years old) have a significant impact on net employment, contributing on average to around 15% in net employment.
- Start-ups and young firms that innovate, particularly those associated with the introduction of new marketing methods, contribute on average to between 7 and 9% in net employment.
- Another significant determinant of net employment is government financial assistance, contributing on average approximately 3% to job creation.
- Our analyses demonstrate that start-ups and young firms are important drivers of net employment in Australia and, when considering the effects of age and innovation together, we find that these factors significantly contribute to job creation and are important sales growth and performance differentiators.
- Our results show compelling evidence that the innovation capability of start-ups and young firms underpins the observed firm-employment dynamics, significantly influencing employment outcomes in the Australian economy.
- An important policy objective, therefore, is the early identification of start-ups and young firms that have innovation capabilities, as these firms contribute significantly to net job creation.



Notwithstanding the high occurrence of employment in large firms, Hendrickson et al⁴¹³ show that Australia is more intense in its reliance on young SMEs for gross job creation, with young SMEs contributing to around 50% of gross job creation compared to the OECD average of 41%.

With respect to employing businesses, the ABS defines a small business as having less than 20 employees. These are defined as being either a micro (less than 5 employees) or a small business (5 to 19 employees). They make up around 94% of all employing firms and account for 41% of total employment.⁴¹⁴

A report on the small business sector by the Office of the Australian Small Business and Family Enterprise Ombudsman (2016) similarly details that small businesses make up the vast majority (over nine in ten) of businesses in Australia, accounting for 33% of Australia's GDP, employing over 40% of Australia's workforce, and providing around 12% of total company tax revenue.

Meanwhile, OECD entrepreneurship data (2014) show that most businesses in OECD countries are micro-enterprises (defined as less than 10 employees by the OECD), with the highest proportion of micro-enterprises found in the services sector. In comparison to other OECD countries, where the median share of micro-firms is around 81%, Australia has a relatively high share of micro businesses, accounting for around 87% of all businesses and employing around 16% of the total Australian workforce.

The statistical descriptions provided above demonstrate that SMEs are an important contributor to the Australian economy and they are a major source of employment for Australians. SMEs often provide more employment opportunities for unskilled workers, thus they help to drive down the unemployment rate, which can have positive flow-on effects to Australian society in general by lowering the crime rate, decreasing welfare dependency, improving living standards, and so on.

For decades, economic policy-making and economic research have been influenced by the assumption that business growth is independent of firm size. However, more recently, economic research has questioned this assumption by demonstrating that small firms grow faster than larger firms and that smaller enterprises are a more important source of job creation in the economy. Indeed, a body of research on employment shows that employment growth actually depends on the size of the enterprise, with

some empirical evidence indicating that job growth is inversely related to firm size. Notwithstanding this inverse relationship between employment and firm size, we also note from the Productivity chapter in this white paper that there are significant, persistent productivity differences between different SME firm size and age classes, which possibly affect both firm survival and growth. Moreover, the extant literature⁴¹⁵ reports that entry, exit, expansion and contraction of firms are significantly associated with various measures of productivity and profitability.

The concept of 'creative destruction' – a term coined by Austrian-American economist Joseph Schumpeter in 1942 – is an important feature of competitive markets dominated by small firms. The concept describes what happens when new entrepreneurial small businesses challenge existing incumbents, driving productive 'churn' whereby inefficient firms exit and the efficient grow. The efficient reallocation of resources between these growing and shrinking firms is critical to aggregate productivity growth and employment.

Accordingly, this chapter examines net employment among SME firms by considering whether size, age and innovation (and the type and processes of innovation) are important determinants of net job creation among SMEs in Australia. The content of this chapter draws from an academic paper written by members of the IPA-Deakin SME Research Centre.⁴¹⁶ Understanding these SME firm dynamics will assist in formulating better policy outcomes regarding job creation in the SME sector.

Perspectives on SME employment growth

While economic research⁴¹⁷ has demonstrated for some time that small firms grow faster than large firms and that smaller enterprises are a more important source of job creation in the economy, more recent literature⁴¹⁸ shows no significant relationship between net employment and firm size, questioning whether factors other than firm size are more important to better understand net employment growth. For example, evidence provided in the literature shows job creation and net employment growth are generated by a few rapidly growing firms which produce a disproportionately large share of all new net jobs in developed economies compared with non-high-growth firms.⁴¹⁹

410 Henrekson and Johansson (2010).

411 Hendrickson, Bucifal, Balaguer and Hansell (2015).

412 Hendrickson, Bucifal, Balaguer and Hansell (2015).

413 Hendrickson, Bucifal, Balaguer and Hansell (2015).

414 Hendrickson, Bucifal, Balaguer and Hansell (2015).

415 see Syverson (2011); Foster, Haltiwanger and Krizan (2001).

416 see Cowling, Kiaterittinum, Mroczkowski and Tanewski (2018).

417 e.g. Birch (1979, 1981, 1987).

418 e.g. Haltiwanger, Jarmin and Miranda (2010).

419 Henrekson and Johansson (2010).

Given this conflicting evidence, it is unsurprising that the business and economics literatures provide two contrasting, entrenched perspectives on the 'true' competitiveness of the SME sector. On the one hand, small business advocates argue that, as SMEs enhance both entrepreneurship and competition, these two fundamental elements provide a number of benefits to the economy, including greater efficiencies, innovation and aggregate productivity growth. Accordingly, this perspective also maintains that, as SMEs are more productive and boost employment more than large firms (thereby providing social benefits to the whole of society), it is thus necessary to provide direct government support to SMEs precisely because financial markets and other institutional failures impede their development.⁴²⁰

Notwithstanding the SME advocates' viewpoint, a number of opposing perspectives challenge the efficiency and competitiveness arguments attributed to the SME sector. These perspectives⁴²¹ point out that SMEs are not as productive and effective compared to large firms, precisely because large enterprises have a number of unique advantages. For example, large firms are:

- better at exploiting economies of scale⁴²²
- more easily able to manage the fixed costs associated with research and development (R&D) provide more stable, and therefore higher-quality, jobs than smaller firms.⁴²³

More importantly, some research finds that SMEs are neither more labour-intensive, nor better at job creation than large firms.⁴²⁴ There is also literature⁴²⁵ that questions the validity of considering firm size as an exogenous or independent determinant of economic growth. This literature⁴²⁶ highlights that some countries' institutional frameworks and policies provide natural comparative advantages to the production of goods produced efficiently in large firms, whereas other institutional frameworks provide a comparative advantage specifically to smaller firms, suggesting that firm size and economic growth are endogenously (or internally) influenced by a country's institutional environment and framework. Furthermore, yet another stream of literature questions whether providing government support to SMEs is prudent⁴²⁷, given that the business environment affects all firms regardless of size of the firm.

As there are contrasting perspectives on the SME sector and some evidence to suggest that SMEs are not particularly effective job creators (nor does research universally support the claim that SMEs foster innovation), this chapter revisits these issues by examining whether size, age and innovation (and the type and processes of innovation) are important determinants of net job creation among SMEs in Australia.

Determinants of employment growth

The economic literature⁴²⁸ on employment growth among entrepreneurial firms, usually defined as small and young firms, shows that these firms are positively associated with employment, productivity, innovation and utility. In particular, Van Praag and Versloot⁴²⁹ highlight that smaller and younger firms create more employment than their larger and older counterparts, providing support to the contention that factors other than firm size are more important to better understanding net employment growth. Indeed, more recent studies such as Haltiwanger et al⁴³⁰ show that the relationship between firm size and employment growth is sensitive to firm age, highlighting the importance of business start-ups and young businesses to the US economy.

The start-up and small firm job-creation phenomenon can be explained as being part of a healthy, dynamic economy, which results in productive 'churn' by "the sorting of successful endeavours from unsuccessful ones [and the associated reallocation of scarce resources to more productive endeavours]".⁴³¹

Economists such as Adelino et al⁴³² argue that, during significant economic shocks, new firm start-ups are less exposed to such shocks compared to large firms, which more easily shed jobs due to the shocks. Hence, start-ups are more able to respond to such crises, thereby creating more jobs. The net employment gain resulting from employment losses and gains due to exogenous shocks also demonstrates the importance of churning in the job-creation process.⁴³³

A recent report by Hendrickson et al⁴³⁴ from the Department of Innovation, Industry and Science (DIIS), examines the contribution of young firms, particularly start-ups, to net job creation in the Australian economy from 2001 to 2011. Hendrickson et al results show that young SMEs contribute disproportionately to job creation in Australia.

420 e.g. Schiffer and Weder (2001).

421 e.g. Sullivan and Kang (1999); Davis, Haltiwanger and Schuh (1993); Damanpour (1992).

422 e.g. Pagano and Schivardi (2003).

423 e.g. Davis, Haltiwanger and Schuh (1993).

424 Little (1987).

425 e.g. Kumar, Rajan and Zingales (2001).

426 e.g. Hallberg, 2001; Kumar, Rajan and Zingales (2001)..

427 Karhunen and Huovar (2015).

428 e.g. van Praag and Versloot (2008).

429 van Praag and Versloot (2008), p 135.

430 Haltiwanger, Jamin and Miranda (2013).

431 Haltiwanger (2011), p 2.

432 Adelino, Ma and Robinson (2017).

433 Adelino, Ma and Robinson (2017).

434 Hendrickson, Bucifal, Balaguer and Hansell (2015).



More importantly, start-ups account for most of this employment growth. That is, start-ups add one in five jobs to the economy within a three-year period, providing further support to Haltiwanger et al⁴³⁵ findings that firm size and employment growth is enhanced by firm age.

The DIIS report highlights that only a small fraction (3%) of start-ups create new jobs and, while these firms' sales and profit performance is superior compared to other surviving start-ups, their labour productivity is lower during that period of dramatic employment growth and investment. These productivity differences among high growth start-ups may be explained by strategic decisions that small business owners make, such as investment in innovation and other risk-taking behaviours such as the introduction of new or significantly improved goods, services and methods⁴³⁶ for organising production. Indeed, both US⁴³⁶ and Australian⁴³⁷ evidence suggests that innovation drives growth in profitability, employment, economies of scope and productivity among high growth firms, particularly among start-ups and young firms.

We now turn our attention to the relationship between employment growth and innovation. This relationship is complex precisely because innovation is measured as a direct effect of technological change, rather than as a systems-wide change whereby the direct labour-saving impact of both product and process innovation can combine in many diverse outcomes to enhance employment growth in other areas of the system.

The literature acknowledges that the employment-innovation relationship is context-specific, with a number of studies showing that age of SME, type of innovation and other SME-specific factors such as cultural context affect the magnitude of the impact of innovation on employment growth.⁴³⁸ The literature also suggests a relationship between human capital formation and innovation⁴³⁹, while some research⁴⁴⁰ highlights the problems of establishing a clear link between employment growth and innovation by indicating that this relationship is merely due to a third unidentified variable rather than a direct association between employment growth and innovation.

Notwithstanding these issues, we use unique data from the ABS to examine whether size, age and innovation (and, importantly, the types and processes of innovation) are important determinants of net job creation among SMEs in Australia.

We find that start-ups and young firms are important drivers of net employment and, when considering the effects of age and innovation together, we observe that these factors are significant contributors to job creation and to the SME's sales growth. We now provide an explanation of the ABS data and the evidence of SME dynamism and employment growth in Australia.

The BLD data

Economists view business dynamism or productive 'churn' as the process by which firms are continually born, fail, expand and contract. This process also describes employment in the economy, whereby some jobs are created, others are destroyed, whereas others still are turned over.

Business dynamism is regarded as important to aggregate productivity growth and employment because it leads to an efficient reallocation of resources between growing and shrinking firms or between those jobs that are created and those jobs that are destroyed or turned over.

This chapter draws together evidence on the dynamics of net employment among SMEs by utilising two unique datasets obtained from the ABS – the Business Longitudinal Database (BLD) Confidentialised Unit Record File (CURF) over two five-year periods (for the financial years 2006-07 to 2010-11 and 2009-10 to 2013-14).

Access was provided to two separate data files, based on two separate SME panels sampled by the ABS. The two SME panel cohorts are from two survey sampling frames developed by the ABS, which represent the population of some 1.26 million Australian SMEs in June 2007 and about 919,000 SMEs in June 2010. The first panel contains data for a sample of 3,075 or 15,375 firm-year actively-trading SMEs over five reference periods from 2006-07 to 2010-11, while the second panel contains data for a sample of 2,011 or 10,055 firm-year actively-trading SMEs over five reference periods from 2009-10 to 2013-14. While these two separate panels have overlapping time periods, each data file was analysed separately and some extrapolation on net employment trends were made based on these two panels.

As the ABS defines a micro-business as having fewer than 5 employees, a small business as having 5–19 employees and a medium-sized business 20–199 employees, the BLD sample design is stratified by these three business-size ranges, including a non-employing (sole proprietor) business range to measure micro drivers of SME

⁴³⁵ Haltiwanger, Jarmin and Miranda (2009).

⁴³⁶ see Balasubramanian and Sivadasan (2011).

⁴³⁷ see Department of Industry, Innovation and Science (2014, 2017).

⁴³⁸ Rosenbusch, Brinckmann and Bausch (2011).

⁴³⁹ Johnson, Baldwin and Diverly (1996).

⁴⁴⁰ e.g. Freel (2000).

performance, productivity, competitiveness and viability over time. The BLD excludes large businesses (i.e. with 200+ employees) and complex businesses (comprising multiple ABNs) from the sample.

The BLD has over 170 variables containing numeric data on a wide range of topics such as employment, years of operation, financial characteristics, main sources of income, debt and equity finance topics, respondent self-reported comparisons to the previous year on various matters such as revenue, profitability, productivity, expenditures etc, and questions related to skills and innovation in undertaking core business activities. The BLD also includes some financial data matched from Australian Taxation Office (ATO) and the Australian Customs and Border Protection Service sources.

The BLD comprises SME data collected by the ABS via a business longitudinal survey on actively trading businesses, which includes both non-employing and employing businesses that are registered for an Australian Business Number (ABN) and that remit Goods and Services Taxes (GST). The ABN identifies an SME business for the BLD. This number is also used to follow the life of the panel over the five-year period. The BLD identifies businesses which cease to operate for whatever reason or are wound up during the life of the five-year panel and any data prior to these businesses ceasing operations are retained in the BLD.

As several employment variables (i.e. full-time, part-time, casual etc.) are utilised in the survey, we can observe SME business employment over time. We utilise total employment, as provided in the BLD 2006-07 to 2010-11 and 2009-10 and 2013-14 data files, to estimate the dynamic employment growth rates.

In the panel, the reference period for total employment is the last pay period ending at the end of each relevant financial year (i.e. 30 June). Following Haltiwanger's definitions of the dynamics of job creation, job destruction and net employment⁴⁴¹, we compute job creation as the ratio of the gross number of new jobs added to the economy by expanding and new SME establishments divided by total employment. Job destruction is the gross number of jobs destroyed by contracting and exiting SME establishments as a percentage of total employment, whereas net employment growth is the difference between the number of jobs in the current and prior periods as a percentage of total employment. Accordingly, the net

employment growth rate is the difference between the job creation and job destruction rates.

Several measures are used to explain variation in the net employment growth rate. The size of the SME business follows the ABS definition of firm size, which is based on employment numbers. That is, a micro business has between 0 to 4 employees, a small business has between 5 to 19 employees, and a medium-size business has between 20-199 employees.

As the BLD captures the number of years of the SME's operation under current ownership, we follow the OECD's approach of classifying 'start-ups' as young firms that are within the first three years of operation (0 to 2 years), 'young firms' are aged between 3 and 5 years of age, 'mature firms' are aged between 6 years and 9 years, while 'old firms' are ten or more years old.⁴⁴²

Innovation is a composite measure based on four items that gauge whether the SME has introduced any new or significantly improved: **(i)** goods or services, **(ii)** operational processes, **(iii)** marketing methods or **(iv)** new organisational/managerial processes.

The BLD also includes an item that measures whether the SME business 'received any financial assistance from government organisations'? This item is used to gauge whether direct government financial support has a positive influence on the SME business's net employment growth rate. The SMEs included in the BLD are grouped into one of 19 industry classifications, in accordance with the Australian and New Zealand Standard Industrial Classification (ANZSIC), 2006 (Revision 2.0) (cat. no. 1292.0).

The evidence on SME dynamism and employment growth in Australia

Average employment across all SME size for the financial years 2006-07 to 2010-11 and 2006-07 to 2010-11 shows a net increasing employment rate of 7.2% over the eight-year period. However, when we segregate young, mature and old SME firms from start-ups, we note that start-up firms (less than two years old) have an increasing rate of employment over the two reference periods (11% for 2008, 18% for 2009 and 21% for 2011, whereas employment for start-ups declined by 6% in 2012).

Interestingly, young firms defined as less than five years old, also show an average increasing net employment rate of 4.3% for the financial years 2006-07 to 2010-11 and 2006-07 to 2010-11.

⁴⁴¹ Haltiwanger (2012).

⁴⁴² see Hendrickson, Bucifal, Balaguer and Hansell (2015).

Characteristics of SME net employment growth, job creation and job destruction in Australia

As the net employment growth rate is equal to the difference between the job creation and the job destruction rate,⁴⁴³ we also examine the rates of job creation and job destruction among SMEs in Australia. Job creation is defined as the gross number of new jobs added to the economy by expanding and new SME business scaled by total employment, whereas job destruction is the gross number of jobs destroyed in the economy by contracting and exiting SME business scaled by total employment.⁴⁴⁴

While there was good employment growth of 8.6% by expanding and new SME businesses over the period 2006-07 to 2010-11, start-ups of less than two years old had the highest rate of employment growth (13.9%), followed by start-ups of less than one year old (10.8%).

In contrast, job destruction rates among contracting and exiting firms had rates of decline of around 5.1% for all groups of SMEs and around 5.3% among start-ups of less than two years old, suggesting that the rate of churning among SMEs in Australia is relatively high.

Table 1a:
Net employment growth rates by SMEs in Australia: 2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 7,747)	0.059	0.170	0.060	0.055
Start-ups (n = 230)	0.108	0.178	.	.
Young firms (n = 1,263)	0.047	0.105	-0.030	0.002
Mature firms (n = 1,409)	0.133	.	0.110	0.067
Old firms (n = 4,679)	0.019	0.197	0.048	0.053
Non-employing (n = 1,667)	-0.061	0.054	0.027	0.000
Micro (0-4 employees) (n = 2,119)	0.081	0.150	0.064	0.064
Small (5-19 employees) (n = 2,045)	0.065	0.118	0.099	0.068
Medium (20-199 employees) (n = 1,916)	0.122	0.347	0.045	0.083

Table 1b:
Net employment growth rates by SMEs in Australia: 2009-10 to 2013-14

	2011	2012	2013	2014
All SMEs (n = 3,790)	0.070	0.020	0.030	0.110
Start-ups (n = 120)	0.205	0.057	.	.
Young firms (n = 489)	0.147	0.038	0.103	-0.066
Mature firms (n = 783)	0.056	0.025	0.090	-0.007
Old firms (n = 2,289)	0.023	0.039	0.066	0.018
Non-employing (n = 261)	0.132	-0.052	0.060	0.029
Micro (0-4 employees) (n = 994)	0.074	0.045	0.050	0.041
Small (5-19 employees) (n = 1,285)	0.090	0.026	0.031	-0.005
Medium (20-199 employees) (n = 1,250)	0.033	0.081	0.141	0.006

Source: ABS Business Longitudinal Data 2006-07 to 2010-2011.

⁴⁴³ Haltiwanger (2012).

⁴⁴⁴ see Haltiwanger (2012).

Figure 1a:

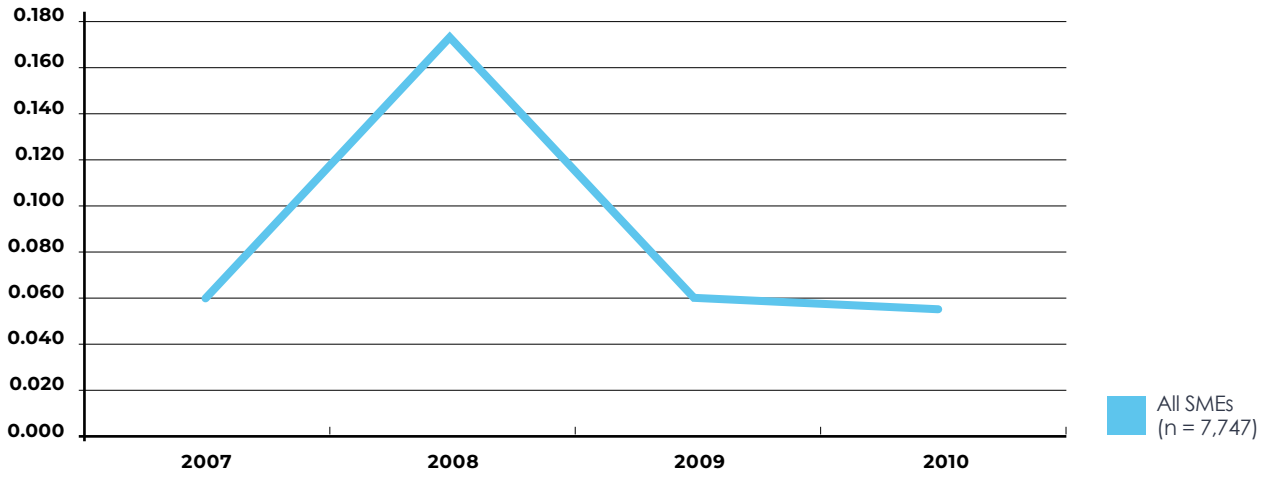


Figure 1b:



Figure 1c:

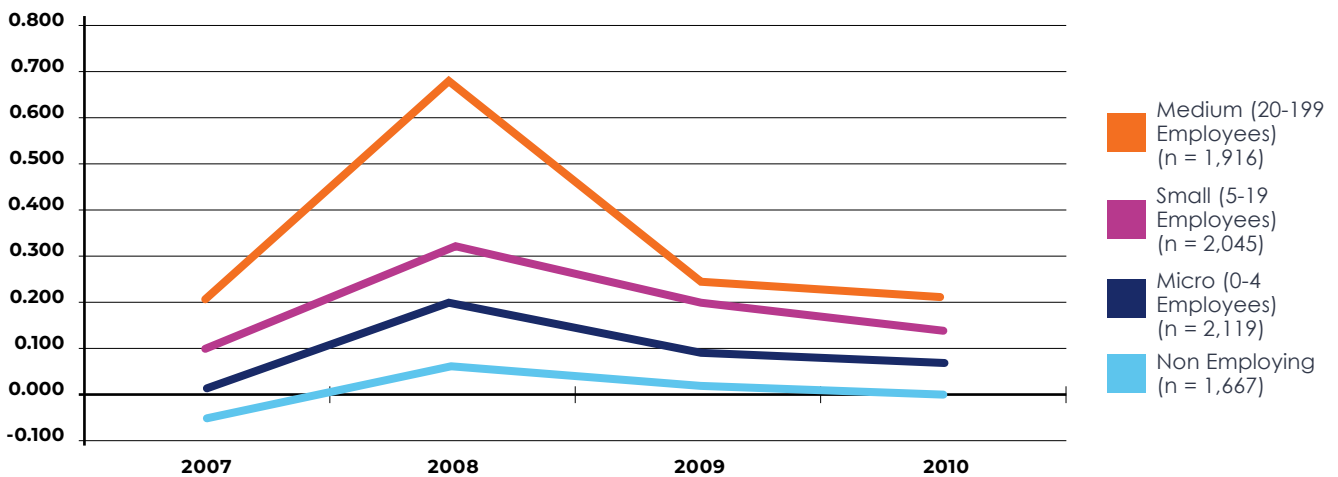


Figure 2a:
Characteristics of SME net employment growth, job creation and job destruction in Australia

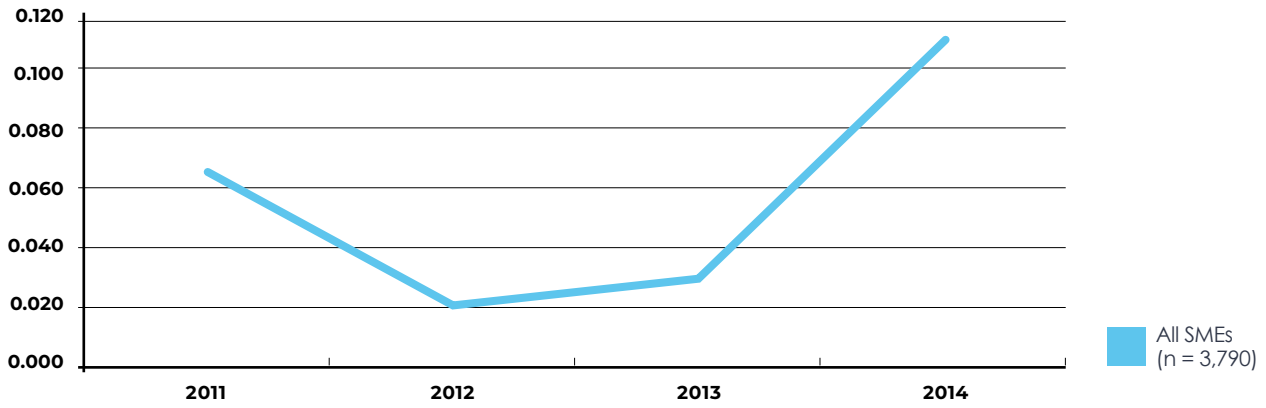


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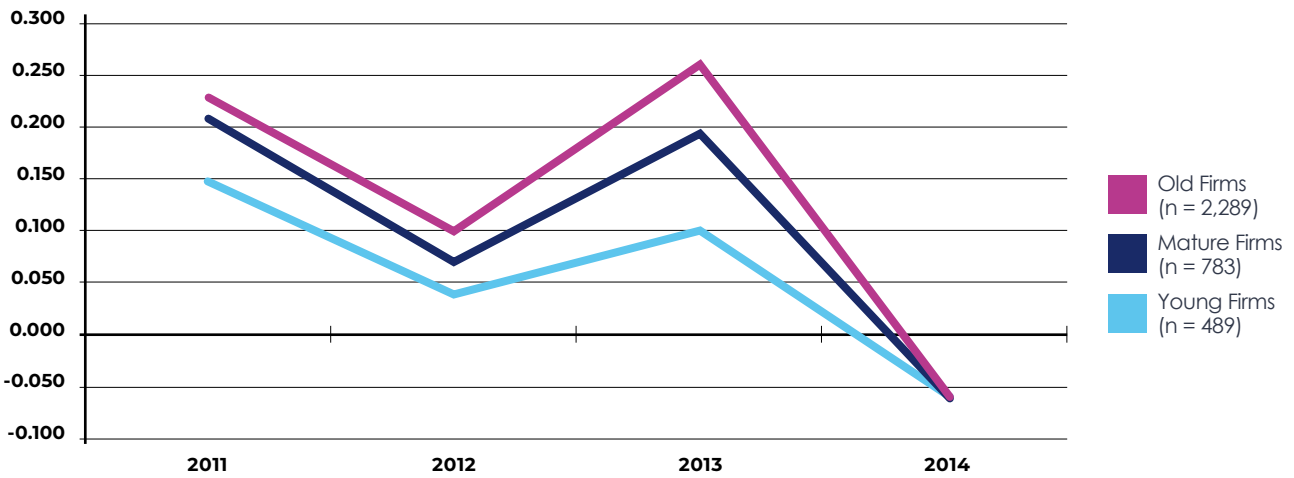
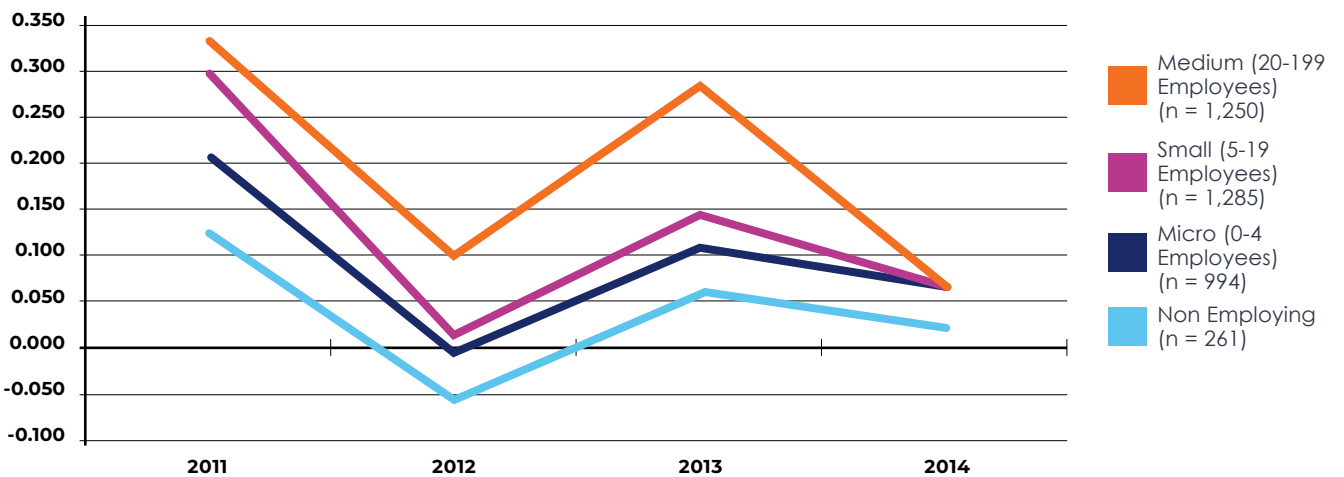


Figure 2c:



Source: ABS Business Longitudinal Data 2006-07 to 2010-2011.

Table 2a:
Average number of jobs created by SMEs in Australia: 2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 1,959)	4.343	3.962	4.232	3.623
Start-ups (n = 89)	4.724	5.888	.	.
Young firms (n = 385)	4.023	3.531	6.048	2.190
Mature firms (n = 339)	4.398	.	4.426	3.258
Old firms (n = 1,092)	4.498	4.017	3.897	3.857
Non-employing (n=458)	2.018	1.981	1.842	1.787
Micro (0-4 employees) (n = 591)	2.719	2.644	2.868	1.943
Small (5-19 employees) (n = 585)	5.574	4.302	4.567	4.079
Medium (20-199 employees) (n = 325)	8.753	9.279	9.793	6.856

Table 2b:
Average number of jobs created by SMEs in Australia: 2009-10 to 2013-14

	2011	2012	2013	2014
All SMEs (n = 1,297)	5.293	5.838	5.204	4.710
Start-ups (n = 39)	7.154	4.538	.	.
Young firms (n = 184)	5.312	6.133	5.688	4.786
Mature firms (n = 265)	5.591	6.377	4.938	5.404
Old firms (n = 762)	4.730	5.689	4.812	4.505
Non-employing (n=58)	2.087	1.500	1.647	1.375
Micro (0-4 employees) (n = 247)	2.635	2.609	3.305	2.820
Small (5-19 employees) (n = 460)	4.450	4.524	4.063	3.731
Medium (20-199 employees) (n = 532)	7.993	8.766	7.608	6.408

Figure 3a:

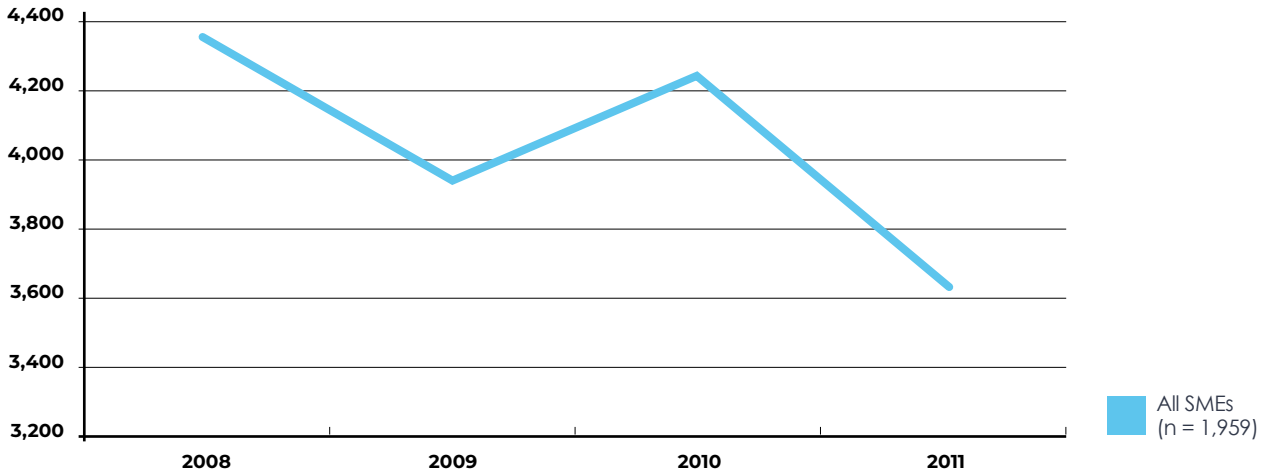


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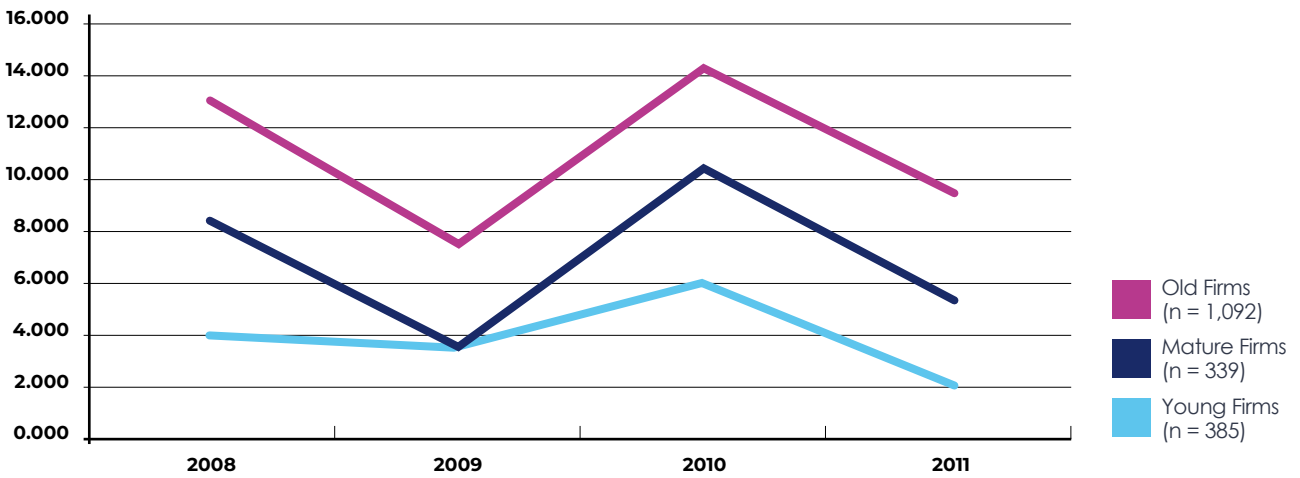


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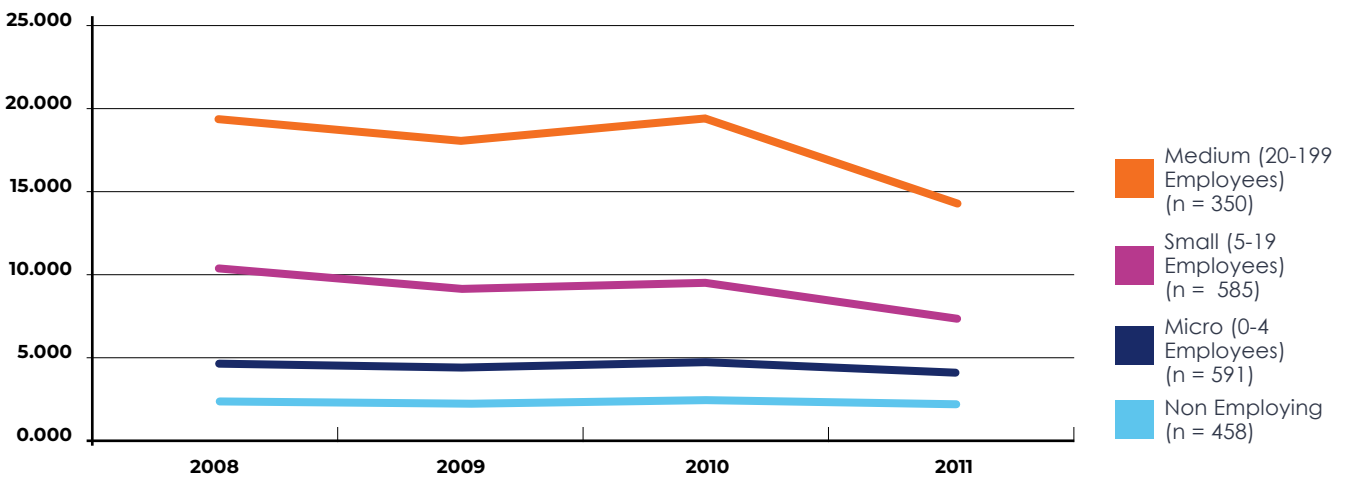


Figure 4a:

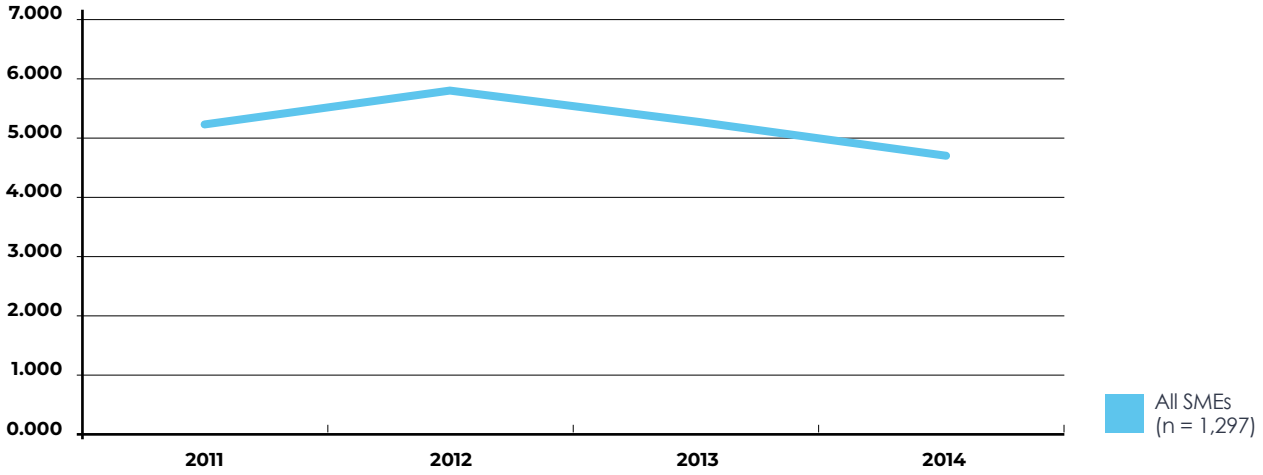


Figure 4b:

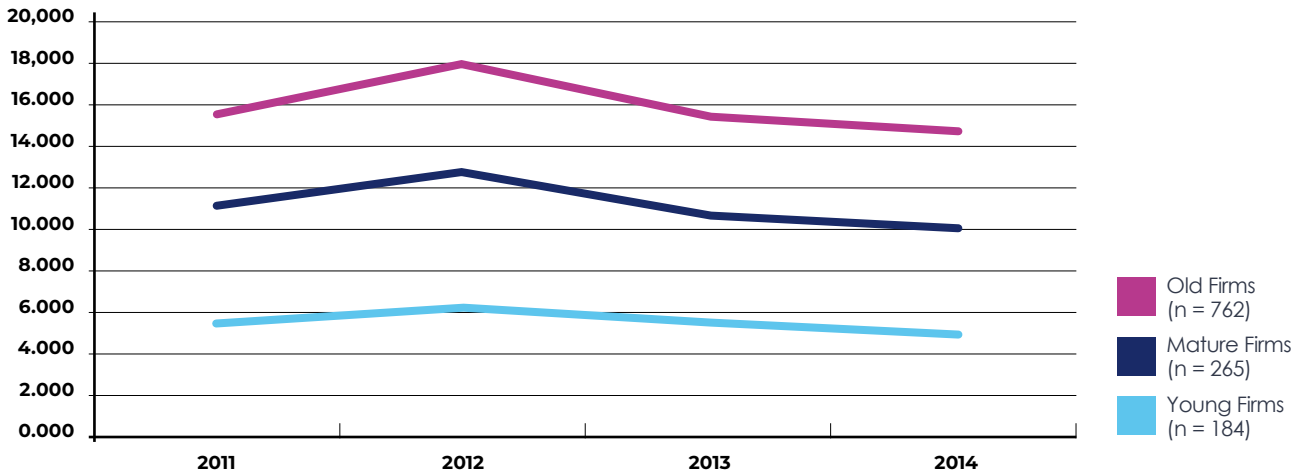
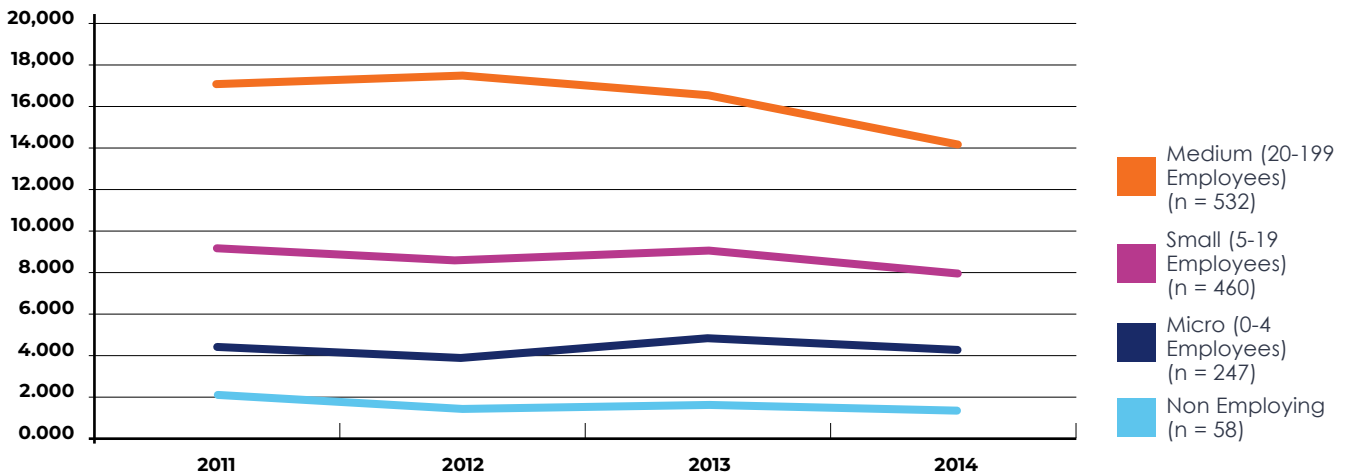


Figure 4c:





It appears that around 18% of SMEs indicated that they had introduced new or significantly improved goods or services, new operational processes, new marketing methods and new organisational/managerial processes in the sample period.

On average, SMEs perceived that the degree of competition was moderate (mean = 1.91) in their sector and that the majority of competition faced by the SME

business was from businesses of the same size (mean = 2.35). SME businesses on average reported income (total sales) of \$3.57 million, with non-capital expenditures comprising the largest proportion (75%) of expenses, followed by wages and salaries (16%). The highest proportion of SMEs operated in the manufacturing sector (14.24%), followed by the construction sector (9.23%), retail (5.8%) and wholesale sector (5.17%).

Table 3:
Average number of jobs created by new establishments:
2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 167)	8.034	4.514	7.500	6.919
Start-ups (n = 4)			.	.
Young firms (n = 34)	3.962	1.950	7.000	2.800
Mature firms (n = 39)	8.733	.	3.125	7.864
Old firms (n = 79)	9.818	4.628	8.375	8.538
Non-employing (n = 36)	4.042	2.929	1.000	2.000
Micro (0-4 employees) (n = 49)	4.200	2.208	5.400	3.550
Small (5-19 employees) (n = 51)	13.063	6.107	4.750	8.955
Medium (20-199 employees) (n = 31)	9.000	10.545	14.917	9.563

Figure 5a:

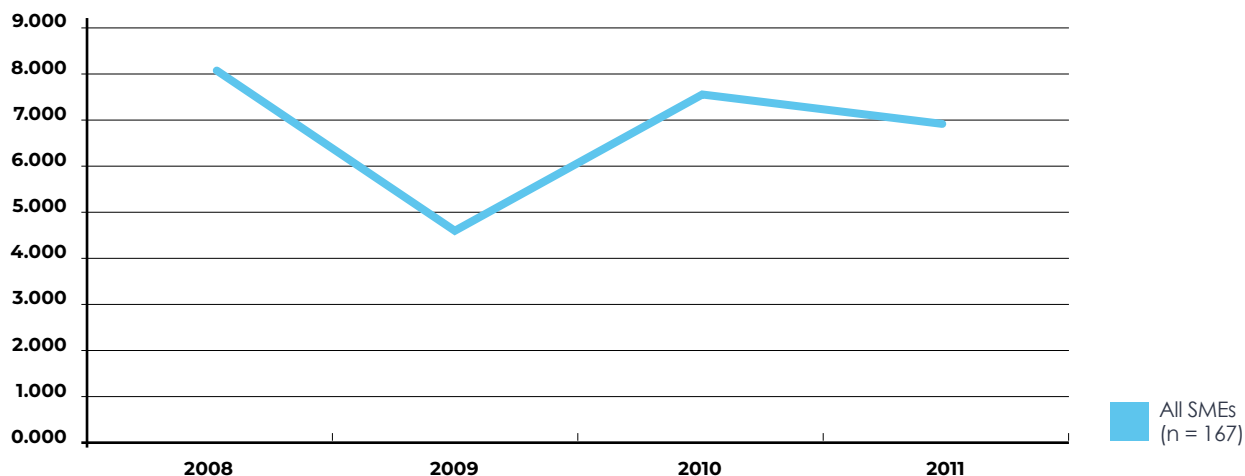


Figure 5b:

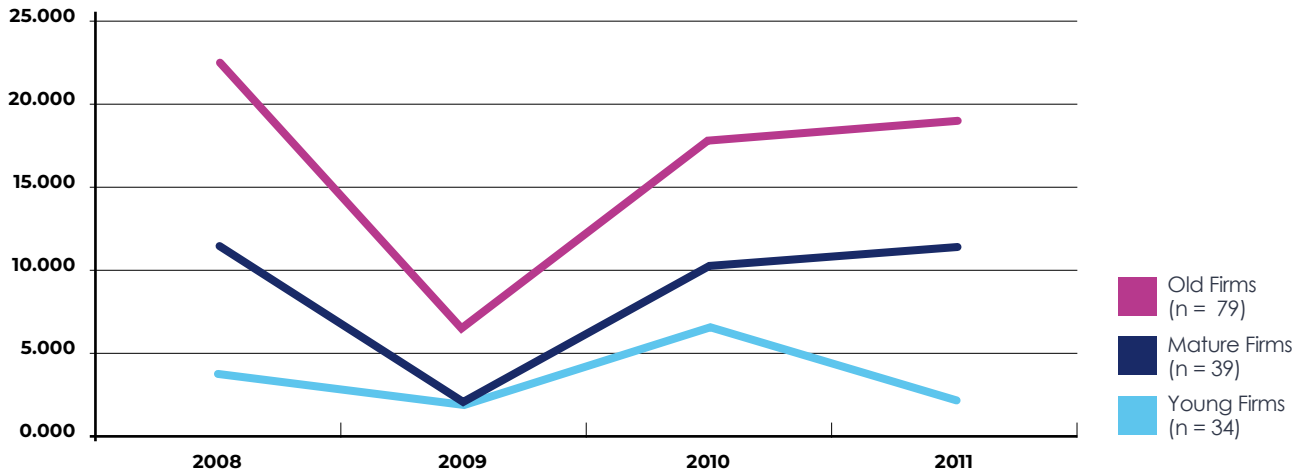


Figure 5c:

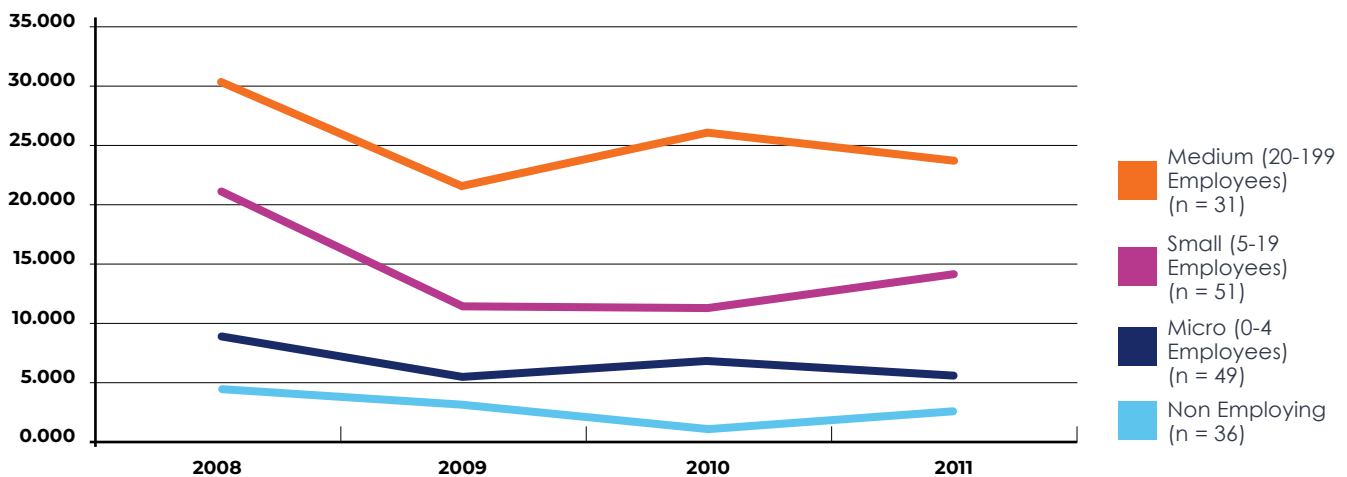


Table 4:
Average number of jobs destroyed by SMEs in Australia:
2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 2,001)	-4.785	-5.605	-4.735	-5.369
Start-ups (n = 48)	-7.650	-3.167	.	.
Young firms (n = 373)	-5.664	-5.027	-6.483	-6.300
Mature firms (n = 375)	-3.680	.	-6.055	-4.845
Old firms (n = 1,166)	-4.583	-5.956	-4.139	-5.478
Non-employing (n=318)	-2.185	-2.563	-2.167	-2.463
Micro (0-4 employees) (n = 994)	-3.398	-2.920	-2.826	-2.939
Small (5-19 employees) (n = 677)	-5.310	-6.206	-4.429	-5.186
Medium (20-199 employees) (n = 412)	-9.145	-10.545	-9.225	-10.515

Figure 6a:

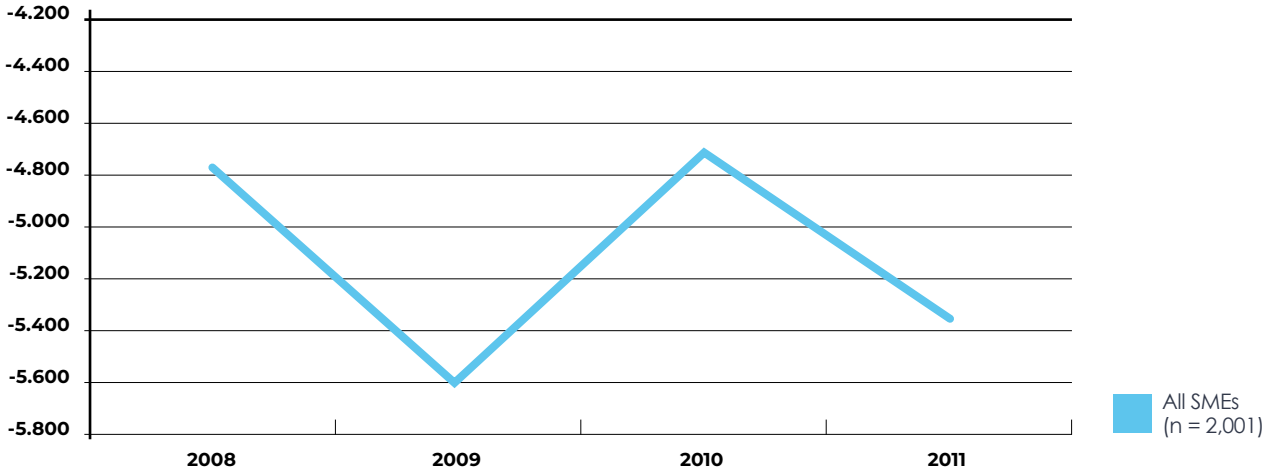


Figure 6b:

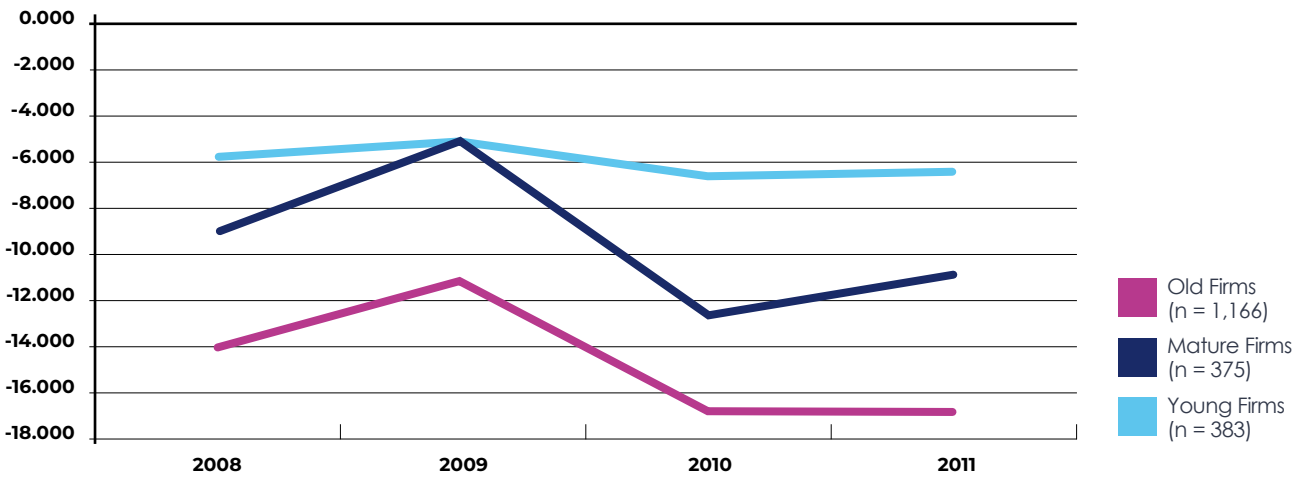


Figure 6c:

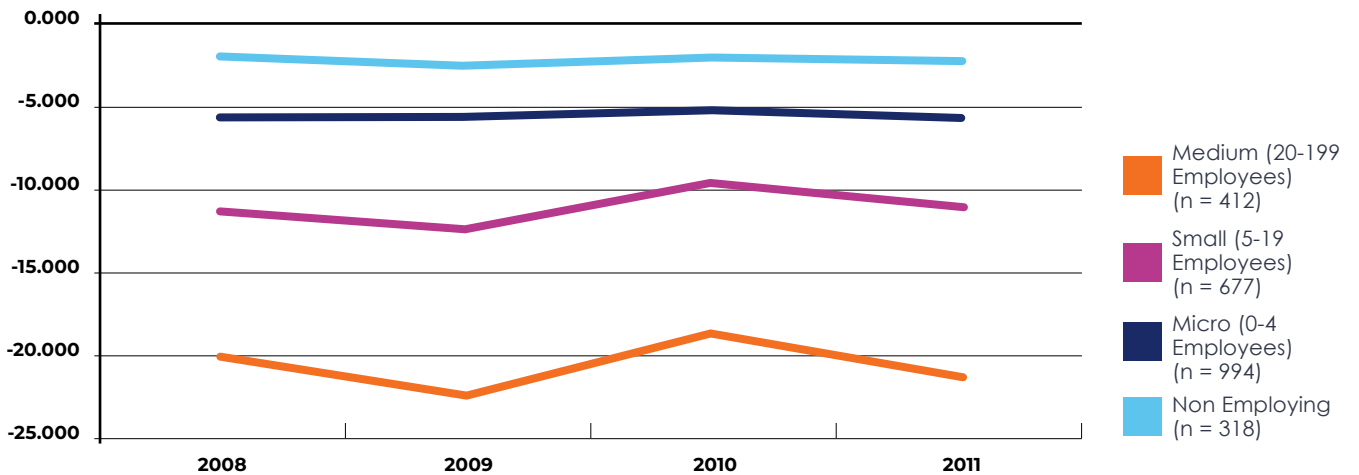


Table 5:
Average number of jobs destroyed by SMEs in Australia:
2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 174)	-8.904	-8.850	-4.528	-8.955
Start-ups (n = 3)			.	.
Young firms (n = 30)	-11.964	-5.850	-7.300	-2.000
Mature firms (n = 34)	-8.308		-4.773	-4.750
Old firms (n = 101)	-6.321	-10.029	-4.069	-12.200
Non-employing (n = 22)	-5.900	-13.167	-4.038	-2.000
Micro (0-4 employees) (n = 45)	-7.321	-5.500	-4.375	-2.875
Small (5-19 employees) (n = 61)	-9.565	-5.611	-3.719	-7.038
Medium (20-199 employees) (n = 46)	-10.367	-16.429	-6.154	-16.273

Figure 7a:

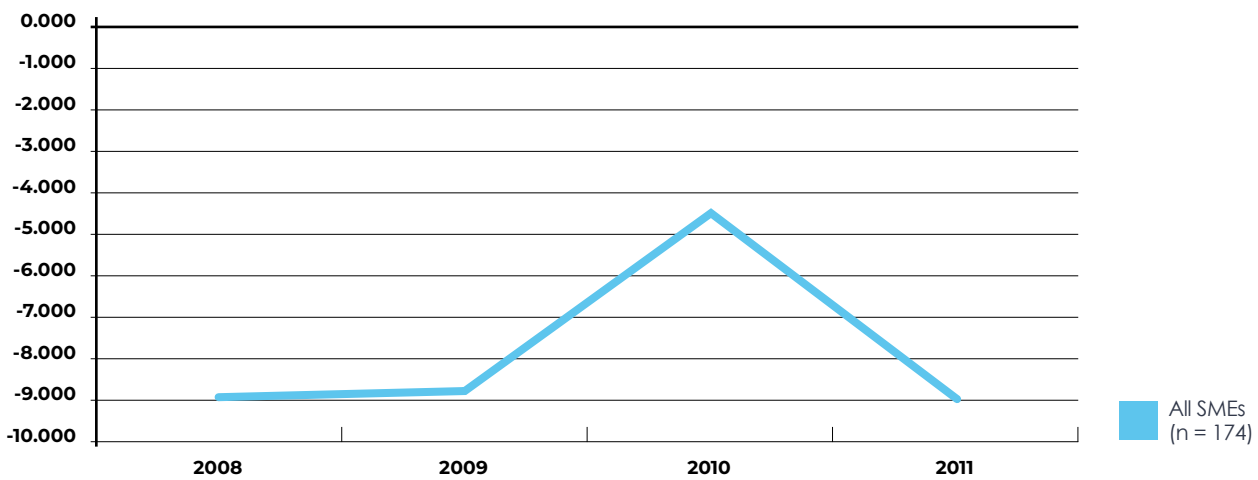


Figure 7b:

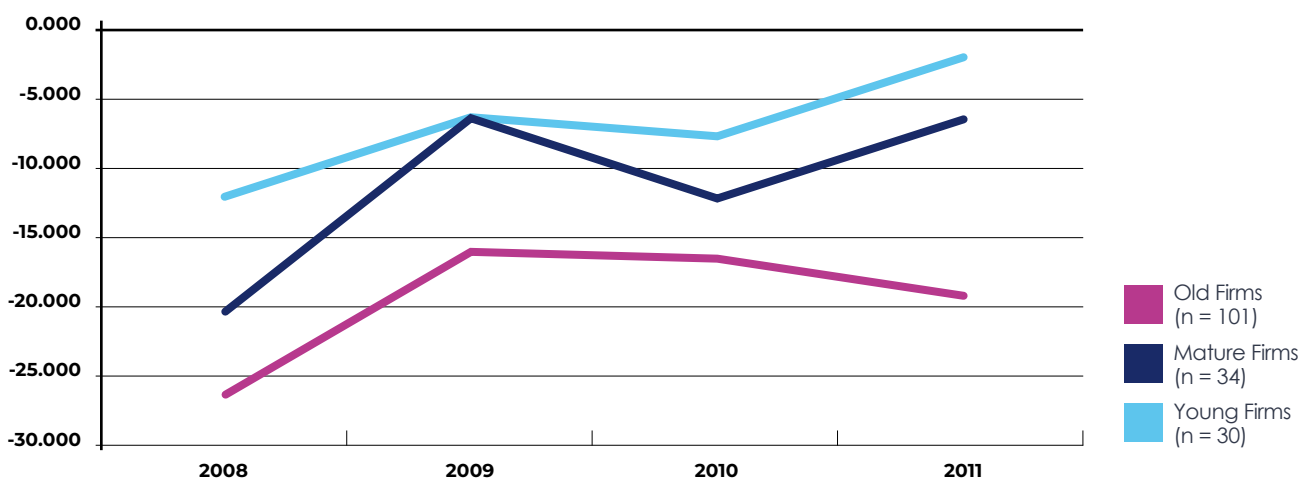




Table 6:
Average number of jobs destroyed by continuing establishments: 2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 1,712)	-4.338	-5.135	-4.708	-4.956
Start-ups (n = 43)	-6.442	-3.294	.	.
Young firms (n = 322)	-4.691	-4.723	-6.320	-5.911
Mature firms (n = 318)	-3.178	.	-5.816	-4.702
Old firms (n = 998)	-4.529	-5.540	-4.217	-4.912
Non-employing (n = 282)	-1.911	-2.194	-1.694	-2.331
Micro (0-4 employees) (n = 519)	-3.175	-2.354	-2.675	-2.731
Small (5-19 employees) (n = 570)	-4.586	-5.977	-4.577	-4.633
Medium (20-199 employees) (n = 341)	-9.396	-9.659	-9.506	-10.119

Figure 8a:

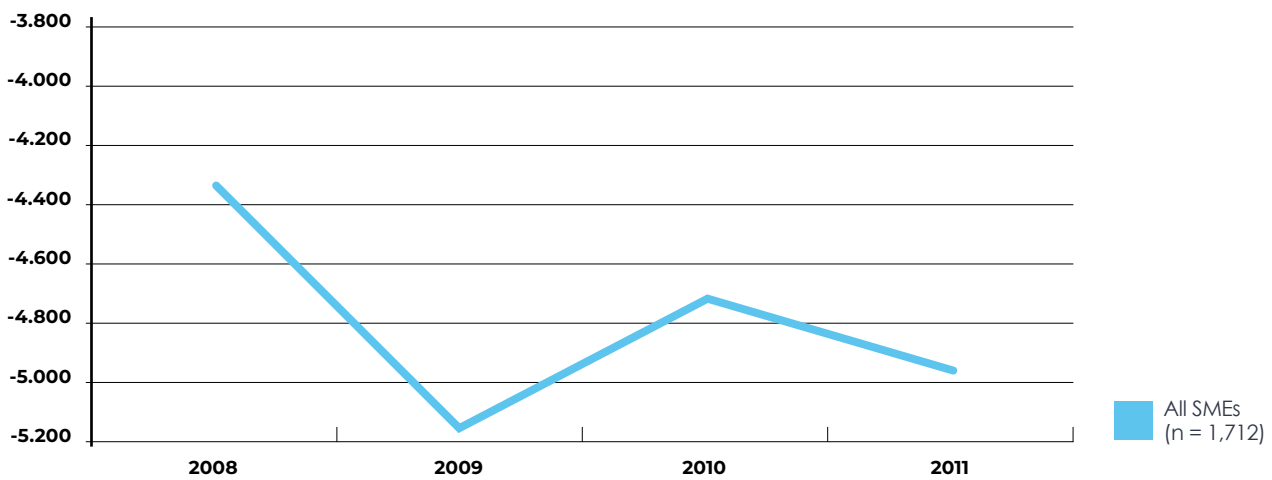


Figure 8b:

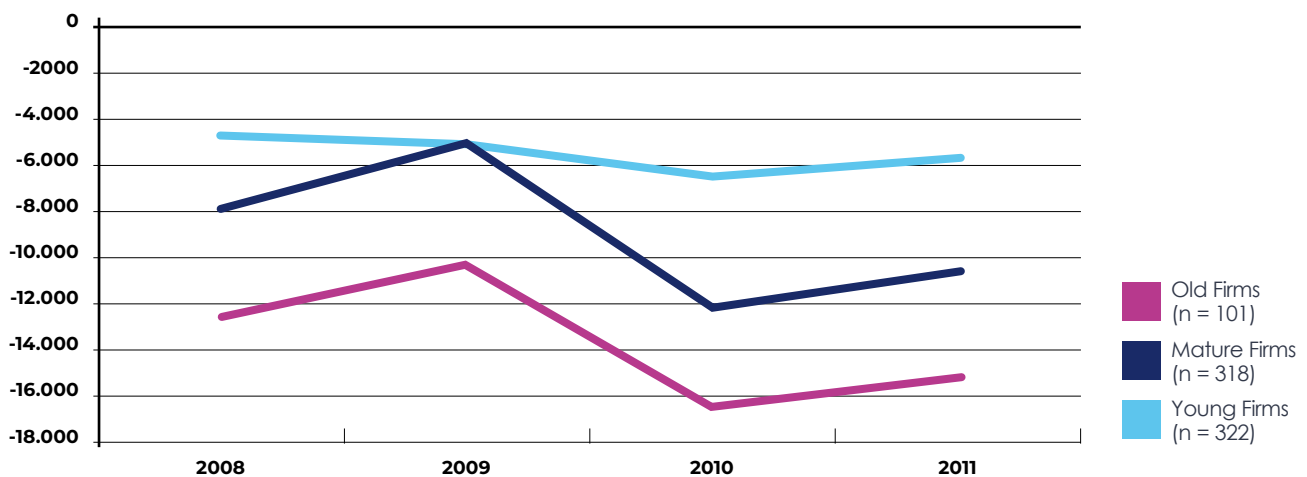


Figure 8c:

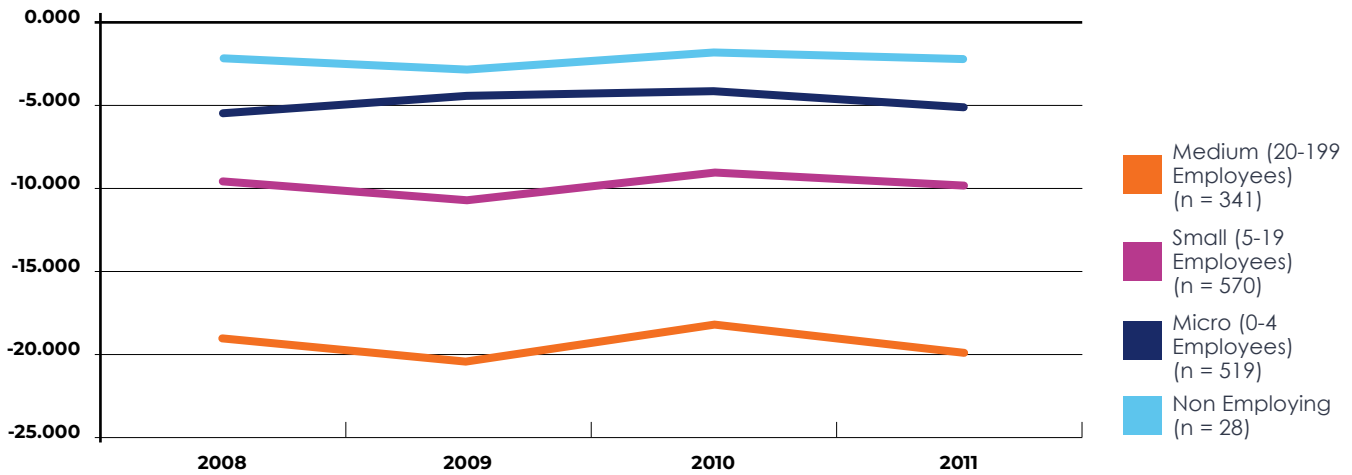


Table 7:
Net employment growth rates by SME industry sectors: 2006-07 to 2010-11

		2008-11
1	Agriculture, forestry and fishing	0.231
2	Mining	0.034
3	Manufacturing	0.043
5	Construction	0.029
6	Wholesale trade	0.043
7	Retail trade	0.037
8	Accommodation and food services	-0.018
9	Transport, postal and warehousing	0.079
10	Information media and telecommunications	0.038
12	Rental, hiring and real estate services	-0.003
13	Professional, scientific and technical services	0.078
14	Administrative and support services	0.034
18	Arts and recreation services	0.161
19	Other services	-0.006
		n = 7,747



Figure 9:

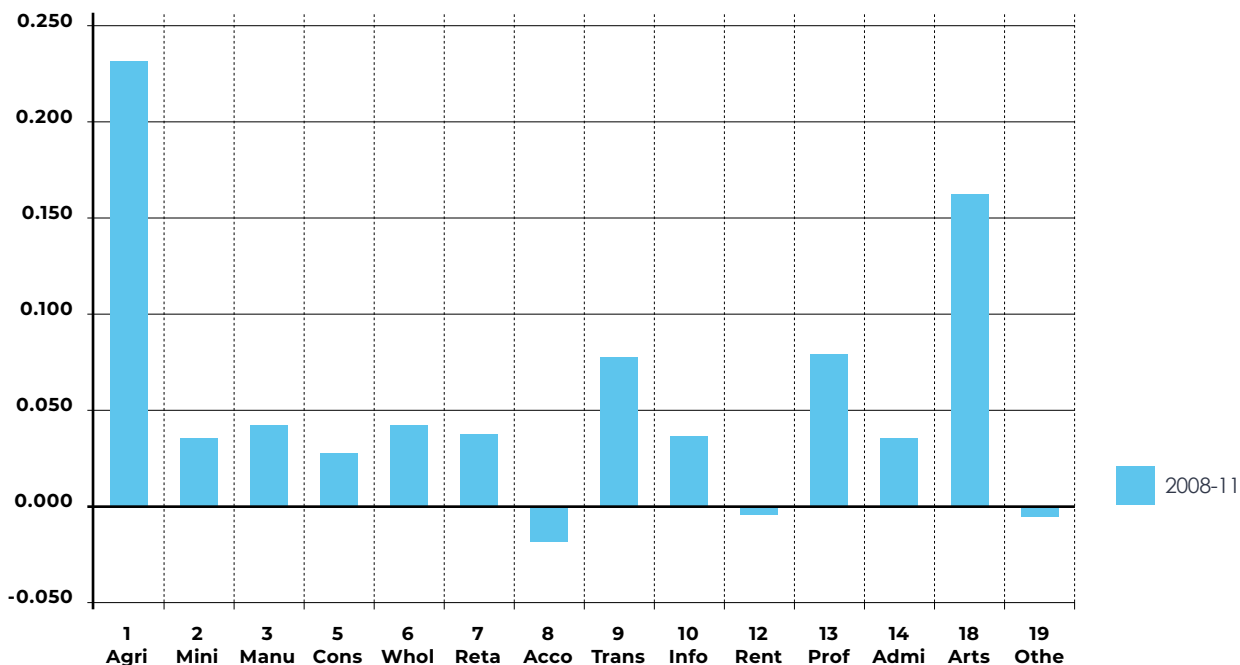


Table 8:

Net employment growth rates by SME industry sectors: 2006-07 to 2010-11

		2008	2009	2010	2011
1	Agriculture, forestry and fishing	0.050	0.558	0.121	0.211
2	Mining	0.158	-0.070	0.028	0.011
3	Manufacturing	0.071	0.046	0.045	0.005
5	Construction	0.038	-0.004	-0.017	0.101
6	Wholesale trade	0.016	0.029	0.104	0.025
7	Retail trade	0.060	0.097	0.005	-0.017
8	Accommodation and food services	0.016	-0.015	-0.061	-0.028
9	Transport, postal and warehousing	0.111	0.112	0.038	0.046
10	Information media and telecommunications	0.117	-0.035	0.042	0.023
12	Rental, hiring and real estate services	-0.105	0.029	0.059	0.023
13	Professional, scientific and technical services	0.240	0.037	0.037	-0.013
14	Administrative and support services	0.014	0.036	-0.030	0.127
18	Arts and recreation services	0.133	0.462	0.181	-0.115
19	Other services	-0.040	0.025	0.021	-0.031
		n = 2,076	n = 1,936	n = 1,900	n = 1,835

Figure 10:

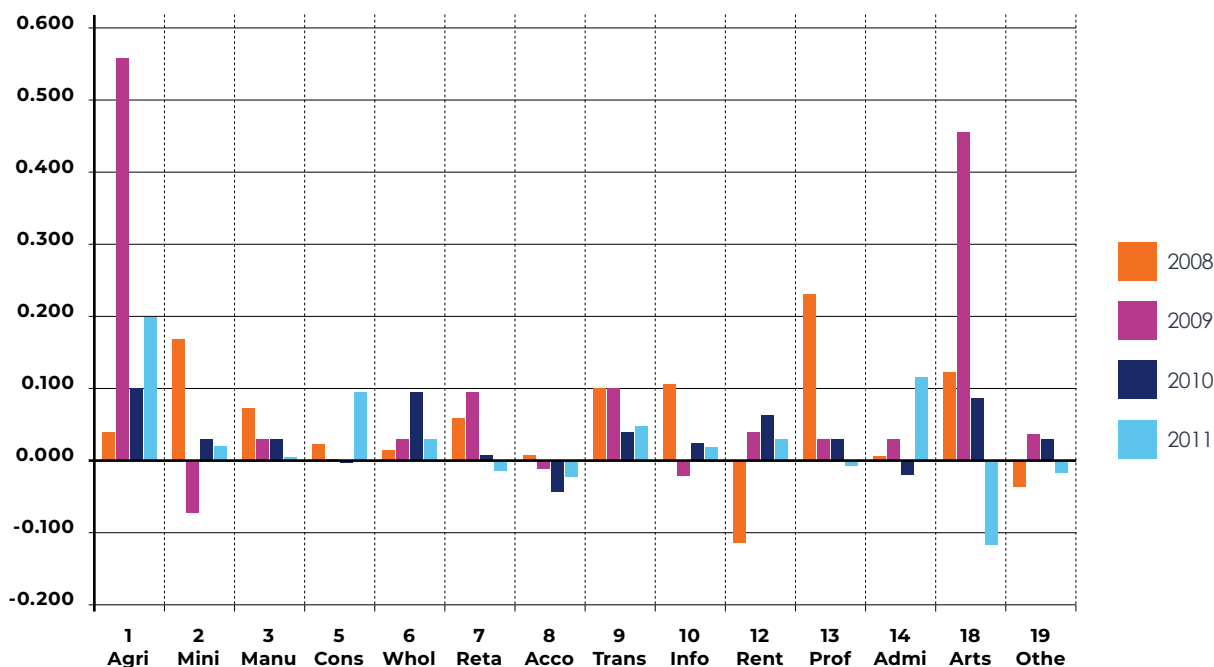


Table 9:
Net employment growth rates by size and industry sectors: 2006-07 to 2010-11

		Non- employing	Micro	Small	Medium
1	Agriculture, forestry and fishing	0.033	0.118	0.177	0.532
2	Mining	0.012	-0.028	0.168	-0.125
3	Manufacturing	-0.003	0.066	0.047	0.056
5	Construction	-0.091	0.044	0.089	0.038
6	Wholesale trade	-0.032	0.117	0.053	0.025
7	Retail trade	0.034	0.081	0.035	-0.007
8	Accommodation and food services	-0.018	0.006	-0.045	-0.013
9	Transport, postal and warehousing	0.025	0.150	0.156	-0.009
10	Information media and telecommunications	-0.019	0.130	0.053	-0.050
12	Rental, hiring and real estate services	-0.090	0.015	0.064	-0.036
13	Professional, scientific and technical services	-0.053	0.315	0.019	-0.010
14	Administrative and support services	0.052	-0.044	0.099	0.019
18	Arts and recreation services	0.080	0.101	0.127	0.433
19	Other services	0.029	0.031	-0.065	-0.028
		n = 1,667	n = 2,119	n = 2,045	n = 1,916

Figure 11:

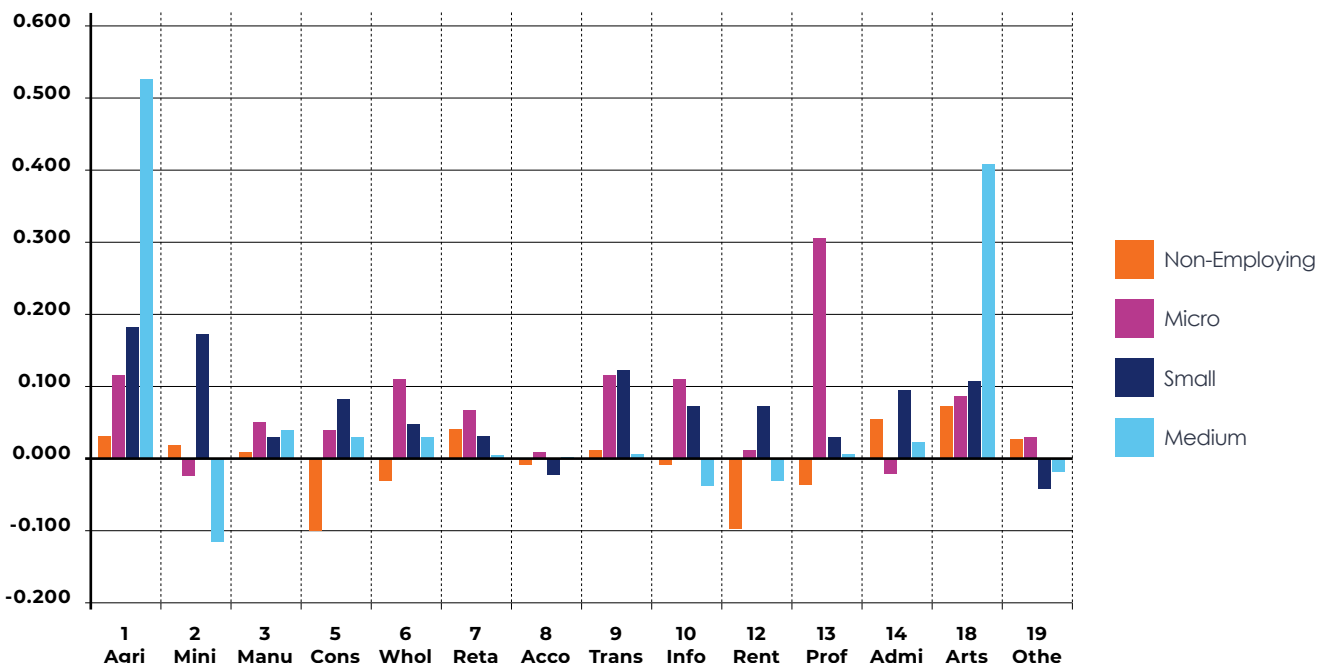


Table 10:

Net employment growth rates by age and industry sectors: 2006-07 to 2010-11

		Start-up	Young firm	Mature firm	Old firm
1	Agriculture, forestry and fishing	0.149	0.124	0.317	0.238
2	Mining	0.264	-0.059	0.017	0.067
3	Manufacturing	0.236	0.024	0.031	0.039
5	Construction	0.033	-0.022	0.068	0.024
6	Wholesale trade	0.169	-0.019	0.082	0.045
7	Retail trade	0.142	0.070	-0.016	0.032
8	Accommodation and food services	0.177	-0.027	-0.033	-0.040
9	Transport, postal and warehousing	0.073	0.200	0.009	0.061
10	Information media and telecommunications	-0.296	0.183	0.025	0.030
12	Rental, hiring and real estate services	0.433	-0.072	-0.047	-0.017
13	Professional, scientific and technical services	0.132	-0.104	0.344	0.021
14	Administrative and support services	0.016	-0.032	0.126	0.029
18	Arts and recreation services	0.346	0.627	0.028	0.091
19	Other services	0.129	0.080	-0.059	-0.022
		n = 230	n = 1,263	n = 1,409	n = 4,679

Figure 12:

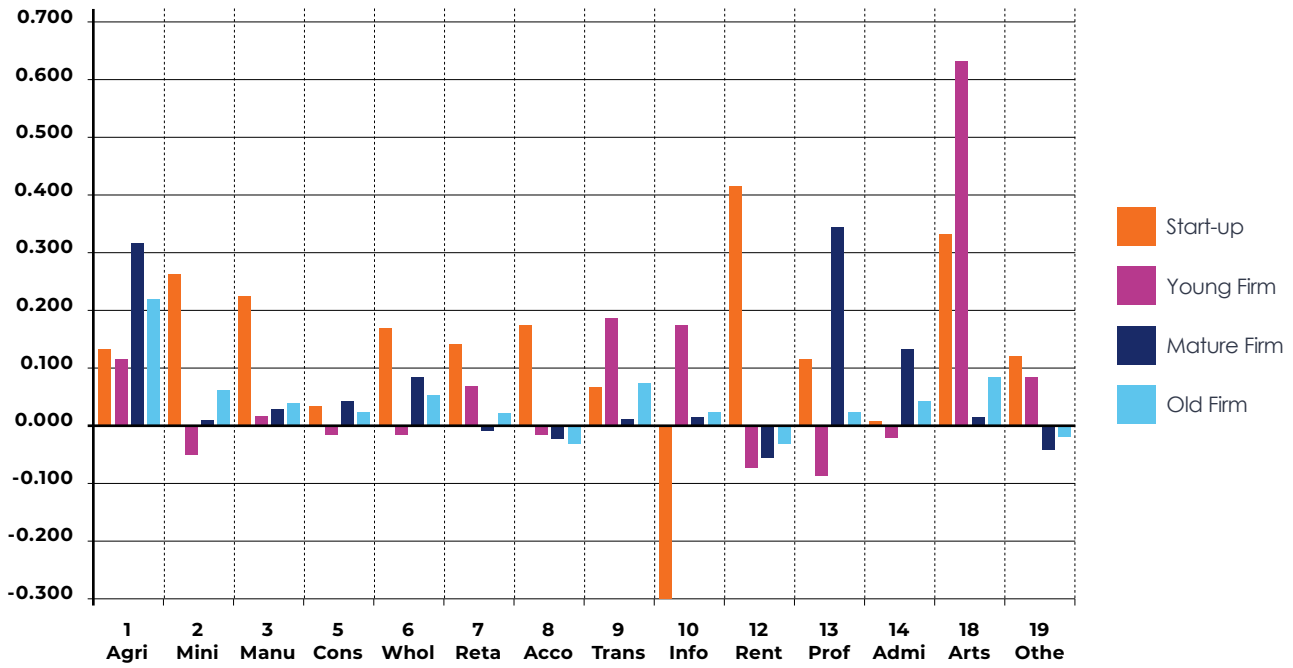




Table 11:
Determinants of SME net employment: 2006-07 to 2010-11

	(1)	(2)	(3)	(4)	(5)
Variables	NetEmp	NetEmp	NetEmp	NetEmp	NetEmp
size1	0.0715***	0.0731***	0.0690***	0.0726***	0.0753***
	(0.016)	(0.016)	(0.016)	(0.016)	(0.016)
size2	0.0550***	0.0604***	0.0517***	0.0562***	0.0593***
	(0.016)	(0.016)	(0.016)	(0.017)	(0.017)
size3	0.0401**	0.0481***	0.0351**	0.0383**	0.0430**
	(0.016)	(0.016)	(0.017)	(0.017)	(0.017)
Start-up	0.0902**	0.0978**	0.0916**	0.0592	0.0588
	(0.042)	(0.042)	(0.042)	(0.044)	(0.044)
Youngfirm	-0.0302*	-0.0243	-0.0295	-0.0290	-0.0289
	(0.018)	(0.018)	(0.018)	(0.018)	(0.018)
Maturefirm	0.0129	0.0190	0.0130	0.0117	0.0120
	(0.016)	(0.016)	(0.016)	(0.017)	(0.017)
innovation	0.0930***		0.0868***	0.0763***	
	(0.022)		(0.023)	(0.023)	
finasany1		0.0369**	0.0321*	0.0285*	
		(0.016)	(0.016)	(0.017)	
SalesGrowth_w1				0.0181**	0.0183**
				(0.008)	(0.008)
innov_gdsser					0.0077
					(0.017)
innov_opproc					0.0272
					(0.019)
innov_orgmanproc					0.0060
					(0.019)
innov_marketing					0.0432**
					(0.019)
2.div06	-0.0842***	-0.0750**	-0.0805**	-0.0939***	-0.0966***
	(0.031)	(0.032)	(0.031)	(0.030)	(0.030)
3.div06	-0.0707***	-0.0557***	-0.0670***	-0.0644***	-0.0682***
	(0.020)	(0.019)	(0.020)	(0.020)	(0.020)
5.div06	-0.0688**	-0.0641**	-0.0654**	-0.0690**	-0.0719**
	(0.029)	(0.029)	(0.029)	(0.028)	(0.029)

	(1)	(2)	(3)	(4)	(5)
Variables	NetEmp	NetEmp	NetEmp	NetEmp	NetEmp
6.div06	-0.0665*** (0.021)	-0.0512** (0.021)	-0.0596*** (0.021)	-0.0523** (0.021)	-0.0586*** (0.021)
7.div06	-0.0739*** (0.026)	-0.0554** (0.025)	-0.0666*** (0.026)	-0.0610** (0.026)	-0.0663** (0.026)
8.div06	-0.1139*** (0.024)	-0.1040*** (0.023)	-0.1085*** (0.024)	-0.1035*** (0.024)	-0.1088*** (0.024)
9.div06	-0.0286 (0.028)	-0.0249 (0.027)	-0.0270 (0.028)	-0.0235 (0.028)	-0.0242 (0.028)
10.div06	-0.0887*** (0.029)	-0.0696** (0.029)	-0.0839*** (0.029)	-0.0758** (0.030)	-0.0801*** (0.030)
12.div06	-0.1195*** (0.029)	-0.1082*** (0.029)	-0.1126*** (0.029)	-0.1104*** (0.030)	-0.1186*** (0.030)
13.div06	-0.0876*** (0.024)	-0.0721*** (0.024)	-0.0800*** (0.024)	-0.0840*** (0.025)	-0.0909*** (0.025)
14.div06	-0.0562* (0.033)	-0.0495 (0.032)	-0.0487 (0.033)	-0.0514 (0.035)	-0.0566 (0.035)
18.div06	-0.0530* (0.030)	-0.0410 (0.030)	-0.0472 (0.030)	-0.0361 (0.030)	-0.0422 (0.030)
19.div06	-0.1077*** (0.024)	-0.0955*** (0.024)	-0.1020*** (0.024)	-0.1028*** (0.025)	-0.1077*** (0.025)
200809.fin_year	0.0877*** (0.022)	0.0905*** (0.022)	0.0879*** (0.022)	0.0949*** (0.022)	0.0944*** (0.022)
200910.fin_year	0.0179 (0.018)	0.0204 (0.018)	0.0191 (0.018)	0.0213 (0.018)	0.0201 (0.018)
201011.fin_year	0.0138 (0.019)	0.0177 (0.019)	0.0154 (0.019)	0.0143 (0.019)	0.0128 (0.019)
Constant	0.0060 (0.022)	-0.0045 (0.022)	-0.0028 (0.022)	-0.0096 (0.022)	-0.0020 (0.022)
Observations	7,554	7,581	7,554	7,295	7,295
R-squared	0.0369	0.0344	0.0391	0.0394	0.0382
Number of ABSBID	2,326	2,332	2,326	2,275	2,275
Chi-sq	108.3	95.50	111.2	114.9	113.5
Prob > Chi-sq	0.000	0.000	0.000	0.000	0.000

Robust standard errors in parentheses: *** p<0.01, ** p<0.05, * p<0.1

Source: ABS Business Longitudinal Data 2006-07 to 2010-2011.



Table 12:
Determinants of SME net employment with interactions: 2006-07 to 2010-11

	(1)	(2)	(3)	(4)
Variables	NetEmp	NetEmp	NetEmp	NetEmp
size1	0.0800***	0.0705***	0.0839***	0.0718***
	(0.018)	(0.016)	(0.018)	(0.016)
size2	0.0654***	0.0557***	0.0667***	0.0571***
	(0.019)	(0.016)	(0.019)	(0.017)
size3	0.0674***	0.0417**	0.0640***	0.0402**
	(0.020)	(0.016)	(0.020)	(0.017)
Start-up	0.0910**	0.0473	0.0604	0.0302
	(0.042)	(0.053)	(0.044)	(0.057)
Young firm	-0.0311*	-0.0589***	-0.0298	-0.0571***
	(0.018)	(0.022)	(0.018)	(0.022)
Mature firm	0.0116	-0.0079	0.0105	-0.0114
	(0.016)	(0.019)	(0.017)	(0.020)
innovation	0.1818***	0.0349	0.1704***	0.0202
	(0.060)	(0.026)	(0.063)	(0.027)
size1_innovation	-0.0709		-0.0894	
	(0.074)		(0.076)	
size2_innovation	-0.0839		-0.0869	
	(0.075)		(0.077)	
size3_innovation	-0.1535**		-0.1505**	
	(0.068)		(0.071)	
Start-up_innovation		0.2081		0.1435
		(0.136)		(0.136)
Young firm_innovation		0.1508**		0.1481**
		(0.064)		(0.065)
Mature firm_innovation		0.1162*		0.1272*
		(0.063)		(0.066)
finasany1			0.0287*	0.0294*
			(0.016)	(0.017)
Sales Growth_w1			0.0180**	0.0181**
			(0.008)	(0.008)
2.div06	-0.0846***	-0.0820***	-0.0942***	-0.0912***
	(0.031)	(0.031)	(0.030)	(0.030)

3.div06	-0.0706***	-0.0711***	-0.0641***	-0.0645***
	(0.020)	(0.020)	(0.020)	(0.020)
5.div06	-0.0657**	-0.0661**	-0.0663**	-0.0663**
	(0.029)	(0.029)	(0.028)	(0.028)
6.div06	-0.0648***	-0.0633***	-0.0509**	-0.0491**
	(0.021)	(0.021)	(0.021)	(0.021)
7.div06	-0.0738***	-0.0735***	-0.0608**	-0.0608**
	(0.026)	(0.026)	(0.026)	(0.026)
8.div06	-0.1121***	-0.1116***	-0.1018***	-0.1006***
	(0.024)	(0.024)	(0.024)	(0.024)
9.div06	-0.0255	-0.0265	-0.0205	-0.0213
	(0.027)	(0.028)	(0.028)	(0.028)
10.div06	-0.0897***	-0.0906***	-0.0773***	-0.0769***
	(0.029)	(0.029)	(0.030)	(0.030)
12.div06	-0.1188***	-0.1184***	-0.1094***	-0.1093***
	(0.029)	(0.029)	(0.030)	(0.030)
13.div06	-0.0847***	-0.0864***	-0.0812***	-0.0828***
	(0.024)	(0.024)	(0.025)	(0.025)
14.div06	-0.0566*	-0.0567*	-0.0525	-0.0510
	(0.032)	(0.032)	(0.035)	(0.035)
18.div06	-0.0525*	-0.0539*	-0.0357	-0.0370
	(0.030)	(0.030)	(0.031)	(0.030)
19.div06	-0.1057***	-0.1040***	-0.1008***	-0.0989***
	(0.024)	(0.024)	(0.025)	(0.025)
200809.fin_year	0.0875***	0.0881***	0.0946***	0.0950***
	(0.022)	(0.022)	(0.022)	(0.022)
200910.fin_year	0.0180	0.0177	0.0214	0.0212
	(0.018)	(0.018)	(0.018)	(0.018)
201011.fin_year	0.0140	0.0135	0.0145	0.0142
	(0.019)	(0.019)	(0.019)	(0.019)
Constant	-0.0058	0.0151	-0.0220	-0.0014
	(0.022)	(0.022)	(0.023)	(0.022)
Observations	7,554	7,554	7,295	7,295
R-squared	0.0382	0.0390	0.0413	0.0426
Number of ABSBID	2,326	2,326	2,275	2,275
Chi-sq	112.8	112.3	119.8	119.1
Prob > Chi-sq	0.000	0.000	0.000	0.000

Robust standard errors in parentheses: *** p<0.01, ** p<0.05, * p<0.1

Source: ABS Business Longitudinal Data 2006-07 to 2010-2011.

Table 13:
Average number of jobs created by SMEs in Australia:
2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 1,959)	4.343	3.962	4.232	3.623
Start-ups (n = 89)	4.724	5.888	.	.
Young firms (n = 385)	4.023	3.531	6.048	2.190
Mature firms (n = 339)	4.398	.	4.426	3.258
Old firms (n =1,092)	4.498	4.017	3.897	3.857
Non-employing (n=458)	2.018	1.981	1.842	1.787
Micro (0-4 employees) (n = 591)	2.719	2.644	2.868	1.943
Small (5-19 employees) (n = 585)	5.574	4.302	4.567	4.079
Medium (20-199 employees) (n = 325)	8.753	9.279	9.793	6.856

Figure 13a:

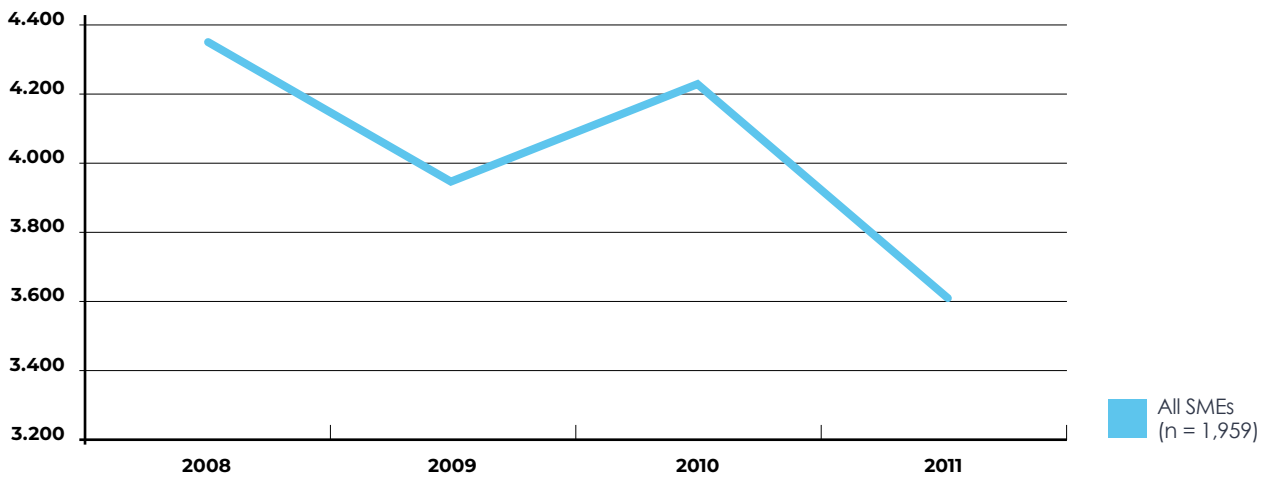


Figure 13b:

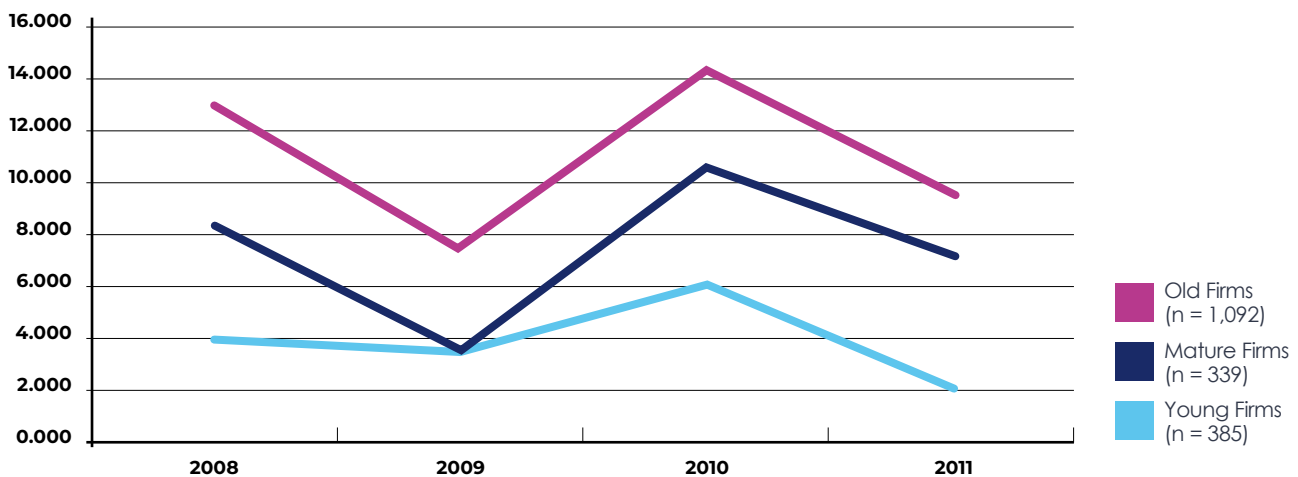


Figure 13c:

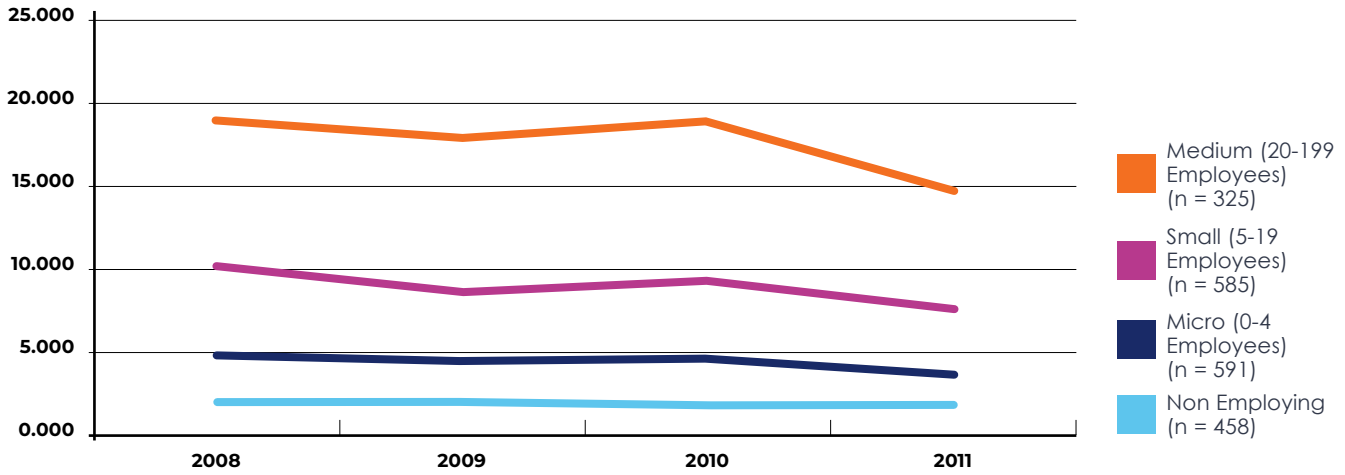


Table 14:
Average number of jobs created by new establishments:
2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 167)	8.034	4.514	7.500	6.919
Start-ups (n = 4)			.	.
Young firms (n = 34)	3.962	1.950	7.000	2.800
Mature firms (n = 39)	8.733	.	3.125	7.864
Old firms (n = 79)	9.818	4.628	8.375	8.538
Non-employing (n = 36)	4.042	2.929	1.000	2.000
Micro (0-4 employees) (n = 49)	4.200	2.208	5.400	3.550
Small (5-19 employees) (n = 51)	13.063	6.107	4.750	8.955
Medium (20-199 employees) (n = 31)	9.000	10.545	14.917	9.563

Figure 14a:

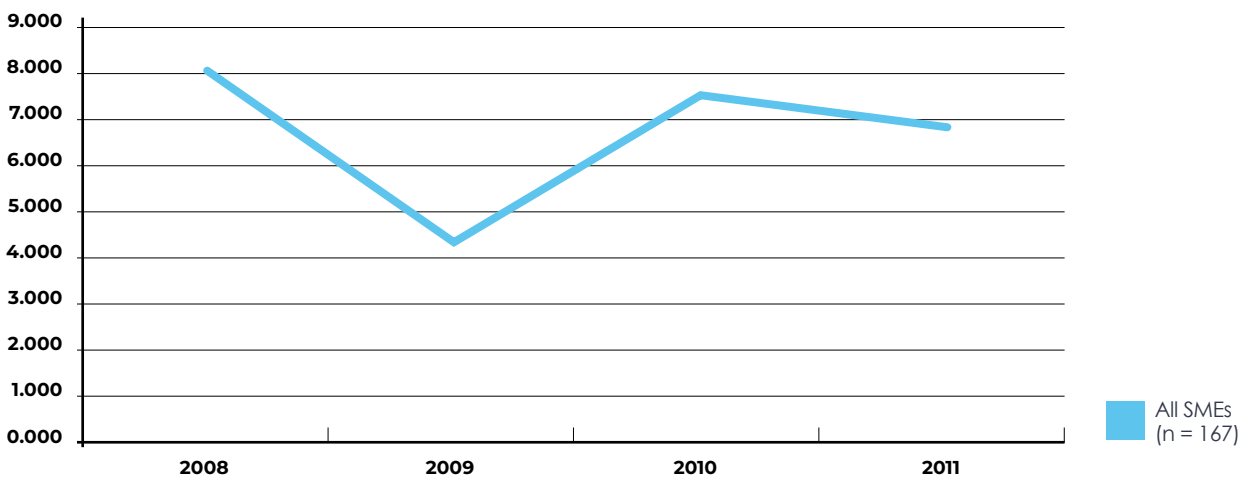




Figure 14b:

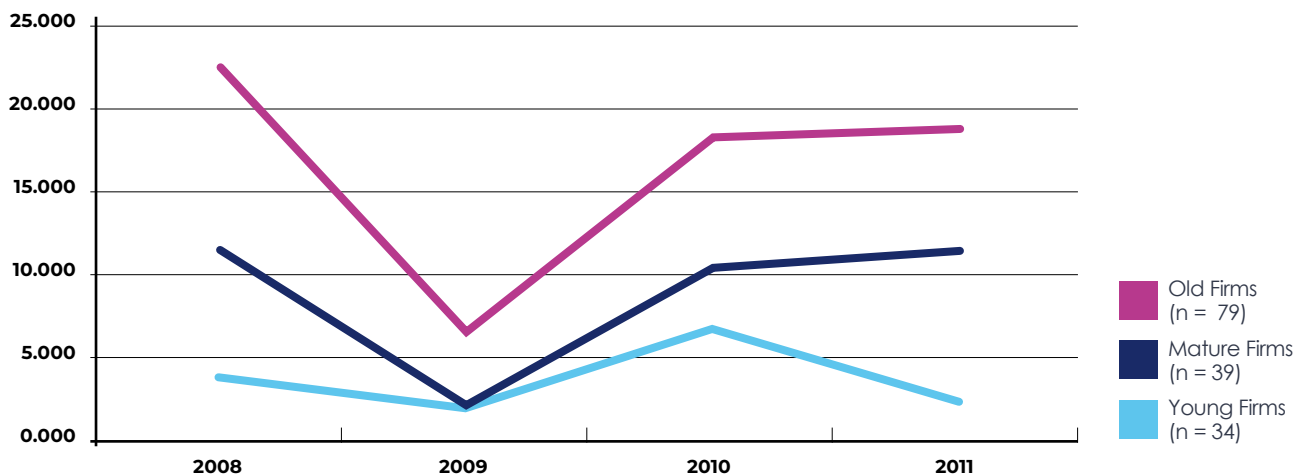


Figure 14c:

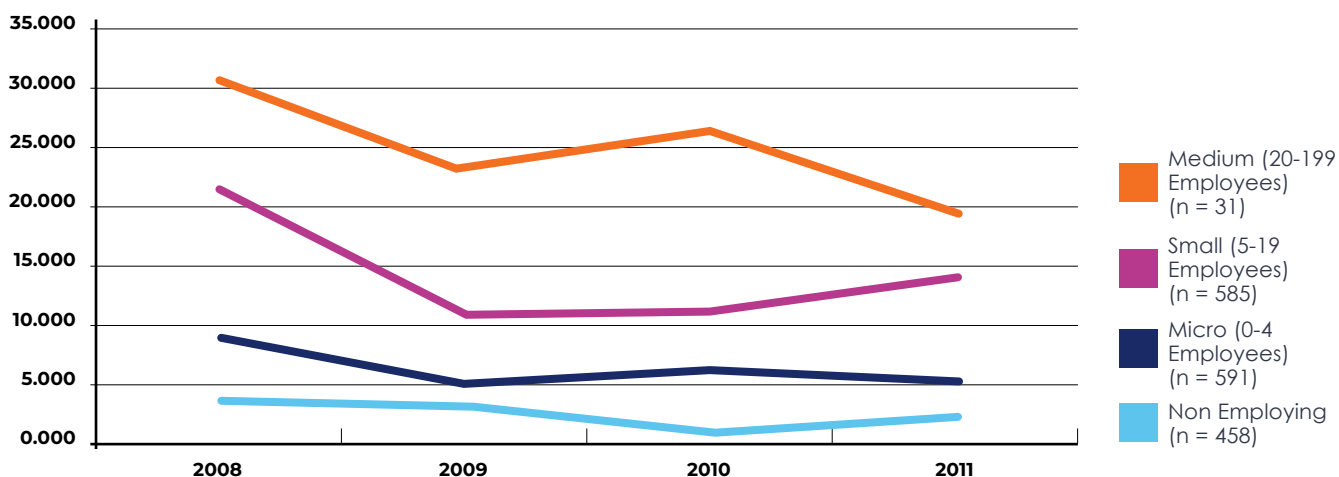


Table 15:

Average number of jobs destroyed by SMEs in Australia: 2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 2,001)	-4.785	-5.605	-4.735	-5.369
Start-ups (n = 48)	-7.650	-3.167	.	.
Young firms (n = 373)	-5.664	-5.027	-6.483	-6.300
Mature firms (n = 375)	-3.680	.	-6.055	-4.845
Old firms (n =1,166)	-4.583	-5.956	-4.139	-5.478
Non-employing (n=318)	-2.185	-2.563	-2.167	-2.463
Micro (0-4 employees) (n = 994)	-3.398	-2.920	-2.826	-2.939
Small (5-19 employees) (n = 677)	-5.310	-6.206	-4.429	-5.186
Medium (20-199 employees) (n = 412)	-9.145	-10.545	-9.225	-10.515

Figure 15a:

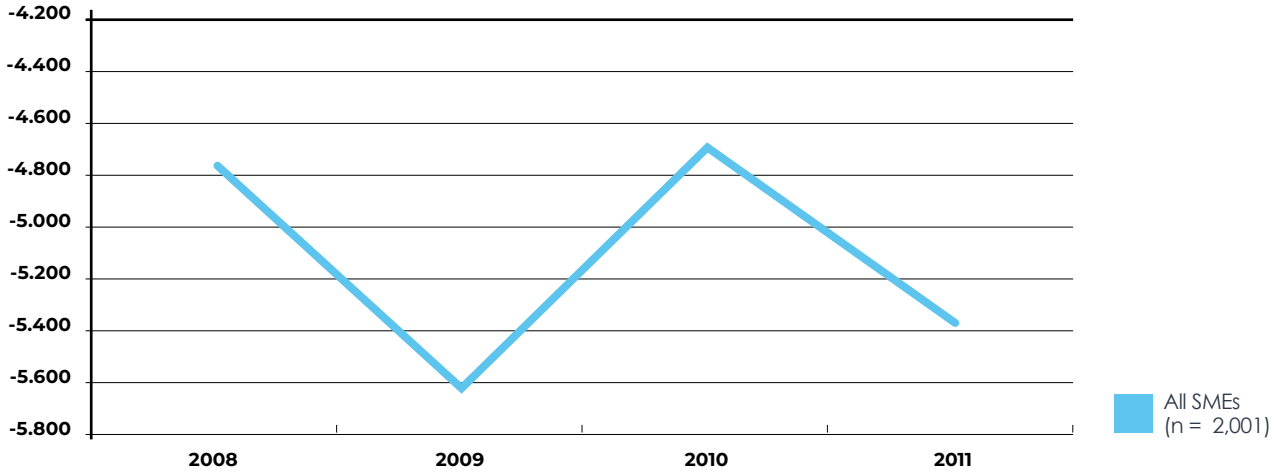


Figure 15b:

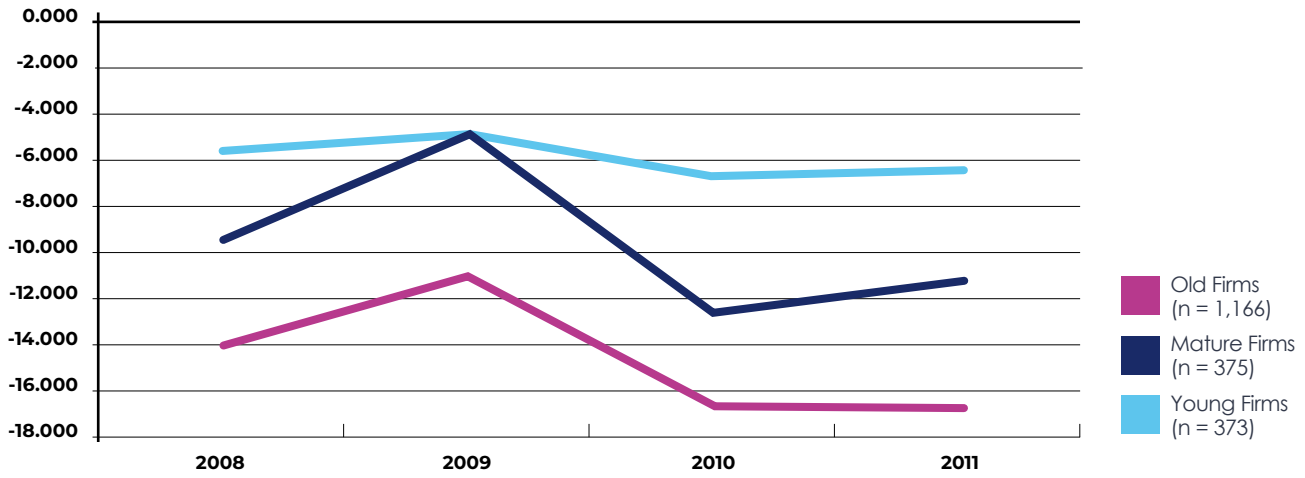


Figure 15c:

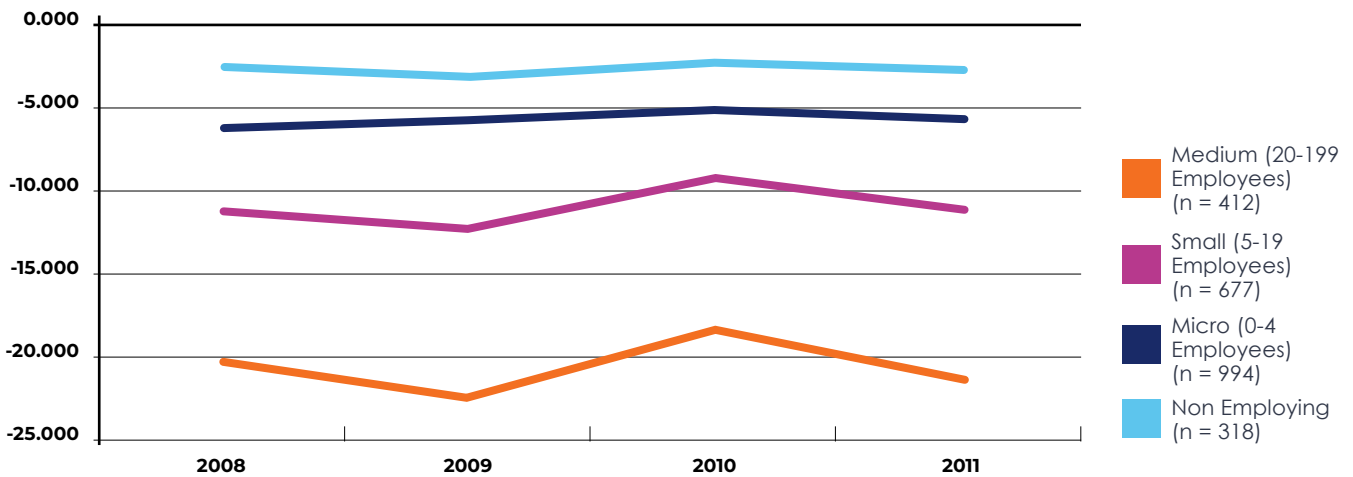




Table 16:
Average number of jobs destroyed by exiting establishments:
2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 174)	-8.904	-8.850	-4.528	-8.955
Start-ups (n = 3)			.	.
Young firms (n = 30)	-11.964	-5.850	-7.300	-2.000
Mature firms (n = 34)	-8.308		-4.773	-4.750
Old firms (n = 101)	-6.321	-10.029	-4.069	-12.200
Non-employing (n = 22)	-5.900	-13.167	-4.038	-2.000
Micro (0-4 employees) (n = 45)	-7.321	-5.500	-4.375	-2.875
Small (5-19 employees) (n = 61)	-9.565	-5.611	-3.719	-7.038
Medium (20-199 employees) (n = 46)	-10.367	-16.429	-6.154	-16.273

Figure 16a:

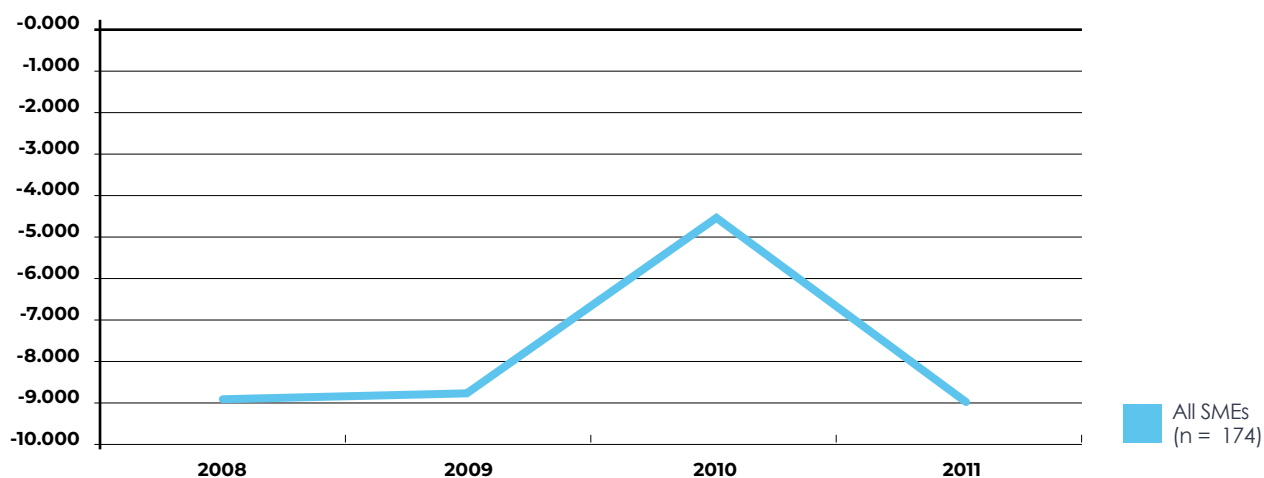


Figure 16b:

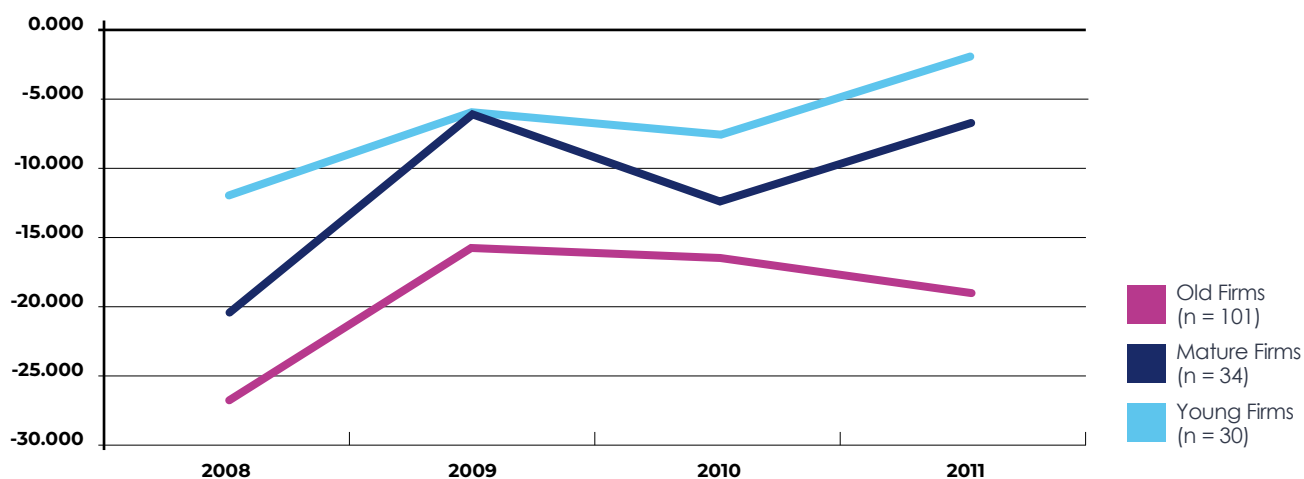


Table 17:
Average number of jobs destroyed by continuing establishments: 2006-07 to 2010-11

	2008	2009	2010	2011
All SMEs (n = 1,712)	-4.338	-5.135	-4.708	-4.956
Start-ups (n = 43)	-6.442	-3.294	.	.
Young firms (n = 322)	-4.691	-4.723	-6.320	-5.911
Mature firms (n = 318)	-3.178	.	-5.816	-4.702
Old firms (n = 998)	-4.529	-5.540	-4.217	-4.912
Non-employing (n = 282)	-1.911	-2.194	-1.694	-2.331
Micro (0-4 employees) (n = 519)	-3.175	-2.354	-2.675	-2.731
Small (5-19 employees) (n = 570)	-4.586	-5.977	-4.577	-4.633
Medium (20-199 employees) (n = 341)	-9.396	-9.659	-9.506	-10.119

Figure 17a:

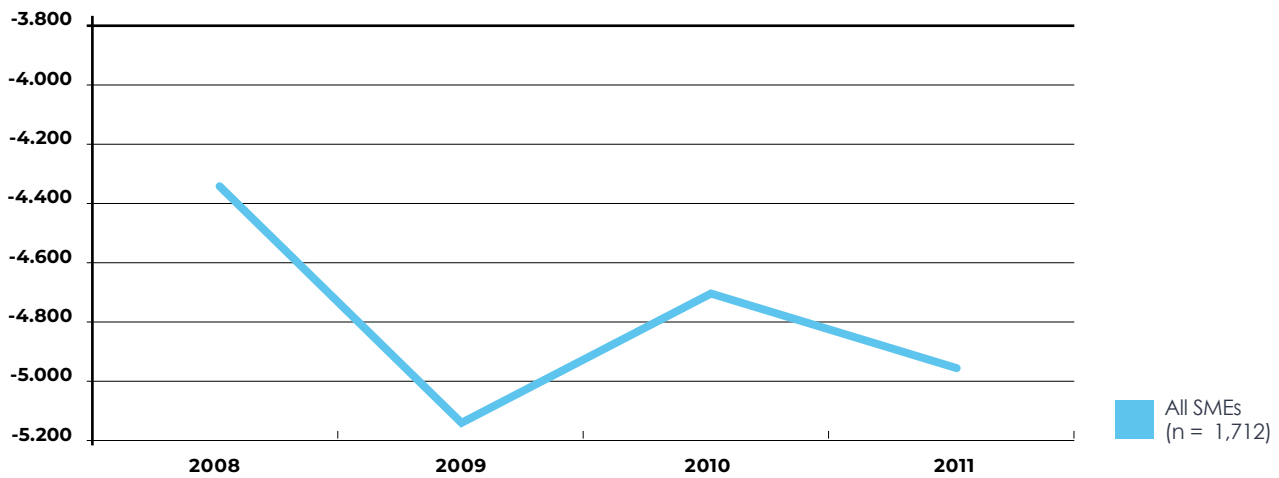


Figure 17b:

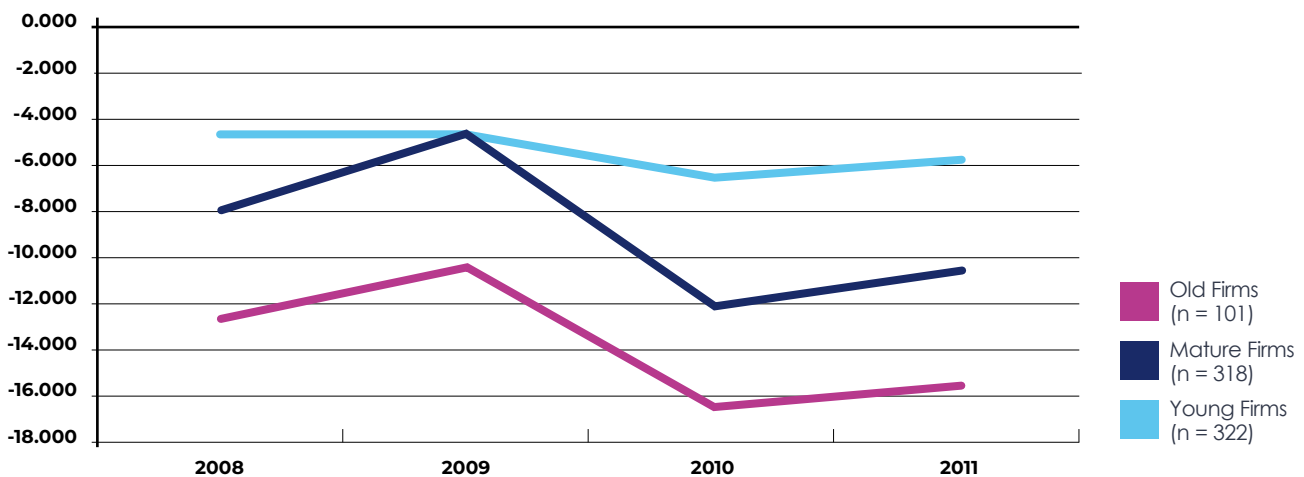
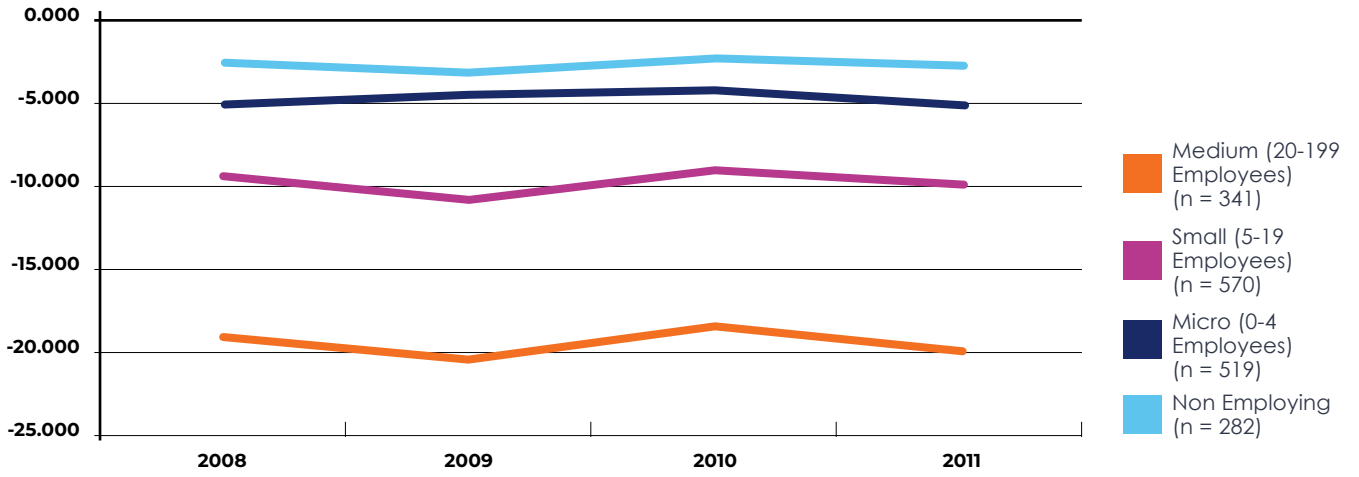




Figure 17c:



Chapter Seven

Innovation

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Deakin University

Introduction: Definition of innovation

The most commonly cited and generally accepted definition of 'innovation' is the *Oslo Manual* definition⁴⁴⁵:

*Innovation is the implementation of a new or significantly improved product (good or service), or process, new marketing method, or a new organisational method in business practices, workplace organisation or external relations*⁴⁴⁶.

Headline findings:

- Innovation is a key driver of productivity, jobs creation and economic performance.
- Innovation policy should include measures that encourage the diffusion and uptake of existing innovations by a broad range of firms, as well as encouraging new innovations per se.
- Federal, state and local governments in Australia have a series of grant schemes available for small businesses seeking to grow.
- Government agencies have extensive small business education programs designed to assist small businesses working within the innovation space.
- Public policy to support innovative SMEs should increasingly consider value capture and business model innovation generally.
- Businesses in Australia experience a wide range of barriers to innovation. This suggests policy to support innovation needs to be flexible and broad-based.
- Talent, not technology, is the key. If wider skill requirements are not addressed, there are likely to be bottlenecks created downstream in the innovation process.
- Technical skills across the workforce, and particularly interdisciplinary skills that bridge areas of expertise, are particularly important for innovation and are often subject to market failures.
- Patent box initiatives are gathering momentum in offshore jurisdictions.

The Australian Government's 'Office of the Chief Economist' adopts a systems approach to innovation (i.e. identifying and understanding all the components of the innovation ecosystem and the way they interact, to assess the innovation performance of an economy).⁴⁴⁷

The definition of an innovation system is thus explained as follows:

An open network of organisations that interact with each other and operate within framework conditions that regulate their activities and interactions. There are three components of the innovation system:

- **Innovation activities** — the discrete activities that lead to discoveries with commercial potential including R&D, entrepreneurial activity, innovation funding (e.g. venture capital), or the generation of skills for innovation.
- **Networks** — the formal and informal linkages between people and organisations in the innovation system, including communities of practice (such as medical professionals and software developers), joint research arrangements, industry-research collaboration and public procurement of private sector research outputs.
- **Framework conditions** — the institutional environment and general conditions for innovation activities, networks and collaboration.

These components collectively function to produce and diffuse innovations that have economic, social and/or environmental value⁴⁴⁸.

Other well-regarded definitions of innovation in the literature include the concepts explored in Johannessen⁴⁴⁹. Innovation is and always has been the implementation of new ideas with the ultimate goal of creating value⁴⁵⁰.

This definition is also similar to that provided in Australian Innovation System Report: "At its simplest, innovation is about novel ideas being put into practice. It drives long-term productivity growth and underpins human progress" (p. vi)⁴⁵¹.

Innovation is widely regarded as a key driver of productivity growth, job creation and superior economic performance⁴⁵². But, despite its importance, innovation is often misunderstood. There is a tendency to equate innovation with high-tech manufacturing, and it is assumed that it is something that only happens in research and development (R&D) laboratories.

⁴⁴⁵ OECD (2005).

⁴⁴⁶ OECD (2005).



Financial services firms, for example, have very low measures of R&D intensity⁴⁵³, but can be highly innovative.

Given that innovative firms (particularly start-ups) are known to create more jobs than any other business category⁴⁵⁴, federal, state, territory and local governments in Australia must do everything within their scope to assist businesses to understand the value of innovation and, where appropriate, to provide financial and other incentives to encourage innovative thinking within the small business community.

Research by an Australian government body, Innovation and Science Australia⁴⁵⁵ (ISA), has led to the development of a 'four pillars' model to support an economic environment where firms have the capacity and resources to innovate.

The ISA's four pillars framework refers to:

- 1. Culture and capital:** this encompasses initiatives to help businesses deal with the risks and incentives involved in starting a new enterprise.
- 2. Collaboration:** this is about ensuring that the level of engagement between businesses, universities and researchers is sufficient to commercialise new ideas and solve problems.
- 3. Talent and skills:** it is necessary to ensure that Australian students are properly trained for jobs of the future and for businesses to be able to add value by improving products, services and processes.
- 4. Government as an exemplar:** a government should set an example to business more generally in the way it invests in solutions to problems and procures goods or services.

The four pillars model has been revised by Innovation and Science Australia⁴⁵⁶ to ensure the innovation framework focuses on growing the capacity to innovate in Australia in the lead-up to 2030. The 2030 Plan is a national roadmap for action to strengthen Australia's innovation performance and put Australia into the international top tier by 2030. The four pillars have, therefore, evolved into five 'imperatives' that cover the following areas:

- 1. Education:** critical to be able to respond to the changing nature of the workplace in the lead-up to 2030.
- 2. Industry:** ensure Australia's ongoing prosperity by stimulating high-growth firms and improving productivity.

3. Government: governments should be catalysts for innovation and be recognised as global leaders in service delivery.

4. Research and development: improve effectiveness of R&D by increasing translation and commercialisation.

5. Culture and ambition: the plan advocates the creation of national missions that will be central to promoting innovation in certain areas (such as medicine).

The expansion of the framework and the establishment of goals to be achieved by 2030, articulated in the most recent document from the ISA, highlights the importance the federal government, government departments and government agencies place on innovation.

There is still, however, an apparent lack of appropriate acknowledgement by small businesses of the importance of innovation to the growth of their enterprises. The IPA-Deakin SME Research Centre⁴⁵⁷ has noted that the Australian Bureau of Statistics reports that only one in seven small businesses see innovation as important. That statistic alone illustrates that more needs to be done to create and promote incentives for small businesses to improve their prospects of future success.

This may not be entirely surprising however, given that some small businesses operated by one person (e.g. a tradesperson) may not see an immediate need to innovate, and it may be sufficient for the survival of the business simply to be competent in the respective trade and comply with industry rules and regulations.

Scoping the innovation landscape

Innovation is and always has been the implementation of new ideas, with the ultimate goal of creating value⁴⁵⁸. A business can implement better methods of doing work, such as automation via computer software or machinery, or process improvements in the way work is done. There may also be innovation in product development, so businesses are in a position to grow their market by having a product that people in their locality, their country or even across the world find useful or appealing.

Johannessen⁴⁵⁹ uses the example of the financial services sector. The paper attributes the growth in the financial services sector, in part, to the creation of new insurance and credit products and observed that economic growth would not have occurred if banks and other

447 Office of The Chief Economist (2015a); Office of the Chief Economist (2017).

448 Office of The Chief Economist (2015a); Office of the Chief Economist (2017).

449 Johannessen (2013).

450 Johannessen (2013).

451 Office of The Chief Economist (2017), p. vi.

452 Haltiwanger (2011).

453 Johannessen (2013).

454 Cowling, Tanewski, and Mroczkowski (2017)

455 Department of Industry, Innovation and Science (2015); Innovation and Science Australia (2017).

456 Innovation and Science Australia (2017).

457 IPA-Deakin SME Research Centre (2018).

458 Johannessen (2013).

459 Johannessen (2013).

entities only offered an existing range of products. Johannessen also refers to several categories of innovation in the paper and these categories are an acknowledgement that innovation in business needs a series of factors to be working together to facilitate growth.

The listed categories are as follows:

- Institutional innovation. The areas of innovation covered in this context are political, cultural and social innovation:
- Political innovation is concerned with the exercise of power within a society that contributes to facilitation of innovation.
- Cultural innovation is about 'norms, values, habits, expectations and new ways of thinking' that may relate to ideology.
- Social innovation is connected to notions of relationships, networks and alliances within a society. Johannessen⁴⁶⁰ argues that the education system can be regarded as a social innovation because it has an impact on product design and manufacture and the adoption of new technologies.
- Economic innovations. There are four kinds of innovation that come under this overarching category. They include:
 - Organisational innovation: which includes administrative innovations within an organisation so that an existing system runs better. It also refers to the adoption of new business models to reshape the way an entity operates. The goal in both cases is to achieve greater efficiency and a reduction of costs.
 - Material innovation: which refers to new products, new uses of existing products, and new technologies that enable the creation of other product lines.
 - Service innovation: which is concerned with innovations in services that may include financial services and financial products. It also provides scope for an examination of the way in which services are delivered and improvements that may be introduced by a business to attain and retain customers.
 - Market innovation: which focusses on channels of product delivery that may emerge as a result of product development.

Each element outlined in Johannessen's work plays a significant role in facilitating an environment where small business innovation is possible. This environment is an 'ecosystem' within which a small business is

able to thrive. Indeed, the work undertaken by Johannessen builds on previous thinkers in the area such as Schumpeter⁴⁶¹, who had thought about the impact of disruptive technologies on the way in which governments and stakeholders view the policy and practical implications of innovation on the economy.

Schumpeter's work in the early 20th century had a major influence on economic thinking about innovation. His underlying idea was that 'new waves' of technology caused significant disruptions in the economy that generated new bursts of economic activity followed by subsequent declines, and then further bursts, in effect driving new economic growth. As a result, Schumpeter wrote, the economy is subject to 'creative destruction', whereby charismatic entrepreneurs come up with new innovations, and their firms grow to disrupt incumbent firms and existing industrial structures, before settling down into a more bureaucratic style of management, at which point the scheme is set for a new entrepreneur to emerge. This model has been extremely influential and underpins much support for high-tech firms, spin-outs from universities, support for entrepreneurship, and tax breaks and subsidies for small firms.

In general, however, the empirical evidence does not support this model of innovation. Arguably, the problem is that Schumpeter (1942) may have confused innovation with invention. The primary reason is that innovation often depends on R&D, which is typically a long, uncertain, expensive and resource-intensive process. Thus innovative firms engaging in major projects often need to have significant financial, technical and managerial resources. This is overlooked in Schumpeter's model in terms of the larger enterprise at least, as he appears to assume that innovation emerges in its fully-formed state.

On another level, however, he may have been right, given that in the current 'cyberspace' climate, whether innovation emerges fully-formed (and thus rapidly) largely depends on the type of innovation. Software and 'app' type innovations, for example, have been known to come to fruition and be delivered to the market within weeks. Against this background, entrepreneurs don't necessarily need huge amounts of financial capital or other major resources, and in this respect have significant advantages over larger incumbent firms.

⁴⁶⁰ Johannessen (2013).

⁴⁶¹ Schumpeter (1942).

However, there still appears to be an unwillingness to embrace new technologies and a reluctance by SMEs to take up the innovation challenge. A good example of this reluctance was highlighted in a report commissioned by the Australian Communications and Media Authority⁴⁶², which shows that SMEs are choosing to be late adopters of digital technology (particularly digital communication technology), notwithstanding their acknowledgement that their businesses could be more creative, more flexible, more competitive, more cost-effective and have better data management.

The underlying policy question thus becomes the following: what must small business owners do to reshape their enterprises so they can be more creative, innovative, and better able to withstand changes in the marketplace that may otherwise cause the business to falter and fade? An earlier paper by Johannessen⁴⁶³ provides some observations worth noting from the perspective of a company needing to innovate to survive. The elements Johannessen⁴⁶⁴ posits as being critical for an organisation to be capable of innovation are:

- culture and tone of the organisation – structural links within an organisation that facilitate communication
- the overall competence of the entity's team
- the willingness of management to pursue an innovation program and the information technology and communications systems that assist in facilitating an environment where innovation becomes possible.

An organisation that has the right culture – that encourages communication and collaboration on projects to enhance the organisation's product range – is more likely to be successful when projects and products are innovatively developed.

Johannessen⁴⁶⁵ also notes the role played by external forces such as customers and suppliers. The issue of demand is critical in this context. To be successful, a product must have a market and this can only properly be achieved by a company working with customers, suppliers and potential customers to deliver a product that will meet a need. For this to occur, there must be a process in place as explained in the following paragraphs.

The process of innovation

Despite the uncertainty and complexity of innovation, it is possible to abstract an underlying set of stages typically followed by innovating firms⁴⁶⁶. These stages are explained below:

1. Searching for new opportunities.

This typically involves firms searching externally for new markets, technologies or delivery mechanisms they can exploit by building on their existing technological capabilities and connections to customers and suppliers.

2. Selecting which opportunities to support.

Once a range of opportunities has been found, firms need to make strategic decisions, under conditions of uncertainty, about which options they will pursue and which options they will reject.

3. Implementation. Once the strategic decision has been made, firms need to implement their strategy and allocate time, people and resources to ensure the process is effectively undertaken. Innovation is inherently uncertain, and this will typically involve formal and informal experimentation to develop new products and services that provide value for customers.

4. Capturing value. Creating value for customers does not guarantee commercial success, as firms need to find ways to monetise the value they have created. Innovations, particularly disruptive innovations, often create non-monetary forms of value, such as improved brand recognition, which firms can also capture. Firms can capture value by learning from their experiences to improve their future innovation processes.

The steps in the process of innovation outlined above will only be successful if business owners and their staff are able to focus on building the business overall, rather than making what they do in their business solely a matter of habit.

This is an area of focus for management consulting authors such as Gerber (1995)⁴⁶⁷, who achieved prominence with his book *The E-Myth*. Gerber observes that business owners who solely set up business to replicate the work they have just left, rather than work on creating a larger vision for a business, may be doomed to failure. In a sequel to the *E-Myth – The E-Myth Revisited*⁴⁶⁸ – Gerber notes a need for a small business person to learn the art of working on their business and not in it. "At its best, your business is something

⁴⁶² Australian Communications and Media Authority (2014), p 4.

⁴⁶³ Johannessen (2009).

⁴⁶⁴ Johannessen (2009).

⁴⁶⁵ Johannessen (2009).

⁴⁶⁶ Tidd and Bessant (2018).

⁴⁶⁷ Gerber (1995).

⁴⁶⁸ Gerber (1995).

apart from you, rather than a part of you, with its own rules and its own purposes," Gerber observes. "An organism, you might say, that will live or die according to how well it performs its sole function: to find and keep customers." Working merely for an existing customer base with an existing suite of products may not lead to business longevity.

Gerber suggests that, where a small business person spends their time being the 'doer' in the business – a 'technician' – rather than thinking about the business more broadly, like an entrepreneur, that business is merely being run rather than being redesigned for growth.

Gerber contrasts the thinking of the different personalities on business problems as the *entrepreneurial perspective* and the *technician's perspective*:

- The entrepreneurial perspective asks the question: 'How must the business work?' The technician's perspective asks: 'What work has to be done?'
- The entrepreneurial perspective perceives the business as a system for producing outside results – for the consumer – resulting in profits. The technician's perspective views the business as a place in which people work to produce inside results – for the technician – producing income.
- The entrepreneurial perspective starts with a picture of a well-defined future and then comes back to the present with the intention of changing it to match the vision. The technician's perspective starts with the present, and then looks forward to an uncertain future with the hope of keeping it much like the present.
- The entrepreneurial perspective envisions the business in its entirety, from which is derived its parts. The technician's perspective envisions the business in parts, from which the whole is constructed.
- The entrepreneurial perspective is an integrated vision of the world. The technician's perspective is a fragmented vision of the world.
- To the entrepreneur, the future is modelled after the entrepreneur's vision. To the technician, the future is modelled after the present-day world.

Gerber⁴⁶⁹ suggests that success in an enterprise is possible over a longer-term period provided the person running the business understands that time needs to be taken to look forward and not sit in neutral

servicing current clients with a product or service that may fall out of favour.

A further way of thinking about innovation in a small business environment, Gerber argues, is to think about the business you are either running or seeking to establish as being a potential franchise and how customers will be guaranteed a uniform experience across a franchise chain. Underlying this mode of thinking is one principle: if you get the processes right and your employees are delivering on the vision, customers will keep coming back. This requires constant innovation in the area of processes and product to ensure the customer experience within a 'bricks and mortar' outlet or online environment encourages customers to return.

There is also the clear possibility that innovators can suffer due to a blind spot that may develop over time. Wang Laboratories is a company that evolved from manufacturing electronic calculators in the 1960s to making word processing machines⁴⁷⁰. Company founder An Wang saw that the electronic calculator, as produced by his company, would have cheaper competition in the marketplace. He therefore moved to creating word processing terminals – machines that replaced typewriters. Microsoft founder and philanthropist Bill Gates believes that Wang could have seamlessly moved into developing personal computer software, but he "failed to spot the next industry turn". Gates notes that Wang developed good software, but it was tied to the word-processing terminals. The inability to separate his software from the word-processing terminals guaranteed the short life span of his product range once personal computers could run word processing software such as WordStar, WordPerfect and MultiMate. Gates observes that Microsoft may never have started if Wang had seen the market for the compatible software applications: "I might be a mathematician or an attorney somewhere, and my adolescent foray into personal computing might be little more than a distant personal memory".

Gates also cites the example of Ken Olsen, founder of Digital Equipment Corporation (DEC), and his computer systems for corporations that resulted in the company growing to \$6.7 billion within the space of eight years. Olsen was a visionary in the computer field, but he dismissed the personal desktop computer as a fad that

⁴⁶⁹ Gerber (1995).

⁴⁷⁰ Gates (1995).



would never take off. Olsen later lost his position at DEC. 'He was brilliant at seeing new ways of doing things, and – after years of being an innovator – he missed a big bend in the road,' Gates notes.

These two case studies also demonstrate something else about innovation: if an existing entrepreneur is unable, unwilling or unprepared to seize an opportunity, for whatever reason, then individuals such as Bill Gates would eventually take their territory by providing customers with a product they need. Gates also observes that successful companies attract investors and also become preferred employers. This is, he observes, the thing that makes other successes in innovation more likely.

Governments and assistance for innovation

Government plays an important role in creating a regulatory environment that encourages companies and individuals to build businesses and create new products. Demand for new products has the potential to encourage business owners to expand their operations and employ more people.

Johannessen⁴⁷¹ refers to the notion of institutional innovation and the role social institutions such as governments fulfil in creating an environment in which small business owners operate. The underlying issues for policy makers is how to encourage small business owners, or those thinking about creating a business, to take the commercial risks required. In some cases, it will be the provision of relief from legal compliance burdens through legislation or via administrative means that assists in minimising the time spent by small business on regulatory compliance. In other cases, there will be a focus on ensuring there are grants or other incentives designed to encourage business creation and growth.

Patent box Initiatives – a way forward in stimulating innovation for SMEs

Consistent with the government's wider agenda on innovation, the possibility of an introducing an 'IP box' regime to encourage research and innovation is evidently close to becoming a reality. The federal government recently announced that it is considering offering tax incentives to encourage the development and commercialisation of intellectual property. As articulated in a

patent box policies paper by the Office of the Chief Economist⁴⁷², a 'patent box is a policy tool that reduces the rate of corporation tax levied on the income generated from certain types of qualifying intellectual property (IP), particularly patents' (hence the term 'patent box').

Patent box regimes are different to incentives-based schemes used by past governments to encourage research and development. These were usually tax credits and considered 'front-end' incentives because they were given at the start of a research project. IP Box incentives, on the other hand, are tax reductions/breaks for income generated by the intellectual property after the research has been commercialised (i.e. the *last stage of the innovation life-cycle*⁴⁷³).

It is timely for the government to consider incentives of this nature, as Australia appears to be lagging considerably behind its international counterparts in direct research and development funding for business. The OECD (2013) has ranked Australia 34th out of 36 countries, making it among the lowest-spending countries in terms of direct funding for research and development activities, alongside Chile and Mexico (the lowest), whereas Russia, Sweden and the United States spend the most on direct funding for business research and development.

While falling behind in the global research funding race could be seen by some international bodies as problematic, what might be of greater concern is whether the introduction of a patent box regime is the answer for encouraging greater innovation? Moreover, given the experiences of several countries already, the use of these schemes as merely a mechanism for attracting mobile income via transfer pricing is often viewed as a *potentially harmful preferential tax practice*.⁴⁷⁴

Given the above, some critical issues need to be considered before Australia can introduce a patent box scheme. For example, what is a patent box and how does it derive its meaning? What economic theories support the introduction of a patent box tax incentive? How do patent box schemes work? Have they worked in the many other countries that have already adopted them? What is the upside/downside of such regimes? Can we expect success if Australia was to implement a patent box regime to encourage innovation?

⁴⁷¹ Johannessen (2013).

⁴⁷² Office of the Chief Economist (2015b).

⁴⁷³ Office of the Chief Economist (2015b).

⁴⁷⁴ OECD (2015).

Firstly, the genesis of the term 'patent box' is interesting, to say the least, and for the uninitiated it conjures up all sorts of imagery – for instance, an imaginary box within which documents relating to patents are stored (anecdotal finding). This is far from the truth, of course. In its simplest form, a patent box is a tax incentive which provides a lower tax regime specifically applicable to income generated from qualifying patents. The term 'patent box' has no prudent dictionary definition as we know it, but has become more of a generally accepted term used in tax circles, arguably derived from the European taxation system where, evidently, it relates to a box that needs to be ticked on the tax form⁴⁷⁵.

Over the past 10 years, patent box regimes have increased in popularity as the 'innovation-based' global economy has taken hold and continues to be fuelled by new ideas, new inventions and the increasing global demand for new processes and new end-products. In an effort to capture the essence of this phenomenon, which is clearly a significant driver of economic growth⁴⁷⁶, governments are vigorously searching for mechanisms that encourage and support innovation initiatives that grow economies and improve the wealth of societies.

Indeed, governments as far back as the early 1980s have already provided key policy measures, by way of tax incentives for research and development (commonly known as R&D tax incentives). This includes Australia, which has a range of tax incentives schemes currently available across a broad range of industries and activities. By many accounts, tax incentives have been successful in supporting research R&D in most countries, including Australia where the registration of patents has increased over the past 15 years. However, R&D tax incentives are 'front-end' measures to encourage research and development, starting from the initial idea and proposal, but they do not necessarily focus on the commercialisation of the research. Thus they are, in effect, 'input-based' measures.

Patent box tax incentives operate differently. They are 'back-end' or output-based incentives designed to provide tax relief from income generated by a patent already registered. In this sense, a patent box initiative incentivises the commercialisation of innovation and not just the research component of innovation (i.e. by providing a firm

with a lower rate of tax to qualifying income that would otherwise attract the normal corporate tax rates). Moreover, the strategic nature of a properly constructed patent box tax incentive will ensure that the lower tax rate is only applicable where profits from innovation are actually aligned with the profit-making activity. In this way, the success of the innovation commercialisation is rewarded and, indeed, ultimately it is the commercialisation that leads to growth and prosperity.

The theoretical arguments in support of a patent box tax initiative are drawn from the economic literature, where it appears that there are two schools of thought, both of which relate to multiple market failures or, rather, the lack of failures (i.e. assuming the normal forces of demand and supply are at play). In this sense, if the market reaches equilibrium through these forces, then there should be no need for governments to use taxation or any other mechanisms to correct for market failure, because markets without external intervention should theoretically maximise a nation's economic welfare.

The point missing here, however, is the existence of positive externalities – i.e. the 'spillover' effect which increases the welfare of society, but at the expense of the creator/inventor. To put this argument in another way, knowledge can be freely used by any consumer and thus it is a public good, meaning that one consumer's consumption of knowledge will not affect the consumption of any other consumer. Similarly, the air we breathe is a public good and, again, one consumer's consumption of fresh air will not affect the consumption of any other consumer.

Extending this argument to intellectual property – if the intellectual property of a creator can be used freely by any person, then there is no incentive for entrepreneurs to invest in research and development, leading to the underproduction of knowledge and, in turn, new innovations. Thus, in a purely free market scenario, some public goods will result in market failure (i.e. the misallocation of resources), which in turn can lead to insufficient innovation and research, leaving society to be worse off in the long term.

An extensive body of economic literature shows that 'companies do not capture anywhere near all the benefits from the research they conduct'⁴⁷⁷, thus requiring some form of tax incentives to correct for the apparent market failure.

⁴⁷⁵ Atkinson and Andes (2011).

⁴⁷⁶ Atkinson and Andes (2011).

⁴⁷⁷ Atkinson and Andes (2011).



Early studies, as far back as the 1980s⁴⁷⁸ also establish this inconsistency in market behaviour: “the median rate of return from twenty prominent innovations was 27%, whereas the social rate of return was 99%, ‘almost four times higher’”⁴⁷⁹. Moreover, Nordhaus⁴⁸⁰ found that inventors “only capture 4% of the total social gains from their innovation; the rest spill over to other companies and to society as a whole”. So, from an inventor’s perspective, it is not really an appealing proposition when everyone other than the inventor stands to gain much more of the benefits that accrue from the innovation.

In light of the above findings, and given that new knowledge is a significant driver of improved public welfare and wealth generally, government intervention is necessary to prevent an underinvestment in the creation and commercialisation of new knowledge. Indeed, Australia has recognised this issue and, along with many other countries, has successfully introduced tax incentives for the ‘front-end’ of the innovation cycle that commences with the conduct of research. These initiatives have been successful in effectively lowering the cost of research and have thus increased the returns of private investors that might otherwise have rejected an investment in innovation, particularly if the risks are high and the returns are low⁴⁸¹.

Moving on to patent box incentives, the IPA-Deakin SME Research Centre has a concern about whether tax incentives at the back-end of the innovation process (i.e. the commercialisation stage) can have the same effect in stimulating further investment in innovation and thus be similarly successful as R&D tax concessions. Indeed, proponents of patent box regimes argue that providing tax incentives which reward commercialisation and success of innovation, “is an important strategy for growth, competitiveness and job creation”⁴⁸². This leads us to a further discussion on the second wave of economic theory relating to market failure – that is, that innovation is now, more than ever, a global, mobile phenomenon. As a consequence, we are witnessing economic inconsistencies (almost akin to a price war) as more and more countries rigorously, aggressively use tax codes and other mechanisms to remain competitive and further grow their economies.

One issue central to the economic argument relating to market failure is the risk factor. Typically, the innovations most likely to ‘change the world’ and have the

greatest impact on society, as well as providing the greatest amount of benefits to society, are the longer-term, large-scale research projects. Indeed, in this respect, these are the projects governments should be supporting (i.e. given that their successful commercialisation will provide the greatest amount of benefits to society and will have the greatest spillover effects as well, thus benefitting hundreds of non-creator firms). However, the longer-term, large-scale research projects have a higher risk profile and require significant investment in research and development over longer periods and, even after these long periods of large investments, may still not be successful commercially. A good example is research undertaken in the pharmaceutical industry, where new medical discoveries such as drugs could take anywhere from 10 to 20 years or more to get to market. Moreover, in competitive global markets with appetites for shorter-term investments, “justifying investment in high-risk [and longer-term] research activities has become much more difficult”⁴⁸³.

In the Australian context, the risks associated with long-term innovation projects have been partially offset by tax code initiatives such as R&D incentives (government support), which have proven to be successful at the front-end of the R&D cycle (i.e. as effective incentives to encourage further research, innovation and job growth)⁴⁸⁴. Similar R&D initiatives have been successful in many other jurisdictions, including the United States, Japan and a host of countries within the EU⁴⁸⁵. From an international perspective, Graetz and Dowd⁴⁸⁶ provide an extensive account of the positive impacts of R&D incentives on economic growth.

The evidence suggests, therefore, that R&D tax credits have been an effective “tool to lower the costs of conducting research, including high-risk research, so that private returns better approximate social returns, encouraging firms to invest to maximise both”⁴⁸⁷. Interestingly, however, some researchers suggest that R&D credits alone are not enough for firms to remain globally competitive in a constantly-changing global market, and a combination of incentives are required to encourage research, innovation and commercialisation. Indeed, as cited by one author, “there are alternative ways of correcting market failure so that inventors of knowledge are rewarded; we need a mixture of different instruments appropriate to different products and circumstances”⁴⁸⁸.

⁴⁷⁸ Tewksbury, Crandall and Crane (1980).

⁴⁷⁹ Cited in Atkinson and Andes (2011).

⁴⁸⁰ Nordhaus (2005), p 4.

⁴⁸¹ Atkinson and Andes (2011).

⁴⁸² Atkinson and Andes (2011).

⁴⁸³ Krehmeyer, Orsagh and Schacht (2006).

⁴⁸⁴ IPA-Deakin SME Research Centre (2018).

⁴⁸⁵ European Union (2014).

⁴⁸⁶ Graetz and Dowd (2013).

⁴⁸⁷ See particularly Atkinson and Andes (2011).

⁴⁸⁸ Owen (2017).

489 Atkinson and Andes (2011).

490 Including Atkinson and Andes (2011); European Union (2014); Griffith, Miller and O’Connell (2014); Alstadsaer, Kopczuk and Telle (2014); de Rassenfosse (2014); Bradley, Dauchy and Robinson (2015); Faulhaber (2016).

491 Alstadsaer, Kopczuk and Telle (2014).

492 Zodrow and Mieszkowski (1986).

493 de Rassenfosse (2014), p.5

494 OECD (2014).

495 Pascal Saint-Amans, OECD, quoted by Fairfax Media, cited in Khadem (2014).

496 Tax Justice Network, quoted in Khadem (2015).

497 Alstadsaer, Kopczuk and Telle (2014).

498 Alstadsaer, Kopczuk and Telle (2014).

499 Atkinson and Andes (2011).

500 Atkinson and Andes (2011).

Some of the alternative ways suggested include:

- government (voluntary or compulsory) buy-outs of patents, thus making them truly public goods without impairing (assuming that a fair value is struck) the benefits attributable to creators of knowledge
- prizes for inventions
- full government funding for research and development costs.

Other contributors have argued for a patent box regime in addition to R&D incentives, so the input (R&D) and output (commercialisation) phases of an innovation are compensated and rewarded. In this sense, there is a better “matching of firm rewards with societal benefits, including the creation of high-paid jobs”⁴⁸⁹.

This state of thinking has now led to a proliferation of patent box schemes in several countries across the globe, as evidenced in numerous studies.⁴⁹⁰ Many of these studies have highlighted the potential benefits that patent box regimes can provide, particularly in terms of supporting further innovation.

But many of the studies also highlight the potential pitfalls that have emerged in countries where patent box regimes have been established – particularly countries within the EU that have experienced severe corporate tax competition as more and more countries joined ‘the race to the bottom in corporate taxation,’⁴⁹¹ as many of these countries continued to lower their respective tax rates to attract local and foreign investment in innovation (lending support to the theoretical prediction by Zodrow and Mieszkowski)⁴⁹². In turn, this had the effect of ‘tax code shopping’ where innovation-driven companies (particularly large multinationals) would actively engage in sourcing countries that offered the best tax package.

An even further development was the incidence of profit shifting by large companies to countries (and in some respect, tax havens) where preferential tax treatment was offered through patent box incentives. For some countries, these incentives were offered even though the intellectual property was developed abroad and ownership of the IP remained abroad⁴⁹³. On the basis of these and other tax avoidance activities orchestrated via tax havens linked to with patent box tax regimes, several countries have been

highly critical of the use of patent box incentives⁴⁹⁴ – indeed, even to the point of stating that patent box schemes lead to harmful tax competition and may need to be stopped.⁴⁹⁵ There have also been calls in Australia to resist the introduction of a patent box scheme given the UK experience where the new patent box rules “created a new way for large businesses to avoid tax in countries in which they operate”⁴⁹⁶.

Notwithstanding the importance and weight of the many arguments critical of patent box regimes, many of them relate to pre-modified schemes with problematic design features – i.e. the original patent box tax incentives before such schemes were modified to include checks and balances aimed at preventing tax abuse as well as ensuring that:

- the IP is developed and remains in the country of origin
- preferential tax treatment is only given in circumstances where the income from the IP is generated in the country of origin.

The modified system is also known as the ‘the nexus’ approach. Following serious criticisms of tax avoidance and the loop holes in patent box schemes, the OECD along with the G20 launched a project aimed at limiting international tax avoidance. The project, referred to as the Base Erosion and Profit Shifting Project (BEPS), developed what has now been termed the ‘nexus’ approach, “where countries, are only permitted to provide benefits under patent boxes, if those benefits are proportionate to the amount of R&D undertaken by the taxpayer receiving benefits or in the country providing benefits”⁴⁹⁷.

This approach works to limit revenue losses from patent boxes, because it establishes a “link between R&D and the income benefit that may arise, therefore constraining the ability of taxpayers to shift income between countries”⁴⁹⁸. In essence, the strictly-applied nexus approach would require the R&D and the production associated with the intellectual property (i.e. IP that is eligible under the scheme) “to be performed in-country in order to qualify for the full-patent box rate”⁴⁹⁹. And, as mentioned in Atkinson and Andes, the nexus approach is appealing for innovation-based tax incentives “because it would incentivise the back-end of R&Ds while, at the same time, tie R&D to commercial outcomes through patent revenues”⁵⁰⁰.

Given the research undertaken by the IPA-Deakin SME Research Centre, we are of the view that, on balance, a carefully crafted patent box tax incentive based on the 'nexus' approach is a plausible mechanism for spawning innovation in Australia. To sum up our view on patent boxes, we quote a statement made to the press by RMIT's Professor Ian Maxwell⁵⁰¹: "If a patent box scheme was introduced, Australia's large corporations would immediately start looking at means to innovate so that they could claim the patent box incentive. The end result of these R&D efforts would be world-leading products and services with export potential."

The potential benefits for Australia if a patent box scheme is introduced

If Australian companies are to remain globally competitive, then the focus of the current debate should be on global competitiveness rather than on tax policy and revenue enhancement⁵⁰². In this sense, we strongly recommend that the Australian Government, as a matter of urgency, introduce a nexus-based patent box scheme.

This would not only assist many of our struggling industries that are in much need of government support, but it would also help to build a strong innovation culture, the basis of which will assist Australian companies to work smarter, more efficiently and faster.

One industry hit hardest over the past 10-15 years is the manufacturing sector, which was once a vibrant, prosperous sector employing thousands of Australians, and is now reduced to a shadow of its former self. Indeed, almost every year, the manufacturing sector loses companies across a range of industries, with the motor vehicle and associated manufacturing industries being most notable in recent years. Arguably, if a more focused, well-funded innovation and training policy is implemented as a matter of top priority, future collapses of Australian businesses, along with thousands of lost jobs, could be avoided.

Cutting red tape to assist small businesses

Federal, state and local governments in Australia need to consider the implications of new and revised laws and regulations affecting the small business sector, so that businesses comply with the spirit of the law. The federal government provides

advice to government departments and statutory bodies about the way they should reflect on the impact of new rules and regulations on the small business sector.

The Office of Best Practice Regulation (OBPR)⁵⁰³ is charged with this role and it forms a part of the system of political innovation relating to small business. A specific guidance note is published on a regular basis by the OBPR to provide public servants involved in regulatory design with a way of evaluating the ultimate impact of regulations on small businesses. This approach is useful and must be maintained over the medium to long term, because it ensures that the impacts of new laws on small business are properly evaluated by those involved in developing proposals.

However, the effectiveness and application of small business impact statements need to be properly assessed and evaluated to ensure they accurately reflect a cost-benefit analysis of the proposed measure and that it is not simply a case of the bureaucracy paying lip service to this requirement.⁵⁰⁴

Government bodies such as the Australian Accounting Standards Board will have the regulatory burden of their rules – accounting standards in this case – on small businesses in mind when they develop aspects of the framework further. The reduced disclosure regime, which provides entities that are not publicly accountable with the opportunity to produce slimmer annual reports, is one such example of regulatory bodies acknowledging that a full set of rules is necessary, but it should not apply to entities that are of little interest to a broad group of stakeholders.

There are numerous examples of government attempts to reduce red tape and these need to be individually assessed against maintaining the integrity of the respective system. On the one hand, attempts by the Department of Foreign Affairs and Trade to make the text of free trade agreements more accessible to businesses through plain language and an extensive online portal are to be applauded. On the other hand, the proposed measure (at the time of writing) to change the annual audit cycle for self-managed superannuation funds to three years may result in more funds becoming non-compliant and therefore posing a systemic risk. Deregulation and reducing red tape is always a balancing act.

⁵⁰¹ Maxwell (2014).

⁵⁰² Atkinson and Andes (2011).

⁵⁰³ Office of Best Practice Regulation (OBPR) (2017).

⁵⁰⁴ See Office of Best Practice Regulation (OBPR) (2017).

As we experience advances in technology, we pose the question of whether we need to stop focusing so much on reducing red tape and more on the application of technology to assist or address the challenges of meeting regulatory obligations. An entire industry has emerged based on 'regtech' – that is, the application of technology to meet regulatory obligations. In the United States, funding of regtech startups in 2017 reached US\$1.3 billion, bringing the total investment in the last five years to over US\$5 billion⁵⁰⁵. Regtech startup investment around the world is increasing, although currently Australia does not rate on the global scale. The United Kingdom has 37% of the deal share for regtech startups, with India coming next at 10% of deals, and Canada next with 9% of deals⁵⁰⁶. Banks are major investors in regtech and the financial services sector attracts a large share of the investment. Progress in predictive analytics and data science means that artificial intelligence (AI) and machine learning will allow stakeholders to proactively identify and predict risk. Real time audit and smart contracts are already happening.

'Robo-regulators' are emerging in the United States, where the government is investing in data libraries, innovation labs and applying AI to undertake pattern recognition, apply predictive analytics and other innovations.

Given the widespread expectation that the Hayne Royal Commission (and the Productivity Commission inquiry into competition in the financial system) will result in more regulation for the financial services sector, we anticipate that regtech, fintech and risk management will become even more embedded.

Educating small businesses on innovation

Governments also assist small business development or innovation by providing information to small business owners keen to grow their enterprises. Australian government web sites publish material on innovation and business. They routinely provide tips on what business owners should focus on to deal properly with the challenges of running an enterprise.

The website of the federal government's Department of Industry, Innovation and Science⁵⁰⁷ suggests that enterprises seeking to innovate should consider the following:

- Conduct an analysis of the trends in the market environment, your customers' wants and needs and your competitors.

- Consult with customers, suppliers and employees for ideas on improving processes, products and services, both internally and externally. Find out more about connecting with customers for ideas.
- Seek advice. Use available resources such as business advisers, grants and assistance to drive innovation in the business. This may include seeking intellectual property (IP) protection to commercialise ideas. Learn more about local and international collaboration with researchers.
- Be open to new ideas and adaptive to change.
- Develop a strategic, responsive plan, which promotes innovation as a key business process across the entire business. Learn about creating an innovative business culture and developing a strategy for innovation.
- Train and empower employees to think innovatively from the top down.

The Commonwealth's business portal is not the sole online source for tips on how best to deal with the notion of growing a small business by thinking outside the normal daily focus. An approach taken by the Victorian Government, which is supported by the IPA-Deakin SME Research Centre, is the provision by Small Business Victoria of free 45-minute business-mentoring sessions from a small business mentor.

These programs enable small business owners to receive some advice on how best to deal with the running of their small business. A small business owner requiring more assistance may be able to book a small business mentor for a 90-minute session at a cost of \$100 per session. Small Business Victoria also runs a range of seminars and workshops aimed at assisting a small business owner to develop as a professional and avoid the pitfalls of failing to properly manage their business.

Small business grants

There are innovation programs run by governments that provide grants and funding to assist small business development. One example is the City of Melbourne small business grants program. This program is only open to businesses operating within the City of Melbourne and involves four grant categories:

⁵⁰⁵ CB Insights (2018).

⁵⁰⁶ CB Insights (2018).

⁵⁰⁷ The website for the Department of Industry, Innovation and Science is <https://www.business.gov.au/info/run/innovation>. Accessed on 22 May 2018.

- **Start-up** – increasing diversity by supporting the establishment of new and creative small businesses. Grants up to \$30,000 are available.
- **Business expansion** – assisting existing businesses that are expanding into other innovative services or products. Grants up to \$30,000 are available.
- **Export entry** – encouraging businesses to enter or expand into new overseas markets. Grants up to \$10,000 are available.
- **Business support services** – supporting member-based organisations to deliver new initiatives and tangible benefits to their members. Grants up to \$10,000 are available.

The applications from small business owners are assessed by an external panel that scores each application against criteria set down by the council. The council's criteria take the following into account:

- Innovation and creativity **(30%)**
- Business readiness **(25%)**
- Financial viability **(20%)**
- Benefits to the City of Melbourne **(20%)**
- Ethical and other considerations **(5%)**

The use of the funds is restricted to capital improvement projects. This means that the funds obtained from this funding exercise are only to be used for fit-outs of premises, development of websites, or upgrades of IT equipment and software. Wages, rent and utility expenses are among the business expenses that are not eligible to be funded by the grants offered under this program.

The IPA-Deakin SME Research Centre supports such initiatives, as they encourage the establishment and growth of small businesses. Such funding does not, however, replace the drive of owners of a small business that is necessary to ensure the business succeeds. Government resources will only be spent appropriately when they are allocated to business owners that demonstrate a genuine willingness to grow, implement new ideas and ultimately employ people to assist in delivering their corporate vision.

Sources of financing for small businesses seeking to innovate

While small business financing is dealt with elsewhere in this white paper, it is important to note that there is a need

to ensure sources of finance other than government grants are accessible to businesses with new ideas.

Various methods may be used in financing. These range from traditional debt financing through authorised deposit-taking institutions, such as banks, to the matching of small business owners with equity partners such as business angels that believe a particular idea is worth supporting financially.

Government policies should continue to support original solutions to small business financing that will assist innovation.

Positive discrimination in government procurement⁵⁰⁸

The ISA's 2030 plan⁵⁰⁹ observes that jurisdictions such as the United Kingdom and United States have small business research programs that are a component of each jurisdiction's procurement policy.

The programs require a government department to scope out a problem requiring resolution that is then released to the public via tender. This allows for innovative small businesses to pitch solutions that satisfy previously identified needs or challenges. Small businesses are able to submit a proposed solution, develop a prototype and even scale their solution. The ISA states that the Small Business Innovation Research (SBIR) program⁵¹⁰ in the United States has led to the creation of new businesses, faster growth of small enterprises and an increased likelihood of securing funding.

Australia has been trialling a similar approach, but the ISA states that current efforts by governments across all levels could be improved. "The Australian Government ranks just 70th out of 140 countries on how well its procurement fosters innovation," the ISA observes. "In addition, SME participation in government tenders, when measured in respect to contract values, is steadily decreasing, from 39% in 2011-12 to 24% in 2015-16."

The ISA recommends in its innovation plan that Australia establish an SME procurement target of 33% of contracts, with the percentage being calculated by dollar value. This target requires the government to ensure it reaches that target of goods or services from SMEs by 2022. The ISA also recommends that the Department of Industry, Innovation and Science be required to report annually on progress towards meeting this target.

⁵⁰⁸ See further discussion in Chapter 2A: 'Finance principles and alternative financing'.

⁵⁰⁹ Innovation and Science Australia (2017).

⁵¹⁰ Innovation and Science Australia (2017).

Recommendations

- Governments should provide more support for research and development by small and medium-sized firms.
- Better linkages should develop between cutting-edge research universities and industry. Typically, only large firms have the resources to fund university-level research and development.
- Governments should provide more support for firms to adapt existing technologies and innovation.
- Measures should be developed and implemented to help the spread of existing innovations to a broader range of firms.
- Encouragement should be given to firms to adopt 'continuous improvement' methods to embed incremental innovation, as this will generate large productivity improvements quickly.
- The federal government should provide tax breaks for companies acquiring new technologies not developed in-house.
- A 'matching' service should be developed to promote the building of collaborative relationships between multinational corporations and Australian businesses, both domestically and abroad.
- The federal government should provide a tax allowance for companies investing in intellectual property protection (through patents, copyright, trademarks, design rights etc) in-house.
- The federal government should provide tax allowances for companies that generate licensing income for in-house new technologies.
- The federal government should rigorously continue with its patent box initiatives, as outlined in their current reform agenda.
- The federal government should further develop government procurement initiatives to ensure small business procurement targets are met and exceeded by 2022. These programs should be based on programs that are running in the United States.
- The federal government should allocate a pool of funds for further research into youth entrepreneurship in Australia, so policy decisions made in this area are based on research evidence.

In addition, it recommends that there be an increasing use of procurement strategies to ensure innovation outcomes are improved and small business innovation research programs should be further developed so they become true equivalents of the SBIR program in the United States.

Research into innovation and young entrepreneurs

The involvement of young people in innovation is an emerging area within the academic literature and one that will have broader policy implications.

Young people are able to commence a business easier than ever before with a range of online platforms creating the ability to sell goods or services as part of the sharing economy. Companies such as Uber, Airbnb and Fiverr provide platforms that can be accessed via an application

installed on a mobile phone by people of any age.

It is important for the development of future policies in the area of innovation that the role of young people in running micro or small businesses is further explored. This app-driven entrepreneurial environment has emerged since the 2001 government study was completed into the area of youth entrepreneurship.⁵¹¹ The federal government should consider allocating a specific pool of funds for research that examines this area.

⁵¹¹ Sergeant and Crawford (2001).

Case study: Research and development tax incentives

Prepared by Arthur Athanasiou, Partner, Thomson Geer

This case study deals with a so-called Research & Development (R&D) 'R&D consultant' who persuaded a small business taxpayer to register for R&D tax incentives and, with the consultant's assistance, prepared what was considered to be all the necessary paperwork required to complete the registration process. Substantial payments were received by the taxpayer from the Australian Taxation Office (ATO) after lodging all the tax returns under the consultant's oversight, after which time the consultant received a sizable commission.

Unfortunately, an audit by both AusIndustry and the ATO revealed that the R&D activities conducted, and the incentive benefits received, were both illegal. The taxpayer had to repay substantial amounts to the ATO.

After further checking the credentials and activities of the 'consultant', the taxpayer found that they had engaged in similar activities in the past with other unwitting taxpayers, and had since simply vanished.

Let's see how certain unscrupulous individuals have unwittingly caused innocent, trusting taxpayers to become involved in R&D tax schemes, for which the refundable offset would not have been payable, but still claimed, and by which a commission was paid to the consultant.

For the sake of the case, let's call the taxpayer 'Mark' and the unscrupulous consultant 'Jeff'.

Mark had worked hard in his tertiary studies and gained degrees in biomechanics and computer science. He became interested in how smartphones and smartwatches were dramatically changing the landscape in relation to personal fitness and well-being.

Through a mutual acquaintance, he met Jeff who, after a series of discussions, persuaded Mark that developing a smartwatch application could have further and broad commercial applications, with the development supported by the government through incentives in the tax system, and the profits from selling the application to consumers potentially enormous.

Jeff told Mark that, as with all things government, there'd be a lot of "red-tape", and that he would look after everything, including establishing a company to undertake the necessary R&D activities. All Mark had to do would be to sign a number of forms. Mark would then get involved after Jeff had gotten everything off the ground to consult. Jeff said he would procure the assistance of "code-writers" in Asian countries to finalise and commercialise the application. All the way through the process, expenditure would be incurred, and Jeff was authorised to lodge all tax returns and take a commission for his involvement.

Mark noticed that Jeff had prepared what appeared to be standard documents, such as business plans, commercial agreements, market surveys and analyses, timesheets, completion certificates and standard invoices that were used to charge costs from the company established by Jeff for Mark, to Jeff personally. Mark was a little naive, and it seemed all too 'streamlined', but he nevertheless went along with the process.

Apart from seeing regular lodgements about eligible R&D activities, and some cash received after lodging ATO documents prepared, there was little else for Mark to do. Jeff assured Mark that, just registering the R&D activities with AusIndustry meant the money the company received would never be checked by the ATO.

After two years, things had died down to the point where Jeff had virtually no contact with Mark. There were unpaid bills to the code-writers, and there were outstanding tax, BAS and AusIndustry lodgements. Mark thought he could just walk away and forget about everything.

Sometime later, Mark received letters from AusIndustry and the ATO wanting to check the progress of his core and supporting activities. He attended an interview with representatives from both bodies that lasted for three hours.

It was subsequently determined that Mark:

- failed to keep adequate records of his R&D-eligible activities to show he incurred eligible R&D expenditure
- did not maintain sufficient business records to verify the amount of R&D expenditure incurred, the nature of his R&D activities, and the relationship of the expenditure to the activities
- failed to retain documents that allowed him to apportion his expenditure between eligible R&D expenditure and other non-R&D activities
- did not maintain accurate records of timesheets and detailed narrations about what time was spent on research and developing the concept in accordance with the business plan.

As a consequence of failing to properly substantiate his R&D activities, AusIndustry withdrew its registration and the Commissioner of Taxation subsequently issued amended assessments for income tax and to refund the amounts paid to Mark. This also included penalties and interest.

Mark then set about to contact Jeff, but the telephone number was disconnected and a quick Google search showed that Jeff had adversely affected others in the same way. Jeff had simply vanished. Mark would have liked, at least, a refund of the commissions paid to Jeff.

Here's the epilogue. The Commissioner promptly wound up the company in insolvency and appointed a liquidator. The accountants that Jeff appointed provided the liquidators with the company's most recent financial statements, showing that Mark owed money to the company, which came as a surprise to Mark.

The Commissioner promptly issued Mark with an amended assessment, treating the loan to him as an unfranked company dividend. The amount payable brought Mark to the brink of insolvency, but he was able to ultimately resist the objection through a prolonged legal process.

The moral of the story is that people who profess to have a special knowledge of a very narrow part of the tax law, and who offer outcomes that seem too good to be true, need their credentials and their story thoroughly vetted and checked.

Chapter Eight

Competition policy

Rachel Burgess: Deakin University

Competition policy: will the new laws benefit small business?

The manner in which the Harper Reforms are implemented will be instrumental to their benefit for small businesses

The much-awaited Harper Reforms came into operation on 6 November 2017. The key changes, from the perspective of small businesses, are the introduction of an 'effects test' for the misuse of market power, a prohibition on concerted practices, and the inclusion of a power for the Australian Competition and Consumer Commission (ACCC) to grant class exemptions.

⁵¹² Australian Competition and Consumer Commission (ACCC) (2018a).

⁵¹³ Australian Competition and Consumer Commission (ACCC) (2018b).

⁵¹⁴ European Commission (2014a, 2014c).

⁵¹⁵ Harper, Anderson, McCluskey and O'Bryan (2015), p 409.

⁵¹⁶ Harper, Anderson, McCluskey and O'Bryan (2015), p 30.

The introduction of an **effects test for misuse of market power**, which will assess the consequence of the conduct in the market as well as its purpose, has the support of the IPA-Deakin SME Research Centre. It is hoped the new provisions will be more effective in addressing the behaviour of firms with market power that substantially lessen, or have the potential to substantially lessen, competition in a market.

The ACCC *Guidelines on misuse of market power*⁵¹² set out clear examples of the types of exclusionary behaviour that are prohibited (exclusionary behaviour is behaviour that excludes a competitor from the market). However, exploitative practices of firms with market power can also be harmful to the market where that exploitation results in a substantial lessening of competition. Small businesses may suffer, for example, where a firm with market power charges excessively high prices or imposes unfair conditions. This type of behaviour should also be considered a misuse of market power if it substantially lessens competition.

The introduction of **concerted practices** into Australia's competition law represents a significant widening of the law. In its *Guidelines on concerted practices*⁵¹³, the ACCC refers to the description of 'concerted practice' provided in the Explanatory Memorandum to the *Competition and Consumer Act (Competition Policy Review) Bill 2017* as:

any form of cooperation between two or more firms (or people) or conduct that would be likely to establish such cooperation, where this conduct substitutes, or would be likely to substitute, cooperation in place of the uncertainty of competition.

This concept is complex and may be misunderstood by small businesses and their advisers, particularly in the early years of operation. Clear guidance is needed to ensure that small businesses understand what is and, perhaps more importantly, is not a 'concerted practice'. Uncertainty may lead to an overly cautious approach by small businesses that, in turn, may lead to paralysis in business decisions which will be detrimental to small business growth.

The ACCC now has the ability to grant **class exemptions**, which will exclude specified conduct from competition law provided certain conditions are satisfied. This is an important new power that could be of great benefit to small businesses. The small business community should consider and approach the ACCC with potential

types of business conduct that could be eligible for exemption on the basis that they are unlikely to cause any harm to competition (lessening or otherwise) or any harm that might occur is outweighed by the public benefit of the conduct in question. Examples could include licensing of intellectual property or exclusive distribution agreements. Vertical agreement and technology transfer agreement exemptions have been widely utilised in Europe and the UK for many years, providing certainty for businesses in relation to common commercial arrangements.⁵¹⁴

Minor legislative changes are still required

Inconsistencies in the definitions of 'small business' in the Competition and Consumer Act 2010 (CCA) and in the definitions of franchise, franchisee and franchisor between the Fair Work Act 2009 and the Corporations Act 2001 create uncertainties for small business and need to be addressed. In this respect, it would be highly desirable to have a consistent definition of 'small business' and a common definition of 'franchise', 'franchisee' and 'franchisor'.

Positive steps need to be taken to ensure small businesses can access justice

Now that the Harper Reforms have been passed into law, government must ensure that small businesses can benefit from the amendments. Although the changes to the law are significant, they will be of little benefit if small businesses are unable to enforce their rights under the law.

The Harper Review recognised the shortcomings for small businesses in obtaining access to justice in relation to competition law issues:

In general, the dispute resolution processes currently available to smaller businesses for competition law-related disputes do not meet their expectations.⁵¹⁵

Access to remedies has been a roadblock for many small businesses, and the [Harper] Panel finds that access should be improved.⁵¹⁶

In addition to the legislative changes made by the Harper Reforms, other potential reforms should be considered to make the law more effective for small business. Concerns in the United Kingdom regarding the ability of individuals and small businesses to obtain access to justice for breaches of competition law led to

Headline findings:

- The Harper Reforms are now in operation:
- The law has widened in relation to restricting anti-competitive behaviour, as it now covers 'concerted practices' (something less than an 'arrangement or understanding').
- The reforms introduce a more effective test for determining the misuse of market power.
- The ACCC now has the power to grant class exemptions to practices that do not harm competition or where the benefit outweighs any harm.
- The reforms have the potential to benefit small business if access to justice can be achieved. Consideration needs to be given to:
 - encouraging private actions for damages (representative or otherwise) for breaches of competition law
 - encouraging voluntary compensation schemes to provide redress to those harmed
 - increased penalties for breach as a means of deterrence
 - other affordable, simple solutions such as online tools and materials and alternative dispute resolution (ADR) for simpler competition law cases.
- Clearer guidelines are needed to help small businesses (and their industry bodies) understand the changes to the law.
- Consistent definitions of 'small business' and 'franchise', 'franchisee' and 'franchisor' are needed so SMEs do not need to apply different thresholds when dealing with different laws (or parts of the law).

Since the 2015 *Small Business White Paper*⁵¹⁷, a number of changes have been introduced to competition policy and law that will benefit small businesses. These changes have mostly arisen out of recommendations (Harper Reforms) made by the *Competition Policy Review Final Report (the Harper Review)*⁵¹⁸. This chapter makes further recommendations regarding the way in which the Harper Reforms should be implemented – that is, to be effective for small business, as well as raising issues that the IPA-Deakin SME Research Centre considers are still outstanding.

a package of reforms.⁵¹⁹ As in the UK, it is likely that the solution to the lack of access to justice in Australia will also require a bundle of practical measures, rather than one 'magic' solution.

Reforms could include:

- Improving the *representative action* procedure to make it more accessible for small businesses and consumers who have suffered competition and consumer law breaches and who do not have the time, resources or desire to commence their own private action. Usually, the value of the claim does not warrant an individual action.

⁵¹⁷ IPA-Deakin SME Research Centre (2015).

⁵¹⁸ Harper, Anderson, McCluskey and O'Bryan (2015).

⁵¹⁹ UK Parliament (2015).

- Taking steps to encourage more private actions for damages for breach of competition and consumer law, which would provide a further avenue to access justice as well as act as a greater deterrent to anti-competitive behaviour.
- Increasing the monetary value of claims (jurisdiction) that can be considered by the small claims tribunals. This will not be relevant to competition law claims.
- Implementing online alternative dispute resolution or court processes, including the provision of simple, clear, relevant information for small business owners to assist them in understanding their legal rights and obligations.
- Increasing penalties for breaches of competition and consumer law, which will bring Australia more in step with penalties imposed in overseas jurisdictions. Although this will not provide compensation or redress for aggrieved parties, it will act as a greater deterrent. This recommendation is consistent with the recent OECD study, *Pecuniary Penalties for Competition Law Infringements in Australia 2018*.⁵²⁰
- A form of compensation scheme for third parties who have suffered from competition law breaches, such as the voluntary redress scheme available in the UK. The UK scheme allows injured parties to claim compensation from an entity in breach of competition law, without the need for litigation.⁵²¹ This could be achieved using the existing section 87B enforceable undertaking procedure.

Many of these initiatives could also form the basis of a broader reform of Australia's justice system, which has been recognised by some as not providing access to justice for ordinary people.⁵²²

Benefiting small business

The Harper Reforms, introduced from 6 November 2017, present a significant change to competition laws in Australia for small business as well as consumers and other stakeholders. In particular:

- the amendments to the misuse of market power provision, so that it now applies in circumstances where the effect of the conduct is to substantially lessen competition
- the widening of the law to cover cooperation between parties, where that cooperation removes the risks of competition, without there

being a contract, arrangement or understanding between the parties (i.e. a concerted practice)

- the potential for the ACCC to grant class exemptions which exclude specified conduct from competition law, provided certain conditions are satisfied.

Putting life into the changes that have been made

Now the Harper Reforms have commenced, focus must turn to ensuring the laws operate in practice in a way that benefits small business. The ACCC has issued guidance on the new misuse of market power and concerted practices provisions. No guidance has been issued yet on class exemptions, although the ACCC has included information on this new power on its website.⁵²³

The precise meaning of the new misuse of market power and concerted practices provisions will be determined by the courts. In the meantime, there is likely to be some uncertainty regarding how the new laws will be applied. The ACCC should be encouraged to bring cases to test these laws at the earliest opportunity, providing businesses (large and small) with greater legal certainty. The government could provide the ACCC with additional funding to bring cases to test the new provisions. This is consistent with the Harper Review recommendation to resource the ACCC to "allow it to test the law on a regular basis to ensure that the law is acting as a deterrent to unlawful behaviour".⁵²⁴

Misuse of market power (section 46)

The law does not prohibit a business from having substantial market power, but it does prevent a business with substantial market power from misusing that power in a way that harms competition in a market. Firms with substantial market power have special responsibilities as a result of their market position. Actions and decisions taken by these firms can have a significantly different effect on a market than the same actions and decisions taken by firms with limited market power.⁵²⁵

Examples of conduct that may be considered a misuse of market power include a firm that refuses to supply a key input to a new entrant (thus preventing that competitor from entering the market) or offering loyalty rebates to a customer for purchasing most of its requirements from the firm (with the result that the customer does not buy from a competitor).

⁵²⁰ Organisation for Economic Cooperation and Development (OECD) (2018).

⁵²¹ Coles Supermarkets Australia Pty Ltd agreed to a scheme as part of its settlement with the ACCC in relation to its unconscionable conduct finding in 2014. This is discussed below.

⁵²² Productivity Commission (2014).

⁵²³ <https://www.accc.gov.au/business/exemptions/class-exemptions>, accessed 12 December 2017.

⁵²⁴ Harper, Anderson, McCluskey and O'Bryan (2015), Recommendation 53.

⁵²⁵ Institute of Public Accountants (IPA) (2016).

In both these scenarios, competition in the market is affected because either a new competitor cannot enter the market, due to supply constraints, or the business of the competitor does not succeed because customers are 'tied' to the firms with market power due to the loyalty rebates. The law (as amended) will be contravened if the entity in question has substantial market power and the purpose or effect of its conduct is to substantially lessen competition.

Previously, the law was not contravened unless the business with substantial market power took advantage of its market power for one of three proscribed purposes: eliminating or substantially damaging a competitor; preventing the entry of a competitor into a market; or deterring or preventing a person from engaging in competitive conduct in a market.

The IPA-Deakin SME Research Centre has noted two main deficiencies within the old provisions:

- The 'take advantage' element, which had been interpreted in a way that had excused conduct even where its purpose was to deliberately harm a competitor or the competitive process
- The focus on 'purpose' alone, which failed to capture conduct having the effect of substantially lessening competition.

As a result, there have been few successful cases under the old section 46.

The test in the amended section 46 now states that a business with substantial market power must not use that market power in a way that has the purpose or effect of substantially lessening competition in a market. It is hoped the removal of the three proscribed purposes (above), together with the introduction of an 'effects' test, will enable more successful cases against firms that misuse their substantial market power. The law will allow the courts to examine the effect of the conduct in the market, and not just the purpose of the conduct.

The ACCC has released *Guidelines on misuse of market power*.⁵²⁶ The guidelines set out clear examples of the types of exclusionary behaviour that are prohibited (exclusionary behaviour is behaviour that excludes a competitor from the market). However, exploitative practices of firms with market power can also be harmful to the market if they exploit their strong position in the market by, for example, charging excessively high prices or imposing unfair conditions.

Examples may include large firms imposing high rentals for shop leases. The amended section 46 should also be applied to exploitative practices.

Concerted practices

Australia's competition law previously prevented firms entering into contracts, arrangements and understandings that substantially lessened competition. 'Arrangements' and 'understandings' have been interpreted by the Australian courts to require:

- a meeting of minds (TPC v Email; ACCC v CC(NSW))**⁵²⁷
- a consensus as to what is to be done rather than just a mere hope (TPC v Email; ACCC v CC(NSW))**
- a commitment to act by at least one party (ACCC v Leahy Petroleum)**⁵²⁸, **but not necessarily a reciprocal obligation (TPC v Service Station; ACCC v CC(NSW); ACCC v Channel Seven Brisbane but compare TPC v Nicholas Enterprises)**.⁵²⁹

In overseas jurisdictions, including Europe, the United Kingdom, Hong Kong and Singapore, competition law prohibits anti-competitive agreements and concerted practices. A concerted practice may exist where there is some level of cooperation that means the parties are not acting independently, although there is no agreement actually reached between them. The cooperation results in the parties having more certainty about how the other is going to behave, thus removing the 'uncertainty' that is a normal part of the competitive process.

Concerted practice was first defined by the European Court of Justice in the *Dyestuffs* case as:

co-ordination between undertakings which, without having reached the stage where an agreement, properly so called, has been concluded, knowingly substitutes practical co-operation between them for the risks of competition.⁵³⁰

The Explanatory Memorandum to the Competition and Consumer Act (Competition Policy Review) Bill 2017 adopts and adapts this definition as follows:

any form of cooperation between two or more firms (or people) or conduct that would be likely to establish such cooperation, where this conduct substitutes, or would be likely to substitute, cooperation in place of the uncertainty of competition.

⁵²⁶ Australian Competition and Consumer Commission (ACCC) (2018a).

⁵²⁷ TPC v Email (1980) 43 FLR 383; ACCC v CC(NSW) Pty Ltd (1999) 92 FCR 375

⁵²⁸ ACCC v Leahy Petroleum (2004) 141 FCR 183

⁵²⁹ TPC v Service Station (1993) 44 FCR 206; ACCC v CC(NSW) Pty Ltd; ACCC v Channel Seven Brisbane Pty Ltd (2009) 239 CLR 305 but compare TPC v Nicholas Enterprises Pty Ltd (No 2) (1979) 40 FLR 83

⁵³⁰ ICI v Commission (1972) ECR 619, para 64

The extension of the law to apply to concerted practices represents a significant widening of the law in Australia against anti-competitive practices. The Explanatory Memorandum confirms the legislative intention that concerted practice be interpreted by the courts as something less than an 'arrangement' or 'understanding':

The amendment to introduce the concept of a 'concerted practice' is made to recognise that lesser forms of coordination than what has been judicially interpreted as required for a contract, arrangement or understanding, should be captured by section 45, provided the practice has the purpose, effect or likely effect of substantially lessening competition.⁵³¹

⁵³¹ The Parliament of the Commonwealth of Australia (2017), para 3.16.

⁵³² Whish (2012), p 580. This also appears to be consistent with the current legal position in Australia: see *ACCC v Leahy Petroleum*.

⁵³³ *Suiker Unie, Re the European Sugar Cartel; Cooperatieve Vereniging 'Suiker Unie' UA v Commission* [1975] ECR 1663, para 174.

⁵³⁴ Australian Competition and Consumer Commission (ACCC) (2018b), para 3.6.

⁵³⁵ Australian Competition and Consumer Commission (ACCC) (2018b), para 3.7.

⁵³⁶ Australian Competition and Consumer Commission (ACCC) (2018b), para 3.9.

⁵³⁷ European Commission (2014a).

It is a difficult legal concept to understand and will be particularly hard for small businesses that may not have access to expert legal advice.

There is likely to be a fine line between a concerted practice and a competitive market response. The former will be illegal if it has the effect of substantial lessening competition in a market. The latter is simply an economic response to demand and supply. For example, when the petrol stations, one by one, follow the lead of other petrol stations that increase (or decrease) price, they are not necessarily acting in concert but simply responding to market conditions. In Europe, parallel behaviour is not considered a breach of the law unless there is evidence of an agreement or concerted practice.⁵³²

The European Court of Justice has confirmed that parties can respond to the conduct of competitors (such as price increases by the neighbouring petrol station), but there must not be:

direct or indirect contact between such operators, the object or effect whereof is either to influence the conduct on the market of an actual or potential competitor or to disclose to such a competitor the course of conduct which they themselves have decided to adopt or contemplate adopting on the market.⁵³³

It remains to be seen, of course, whether the Australian courts take a similar approach. The *ACCC Guidelines on concerted practices* recognise that "parallel behaviour by competitors in the market, such as where their prices are similar or they make similar offers, is not by itself evidence that those competitors are engaged in a concerted practice".⁵³⁴

However, the guidelines then go on to state that "[p]rices moving in concert ... may also be the result of a contract, arrangement, understanding or concerted practice".⁵³⁵ Without clearer guidance on this issue, small businesses are likely to adopt an overly cautious approach which could be harmful to economic growth.

In Europe, a concerted practice has been found to exist following one-off discussions, meetings or exchanges of commercially sensitive information. The ACCC guidelines state that, "depending on the circumstances, a concerted practice may arise from a single instance of information being provided by one person to one or more other persons".⁵³⁶

For a small business, it will be extremely difficult to understand what discussions can (and cannot) be had. For example, could a small business be implicated in a cartel if the small business has been:

- sitting in a room where a cartel is being discussed without participating?
- involved in a one-off meeting where anti-competitive conduct was discussed?
- given commercially sensitive information, without requesting it?

To assist small businesses, the IPA-Deakin SME Research Centre has suggested (IPA, 2017) that the ACCC should issue separate guidance for small businesses on concerted practices that focuses on practical examples of:

- What is commercially sensitive information?
- When could an exchange of commercially sensitive information result in a concerted practice?
- When would a one-off discussion or meeting be considered a concerted practice?
- When would providing information to a non-competitor (such as a retailer sharing information with a manufacturer) be a problem?
- In all these cases, what would the individual need to say or do to raise concerns?

Safe harbours

The size of the business involved should be relevant to whether there is found to be an anti-competitive contract, arrangement, understanding or concerted practice. The European Commission has issued a notice (the *De Minimis Notice*)⁵³⁷ that gives small businesses in Europe and the UK (at least until Brexit) significant comfort in relation to the application of competition law to

their day-to-day dealings. Businesses that only have a small share of the market (10% in the case of agreements between competitors and 15% in the case of agreements between non-competitors) are unlikely to infringe competition law, except where those parties enter into cartels. (Cartel behaviour is prohibited, regardless of the market share of the parties involved.) In non-cartel cases, small businesses can obtain a significant degree of certainty regarding their day-to-day dealings with other businesses.

Trade associations and industry bodies

The inclusion of concerted practices in Australia's competition law can potentially have a significant impact on industry associations, particularly in the context of information exchanges. Trade associations involve meetings of competitors to discuss legitimate industry concerns and often involve the sharing of information and ideas. It is vital that these legitimate purposes are not stifled by an overly cautious approach to 'concerted practices'.

Trade associations play a key role for small businesses, acting as a representative on a range of issues affecting an industry. Small businesses must be able to continue to have open and frank discussions in trade association meetings, subject to compliance with competition law.

The IPA-Deakin SME Research Centre notes the removal of the ACCC guidance on *Industry Associations, Competition and Consumers*. This document contained much useful information for associations and their members. It is hoped that the ACCC will update this guidance (or issue alternative guidance for industry associations) to provide clarity on:

- what types of information can be shared and in what format
- circumstances in which an association may be found to have been part of a concerted practice
- what steps an association should take to protect itself and its members in relation to concerted practices
- the position in relation to the exchange of price recommendations and fee schedules (referred to in the previous guidance on *Industry Associations, Competition and Consumers*).

(These issues were raised in the IPA's response to the ACCC's consultation on its *Interim Guidelines on Concerted Practices*.)⁵³⁸

In providing guidance, the ACCC should take a pragmatic approach to ensure the new concerted practices prohibition does not result in an overly cautious approach to compliance required by trade associations and their small business members.

Class exemptions

The ACCC now has power to grant class exemptions that 'exempt' conduct from the competition prohibitions where the conduct does not create competition concerns or where the public benefit outweighs the public detriment. This could be an extremely useful tool for small businesses.

Class exemptions have the potential to provide legal certainty for many small businesses (and their representative bodies) in relation to common business arrangements, such as distribution agreements and the licensing of intellectual property. As noted in the Harper Review, a class exemption power would "reduce costs for business, especially small business", as it would not be necessary to seek individual authorisations or notifications. The Harper Review specifically referred to the potential of granting class exemptions for liner shipping arrangements and licensing of intellectual property rights.⁵³⁹

Legal certainty could be enhanced if market share thresholds were included in any class exemptions. This would mean, for example, that a particular agreement could be exempt if the market shares of the parties were below a defined level, provided any other conditions were satisfied. This is common practice in Europe. For example, the Vertical Agreements Block Exemption⁵⁴⁰ exempts vertical agreements provided the market share of the supplier does not exceed 30% (on the relevant market in which goods or services are supplied) and the market share of the buyer does not exceed 30% (on the relevant market in which goods or services are purchased) and provided other key conditions are met.

The small business community could consider identifying common business agreements that may benefit from a class exemption and approach the ACCC.

Further small-scale legal amendments

Definition of 'small business'

It would be desirable to adopt a common definition of 'small business' in the CCA, rather than the multiple definitions presently found throughout the Act. This would make it easier for small businesses, regulators and industry associations to

⁵³⁸ Institute of Public Accountants (IPA) (2017).

⁵³⁹ Harper, Anderson, McCluskey and O'Bryan (2015), pp 40, 42.

⁵⁴⁰ European Commission (2010).

understand when the law applies (or does not apply) and for small business to understand their obligations and to exercise their rights. If possible, the definition should be the same as used by other state and federal agencies.

The CCA has several provisions that only apply, or apply differently, to small businesses. Being able to identify the business as a 'small business' is therefore important. Currently, a small business that wishes to take advantage of the *unfair contract terms provisions* must satisfy section 23(4) of the Australian Consumer Law, which defines a small business contract as follows:

(4) A contract is a **small business contract** if:

- (a)** the contract is for a supply of goods or services, or a sale or grant of an interest in land; and
- (b)** at the time the contract is entered into, at least one party to the contract is a business that employs **fewer than 20 persons**; and
- (c)** either of the following applies:
 - (i)** the upfront price payable under the contract does not exceed \$300,000;
 - (ii)** the contract has a duration of more than 12 months and the upfront price payable under the contract does not exceed **\$1,000,000**.

A small business that wishes to notify a collective bargaining agreement can only do so if the price for the supply or acquisition of the goods or services under the contract (or sum of the prices where there is more than one contract) does not exceed **\$3,000,000** in any 12-month period.

Prior to 1 September 2017, only a large merchant was required to comply with the new credit card surcharge obligations. A large merchant was a merchant that satisfied two of three conditions: (i) consolidated gross revenue of more than \$25 million, (ii) consolidated gross assets of more than \$12.5 million, and (iii) **50 or more employees**. Therefore, a business could have been a 'small business' for this purpose if it had had up to 50 employees (compared to 20 persons for a "small business contract").

Under the Australian Consumer Law (ACL), a small business may be considered to be a 'consumer' in relation to the acquisition of goods or services where the amount paid for the goods or services does not exceed \$40,000. The price payable is proposed to be increased to \$100,000 following a recommendation of the Australian Consumer Law Review Final Report⁵⁴¹.

In Australia, many businesses are classified by size, based on the definitions applied by both the Australian Bureau of Statistics (ABS) and the Australian Taxation Office (ATO). The ABS classifies business size based on the number of employees, which is consistent with the OECD approach:

- Non-employing businesses
- Micro: 0-4 employees (note, the ABS Counts of Australian Businesses combines micro and small businesses)
- Small: 5-19 employees
- Medium: 20-199 employees.

In contrast, the ATO classifies business size based on revenue:

- Small: less than \$10 million
- Medium: \$10-\$100 million.

Section 5(1) of the Australian Small Business and Family Enterprise Ombudsman Act 2015 uses yet another definition:

A business is a **small business** at a particular time in a financial year (the **current year**) if:

- (a)** it has fewer than 100 employees at that time; or
- (b)** either:
 - (i)** its revenue for the previous financial year is \$5,000,000 or less; or
 - (ii)** if there was no time in the previous financial year when the business was carried on—its revenue for the current year is \$5,000,000 or less.

Based on extensive definitional work by the IPA-Deakin SME Research Centre, we are of the view that one definition of 'small business' should be inserted into the law to provide small businesses with certainty regarding their classification for the purposes of the CCA.

Consideration should also be given to amending the definition in the *Australian Small Business and Family Enterprise Ombudsman Act 2015*. Ideally, a definition that is consistent with the ATO and ABS's commonly-used classifications would be helpful to small businesses.

Definition of 'franchise'

Recent changes introduced to the *Fair Work Act by the Fair Work (Protecting Vulnerable Workers) Act 2017* impose an obligation on a responsible franchisor entity that "knew or could reasonably be expected to have known" that a franchisee (for which that franchisor was

541 Ministers have asked officials to undertake a regulatory impact assessment on this proposal to inform future decision making: see LGFCA, 2017

responsible) was contravening certain provisions of the Fair Work Act.

'Franchisee' and 'responsible franchisor entity' are defined in section 588A of the Fair Work Act as follows:

- (1) A person is a franchisee entity of a franchise if:
- (a) the person is a franchisee (including a subfranchisee) in relation to the franchise; and
 - (b) the business conducted by the person under the franchise is substantially or materially associated with intellectual property relating to the franchise.
- (2) A person is a responsible franchisor entity for a franchisee entity of a franchise if:
- (a) the person is a franchisor (including a subfranchisor) in relation to the franchise; and
 - (b) the person has a significant degree of influence or control over the franchisee entity's affairs.

However, franchise is defined in section 12 of the Fair Work Act as having the meaning given by the Corporations Act which provides, in section 9:

franchise means an arrangement under which a person earns profits or income by exploiting a right, conferred by the owner of the right, to use a trade mark or design or other intellectual property or the goodwill attached to it in connection with the supply of goods or services. An arrangement is not a franchise if the person engages the owner of the right, or an associate of the owner, to exploit the right on the person's behalf.

The inconsistencies in the definitions of franchise and franchisee/franchisor need to be addressed so that franchisors are clear about their obligations under the Fair Work Act.

Access to justice for small business

It is well recognised that small businesses struggle to have their legal issues resolved, either because they do not understand they have a problem, they do not know where to go to seek assistance, or they do not have the time or money to pursue a resolution.⁵⁴² The problem is aptly described by the terms of reference to the 2014 Productivity Commission report into *Access to Justice Arrangements*:

The cost of accessing justice services and securing legal representation can prevent many Australians from gaining

effective access to the justice system. For a well-functioning justice system, access to the system should not be dependent on capacity to pay and vulnerable litigants should not be disadvantaged.

A well-functioning justice system should provide timely and affordable justice. ... A justice system which effectively excludes a sizable portion of society from adequate redress risks considerable economic and social costs.⁵⁴³

In relation to competition law specifically, the Harper Review recognised the need for better access to justice to address competition law breaches for small business:

Access to remedies has been a roadblock for many small businesses, and the [Harper] Panel finds that access should be improved.⁵⁴⁴

In the context of a recent review of Australia's consumer law, the Australian Consumer Law Review Final Report found:

A recurring issue raised in the review was the difficulty that consumers and small businesses face in accessing remedies. Many of the issues relate to evidentiary rules and broader processes in civil justice systems and are beyond the scope of the consumer law and this review process.⁵⁴⁵

Although a range of inquiries on access to justice in Australia (discussed below) have identified this issue, a lot more work remains to be done.

Previous inquiries

There have been a range of inquiries, studies and research papers into access to justice in Australia in recent years, including:

- Australian Government Attorney-General's Department, *Access to Justice Taskforce, A Strategic Framework for Access to Justice in the Federal Civil Justice System* (2009)⁵⁴⁶
- Legal Australia-Wide Survey, *Legal Need in Australia* (2012)⁵⁴⁷
- RMIT University Centre for Innovative Justice, *Affordable Justice – a pragmatic path to greater flexibility and access in the private legal services market* (2013)⁵⁴⁸
- Productivity Commission report into *Access to Justice Arrangements* (2014)⁵⁴⁹
- Queensland Law Society, *Access to Justice Scorecard* (2015)⁵⁵⁰
- Victorian State Government, *Access to Justice Review* (2016).⁵⁵¹

⁵⁴¹ Ministers have asked officials to undertake a regulatory impact assessment on this proposal to inform future decision making: see LGFCA, 2017

⁵⁴² Productivity Commission (2014), p 8; Coverdale (2012), p 26; ASBFEO (2016), pp 56-64.

⁵⁴³ Productivity Commission (2014), p iv.

⁵⁴⁴ Harper, Anderson, McCluskey and O'Bryan (2015), p 30.

⁵⁴⁵ Consumer Affairs Australia and New Zealand (CAANZ) (2017), p 80.

⁵⁴⁶ Attorney-General's Department, *Access to Justice Taskforce* (2009).

⁵⁴⁷ Coumarelos (2012).

⁵⁴⁸ RMIT University, Centre for Innovative Justice (RMIT) (2013).

⁵⁴⁹ Productivity Commission (2014).

⁵⁵⁰ Queensland Law Society (2015).

⁵⁵¹ Victorian State Government (2016).

- 552 A. The Treasury (2011).
- 553 Coverdale (2012).
- 554 Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2016).
- 555 Queensland Law Society (2015); Martin (2014).
- 556 Queensland Law Society (2015), p 4.
- 557 Productivity Commission (2014), p 11.
- 558 Queensland Law Society (2015), p 5.
- 559 Queensland Law Society (2015); Coverdale (2012), p 30; Coumarelos (2012).
- 560 Coverdale (2012), p 14.
- 561 Coverdale (2012), p 16.
- 562 Coumarelos (2012), p xiv.
- 563 Coumarelos (2012), p xiv.
- 564 Consumer Affairs Australia and New Zealand (CAANZ) (2017), p 10. Note that many consumer law protections have now been extended to small businesses (e.g. unfair contract terms and unconscionable conduct).

Some reports and inquiries have specifically considered the position of small businesses:

- The Treasury, Australian Government, *Resolution of Small Business Disputes – Options Paper* (2011), which included a recommendation for a small business advocate (the ASBFEO from 1 March 2016)⁵⁵²
- Deakin University report, *Providing Legal Services to Small Business in Regional Victoria* (2012)⁵⁵³
- Australian Small Business and Family Enterprise Ombudsman (ASBFEO), *Inquiry into small business lending* (2016).⁵⁵⁴

Relevant findings of the various inquiries, studies and research papers include:

(a) Complexity and cost:

- the legal system in Australia is unaffordable, with the length of the court process having a significant impact on cost⁵⁵⁵
- the perceived complexity and length of resolving legal issues through courts and tribunals⁵⁵⁶

Some individuals are deterred from pursuing action for fear that the process will prove too slow and costly. One third of individuals who chose not to act on a substantial legal problem cited a belief that it would be too costly as a reason for inaction. A similar proportion thought it would take too long.⁵⁵⁷

(b) Alternative dispute resolution and awareness:

- the importance of alternative dispute resolution in providing affordable solutions⁵⁵⁸
- lack of awareness and knowledge of the law and legal service options.⁵⁵⁹

(c) The role of lawyers:

- half of all small business participants (55%) in the Deakin University study responded that they rarely (either never or less than once a year) sought legal assistance⁵⁶⁰: **“[Our research] shows that most SMEs go to their accountants first, rather than a lawyer. This is because accountants are the one source of business advice that the law mandates you to use, for your tax returns every year (Stakeholder consultations).”**⁵⁶¹
- a sizeable proportion of people take no action to resolve their legal problems and consequently achieve poor outcomes;⁵⁶²

- most people who seek advice do not consult legal advisers and resolve their legal problems outside the formal justice system.⁵⁶³

Although many of these findings relate to access to justice by individuals, they are equally applicable to small businesses who are more akin to an individual in terms of their ability to access justice.

The ACL Review Final Report noted:

Businesses, and particularly small businesses, should have similar protections to consumers under the ACL in most circumstances as they often behave like individual consumers and may lack the time and resources to assert their consumer rights.⁵⁶⁴

Recommendations and current proposals for change

Relevant recommendations that have emerged from these inquiries include:

- The need to review the class action regime under Part IVA of the *Federal Court of Australia Act 1976* “to ensure they are operating in a manner consistent with the objectives of improving access to justice ... Among issues the review should consider are ... whether there is scope for the greater involvement of regulatory agencies in class actions ...”⁵⁶⁵
- The need to broaden the use of the Federal Court’s fast track model to facilitate lower cost and more timely access to justice (Productivity Commission, 2014, Recommendation 11.1). This was endorsed by the Harper Review. The changes to the fast track procedure introduced from 25 October 2016 appear to implement this recommendation.⁵⁶⁶
- The need to introduce an online dispute resolution system for small civil claims in Victoria.⁵⁶⁷

In addition, the Harper Review recommended amending section 83 of the CCA. Section 83 allows a person bringing an action for damages for breach of competition law to rely on ‘findings of fact’ made by the court. The Harper Review recommended extending this provision to allow a person bringing an action for damages to also rely on ‘admissions of fact’. This change has been introduced with the *Competition and Consumer Act (Competition Policy Review) Act 2017*.

The *Competition and Consumer Legislation Amendment (Small Business Access to Justice) Bill 2017* would have allowed a judge to make a 'no adverse costs' order in favour of a small business bringing an action for breach of the competition prohibitions. The policy objective was to ensure that a small business bringing an action for breach of competition law would not have to pay the other side's legal costs, even if the small business lost the case. Although the Bill passed the Senate, it is not proceeding through the House of Representatives. Even if the Bill had been passed, it would only have provided limited assistance for small businesses, as their own legal costs (not to mention time) would still be likely to deter a small business from bringing an action in any case (see discussion on 'private actions on damages' below).

Accessing justice for competition law breaches in Australia

Many of the new competition law changes have the potential to directly benefit small businesses. However, the ability of small businesses to take advantage of the changes depends on their ability to access justice. The IPA-Deakin SME Research Centre considers that this is the next key area for development by government. (The IPA-Deakin SME Research Centre notes the inquiry currently being undertaken by the ASBFEO into broader access to justice issues for small business.)

Current options

Small businesses have a number of existing options for obtaining access to justice in relation to competition law breaches. These include representative actions, private damages claims or asking the ACCC to prosecute. As noted by the Harper Review, "access to remedies has been a roadblock for many small businesses", suggesting that these options are not working in their current form.

Representative actions

Under Part IVA of the *Federal Court of Australia Act 1976*, a representative action may be brought on behalf of a group, provided there are at least seven members of the group with a common issue (section 33C). The objectives of "introducing representative proceedings [into Part IVA] were to promote the efficient use of public and private resources in resolving disputes and enhance access to justice by providing a means by which similar

claims which, by themselves, might be too small to be worth pursuing, could be considered together".⁵⁶⁸

The number of representative actions for breaches of competition law in Australia are low compared with other categories of claims, with only five claims (0.9%) by cartel victims in the 25 years between 1992 and 2017.⁵⁶⁹ There are more actions for consumer protection claims (47 in 25 years, amounting to 9.1% of all claims) (Morabito, 2017b).⁵⁷⁰ The recently successful ACCC action against Reckitt Benckiser for misleading and deceptive conduct in relation to its Nurofen Specific Pain Relief products provides a good example. Reckitt Benckiser was fined \$6 million by the ACCC. In addition, the Federal Court approved a settlement deed under which Reckitt Benckiser will pay \$3.5 million into a fund to compensate consumers who purchased the products.⁵⁷¹

More research needs to be undertaken to understand why there are so few competition law representative actions in Australia. Reasons may include:

- Difficulties in obtaining the evidence required to prove a competition law breach. The investigation powers of the ACCC are usually needed to uncover the relevant evidence. Facilitating follow-on actions (where an action is brought after a breach is proven by the ACCC) may be more successful than stand-alone actions (where the claimant needs to prove the breach), provided the evidence of the ACCC can be utilised in the follow-on proceedings. It is understood that parties can seek discovery of ACCC information and documents, other than where the information or documents were provided in confidence and relates to a suspected cartel (section 157B, 157C CCA).
- The nature of the 'representative' that can bring proceedings.

Australia's representative actions require the 'representative' to, itself, have standing to bring the claim (section 33D), although the Full Federal Court has accepted that this requirement is satisfied where the applicant has legislative standing to bring an action. This has enabled the ACCC to bring representative proceedings on behalf of consumers based on section 87(1A) and (1B) CCA⁵⁷² (although the ACCC has not brought any representative actions since 2003).⁵⁷³

⁵⁶⁵ Attorney-General's Department, Access to Justice Taskforce (2009), Recommendation 8.11.

⁵⁶⁶ Federal Court of Australia (2016).

⁵⁶⁷ Victorian State Government (2016), Recommendation 5.2.

⁵⁶⁸ Attorney-General's Department, Access to Justice Taskforce (2009), p 124.

⁵⁶⁹ Morabito (2017).

⁵⁷⁰ Morabito (2017).

⁵⁷¹ Settlement Deed available at http://www.fedcourt.gov.au/__data/assets/pdf_file/0013/45040/NSD273-2016-Deed-31Jul2017.pdf, Accessed 30 December 2017

⁵⁷² Morabito and Waye (2017).

⁵⁷³ Morabito (2017).

574 Emmerig (2017), pp 167-8.

575 Emmerig (2017), p 217ff.

576 Amended by Schedule 8 of the Consumer Rights Act 2015

577 Department of Innovation, Business and Skills (DIBS) (2013).

578 Competition Appeal Tribunal (2015).

579 [2017] CAT 9; see also Walter Hugh Merricks CBE v Mastercard Inc [2017] CAT 16 where the proposed representative (a solicitor and a member of the class that had suffered loss) would have been authorised to act as representative (subject to changes to the funding agreement) however the collective proceedings application was refused on other grounds.

580 Discussion between Rachel Burgess (IPA-Deakin SME Research Centre) and Vince Morabito, December 2017

581 Harper, Anderson, McCluskey and O'Bryan (2015), p 470.

582 Beaton-Wells (2014).

The requirement for the representative to have standing to bring the claim itself necessarily confines the list of those who could be applicants, and increases the risk of a conflict of interest arising.⁵⁷⁴ The other concern relates to funding, as an individual may be reluctant to act as a representative without some assurances regarding the payment of legal costs incurred.⁵⁷⁵ Some of these issues may be able to be addressed by expanding the scope of permitted representatives (e.g. to include an industry association body).

Recent amendments to the UK Competition Act 1998 permit a representative approved by the UK Competition Appeal Tribunal (CAT) to commence collective proceedings for damages for breach of competition law, even where the representative itself has not suffered loss (section 47B(8) Competition Act)⁵⁷⁶. This reform was introduced as part of a suite of changes designed to offer greater access to justice for individuals and small businesses, where there has been a breach of competition law:

Breaches of competition law, such as price-fixing, often involve very large numbers of people each losing a small amount, meaning it is not cost-effective for any individual to bring a case to court. Allowing actions to be brought collectively would overcome this problem, allowing consumers and businesses to get back the money that is rightfully theirs – as well as acting as a further deterrent to anyone thinking of breaking the law.⁵⁷⁷

The representative must satisfy the CAT that it is 'just and reasonable' to be appointed as a representative and the CAT Rules set out criteria that will be applied to determine if this test is satisfied (Rule 78(2)).⁵⁷⁸ The first application for a collective proceeding order was brought before the CAT in *Dorothy Gibson v Pride Mobility Products Limited*⁵⁷⁹. The CAT authorised Gibson, as the General Secretary of the National Pensioners Convention and who had not suffered any loss, to act as the representative for the collective proceedings.

- The sheer complexities of a competition law case may deter applicants (and their legal representatives).⁵⁸⁰

While an improvement in the representative action proceedings would be helpful in the context of competition law claims, it is likely to be only one part of the solution to increase access to justice in this area (see further below).

Private actions for damages

The ability to bring private actions for damages (section 82 CCA) is a significant tool that has been underutilised in Australia. If a competitor or supplier considers that a firm has breached competition law, that competitor or supplier can commence a private action for damages against that firm, subject to having the resources to do so. This type of action (or even the mere threat of an action) could act as a substantial deterrent to firms considering breaking competition laws.

Although the ability to bring private actions for damages has been available in Australia since the earliest days of competition legislation, there has been a scarcity of cases. The Harper Review found:

From submissions and consultations with small business, the Panel is convinced that there are significant barriers to small business taking private action to enforce the competition laws. A private action would be beyond the means of many small businesses. In some cases, a small business might not wish to bring a proceeding for fear of damaging a necessary trading relationship.⁵⁸¹

Commentators have recognized a number of issues relating to private actions (accepted by the Harper Review), including:

- uncertainty regarding limitation periods
- difficulty in obtaining information generally and, in particular, from the ACCC
- the uncertain scope of section 83
- proving and quantifying loss, especially the status of the pass-on or pass-through defence in Australia
- the interaction of private and public enforcement priorities, particularly in relation to immunity policies.⁵⁸²

The concerns regarding the uncertain scope of section 83 have now been addressed as the *Competition and Consumer Amendment (Competition Policy Review) Act 2017* amends section 83 to allow admissions of fact, as well as findings of fact, to be used in subsequent litigation proceedings. Although this is a step in the right direction, a lot more needs to be done to encourage private litigation for competition law breach in Australia.

Developments in the EU and the UK supporting an increase in private litigation for competition law infringements should



be considered. Many of the issues raised in the Australian context have already been addressed in Europe.

The European Directive on Antitrust Damages Actions (the Damages Directive)⁵⁸³ was adopted in 2014 and required implementation by member states by 27 December 2016. Addressing points (a)-(e) above, the Damages Directive requires member states to:

- a. **Set limitation periods of at least five years and allow for a suspension of that period if the national competition regulator commences proceedings (to allow a claimant to wait until a decision is reached in that case). The clock does not start ticking again until at least 12 months after the final decision of the competition regulator.**
- b. **Provide that a finding of a national competition regulator is binding on courts in that jurisdiction in a follow-on damages action. Information in the files of competition regulators must be disclosed if a court orders disclosure, but only after the competition authority has closed its proceedings.**
- c. **Allow a court to order disclosure of evidence held by the defendant and third parties (including the competition regulator), subject to appropriate proportionality and necessity limitations (there is no direct equivalent to section 83).**
- d. **Allow the pass-on defence. That is, the party who suffered the harm (such as an increased price) has passed on that price increase, so has not actually suffered the harm claimed. To counter-balance this defence, indirect purchasers (those who paid the increased price and therefore did suffer harm) must also be permitted to bring an action.**
- e. **Prevent the details of a leniency application to be disclosed in subsequent private actions, thus protecting public enforcement.**⁵⁸⁴

In addition, the Damages Directive introduces some provisions that would be of benefit to small businesses in private actions – in particular:

- A rebuttable presumption that cartels cause loss or damage.
- A requirement that all parties to the infringement are jointly and severally liable for the infringement. However, exceptions must be made for leniency applicants, SMEs and parties that have agreed a settlement.⁵⁸⁵

The implementation of the Damages Directive in the UK formed part of the package of reforms introduced to improve access to justice for competition law breaches. Improvements to the private damages regime in Australia would be an important part of addressing access to justice issues in this area and this debate should be encouraged.

Prosecution by the ACCC

The ACCC is empowered to take action in the public interest. In the 2016-2017 financial year, the ACCC received 450 complaints from small businesses about competition law issues.⁵⁸⁶ This volume of complaints cannot be pursued by the ACCC, due to financial and priority constraints.

The Harper Review recognised a need for improvements in the way the ACCC communicates with small businesses about this:

If the ACCC determines that it is unable to pursue a particular complaint on behalf of a small business, the ACCC should communicate clearly and promptly its reasons for not acting and direct the business to alternative dispute resolution procedures. Where the ACCC does pursue a complaint raised by small business, it should keep the small business informed of the progress and outcome of its investigation.⁵⁸⁷

The inability of the ACCC to pursue all complaints highlights the need for other workable solutions.

Other potential solutions

An understanding of the legal needs of small businesses is required to identify the most appropriate solutions to the 'access to justice' issue. Although the Law and Justice Foundation of NSW regularly undertakes the Legal Australia-Wide (LAW) Survey, which seeks to identify the legal needs of Australians, it does not focus on small business. Studies such as those undertaken in the UK⁵⁸⁸ would be helpful in the Australian context.

The Australian Small Business and Family Enterprise Ombudsman is currently undertaking an *Inquiry into Access to Justice for Small Business*, which is examining the nature and incidence of small business disputes, the level of awareness by small businesses of options to resolve the disputes, and the actions taken by small businesses when faced with a dispute. This inquiry could form the basis of further study in this area.

⁵⁸³ European Commission (2014b).

⁵⁸⁴ Burgess (2016).

⁵⁸⁵ Burgess (2016).

⁵⁸⁶ Australian Competition and Consumer Commission (ACCC) (2017c).

⁵⁸⁷ Harper, Anderson, McCluskey and O'Bryan (2015), p 412.

⁵⁸⁸ Blackburn (2015); Pleasance (2013).

590 <https://nt.gov.au/law/courts-and-tribunals/northern-territory-civil-and-administrative-tribunal-ntcat/types-of-cases-heard-at-ntcat>, accessed 4 June 2018.

591 https://www.acat.act.gov.au/application-type/civil_disputes_and_common_boundaries/increase-in-civil-jurisdiction, accessed 4 June 2018.

In the meantime, it is worth commencing the debate on potential solutions, which need to be affordable, simple and not take much of a small business owner's time. It will be vital that small business owners know where to access information on their legal rights and the options available for resolving a dispute. Possible solutions to be explored can be grouped into court-based and non-court-based solutions.

Court-based solutions

Although it is recognised that many court-based solutions will not be suitable for small businesses, there remains an important role for the courts in accessing justice.

Increased jurisdiction of small claims tribunals

For smaller claims, an increase in the monetary jurisdiction of the state and territory small claims tribunals would help small businesses obtain access to justice, at least in relation to consumer claims (only

the Federal Court and Supreme Courts (by virtue of cross-vesting powers) have jurisdiction to hear competition law claims (section 86 CCA)).

The OECD has recognised the important role that small claims courts offering tailored and fast-tracked procedures can play to “improve access to justice for small and medium businesses”.⁵⁸⁹

The monetary limits applicable to the civil and administrative tribunals in Queensland, New South Wales, the Northern Territory and the ACT are (see **Figure 1a**).

By contrast, Victoria's jurisdiction is unlimited. As Tasmania, Western Australia and South Australia do not currently have civil and administrative tribunals with jurisdiction to hear small claims, claims are heard in the respective magistrates courts with the following monetary limits (see **Figure 1b**).

With the exception of Victoria, many of these limits are low for the types of disputes a small business is likely to want resolved (recovery of debt or disputes relating to contracts for the supply of goods or services).

The ACL Review recommended the definition of ‘consumer’ be amended so that goods or services with a value of up to \$100,000 (previously \$40,000) be covered. This was to take account of inflation since the \$40,000 value was originally set in 1986.⁵⁹⁵ Consideration should be given to whether an inflationary increase is needed for the monetary limits for small claims in the state and territory courts and tribunals.

Fast-track procedures

The recommendation by the Productivity Commission to widen the Federal Court fast-track procedures appears to have been implemented by the National Court Framework reforms (see <http://www.fedcourt.gov.au/about/national-court-framework>, accessed 4 June 2018). Paragraph 6.5 of *Central Practice Note: National Court Framework and Case Management* (CPN-1), introduced with effect from 25 October 2016, indicates that any case may now be expedited.⁵⁹⁶

A fast-track procedure for UK competition law cases was introduced in October 2015 as part of a suite of changes designed to enhance access to justice for competition law breaches, especially for individuals and small businesses.⁵⁹⁷

The CAT Rules 2015 were subsequently amended to specifically provide that, in deciding whether to make particular proceedings subject to the fast-track

Figure 1a:
The monetary limits applicable to the civil and administrative tribunals

Jurisdiction	Monetary limit
Queensland	\$25,000
New South Wales	\$40,000
Northern Territory	\$25,000 ⁵⁹⁰
ACT	\$25,000 ⁵⁹¹

Figure 1b:
The monetary limits applicable to the civil and administrative tribunals

Jurisdiction	Monetary limit
South Australia	\$12,000 (minor claim)
	up to \$100,000 (general claim) ⁵⁹²
Tasmania	\$5000 (minor claim)
	\$50,000 (general claim) ⁵⁹³
Western Australia	\$10,000 (minor claim)
	\$75,000 (general claim) ⁵⁹⁴

procedure, the tribunal “shall take into account all matters it thinks fit including ... whether one or more of the parties is an individual or a micro, small or medium-sized enterprise ...” (Rule 58(3)). In the only case to be accepted under the fast-track procedure to date, judgment was given within two months of the original notice of claim.

It is likely that improvements to the representative action and private actions for damages proceedings will also be required before this fast-track procedure will be of real benefit in Australian competition law cases. Perhaps a debate for another day is whether there is a role for the Australian Competition Tribunal to hear these types of claims.

Online ADR and court systems

Australia’s ‘access to justice’ issues could be improved by the implementation of online alternative dispute resolution or online court processes akin to those being introduced in overseas jurisdictions.⁵⁹⁸

It was recognised in the UK, as part of a comprehensive review of their civil courts structure (Briggs Reports):

that the single, most pervasive and indeed shocking weakness of our civil courts is that they fail to provide reasonable access to justice for the ordinary individuals or small businesses with small or moderate value claims.⁵⁹⁹

The proposal for an online court was considered by Justice Briggs to be key to resolving this issue:

The development of the Online Court (“OC”) is the single most radical and important structural change with which this report is concerned. It provides the opportunity to use modern IT to create for the first time a court which will enable civil disputes of modest value and complexity to be justly resolved without the incurring of the disproportionate cost of legal representation. In my view it offers the best available prospect of providing access to justice for people and small businesses of ordinary financial resources [emphasis added].⁶⁰⁰

The proposed online court recommended by the Briggs Reports involves three stages: an automated online triage, a conciliation stage and a determination stage (if agreement has not been reached). Her Majesty’s Courts and Tribunal Service (HMCTS) is running a pilot of the online court from

November 2017 until September 2019 for claims up to £10,000.⁶⁰¹

Another good working example of an online dispute resolution system is the Small Claims Solution Explorer available through the Civil Resolution Tribunal of British Columbia,⁶⁰² which can be used for claims less than \$5000.

The online system has four stages, commencing with the provision of simple legal information and tools to assist the parties to resolve their dispute themselves.⁶⁰³ This is followed by a system similar to that proposed in the UK, including an online claims system, and an attempt at resolution prior to determination of the dispute by adjudication.⁶⁰⁴

Australia should consider these types of solutions to address wider access to justice issues, not just in relation to competition law.

Increased penalties

There remains a need for greater deterrence for competition law breaches in Australia. In addition to encouraging more private actions for damages (whether representative or otherwise) against companies that have infringed the law (discussed above), this could be achieved by increasing the level of penalties imposed by the courts for those found to have infringed competition law. The ACCC is supportive of the need for increased penalties.⁶⁰⁵

The level of penalties imposed in Australia is very low compared to other developed competition regimes. The European Commission recently fined participants in a transport cartel more than €3.8 billion (approximately A\$5.76 billion). Even the highest fine of \$45 million imposed by the Full Federal Court against Yazaki Corporation for cartel conduct (May 2018) pales into insignificance.

While it is recognised that the EU/UK legal systems are different to Australia and the relevant factors taken into account in calculating penalties differ, this issue needs further consideration. The OECD issued a report, *Pecuniary Penalties for Competition Law Infringement in Australia, in March 2018* following a detailed study of Australia’s penalty regime.⁶⁰⁶ It makes a number of recommendations in relation to the method for calculating penalties for competition law breaches, and calculated that an average Australian penalty would need “to be increased by 12.6 times to be comparable with the level of the average penalty in [comparable] OECD countries”⁶⁰⁷. The fine marks a step in the right direction.⁶⁰⁸

⁵⁹² <http://www.courts.sa.gov.au/RepresentYourself/CivilClaims/Pages/default.aspx>, accessed 4 June 2018.

⁵⁹³ http://www.magistratescourt.tas.gov.au/about_us/civil/minor_civil_claims, accessed 4 June 2018.

⁵⁹⁴ http://www.magistratescourt.wa.gov.au/C/civil_matters.aspx?uid=1226-6994-1097-9582, accessed 4 June 2018.

⁵⁹⁵ Consumer Affairs Australia and New Zealand (CAANZ) (2017), p 72.

⁵⁹⁶ Federal Court of Australia (2016).

⁵⁹⁷ UK Parliament (2015), schedule 8, para 31.

⁵⁹⁸ For a discussion of online ADR and online court processes, see Legg (2016).

⁵⁹⁹ Briggs (2016), para 5.14.

⁶⁰⁰ Briggs (2015), para 6.1.

⁶⁰¹ HMCTS, Practice Direction 51R.

⁶⁰² <https://civilresolutionbc.ca/how-the-crt-works/getting-started/small-claims-solution-explorer/>, accessed 4 June 2018.

⁶⁰³ for an overview of the four stages, see Legg (2016).

⁶⁰⁴ Legg (2016).

⁶⁰⁵ Dunckley (2017).

Non-court-based solutions

A number of non-court-based solutions are worth considering.

⁶⁰⁶ Organisation for Economic Cooperation and Development (OECD) (2018).

⁶⁰⁷ Australian Competition and Consumer Commission (ACCC), OECD finds Australian competition law penalties are significantly lower, Media release, 26 March 2018, available at <https://www.accc.gov.au/media-release/oecd-finds-australian-competition-law-penalties-are-significantly-lower>.

⁶⁰⁸ <https://www.accc.gov.au/media-release/record-46-million-in-penalties-for-yazaki-cartel>

⁶⁰⁹ Organisation for Economic Cooperation and Development (OECD) (2017).

⁶¹⁰ Department of Innovation, Business and Skills (DIBS) (2013).

⁶¹¹ Australian Competition and Consumer Commission v Coles Supermarkets Australia Pty Ltd [2014] FCA 1405 at para 123

Increase in available information

The overseas online ADR and court processes outlined above include online tools and materials that allow small businesses to better understand their rights and obligations, based on answers provided to questions posed. In many cases, this may be sufficient to resolve a dispute, as the parties are able to understand who is 'right' and who is 'wrong'.

This concept could be applied more widely and used by law firms, ombudsmen, small business commissioners and others as another means of accessing justice. For example, an Israeli firm "provides free online legal information and answers to common legal questions". It also "allows people to submit questions to a panel of lawyers".⁶⁰⁹

Compensation schemes

As part of the package of reforms designed to assist consumers (and small businesses) to access justice for competition law breaches, the UK government introduced a voluntary redress scheme (compensation scheme).⁶¹⁰ (These changes coincided with an increase in support for private actions for damages following the passing of the Damages Directive (discussed above).)

The UK's voluntary redress scheme has been operative since 1 October 2015. Any party who has breached competition law may establish a redress scheme which must be approved by the Competition and Markets Authority (CMA) (the equivalent of the ACCC). The burden of establishing the scheme and proving that it is appropriate to compensate victims is on the offending business. Once approved by the CMA, a consumer or small business who has suffered loss as a result of the competition law breach can claim an agreed amount in damages from the offender. The CMA can offer a reduction in penalty for offenders that agree to a redress scheme.

Bearing in mind the difficulties of successful litigation, the benefits for small businesses of being able to claim compensation in this way are apparent. The voluntary redress scheme also offers benefits for businesses in breach of competition law as it:

- (a) provides certainty in terms of the potential liability for private damages (a claimant who has benefited from the scheme is unable to institute a separate action for private damages)
- (b) may result in a reduced penalty.

The ACCC has power to seek an order for compensatory damages under section 87(2)(d) CCA, but the obvious difficulty with this approach is that it involves the court process. A compensation scheme similar to that introduced in the UK does not require the involvement of the court or tribunal.

A similar outcome could be achieved in Australia using the section 87B enforceable undertaking procedure. A good recent example is the enforceable undertaking given to the ACCC by Coles following allegations of unconscionable conduct. Coles undertook to appoint an independent arbiter (Jeff Kennett) to review its conduct vis-à-vis the suppliers in question and assess whether they were entitled to any refunds. This was recognised by the court as "an important part of the resolution of this proceeding"⁶¹¹. The section 87B undertaking can be enforced in the courts, if breached by the party giving the undertaking.

Wider use of the section 87B procedure by the ACCC to encourage those in breach of competition law to offer undertakings, of the kind given by Coles, would greatly assist in achieving redress for small businesses suffering loss as a result of a competition law breach.

Unfair practices

The 'unfair contract terms' provisions were introduced into the CCA with effect from 1 July 2010 and were extended to apply to small business with effect from November 2016. This was a welcome extension of the provisions, supported by the IPA-Deakin SME Research Centre. The ACCC has been extremely active in pursuing cases of alleged unfair contract terms with positive results (see for example, ACCC v JJ Richards & Sons Pty Ltd [2017] FCA 1224). However, further reform is required:

1. The consequences for including an unfair contract term in a standard form contract are inadequate to provide a deterrent effect.
2. The provisions need to apply more widely than just to a 'standard form' contract or an additional prohibition against 'unfair trading practices' is required.



Consequences of breach of unfair contract term prohibition

As currently drafted, the unfair contract term prohibition has little deterrent value for parties who include unfair terms in their standard form contracts. The consequence of a term being found to be unfair is a declaration that the term is void. In practical terms, the ACCC has also sought orders that the party does not rely on the terms in existing contracts, does not include the terms in future contracts and publishes a corrective notice. In a recent case, the ACCC sought an order for consumer redress (see the pending case against Ashley & Martin⁶¹², as yet undecided by the court). Although it is recognised that these sorts of orders will result in unfavourable media attention, it is unlikely that bad publicity alone will incentivise parties to review and amend unfair contract terms in their contracts.

The deterrent effect could be improved if a declaration that a term is 'unfair' also exposes the party to payment of a pecuniary penalty (as is the case with other consumer law provisions such as misleading conduct / false representations and unconscionable conduct).

The IPA-Deakin SME Research Centre is supportive of the Treasury Laws Amendment (2018 Measures No.3) Bill 2018) (passed on 23 August 2018) which increases the penalties payable under Australia's consumer law to align with the competition provisions. This will give the courts the ability to impose significantly higher penalties for breaches of Australia's consumer law. These higher penalties could be extended to apply to breaches of the unfair contract term provisions.

Wider prohibitions needed

A range of practices are engaged in by larger businesses to the detriment of small business for which there is currently no adequate remedy.

In a submission to the Competition Policy Review in 2014, the IPA identified a range of unfair price situations that did not have the protection of either the unconscionable conduct or unfair contract terms provisions (as then in force):

- a. when goods or services are in short supply as a result of supplies being disrupted by a natural disaster or strike**
- b. when alternative supplies of goods or services are not available to a particular business, at all or within a reasonable time, and advantage is taken of a business's urgent need for them**

- c. when a supplier has only one significant customer who uses its monopsony power to force that business to accept an unfair selling price, or contribute to the (dominant) customer's retail marketing efforts**
- d. when advantage is taken of a business's inability to obtain supply elsewhere to extract an additional payment in respect of past supplies**
- e. when advantage is taken of an existing tenant's investment in goodwill or fit-out when negotiating a renewal of the tenant's lease.**

The extension of the unfair contract term provisions to small business contracts in 2016 did not fill this gap.

The IPA-Deakin SME Research Centre remains aware of practices frequently used by stronger market players in negotiations with small businesses that are unfair and not covered by the unfair contract term provisions.

⁶¹² <https://www.accc.gov.au/media-release/accc-takes-action-against-ashley-martin-for-alleged-unfair-contract-terms>

Recommendations

To fully give effect to the new competition law provisions for the benefit of small business, we recommend:

- The ACCC should bring cases on the new provisions as quickly as possible to provide clarity on how they will apply in practice. Additional government funding may be required to achieve this.
- The ACCC should apply the amended misuse of market power provision to exploitative practices as well as exclusionary practices.
- Separate tailored guidance should be available for small businesses on the new concerted practices provision, including practical examples. This is an extremely complex legal area and small businesses are unlikely to understand when conduct is (or isn't) a 'concerted practice'.
- The ACCC should produce separate guidance (which does not take an overly cautious approach) on concerted practices for industry associations and their members. The introduction of a concerted practices prohibition is particularly relevant to industry associations, where small business competitors meet to discuss legitimate matters (but the risk of crossing into illegitimate matters may be high). An overly restrictive approach to concerted practices vis-à-vis associations risks stifling the important work that associations do on behalf of their SME members.
- The small business community should consider lobbying the ACCC for a class exemption in relation to identified common commercial transactions that are technically at risk of breaching competition law but are unlikely to do so in practice. This could significantly improve legal certainty for small businesses.

In addition, the benefit of the Harper Reforms (and competition policy generally) could be enhanced for small businesses if there is an improvement in access to justice for small business. We therefore recommend that:

- Changes are made to facilitate representative private damages actions. For small businesses that are not able to bring private actions themselves, we need to understand why there are so few representative actions for breach of competition law and make changes to

enhance this ability. Use of the Federal Court 'fast-track' procedure for simple competition law cases would be beneficial.

- Procedural changes are made to encourage private actions for damages, as the market could be less reliant on the ACCC to bring action. Although small businesses are unlikely to be in a position to bring actions themselves, larger competitors could, and the risk of a private claim may itself deter anti-competitive conduct. Significant reforms have taken place in Europe and the UK in the last five years to encourage private damages. Australia needs to consider similar reform.
- Higher penalties be imposed on firms that break competition law, creating a greater deterrence effect. The level of penalties imposed in Australia is very low compared with many overseas jurisdictions. This is supported by the recent OECD report Pecuniary Penalties for Competition Law Infringements in Australia 2018 (OECD, 2018).
- Encouragement is given to compensation schemes for those who have suffered as a result of a breach of competition law. This may be achieved by enhanced use of the section 87B procedure or a separate compensation scheme process.
- Online tools and materials be available to assist in the early resolution of competition law disputes, either with or without the use of online alternative dispute resolution procedures.
- The introduction of online court processes be considered, particularly for simpler cases.

Many of these recommendations are applicable to broader access to justice issues in Australia.

Small-scale legal amendments

Small-scale legal amendments are required to provide greater certainty and simplicity for small business owners. We recommend that:

- a. **Consideration should be given to how the definitions used in legislation such as the CCA can be made consistent with the definitions used by the ABS and ATO.**
- b. **Consistency is required between the definitions of franchise, franchisee and franchisor used in the Fair Work Act and the Corporations Act.**

Case study: Leases

When applying an arm's length view of the main issues, from the perspective of a reasonable and business-savvy person, on the 'fairness' of a retail lease contract/dealing, there are presently four recurring categories that the retail shop leases (RSL) legislation does not cover adequately:

- End of lease provisions (lease expiry and continuation of business)
- Duplication of permitted use
- Demolition clauses and limited compensation
- Market rent reviews at lease option (excluding QLD and NSW).

End of lease provisions

Any contract for lease has, as its primary essential terms, commencement and expiry dates.

The core issue, particularly in shopping centres, is that the level of capital investment in attaining the landlord's approval for fit-out design cannot be reasonably amortised over the term of the lease.

This leaves the lessee wholly vulnerable at lease-end, as they have a remaining debt facility over the fit-out, from which they cannot walk away. This is leveraged by the landlord to enter into a renewal of the lease at rental rates that would otherwise not be achieved in a fair and open market.

Added to the amortisation of the initial fitout is the loss of the business goodwill that again may be leveraged by the landlord in taking the opportunity to lease these premises to direct competitors who are prepared to pay a premium in rent with the knowledge of the incumbent lessee's goodwill value and no consideration required for the value of the business.

Landlords are strategically positioning themselves to benefit directly from the goodwill established from the lessee's investment in capital and effort.

This scenario is common industry practice, with landlords' planning and facilitating predatory competitor outcomes, usually without the knowledge of the Lessee and up to two years prior to the lease expiry.

Case study 1: Pharmacy 1

Pharmacy 1 is a business that has been located in the same premises for 18 years, with its second 10-year lease expiring in two years' time.

The business is professionally run and has never breached its lease. It employs 21 people (full-time and part-time), including pharmacists, pharmacy assistants and retail shop staff. The business turns over several million dollars and is valued as an asset accordingly.

The landlord, without prior notice, wrote to the owners advising that Pharmacy 1 will not be offered a new lease in two years.

Within days of this notice, the owners are contacted by a national pharmacy discount chain (which has no previous ties to this community) advising that it will be taking over the premises in two years.

The lessee has not been offered the opportunity to negotiate to match the new commercial terms. The new lessee will gain significant goodwill, without fair and reasonable consideration to Pharmacy 1 as a long-standing, successful business.

Outcome

With the restrictions of having to move the pharmacy at least 500 metres, and with no suitable premises prospectively available, this business will more than likely close in 18 months, realising a total loss in excess of \$3 million. This figure is the equivalent of the joint owners' superannuation. It means the owners are likely to have to continue working well into their 70s.

Duplication of business/permitted use

This is an area about which much has already been published, as a result of the *Sumo Salad v Westfield* disputes played out during 2016 and 2017. Sumo sought to have several of its commercial lease terms reviewed, based upon the mass duplication of similar types of business introduced into the respective shopping centres. These duplicate businesses bastardising Sumo's sales and significantly increased the occupancy cost for its stores.

The real issue relates to permitted uses being directly duplicated in close isolation, rather than across a broad retail category such as 'takeaway food'.

These direct duplications do not take into account the commercial landscape for the incumbent, which has usually paid a premium in rent and capital to achieve a suitable return on investment, based on the sales and market conditions of the time.

With the landlord introducing a direct competitor, it is effectively diluting the incumbent's business overnight, without regard to reviewing or adjusting the commercial terms to match the immediate change in the primary market and business opportunity.

Although retail leases will include clauses that provide the landlord with the right to lease premises to any type of business without exclusivity, there is no mechanism of fairness in the contract to bring these significant changes into review. This often leads to the failure of the incumbent which, in turn, results in the landlord's further opportunity to churn the previous lessee's site and goodwill, again without having invested in the benefit.

Case study 2: Pharmacy 2

This business has traded in the current location for the past 12 years and employs 19 staff, including pharmacists, pharmacy assistants and retail shop staff.

The business turns over several million dollars and is valued as an asset accordingly. The business is two years into a 10-year lease and the owners seek to rebrand and refit the pharmacy, which will require an outlay of \$500,000. Presently, there is only one pharmacy in this shopping centre.

The owners present their business case to rebrand and seek approval for their fit-out design. The landlord has significant input into the level of the fit-out, which adds to the capital expense of the project.

Three months after the pharmacy completes its rebrand and fit-out works, and is starting to realise the benefits in sales growth, the landlord introduces a second pharmacy into the centre.

Immediately, sales drop to levels below those achieved of the previous two years, before the \$500,000 investment.

The lessee is now left with an unsustainable occupancy cost and a loan that cannot be supported.

At no stage did the landlord reasonably advise that it intended to duplicate the permitted use and, in fact, was party to the level of capital investment the business would incur through its fit-out design approval processes, which compounded the outcome.

In such cases, it is only reasonable and fair, if the landlord is party to a significant change in the trading market, that they also be held to review the corresponding commercial outcomes to allow profitable trade.

Outcome

The lessee is seeking rent relief from the landlord, and is trying to sell the business at a significant loss of several million dollars to clear the debt for the shop fit-out. It has already been put on notice by its bank in relation to loan covenants.

Regardless of the outcome from the landlord, without a sale of the business, the owner will have to sell the family home.

Demolition clauses

Presently, RSL legislation nationally does not provide adequate compensation to lessee's when the landlord seeks to repurpose a building with the demolition of the leased premises.

The current legislation only provides for the depreciated (or written down) value of the lessee's shop fit-out at the time of the demolition notice.

Firstly, this falls well short as, regardless of book value of a lessee's fit-out, there remains an operational in situ value of fixtures and fitout. Further, it does not take into account the financial facility or loans remaining over the fit-out.

Secondly, compensation does not provide for the value of goodwill the business has built from trading at the location. The situation is wholly uncommercial and unfair, and does not consider the costs (both financially and physically) in re-establishing the business elsewhere, if that is at all possible.

Regulated and licensed businesses, such as pharmacies and licensed post offices (or other franchises that depend on set trade territories) may not be able to secure an alternative location.

Particularly for pharmacies, for which 'location rules' are highly restrictive, a demolition notice has the likely effect of a multi-million dollar business being compensated for as low as only tens of thousands of dollars, and incurring losses that are unrecoverable.

Market rent reviews at lease options

Where a lessee has a lease that provides for options for further term(s), the industry norm is that the rent for the first lease period (year) of the new term will be reviewed to market.

Over the past 20 years, reviews of the RSL legislation have resulted in amendments so ratchet mechanisms that prevent market rent reducing from the current are now void.

The issue is that the process of the parties entering into negotiations or a



determination on market rent is predicated on the lessee first exercising its right for the further lease term which, once acknowledged by the landlord, becomes binding on the parties.

The practice, if reasonable and fair, should involve the parties seeking to understand their respective outcomes as to the market rent before the lessee commits to the new term. However, the RSL legislation is flawed in that there is no provision for the parties to resolve market rent before the lessee exercises its option. This has the risk of the lessee being locked into a rent (in an upswing market) that cannot be sustained.

Fortunately, we have been successful in recent reviews of the RSL Acts in Queensland and NSW to introduce 'early determination of market rent' provisions, which unfortunately leaves lessees in the remaining jurisdictions left in the antiquated situation of "signing the contract to buy the car, receiving the keys, and then being told the price".

It should be noted that, even in Queensland and NSW, the onus is on the lessee to fully understand their rights and the timing of early determination of market rent under these Acts. Most do not and the system unfairly leaves the lessee exposed to the process that favours the landlord.

A sound solution here is to have the process of market rent reviews at lease option determined prior to a lessee being bound to the option period, if the rent is unsustainable, as a mandatory minimum lease standard nationally.

Case study 3: Licensed Post Office (LPO)

The LPO (and sub-newsagency) has been trading in the same building for over 15 years and is approaching the last of their 5-year options for a further lease term.

The business is well run by a family (primarily husband and wife) with between two and four casual staff, depending on the time of year.

Prior to exercising their option for the further lease term, the lessee sought to understand and negotiate the rental the landlord was seeking as market rent.

The landlord, via its managing real estate agent, refused to respond. After several formal requests, the lessee was advised that the landlord will only advise the rent they are seeking after the lessee gives notice to exercise the lease option.

Effectively, the lessee is locked into a five-year term with no knowledge of what rent they may be liable for.

Outcome

The landlord sought a market rent increase of 20%. The parties negotiated and a 10% increase was settled on, as the cost of the specialist retail valuer was a barrier for the lessee.

Chapter Nine

Family firms

Dr Nick Mroczkowski: Deakin University



Family firms

Family firms represent a significant component of the SME community and research studies suggest a resurgence of interest in family businesses in scholarly journals and in professional and industry publications.⁶¹³ In many countries, including Australia, family firms account for a significant component of GDP⁶¹⁴, with some scholars claiming that “The family business is the most frequently encountered ownership business model in the world and their impact on the global economy is considered significant. It is estimated that the total economic impact of family businesses to global GDP is over 70%”.⁶¹⁵

Headline findings:

- Family firms are a major component of the SME community and are continuing to be recognised as significant contributors to GDP in most countries in the world.
- There has been a resurgence of interest in family business, both in academic and industry circles.
- Australia has witnessed unusual growth in company listings on the ASX, particularly in 2015 where the growth in the number of listings far outperformed most other developed countries.
- Evidence shows that larger family firms are still partaking in the public float route to address their financing needs. This is despite the ASX tightening the listing criteria to discourage small-cap businesses from applying to list on the ASX.

An emerging body of evidence also shows that family firms are continuing to take the public flotation route to fund further growth, particularly during periods where listings on security exchanges are growing.⁶¹⁶ Interestingly, during 2014, 2015 and 2016, Australia was one of a few developed countries that experienced considerable growth in listings⁶¹⁷ and predictions for 2017 suggest constant growth. Moreover, a recent study undertaken by the IPA-Deakin SME Research Centre⁶¹⁸ shows that many of the listings over the three-year period were family firms, which suggests that *going public* is still a popular route for family firms for a variety of reasons.

The first study in Australia to document similar findings showed that at least 17.1% of firms listing on the ASX during 2003 were family firms.⁶¹⁹ This is consistent with preliminary results from a current study undertaken by the IPA-Deakin SME Research Centre in 2017⁶²⁰ that found that 15% of firms listing in 2015, and 16% in 2016, were family firms.

Given the apparent rise in interest in family firms within academic and other disciplines, along with evidence suggesting that listing continues to be a viable option for family firms to follow for a variety of reasons, the IPA-Deakin SME Research Centre has included a special feature in this paper on family firms and the public flotation route. The IPA-Deakin SME Research Centre further notes that much of the commentary below is based on an original article published by the IPA on the topic 'Going public', which explains the process involved along with the possible advantages and disadvantages of going public.⁶²¹

IPO - Decision time for family business

Many family firms experience the 'cross-roads' phenomenon at some stage in their life cycle, where existing family members need to decide the future of the firm. Possibilities for consideration include whether to sell the firm (in part or in whole) directly to another party or indirectly through a public float, whether to continue to grow and further expand the firm by using internal funds, by incurring costly debt or by raising funds via the public float medium, or whether to simply hand over the reins to a successor.

While there are many advantages to be gained for family firms wishing to make the transition from a private to a public firm, this route can also be fraught with significant disadvantages which, for the uninformed, could potentially launch their successful family business into a perilous journey.

Going public

There are two principal reasons why companies enter the new issues market. The first reason relates to refinancing the firm by using external funds (i.e. in contrast to internal funds). Under this scenario, existing founders and other holders of shares who have a considerable amount of wealth invested in the firm are seeking to liquidate and diversify their personal investment portfolios. A public listing is generally a far more simplistic route to 'off load' part or all of their investment, in contrast to selling shares back to the firm which will need



to finance the buy-back from valuable internal sources. Indeed, if the firm has a stable, profitable trading history and the market is opportune for quality investments, a public listing may well be a profitable exit strategy for existing shareholders.

Secondly, public listing may be one of a limited number of sources of funds available to the firm seeking to finance new investments. Where substantial amounts of capital are involved, public listing may be the only alternative. Notwithstanding, flotation of a company is an attractive form of financing which can offer substantial benefits to the firm in comparison with other financing mechanisms. For instance, with the exception of dividends (which, in the case of ordinary shares, are only payable at the discretion of directors), there are generally no servicing costs associated with equity. In contrast, other forms of finance (particularly debt) require regular repayments of interest and principal.

There are many other benefits that accrue to the firm and stakeholders from going public, including ongoing access to large pools of costless funds via the capital market, increase in the profile of the firm, and a mandatory disclosure regime which provides a basic level of transparency and accountability (thereby reducing agency costs to the firm). Thus, from a macro perspective, new listings represent a significant source of finance for capital market participants.

Rationale for family firms going public

An examination of the rationale for family firms to go public suggests that the decision may, in many circumstances, be a cross-roads phenomenon. That is, the firm is driven to a certain point in its life cycle (by numerous factors, explained below) where a critical decision needs to be made, for instance, about whether to invest more funds and grow the firm, or to sell the firm. In either case, going public can be useful in addressing the needs of existing owners.

There are several possible reasons why family firms can reach the 'cross-roads' phase in their life cycle. The following are some of the more common and, in some respects, related reasons.

1. The need for further capital

Often firms get to a point where financing current or future operations is beyond the existing funding structure and/or family assets are not available for further funding purposes. Access to a large amount of

external funds is restricted due to existing funding arrangements and/or prohibitive interest rate regimes offered by external financing sources.

2. Technological and industrial evolution

Changes in the nature of the industry, particularly technological developments, can seriously impact the long-term viability of the firm. For example, many manufacturing industries have evolved through varying degrees of sophistication in production processes, packaging and distribution, often requiring firms within such industries to make substantial investment in new technology and processes to remain competitive.

3. The constant need to remain competitive

Changes in the nature of competition can drive the need for further large investments to remain competitive, in addition to keeping up with technological developments. For instance, the emergence of so-called 'killer chains' in Australia over the past two decades has seen the demise of smaller firms across a wide variety of industries, including hardware, pharmacies, grocery stores, bakeries, butcher shops, licensed beverages and so on.

Within some of these industries, however, smaller firms are able to compete by investing in structures that consolidate the individual strengths of several similar firms, which are then able to share costs and take advantage of efficiencies enjoyed by their larger counterparts. Independent food chains are an example of this competitive strategy.

4. The succession dilemma

Several perspectives in the succession debate can drive the business to the 'cross-roads' point. Many owners of long-established, successful businesses express anxiety about the possibility of handing the business to an heir or other relative, for two reasons:

1. They may have the perception that the business has achieved all that can possibly be achieved. Hence, the introduction of new owners would not further maximise the wealth of the firm.
2. They may question the ability of heirs or other potential successors to operate and grow the business and may view selling the business as the best possible outcome, since the firm is at its peak and will attract maximum sale value (which cannot be guaranteed at a later stage if the business was passed on to other family members).

613 Pounder (2015).

614 Mroczkowski and Tanewski (2007).

615 Osunde, C (2017).

616 Deloitte (2017).

617 Deloitte (2017).

618 Mroczkowski, Tanewski and Kiaterittinun (2017).

619 Mroczkowski and Tanewski (2007).

620 Mroczkowski and Tanewski (2007).
Mroczkowski (2007).

621 Mroczkowski (2007).

On the other hand, there is an abundance of examples where second, third and even fourth-generation family businesses are operating successfully and continuing to grow.

So, an alternative perspective on the succession debate is that, at some period, the existing owners will consider 'handing over' the business to other family members. However, measures need to be taken to ensure that such owners are properly compensated now and in the future and that there are sufficient returns and rewards for the new owners.

Perhaps one of the last reasons worthy of mention (for family businesses being at the 'cross-roads' in the life cycle of the firm) relates to greed, as briefly discussed below.

5. Greed and related monetary considerations

For some family businesses, a downstream generation of owners (more often three or more generations on) will have no affinity with the vision of the founding owners and little, if any, interest in growing the firm and taking it to new heights. In this regard, their interest may be completely myopic and pecuniary. This will often be the basis for maximising the firm's value in the shortest time possible and then using the best available means to dispose of the interest in the business at the best possible price.

Whatever the reason for being at the cross-roads, family firm owners will need to make decisions that will be critical to the future of the firm. It is also a time for asking some fundamental questions. For example, can the firm afford more debt? Do potential successors have the ability to take the business to new heights and sustain returns for all family members? Do the owners have a desire for a specific relative or relatives to take charge of the business they have worked so hard to build? Do the owners simply wish sell up because they are tired of competing?

In some cases, answers to such questions will mean selling the firm, because the owners are simply tired of trying to meet all the ongoing challenges, or just want to quickly sell for opportunistic reasons, since they don't really have any particular affinity with the firm, its history or its future. In other cases, the owners might wish to make a quantum leap by taking on all the challenges that lie ahead and make decisions to further invest and grow the firm, ensuring appropriate returns are generated for current and future owners.

In either case, going public can be an effective mechanism to maximise benefits for all parties concerned. However, there are also several disadvantages associated with going public which must be fully understood by the relevant parties before embarking upon this structural route.

Some of the more publicised advantages and disadvantages of going public are discussed below.

Advantages of going public

1. Funding

An obvious advantage of a public float is the potential to raise significantly large sums of capital at relatively low cost, in contrast to private firms that often face difficulties in accessing large amounts of funds from traditional sources such as banks and finance companies. Additional funds can be used to restructure or settle current debt arrangements to minimise interest costs and provide a stronger capital base, or to fund growth initiatives by investing in projects that might involve considerable outlays for current technology, buildings, plant and equipment, human resources, marketing and so on.

2. Profile and investor recognition

Research has found that listing a firm is a significant advertisement for a company that would otherwise be largely ignored by the investment community. The resulting firm profile can be used to build and sustain competitive advantage and can lead to greater success.

3. Diversification

It is acknowledged that founders and successive owners of family firms invest substantial amounts of personal wealth in the business. As a result, they are less able to diversify their personal portfolios and are thus exposed to considerable risk should the firm fail. A float can give existing owners additional cash for their share of equity foregone in the business which can then be reinvested in other unrelated projects and investments, resulting in more balanced portfolios from a risk perspective.

4. Discipline

Through listing, the firm will not only receive an increased public profile, but will also be subjected to greater scrutiny by market participants and regulatory bodies. Additionally, in most developed markets, the existence of so-called corporate raiders who continually scan markets for good opportunities can put the firm within



reach of a potential takeover offer which, if successful, could lead to complete loss of control of the family firm.

Arguably, these perhaps less palatable aspects of going public could have positive implications. For instance, they could act as an incentive for management to perform and grow the firm to its maximum potential. There is ample evidence in many countries that listed family firms thrive on pressures from the market to achieve substantial returns to shareholders, as NewsCorp Ltd and PBL Ltd demonstrate.

5. Liquidity

Once the firm has listed and secondary trading has commenced, the purchase and sale of shares can freely occur between market participants, assuming there are no legal restrictions. This market liquidity can provide benefits otherwise unavailable to the private firm. For instance, owners of shares can readily measure the value of their holdings and can, if desired, sell these holdings in an established market with relative ease.

Private firm shares are less negotiable, due to lack of liquidity, and are thus valued at a considerable discount to publicly traded shares. Note that high liquidity in a share creates greater public interest and profile, which can benefit the business and its products.

The potential downside of going public

Despite the many advantages cited above, there are several potential disadvantages associated with public listings that need to be seriously considered (particularly in the cost-benefit trade-off analysis by interested parties) before taking this route.

1. Costs, procedures and regulations

One of the most documented disadvantages is the enormous cost involved in the initial listing. The process of listing a company is generally lengthy and complicated, potentially involving representatives of the issuing firm, underwriters, financiers, auditors and corporate advisory specialists, lawyers, marketing experts, printers and various experts who might provide opinions on particular aspects of the listing.

There are also numerous regulatory and compliance mechanisms to be observed, including the requirement to prepare a detailed disclosure document. Although the Australian evidence is sparse, the cost of a public issue in Australia is in the range 2 to 7.5%.

2. Public scrutiny

A listed company in Australia is required to comply with several financial and other ongoing disclosure requirements, including the ASX listing rules and various provisions of the Corporations Act. The 'disclosing entity' provisions of the Corporations Act require the preparation of comprehensive audited financial statements, which comply with all relevant accounting standards and pronouncements on an annual and half-yearly basis. These are ongoing requirements and for many companies compliance is onerous and expensive, often requiring the establishment of large accounting systems and specialist departments.

3. Confidentiality and competitive costs

Additional costs may arise from competitors exploiting company information disclosed in financial statements. There may also be potential costs in defending a takeover bid for shares in the company.

4. Loss of complete control

While the family interest in the firm may continue to be substantial after the float, the presence of other owners in the business will invariably lead to one or more non-family members being appointed to the board. This changes the dynamics of the board structure and the decision-making process. Procedures are more formal, requiring compliance with regulations and other pronouncements that protect the rights of outsiders.

The presence of outsiders may have the effect of diminishing the control and efficiency of the pre-listing board that was the key to the success of the company.

5. Change in focus

Once the firm is listed, the management is potentially answerable to thousands of shareholders, which arguably could shift the focus from attending to the needs of running and growing the business to the needs of the shareholders. Thus, in order to keep shareholders content, the board may become preoccupied with movements in share price and the upswings and downswings of the market, instead of the real issues which keep business at the competitive edge.

Despite these disadvantages, the equity market has become an important medium for owners of family firms, either to exit the business and, in so doing, receive a fair price for their investment, or to raise funds to further grow and strengthen the firm.

Procedural and regulatory aspects

As discussed above, one of the most observed disadvantages of publicly listing a firm on a stock exchange is the long, often drawn-out process of taking the firm from a private entity to a public entity. This will involve extended periods of planning, followed by numerous steps and detailed procedures, ranging from ensuring the fundamentals are in place, even before deciding whether the listing is feasible, to compliance with complex, detailed legal provisions and pronouncements.

The business fundamentals required for an IPO to have any success might include such things as strong financials (e.g. stable revenue history, strong cash flows, a sound balance sheet in terms of assets and appropriate levels of debt, and well-managed levels of working capital requirements, such as stock and debtors etc), a stable industry, growth opportunities in products and markets, a stable interest rate regime, sound management, and so on. All of these issues and more are critical and must be addressed if the firm is to attract sufficient interest from potential equity investors, who will only subscribe to the new issue if the investment is sound and has the potential to yield sufficient returns.

Indeed, building the firm's profile to a level where the fundamentals are appropriate for an IPO listing may take months or even several years of hard work. Moreover, even after the hard work has been done, the directors still need to spend weeks and sometimes months marketing the firm to brokers, underwriters, financiers and other parties that will assist in ensuring the float is successful.

From a family firm perspective, the procedural, regulatory and funding aspects associated with an IPO may present as somewhat more onerous and daunting than for non-family firms. Three issues, in particular, warrant further discussion here; market discipline, firm size and profile, and the cost of listing.

One of the privileges and a significant advantage of a family-firm structure is that the owners are able to make decisions regarding aspects of the firm freely and expeditiously. Thus, in effect, they can 'run the show' as they wish with little, if any, interruption from outsiders. Once listed, however, the dynamics of managing the firm change considerably and, even with a controlling interest, the original owners will still find themselves accountable to a diverse range of

stakeholders, including potentially hundreds of shareholders, fellow directors (some of whom may not be related to the family) and other interested parties such as regulatory bodies. This loss of flexibility and increased accountability to the board for all decisions can be quite a bitter pill to swallow for directors not accustomed to acting in the interest of others or to being constrained by specific compliance mechanisms (for instance, there is an overriding requirement in the Corporations Act, 2000 for directors to act in the best interests of the shareholders as a whole).

Firm size and public profile can also be issues for family firms intending to go public. While family firms are not necessarily small firms (for instance, some of the largest companies listed on the Australian Securities Exchange are family firms), the evidence in the literature shows that the typical family firm IPO is considerably smaller than its non-family counterpart (i.e. in terms of total assets, total revenue, size of share issue, market capitalisation etc).⁶²² This will often mean that family firms will lack sufficient profile to attract interest from the IPO market and will, thus, require existing owners to undertake considerable prelisting work to build and establish the identity of the firm.

As noted above, this can be an expensive, long-drawn-out process that will require extensive funding which, in the case of family firms, will often be limited. Indeed, the ability of family firms to absorb these costs in the short term may be constrained for the same reasons. An additional concern in this regard is the evidence in the literature which shows that the profitability of IPO firms deteriorates considerably in the first three years after listing and at a greater rate for family firms than for non-family firms.⁶²³

Arguably, all of the above issues would act as a deterrent for family firms wanting to transform into a public form yet, every year in Australia, between 15% -18% of firms that list on the ASX are family firms.⁶²⁴ It may be, however, that family firms decide to go public not because they wish to finance and further grow the business, but merely as an exit mechanism. For example, the primary objective of family firms going public is to eventually 'offload' the business at the best possible price.⁶²⁵

Whatever the reason for going public, however, there are many issues that need to be carefully considered by family firms

⁶²² See Mroczkowski (2007).

⁶²³ Mroczkowski (2007).

⁶²⁴ Mroczkowski (2007).

⁶²⁵ Mroczkowski (2007).



Recommendations

- State and federal governments should encourage more research on family firms and their role in contributing to the wealth of the economy. One way this could be achieved is through grants and similar incentives.
- The ASX should consider removing the recent barriers caused by changes to the listing rules, thus allowing and encouraging family firms to take up the option of listing, as many firms listed on the ASX started as small family firms, some of which are now the largest firms listed on the ASX.
- An alternative to the above would be to consider resurrecting the former 'Second Board', which would allow smaller cap companies to list and thus have another option available in terms of financing.

intending to go public, particularly in terms of the procedural and regulatory aspects and also, to some extent, the rising trends in equity market investments in Australia. Procedural and regulatory aspects of IPOs have not been given coverage in this paper, as this maybe further explored in a separate future publication.

Conclusion

Consistent with most modern economies, the listing process in Australia is a lengthy and expensive procedure driven by a complex regulatory regime requiring compliance with detailed legal and institutional listing procedures.

For family firms in particular, despite the potential for gaining many advantages using the public route, the complex process of listing the firm on the security exchange can be daunting and expensive, and will require careful consideration before this means of either expanding or exiting the business is undertaken.



Chapter Ten

Internationalisation

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Global issues impacting all businesses

The role of international trade is crucial to the development of national economies in many countries including Australia (OECD, 2017). As demonstrated in previous sections of this white paper, SMEs play a critical role in contributing to Australian employment and economic growth.

⁶²⁶ <http://www.abs.gov.au/ausstats/abs@.nsf/mf/8165.0>

⁶²⁷ <http://www.abs.gov.au/Business-Indicators>

⁶²⁸ The estimated total value of exports 2015-16 is A\$311.5 billion (Australian Bureau of Statistics: Table 5.1). However, when disaggregating by size of enterprise, the methodology employed by the ABS does not count businesses classified as exporting 'other service types', including travel, insurance, financial and government service types. Thus, the estimate of the export value above is based on a total A\$269 billion and is an underestimate of the contribution of service-sector SMEs.

There were 2,238,299 actively trading SMEs operating at the end of 2016-17, comprising 99% of all businesses in Australia.⁶²⁶ These SMEs generated AUD\$379 billion worth of industry value added to the economy, and employed seven million people.⁶²⁷ But what of their international trading activities? How significant are SMEs in the international trade of Australia? This chapter focuses on the international activities of SMEs, particularly their exporting behaviour. Australian SMEs are acknowledged as significant contributors to the economy, with SME businesses accounting for 88% of all goods and 65% of all services in the economy

In value terms, out of the AUD\$269 billion of total export revenue generated by Australian businesses, an estimated 14.0% of this is contributed by SMEs exporting goods and 27.4% via exporting services during the period 2015-16.⁶²⁸ Thus, while SMEs make up a significant contribution to exports in terms of the number of firms, their financial contribution is understandably much lower, reflecting the small scale of operations per firm and probably also, the low contribution of exports to their overall turnover.

The performance of Australian firms in international markets will, of course, be shaped by the global context. Globalisation, together with the increasing turbulent international business environment, has had significant effects on the internationalisation of small firms. Economic and political changes, such as the UK's decision to withdraw from the European Union (Brexit), the Trump

administration's initiatives in the USA and tensions arising from developments in North Korea, may create uncertainties for SMEs seeking and operating in international markets. For example, Brexit has either directly or indirectly influenced the internationalisation behaviour and planning of UK SMEs.⁶²⁹

Recent evidence suggests that 32% of the surveyed UK SMEs expressed their concerns about the negative impact of Brexit their businesses, and 35% of SMEs have cancelled their expansion plans as a direct consequence of Brexit.⁶³⁰ This indicates a lack of confidence among UK SMEs as there has not been any clear advice for SMEs on how to deal with Brexit. As a result, this may influence their international trade activities with foreign partners and suppliers, including those based in Australia. A recent survey of 1758 UK small businesses by the Federation of Small Businesses⁶³¹ reported a rather negative impact of Brexit on UK SME's international trade. However, this effect appeared to be more negative for those SMEs that trade within the EU rather than in non-EU markets. For example, 60% of the surveyed exporters trading in non-EU markets reported a minimal impact of Brexit and 26% of the total non-EU exporters expect more trade. This compares positively with those trading within the EU (50% and 10% respectively). Similarly, UK importers also expect to trade more in non-EU markets (19% versus 2% in the EU market) or have very little change because of Brexit (60% of non-EU importers vs 56% of EU importers).

Although much of the reporting on the impact of Brexit is opinion and perception based, the immediate impact has been on the value of the sterling. The sharp depreciation of sterling currency since the beginning of 2016 may attract more FDI investors to the UK due to the cheaper costs of production (Federation of Small Business, 2017b). At the same time, the cost of imported materials, such as components and raw materials, has increased. Despite the increasing uncertainty resulting from Brexit, it may be also seen as a potential opportunity for Australian businesses to increase the trading flow with UK firms. HSBC Australia bank, for example, commented (2017, p 2) *"...in the long-term, however, the UK could benefit from greater non-EU trade, as it looks to reduce barriers bilaterally with trading nations beyond the EU such as Australia."*⁶³²

The United States withdrawal from the Trans-Pacific Partnership (TPP: includes Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam), has resulted in continual negotiation and negative reaction among TPP members. Specifically, the US withdrawal from TPP has raised concerns among Australian SMEs about the effects of the introduction of tariff barriers to the US market. On the one hand, the absence of the US from TPP is argued to be a positive for the Australian dairy industry. On the other hand, it raises concerns about the investor-statement-dispute-settlement⁶³³ mechanism (ISDS). In other words, companies could sue the Australian Government and fight for access to the Australian market.⁶³⁴

The US withdrawal from TPP has also implicitly opened the way for the increasing power of China in Asia, which is of concern for many SMEs in the economic area including Australian firms.⁶³⁵ More recently, the introduction of tariff barriers between China and the USA adds to a growing complexity and uncertainty in the international marketplace. The escalating 'trade war' between China and USA, in terms of trade barriers and intellectual property, is likely to result in the increasing of tariffs, which adds costs to those enterprises in global supply chains.⁶³⁶ Thus, in setting out the policy context for Australian SMEs, recent world events may be creating further challenges to their internationalisation.

This section of the white paper thus discusses and focuses on four areas related to internationalisation:

1. **The main ways in which SMEs enter export markets**
2. **Types of SMEs that are most likely to be involved in exporting**
3. **Exporting performance of Australian SMEs**
4. **Policy implications**

However, it is also important to understand the modes of internationalisation of SMEs: how do they enter overseas markets, what are the characteristics of firms that undertake internationalisation and what are the main challenges? This will form a backdrop for the detailed evidence on the international performance of Australian SMEs.

Theories of internationalisation

Since the work of Welch and Luostarinen,⁶³⁷ the concept of internationalisation has been defined and evolved from a variety of viewpoints.

Headline findings

- There were 2,238,299 actively trading SMEs operating in Australia at the end of 2016-2017. These enterprises generated A\$379 billion worth of industry value added to the economy and employed seven million people.
- Australian SMEs contributed 14% of the total export revenue of goods and 27.4% of service-sector exports (2015-2016).
- The number of firms engaging in direct import is 44% higher than that of exporters. The value of SMEs' exports is about 25% less than that of imports (2009-2013), suggesting an imbalanced trade situation in Australia.
- The current unstable global trade environment (arguably driven by global events and developments such as, for example, Brexit, China-US trade disputes, US withdrawal from the Trans-Pacific Partnership (TPP) etc) has heightened the level of uncertainty and market risk among Australian SMEs. However, such global disturbances may also bring about potential market opportunities.
- The bulk of Australian SMEs are domestically oriented: on average, between 2009 and 2014, 80% of SMEs were active in local markets while 12.5% were involved in overseas markets.
- The majority of Australian SMEs are found to follow the 'Uppsala model' of internationalisation, which suggests a staged approach to exporting, starting out in locations of geographic proximity, allowing an accumulation in knowledge and resources to draw upon when venturing further afield.
- More than one in 10 SMEs generated income from direct exports: with 7.5% of income generated by the direct export of goods and 4.8% by the export of services.
- Internationalisation among SMEs varies by business sector. The three sectors showing the highest levels of internationalisation are wholesale trade, information media, and professional, scientific and technical services.
- Larger and more mature firms have higher levels of engagement in international activities. Medium-sized firms are three times more likely to be active in foreign markets than the self-employed and twice that of small-sized firms. Approximately one half of all internationally-active firms have operated for more than 10 years.
- The most popular source of external finance is from the banks. The proportion of SMEs with loans increases with their turnover. However, Australian SMEs have increased their use of credit cards while all other forms of lending sources, including bank finance, have marginally declined.
- Innovation plays an integral role in exporting, both enabling and stimulating subsequent export behaviour. Australian exporters are twice as innovative as importers, particularly in terms of introducing new products or operational processes.

One of the conventional views defines internationalisation as "...a pattern of investment in foreign markets explained by rational economic analysis of internationalisation, ownership and location advantages".⁶³⁸ Another view emphasises the firm's ongoing process of evolution in international involvement with increasing accumulation of knowledge and market commitment.⁶³⁹ Beamish⁶⁴⁰ develops this concept as the "the process by which firms both increase their awareness of the direct and indirect influence of international transactions on their future, and establish and conduct transactions with other countries". Hence, internationalisation can be understood as an ongoing process including both outward operations (such as exports, licencing and FDI) and inward activities, such as imports and subcontracting.⁶⁴¹

SME internationalisation has been subject to a number of theories during the last 40 years.⁶⁴² Overall, the internationalisation modes of SMEs can be viewed from the perspective of *stage models* (or the so-called Uppsala model),⁶⁴³ *network theory*,⁶⁴⁴ and *innovation-related models*.⁶⁴⁵ More recently, attention has focused on *born global* firms, those that are international from birth, which is reflected in the *international entrepreneurship* theory. These different modes of internationalisation will now be discussed in more detail.

Stage models of internationalisation
Stage models, including the 'Uppsala' model, where a firm seeks out markets nearest to home and then steadily goes further abroad, is among the most well-known theories of internationalisation. 'Psychic distance'⁶⁴⁶ is a core concept in stage models that helps

to explain the internationalisation behaviour of a firm.⁶⁴⁷ Psychic distance includes the differences in language, culture and political systems that influence the flow of information between the firm and the market.⁶⁴⁸ A firm's international behaviour is based on its market knowledge and resource commitment⁶⁴⁹ and risk management. This influences the firm's overseas entry mode and target markets.⁶⁵⁰ A staged approach makes sense in that risk is managed carefully: a firm expands beyond psychically close markets to those further afield and in doing so learns and builds up networks, capacity and market intelligence. This view also implies the significance of geographic proximity on the behaviour of small firms when going international.

Figure 1 depicts a staged process of SME internationalisation: each stage reflects an increasing level of risk and costs as the firm moves from indirect exporting (many SMEs will be involved in staged process modes, but it is difficult to ascertain due to data limitations) through to direct export and then foreign direct investment (FDI).⁶⁵¹

Even though stage models have been applied to SMEs because of their relative limited resources, these models have been criticised for a lack of consideration in the time gap between business start-up and the internationalisation phase, which has shortened because of globalisation.

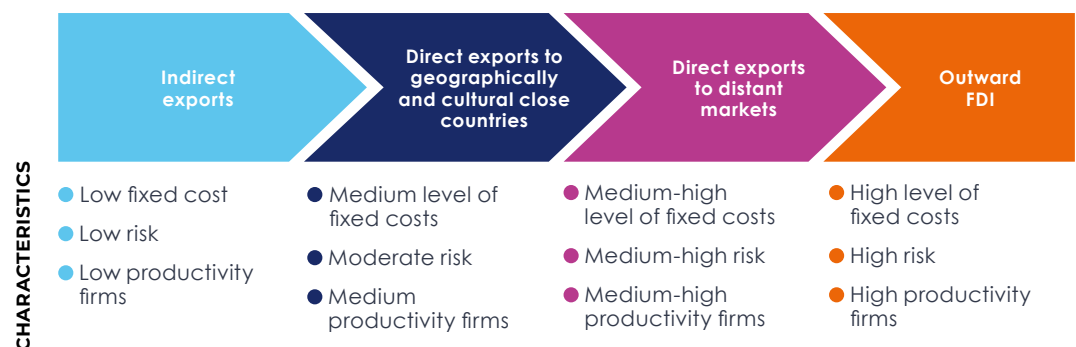
Network approach

Alternative approaches focus on the use of networks to explain the internationalisation behaviour of firms. Coviello and Munro,⁶⁵² for example, argue that a firm's selection of foreign market entry is driven by a network perspective rather than "psychic distance". Therefore, stage model approaches, while

629 Federation of Small Businesses (2017a).
630 Dun and Bradstreet (2017).
631 Federation of Small Businesses (2017b).
632 https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Foreign_Affairs_Defence_and_Trade/tradewithUK/Interim_Report/section?id=committees%2Freportjnt%2F024101%2F25068

633 A system through which investors can sue countries for alleged discriminatory practices.

Figure 1:
Evolution of the internationalisation process of SMEs



Source: Falk et al, (2014).

intuitively appealing, are now regarded as not fully reflecting the internationalisation process of modern firms.⁶⁵³ This is also confirmed in Johanson and Vahlne,⁶⁵⁴ who suggested that export market selection is influenced by the networks and relationships built by the internationalising firm rather than because of close proximity. In the same vein, Lehtinen and Penttinen⁶⁵⁵ propose internationalisation as the process of developing networks of business relationships in other countries. These can be achieved through *extension* (for example, by investments in new networks), *penetration* (that is, developing positions and increasing resource commitments in existing networks) and *integration* (that is, the co-ordination of different national networks). In this sense, both direct and indirect relations within networks need to be emphasised as firms are interdependent via either competition or cooperation.⁶⁵⁶

Innovation related model

This perspective views internationalisation as a process involving different stages, each of which is considered as 'an innovation'.⁶⁵⁷ This approach focuses on the export development process within SMEs. It is suggested that the number of stages involved can vary from three to six.⁶⁵⁸ Overall, the most common three basic stages are identified, including pre-export, initial export, and the advanced export stage.⁶⁵⁹ This model also identifies individual learning and the presence of top managers as critical elements to help explain a firm's internationalisation behaviour.⁶⁶⁰ However, this approach has been criticised as vague because of the inconsistent number of stages, operationalisation of the stage, and the time differences in each stage (Andersen, 1993). In addition, this perspective focuses only of the process of change without paying attention to the firms' different approaches in developing their activities.⁶⁶¹

The rise of 'born globals'

More recently, the emergence of international new ventures (INVs), or 'born globals', has received attention in theories of internationalisation.⁶⁶² Born globals are firms that internationalise at start-up, or within three years after foundation.⁶⁶³ Born globals are often based on owner-manager's knowledge about market opportunities, access to networks and previous international experience.⁶⁶⁴ This concept has received an additional fillip with the rise of the internet, which to all

- 634** <http://www.abc.net.au/news/2018-01-24/what-is-the-new-tpj-and-what-does-it-mean-for-australia/9357020>
- 635** <http://www.news.com.au/finance/economy/australian-economy/why-the-us-withdrawal-from-the-transpacific-partnership-could-be-bad-for-australia/news-story/661c9bffc7bf9c58023299248ca9aea7>
- 636** <http://www.abc.net.au/news/2018-04-09/trade-war-could-wipe-billions-from-australian-economy/9633176>
- 637** Welch and Luostarinen (1988).
- 638** Dunning (1988); Coviello and McAuley (1999), p 224.
- 639** Johanson and Vahlne (1977).
- 640** Beamish (1990), p 77.
- 641** Welch and Loustarien (1993); European Commission (2010).
- 642** Lu and Beamish (2001); Love and Roper (2015); Emontspool and Servais (2017); Sozuer et al, (2017).
- 643** Johanson and Vahlne (1977, 1990, 2006).
- 644** Lehtinen and Penttinen (1999); Johanson and Vahlne (2003); Sharma and Blomstermo (2003).
- 645** Ruzzier, Hisrich and Antoncic (2006).
- 646** Psychic distance is defined as "...the sum of factors preventing or disturbing the flows of information between firms and markets" (Johanson & Wiedersheim-Paul, 1975, p 308)
- 647** Johanson and Vahlne (1977); Ruzzier, Hisrich and Antoncic (2006); Johanson and Vahlne (2006).
- 648** Johanson and Wiedersheim-Paul (1975).
- 649** Nummela (2011).
- 650** Johanson and Vahlne (2003); Figueira-de-Lemos et al (2011).
- 651** Madsen and Servais (1997); Sharma and Blomstermo (2003); Cavusgil and Knight (2009).
- 652** Coviello and Munro (1997).
- 653** Crick (2002); Crick and Spence (2005); Nummela (2018).
- 654** Johanson and Vahlne (2009).
- 655** Lehtinen and Penttinen (1999).
- 656** Johanson and Mattsson (1993).
- 657** Gankema, Snuif and Zwart (2000).
- 658** Cavusgil (1980).
- 659** Ruzzier, Hisrich and Antoncic (2006).
- 660** Andersson (2000).
- 661** Ahokangas (1998).
- 662** Andersen (1993); Autio, Sapienz and Almeida (2000); Aspelund and Moen (2004); Oviatt and McDougall (2005); Andersson and Baffour Awuah (2015); Cavusgil (2009, 2015); Amorós, Etchebarne, Zapata and Felzenstein (2015); Nummela (2018).
- 663** Autio, Sapienz and Almeida (2000); Cavusgil (2009).
- 664** Lehmann and Schlange (2004); Pock and Hinterhuber (2011).

⁶⁶⁵ Zaheer (1995); Elo (2016).

⁶⁶⁶ Agostino et al (2015); Crick (2009); Kuivalainen et al (2007); Love and Roper (2015).

⁶⁶⁷ Leonidou and Samiee (2012); Moen and Servais (2002).

⁶⁶⁸ Leonidou and Samiee (2012).

⁶⁶⁹ Cavusgil and Knight (2009).

⁶⁷⁰ Crick and Jones (2000).

⁶⁷¹ Leonidou and Samiee (2012).

⁶⁷² Mackinnon, Chapman and Cumbers (2004); Freeman et al (2006); Fernhaber and Prashantham (2015); Numella (2018).

⁶⁷³ Lu and Beamish (2001); Johanson and Vahlne (2003); Sharma and Blomstermo (2003).

⁶⁷⁴ Johanson and Vahlne (2009); Nummela (2011); Dominguez and Mayrhofer (2017).

⁶⁷⁵ Fernhaber and Li (2014).

⁶⁷⁶ Bleaney and Wakelin (2002); Knight and Cavusgil (2004); Forsman (2010); Raymond, St-Pierre, Uwizeyemungu and Dinh (2014); European Commission (2015); Love and Roper (2015).

intentions and purposes does not recognise conventional international boundaries. However, going global at start-up is not without its risks. The 'liability of foreignness' – the additional economic and social costs of operating overseas – present special challenges for born globals.⁶⁶⁵ Hence, SMEs that are newcomers to a market may have to expend additional resources to assimilate new market tastes, cultures and languages and well and understand and adapt to the host countries' regulations and economic systems.

Born globals, however, have been found to have a more proactive and dynamic approach to internationalisation than firms entering overseas markets later in life. They are less burdened by established organisational structures and routines. Hence, they tend to outperform other firms in terms of export speed, intensity and scope.⁶⁶⁶ Given that born globals rely on foreign markets and international activities for income and profits, those running these firms tend to prioritise factors such as the urgency to internationalise and the attractiveness of export markets, rather than define their internationalisation process following the psychic distance orientation approach.⁶⁶⁷ However, entering a number of foreign markets at the same time imposes exceptional pressures on born globals,⁶⁶⁸ which then influences their internationalisation behaviour.⁶⁶⁹ Thus, born globals have been found to approach a less intensive internationalisation mode such as exporting via agents,⁶⁷⁰ or engaging in alternative collaborative governance structures including subcontracting, licensing, franchising) for cost and risk minimisation.⁶⁷¹

Critical factors affecting SMEs internationalisation

Networks and Relationships

Networks and business relationships play a crucial role in the internationalisation process. They are crucial in providing a source of market information and knowledge.⁶⁷² They also provide human, technology and financial resources, and offer the ability to identify potential international business partners and market opportunities.⁶⁷³ As a result, networks and networking relationships contribute to reducing the "psychical distance" faced by internationalising SMEs.⁶⁷⁴

There are of course, many different types of networks. SMEs are involved in both formal (e.g. strategic alliances and agreements which facilitate collaboration or partnership to create synergies in internationalisation) and informal networks (e.g. through personal contacts and social relationships). Informal networks are more often relied upon by smaller and younger firms, because of their relative low cost and ease of access.⁶⁷⁵

Innovation

Innovation is considered one of the critical factors that significantly enables the internationalisation of SMEs.⁶⁷⁶ While firms seeking to internationalise need to have something unique to offer at a competitive price, this also appears to be a two-way process: firms involved in exporting benefit from the pressures of competition and exposure to new ideas. They are subsequently driven to further innovations in products, processes and services. Evidence from the European Commission,⁶⁷⁷ for example, shows that international firms are three times more likely to produce innovative products and services than domestic focused SMEs.

Competitive Advantage

Based on the resource-based view (RBV) of the firm, SMEs' internationalisation is also assumed to be dependent on how firms allocate and develop their internal and external resources.⁶⁷⁸ Hence, the utilisation of resources that are valuable, unique, rare and irreplaceable, contributes to building competitive advantages for SMEs,⁶⁷⁹ and can also contribute to enhance internationalisation.⁶⁸⁰ This is also consistent with findings in Pereira et al,⁶⁸¹ who suggest that competitive advantage can create distinctive value for its customers, outperforming its competitors and creating defensible position in the market.

SME characteristics

The literature suggests that firms with particular characteristics are more likely to be involved in internationalisation. Hence, size, age, sector and capabilities have been shown to influence the international performance of SMEs.

Firm size

The evidence shows a positive relationship between firm size and internationalisation. In the EU, for example, the proportion of exporters among micro, small and

medium sized-enterprises was 24%, 38% and 53% respectively.⁶⁸² The size of a firm often reflects its capacity to internationalise.⁶⁸³ The bigger the firm, the higher the firm's capacity to meet the additional costs of going overseas, the greater their ability to adapt and absorb the uncertainty of international markets as well as meeting the demands of their international operations.⁶⁸⁴ Consequently, firm size influences the international behaviour of SMEs, including their entry mode.⁶⁸⁵ This has implications for policy intervention: for example, many micro-firms with innovative products or services may be deterred from exporting alone because of the additional risk and costs incurred and thus may be more inclined to seek alliances and partnerships.

Firm age

The evidence on the relationship between the age of firms and internationalisation is mixed. As a firm ages, it can accumulate economic and social capital as well as develop networks that can enhance a firm's capabilities and capacity for exporting.⁶⁸⁶ However, evidence suggests that SMEs founded in the last decade are more export-intensive than firms started during the last five years.⁶⁸⁷ This may be explained by the learning that takes place over time. As firms accumulate market knowledge and increase their ability to deal with uncertainty, their capacity and expertise to work in international markets may increase.⁶⁸⁸ However, the growth in born-globals and the increasing role of the internet has contributed to breaking down this positive relationship between firm age and international capability.

Business Sector

SMEs' internationalisation behaviour differs tremendously across industry sectors. Evidence from Europe, for example, shows that sectors with the highest share of exporting SMEs are mining (58%), manufacturing (56%), wholesale trade (54%), research (54%), sales of motor vehicles (53%), and transport and communication (39%).⁶⁸⁹ Among these, manufacturing SMEs are found to be more likely to export to non-EU markets.⁶⁹⁰ There is no reason to assume that this sector differentiation will vary substantially between countries. However, the number of exporters and export earnings will inevitably vary depending on the industry-mix of countries.

Financing for SMEs to internationalise

Access to external finance plays a critical role in business expansion and internationalisation. SMEs require resources to market their products and services, cover the additional costs of insurance, absorb exchange rate risks and delays in payment, and cover shipping and meeting regulatory requirements. Depending on firm size, speed and scope of internationalisation, SMEs will have different financial needs. For example, born globals who are often smaller sized firms, pursuing multimarket at the early stage of development will have financial needs that are greater than their counterparts because of their limited resources and lack of experience in the market.⁶⁹¹ Born globals also often have to deal with higher market risks because of their intensive engagement in international market as well as the coping with the liability of "newness" and small firms. This may restrict their ability in securing external finance compared to internationalising SMEs following the Uppsala approach (that is, those firms who gradually engage in internationalisation, following the "close proximity" principle in selecting target markets. The most popular source of external finance for SMEs is the banks. SMEs can also raise external finance through shareholders, venture capital, business angels, crowd funding and leasing. Although SME financing is discussed in some depth in other sections of the White paper, this section provides a brief review of the ways SMEs raise finance in Australia.

External finance and SMEs in Australia

Seventy percent of small businesses in Australia used a 'lending product' (including credit cards) and this has been stable between 2013-16.⁶⁹² The most frequently used finance products by SMEs include credit cards (50%), overdrafts (24%), long-term loans (15%) and property mortgages (14%). Between 2013 and 2016, the data suggests that firms have increased their use of credit cards while all other forms of lending sources have marginally declined. There is also some differentiation within the SME population in terms of the type of finance product used - the proportion of SMEs with loans increases with their turnover.⁶⁹³ For example, about 65% of SMEs with a turnover of \$1-5 million have access to lending products, compared to about 30-35% with a turnover below \$50,000.

⁶⁷⁷ European Commission (2015).

⁶⁷⁸ Ahokangas (1998).

⁶⁷⁹ Barney (1991).

⁶⁸⁰ Westhead, Wright and Ucbasaran (2001).

⁶⁸¹ Pereira, Fernandes and Diz (2005).

⁶⁸² European Commission (2010).

⁶⁸³ Loane, Bell and McNaughton (2007).

⁶⁸⁴ Mittelstaedt, Harben and Ward (2003); Rashid and Waqar (2017).

⁶⁸⁵ Karadeniz and Goçer (2007).

⁶⁸⁶ Karadeniz and Goçer (2007).

⁶⁸⁷ European Commission (2010).

⁶⁸⁸ Johanson and Vahine (2009).

⁶⁸⁹ European Commission (2010).

⁶⁹⁰ European Commission (2015).

⁶⁹¹ Cavusgil and Knight (2009); Freeman, Edwards, and Schroder (2006).

⁶⁹² Pearson (2016).

⁶⁹³ Pearson (2016).

One of the challenges for SMEs is to demonstrate their overall creditworthiness and the expected future cash flow of the firm.⁶⁹⁴ This is often declared on the financial statement lending which reflects the borrowers' financial position including the ratio of current assets over current liabilities, debts to equity ratio, gross profit percentage, return on assets and return on equity. Credit scoring is also a way of assessing the viability of loans to SMEs.

The internationalisation performance of Australian SMEs: Facts and Figures

Exporting Behaviour of SMEs

Overall, according to data obtained from the Australian Bureau of Statistics (ABS) *Business Longitudinal Database (BLD) Confidentialised Unit Record File (CURF)*, which is based on a panel survey study of a representative sample of SMEs over a five-year period between 2009-10 and 2013-14, just over one in 10 SMEs is involved in direct exporting (**Table 1**). As expected, the bulk of SME's sales are to local markets: 79.9% of SMEs were active in 'local' markets, compared with 12.5% active in

overseas markets (**Table 1**). In other words, there is distance-decay in the sales of Australian SMEs. Although comparative statistics should be treated with caution, the data suggests that Australian SMEs are less inclined to export than those in other advanced economies. In Europe, for example, approximately 25% of SMEs are involved in direct exporting to countries outside the EU;⁶⁹⁵ and for the USA this figure is about 10%^{696, 697}.

An alternative way of examining the data is to look at the income from exporting for SMEs (**Table 2**). Overall, more than one in 10 firms (11.2%) received income from direct exports. If we break this down further, on average, 7.5% of income for SMEs was generated by the direct export of 'goods' and 4.8% for the export of services. Of course, these data do not include expenditure by foreigners within Australia, such as tourists, or income from indirect sales through sub-contracting to larger organisations that subsequently export.

The data also shows variations in the geographical sales of SMEs by industry. Overall, the six most active industries

⁶⁹⁴ Pearson (2016).

⁶⁹⁵ European Commission (2015).

⁶⁹⁶ Care should be taken in comparisons between different jurisdictions and definitions: in the EU, a SME is an enterprise that employs less than 250 people; in the USA this includes enterprises of less than 500 employees.

⁶⁹⁷ <https://www.statista.com/statistics/708151/sme-engagement-in-international-trade-us/>

Table 1:
SMEs Geographic Markets (multiple response)

Geographic markets	Per Cent
Local	79.9
Outside local/within State	44.7
Outside State/within Australia	31.4
Overseas	12.5
Data shows average for period 2009-14	

N = 7592

Table 2:
Exporting SMEs and Income

Category	Per Cent
SMEs Exporter	11.2
Goods Income from Exporting**	7.5
Services Income from Exporting**	4.8

* N = 7592 ** N = 7690

selling beyond their local markets include Mining, Manufacturing, Wholesale Trade, Agriculture, Information Media and Telecommunications, and Professional, Scientific and Technical Services (Figure 2). The top three industries with SMEs active in overseas markets and outside their states included Wholesale Trade, Information Media, and Professional, Scientific and Technical Services. The longitudinal statistics show that the percentage of SMEs targeting export markets in Manufacturing and Wholesale Trade decreased by 4.5% and 4.7%. In contrast, the percentage of SMEs in Professional and Information industries experienced an increase of 4.4% and 4.2%; which is approximately twice that of the average across all industries.

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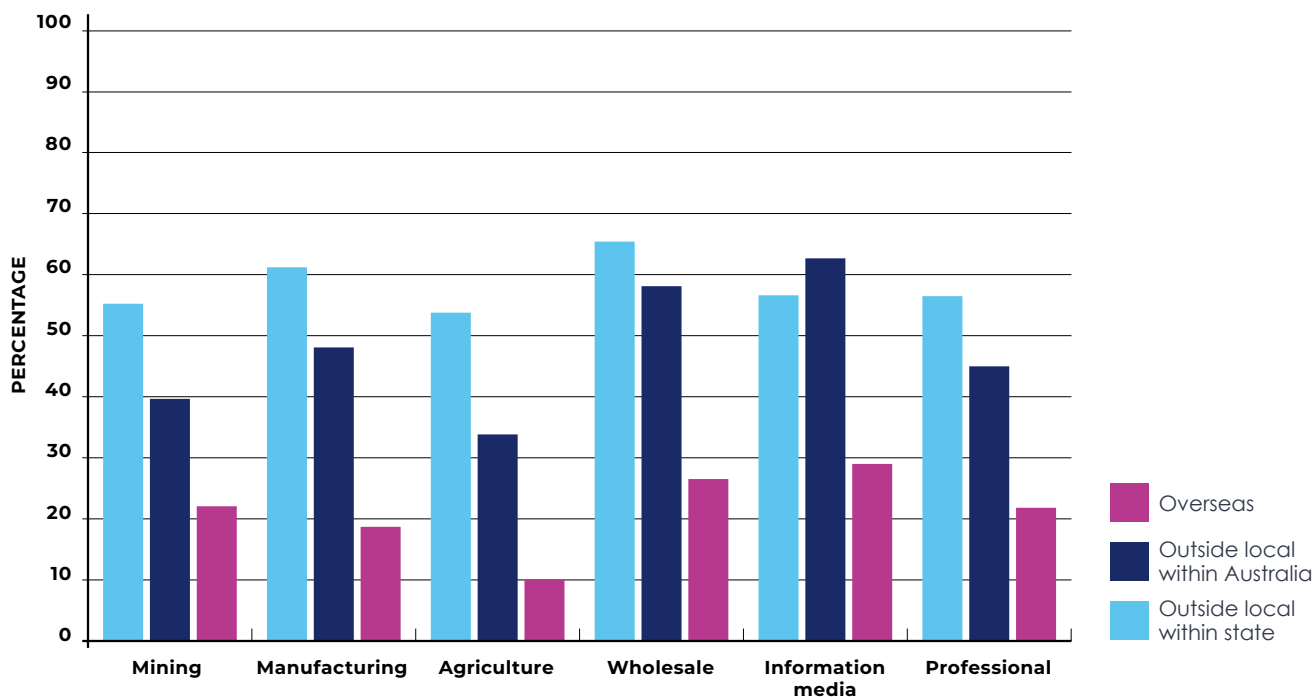
included Wholesale Trade, Information Media, and Professional, Scientific and Technical Services. The longitudinal statistics show that the percentage of SMEs targeting export markets in Manufacturing and Wholesale Trade decreased by 4.5% and 4.7%. In contrast, the percentage of SMEs in Professional and Information industries experienced an increase of 4.4% and 4.2%; which is approximately twice that of the average across all industries.

As expected, there is a positive relationship between firm size and internationalisation performance. Figure 3 highlights the difference between the self-employed, micro, small and medium sized enterprises. There is a clear positive relationship: the larger the firm, the more likely it will export. While firms of all sizes are more likely to be domestically oriented, especially selling to local markets, there are remarkable differences in the geographic reach of sales by firm size. This positive relationship with size of enterprise reflects what is seen in the EU⁶⁹⁸ and is a reflection of the resource constraints, financial, human and network capabilities, of smaller firms and the advantages deriving from size.

⁶⁹⁸ European Commission (2010, 2015).

Figure 2:
Percentage of Australian SMEs in Different Geographic Markets by Industries

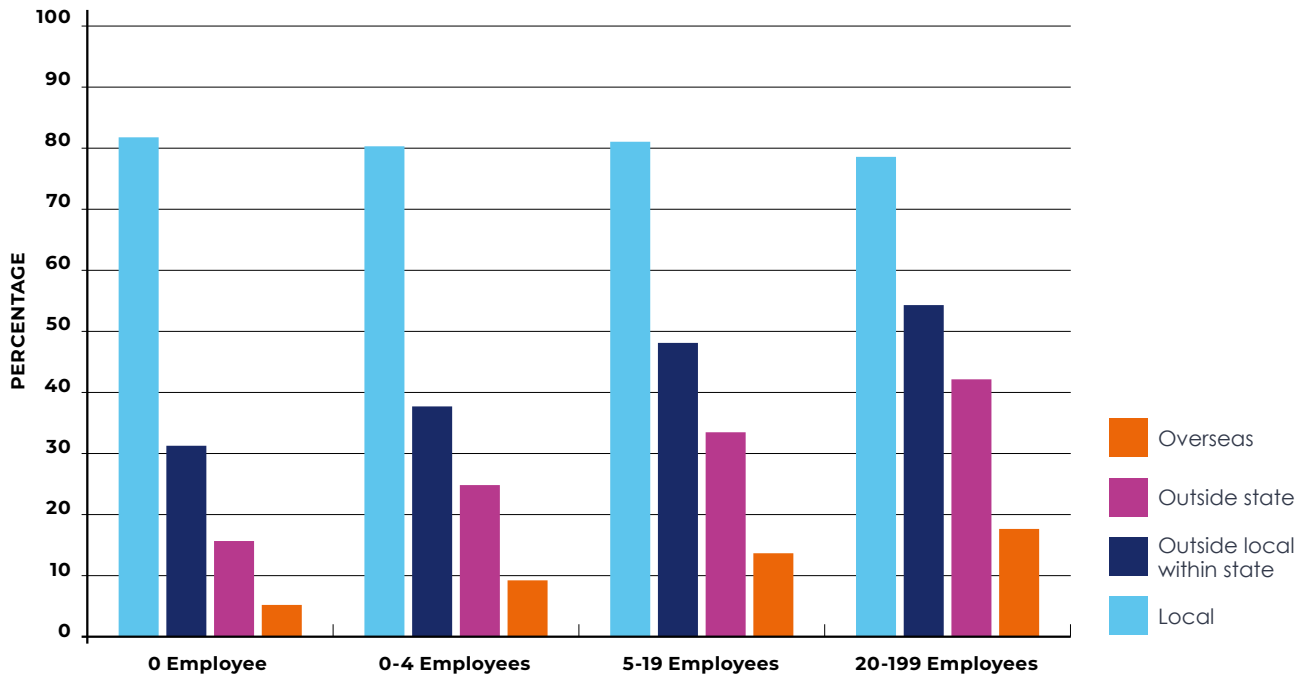
(N=7592)



Source: Australian Bureau of Statistics BLD CURF, 2009-2014.

Figure 3:
Percentage of SMEs in Different Geographic Markets by Size of Enterprise

(N=7592)



Source: Australian Bureau of Statistics BLD CURF, 2009-2014.

This is also consistent with the Uppsala model discussed earlier, which describes the effect of “psychic distance” and the firm’s resources to deal with the liability of foreignness in new markets.

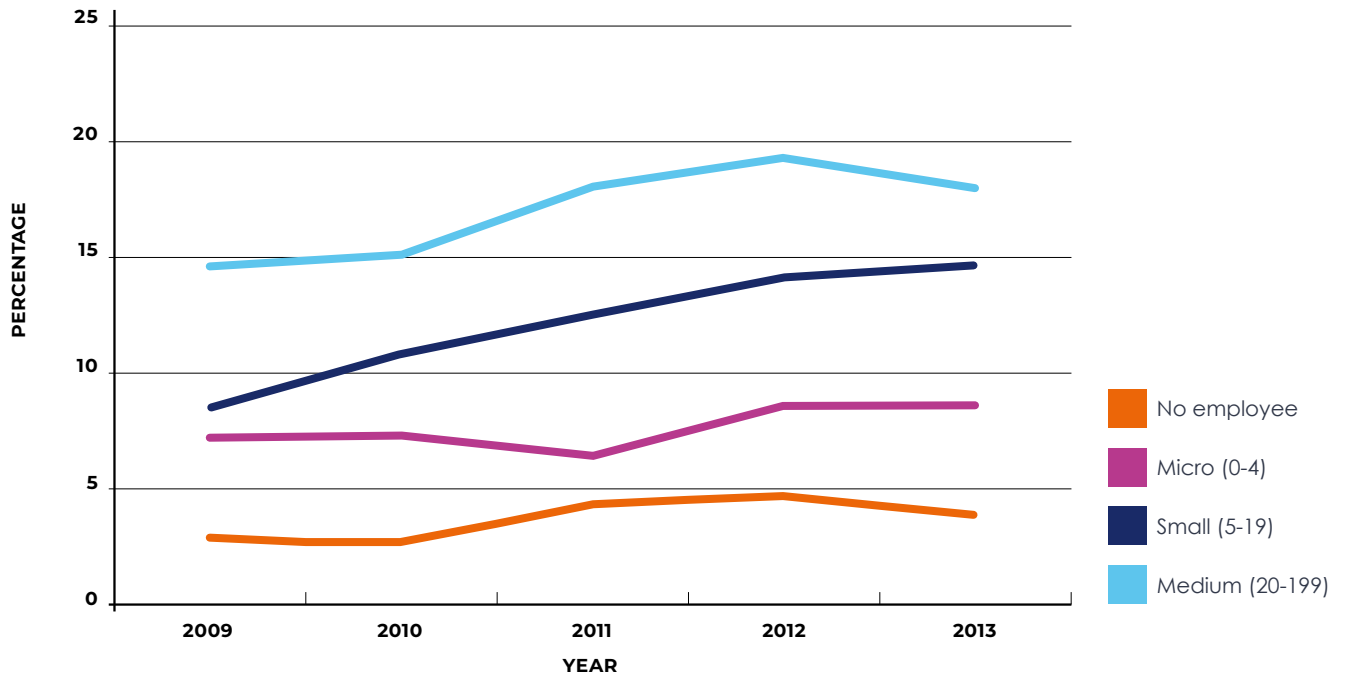
Figure 4 shows the trend in exporters by size of enterprise between 2009 and 2013. The percentage of medium-sized firms engaged in direct export was triple that of self-employed and double that of small sized firms. The data shows a slight decrease in the percentage of exporters among medium sized and self-employed firms. However, small firms showed a substantial increase in exporters from around 8% to almost 15%: a performance outstripping all other enterprise size-bands.

The internationalisation performance of Australian SMEs also varies by age of firm (**Figure 5**). Overall, the older the firm the more likely it will be involved in overseas markets. For example, half of the internationally active businesses are those who have operated for more than 10 years, whereas only 3.4% of the exporting SMEs are young firms, that is aged below four years. What is surprising, however, is that the

difference in the proportions of those who are internationally active within each firm age group is not exceptional as demonstrated in **Figure 5**. One interpretation of this pattern is that SMEs need time to marshal the resources, develop products and services and gather market knowledge before they can then sell outside their immediate geographical area. Of course, older firms are also larger suggesting that a critical mass, in terms of enterprise size, is an important factor in enabling SMEs to internationalise.

Further evidence from the ABS’s *BLD CURF* during 2009-2013 indicates that the main source of income from exporting goods by old firms (7.9%) was four times higher than that of start-ups (2.7%) and approximately double that of young firms (4.2%) In contrast, start-ups outperformed all other firm age groups with regard to the income generated from exporting services, which was 0.7% higher than that of old firms, 1.24% higher than that of young firms and 1.6% more than that of mature firms. This suggests that service-sector Australian SMEs are becoming more important as a source of export earnings.

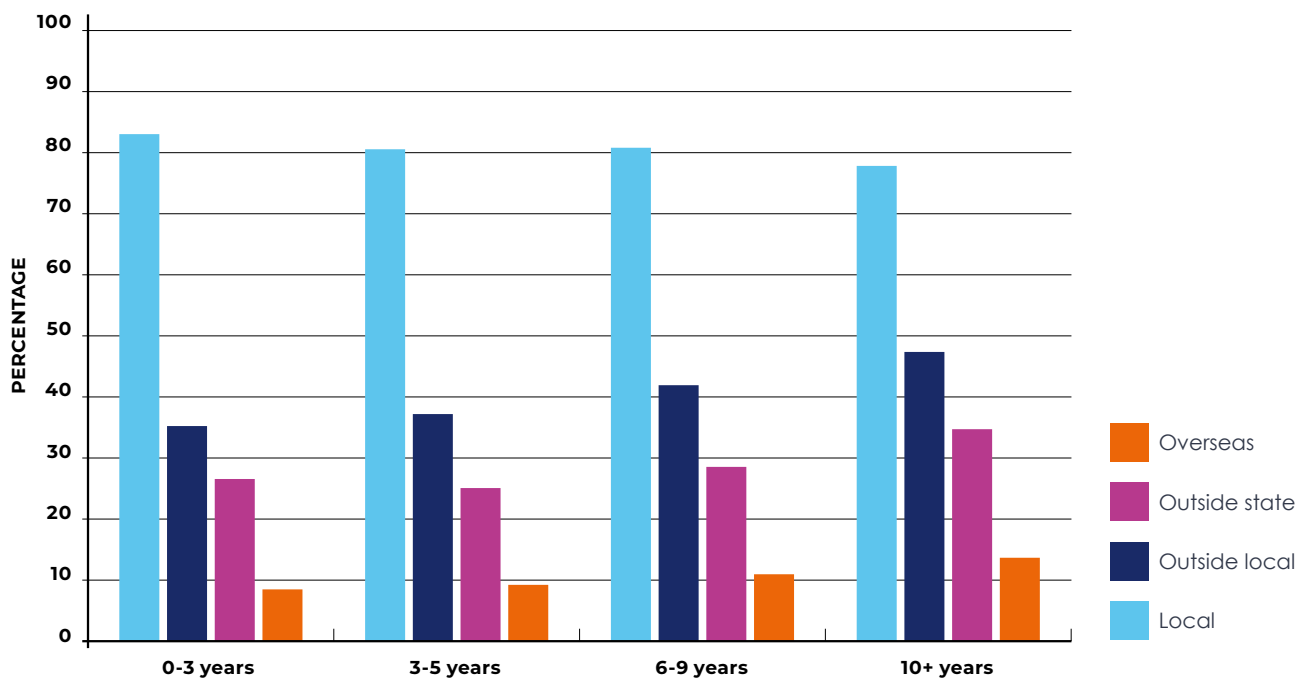
Figure 4:
Flexible working hours by business size: 2007-08 to 2015-16



Note: N= 1750 (2009) N= 1651 (2010), N=1527 (2011), N= 1425 (2012), N=1295 (2013)

Source: Australian Bureau of Statistics BLD CURF, 2009-2013.

Figure 5:
Percentage of SMEs in Different Geographic Markets by Firm Age
(N=5410)



Source: Australian Bureau of Statistics BLD CURF, 2009-2013.

For SMEs to engage in exporting successfully, the literature suggests that it is crucial to have a unique product or service or method of production: in other words, they are more likely to succeed if they are innovative. The data shows that around one-fifth of all Australian SMEs had introduced new, or significantly improved their goods or services (20.8%); or new operational processes (19.6%); and a quarter their organisational or managerial processes (23.4%). A further 19.5% had introduced new marketing methods. The type of innovation also varies by industry sector. For example, SMEs in Wholesale emphasised the introduction of new goods and services, those in manufacturing industry placed higher priority on operational processes, whereas managerial processes are found to be dominant in the Professional industry. Marketing innovation tends to be less important in Mining and Agriculture industry but was ranked first in the information media sector.

The Australian SME trade balance

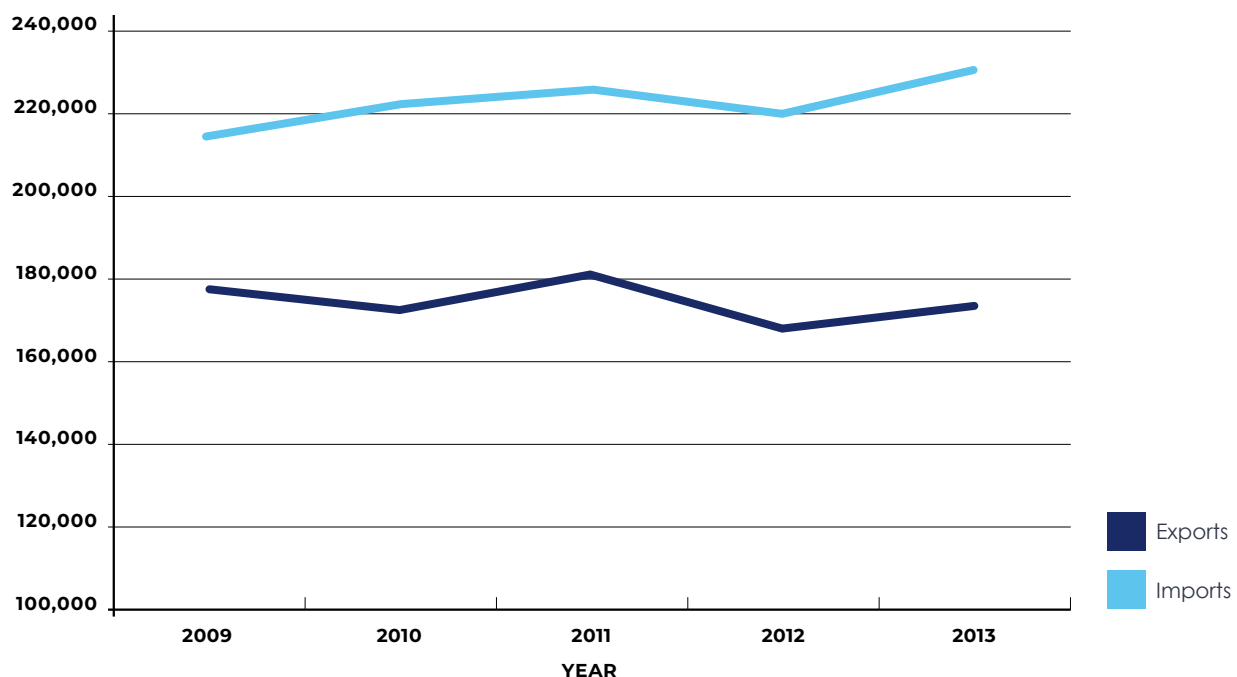
Overall, the data shows a significant gap in the international trade balance of Australian SMEs: the number of direct importers is estimated to be 44% higher than that of

exporters (**Figure 6**). The value of SME's exports was approximately 25% less than that of imports during 2009-2013. Hence, Australian SMEs are net-importers. However, these data do not include the contribution of SMEs to exports as sub-contractors and suppliers to other Australian firms who may then subsequently export. The time-series trend may be of some concern as the value of exports has declined over the four-year period, while that of imports has increased.

A further dis-aggregation of the data shows that SMEs in Mining, Manufacturing and Wholesale had the highest shares of imports (52%, 49%, and 58% respectively of SMEs in those industries have imports value above AUD\$600,000 in 2013).

Figure 7 shows a positive relationship between imports and size of enterprise: the self-employed are rarely found to import (accounting for only 0.51% of all importing SMEs), compared with small and medium size businesses (35.2% and 52% of all importing SMEs respectively). Within the self-employed group, approximately 83% of them engaged in importing with relative small value (under AUD\$10,000), and 16.7% importing with the value ranging from \$10,000 to \$99,999.

Figure 6:
Average Value of Imports and Exports of Australian SMEs (2009-2013)

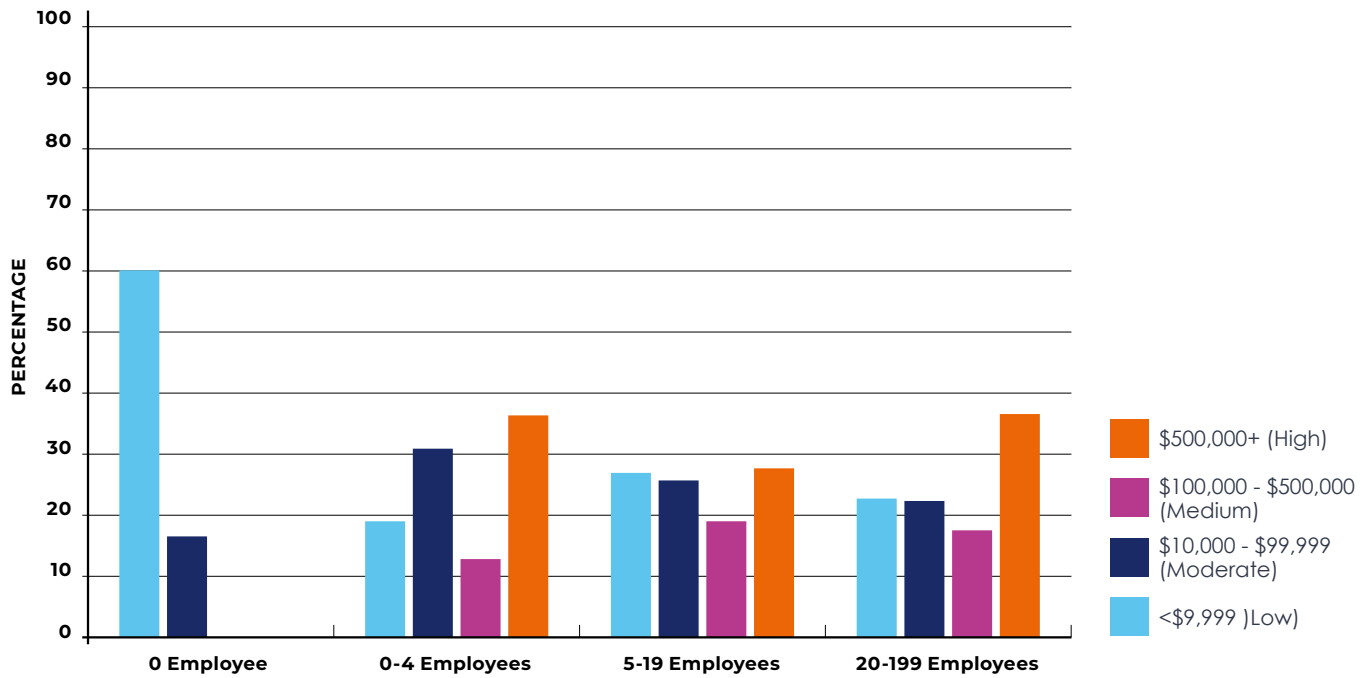


Note: (Total importers N=1176; Total exporters N=653)
Source: Australian Bureau of Statistics BLD CURF, 2009-2013.



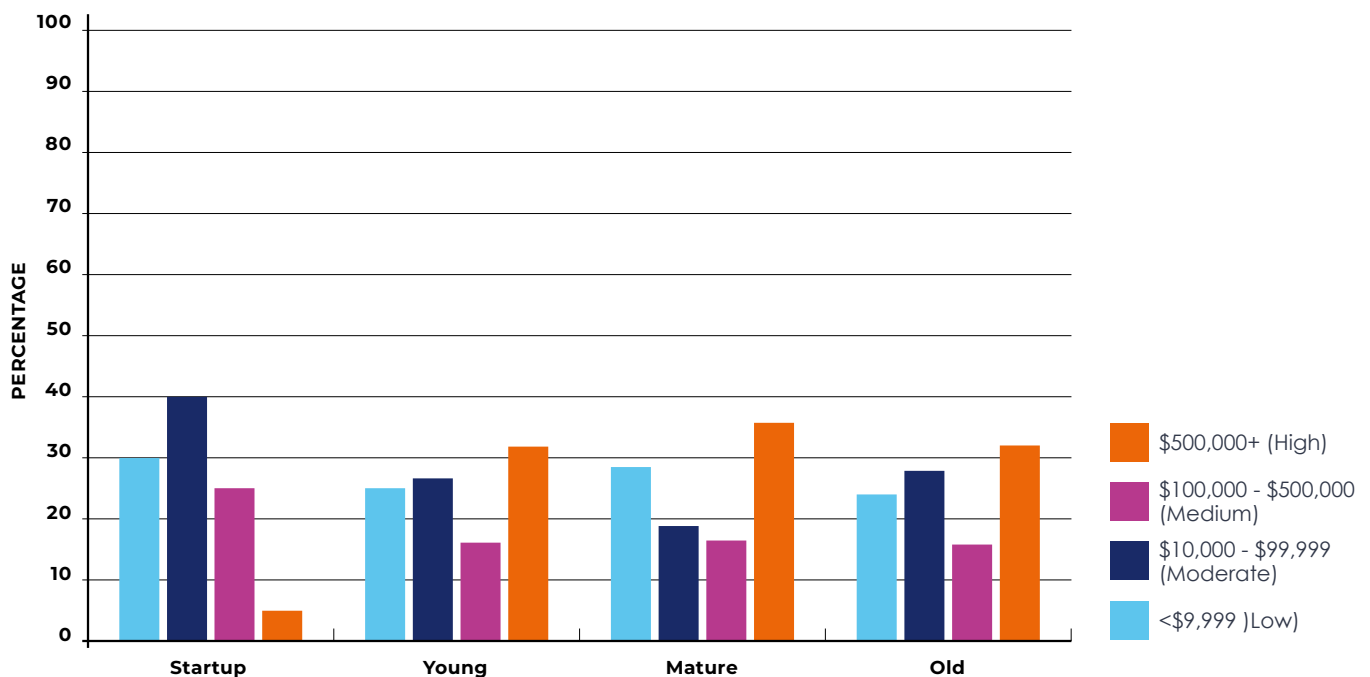
Figure 7:
Import Value and Firm Size, average 2009-2013

(N=1176)



Source: Australian Bureau of Statistics BLD CURF, 2009-2013.

Figure 8:
Import Value and Firm Age, average 2009-2013



Source: Australian Bureau of Statistics BLD CURF, 2009-2013.

Imports were found to increase in firms with more than one employee; and highest among firms with more than 20 employees. Surprisingly, there is little difference in the percentage of micro and medium sized firms that import with the value over \$500,000. These data have to be taken in context as larger SMEs also tended to be more export orientated. However, when compared with the differences in exports by enterprise size, these data are quite stark.

Overall, the majority of Australian firms reported low or moderate value of imports and the amount of import value increased with firm size. However, the relationship between firm age and value of imports was found to be fluctuating: there is no simple pattern by age of enterprise (Figure 8). However, the proportion of SMEs having low and moderate value imports was more dominant in start-ups than among any other age group.

Figure 9 compares the innovativeness of SME exporters and non-exporters. This is classified in terms of introducing new products, operational process, organisational and managerial processes and marketing innovation. Exporters were found to be twice more likely to

introduce new products or operational processes than importers. Similarly, the percentage of SME exporters engaging in organisational processes and marketing innovations were about 30% higher than that of importers. This is consistent with findings in the literature discussed earlier which suggests a positive association between innovation and export.⁶⁹⁹ It also adds weight to the argument that exporting stimulates subsequent improvements in products and processes.

Challenges to internationalisation

The literature suggests that SMEs face a number of internal and external challenges to internationalisation.⁷⁰⁰ The five top challenges include finding customers, lack of skilled staff, regulation in target markets, access to finance, competition and production costs.⁷⁰¹ These are illustrated with a focus on the global wine industry⁷⁰² which highlights the challenges deriving from currency exchange uncertainties, issues of trust and entry barriers that SMEs have to face when diversifying into overseas markets.

For many SMEs, many of the challenges are internal and linked to their size. The most

⁶⁹⁹ Love and Roper (2015).

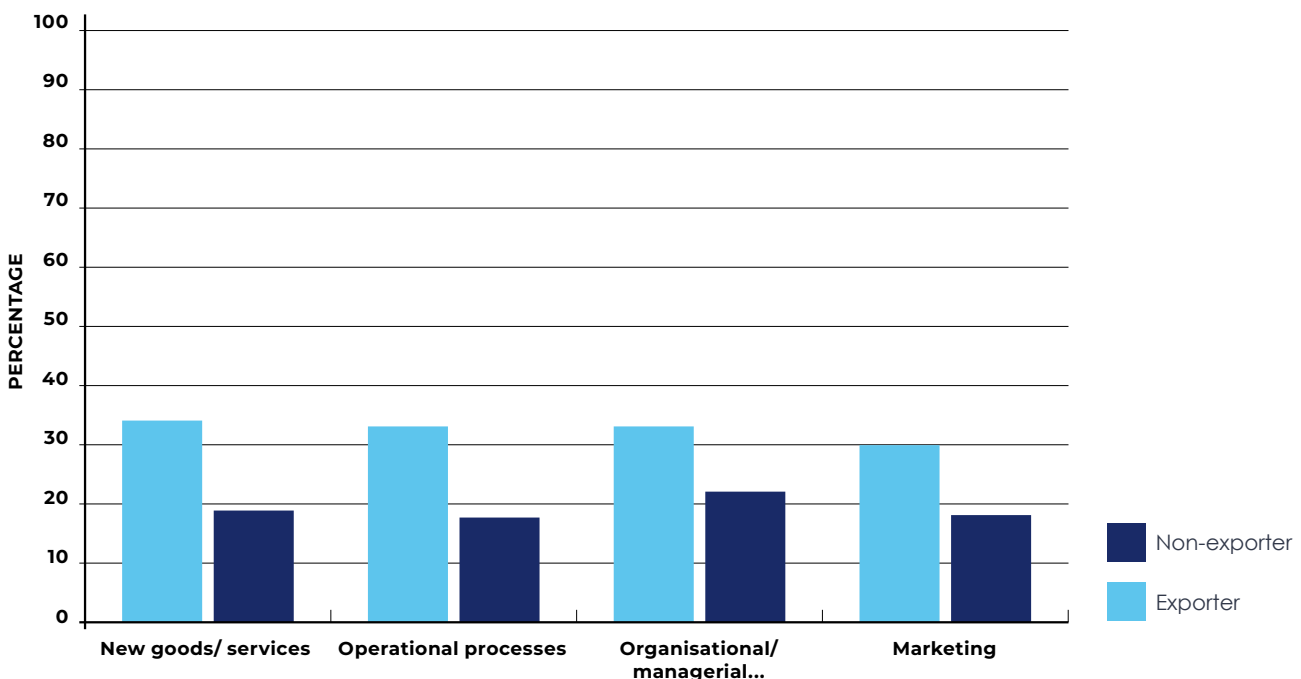
⁷⁰⁰ Ruzzier, Hisrich and Antoncic (2006); Love and Roper (2015); Paul, Parthasarathy and Gupta (2017).

⁷⁰¹ European Commission (2015).

⁷⁰² Duarte Alonso et al (2014).

Figure 9: Innovating and Exporting Enterprises (average 2009-2013)

(N= 7647)



Source: Australian Bureau of Statistics BLD CURF, 2009-2013.



common internal obstacles include firms' limited skills and expertise, their limited financial capabilities, management commitment and confidence, perceived risks as well as product or service quality.⁷⁰³ Many SMEs lack the additional internal financial resources needed to scale-up for exporting and have difficulty raising external funds, or lack of financial guarantee to approach banks and investors or other financiers due to the high risk involved.⁷⁰⁴ For example, new international enterprises face particular problems related to the lack of capital requirements and disadvantages to accessing operating and term loans compared with more established counterparts.⁷⁰⁵ In addition, SMEs are often seen to lack the ability of assessing data and information about foreign markets, which restricts their market access and identification of potential opportunities.⁷⁰⁶

External constraints may include the availability of foreign market information, limited contacts and networks, language and culture barriers, and the foreign business environment including regulations and customs.⁷⁰⁷ Perceived and real challenges deriving from a turbulent political and economic environment, corruption and bureaucracy, and ineffective justice systems in target markets all add to the risks faced by internationalising SMEs. Recent evidence indicates that more than 30% of internationalising SMEs are concerned with payment issues from foreign countries, the added complications of different taxation systems and the lack of market knowledge.⁷⁰⁸

The 2009-2014 ABS *BLD CURF* survey data reveals that approximately 20% of the SMEs within the agriculture and mining industries and 15% in the manufacturing and professional industries identified government regulations or compliance as a major business restriction. Additionally, non-tariff barriers, such as foreign technical standards, licensing and certifications (for example, ISO certification), and a lack of IPR enforcement also impose challenges for SMEs. Many of the fixed compliance costs might not be proportional to the amount traded and the inability of SMEs to spread these costs over large export values, compared to larger firms⁷⁰⁹.

It is clear that SMEs need assistance when looking to internationalise: many SMEs have the potential to

internationalise but are unable to do so because of their lack of financial and human capital and their ability to manage the range of additional potential risks compared with serving domestic markets. Within the SME population itself, there appears to be diversity in the capability to internationalise. Interventions to support SME internationalisation need to be cognisant of these differences to enhance their efficacy and take-up.

703 Blackburn (2016).

704 Love and Roper (2015).

705 OECD (2009).

706 Fletcher and Harris (2012).

707 OECD (2009); EIM (2010); European Commission (2010); Blackburn (2016).

708 European Commission (2015).

709 Cemat, Norman-Lopez and T-Figueras Ana (2014).

Recommendations

This Chapter draws on a range of research literature and Australian official government data to provide a basis for discussion on the performance of Australian SMEs and suggest pointers for Australian policy makers. Certainly, there is much to be done to help Australian SMEs 'raise their game' in the international marketplace. The evidence presented shows a weak international performance by SMEs but also grounds for optimism.

1. Findings from the longitudinal study by the Australian Bureau of Statistics (ABS) suggest the majority of small and young firms are still more domestically oriented, compared with larger firms. In terms of policy interventions, a targeted approach is suggested, aimed at those SMEs that are seeking to internationalise but have not yet done so, and those that are already exporting and are seeking to expand their international reach into additional new markets. Hence, the strategy should be to build upon current successes and to increase the volume of direct exporters. Inevitably, such an approach requires some targeting of different categories of SME with specific types of support.

2. Australian interventions should place more priority on facilitating SME exports in the six most internationally-active industries – including mining, agriculture, manufacturing, wholesale, information media, and professional services. These are the main sectors in terms of generating export revenue for the economy. However, as geographic sales of SMEs vary across sectors, this suggests that a tailor-made intervention for each sector is highly recommended to boost the rate of internationalising SMEs. Tailor-made interventions are much more likely to be relevant and effective and would encourage higher levels of take-up by SMEs.

3. Size and age of enterprise are also important when designing and delivering support measures. As revealed in the longitudinal data (ABS), the significant difference in the level of international involvement between medium-sized and self-employed firms can be attributed to two reasons: their limited resources (which adds costs and risks in engaging internationalisation) and/or their lower levels of motivation to go beyond their

local markets because of their resistance to grow (risk aversion). On the other hand, 'born globals' (who are highly motivated to internationalise) may encounter more challenges in accessing finance, compared with their counterparts, due to the higher risks involved and less-developed networks and lack of experience in the foreign market. Hence, more emphasis should be placed on encouraging small and self-employed firms to participate in foreign markets by providing targeted export incentives, support for networking and international collaboration, business matching opportunities, and facilitating access to finance.

4. Innovation has been acknowledged in literature as a critical factor in enhancing internationalisation. Investment in innovation also contributes to developing competitive advantage for firms to outperform others in the international market, as well as to increase sales revenue. This is consistent with findings of the data collected by the ABS during 2009-2013. Evidence suggests that innovation is more intensive in Australian exporting

SMEs than non-exporters. Hence, support for growth and innovation can be helpful to boost the number of exporters and accelerate their international activities.

5. In the increasingly uncertain global environment, SMEs would benefit from clear guidance and signposting to identify and assess the risks of internationalisation. More support in terms of detailed information provision would be helpful, such as the provision of tailored advice and a mentoring program for firms internationalising in different geographical markets. In-depth discussion forums and network events, such as how to evaluate the impact of Brexit and opportunities for Australian SMEs, challenges emerging from the policies of the Trump Administration for those involved or seeking to trade in the USA, and how to gain best benefits from the TPP agreement, should be offered. This will not only help the government to understand SMEs' needs, but it will also build a bridge between SMEs and policy makers in designing specific instruments to support their internationalisation.

Addendum: Mutual Recognition Agreements and Internationalisation

Will Australian firms benefit?

Mutual Recognition can be defined within several different contexts, but as a starting point, a good simple definition is provided in Wikipedia (a popular search engine) as follows; “A **mutual recognition agreement (MRA)** is an international agreement by which two or more countries agree to recognize one another's conformity assessments. A mutual recognition arrangement is an international arrangement based on such an agreement⁷¹⁰”. The Mutual Recognition Act (1992) in Australia sets out the basic purpose of an MRA which is to reduce inefficiencies and regulatory barriers. A good example of an MRA currently in place is the arrangement between Australia and New Zealand whereby;

- goods that can be lawfully sold in one Australian jurisdiction are sold in other Australian jurisdictions without having to meet additional requirements
- people registered to practise an occupation in one Australian jurisdiction are entitled to practise an equivalent occupation in other Australian jurisdictions.

Thus, put simply, an MRA allows goods or services to be legally sold in more than one jurisdiction without having to satisfy additional legal requirements that can act as a barrier to entry to a particular market. This includes the notion of people practising an occupation in one jurisdiction being entitled to be registered to provide the same service after notifying the local registration authority. Mutual recognition agreements between jurisdictions will have as a key feature the removal of regulatory hurdles in order to ensure that companies or individuals are able to enter a market more quickly than they ordinarily might have when legislative barriers are in place.

It should be noted at the outset that mutual recognition agreements can be struck within a jurisdiction such as Australia between states to improve the ability of businesses and individuals to access markets and also between countries to achieve a similar impact. Mutual recognition arrangements do work and have been successful in benefiting trade, as evidence by academic studies in the area.⁷¹⁰

Mutual recognition between governments in Australia has its genesis in agreements signed between the Australian states and also between the Australian and New Zealand governments during the 1990s. The agreement to pursue mutual recognition between Australian governments was signed in 1992 and the Trans-Tasman Mutual Recognition Arrangement (TTMRA) was signed by the signatories of the Australian MRA and the New Zealand government. These arrangements are subject to detailed periodic review by the Productivity Commission^{711, 712, 713}.

A subsequent review of the mutual recognition agreements by the Productivity Commission in 2015, found that the two main agreements were progressing well but that there were still a series of unresolved issues relating to the aspects of governance of the schemes. Among the specific issues that were identified in this area was what the Productivity Commission referred to as 'shopping and hopping' for registrations in order to find the one where the bar for entry into a trade or profession is set at the lowest. The Commission proposed the following reforms to governance arrangements by:

- strengthening the cross-jurisdictional group of officials that oversees the schemes, including by giving the group more specific outputs, timeframes and reporting requirements
- improving the accountability of regulators in individual jurisdictions and their coordination with policy makers responsible for mutual recognition.⁷¹⁴

Specific measures recommended by the Commission to deal with improving the governance of the mutual recognition schemes at a domestic level were as follows:

- Dealing with any disparities in the registration processes of professionals covered by the agreement by referring concerns to a meeting of the Council of Australian Governments (COAG),

710 Hildegunn Kyvik Nordås (2016) Does mutual recognition of qualifications stimulate services trade? The case of the European Union, Applied Economics

711 Productivity Commission (2003) Productivity Commission Research Report – Evaluation of Mutual Recognition Schemes: 8 October 2003, Australian Government, Canberra

712 Productivity Commission (2009) Productivity Commission Research Report – Review of Mutual Recognition Schemes: 6 February 2009, Australian Government, Canberra

- Ambiguity of schemes for professionals should be reduced and scheme requirements should embed professional requirements for all individuals renewing occupational registration. This includes those that are seeking recognition under mutual recognition,
- Registration bodies should be entitled to conduct their own background checks on persons seeking registration under the mutual recognition agreement, and,
- Governments should update all Ministerial Directions related to equivalence of occupations and consider extending the requirement to New Zealand.

The report also recommended that automatic mutual recognition should be implemented for the recognition of professionals and that the various schemes for mutual recognition should be reviewed at least once every ten years.

The IPA-Deakin SME Research Centre is encouraged by the continuing discussions related to mutual recognition with the New Zealand government as well as discussions with jurisdictions such as the Japan and the United Kingdom. High level discussions regarding the ability of professionals to have their qualifications recognised is vital in an era where professionals with transferable skills are seeking employment in other jurisdictions. The underlying policy goal must always be the provision of recognition for those who have appropriately qualified in their own jurisdiction as professionals. Australia would then be in a position to provide reciprocal recognition for suitably qualified professionals from jurisdictions with which an agreement has been struck.

One way of achieving something akin to The Trans-Pacific Partnership, which was signed in January 2018, is an agreement that lays down foundations for the opening of trade channels into markets in which Australia has not previously had a presence. The agreement embeds the objectives of 'breaking down the barriers' in certain markets by ensuring business operating in a range of industries are able to sell into overseas markets thus greatly supporting growth initiatives. The TPP also provides for accounting firms and other professional services firms based in Australia to be recognised for the purposes of tendering for government work in several jurisdictions that were previously not open for this purpose to

Australian organisations. The countries specifically covered by the TPP in this area include Brunei Darussalam, Canada, Malaysia, Mexico and Vietnam. Other services for which markets are being opened by the TPP, according to the Department of Foreign Affairs and Trade (DFAT), include:

- Accounting, auditing and taxation services in Brunei Darussalam, Canada, Malaysia, Mexico and Vietnam;
- Management consulting services in Brunei Darussalam, Malaysia and Mexico; computer and related services offer by all Parties, along with maintenance of office machinery in Brunei Darussalam, Canada, Malaysia, Mexico and Vietnam;
- Architectural engineering and other technical services in Brunei Darussalam, Canada, Malaysia and Mexico;
- Land and water transport services in Brunei Darussalam and Malaysia;
- Telecommunication and related services in Brunei Darussalam, Canada and Malaysia;
- Environmental protection services in Brunei Darussalam, Canada, Malaysia, Mexico and Vietnam; education services in Brunei Darussalam, Canada, Japan, Malaysia and Mexico; and
- Health and social services in Brunei Darussalam and Malaysia.

The TPP agreement represents greater access for certain professional firms in countries within our region, namely Malaysia and Vietnam.

The signing of any trade agreement, however, may not be the end of the matter when it comes to the recognition of the export of services. Work undertaken by the Productivity Commission in 2015⁷¹⁵ that examines barriers to growth in the area of service exports, explains that trade agreements may be the first step. Other measures such as mutual recognition agreements may be necessary in order to ensure that measures outlined in principle in trade agreements are appropriately acted upon by each jurisdiction.

713 Productivity Commission (2015) Productivity Commission Research Report – Mutual Recognition Schemes: 25 September 2015, Australian Government, Canberra

714 Productivity Commission (2015) Productivity Commission Research Report – Mutual Recognition Schemes: 25 September 2015, Australian Government, Canberra

715 Productivity Commission (2015) Productivity Commission Research Report - Barriers to Growth in Service Exports: November 2015, Australian Government, Canberra

Case study 1: Edible Blooms – a successful online business (Australia)

Founded in 2005, Edible Blooms¹ is a family business owned by sisters, Kelly Jamieson and Abbey Baker. From a small commercial kitchen and online store, the company has grown to a team of 50 employees in seven locations across Australia and New Zealand. Edible Blooms is now one of Australia's largest networks of gift delivery stores. Their products include gourmet chocolate bouquets, fresh fruits bouquets and hand-made gift designs.

The key to success

Use of technology

Edible Blooms' business concept is to grow fast from day one. Edible Blooms utilises the cloud-based business system to develop a strong online presence. Kelly commented "cloud-based systems allowed me to be on the go and work in different locations and to keep moving forward. I also made sure that I had a fully transactionable website from day one. Looking at the financials for the business and the cost of rent in capital cities, it made sense to locate our premises near our suppliers and focus our marketing online"⁷¹⁶.

Edible Blooms takes advantages of Telstra technology solution⁷¹⁷ which enables the company to find customers online, responding faster, and improving the customer experience. The company also uses management software provided by Deputy (<https://www.deputy.com/>) and an invoice processing management system supported by Shoe-boxed company.

Focus on quality

Kelly places high priority on the quality of their products and services:

We have a genuine approach to giving it a go and trying new things. At the same time, I believe one of the keys to success with a small business is quality and consistency. This is really important for ensuring that customers have peace of mind, especially when transacting online.

This value has been embedded well into their business. Kelly estimates 60% of their turnover come from returning customers.

Use of digital marketing and social media

Digital marketing and social media play an important role in Edible Blooms' marketing strategy. The company uses digital marketing such as Google Adwords, email marketing, and utilising marketing campaigns to find customers and social media such as Facebook and Twitter and engage customers. Kelly commented:

Trust me, I understand the time and financial constraints business owners are under. But with the technological resources now available, it's possible to get a fantastic return on investment from modest inputs. Over the last five years Edible Blooms has been averaging double-digit growth with social media marketing playing a big part in that. Yet I've got precisely one employee handling all Edible Blooms' social communications, albeit with team members in outlets around Australia and New Zealand contributing ideas and content.⁷¹⁸

⁷¹⁶ According to Edinburgh group (2012) "Growing the global economy through SMEs", report.

⁷¹⁷ <https://www.telstra.com.au/small-business/latest-offers/doyourthing>

⁷¹⁸ <https://business.nab.com.au/making-business-bloom-social-media-22230/>

Case study 2: Drilling Systems – scaling up with working capital support (UK)

Founded in 1988 in Bournemouth, Drilling Systems is a leading global supplier of drilling simulator systems and software. The company has grown to deliver more than 1000 training simulators across 50 countries. With the help of UK Export Finance⁷¹⁹, Drilling Systems have won a \$1 million contract with Pan American Energy – an Argentine based firm specialising in oil and gas exploration and production, to scale up its training capabilities.

Export working capital scheme

The initiative was launched by UK Export Finance (UKEF), aiming to assist UK based exporters in gaining access to working capital finance both pre- and post-shipment in respect of specific export related contracts. There is no minimum or maximum value for the working capital facility. The scheme provides partial guarantees to lenders to cover the credit risks associated with export working capital facilities. Where a lender provides such a facility in respect of a UK export related contract, UKEF can guarantee up to 80% of the risk. This enables UK exports to have an opportunity to win an overseas contract that is higher in value than they can typically fulfil.

Additionally, the scheme can be applied directly via main banks in the UK such as Barclays, HSBC, Lloyds Banking Group, Bank of Scotland, the Royal Bank of Scotland, National Westminster Bank, Ulster Bank, and Santander UK Plc.

In order to secure a \$1 million contract with Pan American Energy, Drilling Systems has taken advantage of the Export Working Capital Scheme provided by UK Export Finance, to help it to prepare for an initial significant investment. This has enabled the company to have a bank funded working capital facility of £375,000.

The Chief Financial Officer of Drilling Systems, Stephen Dines commented:

UKEF's Working Capital scheme was instrumental in enabling us to significantly scale up our activity with Pan American Energy. This opportunity enabled us to substantially increase revenue, strengthen our presence in Latin America and lay groundwork for further phases of business.⁷²⁰

⁷¹⁹ UK's export credit agency and a ministerial department of the UK government

⁷²⁰ <https://www.gov.uk/government/case-studies/bournemouth-based-firm-strengthens-its-presence-in-latin-america>

Case study 3:

Global Diagnostic – Enterprise Ireland (Ireland)

Global Diagnostics is an international telemedicine enterprise, specialising in diagnostic imaging. Initially founded in 1995 in Western Australia, the founder and chairman, Dr Johnny Walker (no relation), started to expand his business to Ireland in 2007. The company provides a service whereby patient scans can be sent digitally from anywhere around the world for expert medical assessment by trained radiologists, with the aim of greatly speeding up the time to diagnose and treat potential problems. Since relocating to Ireland, the company has grown substantially and now operates across Australia, the UK and Ireland.

The key success: networking

Walker originally brought the business to Ireland via a joint venture with Centric Health, which saved the business lots of costs and efforts for a new start-up in a foreign market. Ireland's generous 12.5 % corporate tax rate was one of the incentives for Walker to choose this market, in addition to sources of investment funds for growth available in Ireland.

As an Australian, Walker's challenge was to plug in to the indigenous business community. With the help of Enterprise Ireland, he has opportunities to expand his networking in Ireland, having the right contacts and meeting right people that make the business work. "As an Aussie coming to Ireland, from a social point of view it was fantastic", said Walker. Through Enterprise Ireland (the government organisation responsible for the development and growth of Irish enterprises in world markets), Walker was invited to attend the class of 2009 Leadership4Growth mentoring program at Stanford University in the US, which put him among a group of like-minded entrepreneurial CEOs who remain in contact to this day.

"That's where I've been blessed. The Stanford program put me among my own, and we all rally to support each other," he says.

"They talk about six degrees of separation but in Ireland that's more like half a degree; you all know each other. There's huge upside from a business perspective in terms of the network that you can build very rapidly".⁷²¹

⁷²¹ <https://www.enterpriseireland.com/en/Start-a-Business-in-Ireland/Startups-from-Outside-Ireland/Case-Studies/Global-Diagnostics.html>



Chapter Eleven

SME owners' mental health

Professor George Tanewski & Professor Andrew
Noblet: Deakin University



SME owners' mental health and performance

The state of mental health among SME owners in Australia

A growing body of evidence indicates that SME owners are particularly vulnerable to experiencing high levels of job stress, burnout and depression.⁷²²

Research involving a small sample of Australian-based SME owners found that more than one in three respondents (37%) reported high or very high levels of psychological distress.⁷²³ More recent research focusing on mental ill-health among SME owners indicated that the proportion of participants reporting 'moderate' to 'extremely severe' levels of depression and anxiety was higher than that found in the general population. In the case of anxiety, for example, the proportion of participants reporting 'severe' to 'extremely severe' was double that reported in the national data.⁷²⁴

Given the far-reaching consequences of work-related strain (e.g. productivity, impaired functioning, follower distress, relationship breakdown) coupled with the critical role played by SMEs in the Australian economy, the high levels of strain among small business owners represents a serious workplace health issue and a major impediment to sustained business and overall economic success.

The heightened levels of stress experienced by small business owners has been attributed to a range of work and non-work factors, including long working hours, financial pressures, isolation, the obligation to work when sick, family and relationship problems, and work-family/life conflict.⁷²⁵ However, dealing with these stressors is compounded by owners' unique position in the organisation. Being the most senior member of the organisation, and having ultimate responsibility for the fortunes of the firm, has been shown to impede the help-seeking behaviours of owners, undermining their ability to form open and mutually-supportive relationships with their employees.⁷²⁶

While support from internal sources may be limited, information, guidance and other support provided by external sources may play a key role in protecting and promoting the wellbeing of small business owners. Accountants are a widely trusted and particularly important source of support for SME owners, as their overall business and financial expertise is sought on a regular basis. Clients therefore often develop a trusting, long-term relationship with their accountant.⁷²⁷

Anecdotally, there are also signs that the technical and moral support provided by accountants may prevent or reduce the impact of financial and business-related stressors, although there's a dearth of scholarly research examining this relationship.

An area that is particularly under-researched is the types of support offered by public accountants and the extent to which these can mitigate the work-related (e.g. business failure, financial pressures, work-family conflict) and non-work-related stressors (e.g. relationship breakdown, drug and alcohol misuse, mental health concerns) experienced by SME owners.

Indeed, the role of accountants is evolving towards a greater emphasis on business mentorship and guidance. There are, therefore, ample opportunities for integrating mental health promotion messages with more wholistic business and financial planning services.⁷²⁸

Pilot project

As briefly mentioned above, the IPA-Deakin SME Research Centre is currently working on a (pilot) project with the Institute of Public Accountants (IPA) and a group of researchers from Deakin University's Centre for Employee and Consumer Wellbeing (CECW) aimed at examining the role of accountants in supporting the mental health and performance of SME owners.

The primary objectives of the pilot project are to gauge the levels of wellbeing (i.e. psychological distress, burnout), performance (i.e. adaptive performance, perceived effectiveness), and help-seeking opportunities among a sample of SME owners recruited via the IPA and its members, with the aim of:

- identifying the types of business and non-business support that SME owner clients receive from their accountants

⁷²² Cocker et al (2012, 2013); iCare and Everymind (2017).

⁷²³ Cocker et al (2013).

⁷²⁴ iCare and Everymind (2017).

⁷²⁵ Naughton et al (1987); Rauch and Frese (2007); Prottas and Thompson (2006); Everymind (2017).

⁷²⁶ Rahim (1996); Tetrick et al (2000).

⁷²⁷ Blackburn, Carey and Tanewski (2018); Carey and Tanewski (2016); Storey (2016).

⁷²⁸ Blackburn, Carey and Tanewski (2018); Carey and Tanewski (2016); Storey (2016).

- assessing the extent to which accountant support can moderate the influence of job stressors on the wellbeing and performance of SME owners.

Outcomes of pilot project

The above-mentioned pilot project will provide insights on the role that accountant support can play in combating the stressors commonly experienced by SME owners. More importantly, the pilot will assist in developing and validating scales designed to measure the common sources of stress experienced by SME owners and the types of business and non-business support provided by accountants.

This is an important outcome, as these scales will be utilized by the IPA-Deakin SME Research Centre in future planned national studies examining the role of accountants and business advisors in buffering the stressors experienced by SME owners.

A national survey of Australian SME firms will, on the one hand, measure levels of wellbeing, performance and help-seeking opportunities among SME owners across Australia. It will also assess the extent to which the support provided by accountants and business advisors can moderate the influence of job stressors on the psychological health and performance of SME owners.

On the other hand, a national survey of accountants and business advisors will establish the levels of business and non-business support that accountants typically provide their SME owner clients. It will also assess the degree to which these levels match those perceived by owners, and will examine the willingness and capacity of accountants and business advisors to encourage SME owner clients to seek help if they recognize that the owner may be experiencing mental health issues.

The national survey of accountants and business advisors will be developed in conjunction with Deakin's Centre for Innovation in Mental and Physical Health and Clinical Treatment (IMPACT) and will include scales aimed at assessing levels of mental health literacy (e.g. recognising the symptoms of depression) and mental health stigma (e.g. a person with depression can 'snap out' of the problem if they wanted to) among accountants, as well as measuring their willingness to assist people showing signs of depression, anxiety or other mental health problems.⁷²⁹

Headline findings and recommendations

As this chapter is based on research that is ongoing and still in progress, the IPA-Deakin SME Research Centre is unable to provide details on findings or recommendations at the time of writing.

The Centre is of the view, however, that mental health and wellness is a significant area of concern for all businesses, not just SMEs. In this sense, we feel a responsibility to inform readers of the extent of mental health issues impacting SMEs and their advisers.

We also believe it is important to articulate the current work undertaken by the Centre to identify the real mental health issues impacting IPA members and their clients, and the potential mechanisms that can be utilized to address these issues and assist businesses, their owners and advisers in their struggle to cope with day-to-day mental health issues.

Participant responses to the accountant survey will be particularly useful for informing the mental health and wellbeing resources that will be developed for accountants at a later stage. These resources will be aimed at enhancing the capacity of accountants and business advisors to better support the needs of SME owners to reduce distress and disability. They will be developed in conjunction with relevant stakeholders (including the accounting associations, small business groups, mental health providers and OHS authorities) and will comprise a package of professional development and awareness-raising activities.

Chapter Twelve

Cybersecurity

Professor Matthew Warren, Dr Nick Mroczkowski & Dr Geoff Speight: Deakin University

Cybersecurity and Australian SMEs

A good definition of cybersecurity is provided in the ASBFEO report.⁷³⁰ It is simply explained as those policies and measures that are implemented to prevent theft, fraud, misappropriation or loss of corporate data; which could, in turn, prevent the disruption of computer systems and any potential interference with the normal operations of the entity. In the event of a failure of these policies and procedures, cybersecurity also encompasses methods to mitigate the losses and expeditiously restore the functionality of disrupted systems.

Headline findings

Given the alarming findings tabled in the report *Cyber Security: Small Business Best Practice* by the Australian Small Business and Family Enterprise Ombudsman (2017)⁷³¹, which are not dissimilar to the findings of the IPA-Deakin SME Research Centre, we reiterate the following ASBFEO key findings, which we fully endorse and which we believe need constant reinforcement within small business and SME communities.

- Small business is the target of 43% of all cybercrimes.⁷³²
- 60% of small businesses that experience a significant cyber breach go out of business within six months.⁷³³
- 22% of small businesses that were breached by the 2017 Ransomware attacks were so affected they could not continue operating.⁷³⁴
- 33% of businesses with fewer than 100 employees don't take proactive measures against cybersecurity breaches.⁷³⁵
- 87% of small businesses believe their business is safe from cyberattacks because they use antivirus software alone.⁷³⁶
- Cybercrime costs the Australian economy more than \$4.5 billion annually.⁷³⁷

⁷³⁰ Australian Government: Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2017).

Large organisations may have the resources to deal with cybercrime. SMEs face much the same threats, but may not have the mitigating resources of larger firms. Most solutions for cybercrime require the deployment of a level of resources and expertise beyond the scope of SMEs. Even the use of outside consultants or technical experts is beyond the financial resources of many small SMEs.

The well-respected Gartner Group has forecast that cybersecurity spending worldwide will reach \$96 billion in 2018.⁷³⁸ This staggering sum reflects the urgent need for governments and businesses to protect their computer systems from malicious attacks in the current environment.

This chapter of the white paper will focus on cybersecurity issues now confronting Australian SMEs and, in some cases, posing serious threats and potential disruptions to normal operations. It is based on research undertaken by the OECD and reports commissioned by the Australian Government (Refs to be inserted).

Cybersecurity has been recognised as one of the most serious threats to all businesses, not just SMEs. Indeed, any person living in a technology or cyber-based environment is potentially impacted by cybersecurity threats. Accordingly, the IPA-Deakin SME Research Centre includes cybersecurity and related topics as major items on its ongoing research agenda.

Background – types of risk

An Australian government website, Stay Smart Online (<https://www.staysmartonline.gov.au/>), provides important information relating to cybersecurity.⁷³⁹ Almost daily reports of cyberattacks indicate the level of threats faced by every business and person exposed to the cyber-environment.

It is widely acknowledged that cyber-threats are becoming both more numerous and more sophisticated. SMEs are not immune to a wide range of cyber-threats. One US industry survey lists the top 10 hacking methods used to compromise computer systems⁷⁴⁰ as shown in **Table 1**.

The above findings indicate that the most common threat is social engineering, which is a process that cybercriminals use to psychologically manipulate an unsuspecting person into divulging sensitive details (such as login passwords) through the use of many different techniques; including phishing, identity theft and spam.⁷⁴¹ Social engineering often involves convincing employees to disclose confidential information such as



Table 1:
SMEs Geographic Markets (multiple response)

Hacking method	Percentage
Social engineering (e.g. phishing)	81%
Compromised accounts (e.g. weak passwords)	62%
Web-based attacks (e.g. SQL/command injection)	51%
Client-side attacks (e.g. against doc readers, web browsers)	33%
Exploit against popular server updates (e.g. OpenSSL, Heartbleed)	23%
Unmanaged personal devices (e.g. lack of BYOD policy)	21%
Physical intrusion	15%
Shadow IT (e.g. users' personal cloud-based services for business purposes)	11%
Managing third party service providers (e.g. outsourced infrastructure)	9%
Take advantage of getting data put to the cloud (e.g. IAAS, PAAS)	6%

Source: Balabit (2015), Black Hat Survey Results: Know Your Enemy from the TOP 10 Most Popular Hacking Methods.

login details or convincing employees to click on email links that install software that allows cybercriminals to take control of the user's computer.

Taking control of a single computer may allow the cybercriminal to access all the computers on the network and pillage intellectual property or transfer funds out of the company's bank accounts.

Cybercriminals often use publicly available information on social media sites such as Facebook profiles to target users and develop strategies to convince targets of the legitimacy of emails or other forms of communication which are in fact malicious and infected.

Of increasing prevalence is the use of social engineering to introduce ransomware into a computer system. When ransomware is inserted into a computer, it typically encrypts all the data, making that data inaccessible to legitimate users. To regain access to their computer data, businesses must pay a ransom, often in untraceable bitcoins or some other cryptocurrency. In December 2013, ZDNet estimated, based on Bitcoin transaction information, that between 15 October and 18 December 2013 the operators of a version of ransomware called CryptoLocker had procured about US\$27 million from infected users.⁷⁴²

In a recent report closer to home (Telstra, 2018), three-quarters of Australian businesses (with 50 employees or more) were hit by a ransomware attack in the past year, with the study also finding that 31% of Australian respondents reported experiencing ransomware attacks on a weekly or monthly basis.⁷⁴³ Further research undertaken by IBM has found that cybercriminals are shifting their focus from stealing data to ransomware attacks.⁷⁴⁴

Yet another report, published by Cybersecurity Ventures, predicts that ransomware damage costs will exceed \$5 billion in 2017, up more than 15 times from 2015.⁷⁴⁵ In addition, global damage in connection with ransomware attacks is predicted to reach \$11.5 billion annually by 2019.⁷⁴⁶

The costs include damage and destruction (or loss) of data, downtime, lost productivity, post-attack disruption to the normal course of business, forensic investigation, restoration and deletion of hostage data and systems, reputational harm, and employee training in direct response to the ransomware attacks.⁷⁴⁷

Research by the Federation of Small Business (FSB) in the UK found that two thirds of FSB members have been a victim of cyber-crime in the period between

731 Australian Government: Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2017).

732 Sophy (2016).

733 Testimony of Dr Jane LeClair, Chief Operating Officer, National Cybersecurity Institute at Excelsior College, before the US House of Representatives Committee on Small Business (22 April 2015), available at <<http://docs.house.gov/meetings/SM/SM00/20150422/103276/HRG-114-SM00-20150422-SD003-U4.pdf>>; Mansfield (2017).

734 Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2017a).

735 Telstra (nd).

736 MYOB (nd).

737 Acumen Insurance Brokers (2017).

738 Gartner (2017).

739 <https://www.staysmartonline.gov.au>

740 Balabit (2015).

741 Gosafeonline (2017).

742 Blue (2013).

743 Redrub (2018).

744 IBM News (2018).

745 Morgan (2017).

746 Morgan (2017).

747 Morgan (2017).

748 FSB (2016).

749 Leyden (2016).

750 Leyden (2016).

751 <https://www.statista.com/statistics/272014/global-social-networks-ranked-by-number-of-users/>. Accessed 26 April 2018.

752 <https://www.cybersecurityintelligence.com/blog/social-media-sites—cyber-weapons-of-choice-1692.html>

753 <https://www.cybersecurityintelligence.com/blog/social-media-sites—cyber-weapons-of-choice-1692.html>

754 <https://www.cybersecurityintelligence.com/blog/social-media-sites—cyber-weapons-of-choice-1692.html>

755 <https://www.workplacelawandstrategy.com.au/2014/02/social-media-in-the-workplace-the-good-and-the-bad/>

756 <https://www.asd.gov.au/publications/protect/using-social-media.htm>

757 McRae (2017).

2014 and 2016, with the attacks costing an average of £3,000 per business.⁷⁴⁸ Moreover, almost 48% of Britain's small businesses were hit by cybercrime in the last year (2016), with 10% targeted many times.

Despite the findings above, only one in five see cybersecurity as a business priority, and just 15% are confident that they have adequate measures in place to prevent cybercrime, according to a Barclaycard-sponsored study.⁷⁴⁹ Ten per cent of the 250 small businesses surveyed have never invested in improving website security.⁷⁵⁰

Social media and cybersecurity

Social media has become a series of services (Facebook, LinkedIn, Weibo, WeChat etc) connecting very large numbers of people. Current estimates suggest there are approximately 2.2 billion active accounts on various social media platforms⁷⁵¹.

Data shows that consumers implicitly trust people's activity on social media more so than on any other communications channel⁷⁵². This implicit trust results in many users sharing much about their personal lives on platforms such as Facebook. Cybercriminals often exploit such information-sharing, with a view to mounting attacks against users. If those users are surfing from corporate computers, the cybersecurity of those computers can be compromised, placing the whole corporate network at risk.

LinkedIn was a key tool for reconnaissance (the scraping of public

social data and social engineering tactics) for cybercriminals who executed Anthem Health's 2015 breach and its 80 million stolen records⁷⁵³.

PricewaterhouseCoopers found that more than one in eight enterprises suffered a security breach due to a social media-related cyberattacks⁷⁵⁴. Moreover, banning employees from social media sites has proven to be ineffective⁷⁵⁵. To protect their networks, organisations need to create a security-aware culture, one in which employees understand the potential risks of using social media, particularly at work.

There are basic steps employers can suggest that employees take, such as limiting what outsiders are able to find out about them by considering the security implications of the information they share. Security is also enhanced if users refuse friend requests from people they don't know and, most importantly, avoid clicking on unknown links in pages or messages they receive.

Given the implicit trust noted above, it is not an easy task to convince employees of the need for these security measures. The Australian Government's Defense Signals Directorate has produced a series of measures to protect against this cybersecurity threat. It largely focuses on user education, as noted above⁷⁵⁶.

Figure 1, sourced from an excellent study by McRae,⁷⁵⁷ provides a useful guide for non-technical executives on how survive the cyber-attack battleground.

Figure 1: Surviving the rise of cybercrime – a non-technical executive guide



205
BILLION
emails are sent every day



2/3
of all emails are spam



91%
of cyber attacks start with an email



\$276
THOUSAND
is the average cost of a cyber attack to a business

Source: McRae, J (2017), Infographic: Counting the costs of cybercrime, Mail Gard Blog, 18 May 2017. <<https://www.mailguard.com.au/blog/infographic-counting-the-costs-of-cybercrime>>. Accessed 18 April 2018.

Why is it important for the SME community to understand cybersecurity?

As explained in other chapters of this white paper, SMEs are among the biggest contributors to Australia's growth and prosperity. If we defer to the Australian Bureau of Statistics definition of SMEs (i.e. as businesses that have fewer than 200 employees, with medium-sized businesses employing 20–199 staff and small businesses employing fewer than 20 staff),⁷⁵⁸ SMEs account for more than 95% of active businesses by number and employ more than 70% of the nation's workforce.⁷⁵⁹ Moreover, they contribute more than A\$480 billion to the national economy.⁷⁶⁰

More recent statistics also show that the vast majority (over nine in ten) of Australian businesses are small businesses. They account for 33% of Australia's GDP, employ over 40% of Australia's workforce and pay around 12% of total company tax revenue.⁷⁶¹

SMEs have adopted technology and internet usage at increasingly higher levels over time and are now approaching saturation level. As shown in **Figure 2**, SME internet access increased from 82.9% in 2006 to 95.5% in 2013. While current data on usage is unavailable, a general extrapolation of this increasing trend would suggest even more reliance on the internet. Greater reliance on the internet by SMEs

concomitantly and exponentially increases the risk of the threats of cyberattacks.

Figure 2 utilises two separate datasets obtained from the Australian Bureau of Statistics (ABS) and the Business Longitudinal Database (BLD) Confidentialised Unit Record File (CURF) over an eight-year period for the financial years 2006-07 to 2013-14.

The BLD panels are from two survey sampling frames (two separate cohorts of SMEs) developed by the ABS, which represent the population of some 1.26 million Australian SMEs in June 2007 and about 919,000 SMEs in June 2010. The first panel contains data for a sample of 3,075 or 15,375 firm-years' actively-trading SMEs over five reference periods from 2006-07 to 2010-11, while the second panel contains data for a sample of 2,011 or 10,055 firm-years' actively-trading SMEs over five reference periods from 2009-10 to 2013-14, resulting in 25,430 firm-year observations.

With this near-universal access to the internet, it is becoming increasingly easier to move a business online. One current national television advertisement in Australia suggests that an online store can be established in under an hour, with no coding required.⁷⁶² The site has a number of techniques available to enhance cybersecurity⁷⁶³, but all require additional steps that add to the complexity of site setup and are not mandatory.

⁷⁵⁸ Department of Innovation, Industry, Science and Research (DIISR) (2012).

⁷⁵⁹ MacGregor and Kartiwi (2010).

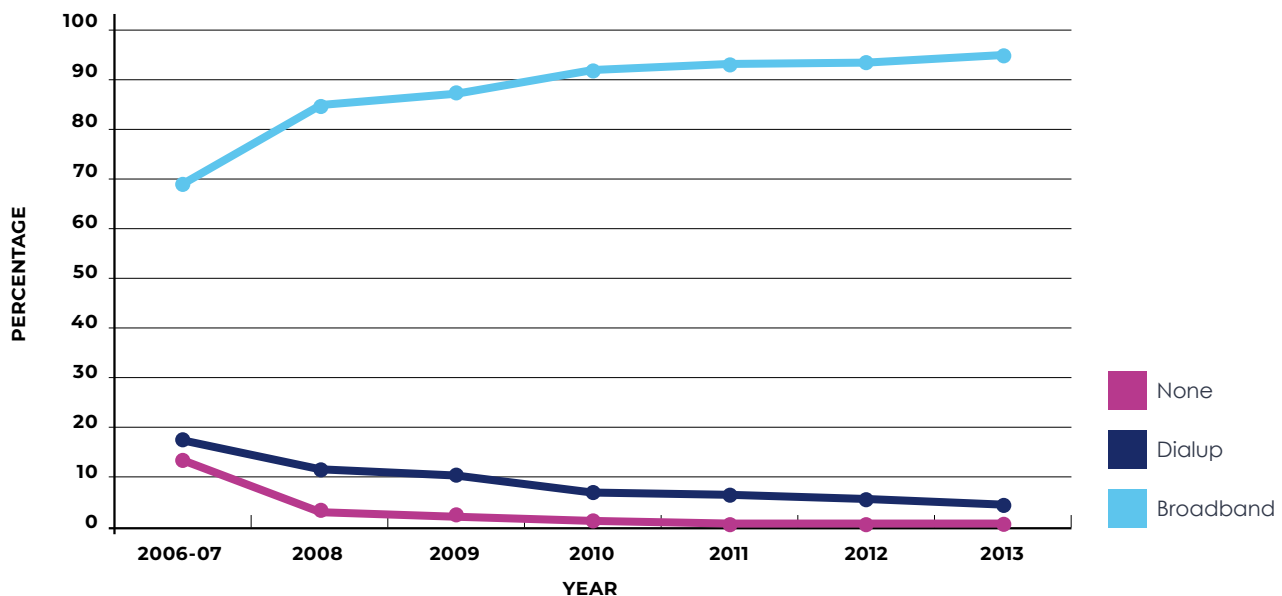
⁷⁶⁰ Department of Innovation, Industry, Science and Research (DIISR) (2012).

⁷⁶¹ Australian Government (2016a).

⁷⁶² Meagher (nd).

⁷⁶³ <https://au.godaddy.com/web-security#secure>. Accessed 18 April 2018.

Figure 2:
Australian SME internet access



Source: Australian Bureau of Statistics (2006-11) and Australian Bureau of Statistics (2010-14).

Cybersecurity in the Australian context

Cybersecurity is about protecting technology and information from accidental or illicit access, corruption, theft, loss or damage (Australian Government, 2018). In 2016, the Australian Government developed a new national cybersecurity strategy for Australia. The strategy was broken down into the following key areas:⁷⁶⁴

- **A National Cyber Partnership.** Development of joint new national cyber partnership. The Australian Government and business leaders will jointly drive Australia's cybersecurity, setting the strategic agenda through annual cybersecurity meetings. This partnership focuses on the needs of larger businesses.⁷⁶⁵
- **Strong Cyber Defences.** Improving Australia's capabilities to detect, deter and respond to cybersecurity threats and better anticipate risks.
- **Global Responsibility and Influence.** Australia will work with its international partners to champion an open, free and secure internet. Most cybercrime targeting Australians originates overseas, so the government will partner with international law enforcement, intelligence agencies and other computer emergency response teams.
- **Growth and Innovation.** Cyberspace presents enormous opportunities for all Australian organisations. The government's commitment to cybersecurity will help businesses to diversify and develop new markets, laying the foundations for a prosperous future.
- **A Cyber Smart Nation.** Underpinning the success of the other themes in the strategy is Australia's commitment to addressing the critical shortage of skilled cybersecurity professionals.

In relation to SMEs, the national strategy includes a strategy specific to SMEs.⁷⁶⁶ The SME strategy is stated as follows:

- **Strategy.** Support SMEs to have their cybersecurity tested.
- **Aim.** SMEs often find it challenging to allocate resources to develop and implement cybersecurity measures effectively. Without adequate cybersecurity measures in place, SMEs can become the soft underbelly or back-door medium for accessing connected organisations. The federal government will provide support for small businesses to

have their cybersecurity measures tested by certified practitioners.

- **Planned Outcomes.** The planned outcomes of the strategy include the following:
 - support SMEs to have their cybersecurity risks tested by CREST Australia New Zealand accredited providers (CREST Council of Registered Ethical Security Testers Australia New Zealand)
 - Australian SMEs have access to accredited experts to assess their cybersecurity status, helping them to take responsibility for the security of their own networks
 - assist Australian SMEs to understand their potential cybersecurity vulnerabilities and where to find trusted cybersecurity advice
 - ensure that Australian SMEs are empowered with the knowledge they need to make considered cybersecurity investments to protect their business in the long term
 - assist large firms and SMEs to increase trust in the connections they have with each other.

Cybersecurity and SMEs – further Australian evidence

In 2015, the Australian Government commissioned a study focusing upon the impact of cyberattacks on SMEs (*Stay Smart On-Line*).⁷⁶⁷ The government has defined a cyberattack as a deliberate act through cyberspace to manipulate, disrupt, deny, degrade or destroy computers or networks, or the information resident on them, with the effect of seriously compromising national security, stability or economic prosperity.⁷⁶⁸

In the period between 2014 and 2015, 693,053 cyberattacks had occurred against Australian organisations in a year. Of these Australian organisations, 60% were SMEs.⁷⁶⁹

The *Stay Smart Online 2015* study also, for the first time in Australia, highlighted the financial impact of the different types of cyberattacks, with the figures based upon a single attack.⁷⁷⁰

The figures per attack are stated as follows:

- Denial of service **\$180,458**
- Web-based attacks **\$79,380**
- Malicious insider **\$177,834**
- Malicious code **\$105,223**
- Phishing and social engineering **\$23,209**
- Malware **\$458**
- Stolen devices **\$13,044**
- Virus, worm or trojan **\$421**
- Botnet **\$867**

⁷⁶⁴ Australian Government (2016b).

⁷⁶⁵ Australian Government: CERT Australia <<https://www.cert.gov.au/jcsc>>. Accessed 18 April 2018.

⁷⁶⁶ Australian Government (2016b).

⁷⁶⁷ Australian Government (2015a).

⁷⁶⁸ https://www.acsc.gov.au/publications/ACSC_Threat_Report_2016.pdf

⁷⁶⁹ Australian Government (2015a).

⁷⁷⁰ Australian Government (2015a).



More recent studies indicate the total cost of a single ransomware attack in Australia⁷⁷¹ now has a median total cost of \$133,000. This extends beyond any ransom demanded and includes downtime, manpower, device cost, network cost, and lost opportunities. Five percent of those surveyed reported a \$1.3 million to \$6.6 million total cost.⁷⁷²

The *Stay Smart Online 2015* study⁷⁷³ also highlighted the time to recovery following a cyberattack. The average time to resolve a cyberattack is 23 days and this time increases to 51 days if the attack was a malicious insider, employee or contractor.

The *Stay Smart Online 2015* findings also show that SMEs in Australia are targeted by the majority of cyberattacks. Furthermore, they highlight the full extent of the damage caused by a cyberattack and the time it would take to recover from a cyberattack. In turn, the findings highlight the vulnerable positions SMEs find themselves in.

In addition, as part of the *Stay Smart Online 2015* survey activities, a national survey was undertaken of 306 SMEs across Australia. The survey showed that SMEs generally have low awareness and understanding of online risks, and included the following findings:⁷⁷⁴

- Only 2% of survey respondents identified theft or damage to their business's online information or data as a priority consideration or risk
- 4% of SMEs identified other IT risks, such as the risk of getting a virus or the system going down
- Only 33% of SMEs considered there was a risk of stolen data for their business, increasing to 38% who considered phishing and scams were a risk
- 55% of SMEs believe they have very little, or an average amount, of online information such as customer information, orders, account and financial details, appointments and social media
- 55% of SMEs stored data on their hard drive, 15% on a server in the office, and 13% in the Cloud
- 60% of SMEs claim to be good at installing anti-virus software, with 48% claiming to be good at keeping it up to date
- 67% of SMEs thought they did well at backing up data (held 40% onsite and 27% offsite)
- A relatively low percentage of SMEs believed they did the following well:

- Enforcing appropriate and different passwords (30%)
- Ensuring locking systems on computers (26%)
- Preventing staff from using unprotected USB storage devices (22%)
- Having a data recovery plan in place (21%)
- Encrypting data (17%)
- Having a tracking system to reveal the identity of IT users (14%).

The most common reasons cited by SMEs for why they did not protect themselves was lack of expertise (46%), lack of budget (44%), lack of time (35%) and no access to an IT security specialist (32%).

The *Stay Smart Online 2015* survey activities highlighted many key questions about the capabilities of SMEs. In part, this lack of capability was due to the following:

- Limited budgets and resources
- Lack of technical knowledge
- Lack of cybersecurity awareness (threats and dependence)
- Lack of cybersecurity processes.

SMEs as targets

We have now seen instances of Australian SMEs with defence links being the targets of cyberattacks. In November 2016, the Australian Government became aware that a malicious cyber adversary had successfully compromised the network of an Australian SME with contracting links to national security projects. Australian Government analysis confirmed that the adversary had sustained access to the network for an extended time and had stolen a significant amount of data. The adversary remained active on the network at the time.

Analysis showed the adversary gained access to the victim network by exploiting an internet-facing server, then used administrative credentials to move laterally within the network, where they were able to install multiple webshells (a script that can be uploaded to a webserver to enable remote administration of the machine) throughout the network to gain and maintain further access.⁷⁷⁵

We also face the issue in relation to different sectors. For instance, the unique role of accountants will make them a greater target. Many clients of accounting firms seek advice from their professional advisers about best practices in terms of cybersecurity and appropriate security

⁷⁷¹ Sophos (2018).

⁷⁷² Sophos (2018).

⁷⁷³ Australian Government (2015a).

⁷⁷⁴ Australian Government (2015b).

⁷⁷⁵ <https://www.scmagazineuk.com/contractors-only-it-technician-steals-30gb-of-australian-defence-secrets/article/699434/>

approaches they should implement. This is based, of course, on the trusted relationship accountants have with their clients. But the fact that accountants have a trusted relationship with their customers would make them a potential target.

A cyberattacker may undertake an attack against an accountant to gain:

- information about the accountant and their clients
- The accountant's or clients' financial information.

Stolen data is a financial commodity for attackers and can be sold on to other criminal entities.

This indicates that there is a need for more focused, expert security advice for all SMEs and for specific sectors or professions (e.g. defence or accountants).

We have discussed the many cybersecurity threats that an SME could face, but a cyberattack could also present business risks to SMEs.

Sixty per cent of small businesses that experience a significant cyber breach go out of business within 6 months.

Every SME should ask and answer the following key questions when considering whether security measures should be implemented as a matter of urgency:

- What would happen if your organisation was a victim of a cyberattack – how could your organisation recover?
- How much immediate business would the business lose?
- Could you restore your key IT systems and key data?
- Could you protect your organisation against future attacks?
- How would your customers feel about their data being compromised?
- Would your customers have confidence in your organisation in the future?
- How would you explain to your customers how the cyberattack attack had occurred and what was the outcome of that cyberattack?

SME cybersecurity advice

SMEs can take simple steps to improve their cybersecurity, such as:

- 1. Applying the latest updates from software suppliers to repair newly-discovered cyber vulnerabilities. This process can and should be automated and should cover operating systems and key applications.**

- 2. Using strong passwords and two-stage authentication (e.g. users are sent a text code to login with their password).**
- 3. Using a cloud-based email service and cloud storage, rather than organisations setting up their own email servers and storage servers.**
- 4. Backing up important data on a regular basis and checking that you can reinstall the data you have backed up. Backups should be stored off-site.**
- 5. Installing security software (e.g. installing anti-malware software that offers protection against malware).**
- 6. Keeping anti-virus and anti-malware software up-to-date.**

Some advanced cybersecurity steps can be implemented to improve security, such as:

- 1. Developing cybersecurity guidelines, policies and practises that an SME should follow in relation to cybersecurity (e.g. the handling of sensitive information, how to manage incidents, a formal organisational cybersecurity policy)**
- 2. Undertaking a security risk analysis/audit to be aware of cybersecurity threats and risks that an SME could face and then take steps to mitigate or remove the threat of high-level risks**
- 3. Testing that security features actually work (e.g. testing back-up approaches, running simulations of cyberattacks and seeing how an SME would react to a cyberattack)**
- 4. Considering security alternatives (e.g. outsourcing certain security functions to a third party or considering cybersecurity insurance to help recover from a cyber incident if one occurred).**

The Australian Government also offers advice for all organisations in relation to cybersecurity. The Australian Signals Directorate (ASD), for example, offers advice for organisations to protect their systems. The ASD's following four mitigation strategies are commonly referred to as the ASD "Top 4" and, if implemented, would protect against 85% of cyberattacks (ASD, 2017):

- Use applications to help prevent malicious software and unapproved programs from running

- Apply security updates to known risky applications such as Adobe Flash, web browsers, Microsoft Office, Java and PDF viewers
- Patch operating systems (Windows 10 is automatically patched)
- Restrict administrative privileges for operating systems and applications, based on user duties.

The Stay Smart Online initiative has developed a cybersecurity guide for SMEs. It identifies the following key steps that SMEs should undertake (Australian Government, 2016C):

- Privacy – ensuring that SMEs are aware of the importance of cybersecurity and privacy
- Passphrases – SMEs to use passphrases (e.g. 'richmondisthebestfootyteam') instead of passwords and, where possible, two-stage authentication
- Awareness – ensuring SMEs are aware of security threats and risks
- Network and device security – ensuring that security data and software is kept up to date
- Backups – ensuring key data is regularly backed up and stored in a secure offsite location.

Conclusion

Within Australia, SMEs increasingly depend on IT systems and are thus vulnerable to existing cybersecurity risks and newly-emerging cyberattacks. SMEs may not have the appropriate resources, expertise or understanding to protect their systems and key data.

It is critical that SMEs take steps to improve their cybersecurity and use the freely-available information to support these steps. The Australian Government and professional bodies can play a key role in helping SMEs on their cybersecurity journey by providing guidance and support.

Cybersecurity and advice

The following are key resources that can help Australian SMEs in relation to cybersecurity (accurate as of March 2018).

General advice

Creating a cybersecurity policy <https://www.business.gov.au/info/run/cyber-security/creating-a-cyber-security-policy-for-your-business> (Accessed 18 April 2018)

Table 2:
Notifiable data breaches⁷⁷⁶

Kinds of personal information	% of NDBs received
Contact information	78%
Financial details	30%
Health information	33%
Identity information	24%
Other sensitive information	2%
TFN	14%

Specific advice

The Australian Government has developed a guide for SMEs to protect themselves in an online environment. It is one of the few documents pitched at a level that is accessible to non-technical managers of small SMEs – *Stay Smart Online – Small Business Guide*.⁷⁷⁷

Incident reporting

Voluntary

The Australian Government has a voluntary reporting system for cyber breaches. Reports help the Australian Cyber Security Centre to develop a better understanding of the threat environment and will assist other organisations at risk.

Cybersecurity incident reports are also used in aggregate for developing new defensive policies, procedures, techniques and training measures, to help prevent future incidents.⁷⁷⁸

Mandatory

The Australian Government has (effective from 22 February 2018) introduced amendments to the Privacy Act 1988, mandating the reporting of notifiable data breaches (NDB). The NDB scheme applies to entities with existing obligations to secure information under the Privacy Act 1988.

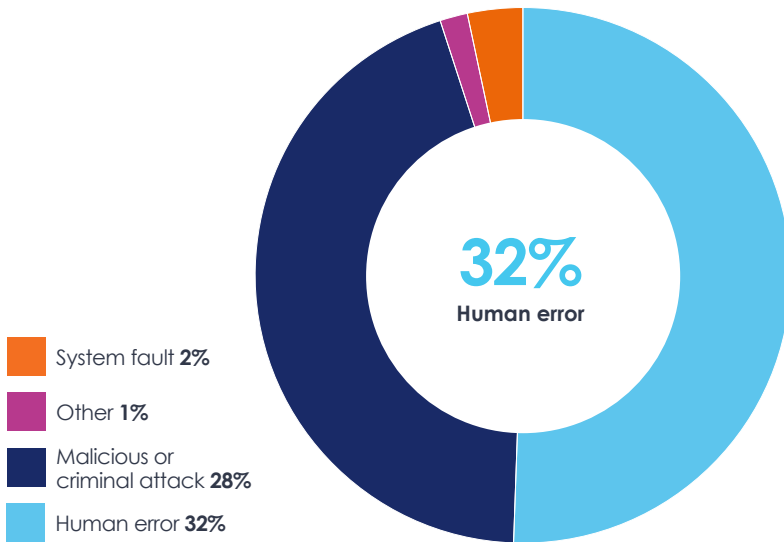
As shown in **Table 2**, during the first quarter of 2018, one of the largest proportions of eligible data breaches reported to the Office of the Australian Information Commissioner (OAIC) was from health service providers, accounting for at 33% of all breaches.

⁷⁷⁶ Australian Government: Office of the Australian Information Commissioner (2018).

⁷⁷⁷ Australian Government: Stay Smart Online (2016).

⁷⁷⁸ Australian Government: Australian Cyber Security Centre, Cyber Security Incident Report Form <<https://www.acsc.gov.au/incident.html>> Accessed 18 April 2018

Figure 3:
Notifiable Data Breaches



Source: Australian Government: Office of the Australian Information Commissioner (2018), Notifiable Data Breaches Quarterly Statistics Report: January 2018 – March 2018. <https://www.oaic.gov.au/resources/privacy-law/privacy-act/notifiable-data-breaches-scheme/quarterly-statistics/Notifiable_Data_Breaches_Quarterly_Statistics_Report_January_2018_March_.pdf>. Accessed 18 April 2018.

A health service provider includes any organisation that provides a health service and holds health information.

The second largest proportion of breaches was from the legal, accounting and management services sector, accounting for 30%. This was followed by the finance sector (13%), private education sector (10%) and charities (6%).

An eligible data breach may involve one or more types of personal information. The majority of data breaches reported to the OAIC involved 'contact information', such as an individual's name, email address, home address or phone number. This is distinct from 'identity information', which refers to information that is used to confirm an individual's identity, such as driver licence numbers and passport numbers.

Interestingly, **Figure 3** shows that most attacks are made possible due to human error (32%), whereas malicious and criminal activity account for 28% of attacks and systems faults 2%. This is an alarming finding, given that attacks can still penetrate through systems that are operating without fault.

Recommendations

To avoid or defend against the high risk of cyberattacks, it is recommended that SMEs consider the following:

- At the most extreme (somewhat obvious) end, business owners may consider not owning or operating a computer.⁷⁷⁹ Of course, this is totally unrealistic and absurd in the current business environment, where technology drives almost every aspect of any business and, indeed, society in general. Everyone involved in business and society is, by default or otherwise, captured by technology. Thus, given that SME owners cannot escape

the all-encompassing technology net, they need to be acutely aware of the perilous seas ahead if adequate checks and balances are not in place (i.e. to prevent or mitigate potential security exposures to their operations, particularly the significant risk of being a victim of cybercrime).

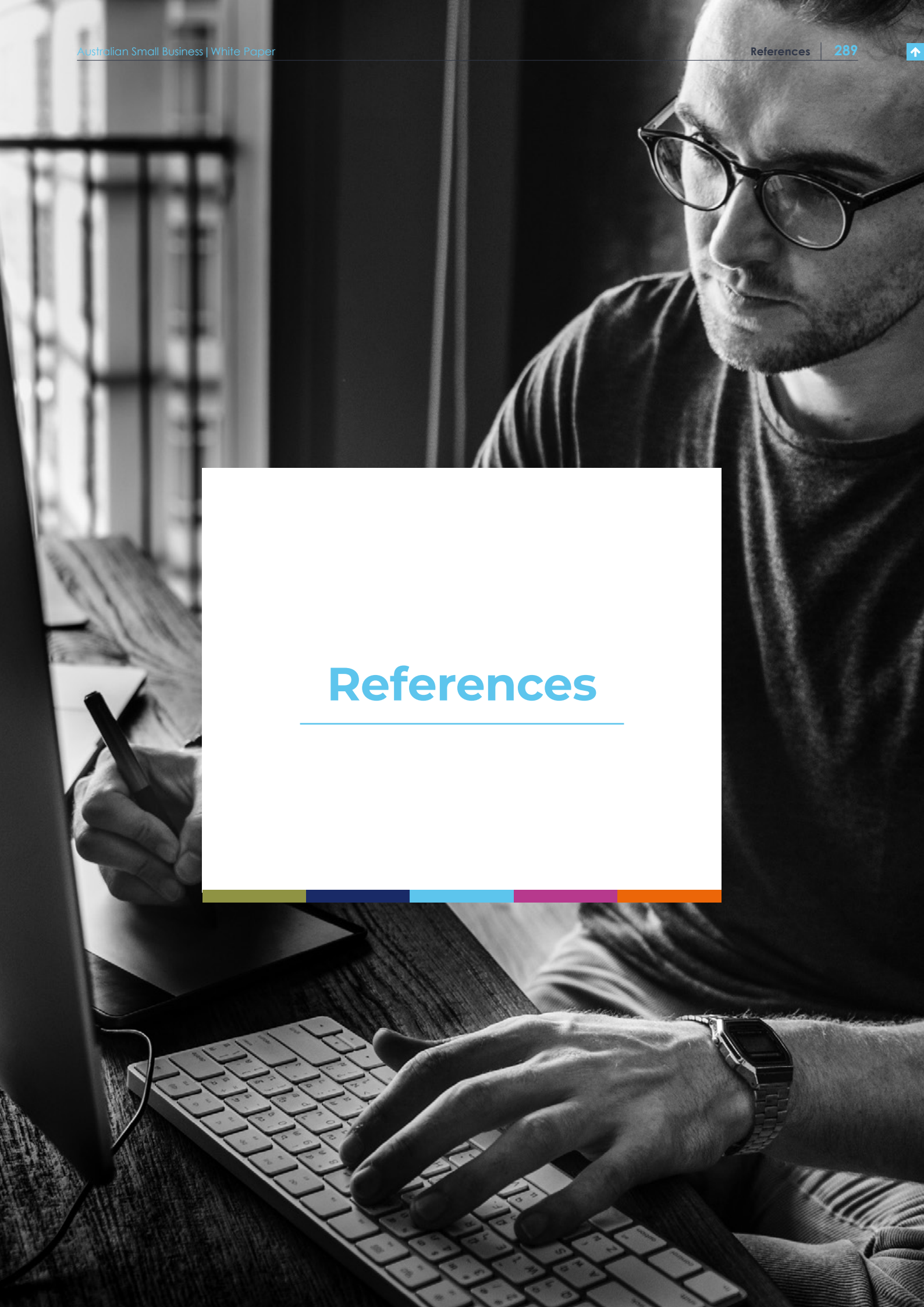
- SMEs, as a matter of urgency, must be made aware of the significant risk they face from cybercrime, including the risk of their systems being used as a 'stepping stone' into connected systems in the supply chain.

- Techniques for 'hardening and shielding' websites from cybercrime need to be simplified to be accessible to SMEs (particularly small businesses).

- A range of online 'cloud-based' host sites should be established so that SMEs can migrate their IT systems into a secure cloud environment. Typically, by managing a number of SME sites, a host site would have sufficient scale to adequately resource the security of the mother system to protect it from cyberattacks.

⁷⁷⁹ Australian Small Business and Family Enterprise Ombudsman (ASBFEO) (2017a).

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Chapter 8

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Appendix A: Matrix of ASEAN countries' SME definitions

Country	Employees	Assets	Revenue	Other
Brunei Darussalam				
Micro	1 - 5	NA	NA	NA
Small	6 - 50	NA	NA	NA
Medium	51 - 100	NA	NA	NA
Large	100 +	NA	NA	NA
Cambodia				
Micro	< 10	< \$50,000	NA	NA
Small	11 - 50	\$50 - \$250,000	NA	NA
Medium	51 - 100	\$250 - \$500,000	NA	NA
Large	> 100	> \$500,000	NA	NA
Indonesia				
Micro	NA	NA	< 300m Rup	Net Assets# < 50m Rup
Small	NA	NA	Between 300m and 2.5b Rup	Net Assets# between 50m and 500m Rup
Medium	NA	NA	Between 2.5b and 50b Rup	Net Assets# between 500m and 10b Rup
Large				

#Not including Land and Buildings



Country	Employees	Assets	Revenue	Other
Lao PDR				
Micro	NA	NA	NA	NA
Small	< 20	≤ 250m Kip	≤ 400m Kip	NA
Medium	< 100	≤ 1,200m Kip	≤ 1000m Kip	NA
Large	NA	NA	NA	NA
Malaysia				
Manufacturing				NA
Micro	< 5 or (see revenue)	NA	<RM300,000	NA
Small	From 5 to < 75 or (see revenue)	NA	RM300,000 <RM50m	NA
Medium	From 75 ≤ 200 or (see revenue)	NA	RM75m ≤RM200m	NA
Large		NA		NA
Services and other				
Micro	< 5 or (see revenue)	NA	<RM300,000	NA
Small	From 5 - 30 or (see revenue)	NA	RM300,000 <RM3m	NA
Medium	From 30 ≤ 75 or (see revenue)	NA	RM3m ≤RM75m	NA
Large		NA		NA
Myanmar				
Small				
(a) Manufacturing	Up to 50	NA	NA	Up to 500m# Kyats
(b) Labour Intensive Manufacture	Up to 300	NA	NA	Up to 500m# Kyats
(c) Wholesale	Up to 30	NA	Up to 100m Kyats	NA
(d) Retail	Up to 30	NA	Up to 50m Kyats	NA
(e) Service	Up to 30	NA	Up to 100m Kyats	NA
(f) All others	Up to 30	NA	Up to 50m Kyats	NA
Medium				
(g) Manufacturing	From 51 - 300	NA	NA	From 500m# – 1000m Kyats
(h) Labour Intensive Manufacture	From 51 - 300		From 100m – 300m Kyats	From 500m# – 1000m Kyats
(i) Wholesale	From 301 - 600	NA	From 50m -100m Kyats	NA
(j) Retail	From 31 - 60	NA	From 100m – 200m Kyats	NA
(k) Service	From 51 - 100	NA	From 50m – 100m Kyats	NA
(l) All others	From 31 - 60	NA		NA

#Not including Land and Buildings

Country	Employees	Assets	Revenue	Other
Philippines				
Micro	1 - 9	Up to P3m	NA	NA
Small	10 - 99	Between P3m – P15m	NA	NA
Medium	100 - 199	Between P15m – P100m	NA	NA
Large	NA	NA	NA	NA
Singapore				
Micro	NA	NA	NA	NA
Small	< 200	NA	< S200m or (See no of employees)	Small to medium not distinguished
Medium	< 200	NA	< S200m or (See no of employees)	30% of capital held by Singaporeans
Large	NA	NA		
Thailand				
Manufacturing				
Micro	NA	NA	NA	NA
Small	< 50	< THB 50m#	NA	NA
Medium	51-200	50< THBm <200	NA	NA



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